JANUARY 2025 MARKET ANALYSIS

The State of Commercial Banking

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Key Takeaways

01 Liquidity has improved but has become more costly, squeezing net interest margins.

Financial institutions (FIs) have emerged from the liquidity crisis with a solid foundation of deposits, approaching pre-crisis levels. The impressive deposit growth has come at a cost, with FIs paying incrementally more than Fed action, both in periods of tightening and easing. Meanwhile, the revenue side has not kept pace with rising funding costs, intensifying pressure on net interest margin (NIM).

02 Fed rate cuts have reshaped the commercial loan pricing landscape.

The 100 basis points in Fed rate cuts between September and December 2024 contributed to a shallowing of the inverted yield curve, with short-term rates declining while midterm rates spiked. This shift reflected changing market expectations, as FIs anticipated a slower pace of future rate cuts. In response, funding managers adjusted their curves strategically, pushing fixed-rate loan coupons upward even as floating rates continued to decline.

03 There are pockets of credit stress in the commercial real estate sector.

Credit performance has exceeded expectations across much of the market, with only a modest increase in delinquencies and a decline in commercial and industrial (C&I) downgrades. In the commercial real estate sector, credit ratings have remained largely stable, although FIs have taken a more proactive approach to downgrading loans nearing maturity.

04 The ever-increasing burden of fraud requires a united, proactive response.

Fraud continues to rank high among the concerns of FI executives, especially when it comes to checks and ACH. By embracing collaboration, advanced technologies like AI, and a centralized approach, FIs can be a strong ally for business customers against the ongoing battle against fraud.

05 Data and digital technology drive the acquisition and growth of small business relationships.

The underserved small and medium-sized business (SMB) market presents an opportunity for FIs looking to grow deposits. To take advantage, FIs need digital platforms that integrate with fintech solutions, deliver exceptional customer interaction, and leverage data for personalized outreach.

06 Efficiency and user experience are becoming even more pivotal for midsize and large companies.

Business customers are looking to their FIs to help streamline back-end processes and operate more efficiently. FIs that offer ways to help—such as integrating digital banking with business' enterprise resource planning (ERP) software or connecting with instant payments rails—will attract and retain business customers.

Methodology

The Q2 PrecisionLender data in this report is for the 2024 calendar year. It reflects actual commercial relationships (loans, deposits, and other fee-based business) from more than 140 banks and credit unions, ranging in size from small community banks to top 10 U.S. institutions. In addition to their variance in size, these institutions are also geographically diverse, with borrowers in all 50 U.S. states.

This report also references data from Q2's Centrix Exact TMS positive pay solution and live polling conducted during Q2 webinars, as well as published industry research and economic data from several public sources such as FDIC and the Federal Reserve.

Introduction

In 2024, the commercial banking industry navigated a shift in Fed monetary policy, albeit delayed, and the realities of the "higher for longer" rate environment. Bankers started the year in a liquidity-constrained position, prioritizing deposit growth and retention above all other strategic goals. Following the deposit outflows that culminated in a series of bank failures a year earlier, financial institutions (FIs) adopted aggressive measures to attract and retain deposits. By the end of 2024, deposits had nearly returned to pre-crisis levels, reflecting industrywide efforts to meet investor demands for higher yields. That liquidity, however, came at a cost. The shift from non-interest-bearing to interest-bearing deposits—extending even to core operating accounts—coupled with deposit rate changes that were more favorable to customers than the Fed adjustments, drove funding costs higher. Meanwhile, revenue growth lagged, with floating-rate spreads compressing over the course of the year. Not surprisingly, the combination of rising costs and declining revenue has squeezed net interest margins (NIM), underscoring the importance of ancillary business to maintain risk-adjusted relationship profitability.

The Fed's shift toward monetary easing in late 2024 reshaped the commercial loan pricing landscape. A series of rate cuts totaling 100 basis points (bps) between September and December flattened the inverted yield curve. Short-term rates declined while midterm rates rose, as pricing managers adjusted fixed-rate funding curves to reflect the ongoing elevated rate environment. Rising fixed-rate funding costs allowed bankers to seek higher coupon rates from their borrowers—with mixed results on margins during Q4. While margins fell on both fixed- and floating-rate loan structures through July 2024 to about 200 bps, by year-end fixed-rate NIM had moved up to 222 bps. The coupon gap between fixed-rate and floating-rate structures had narrowed to 36 bps by year-end after growing as wide as 160 bps in August—just prior to the Fed cuts.

Despite early concerns about economic headwinds leading to widespread credit stress, credit performance in 2024 exceeded expectations. Delinquencies on commercial and industrial (C&I) loans increased only modestly, while challenges in the commercial real estate (CRE) sector were more pronounced but largely contained. Internally assigned bank ratings held steady in aggregate, signaling overall stability. At the same time, maturing CRE loans drew closer scrutiny as FIs took proactive steps to manage credit risks associated with refinancing at potentially higher rates.

Fighting fraud, driving profitability, and meeting customer demand for more efficiency and better experiences are among the top trends in the overall commercial banking industry as we head into 2025. As fraud—especially payments fraud—continues to impact the bottom line, FIs will need to get more creative with their approach, including working together to create an allied front. To drive profitability, the thriving small and medium-sized (SMB) market provides a ripe opportunity for those FIs that can segment and target with the right digital solutions. And for both the SMB and large commercial market, payments modernization continues to be a priority, with 2025 expected to be a year for increased adoption of both ERP integration and instant payments.

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Part I:

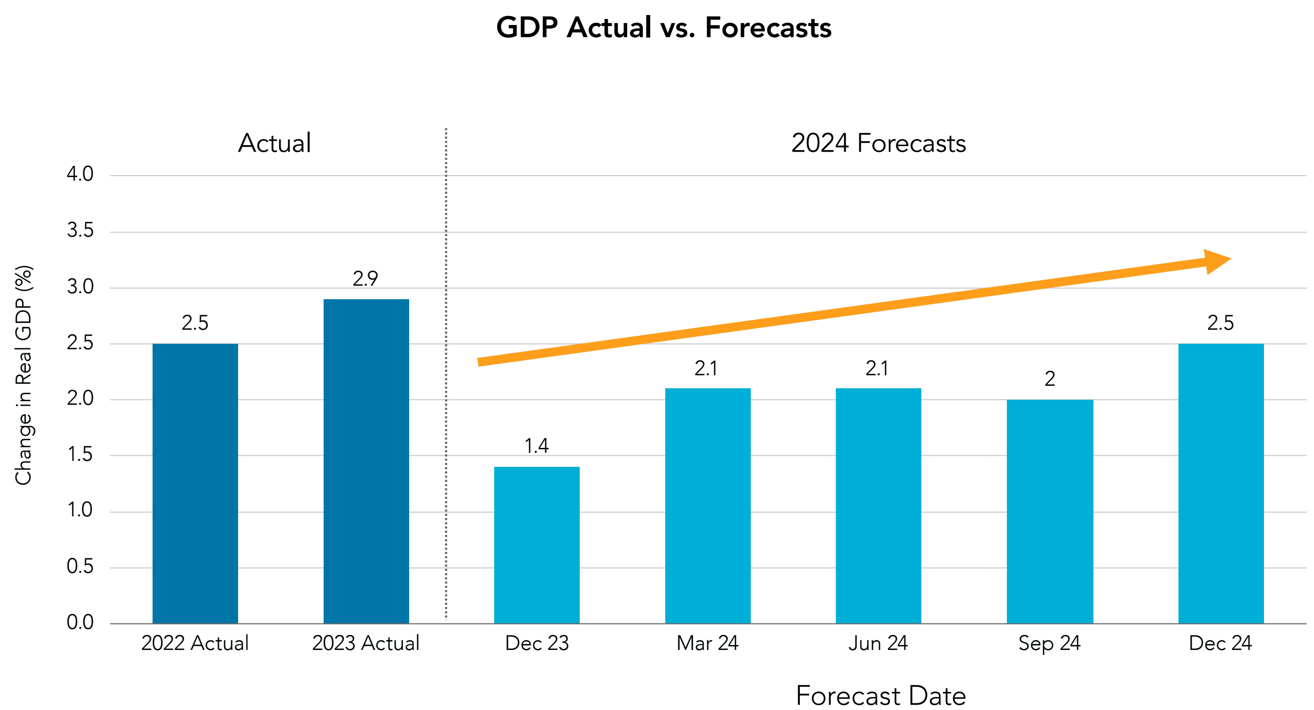
Liquidity Management

Economic Indicators

At the start of the year, the Fed appeared poised to ease monetary policy. With the last rate hike being a distant five months in the rearview mirror and GDP growth projected at just 1.4%, it seemed likely that action would be taken to stimulate the economy. However, by March, GDP forecasts were revised upward to over 2% (Figure 1), while inflation remained above target, prompting the Fed to delay any rate action. The first cut didn't arrive until mid-September, followed by smaller reductions in November and December. The "higher for longer" rate dynamic was coming to fruition.

Steadily improving economic outlook

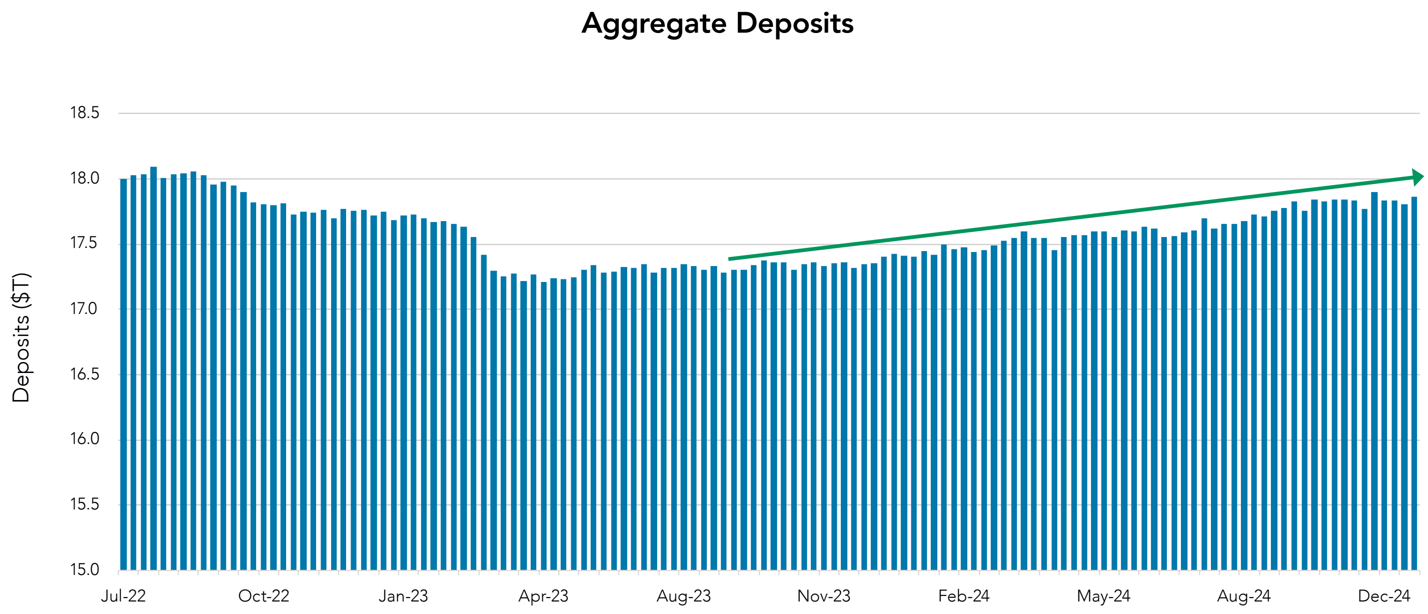
Figure 1



Source: Federal Open Market Committee

Deposits trend higher

Figure 2



The Drive for Deposits

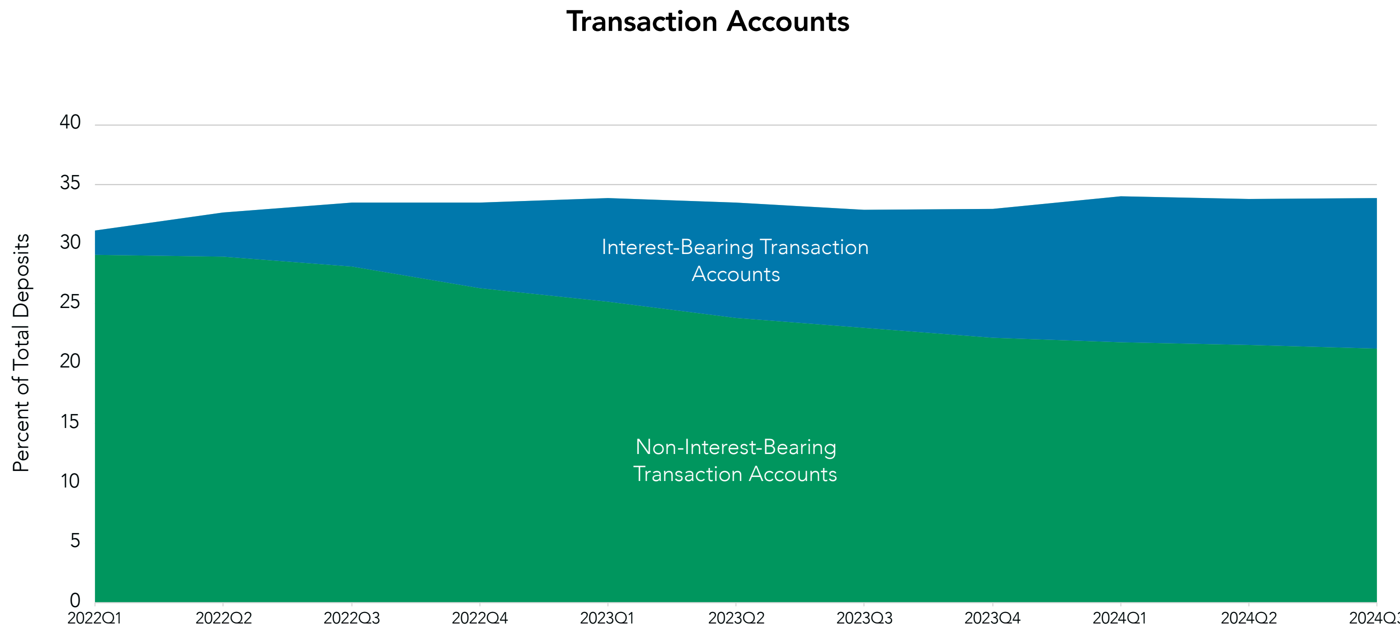
In the elevated rate environment, liquidity was top of mind for bank executives as deposit outflows reached unprecedented levels. With investors chasing higher yields, FIs faced intense pressure to compete with alternative investments by bolstering deposit rates. These efforts paid off, as deposit balances steadily increased throughout 2024 (Figure 2). By year-end, industrywide deposit balances had nearly returned to pre-crisis levels.

Source: Fed H8 Release

The rising cost of deposits is evidenced in the industry's shift from non-interest-bearing (NIB) to interest-bearing (IB) transaction accounts. Prior to the start of Fed tightening, NIB comprised more than 93% of all transaction accounts. By the third quarter of 2024, the percentage had plummeted to just 63% (Figure 3), as more operating accounts transitioned to hybrid structures that offered interest while maintaining the liquidity needed for working capital. Clearly, even after the Fed paused rate hikes, customers increasingly demanded returns on their deposits, driving a fundamental sea change in the industry's deposit mix.

Deposit mix shifts toward interest-bearing

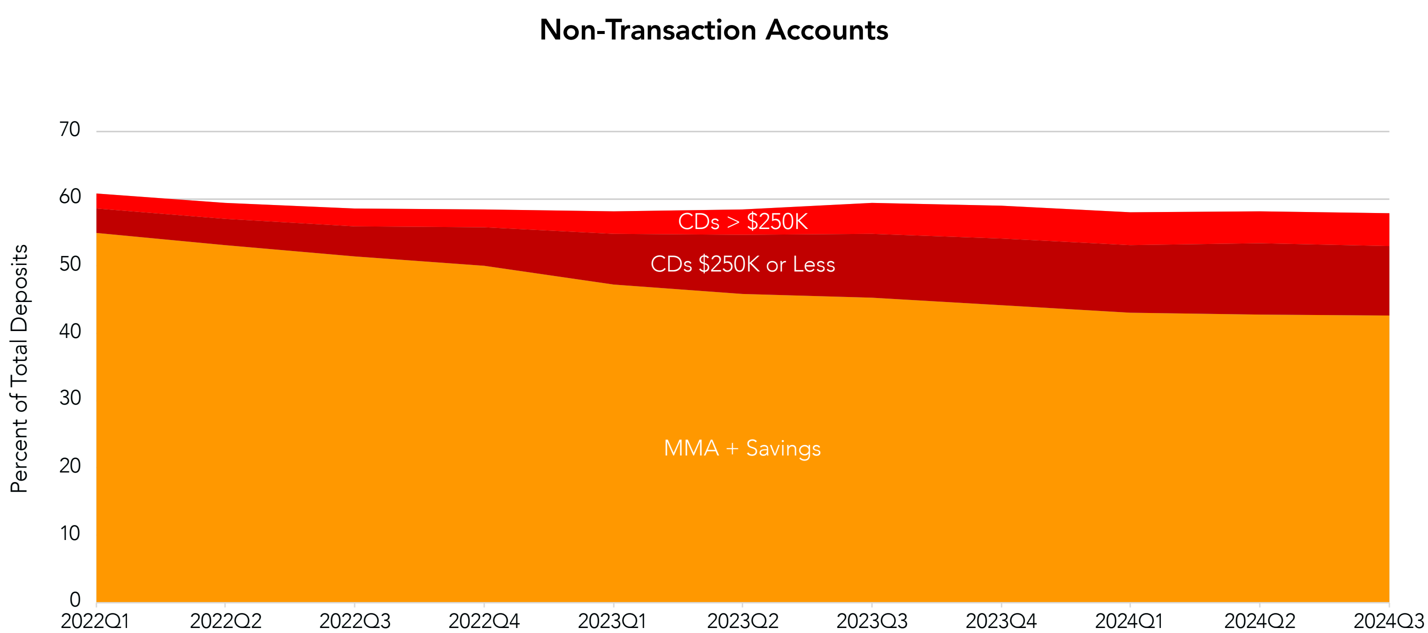
Figure 3



Source: Federal Financial Institutions Examination Council (FFIEC). Data reflects all U.S. commercial banks.

Pronounced rise in time deposits

Figure 4



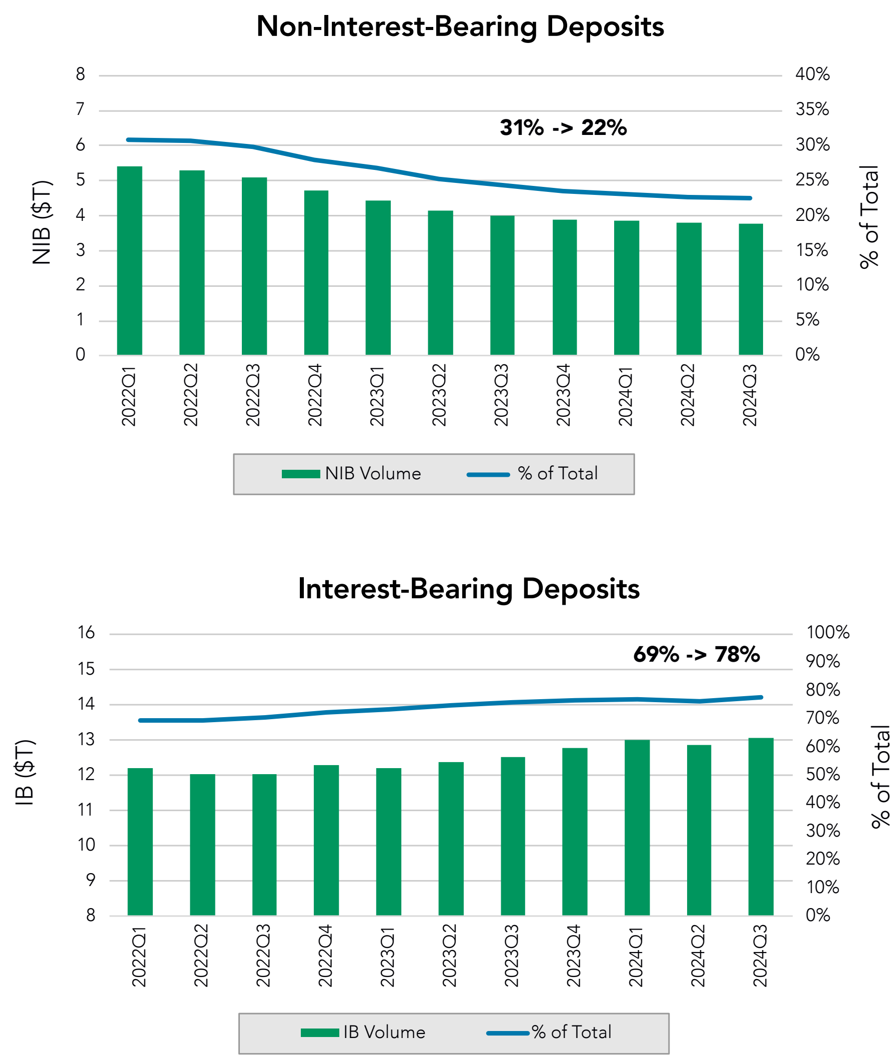
The search for yield has also spurred a notable shift in the composition of non-transaction accounts. With the inverted yield curve making short-term CDs more lucrative than money market accounts (MMAs), investors have shifted their funds accordingly. As a result, the non-transaction account mix has shifted dramatically from 90:10 to 75:25 in less than two years (Figure 4).

Source: Federal Financial Institutions Examination Council (FFIEC). Data reflects all U.S. commercial banks.

When transaction and non-transaction accounts are combined into a single view, the industry's transformation is clear: Non-interest-bearing deposits have steadily declined as a share of the total, while interest-bearing deposits have risen. According to the latest FDIC data, interest-bearing deposits now represent 78% of all deposits, an increase of nearly 10 percentage points since early 2022 (Figure 5).

Sharp rise in interest-bearing deposits

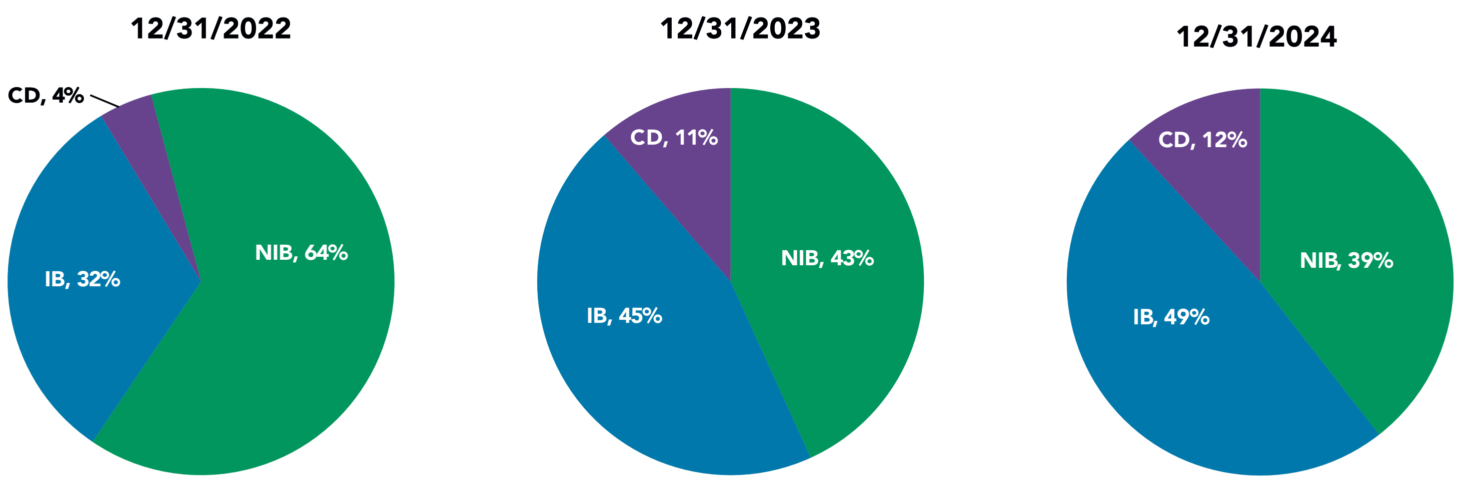
Figure 5



Source: Federal Financial Institutions Examination Council (FFIEC). Data reflects all U.S. commercial banks.

Commercial deposit mix shifts

Figure 6



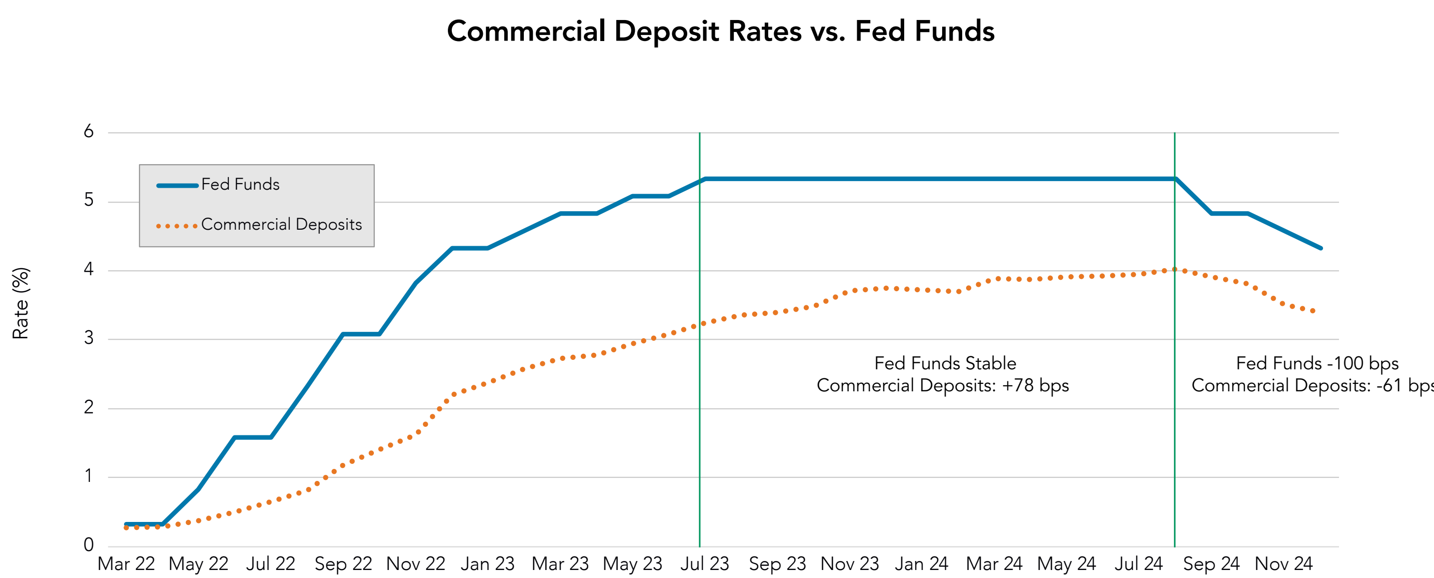
Paralleling the industrywide view, the composition of commercial deposits has undergone a significant shift over the past two years. Q2 PrecisionLender data, which isolates commercial relationships, shows a pronounced drop in the proportion of NIB accounts and a rise in both IB and CDs. This shift has continued even after the Fed paused its rate hikes and then reversed course (Figure 6).

Source: Q2 PrecisionLender
IB category includes all non-time interest-bearing accounts. NIB category includes non-time accounts with interest less than 10 bps.

Not only has the mix shifted toward interest-bearing accounts, but the rates paid on those accounts have become increasingly expensive for the industry. Historically, deposit rate adjustments closely mirrored Fed actions, but over the past year, the industry has broken from this dynamic. Deposit rates continued climbing even after the Fed paused its hikes, as FIs offered competitive rates in search of liquidity. Similarly, since the Fed began easing monetary policy in mid-September, deposit rates have fallen more modestly than the Fed's cuts (Figure 7).

Deposit rates diverge from Fed action

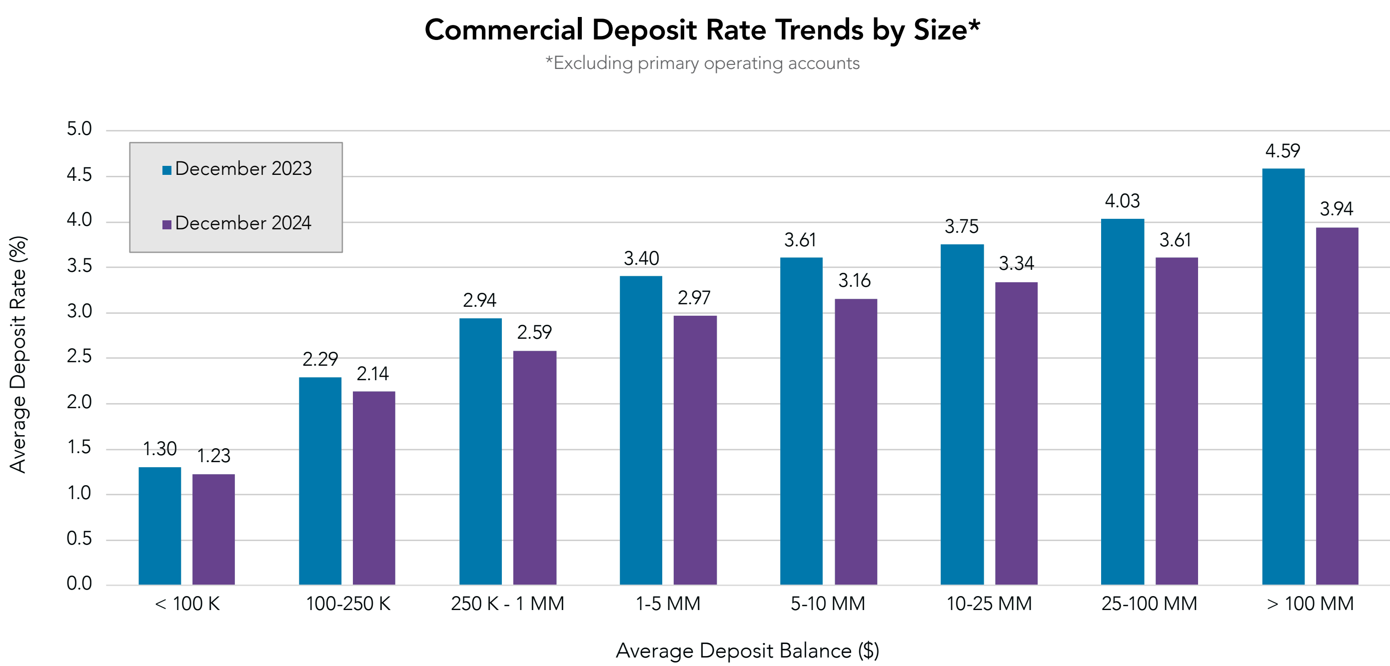
Figure 7



Source: Fed H15 Release, FDIC, and Q2 PrecisionLender Commercial deposit rate figures reflect non-time, interest-bearing accounts. Figures are dollar-weighted and reflect month-end levels.

Deposit rates remain elevated across the size spectrum

Figure 8



Efforts to shore up liquidity are particularly evident when examining deposit rates paid based on account size. While deposit pricing has fallen across the size spectrum, rate reductions for even the largest accounts have been well below the 100 bps Fed Funds cut in 2H 2024. This pattern highlights the industry's continued willingness to pay premium rates to secure larger, more impactful deposits (Figure 8).

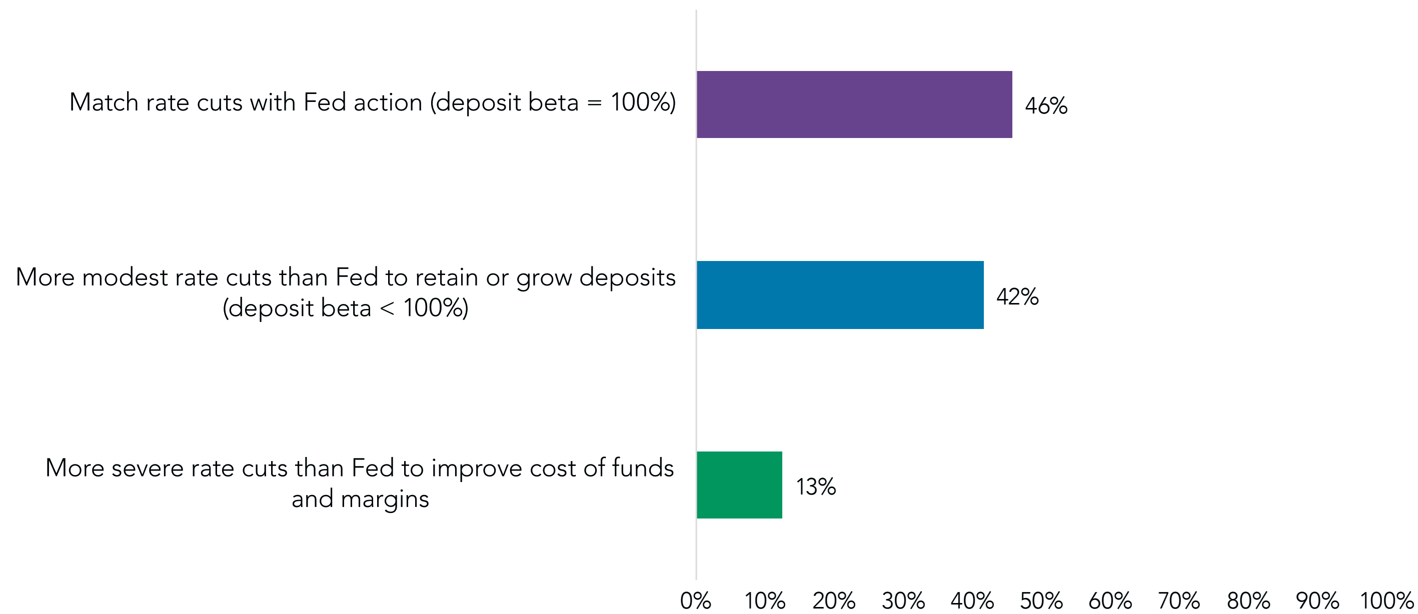
Source: Q2 PrecisionLender
Commercial deposit rate figures reflect non-time, interest-bearing accounts. Figures are dollar-weighted and reflect period-end data as of the indicated date.

Looking ahead, bankers anticipate continuing to diverge from the Fed to remain competitive in the drive for liquidity. In a survey of bank executives conducted just before the Fed's first rate cut of 2024, only about half indicated plans to align their deposit rate reductions with the Fed's actions. Notably, over 40% expressed plans to implement more modest cuts instead (Figure 9).

Survey: Expected deposit rate cuts

Figure 9

As you are setting forecasts for 2025, what is the planned/targeted deposit rate paid reductions you are expecting on interest-bearing accounts?

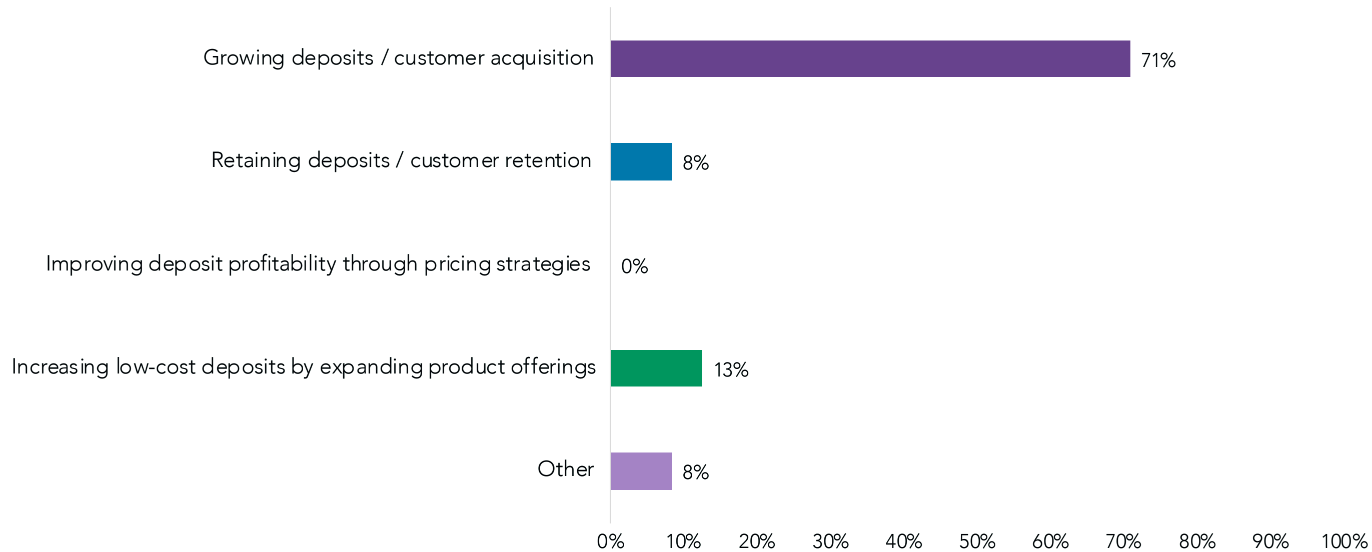


Source: Q2 PrecisionLender
Survey of commercial banking executives.
Data as of September 2024.

Survey: Strategic priorities related to deposits

Figure 10

What is your institution's biggest strategic priority related to deposits for 2025?



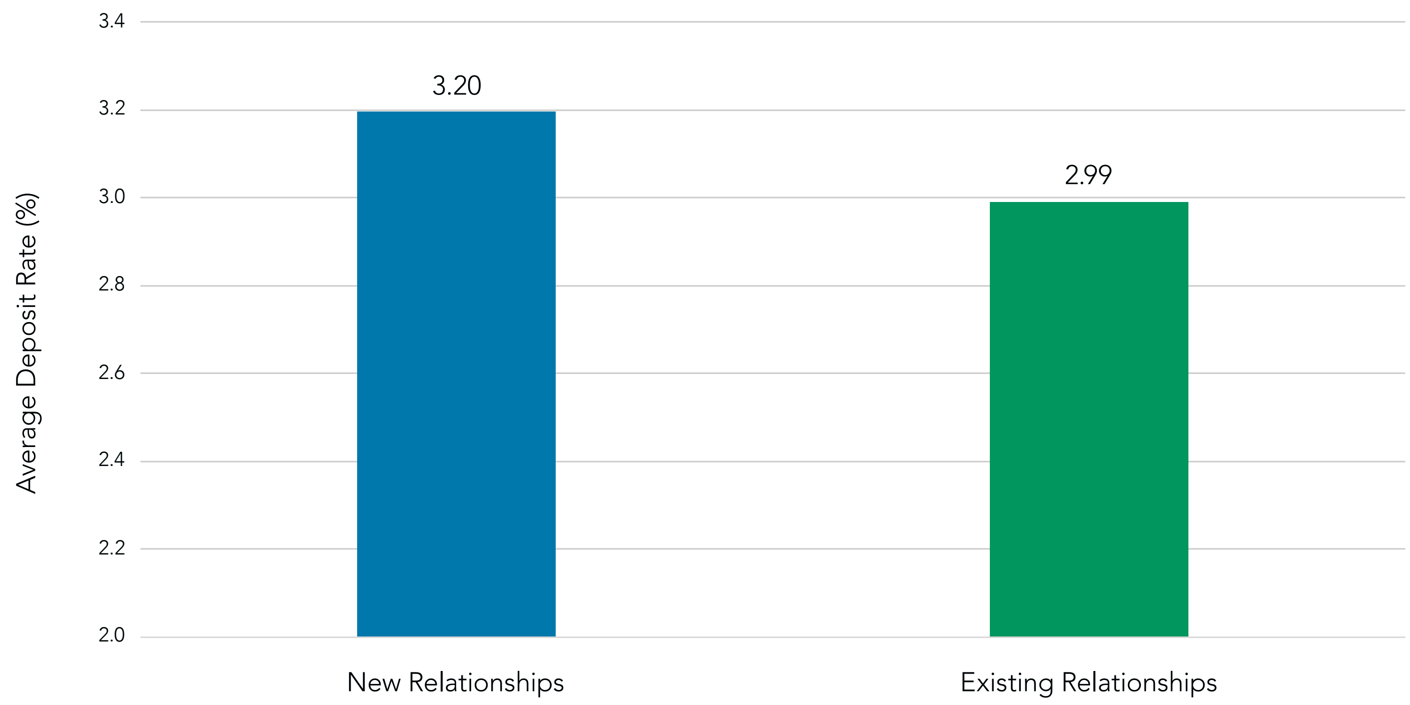
FIs have employed a broad range of tactics to enhance deposit volume and profitability, including expanding treasury management offerings to attract low-cost operating accounts and leveraging competitive promotional pricing to secure new client relationships. According to a recent Q2 PrecisionLender survey of bank executives, client acquisition has emerged as the top priority, with over two-thirds of respondents identifying it as their primary focus area (Figure 10).

Source: Q2 PrecisionLender Survey of commercial banking executives. Data as of September 2024.

Q2 PrecisionLender commercial deposit data underscores this strategic emphasis, revealing that rates paid to new client relationships are, on average, one-eighth of a point higher than those offered to existing clients. While concerns about client attrition undoubtedly exist, the data underscores that FIs are prioritizing competitive rates to attract new accounts (Figure 11).

Focus on client acquisition or retention?

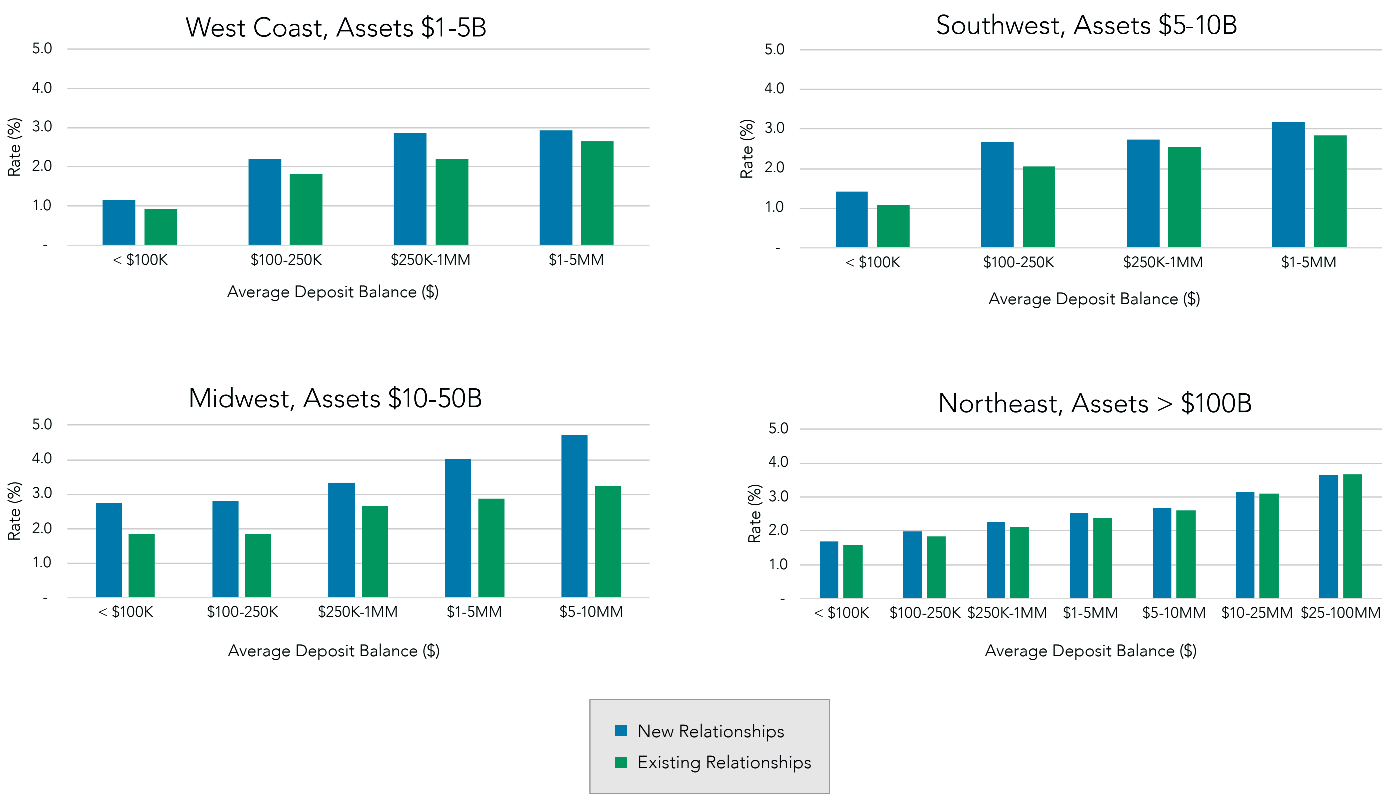
Figure 11



Source: Q2 PrecisionLender
New Relationships are those which did not exist as of 12/31/2023. Rate data reflects non-time, interest-bearing accounts and excludes deposits over $100 million due to their disproportionate impact on the results. Figures are dollar-weighted. Data as of 12/31/2024.

Client acquisition focus spans FIs

Figure 12



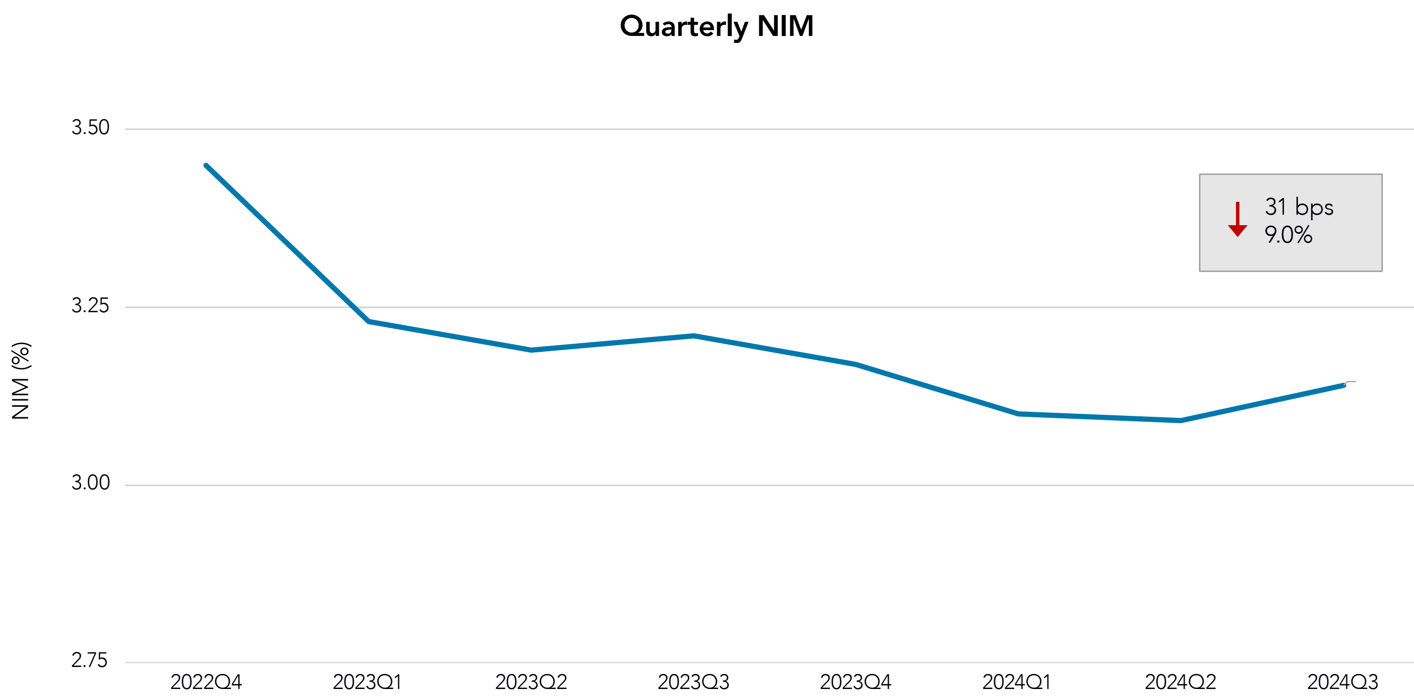
The propensity to use rate as a catalyst for winning new relationships is widespread across the commercial banking landscape. While the actual rates vary across FIs, the tendency to offer higher rates to new clients is consistent. A case in point: An examination of four commercial banks of varying sizes and geographic footprints shows that, across the size spectrum, deposit rates paid to new client relationships surpass those paid to existing customers (Figure 12).

Source: Q2 PrecisionLender
New Relationships are those which did not exist as of 12/31/2023. Rate data reflects non-time, interest-bearing accounts. Figures are dollar-weighted. Data as of 12/31/2024.

Not surprisingly, the elevated rates offered to attract and retain deposits have driven up funding costs, intensifying pressure on NIM. For most of 2024, as the Fed funds rate held steady and deposit rates climbed, margins eroded. The declines over the longer time frame are striking: Since the onset of Fed tightening in late 2022, the industry has lost 31 bps of NIM or 9% of the total (Figure 13).

Rising funding costs drive down NIM

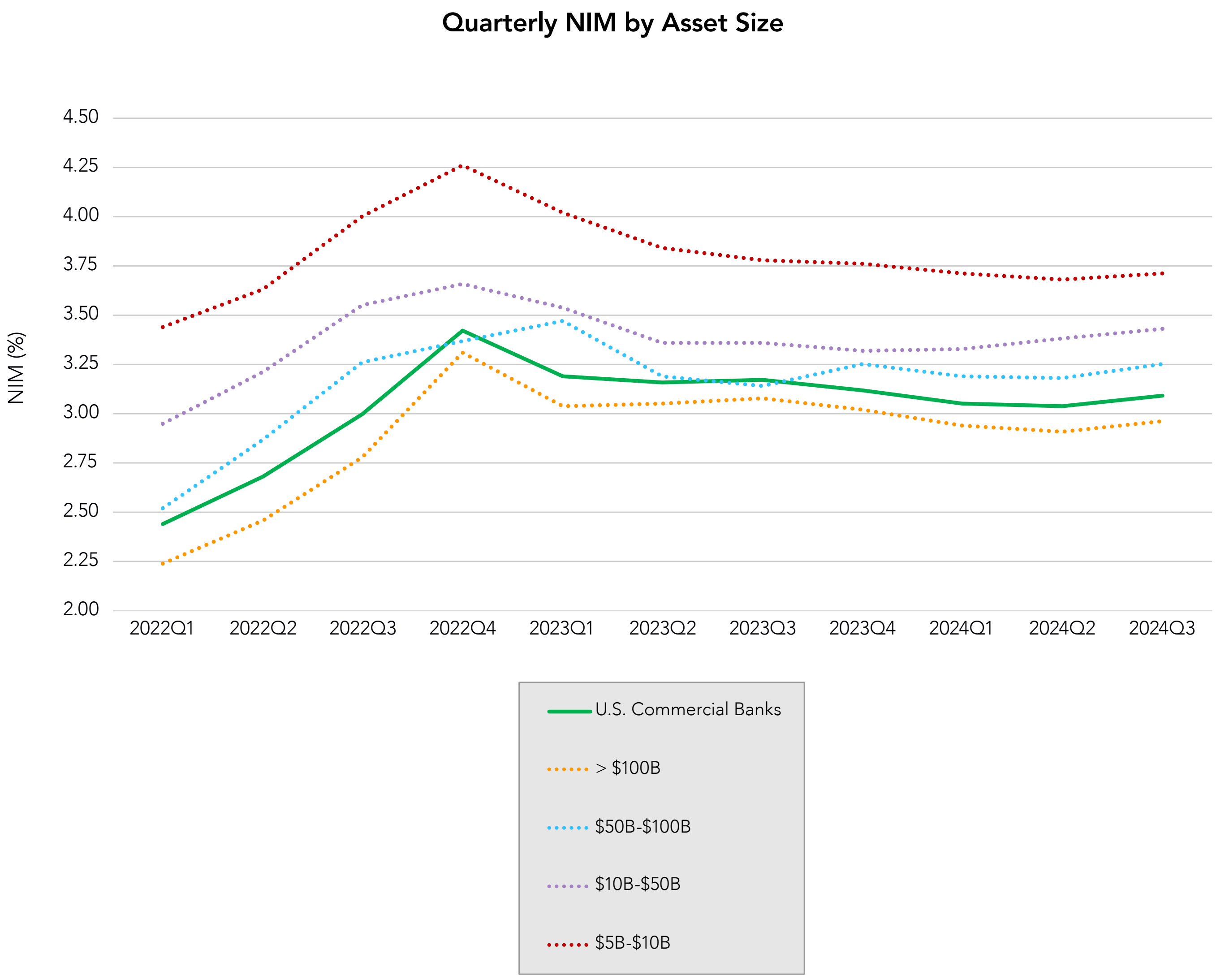
Figure 13



Source: Federal Financial Institutions Examination Council (FFIEC).
Data reflects U.S. commercial banks. NIM reflects net interest income as a percentage of earning assets.

NIM pressures span banks of all sizes

Figure 14



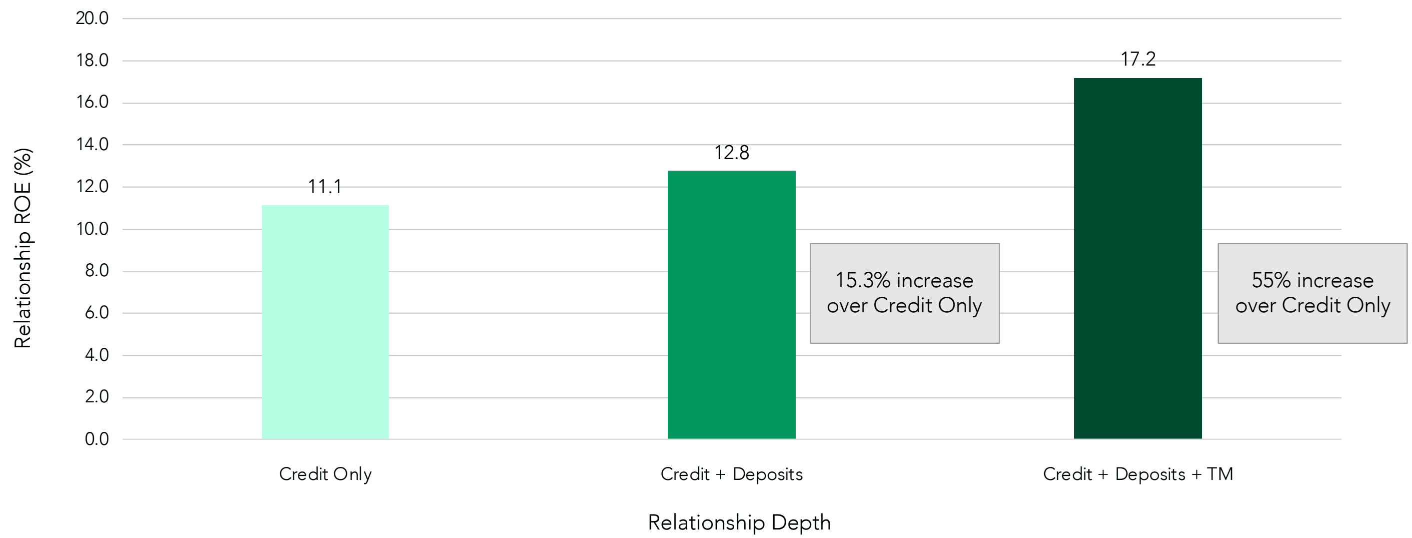
Rising funding costs have impacted commercial banks of all sizes. While the specific NIM levels vary based on customer mix, the erosion trend has been consistent across the market since late 2022 (Figure 14).

Source: Federal Financial Institutions Examination Council (FFIEC). Size groupings based on total assets. Data reflects U.S. commercial banks. NIM reflects net interest income as a percentage of earning assets.

NIM compression has undoubtedly taken a toll on aggregate relationship profitability. Prior to the first rate cut in September 2024, risk-adjusted relationship profitability on credit-only relationships stood at just 11.1%, according to Q2 PrecisionLender data. Still, while deposits have become more costly, relationships with both loans and deposits achieved about 15% more in relationship return on equity (ROE), and relationships with loans, deposits, and treasury management services yielded an impressive 55% more than their credit-only counterparts (Figure 15).

Material gains in relationship returns from deposits and cross-sell

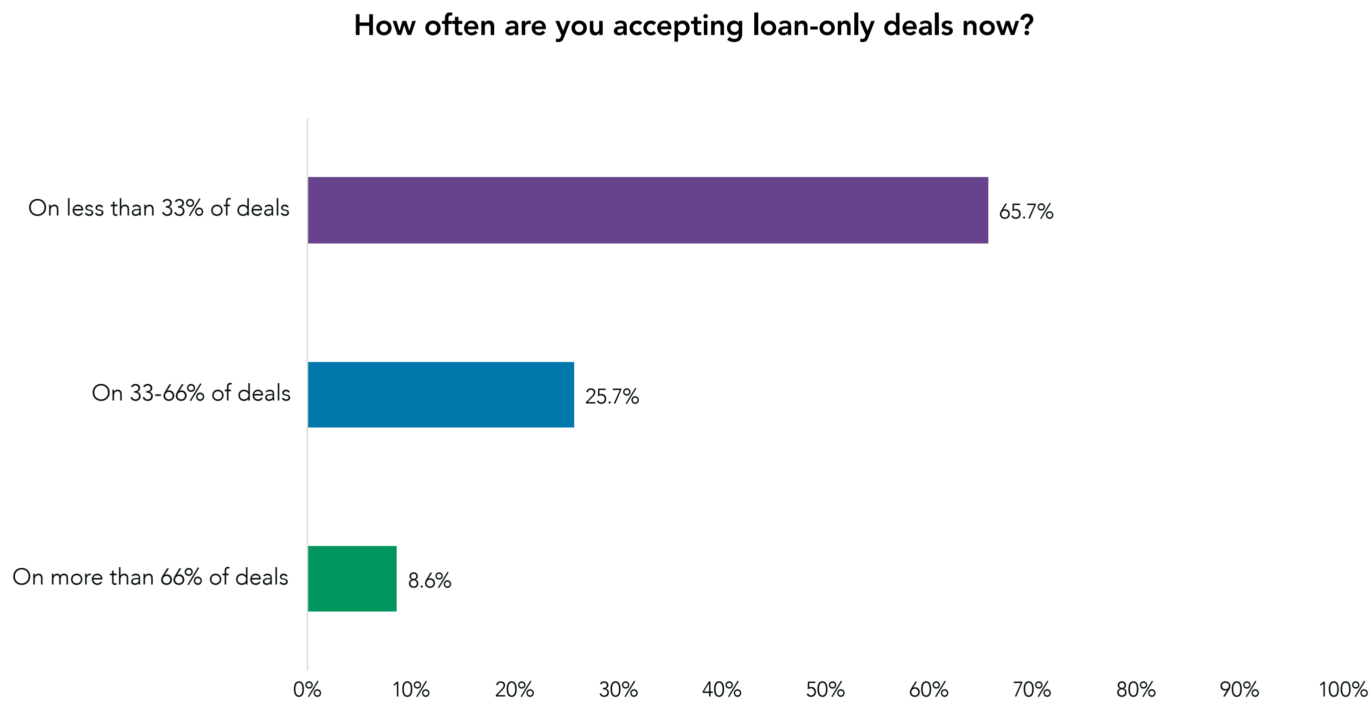
Figure 15



Source: Q2 PrecisionLender.
Data as of August 2024.

Survey: Credit-only structures no longer viable

Figure 16



The recognition that credit-only relationships are not lucrative in the current rate environment is supported by a recent survey conducted by Q2 PrecisionLender. Nearly two-thirds of commercial bank executives indicated they would accept credit-only relationships less than one-third of the time (Figure 16). Institutions more willing to accept credit-only structures typically have already met their liquidity goals or operate in highly profitable market subsegments, such as syndications and leveraged finance.

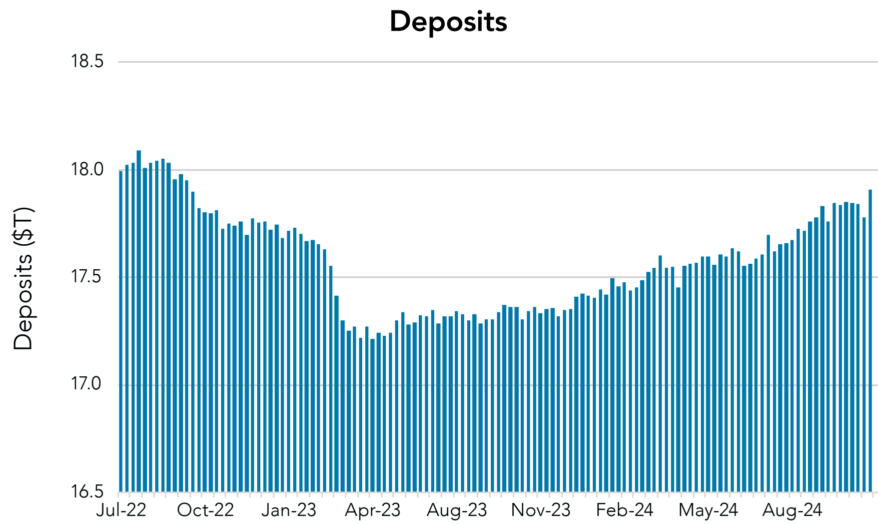
Source: Q2 PrecisionLender.
Survey of commercial executives.

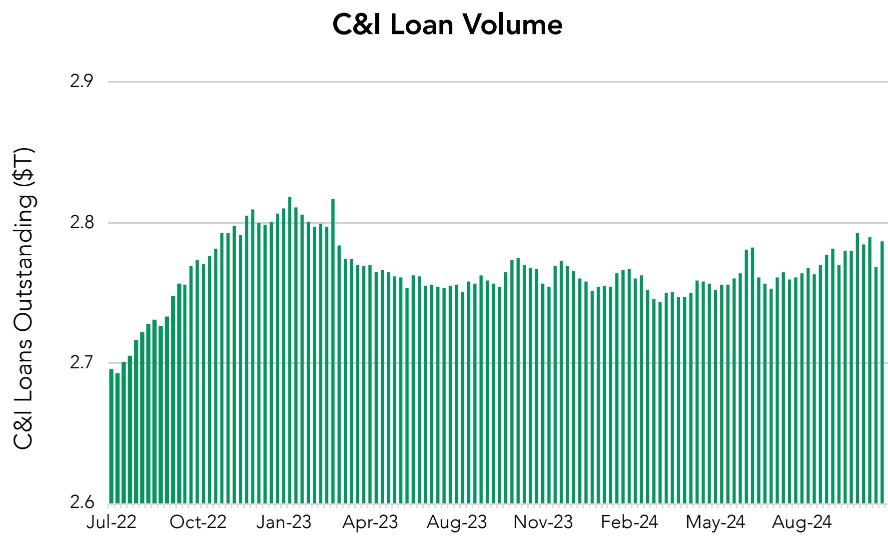
Loan Demand and Supply

Liquidity for the industry as a whole is now rising faster than loan demand, indicating that banks are now poised to open the lending spigots, albeit for the right price. C&I loan volume has trended higher in 2024, rising about 1.4% over the course of the year while aggregate deposits have grown nearly 2.6% (Figure 17).

Liquidity improves, outpacing growth in loan demand

Figure 17

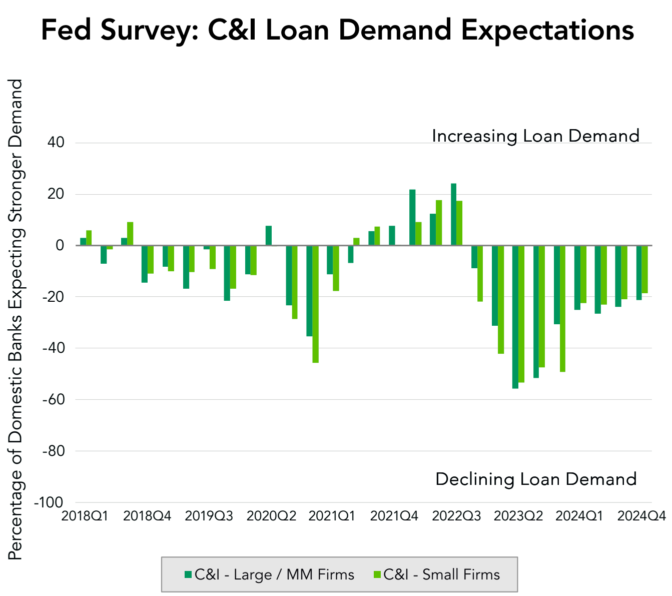


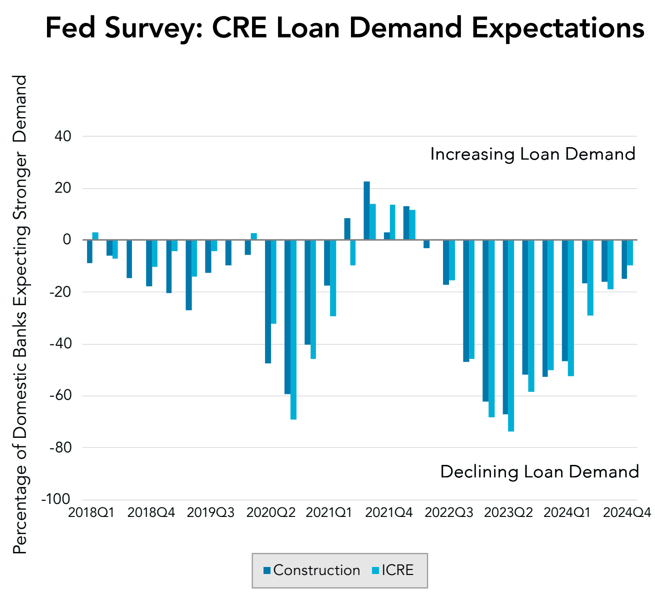


Source: Fed H8 Release
Figures are seasonally adjusted and reflect all U.S. commercial banks.

Modest improvement expected in loan demand

Figure 18





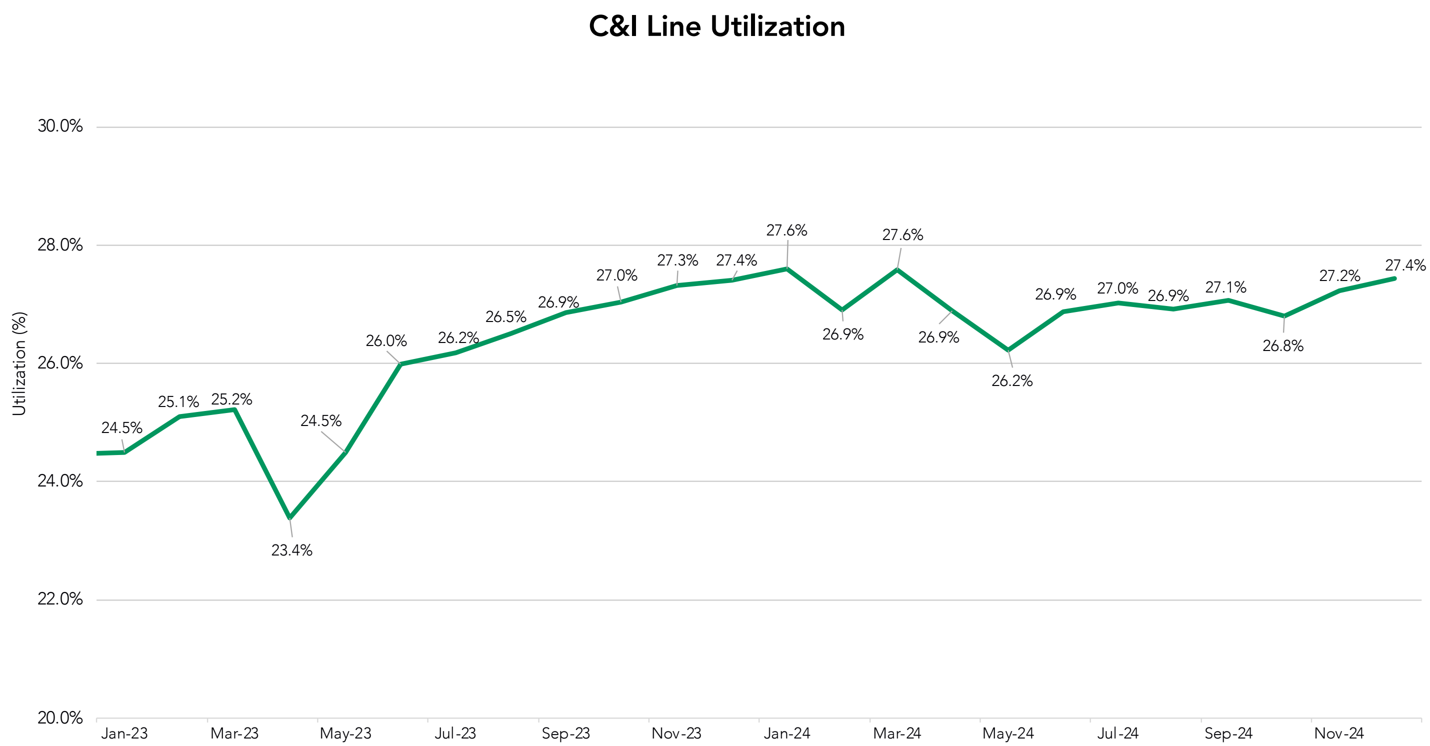
While aggregate loan volume has trended higher, senior bankers remain cautious about forecasting a full recovery. According to the Federal Reserve survey, expectations for loan demand have remained in negative territory for several quarters. However, sentiment has improved compared to year-ago levels, with less pessimistic outlooks noted across both large/middle market and small C&I firms. Bankers are also forecasting improvement in the CRE sector, both on construction and investor developer deals (Figure 18).

Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

After the unprecedented pace of Fed rate hikes starting in late 2022 and the subsequent collapse of several large commercial banks including SVB and Signature, commercial line utilization had plummeted to historic lows by spring 2023. Fast forward to 2024, and usage across the C&I market has rebounded, returning to historical norms (Figure 19).

Usage recovers from rate hikes and bank failures

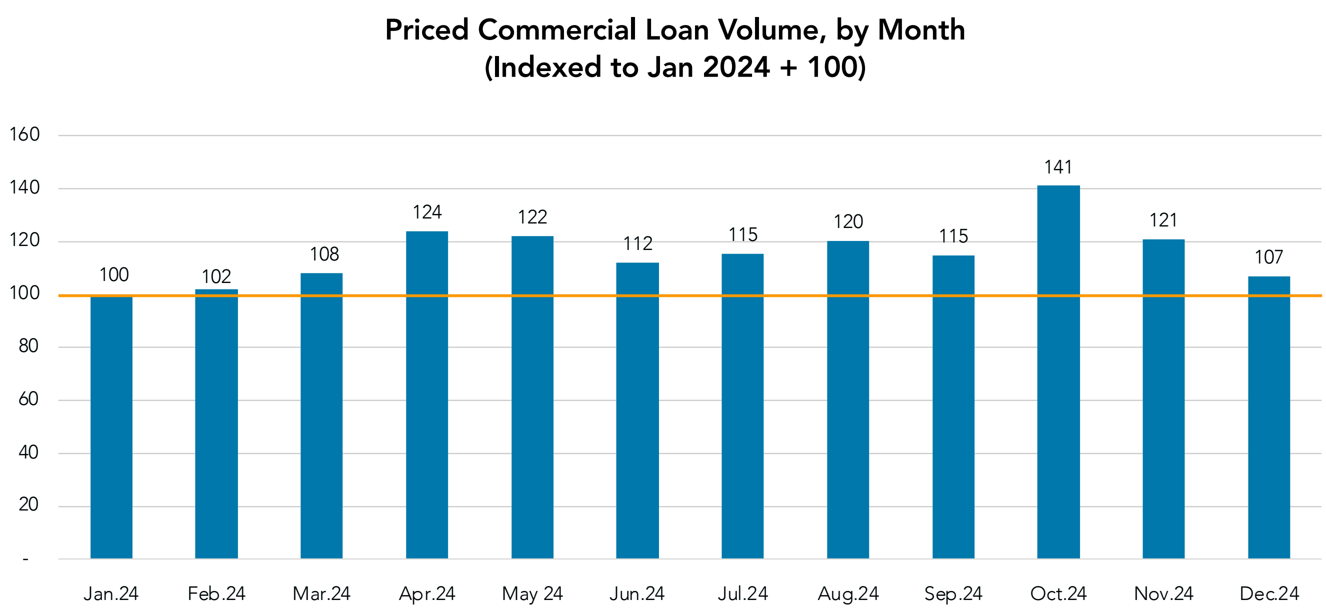
Figure 19



Source: Q2 PrecisionLender
Analysis reflects line utilization on committed C&I lines of credit up to $100MM as of the indicated period and excludes overdrawn accounts.

Pricing volume belies stated selectivity goals

Figure 20



At the start of 2024, bankers anticipated greater selectivity in the deals they would consider and close. However, pricing activity data revealed no significant reduction in volume, suggesting that both bankers and borrowers remained actively engaged in pursuing new business opportunities. Notably, activity in the second half of 2024 remained steady month-over-month, with a seasonal decline of just 10% in December compared to November—half the typical seasonal drop of around 20% observed in 2023. These trends indicate that market participants stayed "open for business" during the rate cuts, rather than retreating to the sidelines (Figure 20).

Source: Q2 PrecisionLender
Analysis reflects the volume of loans priced on PrecisionLender for a cohort group of clients, indexed to 100 for January 2024.

Part II:
Pricing and Credit Risk

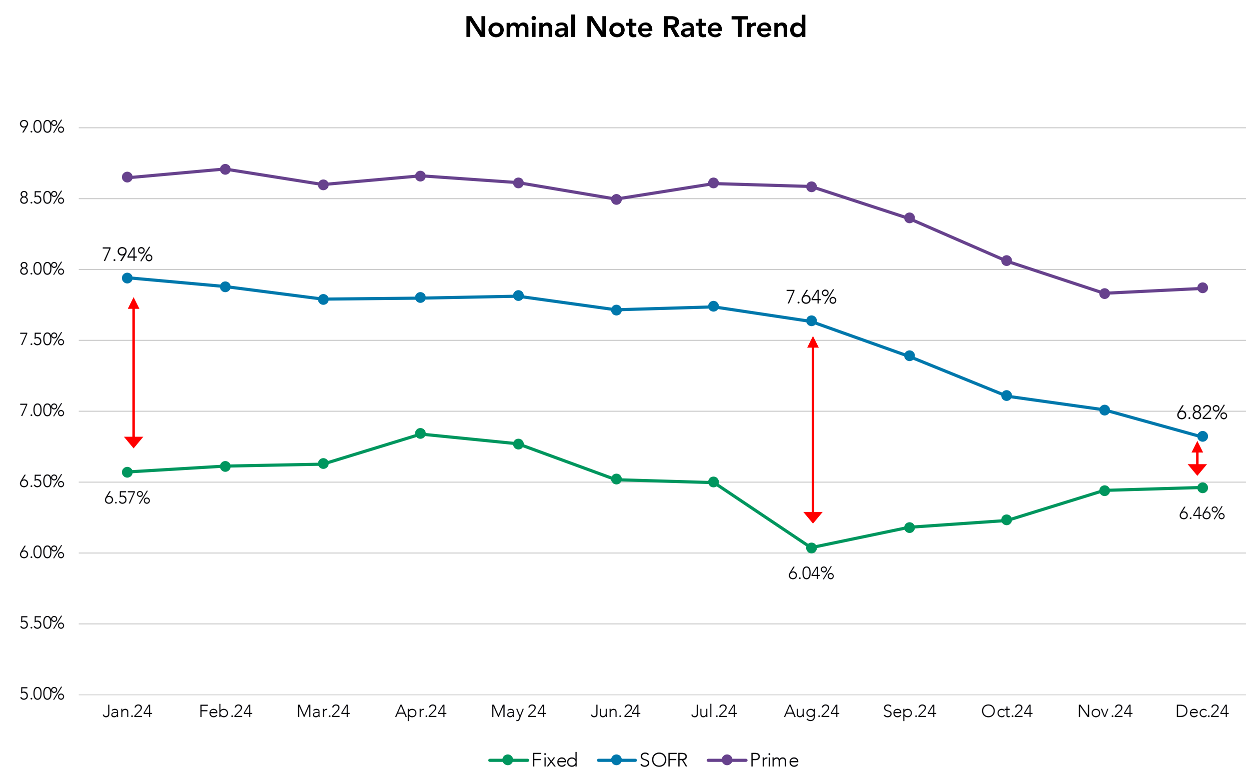
Pricing Trends

The combination of increased volume, rising funding costs, and lower revenue metrics has characterized much of 2024, steering the market toward a moderate downward trajectory with a stronger reliance on floating-rate structures over fixed-rate alternatives.

Throughout 2024, a key theme was the "discount" on fixed-rate loans relative to their floating-rate counterparts, driven by the inverted yield curve and the prolonged "higher for longer" rate environment. Early in the year, the expectation was that rate cuts were just around the corner, prompting bankers to discount fixed-rate loans to make them more attractive ahead of anticipated changes. When the rate cuts finally materialized later in the year, bankers had the opportunity to further reduce fixed-rate pricing, but instead, they raised the coupons on these loans. The near 50 bps increase in fixed-rate coupon since August is leading the change in relative value (Figure 21).

Fixed-rate discount is decreasing

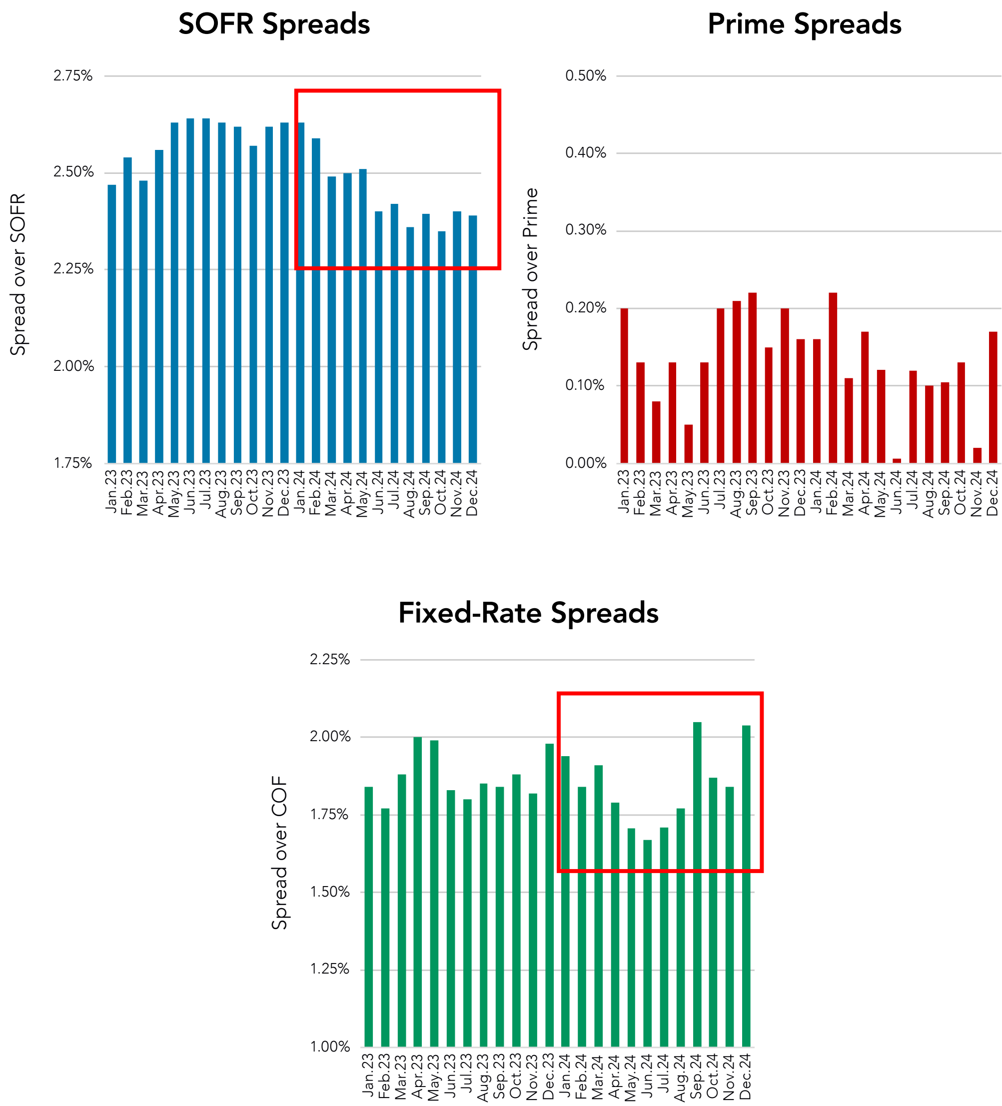
Figure 21



Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

Signs of sustainability challenges on the revenue side

Figure 22



Turning to the key revenue metrics that drive coupon rates, we examined spreads. SOFR structures, which comprise 55%-60% of all loans priced, experienced 24 bps of spread erosion in 2024.

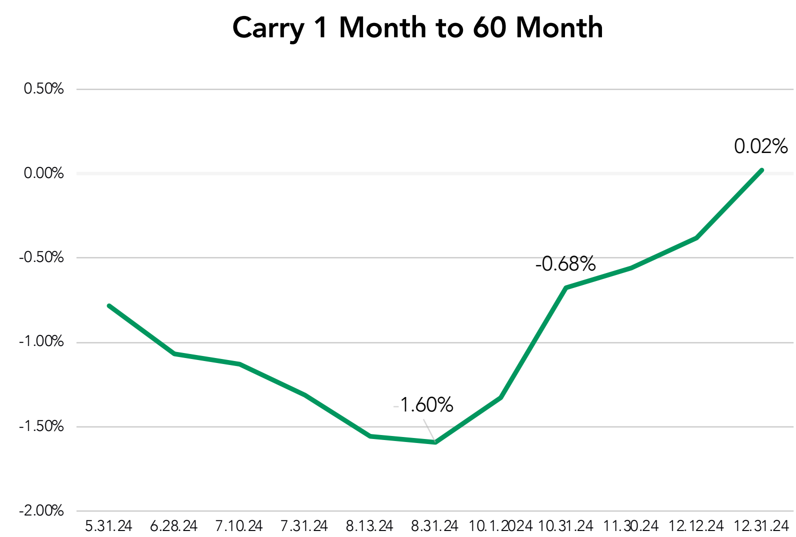
Meanwhile, fixed-rate spreads drifted lower during the first half of 2024 but appear to have found support above 175 bps in the second half of the year. They started the year at 1.94%, dropped to 1.67% in June, peaked at 2.05% in September, then fell back to 1.84% by November, before finally grabbing a year-end uptick to 2.04% in December. The pattern is unclear, as much of the result is caused by swings in underlying market rates. Maintaining stability in these rates was enough to reduce the fixed-rate discount relative to SOFR floating-rate structures.
In addition, Prime spreads exhibited more volatility; it dropped from 14 bps at the start of the year down to just 2 bps in November before rebounding to 17 bps at the end of the year. (Figure 22).

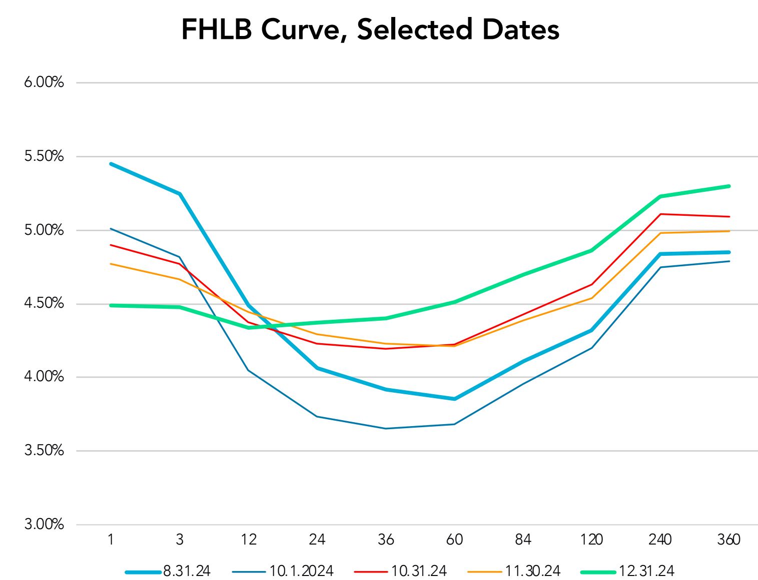
Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

Traditionally, a rate cut would cause the entire funding curve to shift downward, but in 2024, the cuts had an unexpected effect on fixed-rate terms. This can be seen when tracking the 1-month to 60-month carry in the FHLB Curve in 2024. (We choose those points because they align with proxies for funding references for key rate structures: one month for floating, 60 months for fixed rate.) The final FHLB snapshot of 2023 revealed a -1.53% carry. This carry metric fluctuated throughout the first half of 2024, reaching a low of -1.60 by August 31. However, following several Fed rate cuts, the curve then shallowed considerably, with the 1-to 60-month carry rising to -0.38 by December 12 and moving positive to +0.02 by year-end (Figure 23). Pricing managers have been adjusting their funding curves proactively to align with the evolving market conditions.

FHLB curve inversion continues to shallow

Figure 23

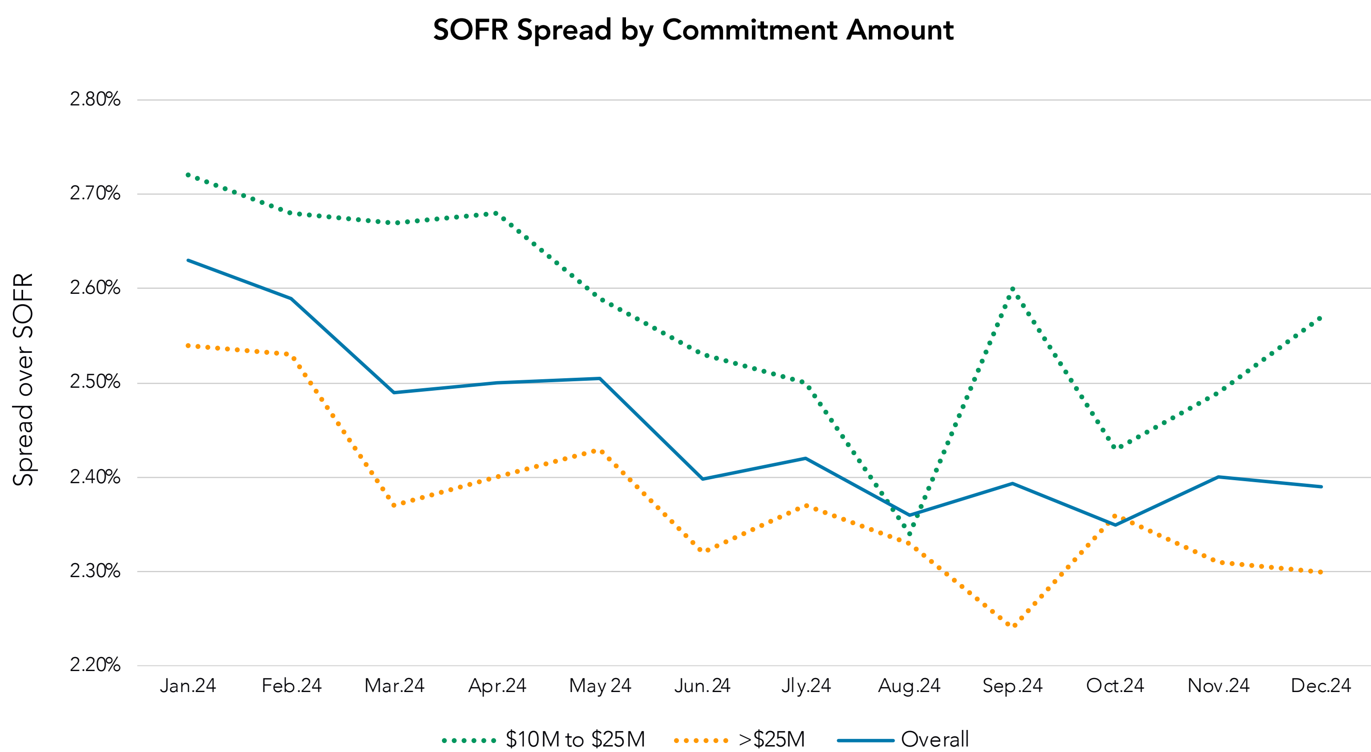




Source: Q2 PrecisionLender FHLB composite curve from PrecisionLender application, selected dates.

Spreads narrow across the size spectrum

Figure 24



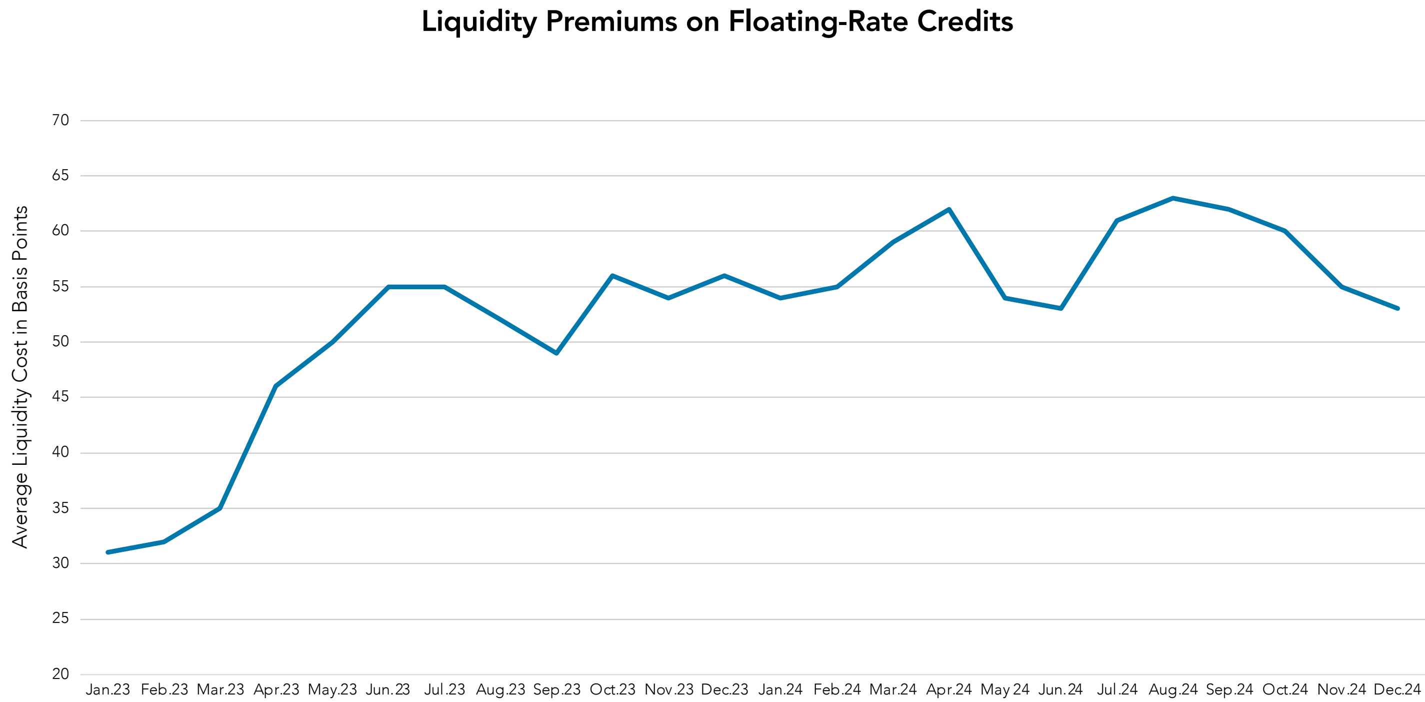
On the floating-rate side, spread to index (the top-line revenue measure), fell not only due to the Fed rate cuts but also because of narrower revenue spreads over the benchmark indices. Rather than restricting their competitive stance to larger credits, bankers have reduced spreads over SOFR across the market, offering thinner pricing to a broader range of borrowers (Figure 24). December's activity posted an improvement in spreads on smaller credits—though for the year, spreads still fell.

Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

Despite the industrywide improvement in deposit balances, liquidity costs—part of the all-in funding costs assessed on loan-generating activities—remained above 50 bps throughout 2024, with no signs of easing. This trend aligns with the slower-than-expected decline in deposit rate betas and underscores how expensive liquidity has become for the industry (Figure 25).

Liquidity premiums remain elevated

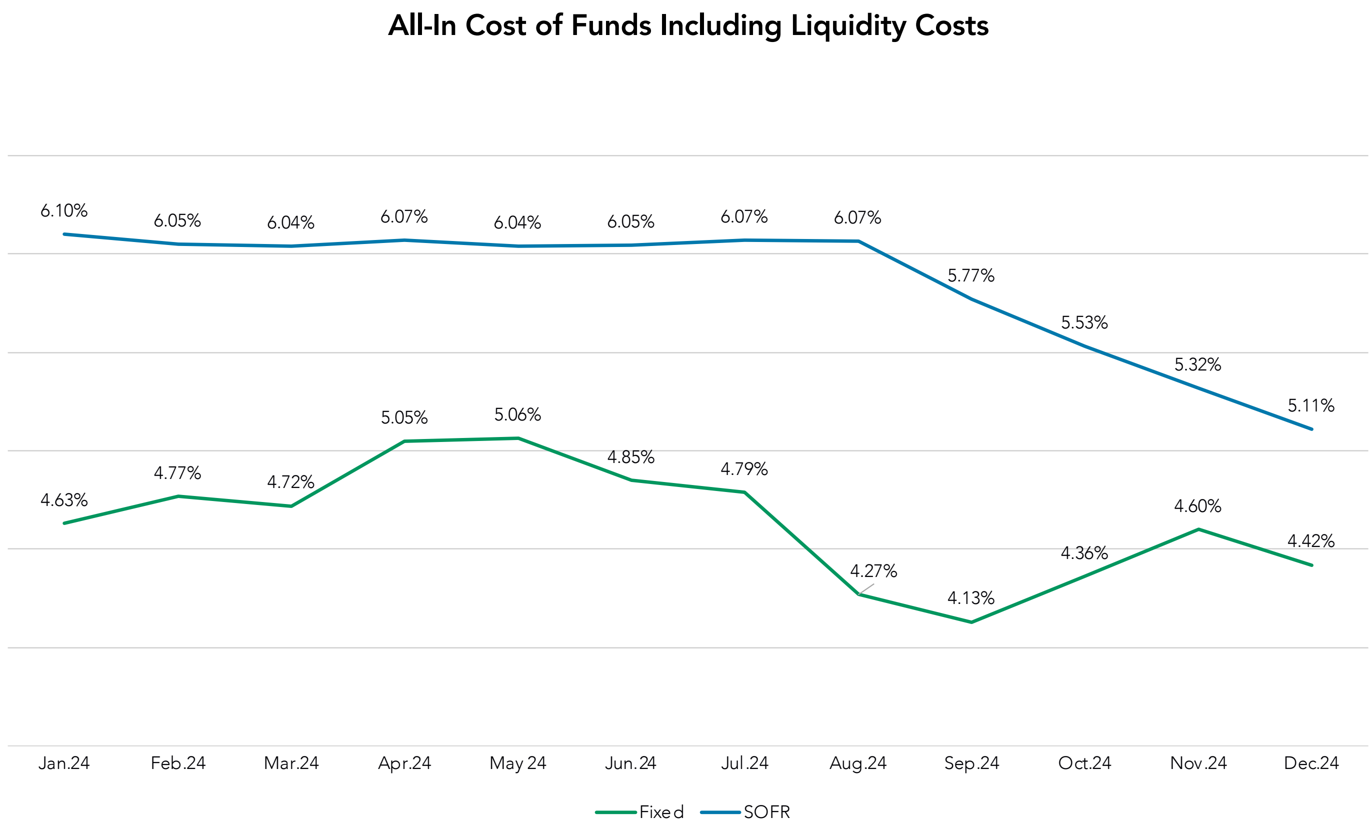
Figure 25



Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

All-in funding costs are converging

Figure 26



The opposing trends for floating and fixed rates in the funding curve also translated into directional differences in all-in cost of funds. While all-in SOFR funding costs have declined in lockstep with short-term rates, fixed-rate costs have increased nearly a half point since September. As a result, the COF gap between fixed and floating structures, which reached 180 bps in August, has narrowed to just 72 bps (Figure 26).

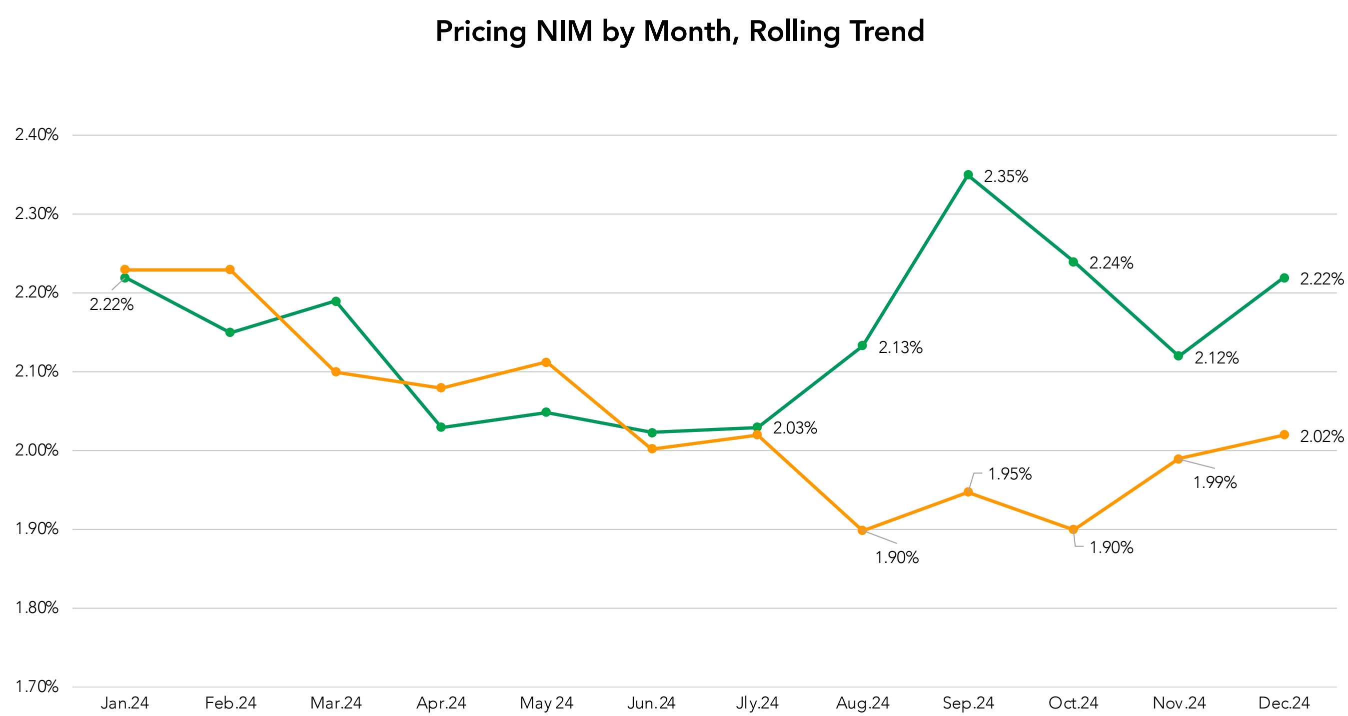
Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

For much of 2024, the NIM for fixed-rate and SOFR structures moved in lockstep, dropping steadily by about 20 bps for both structures from January through July. This was one of the potential explanations for the fixed-rate discount, as even with a lower coupon, bankers were still earning essentially the same NIM as they would with a floating-rate structure.

Then, first in anticipation of rate cuts and then in their aftermath, fixed-rate NIM shot up, while SOFR NIM continued to decline. By the end of September, fixed-rate NIM had surpassed SOFR by 40 bps (Figure 27). That gap has since narrowed, partly because bankers have been unable to raise fixed-rate coupons fast enough to keep up with rising funding costs. By the end of November, the two measures were converging, with fixed-rate NIM retreating to 2.12% and SOFR NIM rising to 1.99%. Mixed results as of December have fixed-rate NIM improving while SOFR ebbed slightly.

NIM trajectory unclear since Fed rate cuts

Figure 27

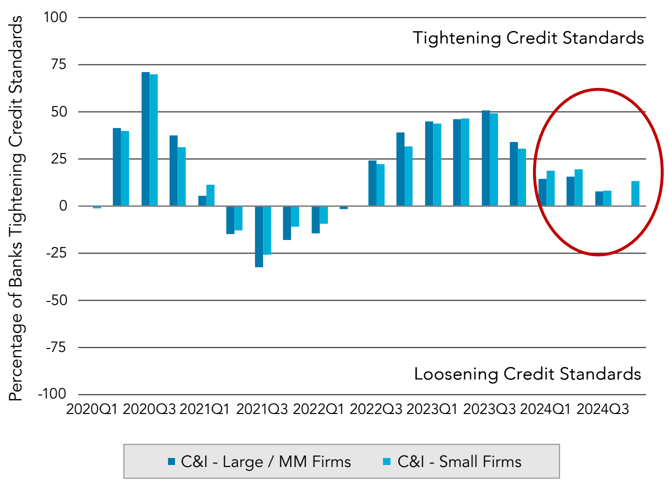


Source: Q2 PrecisionLender
Analysis reflects opportunities priced on the PrecisionLender platform during the indicated month. Figures are dollar-weighted.

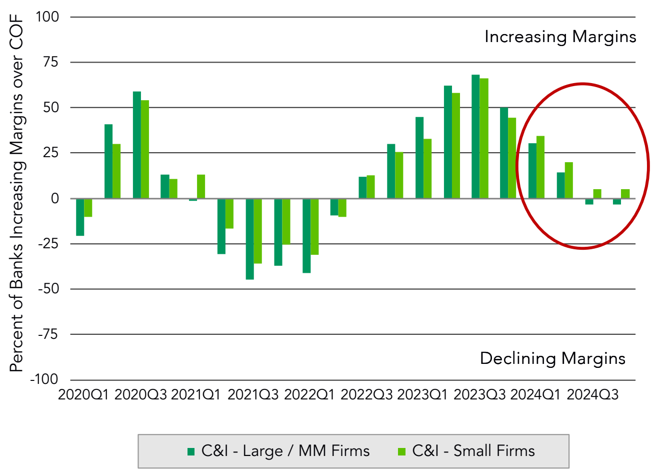
Fed survey suggests concerns ease

Figure 28

Credit Standards



Pricing Expectations



Margin stability is a theme poised to continue in 2025, according to the latest Fed survey. In contrast to the trepidation around a slowing economy that plagued the market a year ago, the latest survey shows an easing of credit concerns. Bankers expect to hold the line on credit standards for larger firms and tighten only slightly on smaller borrowers, while keeping spread levels steady across the board (Figure 28).

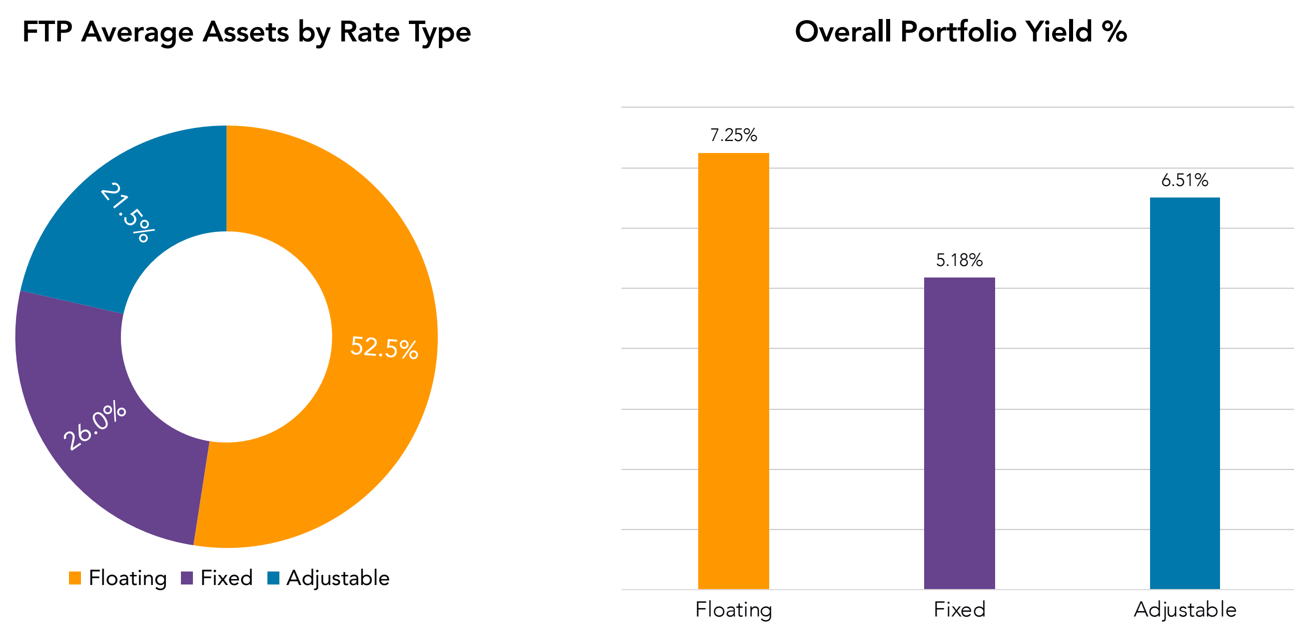
Source: Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Payoffs and Repricing

In the "higher for longer" rate environment, a key industry concern is whether customers with fixed-rate loans can shoulder the increased interest expense when their loans mature and are refinanced at higher rates. Q2 PrecisionLender data indicates that more than one-quarter of all commercial balances reflect fixed-rate structures. Those facilities could face significant increases in rate upon refinancing (Figure 29). The current yield on fixed-rate loan posts 5.18% and is more than 200 bps below the floating-rate book at 7.29%. Adjustable-rate structures yield 6.51%. For the fixed-rate instruments, many were booked in 2020 and 2021 at pandemic-driven, comparatively low interest rates and drive the overall yield downward. Q2 PrecisionLender data indicates that 2024 fixed-rate loan production yield is about 6.50%.

Volume and yields slanted toward floating rate

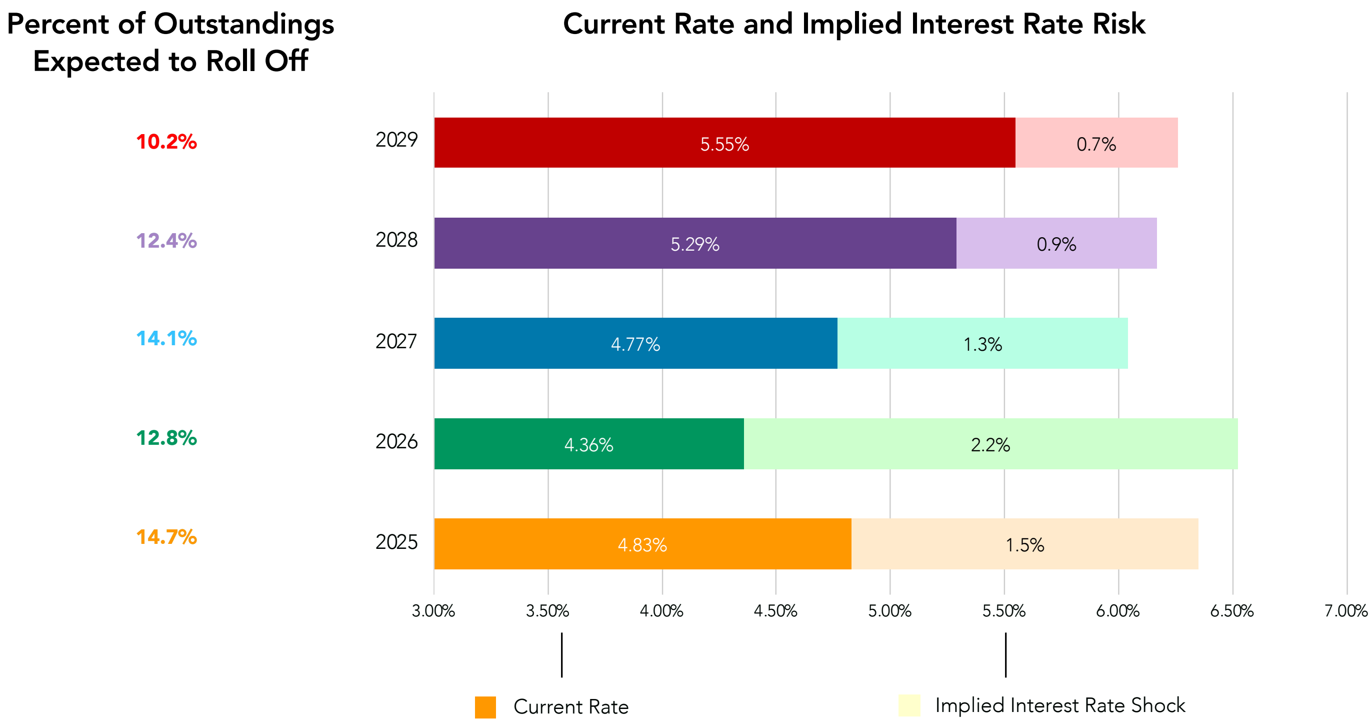
Figure 29



Source: Q2 PrecisionLender
Analysis shows the proportion of interest-bearing loan balances outstanding as of November 2024 by rate type.

Implied interest rate shock and expected roll-off

Figure 30



Nearly 15% of all fixed-rate balances are scheduled to mature in 2025. If those credits were refinanced at current market rates, borrowers would face about 150 bps in additional interest expense. The outlook is even more challenging for loans maturing in 2026, with borrowers likely facing an additional rate increase of 220 bps (Figure 30).

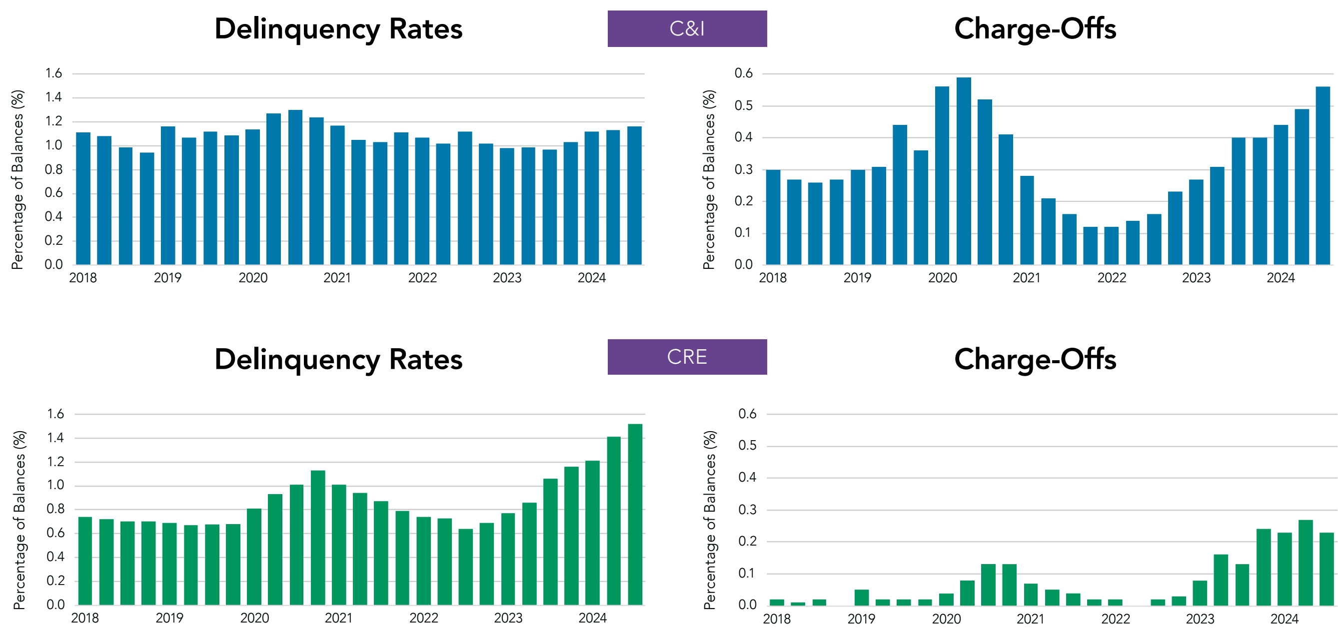
Source: Q2 PrecisionLender
Analysis shows the proportion of fixed-rate balances scheduled to mature in the indicated year and the implied interest rate risk on those exposures, defined as the difference between funding those remaining exposures at current costs versus at the costs at last repricing or origination.

Credit Risk

At the start of 2024, concerns about a potential economic slowdown fueled fears of widespread credit deterioration across the industry. However, those fears largely failed to materialize. Delinquencies on C&I loans edged up only modestly, with more significant increases confined to the CRE sector. While C&I charge-offs did rise, they remained well below pandemic-era highs. CRE charge-offs, on the other hand, saw a more substantial increase, climbing to approximately 30 bps (Figure 31).

Charge-offs trend higher

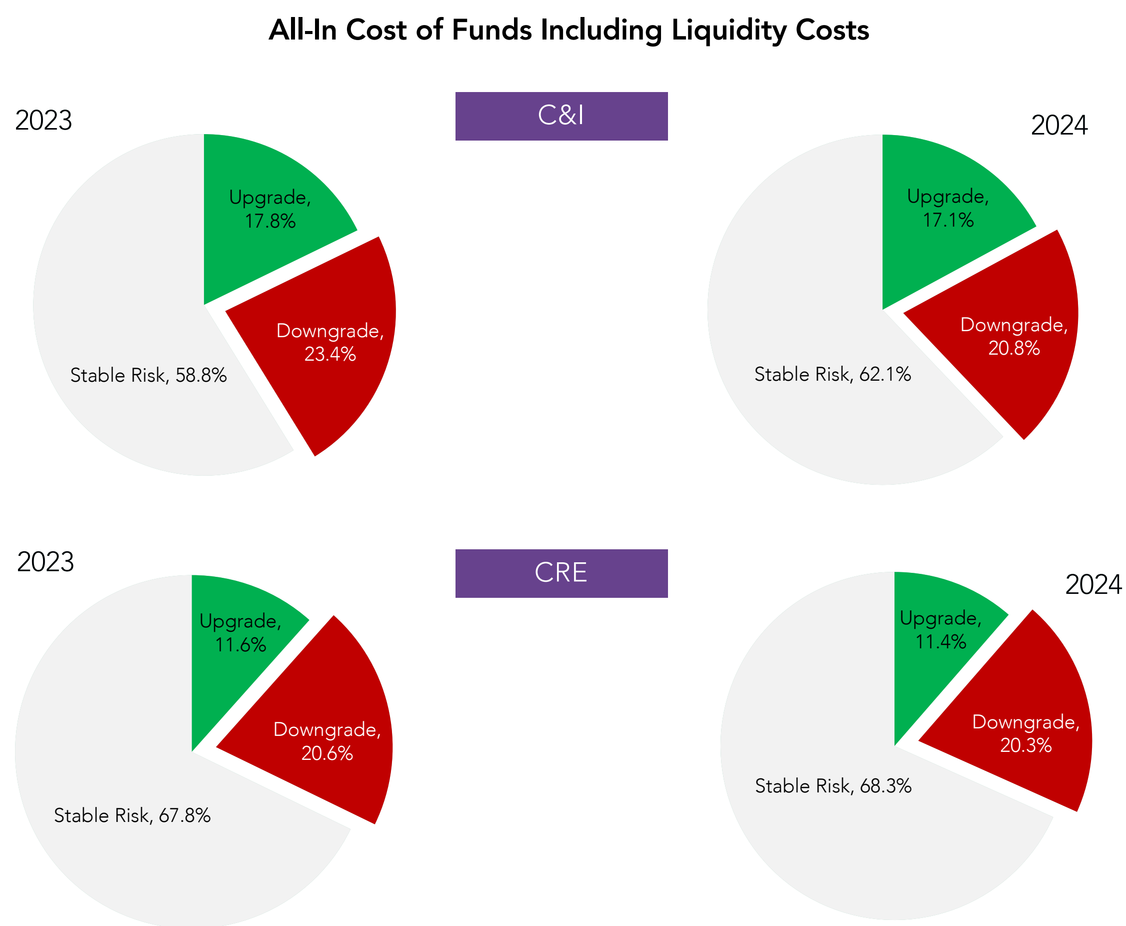
Figure 31



Source: Federal Reserve.
Figures are seasonally adjusted and reflect all U.S. commercial banks.

C&I downgrade activity down year over year

Figure 32



On performing loans, an early indicator of credit stress is the internally assigned bank ratings, which remained largely stable throughout 2024. Most of both C&I and CRE credits experienced no changes in rating during the year. In fact, there was some improvement in the C&I segment, where the proportion of downgrades declined from 23% in the prior year to just under 21% (Figure 32).

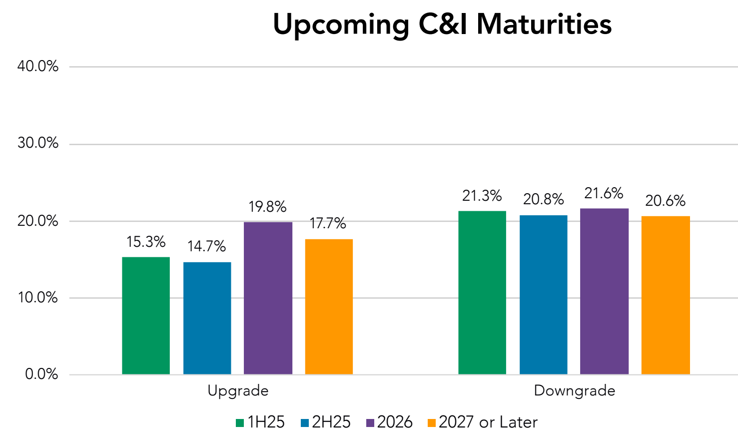
Source: Q2 PrecisionLender
Analysis shows the percentage of credits on which internally assigned borrower ratings were changed during the indicated period. Figures are weighted by outstanding balances.

The absence of any significant spike in downgrades in the CRE sector may seem surprising, but the aggregate stability belies greater scrutiny on those CRE deals approaching maturity. FIs have been proactively downgrading maturing deals more often than longer-term credits (Figure 33).

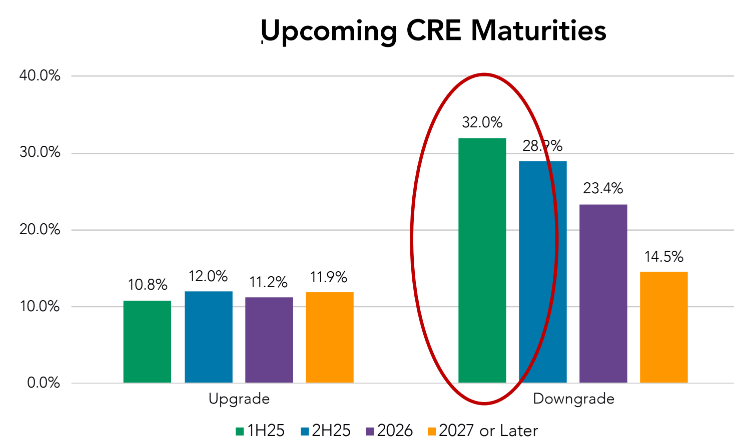
Downgrade activity highest on upcoming CRE maturities

Figure 33

C&I



CRE



Source: Q2 PrecisionLender
Analysis shows the percentage of maturing deals on which internally assigned borrower ratings were downgraded in 2024, segmented by maturity date. Figures are weighted by outstanding balances.

Part III:

Fighting Fraud Through Innovation and Collaboration

The financial services industry faces an unprecedented challenge: Fraud is at an all-time high and continues to grow annually. For bank and credit union executives, the pressing need to combat payments fraud—particularly check fraud—demands a united, proactive response. By prioritizing collaboration, leveraging advanced technologies, and reimagining their approach to fraud prevention, FIs can protect both their customers and their own financial health.

The Rising Tide of Payments Fraud

According to the 2024 AFP Payments Fraud and Control Survey Report[i], 80% of U.S. organizations experienced payments fraud in 2023. Check fraud remains prevalent, despite the increasing digitalization of financial services.

Technological solutions such as positive pay—a system that matches issued checks with those presented for payment—offer promising defenses. In 2024, Q2's positive pay solution prevented over $3.6 billion in fraudulent check and ACH transactions across 587 institutions, which averages to almost $6.3 million per institution. That's a significant increase from $1.4 billion for 341 institutions in 2023, which averaged about $4.1 million. However, adoption rates for positive pay in general are lagging.

2024 Q2 positive pay fraud stopped

Figure 34

$3.6 billion

in fraudulent check and ACH transactions stopped **across**

587

institutions

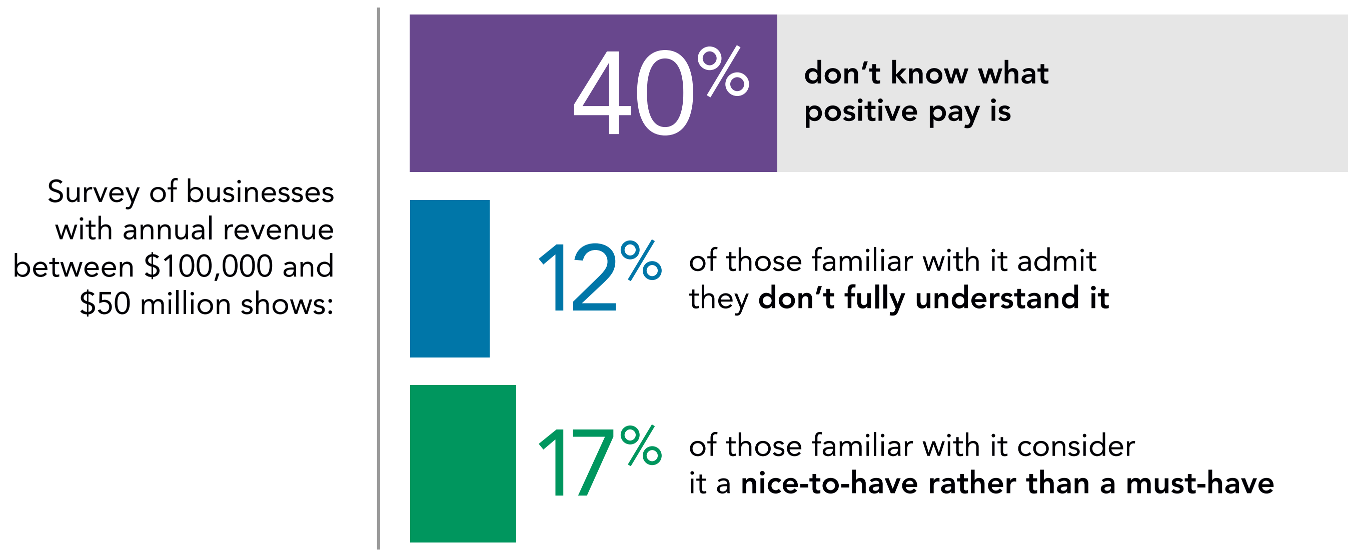
160%

YoY increase

Source: Centrix Exact TMS™

Lack of understanding about positive pay

Figure 35



A January 2024 Datos Insights report[ii] revealed that nearly 40% of business owners with annual revenue between $100,000 and $50 million were unaware of positive pay. Even those familiar with the technology often fail to use it due to inadequate promotion by FIs or a lack of understanding of its value. To combat fraud effectively, FIs must bridge this knowledge gap by educating businesses and actively promoting protective solutions.

Source: Datos Insights

The True Cost of Fraud

Fraud is not just a financial loss; it's a multifaceted drain on resources, reputation, and customer trust. The 2022 LexisNexis True Cost of Fraud Study[iii] revealed that the impact of fraud is approximately seven times the cost of the fraudulent transaction itself. For every dollar lost to fraud, an FI incurs costs of up to $4.36 in mitigation, management, and recovery efforts.

Additionally, many FIs adopt hardline responses to fraud, such as freezing accounts, which creates a fragmented customer experience. According to Alloy's 2024 State of Fraud Benchmark Report[iv], midmarket and regional FIs are over twice as likely as fintech companies to take this approach. While effective in containing immediate risks, these methods often alienate customers and damage relationships.

Advanced technologies, particularly AI, show promise as effective weapons in the battle against fraud. AI tools can analyze vast datasets to identify and mitigate fraud risks before they impact customers, enabling FIs to adopt a more lenient and customer-friendly stance while maintaining security. By leveraging AI to proactively identify red flags, FIs can reduce the cost of fraud while improving the customer experience.

Likelihood to freeze account when fraud is detected

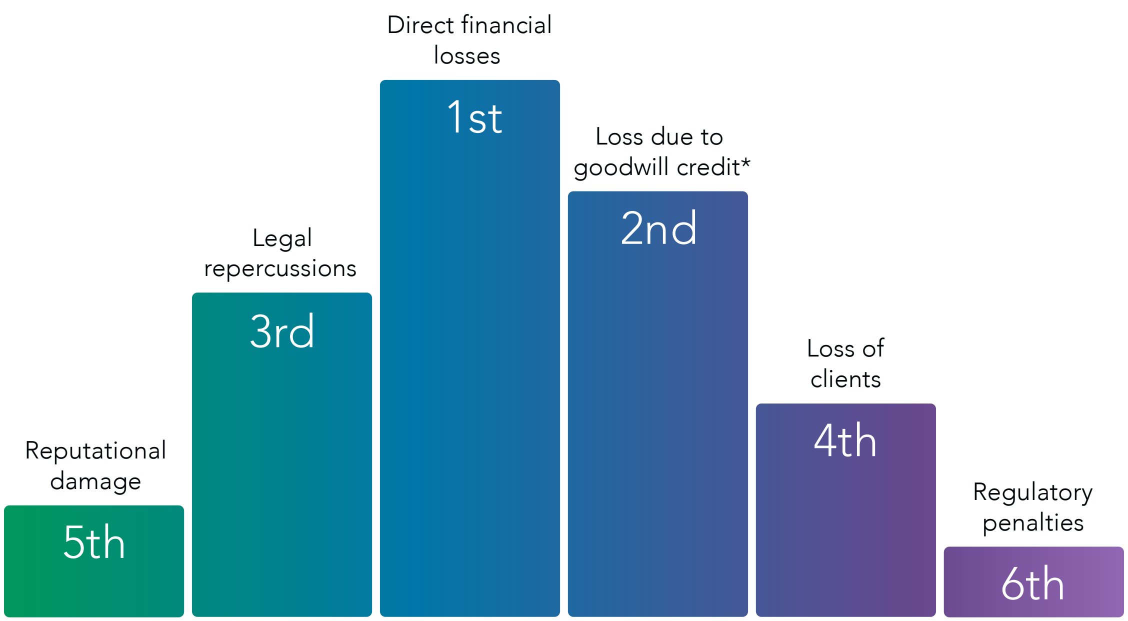
Figure 36

		FINTECH				BANKS				
	Total (N=450)	Growth fintech (N=15)	Strategic fintech (N=32)	Mid-market fintech (N=31)	Enterprise fintech (N=41)	Enterprise bank (N=68)	Mid-market bank (N=50)	Regional bank (N=43)	Credit union/ Community bank (N=42)	Online/ Pure pay lending (N=102)
Step up authentication – phone-centric verification	53%	67%	47%	45%	39%	56%	38%	37%	64%	69%
Step up authentication – selfie or liveness test	52%	33%	44%	26%	59%	53%	40%	40%	62%	65%
Step up authentication – document verification	51%	60%	53%	45%	49%	59%	36%	44%	40%	64%
Step up authentication – knowledge-based authentication (KBA)	47%	33%	38%	45%	41%	37%	46%	47%	48%	65%
Freeze account	**39%**	40%	34%	19%	39%	53%	70%	51%	40%	17%
Extend hold period	39%	27%	16%	52%	22%	44%	52%	42%	43%	36%
Lower payment limits	35%	33%	47%	42%	41%	47%	40%	30%	24%	25%
		Small base size (<30)								

Source: Alloy

Top fraud concerns

Figure 37



*Added in 2023
Chart displays choices in order from highest percentage ranked number 1 to lowest

It's Time for the Banking Industry to Unite

To make true, meaningful advances against fraud, FIs need a unified response based on collaboration and data. Centralized information is essential, both within individual FIs and across the banking industry. According to Alloy's 2024 report, direct financial losses from fraud are the top concern for executives at all management levels, overshadowing reputational risks and goodwill losses. However, the fragmented approach many FIs take—relying on siloed data and isolated systems—significantly hampers progress.

When fraud prevention efforts remain confined within individual FIs, the risk merely shifts from one institution to another. With collaboration among institutions, FIs can systematically reduce fraud across the sector. This requires the creation of fraud-fighting networks where institutions share information about bad actors. By pooling resources and intelligence, FIs can preemptively address threats, protecting customers and reducing losses for everyone.

A critical yet often overlooked area is scam fraud. Because its direct financial impact is usually borne by customers rather than FIs, many institutions deprioritize it. However, a collective effort to share insights and strategies can mitigate scam fraud effectively, enhancing trust and loyalty among customers.

Source: Alloy

The Path Forward: Proactive, Collaborative Solutions

The escalating burden of fraud presents both a challenge and an opportunity for FIs. By embracing advanced technologies, promoting proven solutions like positive pay, and fostering collaboration across the industry, FIs can redefine their role in fraud prevention. To succeed, FIs should:

- **Educate and promote:** Actively inform business customers about available tools and their value. Positive pay, for example, should be marketed as a must-have solution for modern financial security
- **Invest in AI and automation:** Advanced analytics can transform fraud prevention from reactive to proactive, identifying threats before they materialize
- **Adopt centralized data strategies:** Breaking down silos within institutions and across the industry is critical to developing a unified defense against fraud
- **Collaborate across the industry:** Sharing data on fraud trends and bad actors can create a collective shield, reducing risks for everyone

[i] "2024 AFP Payments Fraud and Control Survey Report," Association for Financial Professionals, 2024

[ii] "The Opportunity Your FI Is Missing by Not Effectively Selling Positive Pay," Datos Insights, January 2024

[iii] "6th Annual True Cost of Fraud™ Study: Financial Services and Lending Report," LexisNexis, 2022

[iv] "2024 State of Fraud Benchmark Report: Fraud Trends and Predictions," Alloy, 2024

Part IV:

Capturing the $100 Billion SMB Opportunity

Small and medium-sized businesses (SMBs) represent one of the most overlooked and rapidly evolving segments in the financial services landscape. According to a 2023 Accenture report[i], SMB banking revenue in the United States was forecast to reach $100 billion by 2025. However, this big-opportunity market is characterized by volatility, with SMB owners demonstrating a pronounced willingness to switch FIs or find other banking solutions when their needs are unmet. Another 2023 Accenture report predicted that $32 billion of SMB banking revenue could shift from traditional banking offerings to embedded finance experiences by 2025.[ii]

Other recent surveys underscore the urgency for FIs to address this churn. A 2023 McKinsey survey[iii] revealed that 41% of surveyed SMBs expressed a likelihood to switch their primary bank within 12 months. Similarly, Datos Insights found that this likelihood surged from 19% in January 2023 to 32% by January 2024 for surveyed businesses generating annual revenue between $100,000 and $20 million. For FIs, this indicates a dual challenge: capturing market share in a competitive environment and ensuring the retention of existing SMB clients through enhanced offerings.

Willingness of SMBs to leave their primary FI

Figure 38

$32 billion

of SMB banking revenue could shift from traditional banking offerings to embedded finance experiences by 2025

accenture

41%

of surveyed SMBs expressed a likelihood to switch their primary bank within 12 months

McKinsey & Company

Likelihood to leave surged from

19% in Jan 2023

to

32% by Jan 2024

datos INSIGHTS

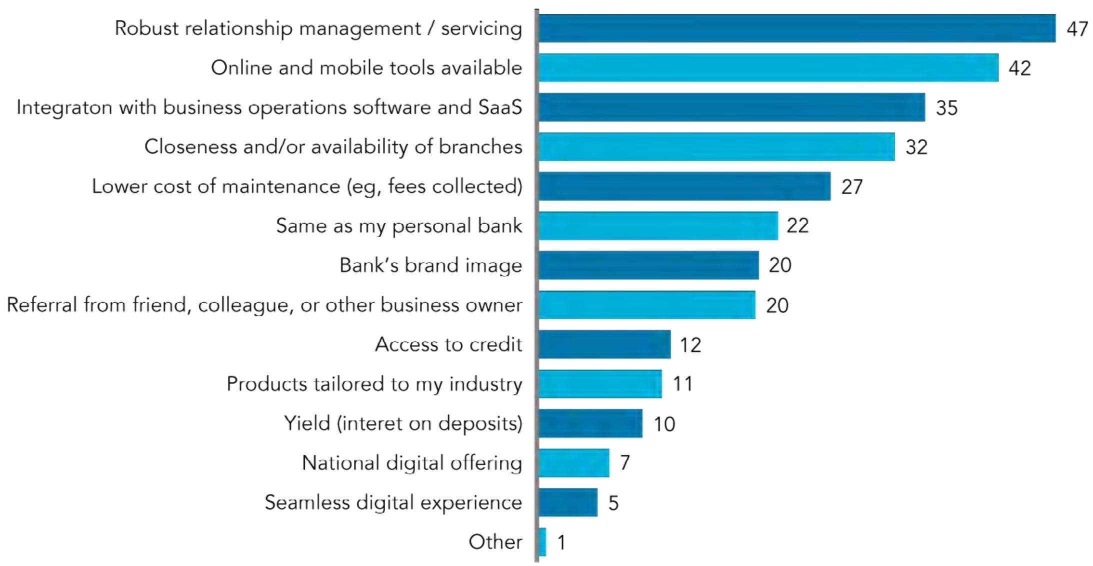
Meeting SMBs' Evolving Expectations

SMBs are actively seeking banking experiences tailored to their unique needs, with an increasing emphasis on digital capabilities. McKinsey's 2023 research highlights that 42% of SMBs prioritize online and mobile tools—a notable rise from 37% in 2022.

Despite the rise of non-bank fintechs, traditional banks retain a critical trust advantage. In McKinsey's survey[iv], 70% of SMBs still preferred banks for their lending needs, compared to only 30% who considered non-bank fintechs. However, the appeal of fintechs lies in their flexibility, with features like payments via credit card receivables and streamlined application processes serving as key differentiators. For banks and credit unions to maintain their edge, they must leverage this trust by expanding digital offerings and replicating fintechs' efficiency and innovation. Rather than trying to compete with fintechs, FIs should look to partner with them to provide business-critical capabilities, such as payroll, invoicing, and cash forecasting.

Most important criteria for SMBs when selecting a primary FI[1]

Figure 39



[1] Respondents were asked to select their top 3 reasons for choosing a primary bank, defined as one that holds 40% or more of the SME client's deposits.
Source: McKinsey 2023 SME survey (n = 1,200+)

Source: McKinsey & Company

Addressing the Disconnect Between Offerings and Needs

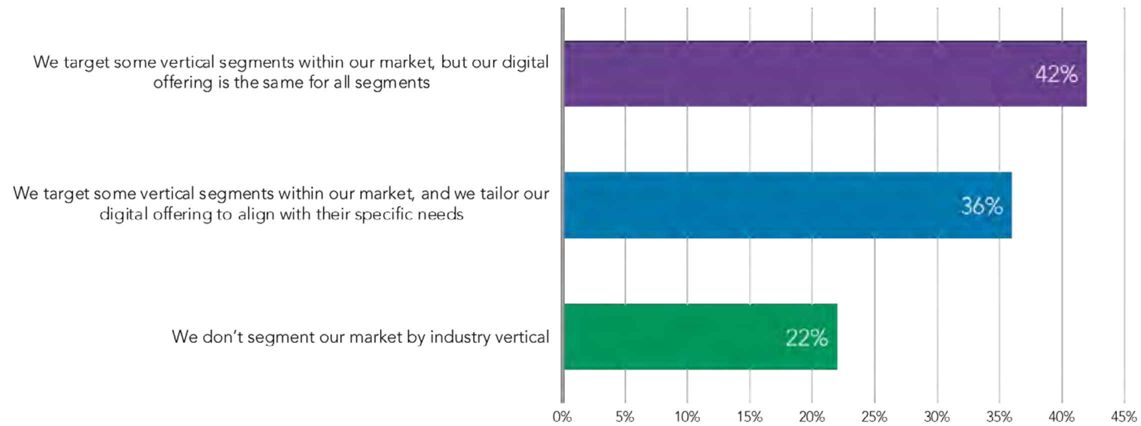
The gap between SMB needs and current FI offerings is stark. In a December 2024 webinar hosted by American Banker[v], Accenture research was shared that showed only 9% of SMBs felt their financial institution was fully meeting their needs. Moreover, 69% of SMBs considered robust digital capabilities a critical factor when selecting an FI. Yet, many banks and credit unions fall short in delivering on these expectations.

The issue stems partly from a lack of targeted segmentation and innovation. Of the FIs surveyed during the December 2024 webinar, 42% are segmenting their SMB portfolio by vertical but are offering the same services across all segments, while 22% reported no segmentation by industry vertical at all. Only 36% reported that they tailor their digital offering to align with the needs of their targeted segments. This lack of tailored solutions exacerbates the disconnect. SMBs need banking services designed with their needs in mind, not overly simplified consumer services or overly complicated commercial services.

And for SMBs, the need goes beyond banking. SMBs face pressing challenges such as growing their business, managing cash flow, and navigating supply chain complexities. They're far less focused on banking. However, although Accenture research shows banking ranks sixth among SMBs' primary concerns, SMB owners value banking partners who can address broader business challenges through integrated solutions and personalized support. Integrating fintech solutions into digital banking platforms offers an avenue to enhance service delivery, and the FIs who get on board have a competitive advantage.

Survey: To what extent is your financial institution focused on specific industry verticals within your market?

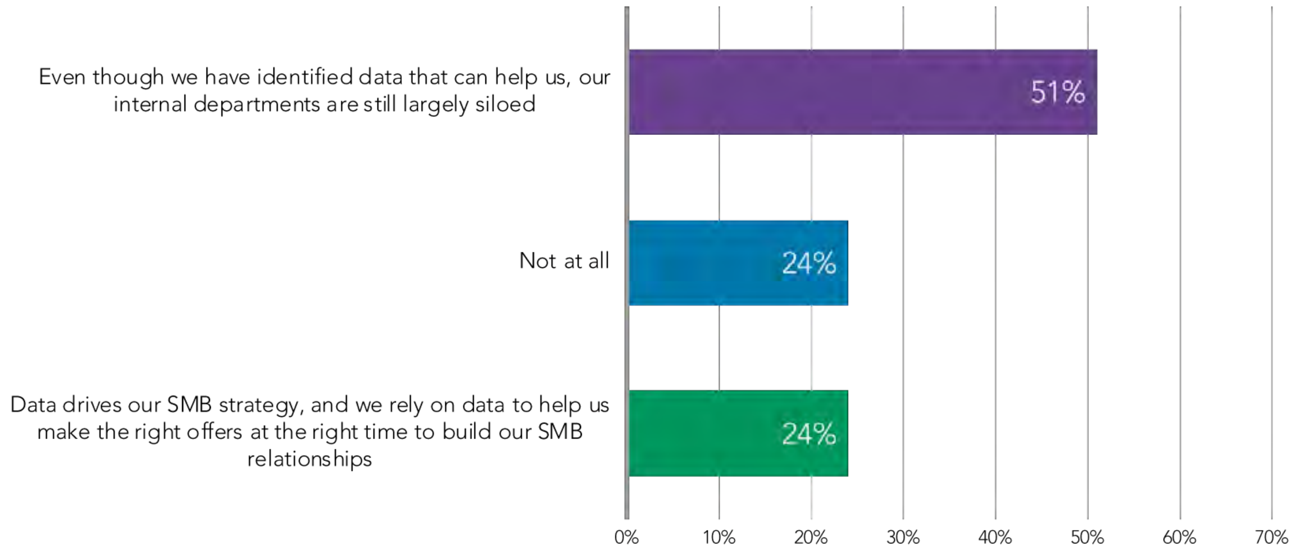
Figure 40



Source: Q2

Survey: To what extent is your financial institution using data to inform your relationships with SMB customers?

Figure 41



Harnessing Data to Grow Relationships

To bridge these gaps, FIs must embrace the transformative power of data and technology. By using data to create personalized experiences for SMB clients, banks and credit unions can deliver timely, relevant solutions that drive engagement and loyalty. The potential of GenAI further amplifies this opportunity, enabling advanced data analysis and hyperpersonalized outreach at scale. For example, what if, after first identifying that SMBs in the health care vertical are particularly profitable for your FI, you were able to leverage that insight to bundle the banking services and tools they rely on most—and deliver it all through a tailored digital experience designed specifically for how they operate?

Yet, many FIs struggle to operationalize their data. According to the December 2024 webinar, only 24% of attendees reported that their SMB strategy is data-driven and supports delivering the right offers at the right time; 51% acknowledged identifying useful data but cited organizational silos as a barrier to effective implementation, and 24% admitted to not using data to inform SMB strategies at all.

Source: Q2

Building the SMB Banking Model of the Future

For banks and credit unions, the SMB market presents a compelling opportunity to drive profitable growth and deepen customer relationships. To succeed, FIs must:

- **Invest in robust digital platforms:** Modernize infrastructure to support seamless online and mobile banking experiences
- **Adopt targeted segmentation:** Design industry-specific products and services to meet the distinct needs of different SMB segments
- **Leverage data for personalization:** Use actionable insights to tailor solutions to individual SMB needs, supported by GenAI capabilities
- **Expand fintech partnerships**: Integrate innovative fintech solutions into digital offerings to address broader SMB challenges

[i] "How to Win in SMB Merchant Acquiring," Accenture, 2023

[ii] "Commercial Banking Top Trends in 2023," Accenture, 2023

[iii] "Five Ways for Banks to Better Serve Small Business Clients," McKinsey & Company, Dec. 12, 2023

[iv] "Driving Growth and Leading in the SME Segment," McKinsey & Company, September 2023

[v] "The Future of SMB Banking: Partnership and Innovation," American Banker, Accenture, and Q2, Dec. 9, 2024

Part V:

The Criticality of Payments Modernization

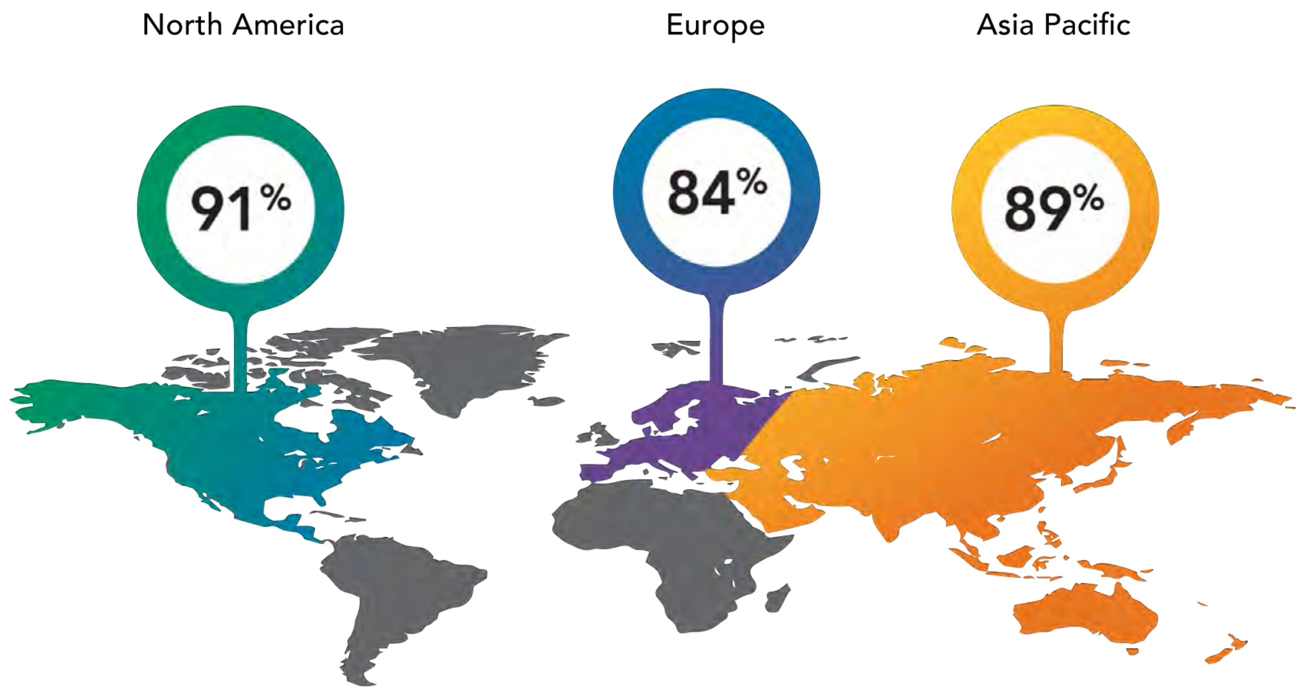
The financial industry is undergoing a profound transformation as business customers increasingly demand more efficient and user-friendly services from their FIs. For midsize and large companies, the emphasis is on streamlining back-end processes through innovations such as accounting system integration, integrated receivables, and the new instant payment rails. As these technologies evolve, financial institutions must rise to the challenge to compete.

The Drive for ERP Integration

Large and medium-sized businesses are prioritizing the integration of their accounting systems with digital banking platforms. This demand has been evident for years, with a 2022 Accenture study[i] revealing that 65% of businesses with over $250 million in revenue prefer using their treasury management systems (TMS) or enterprise resource planning (ERP) systems for banking operations. This trend has only intensified, with 2024 Datos Insights research[ii] showing 91% of midsize and large businesses in North America identifying ERP integration as important or very important.

Share of companies by region who say it's very important or important to run banking operations from their enterprise system

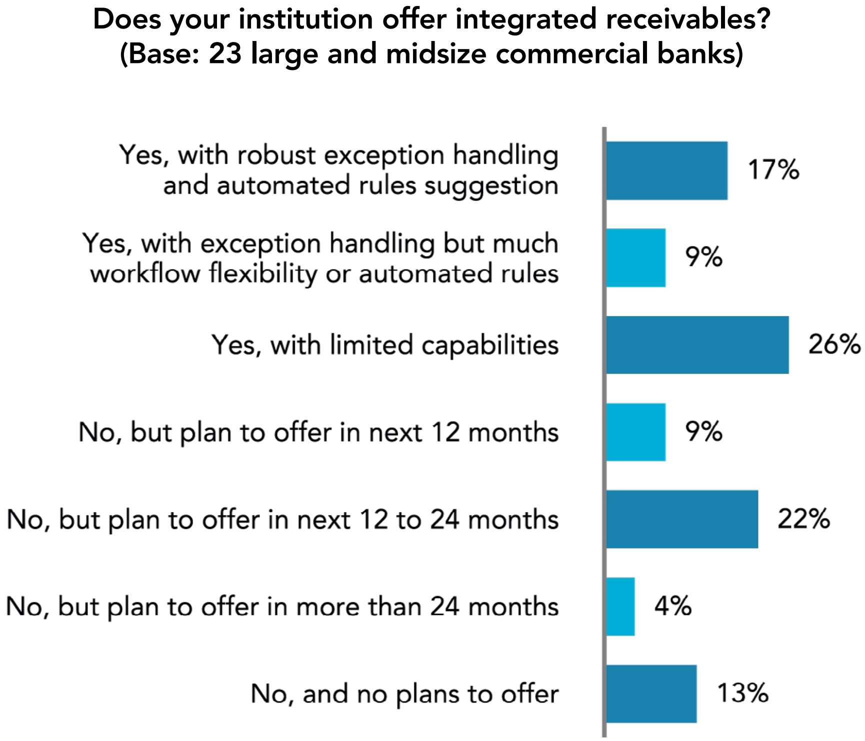
Figure 42



Source: Datos Insights

Large and midsize FIs offering integrated receivables

Figure 43



Despite its importance, adoption remains slow due to the complexity of integration. As the industry works to untangle the technology, many FIs are opting for interim solutions such as secure file transfer protocol (SFTP) or API batch integrations. A 2024 Datos Insights study[iii] showed that 52% of FIs already offer integrated receivables solutions, with another 31% planning to implement them within two years; however, the sophistication of these solutions varies significantly.

These technologies automate the delivery and receipt of ACH and wire payments, reducing manual intervention and improving cash application accuracy. They also enhance operational efficiency by decreasing days sales outstanding and increasing straight-through processing rates, providing businesses with better insights into cash flow management.

Source: Datos Insights

Next Steps in Instant Payments

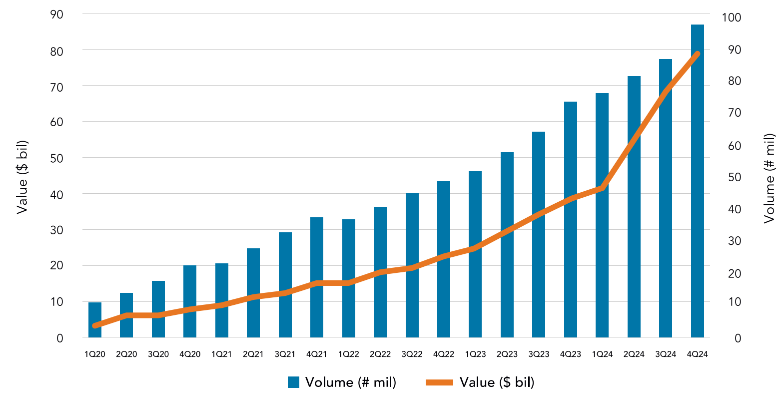
Instant payment networks are gaining momentum, with 2025 anticipated to be a "hockey stick year" for adoption. A Statista forecast[iv] predicts a 289% increase in transaction value for instant payments between 2023 and 2030. However, many FIs lag in offering comprehensive send-and-receive capabilities, a critical component for unlocking the full potential of instant payments in the B2B space.

As of January 2025, RTP® was connected to about 850 institutions, accounting for approximately 70% of U.S. bank accounts and processing payments for about 250,000 businesses each month[v]. FedNow®, launched in summer 2023, had onboarded more than 1,200 institutions and showed steady quarter-to-quarter volume growth throughout 2024[vi]. The Datos study showed that, as of October 2024, 83% of those surveyed were planning to offer FedNow services by 2026.

Source: [1]The Clearinghouse
[2]The Federal Reserve

RTP quarterly payment activity[1]

Figure 44



4Q24

98 million
transactions for $80 billion

12%
volume growth

16%
value increase

FedNow quarterly payment activity[2]

Figure 45

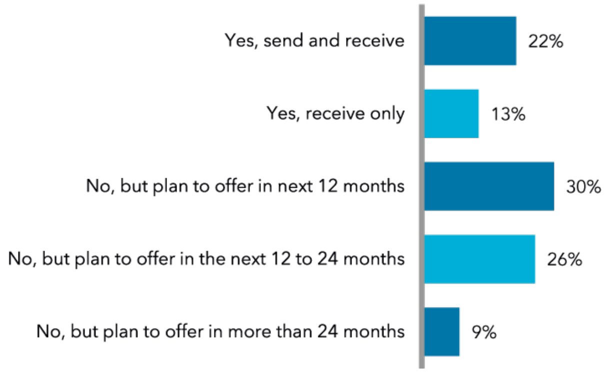
Quarter	Total Settled Payments	Quarterly Volume Growth (percent)	Value of Settled Payments ($)	Quarterly Value Growth (percent)	Average Value per Payment ($)	Average Daily Volume of Settled Payments	Average Daily Value of Settled Payments ($)
2024: Q3	336,487	115.6%	$17,491,272,167.40	3453.3%	$51,982.01	3,657	$190,122,523.56
2024: Q2	156,076	60.2%	$492,250,054.25	1466.6%	$3,153.91	1,715	$5,409,341.26
2024: Q1	97,424	133.6%	$31,421,884.71	130.1%	$322.53	1,071	$345,295.44
2023: Q4	41,698		$13,656,607.58		$327.51	453	$148,441.39
2023: Q3	5,564		$4,776,755.83		$858.51	75	$64,550.75

1. Transfers represent settled customer credit transfers only.
2. Q3 2023 does not reflect a full quarter.
3. 3. Calendar day is used instead of business day.

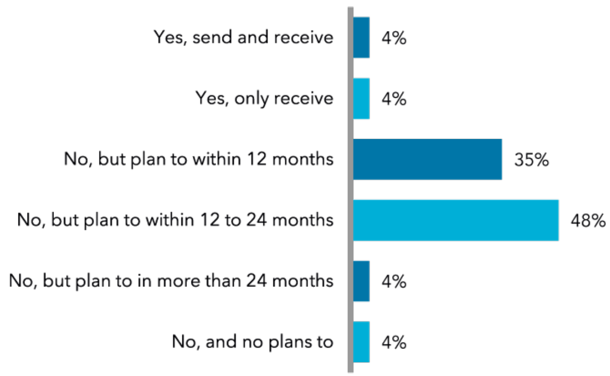
Percentage of FIs now sending and receiving on RTP and FedNow

Figure 46

Does your institution offer clients access to the RTP network? (Base: 23 large and midsize commercial banks)



Does your financial institution offer FedNow to business clients? (Base: 23 large and midsize commercial banks)



Although adoption in general is moving quickly, FIs have been slower to offer send capabilities. However, research shows that the next couple of years will see a big upswing. According to the Datos payments study, only 22% of institutions currently offer full RTP send-and-receive capabilities, and 4% offer full send-and-receive on FedNow. But over the next two years, 56% plan to implement these services on RTP, and 48% plan to implement them on FedNow. Also, while only 17% of institutions currently offer request for pay (RfP) capabilities on RTP, 65% plan to implement this feature by 2026.

Source: Datos Insights

Key Actions to Move Payments Forward

To meet business customer demand for efficiency and a better payments experience, FIs must focus on integrated solutions and instant payment capabilities:

- **Adopt new technology:** Prioritize the development of seamless ERP and TMS integrations to address customer preferences and operational efficiency
- **Enhance interim solutions:** Batch integrations can provide immediate value, but institutions should work toward more sophisticated offerings to stay ahead of competitors
- **Expand instant payment capabilities:** Offering full RTP and FedNow services, including send-and-receive functionality and RfP, will be critical for capturing the growing instant payment market

[i] "Unlock the treasury management treasure chest: Evolve your offering, grow your opportunity," Accenture, 2022

[ii] Datos Insights survey of 1,037 midsize and large organizations, Q3 2024

[iii] "Payment Maturity at Financial Institutions," Datos Insights, October 2024

[iv] "Transaction value of real-time payments worldwide in 2024, with a 2028 forecast," June 25, 2024, Statista

[v] https://www.theclearinghouse.org/payment-systems/rtp

[vi] https://www.frbservices.org/resources/financial-services/fednow/quarterly-volume-value-stats

Conclusion

Following a tumultuous year, the commercial banking sector has regained its footing. The industry successfully tackled an unprecedented liquidity crisis sparked by the fastest rate hikes in 40 years, turning deposit outflows to inflows. FIs uncovered winning tactics for growing and retaining deposits, absorbing higher costs in order to shore up liquidity. They used rate as a catalyst for winning new client relationships, offering attractive promotional pricing and strategically setting deposit betas rather than simply following the Fed.

The industry also navigated an evolving regulatory environment, where initial expectations of multiple rate cuts gave way to the realities of a "higher for longer" environment. FIs adjusted pricing strategies to reflect more realistic expectations of midterm rates and stepped up focus on cross-sell to bolster relationship profitability in the face of shrinking NIM. At the same time, the industry maintained solid credit risk with only pockets of stress within the commercial real estate arena. In review of the final quarter of 2024 for commercial loan pricing activity, bankers and borrowers have materially adjusted the coupon rates upward on fixed-rate loans and lower on floating-rate structures. Heading into 2025, banks' NIM value measurement shows "green shoots" for fixed-rate structures while SOFR has lost ground.

In the new year, financial institutions have unprecedented opportunities to use technology to solve challenges and better serve customers. Addressing the persistent threat of fraud, capitalizing on the underserved small and midsized business market, and advancing payments modernization represent key areas where financial institutions can drive innovation and achieve strategic growth.

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