Staying Nimble With Commercial Loan Pricing

Andy Morgan / March 12, 2024

Agenda

- Prime Based Lending 101
- Market Rates vs. Managed Rates
- Community Banking Trends
- Shift From Prime(+) to Prime(-) Lending
- How to Respond Using Sound Relationship Pricing Analytics

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Meet the Presenter

Andy Morgan

Director

Enterprise Risk & Quantitative Consulting

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Prime Based Lending 101

- Prime rate has traditionally been reserved for borrowers with
  - The best credit quality
  - The lowest probability of default
- Credits of lesser quality usually charged a spread over Prime
- Prime moves in parallel with changes to the Federal Reserve's target Fed Funds Rate
- Prime is typically 300 basis points over the Fed Funds Rate
- Many banks have their own bank-specific Prime Rate

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Market Rates vs. Managed Rates

- The market became flush with liquidity due to the numerous stimulus programs that were put in place during the pandemic
- This caused inflation & economic activity to spike during 2020-2021
- To battle this, the Fed raised the target Fed Funds Rate 525 basis points during 2022-2023
- Market rates, such as the U.S. Treasury Curve, reflect investors' long-term inflation expectations & other market dynamics
- Market rates don't move in parallel with managed rates

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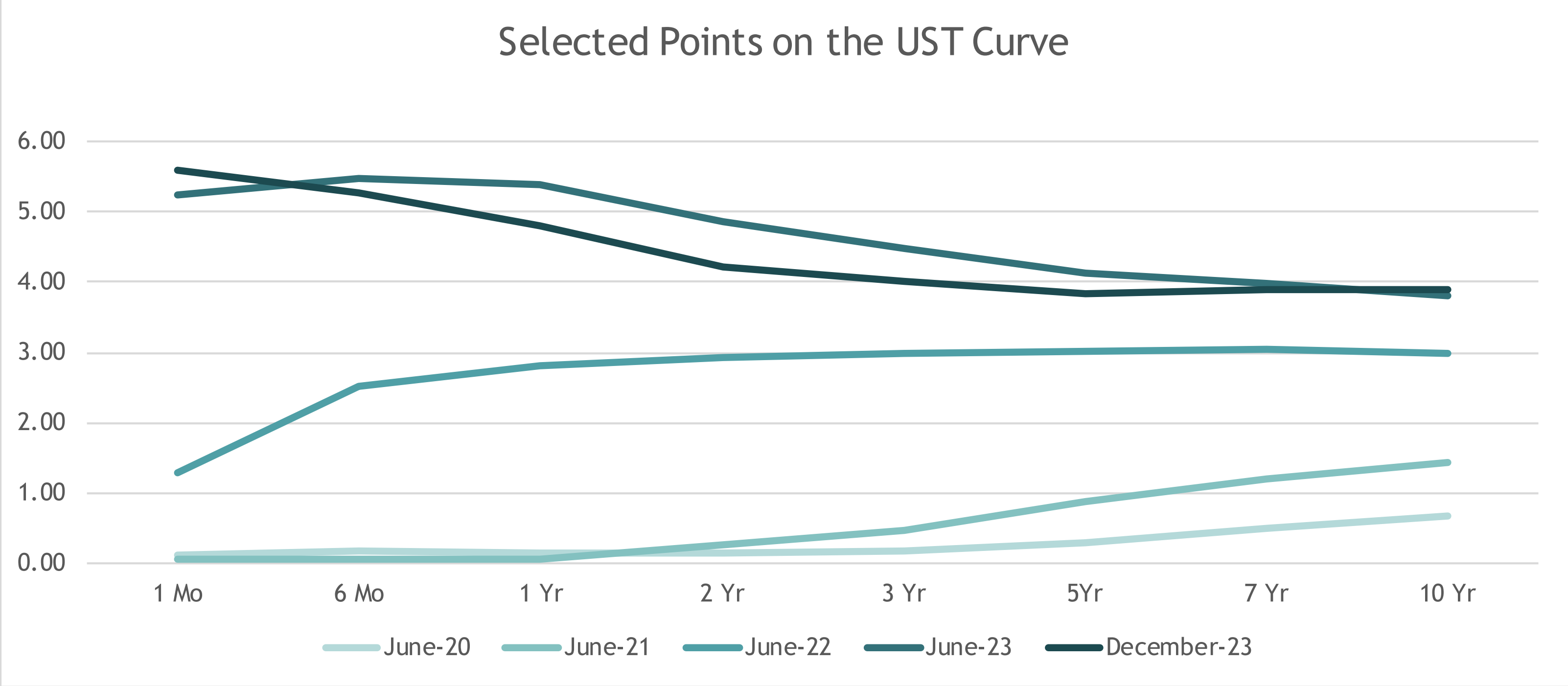
Changes in the UST Yield Curve



UST CURVE	1 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5Yr	7 Yr	10 Yr
June-20	0.13	0.18	0.16	0.16	0.18	0.29	0.49	0.66
June-21	0.05	0.06	0.07	0.25	0.46	0.87	1.21	1.45
June-22	1.28	2.51	2.80	2.92	2.99	3.01	3.04	2.98
June-23	5.24	5.47	5.40	4.87	4.49	4.13	3.97	3.81
December-23	5.60	5.26	4.79	4.23	4.01	3.84	3.88	3.88

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Community Banking Trends Since 2020

- Balance sheets ballooned with pandemic-related liquidity
- By early 2021, Loan/Asset ratios dropped below 60% but are now back to 66%
- Loan growth dropped below 5% in 2021 but increased back to double digits in 2022. It settled at 7.50% in the second half of 2023. PPP loans were partially responsible for the swings
- Non-performing loans continue to drop as a % of Total Loans. Charge-offs have been very low allowing the impact of CECL adoption to be minimal
- Yields on new loans continue to increase but have been outpaced by the rising cost of deposits. We'll dive into this more soon!

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Trends in Community Bank Performance

Assets < $10B	2020Q4	2021Q2	2021Q4	2022Q2	2022Q4	2023Q2	2023Q3	2023Q4
Loan Growth Rate	-7.87	1.23	4.72	15.34	12.12	10.12	7.53	7.44
Loans / Assets	63.15	59.69	57.70	59.40	63.07	65.25	65.97	66.36
Deposit Growth Rate	13.79	5.73	10.21	1.08	-1.43	-3.21	1.52	3.96
Loans / Deposits	73.94	69.66	67.08	67.82	72.92	76.52	77.95	78.52
ROA	0.98	1.15	0.91	1.02	1.12	1.03	0.99	0.90
ROE	8.96	10.95	8.75	11.42	13.25	11.50	11.38	9.96
Equity / Assets	10.67	10.35	10.18	8.85	8.82	9.10	8.99	9.42
NPLs / Loans	0.65	0.54	0.45	0.37	0.32	0.29	0.30	0.29
LLR / Loans	1.30	1.31	1.32	1.29	1.24	1.25	1.24	1.22
Prime Rate	3.25	3.25	3.25	4.25	7.25	8.25	8.50	8.50
New Volume Rates	3.91	3.67	3.61	4.29	5.76	7.29	7.62	7.76
Loan Yields	5.08	5.09	4.96	4.76	5.22	5.66	5.92	6.10
Cost of Funds	0.45	0.32	0.26	0.26	0.61	1.29	1.59	1.81
Loan Yld / Cost Spread	4.63	4.77	4.70	4.50	4.61	4.37	4.33	4.29

source S&P Global Market Intelligence. New Volume Rates sourced from LoanPricingPRO

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Loan Yield/Cost of Funds Spread

- From 2020 to early 2022 deposit costs remained near 0.00% as the Fed Funds Target Rate stayed at 0-25bps
- During this time, loan portfolio yields slowly declined as runoff & high prepayments were replaced with new volume at lower rates
- This caused net interest margins to decrease

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Loan Yield/Cost of Funds Spread

- From 2022-2023 managed rates increased 525bps. Loan portfolio yields increased but were tempered by competitive pricing & the rapid decrease in prepayments
- Initially margins increased as banks were able to lag increasing deposit rates
- By early 2023, the increase in deposit costs outpaced the increase in loan yields causing margins to decline again

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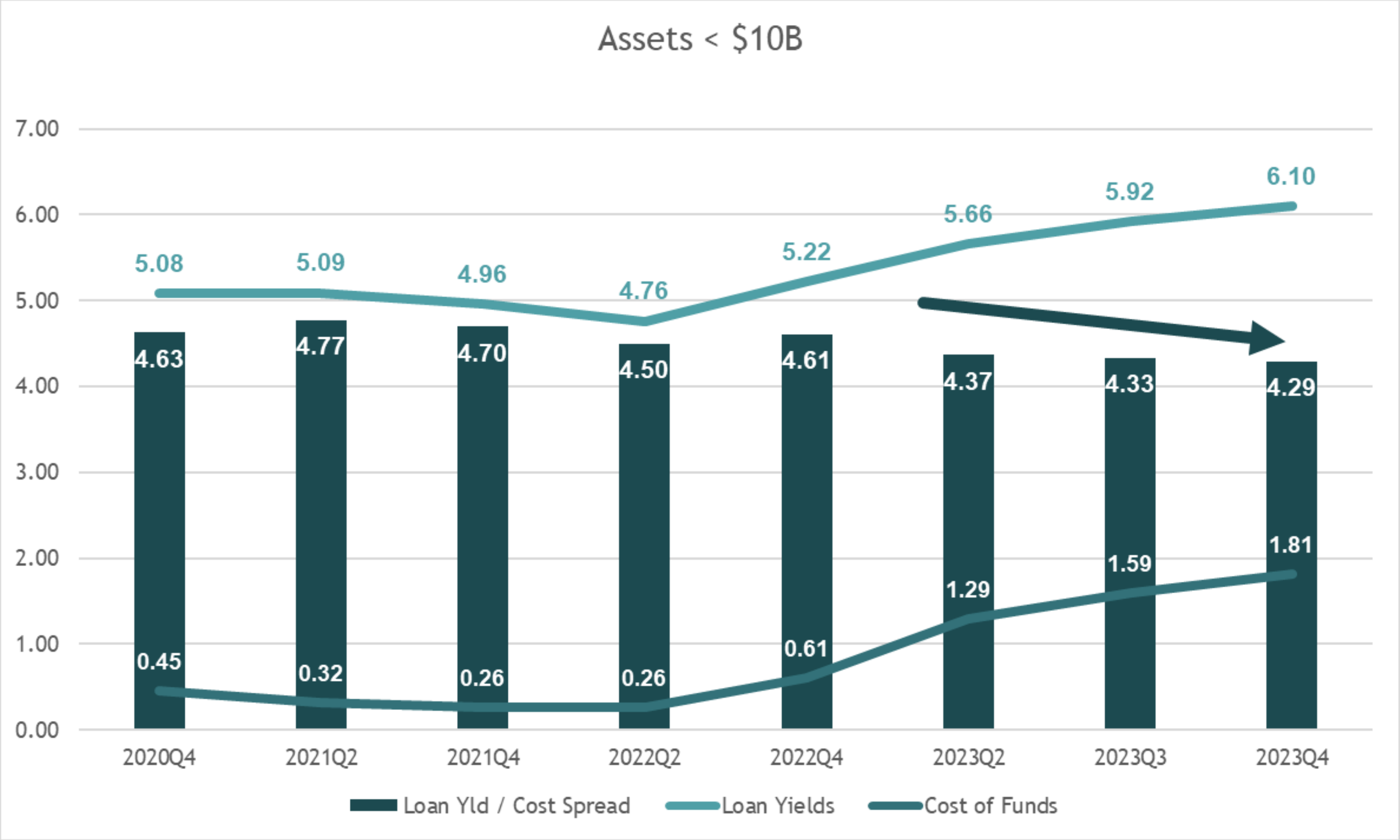
Shrinking Loan Yield/Cost of Funds Spread



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“Prime Plus” to “Prime Minus” Inflection Point

- From 2020 to early 2022 the average rate on new loans was 40-60bps over Prime
- During the 2nd quarter of 2022 the spread over Prime reached an inflection point, & the average rate on new loans became less than Prime
- By the end of 2023, the average new loan rate was Prime minus 75bps
- Why are we seeing so much “Prime Minus” lending, & how should lenders respond to these market forces stressing their margins?

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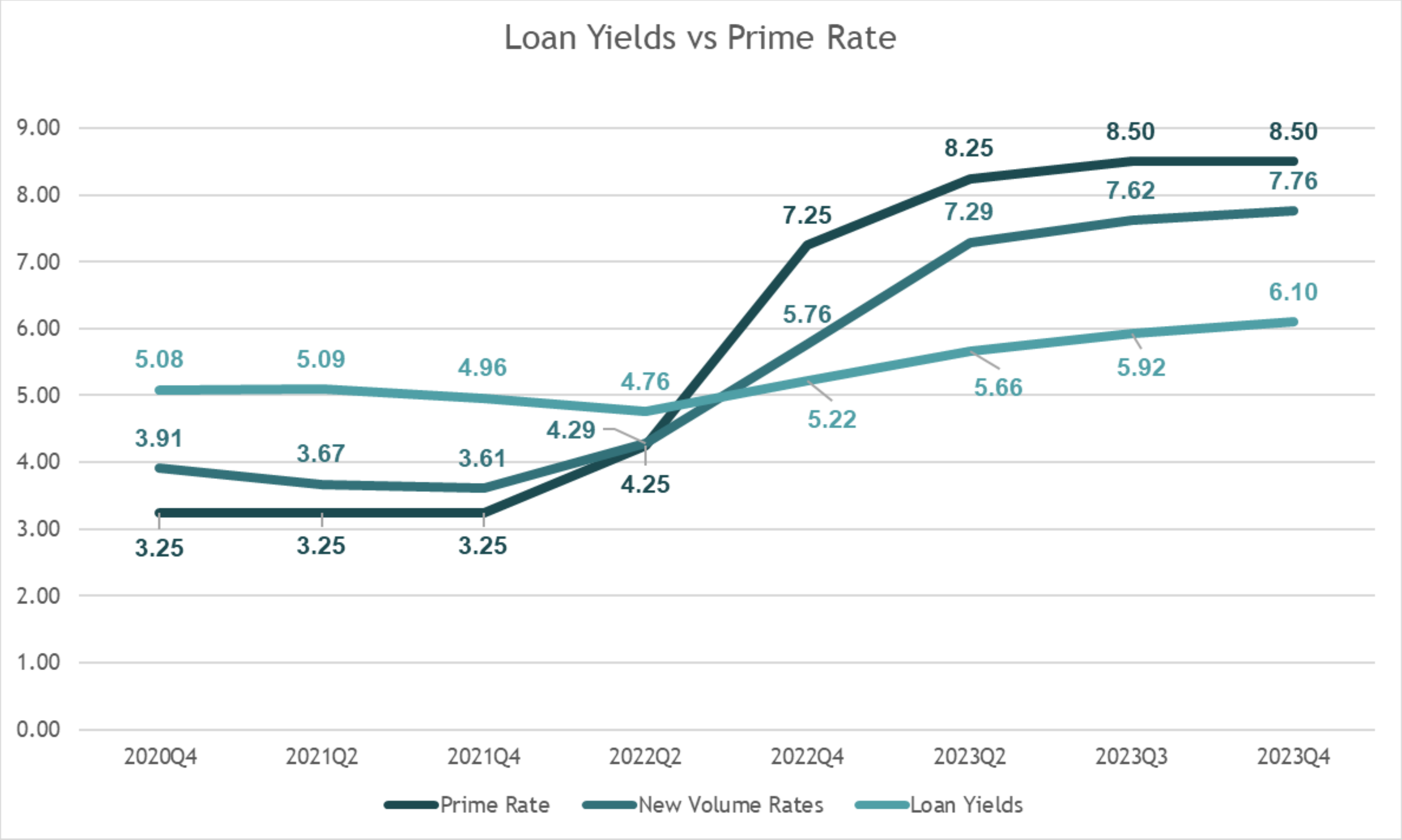
Prime Plus to Prime Minus Inflection Point



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December 2021 Example

- Loan Amount: $1,000,000
- **Floating Rate at Prime (3.50%)**
- No Loan Fees
- Average Credit Quality (grade 3)

- **Result: ROE of 16.94% below minimum loan target of 17.50%**

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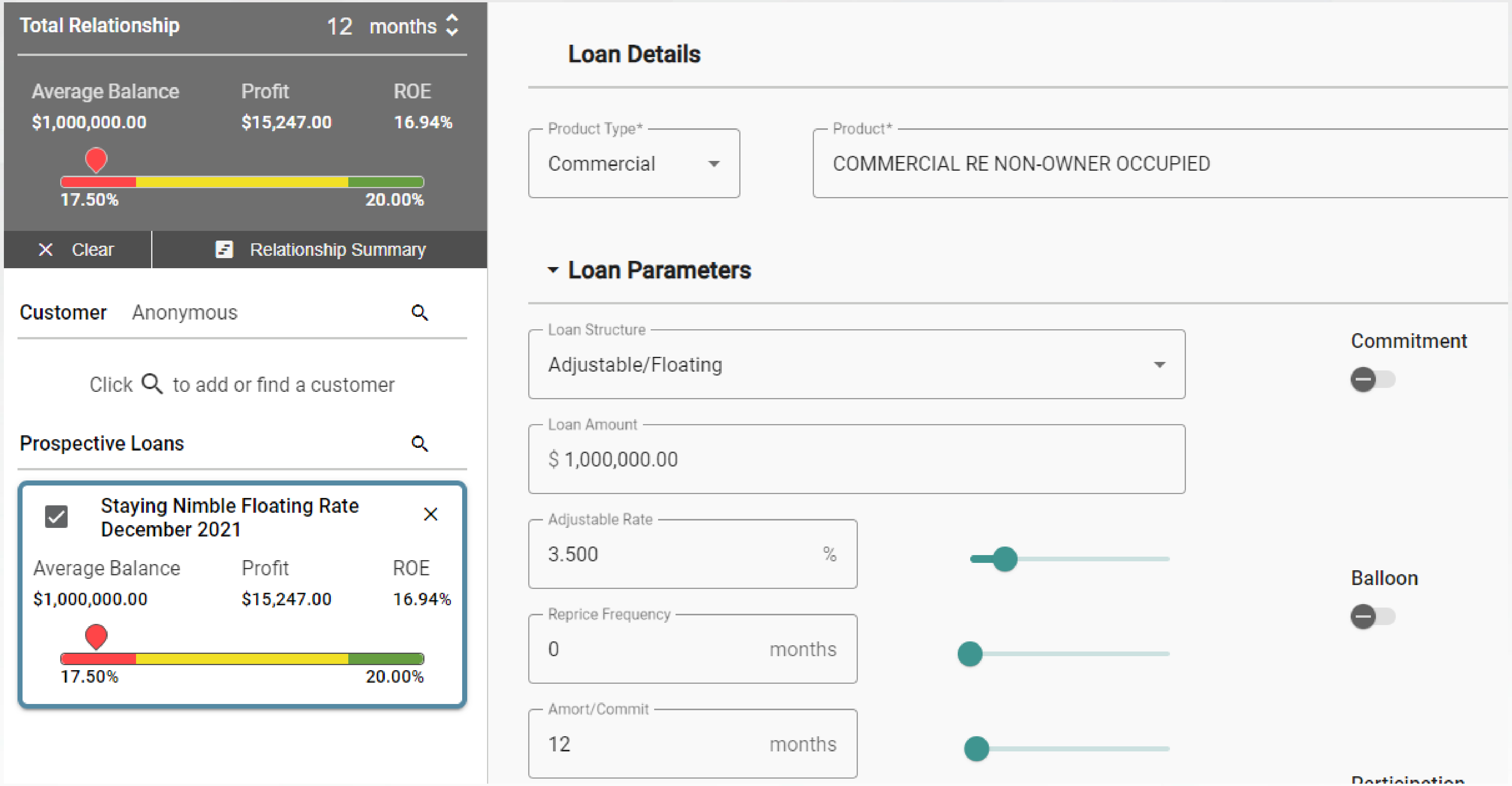
December 2021 Example



December 2021 Example

- Customer Holds Significant Non-Interest Bearing Deposit
- Average Balance: $250,000
- Credit for Funding: 2.00%
- Deposit Rate: 0.00%

- Result: Relationship ROE of 19.83% exceeds minimum relationship target of 18.68% (weighted average of loan & deposit target)
- Allowed for very competitive loan pricing!

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December 2021 Example

Total Relationship 12 months

Average Balance	Profit	ROE
$1,250,000.00	$18,837.55	19.83%

18.68% 21.32%

My Accounts

Include	Account Description	Balance	Credit	COF
✓	Staying Nimble NIB December 2021	$250,000.00	2.000%	0.000%

Prospective Loans

Staying Nimble Floating Rate December 2021

Average Balance	Profit	ROE
$1,000,000.00	$15,247.00	16.94%

17.50% 20.00%

Customer

Staying Nimble

Average Balance	Profit	ROE
$250,000.00	$3,590.55	71.81%

40.00% 45.00%

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December 2023 Example – Low Deposit Cost

- Loan Amount: $1,000,000
- **Floating Rate at Prime minus 0.50% (8.00%)**
- 0.50% Loan Fee
- Average Credit Quality (grade 3)

- Result: ROE of 14.75% below minimum loan target of 17.50%

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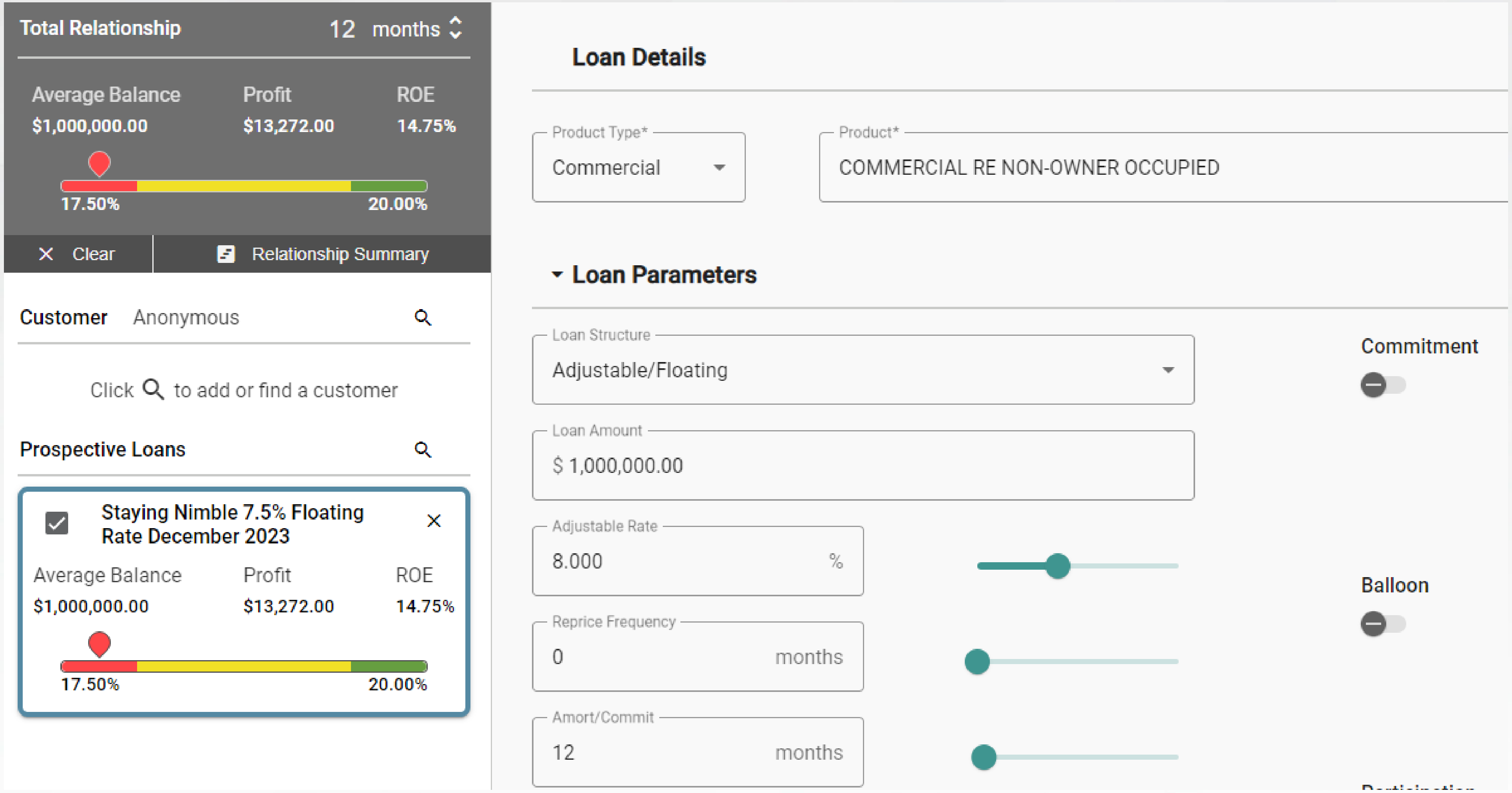
December 2023 Example – Low Deposit Cost



December 2023 Example – Low Deposit Cost

- Customer Still Holds Significant Non-Interest Bearing Deposit
- Average Balance: $250,000
- Credit for Funding: 3.25% (this has increased in today's environment)
- Deposit Rate: 0.00%

- Result: Relationship ROE of 20.35% exceeds minimum relationship target of 18.68%
- Allows for "Prime Minus" loan rate because of bigger credit on deposit

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December 2023 Example – Low Deposit Cost

Total Relationship 12 months

Average Balance	Profit	ROE
$1,250,000.00	$19,331.30	20.35%

18.68% 21.32%

My Accounts

Include	Account Description	Balance	Credit	COF
✓	Staying Nimble NIB December 2021	$250,000.00	3.250%	0.000%

Prospective Loans

Staying Nimble Floating Rate December 2023

Average Balance	Profit	ROE
$1,000,000.00	$13,272.00	14.75%

17.50% 20.00%

Customer

Staying Nimble

Average Balance	Profit	ROE
$250,000.00	$6,059.30	121.19%

40.00% 45.00%

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December 2023 Example – High Deposit Cost

- Customer Now Earning Higher Rate on Deposit
- Average Balance: $250,000
- Credit for Funding: 3.25% (this has increased in today's environment)
- Deposit Rate: 2.50% (customer was looking at alternative banking options unless their deposit rate was raised)

- Result: Customer ROE drops below the target to 15.15%. A higher "Prime Plus" rate is required to bring them above the minimum target

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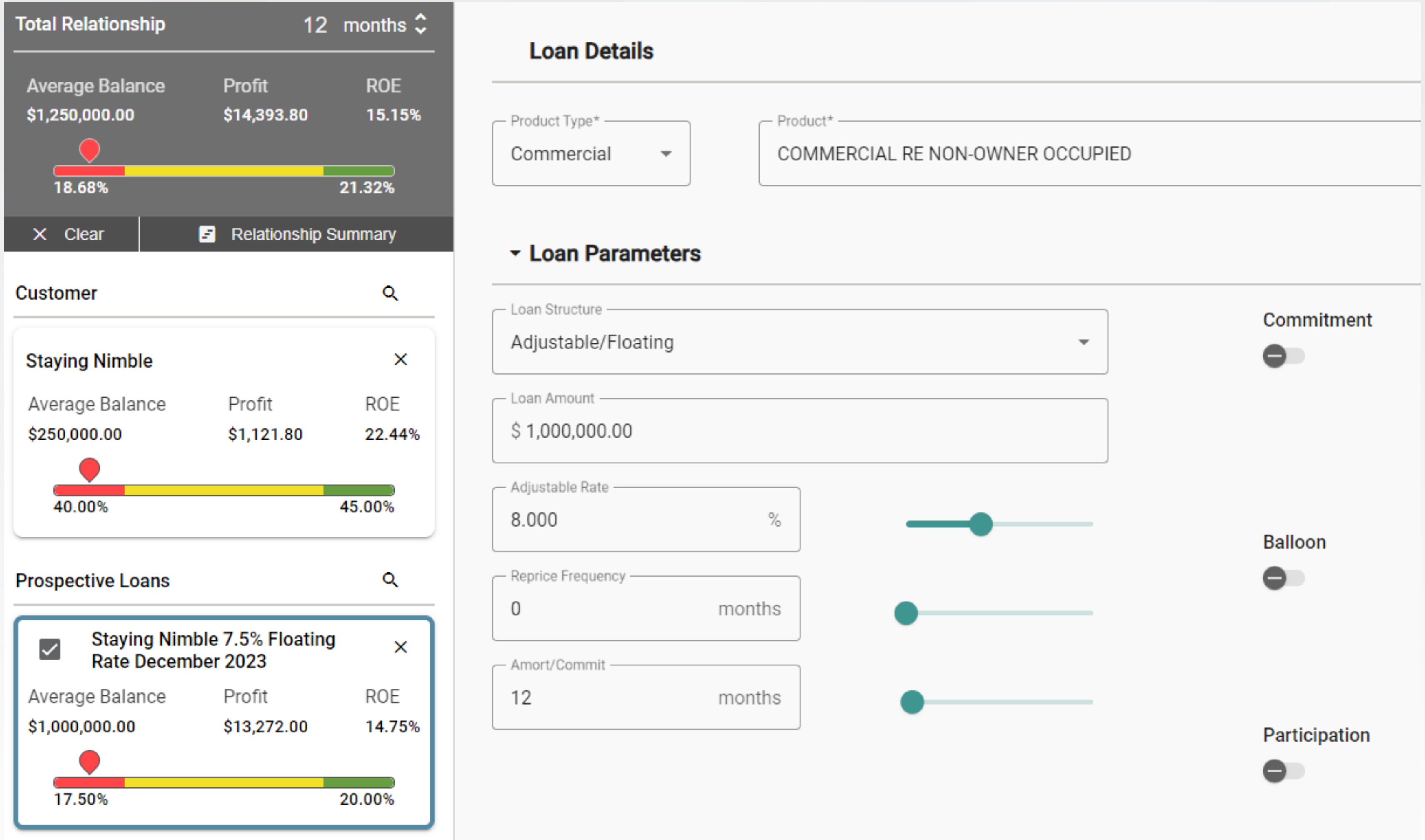
December 2023 Example – High Deposit Cost



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December 2023 Example – High Deposit Cost

- Loan Amount: $1,000,000
- **Floating Rate at Prime plus 0.50% (9.00%)**
- No Loan Fees
- Average Credit Quality (grade 3)
- Result: ROE of 19.31% above minimum relationship target of 18.68%

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December 2023 Example – High Deposit Cost

Total Relationship

12 months

Average Balance	Profit	ROE
$1,250,000.00	$18,343.80	19.31%

18.68% 21.32%

Prospective Loans

Staying Nimble 9% Floating Rate December 2023

Average Balance	Profit	ROE
$1,000,000.00	$17,222.00	19.14%

17.50% 20.00%

My Accounts

Include	Account Description	Balance	Credit	COF
✓	Staying Nimble NIB December 2021	$250,000.00	3.250%	2.500%

Customer

Staying Nimble

Average Balance	Profit	ROE
$250,000.00	$1,121.80	22.44%

40.00% 45.00%

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Summary

- There is no one-size-fits-all approach to setting rates on commercial loans in today's environment
- A complete understanding of the whole relationship is essential
- Disciplined pricing approach allows lenders to value the whole relationship rather than just loan growth
- Calibration is key. A model is only as good as its configuration & is important for lender buy-in
- Profitability can be improved by setting realistic targets

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Thank you!

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