

# Community Banking 2024 & 2025

- Credit and Pricing Trends
- Interest Rates Forecasting
- How to Position Your Community Bank

Chris Nichols and Ed Kofman

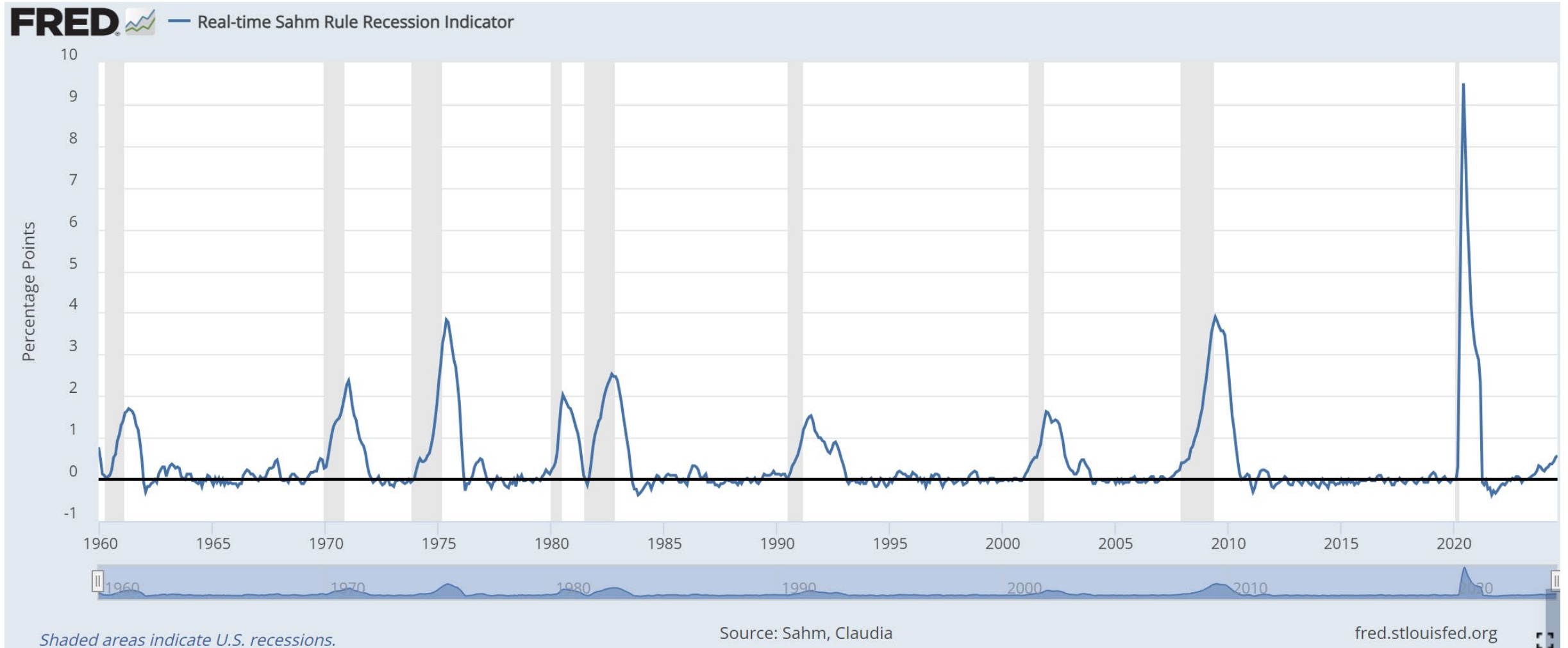


**Commercial Loan Credit &  
Pricing Trends  
For Q4 2024 & 2025**

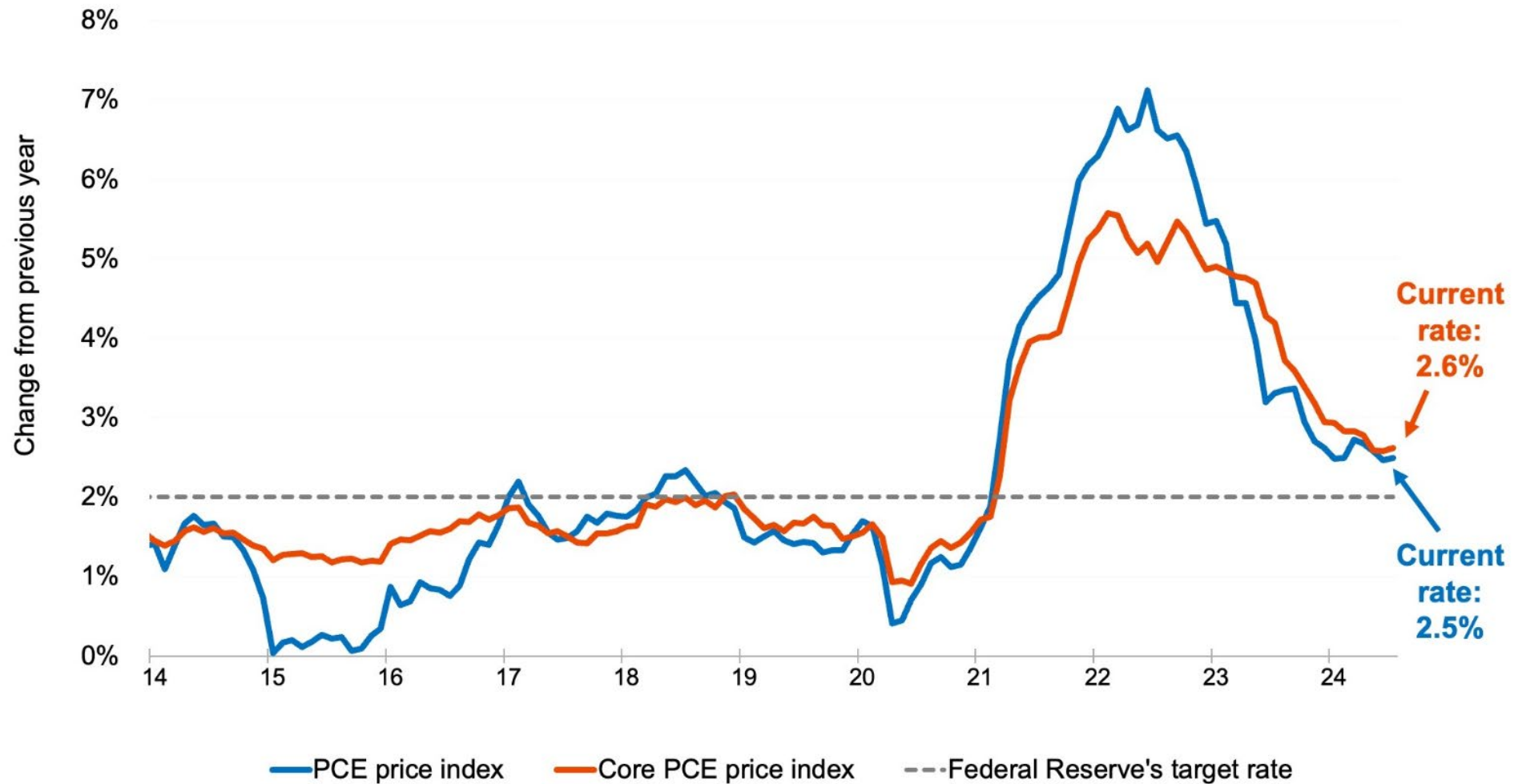
- Pricing/risk data and risk-adjusted profitability data from Loan Command aggregates for 3Q to date through 9/30/24.
- Commercial real estate sector performance data from CoStar as of 9/29/24.
- C&I /owner-occupied probabilities of default and loss given default based on PayNet (Equifax) model forecasted through June 2025.



# The Red Flag of the "Sahm Rule"

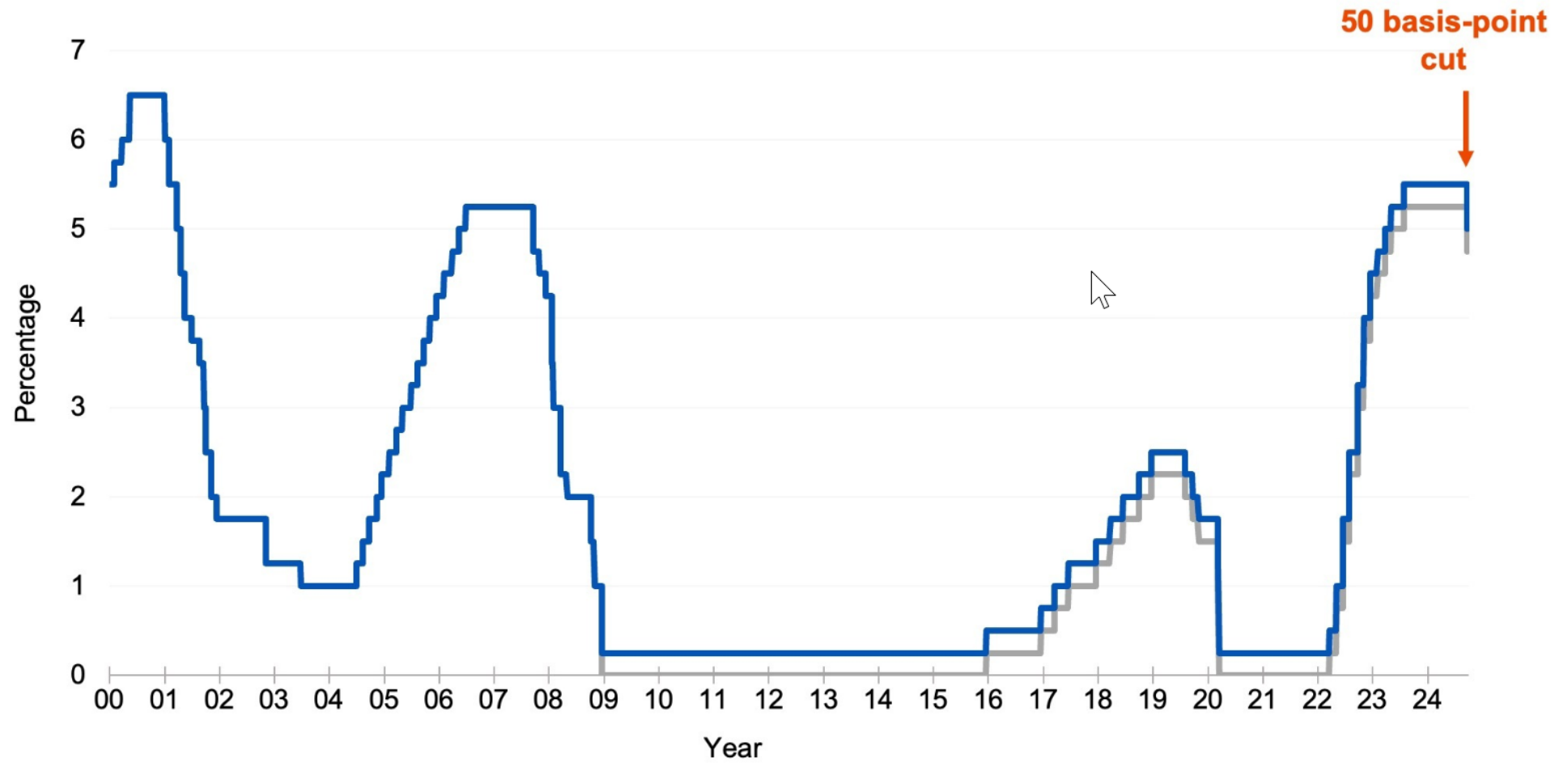


# Inflation Appears Under Control



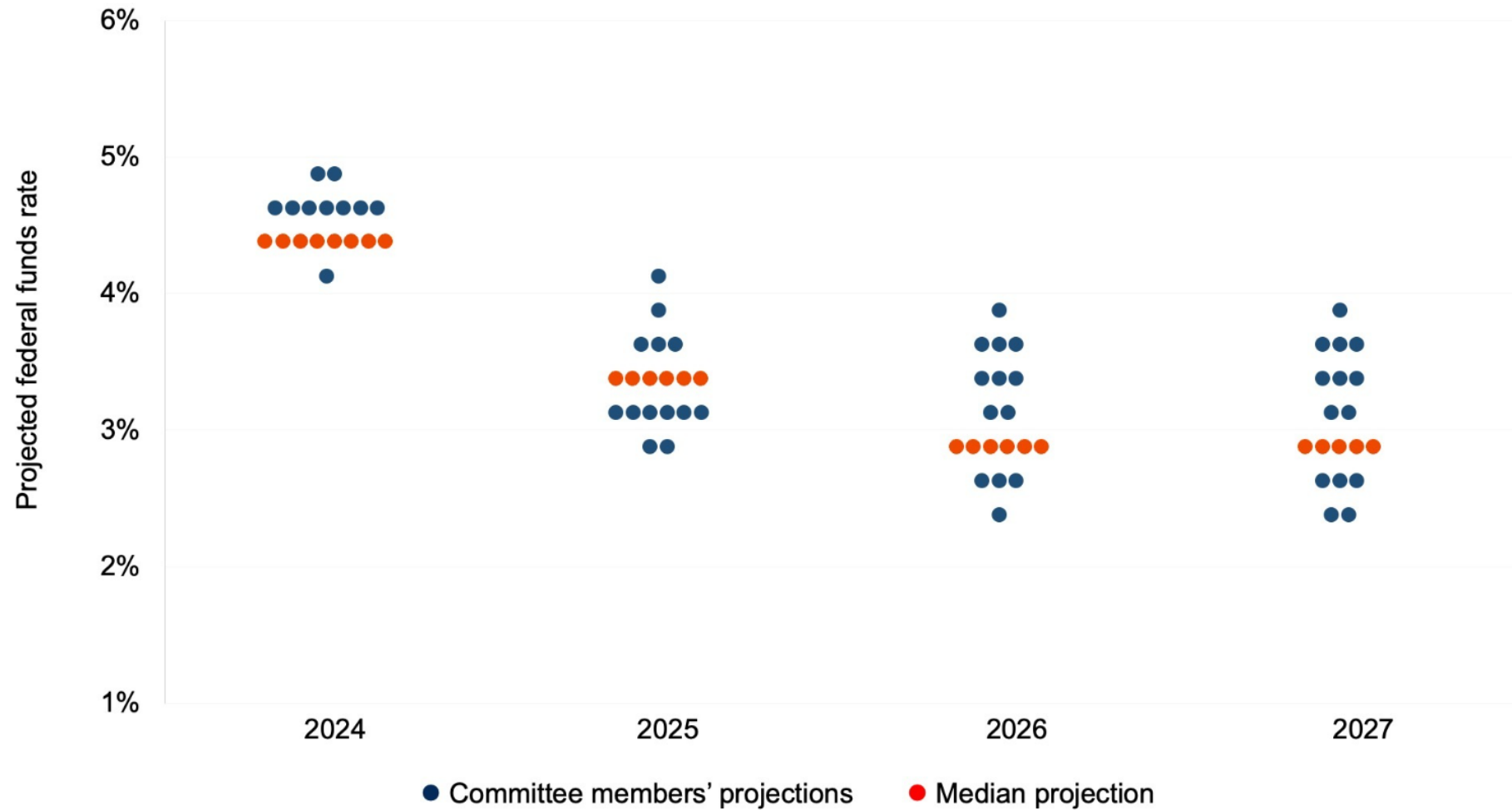
Source: Bureau of Economic Analysis

# The Fed Has Started To "Recalibrate"



— Federal funds target rate, lower bound — Federal funds target rate, upper bound  
Source: Federal Reserve Board

# Fed Sees Rates Falling Through 2026



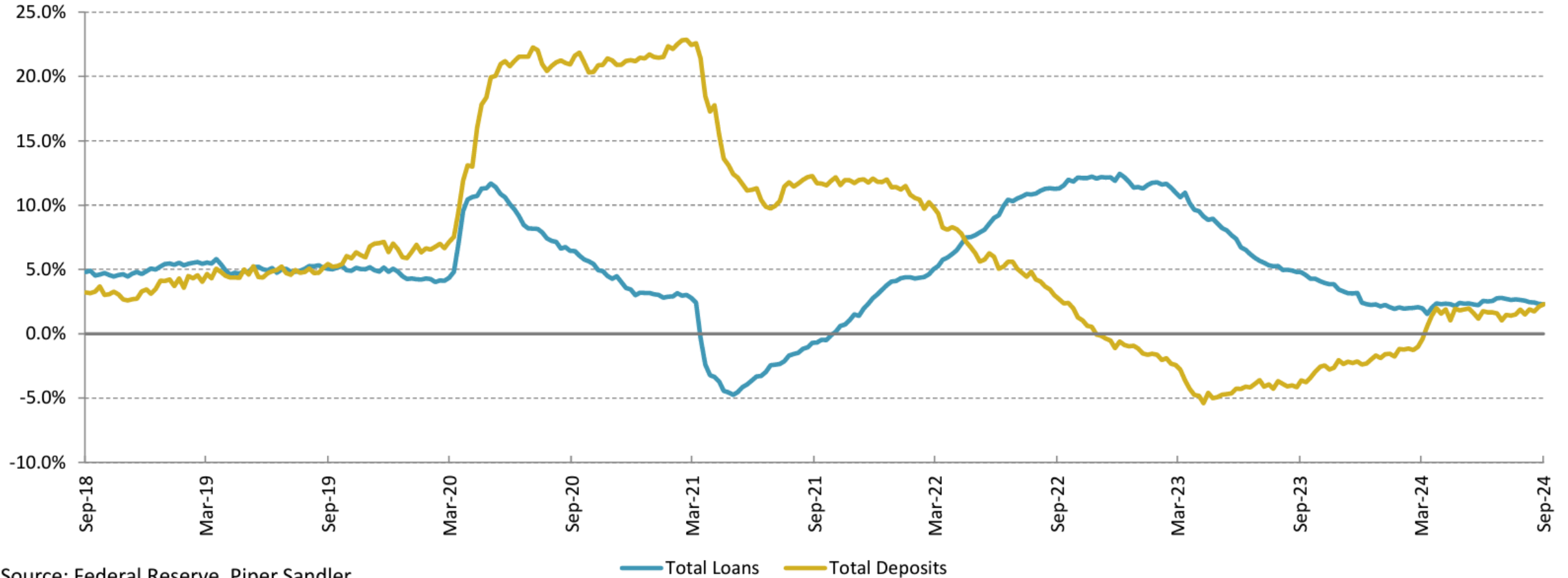
Source: Federal Reserve, Sept. 18, 2024 Federal Open Market Committee projections

# Loan and Deposit Growth



## All Commercial Banks: Total Loans vs. Total Deposits

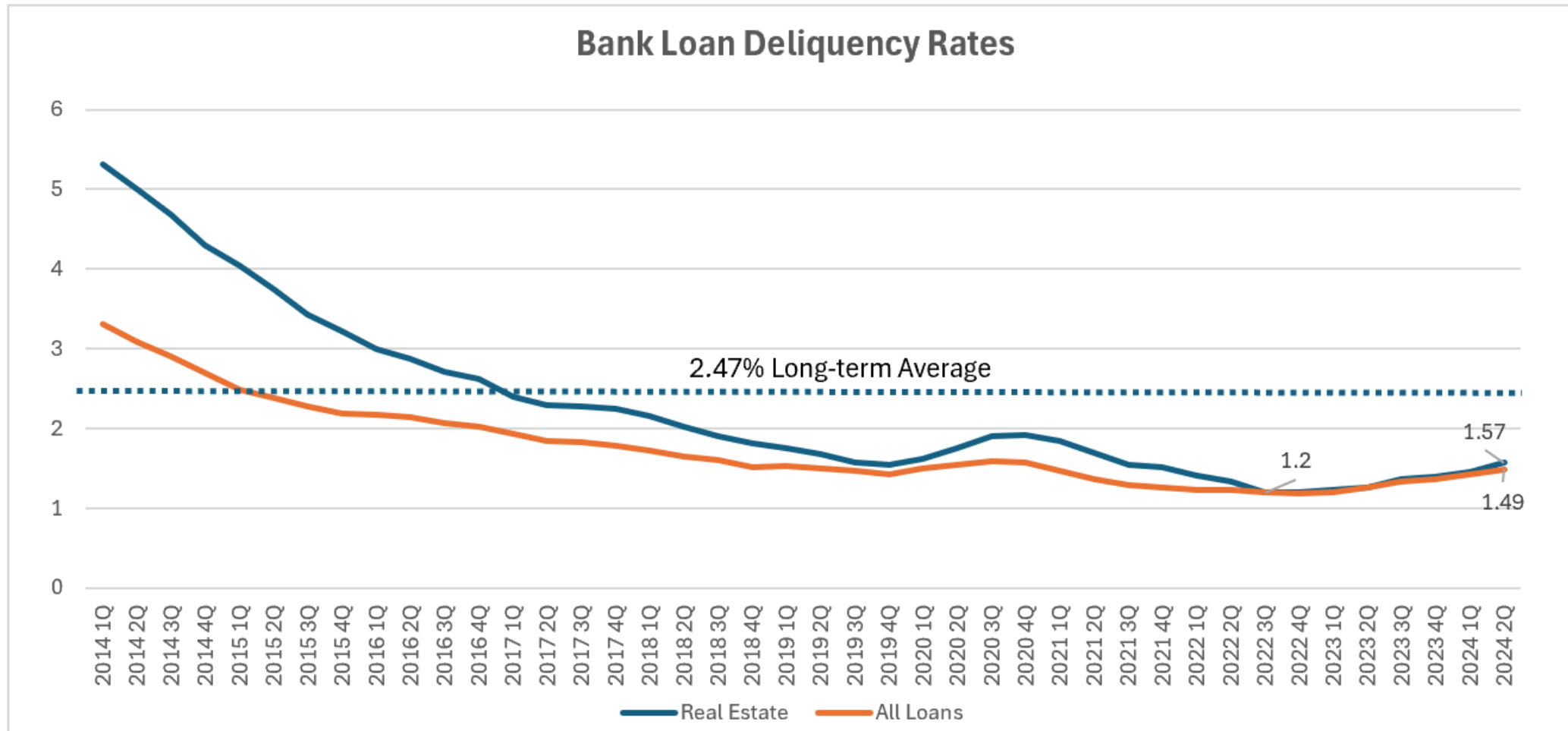
YoY Growth | 5 Year Period



Source: Federal Reserve, Piper Sandler



# Loan Delinquencies are Rising But Muted



Source: Paynet June 2024



- Muted rising credit risk
- Home prices remain at record levels
- Slowing pace of Fed balance sheet runoff helping deposit growth.
- Loan growth is slowing: 2.3% for industry, 3.4% for community banks
  - C&I: 0.8%
  - CRE: 1.9%
- Office risk rising but could be OK
- Some relief but remaining cost of funds pressure

# 4Q Pricing Trends - Summary



- Nominal spreads reversed a trend and tightened 20 bps in 3Q due to expectations of better credit quality and margins. Average SOFR-equivalent credit spread for community banks is currently 2.35% starting 4Q, a trend we expect to stabilize.
- Target risk-adjusted ROE shifted from 16% to 20% due to cost of fund relief.
- The average through-cycle probability of default (POD) is 0.49%, down 2 bps. from 1Q 2024. POD volatility is flat in 2Q and remains low at 0.27%.
- Expected loss given default increased 1.5% percentage points to 44.0% (due to higher cap rates).
- Average community bank portfolio expected loss increased 7bps to 0.28%, or well within bank reserve levels.

# ROE Targets ARE Increased YOY



## LOAN COMMAND

Calculator Scenarios Relationships Loans Pipeline Stats

CALCULATION ANALYSIS CASH FLOW SUGGESTIONS

NEW SCENARIO

Nashville

TYPE New Commercial

Owner CRE

Beverage Manufacturing

\$1,000,000

SOFR 1M | 2.55%

0%

120 Mo

120 Mo

0 Mo

Set Deposits

5

37011

Add Comments

BOOK SCENARIO

### LOAN METRICS



RETURN ON ASSETS

1.6%

DEBT YIELD

21.6%

NOMINAL NIM

3.6%

NET PROFIT

\$89,952

ANNUAL PROBABILITY OF DEFAULT

2.50% 5.55% 8.23%

BASELINE ADVERSE SEVERELY ADVERSE

0.50% 5.00%

POD VOLATILITY

2.68%

AVERAGE

NET POD CHANGE

40.5%

LOSS GIVEN DEFAULT

42.5%

0% 100.00%

EXPECTED LOSS

1.06%

UNEXPECTED LOSS - CAPITAL AT RISK

\$58,989

RECALCULATE RESULTS

### LOAN METRICS

BOOK SCENARIO



RETURN ON ASSETS

2.0%

DEBT YIELD

20.4%

NOMINAL NIM

3.2%

NET PROFIT

\$111,044

ANNUAL PROBABILITY OF DEFAULT

2.50% 5.55% 8.23%

BASELINE ADVERSE SEVERELY ADVERSE

0.50% 5.00%

POD VOLATILITY

2.68%

AVERAGE

NET POD CHANGE

40.5%

LOSS GIVEN DEFAULT

42.5%

0% 100.00%

EXPECTED LOSS

1.06%

UNEXPECTED LOSS - CAPITAL AT RISK

\$58,114

# 4Q Loan Pricing and Expected Performance



**LOAN COMMAND** Calculator Scenarios Relationships Loans Pipeline Stats

NEW SCENARIO

**BORROWER** Nashville

**ORIGINATION TYPE** New Commercial

**LOAN TYPE** Owner CRE

**LOAN INDUSTRY** Beverage Manufacturing

**LOAN AMOUNT** \$1,000,000

**RATE** SOFR 1M | 2.35%

**FEES** 0%

**EXPECTED MATURITY** 120 Mo

**AMORTIZATION** 120 Mo

**INTEREST ONLY PERIOD** 0 Mo

**DEPOSITS** Set Deposits

**CREDIT** 4

**LOCATION** 37011

**COMMENTS** Add Comments

**RECALCULATE RESULTS**

**LOAN METRICS** BOOK SCENARIO

**Regulatory ROE**  
**20.6%**  
EXCELLENT

**Economic ROE**  
**21.2%**  
EXCELLENT

**Stressed ROE**  
**9.8%**  
LOW

**RETURN ON ASSETS** 2.1%

**DEBT YIELD** 22.9%

**NOMINAL NIM** 3.0%

**NET PROFIT** \$111,580

**ANNUAL PROBABILITY OF DEFAULT**

2.08% 5.55% 8.23%

BASELINE ADVERSE SEVERELY ADVERSE

0.50% 5.00%

**POD VOLATILITY** 2.68%  
AVERAGE

**NET POD CHANGE** 40.5%

**LOSS GIVEN DEFAULT** 27.5%

0% 100.00%

**EXPECTED LOSS** 0.57%

**UNEXPECTED LOSS - CAPITAL AT RISK** \$57,940

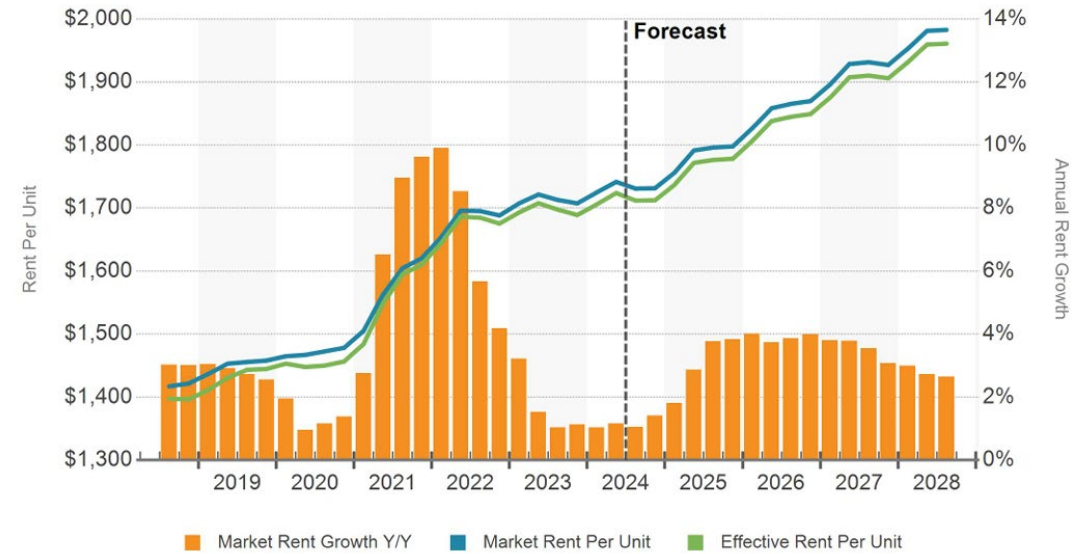
# Multi-Family



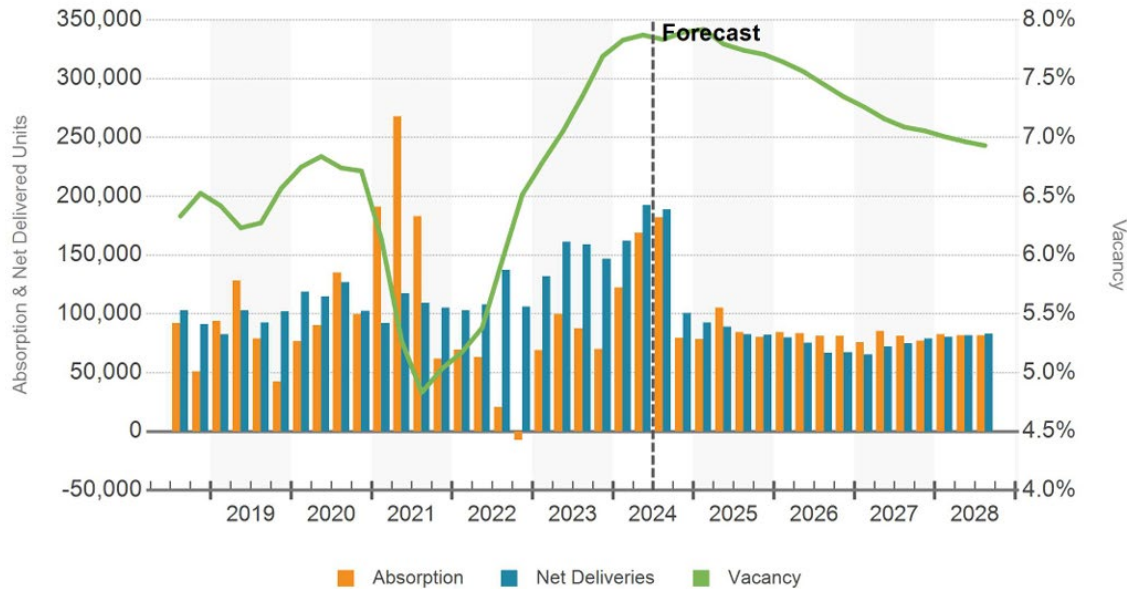
Demand is strongest since 2021 - driven by economic growth, plus higher rates hurting ownership. While supply additions have outpaced demand over the past 11 quarters, the gap has closed significantly. There is large regional variations.

	Historic	Current	5Y Forecast
Rent Growth	1.1%	2.2%	3.0%
Vacancy Rate	0.4%	6.7%	7.4%

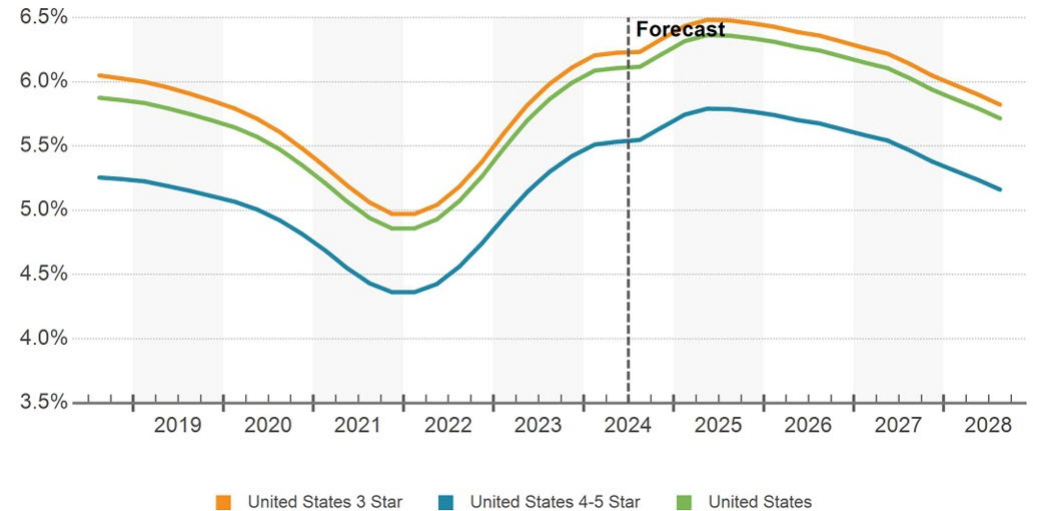
MARKET RENT PER UNIT & RENT GROWTH



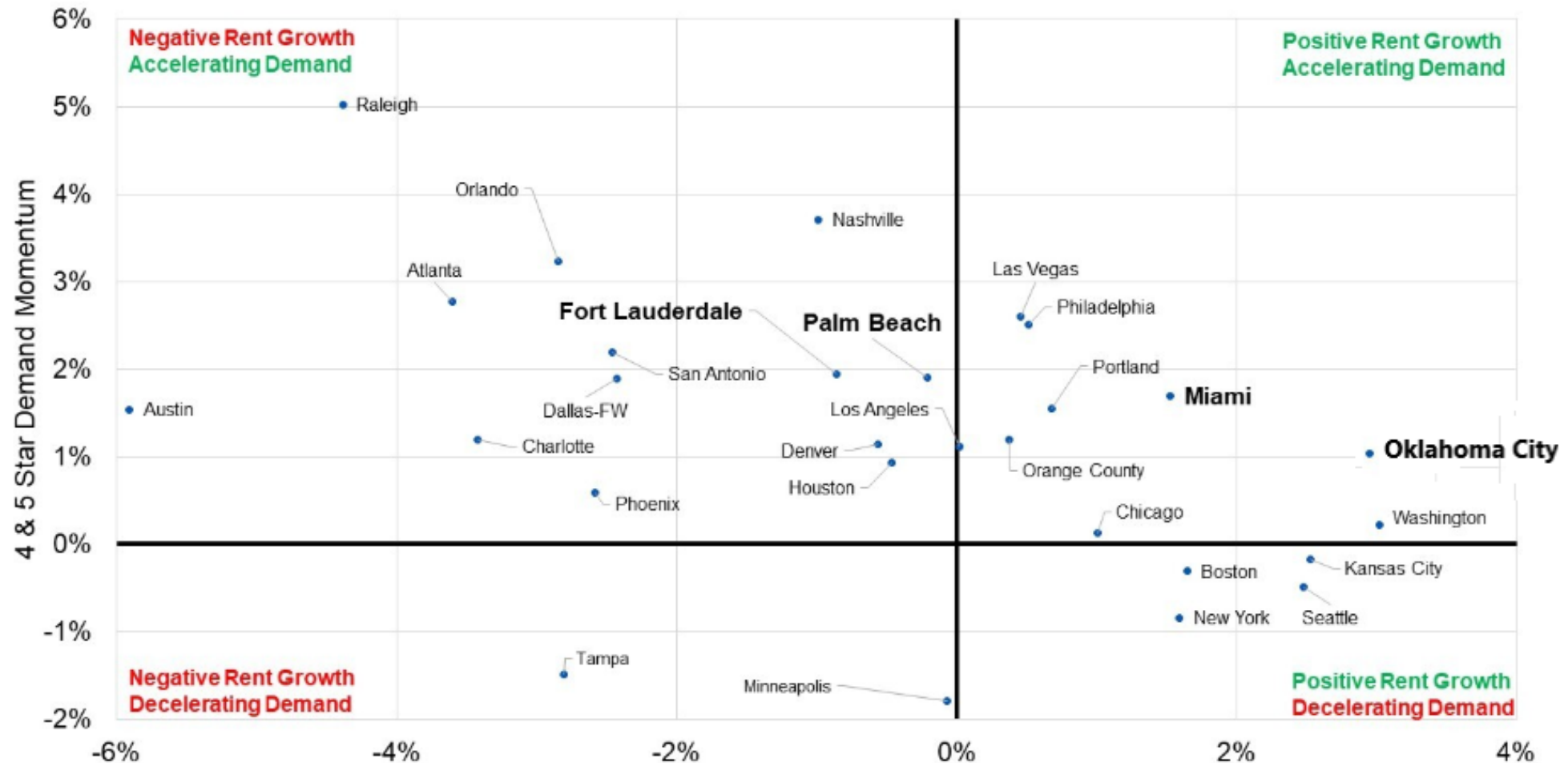
ABSORPTION, NET DELIVERIES & VACANCY



MARKET CAP RATE



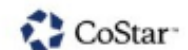
# Multifamily Rent Growth and Demand



4 & 5 Star Annual Effective Rent Growth, Q2 2024

Source: CoStar, As of June 2024

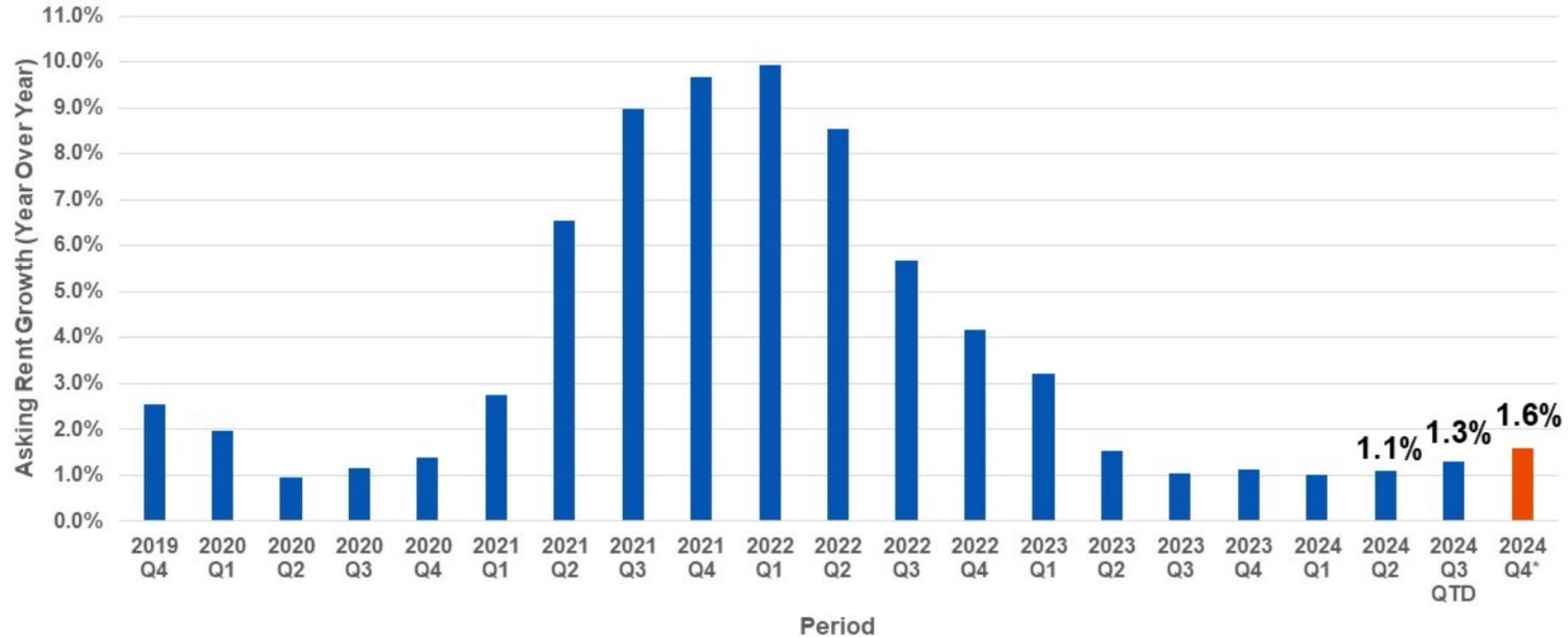
Note: Demand momentum is defined as the change in annual demand growth between Q2 2024 and Q2 2023. The largest 25 multifamily markets are shown along with all South Florida markets.



# Multifamily Rent Growth



## National rent growth appears to have turned to expansion



Source: CoStar, May 2024

\*Forecast





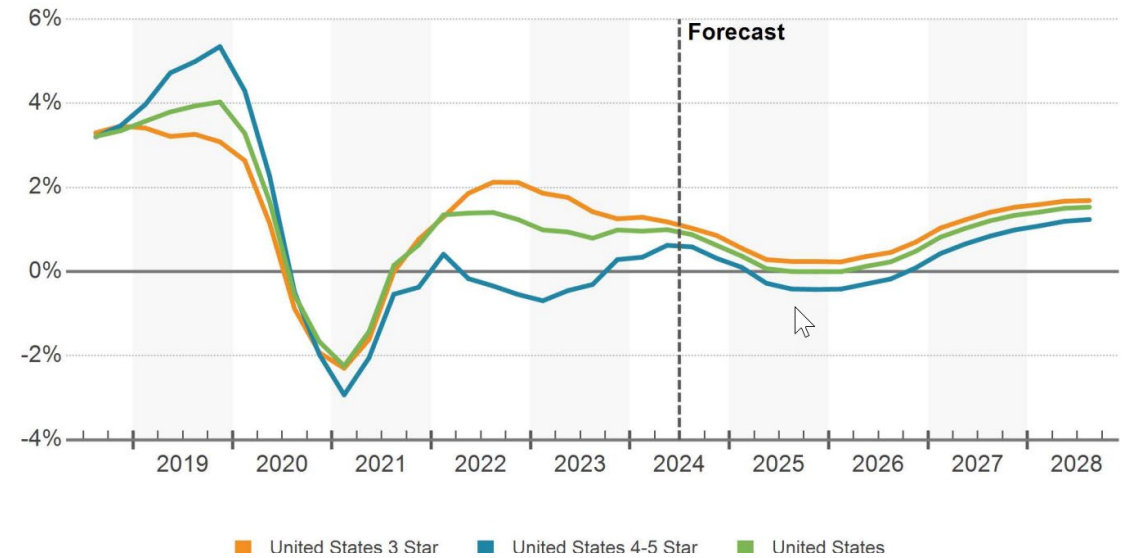
# Office



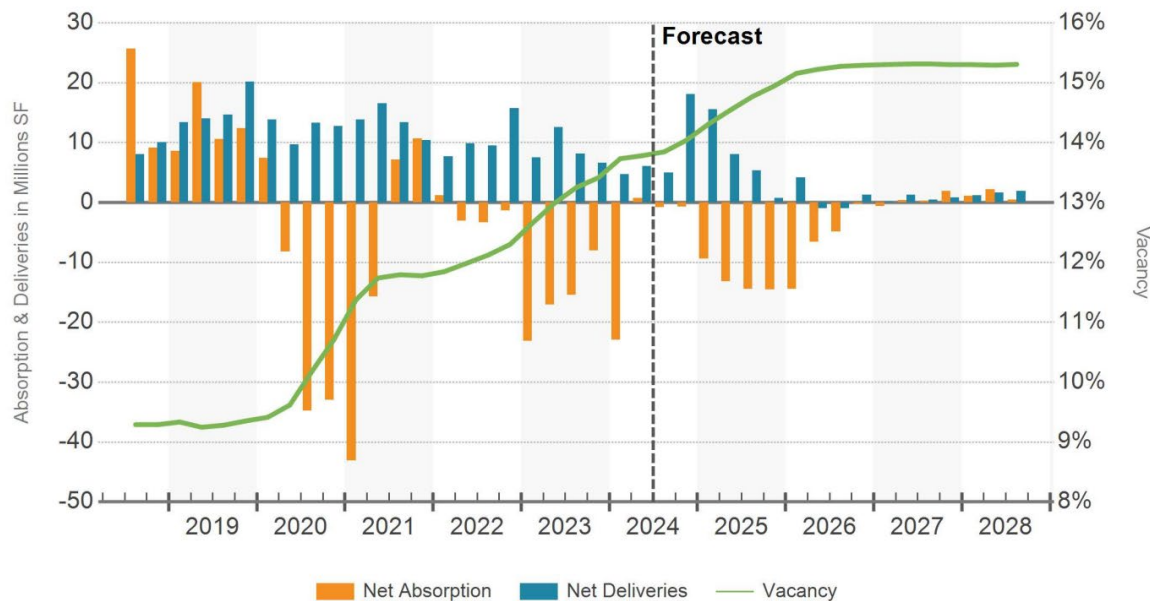
Vacancy projections are improving as positive absorption in 2Q broke a 2Y decline in demand. Owner occupancy, medical office users, and fewer large move-outs drove the uptick in occupancy, but persistently small leases and looming rollover exposure suggest the reprieve is likely temporary after YE.

	Historic	Current	5Y Forecast
Rent Growth	1.5%	0.9%	0.8%
Vacancy Rate	10.8%	13.8%	15.0%

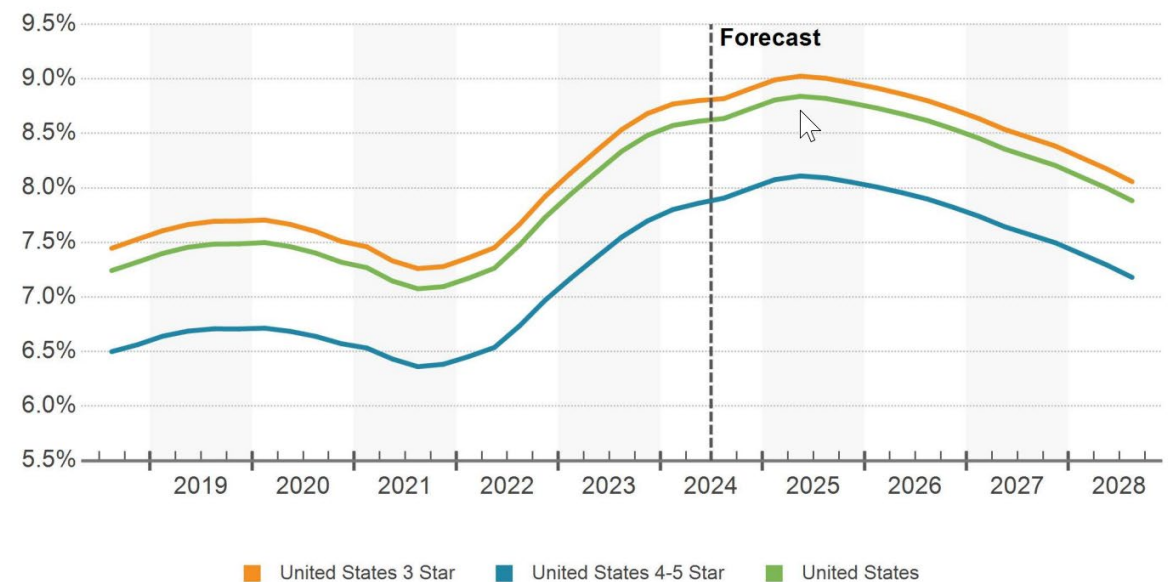
MARKET ASKING RENT GROWTH (YOY)



NET ABSORPTION, NET DELIVERIES & VACANCY



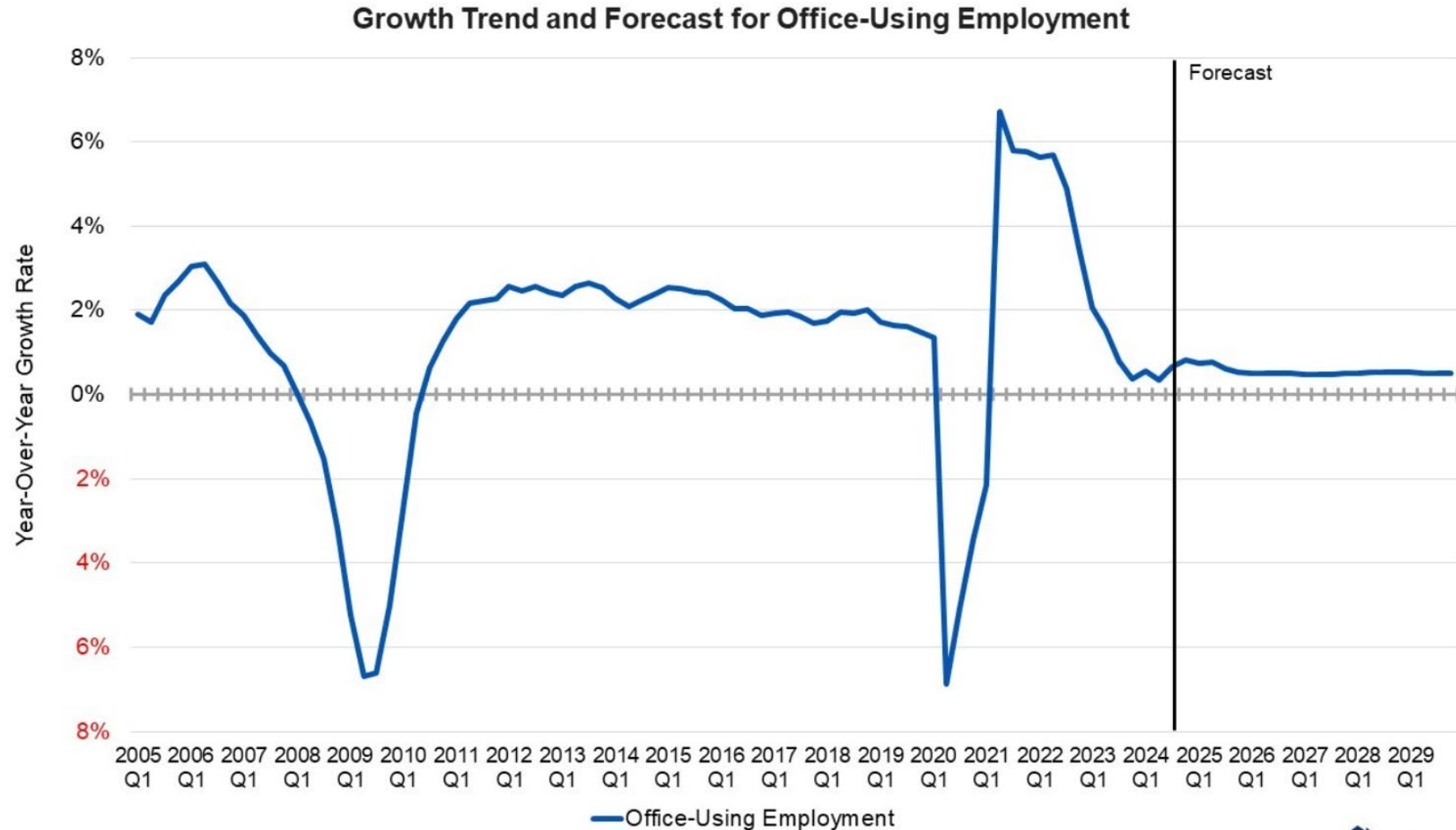
MARKET CAP RATE



# “True” Office Demand



## Long-term office-using job growth looks slower



Sources: U.S. Bureau of Labor Statistics, Oxford Economics, September 2024  
Note: Includes an aggregate of Information, Financial Activities, and Professional and Business Services supersectors

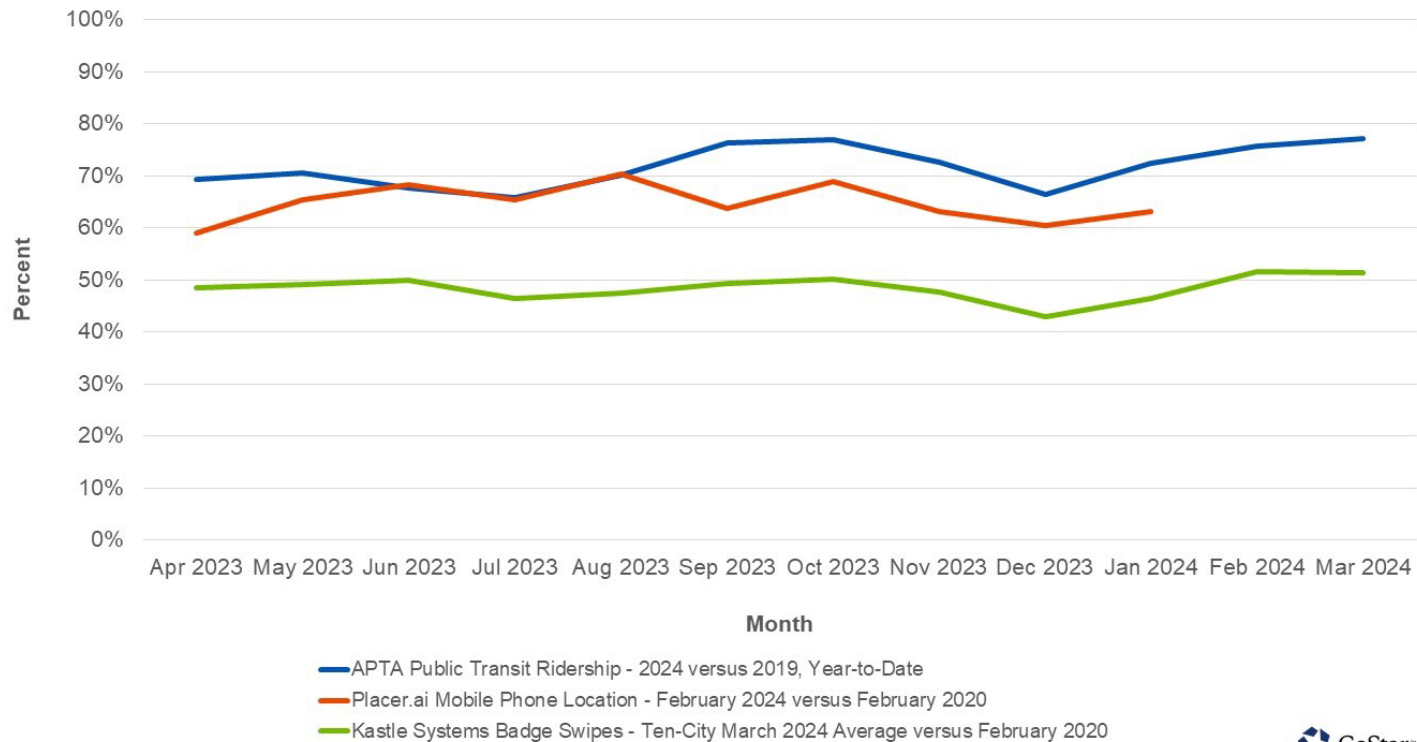
- Looking at transit, cell phone and office control data, office usage has continued to improve this year.
- Peak usage is now at 70% based on cell data.
- However, average usage is in the 40% to 65% range. Or about 50% of pre-pandemic levels.
- **45% of the office space has yet to come up for renewal**
  
- **Lease reduction has been in the 12% range which we use for modeling purposes.**
  
- Forecasting the “peak day” syndrome
- LTV lower than last recession

If at risk – Restructure NOW!!!



## Office Attendance Stabilizes

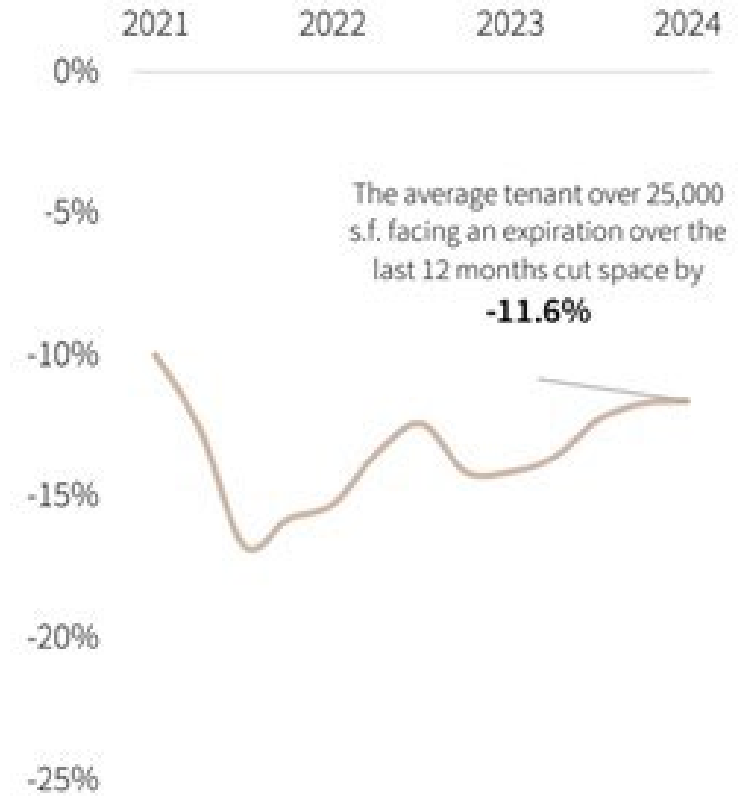
Office Attendance Indicators, 12-Month National Trend



Sources: American Public Transit Association (APTA), Placer.ai, Kastle Systems, May 2024



## Downsizing rate for major tenants

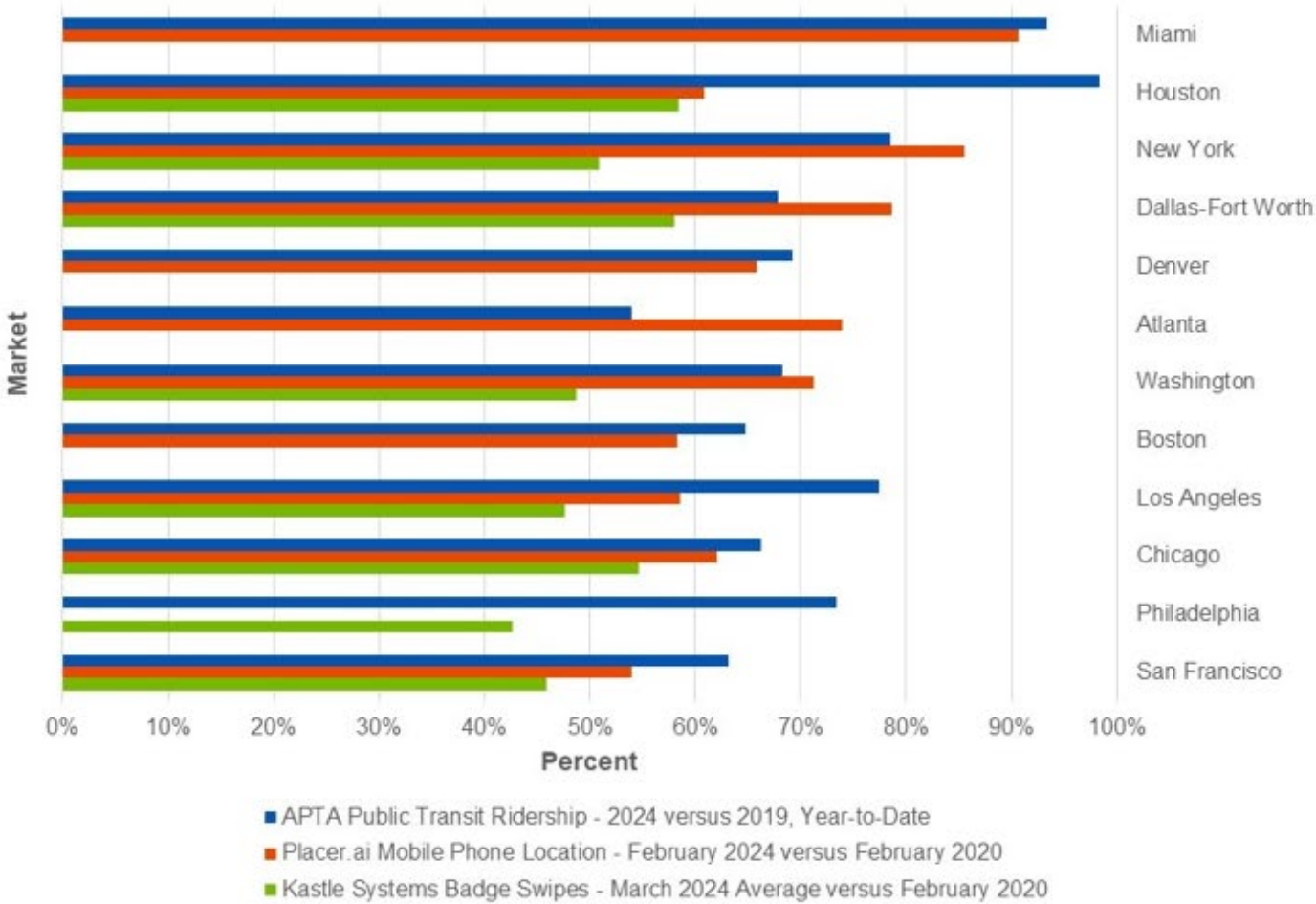


Source: JLL Research

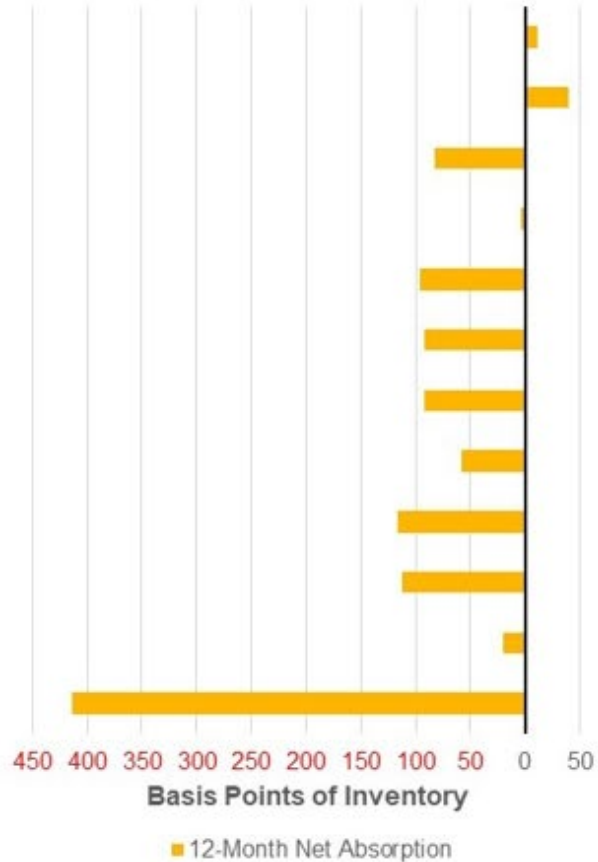
Note: Includes tenants above 25,000 s.f. with a single office location in the market. Excludes tenants who downsized by more than 50% or expanded by more than 50%. N = 1,362



### Office Attendance Indicators



### Change in Office Demand, April 2023 to March 2024



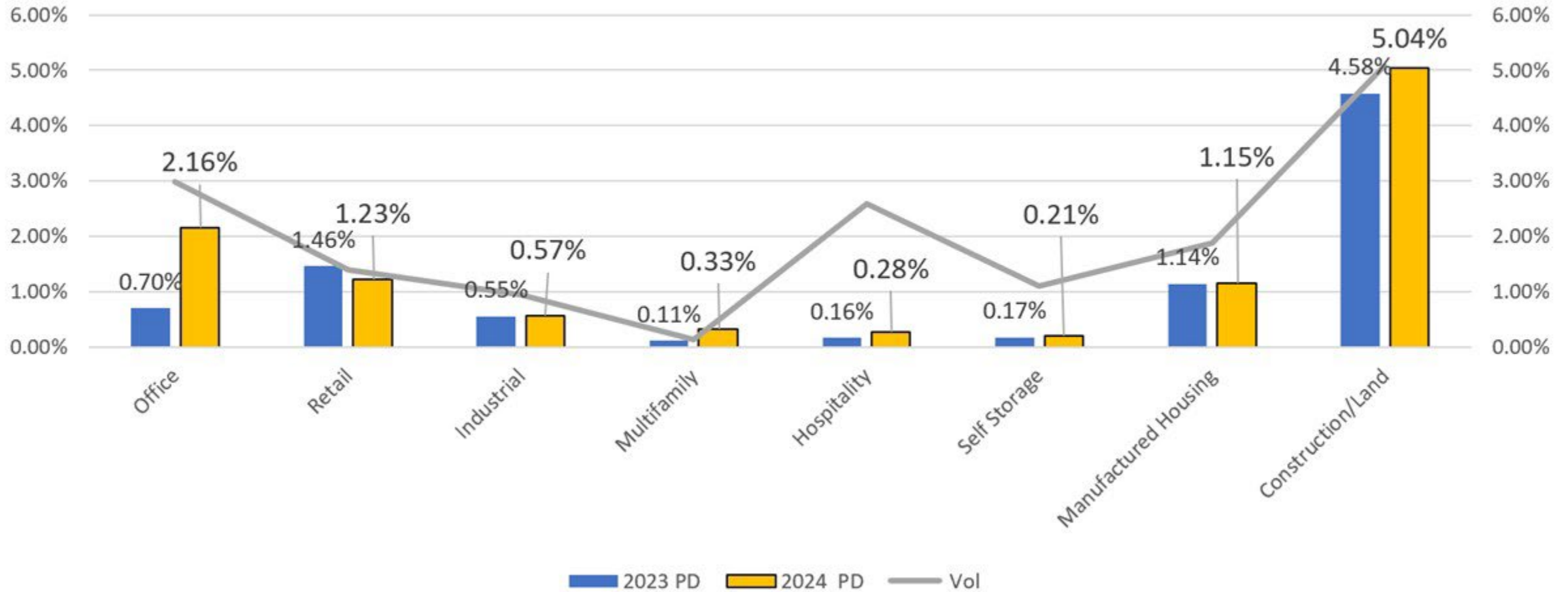
Sources: American Public Transit Association (APTA), Placer.ai, Kastle Systems, CoStar, May 2024



# Investor Owned CRE Performance



## Investor Owned CRE Probabilities of Default by Sector



# Bank Election Playbook



	Harris	Trump
Tax Rate	21% => 28%	21% to lower
Inflation	Lower probability	Higher probability
Employment	Mixed	Stimulative
Regulation	More	Less
Retail	More stimulus helps retail	Higher tariffs hurt retail + increases inflation
Healthcare	More investment in hospitals	More investment in managed care insurance
Housing	More investment in multifamily and lower price housing. Overall - stimulative	More investment in luxury housing. Overall neutral.
Global Trade	Stimulative	Restrictive
M&A	Decreases to lower	Increases
Industries to Invest	Clean energy, infrastructure construction, technology, REITs,	Paper, packaging, mining, energy, gaming, media, transportation,

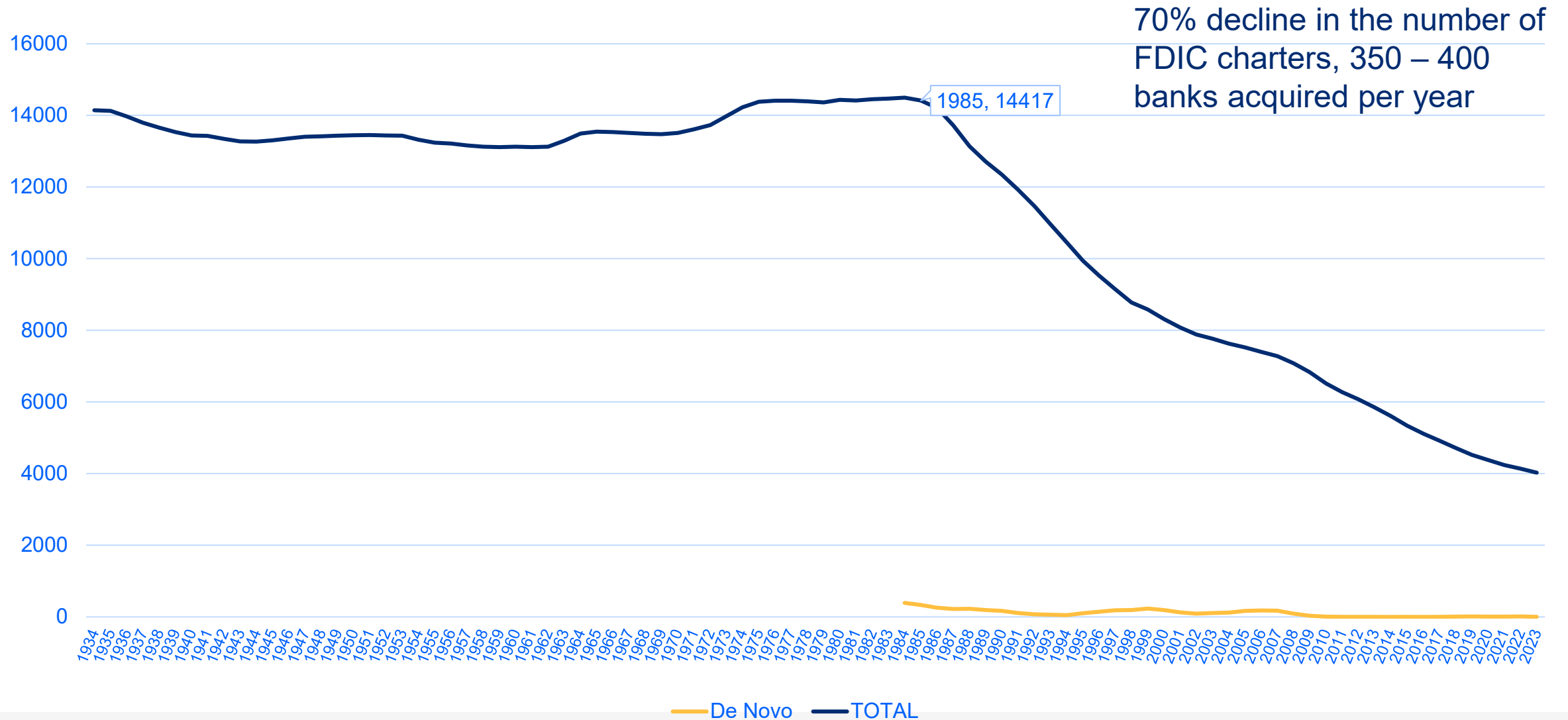
- **Community bank challenges**
- **Community bank opportunities**
- **How to position your bank remainder of 2024 and 2025**
  - **Strategy over forecasting**



# Competitive Landscape



## FDIC Commercial Charters

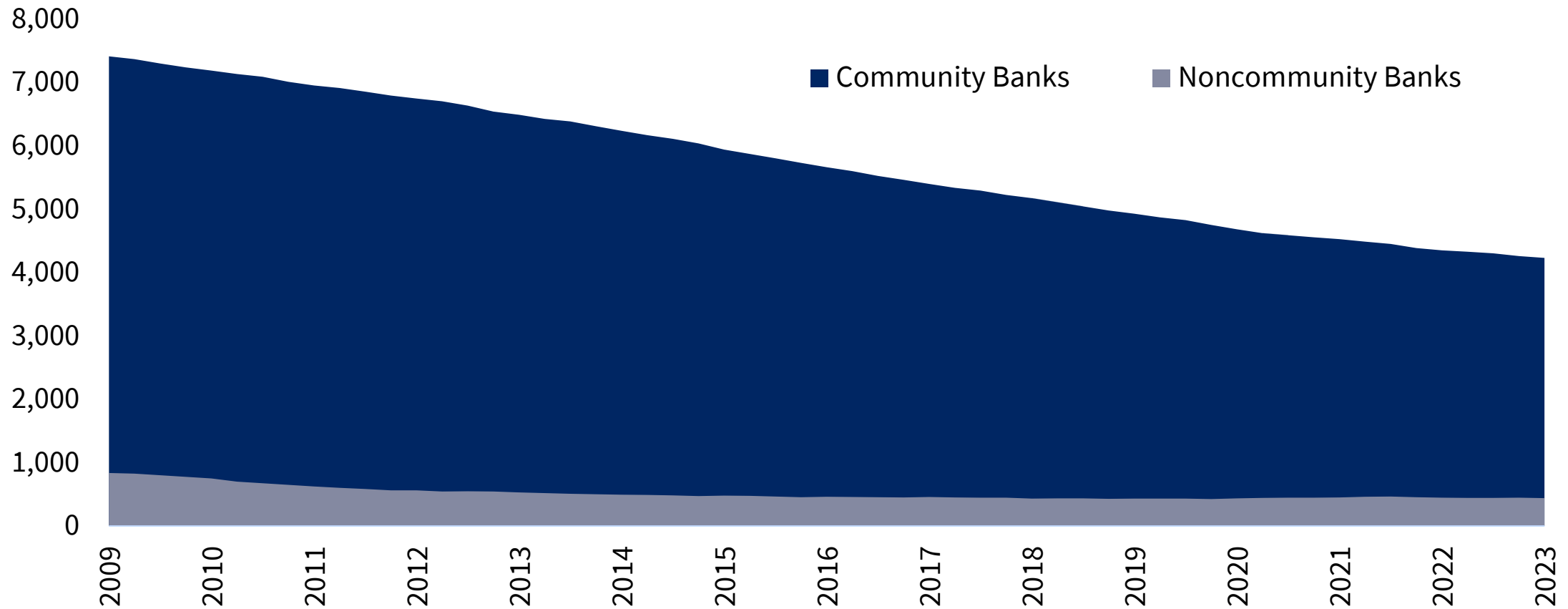


# Competitive Landscape



Not all banks are consolidating equally

Count of Banks



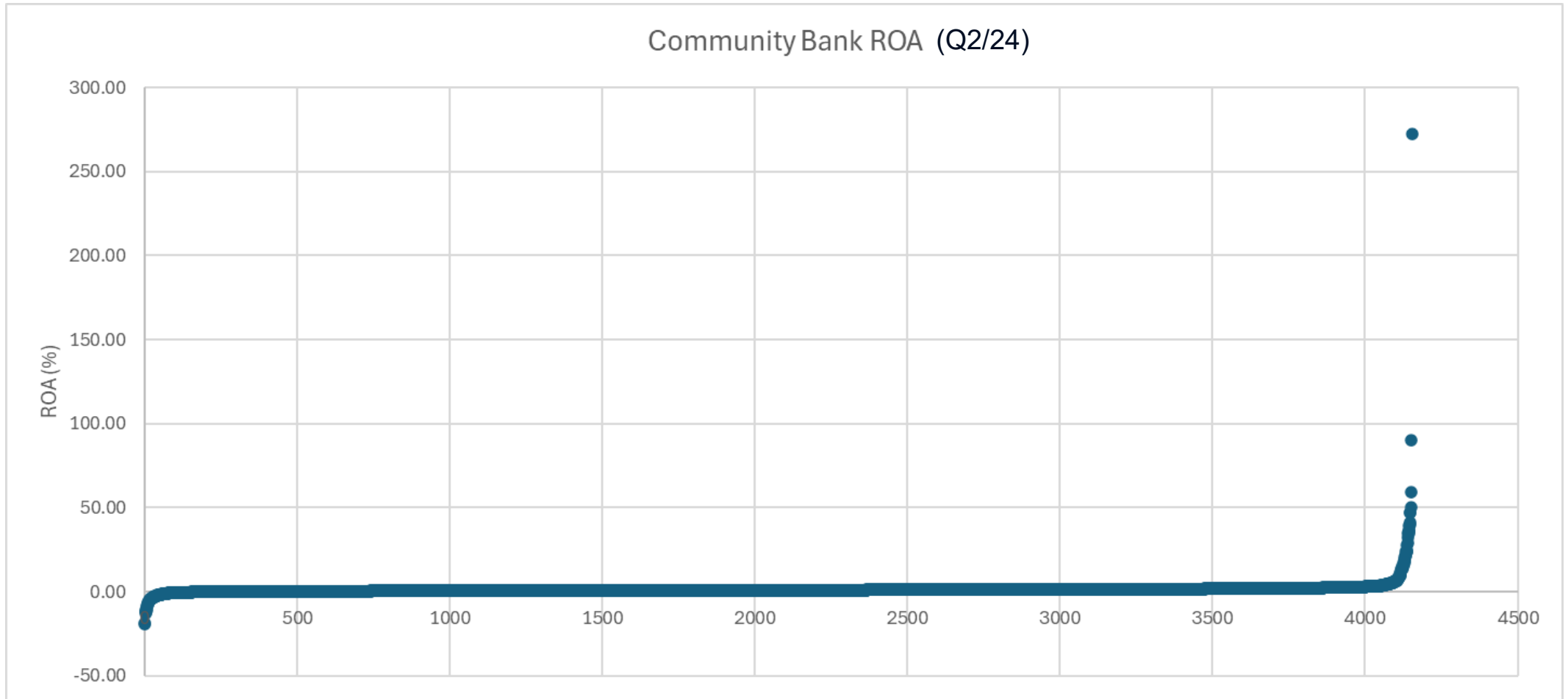
Source: FDIC. Data is as of 1Q2023.

# Community Bank Challenges



Avg = 1.08%

5.7% of community banks negative ROA, 21.9% under 0.50%

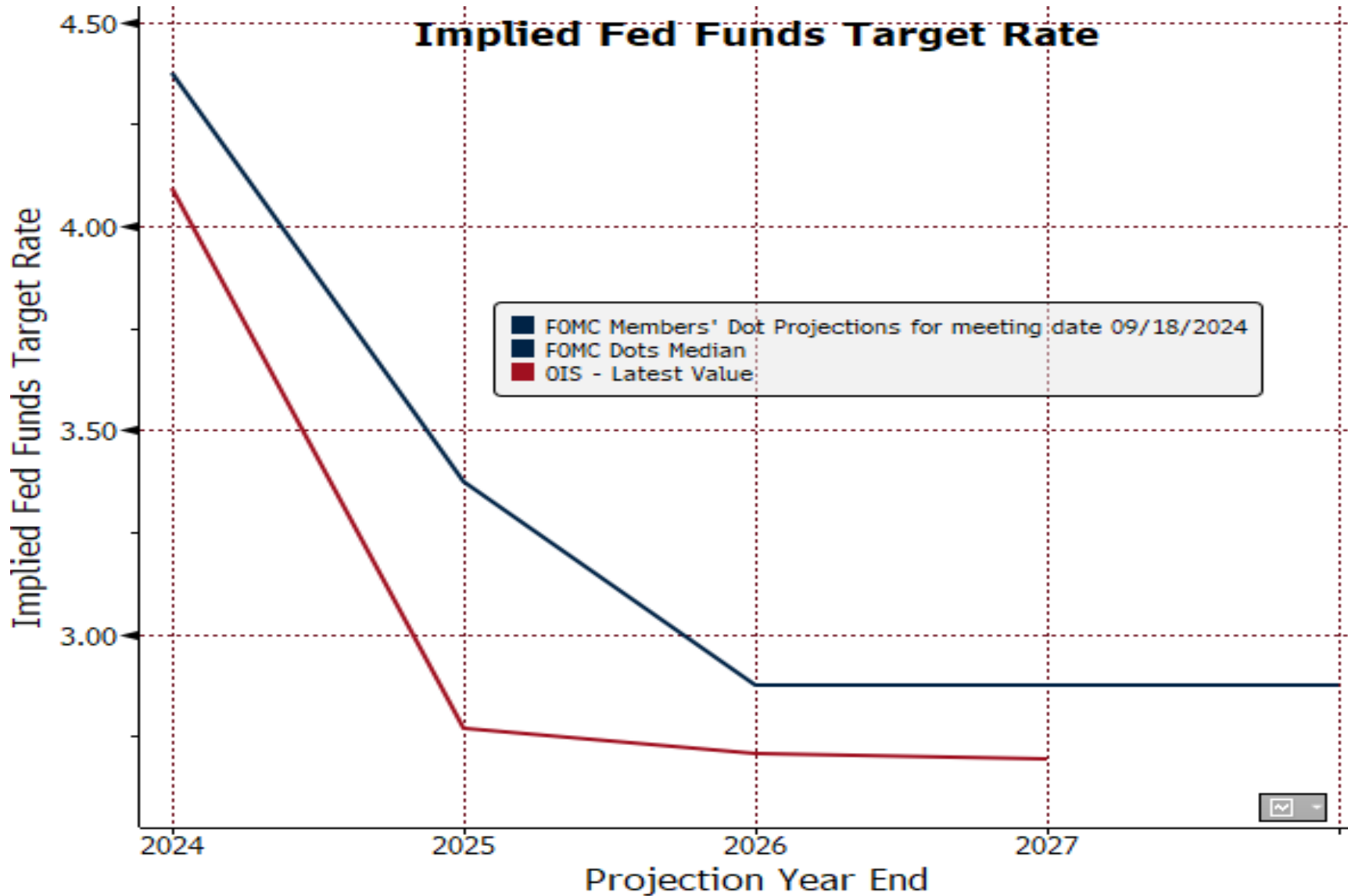


## **Thesis:**

**Forecasts are incorrect, because no one can consistently predict future events.**

**A bank's strategy and execution is a long-term plan (years and decades) and is the principal determinant of performance.**

# Fed Forecast of Interest Rates



**A Hawkish 50bps cut.**

“solid labour market conditions” “economy growing at a healthy pace”. 9 out of 16 Fed officials expect zero additional cuts in 2024.

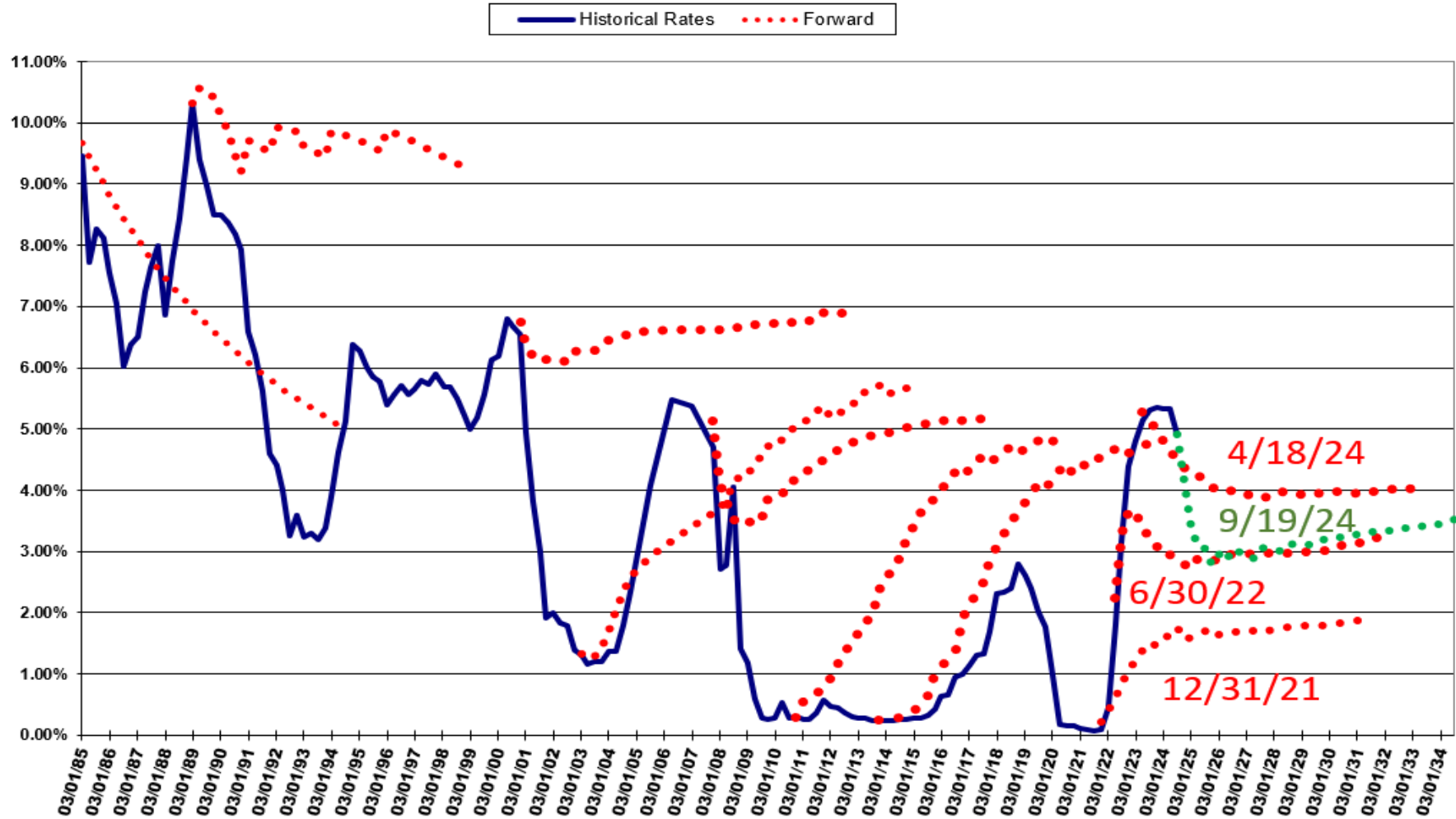
FED want to reach neutral (around 3%) at the end of 2026 - no rush and will take time.

The long run rate ~ 3%.

# Market Forecast of Interest Rates



## Market prediction accuracy

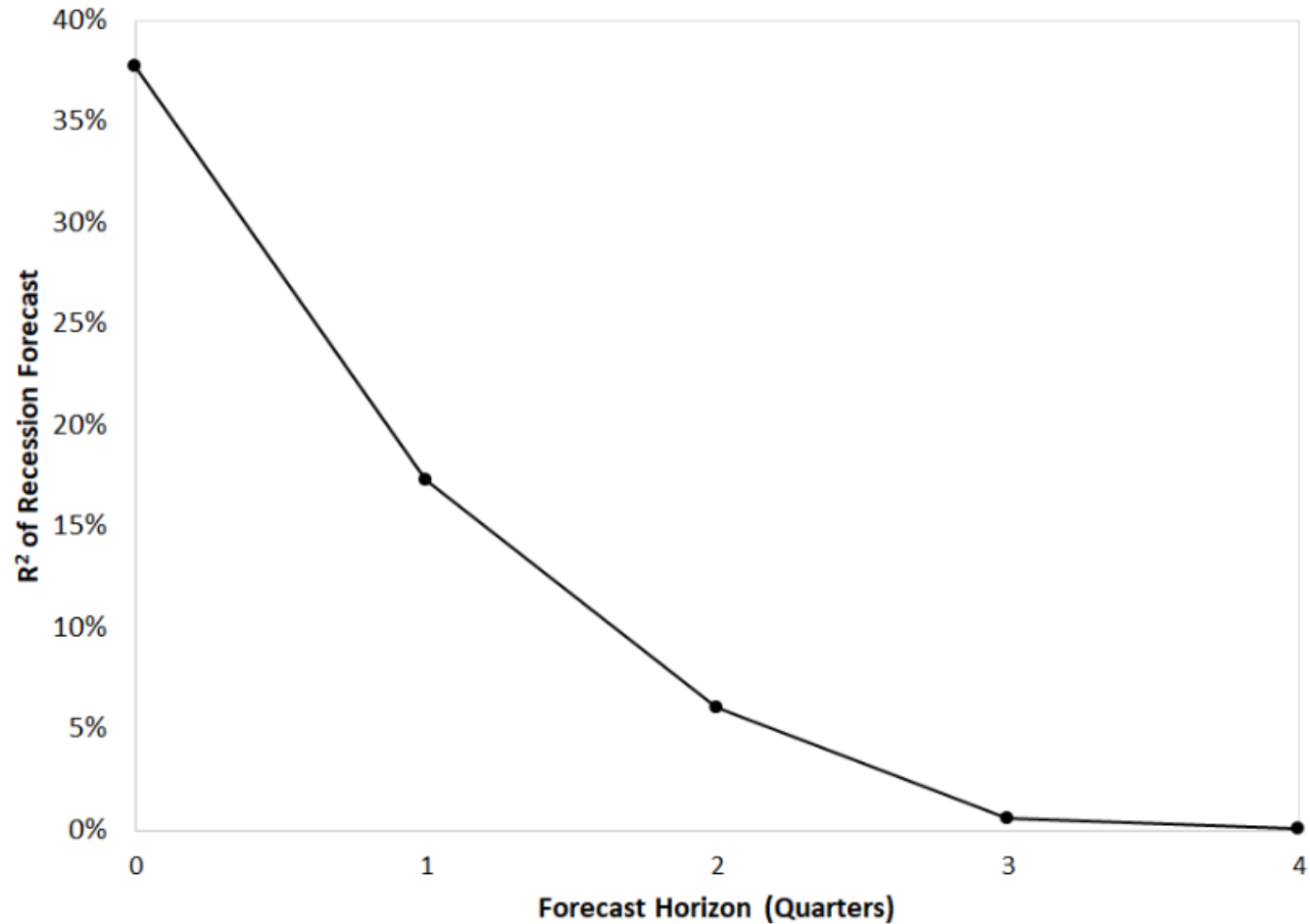


# Economist Forecast of Interest Rates



## Economist prediction accuracy

The Precision of Recession Forecasts

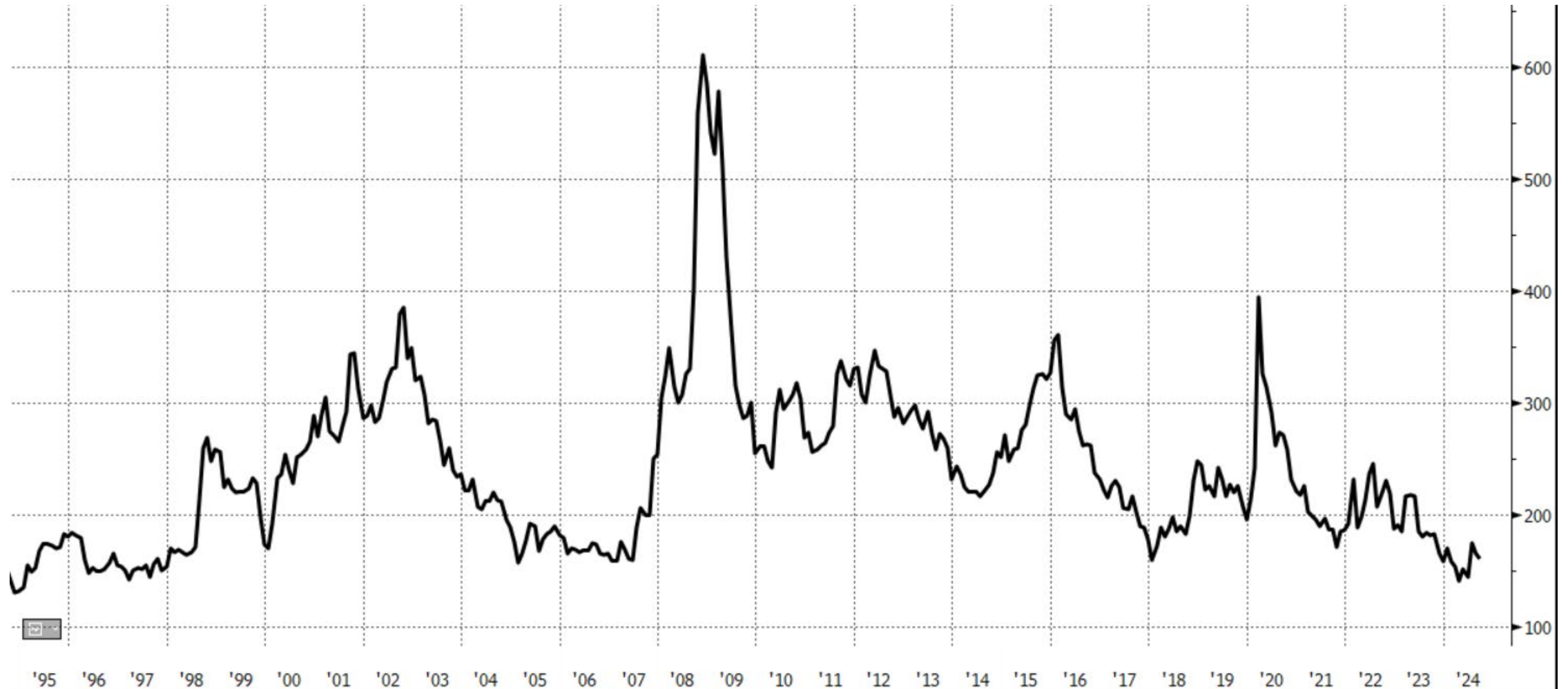


■ FEDERAL RESERVE BANK OF ST. LOUIS

# Chance of Recession – Soft or Hard Landing



US Corporate Spreads (Moody's medium grade)

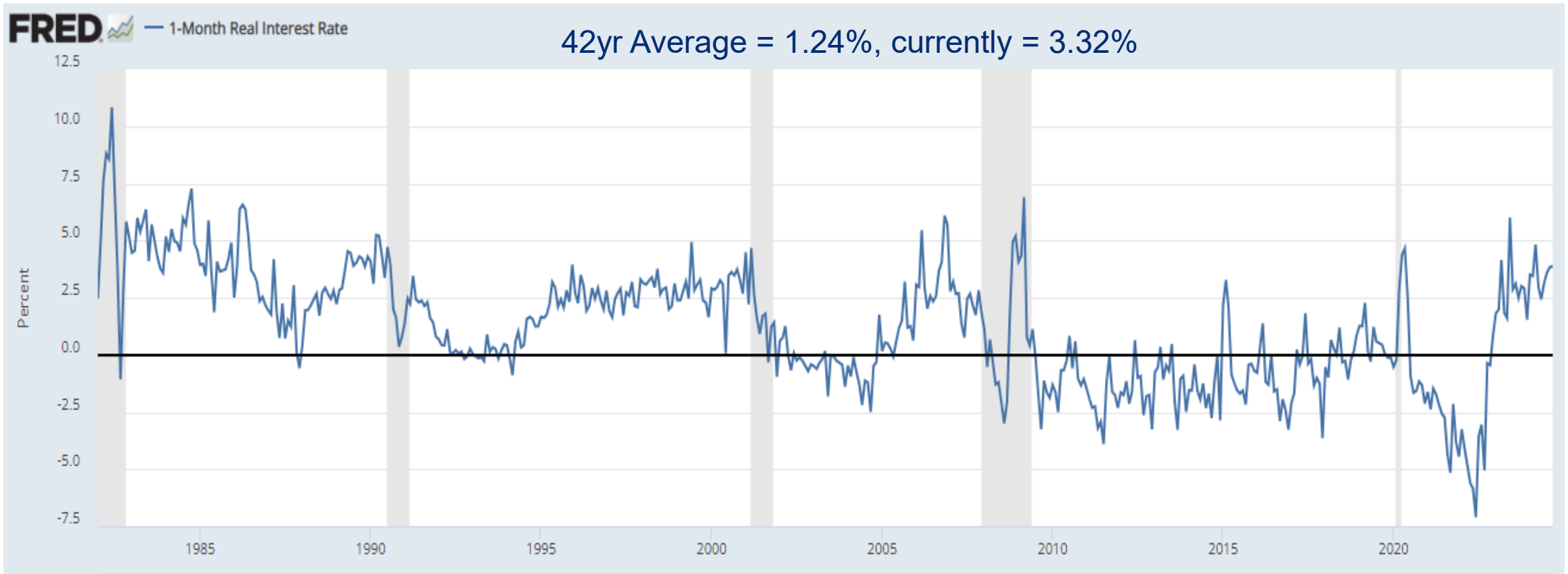




# Real Interest Rates



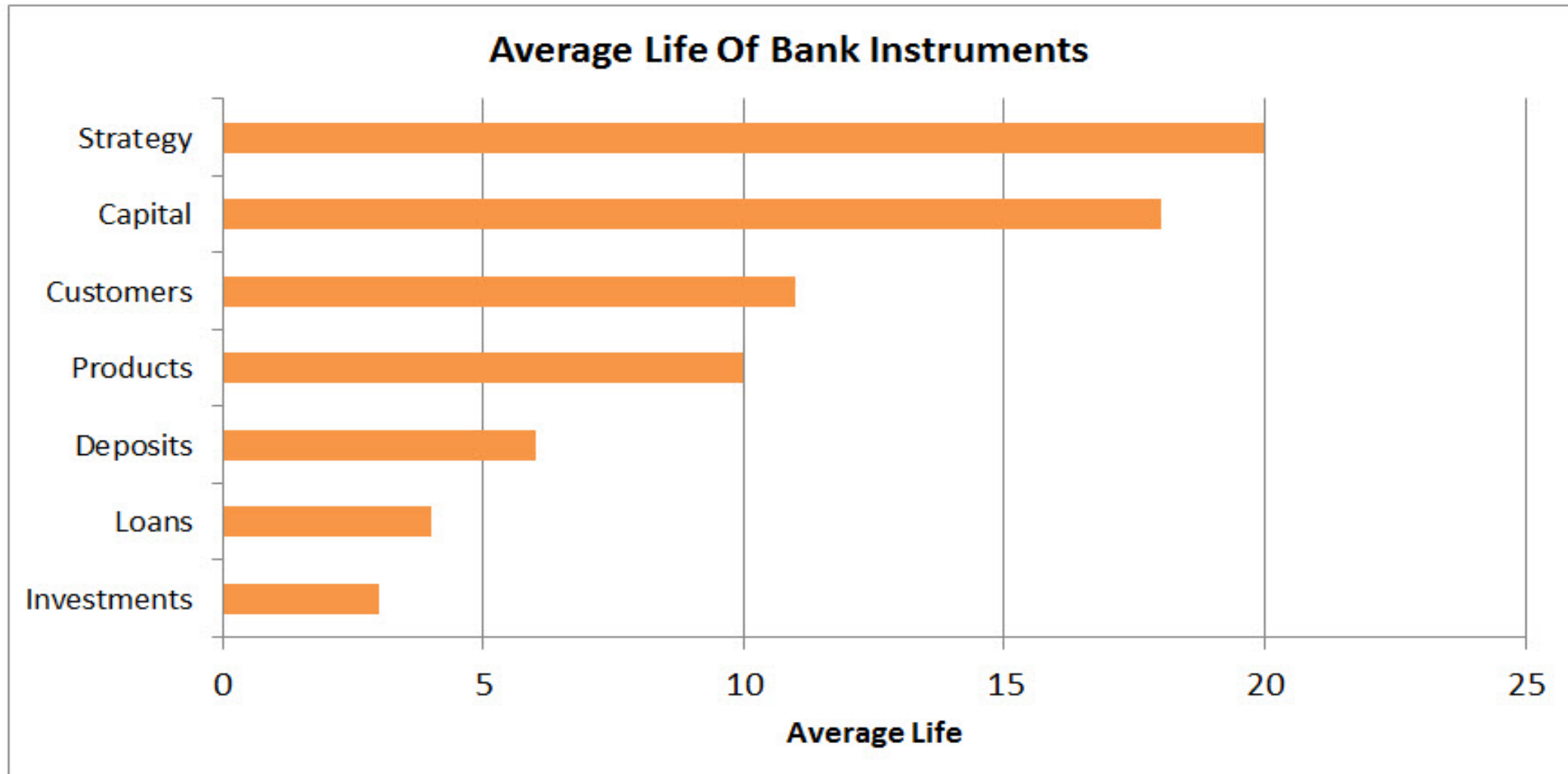
$R^*$  (star) - long-run equilibrium interest rate, short-term interest rate for full employment and stable inflation.



# Strategy vs. Forecasting Timelines



Match expected life horizons

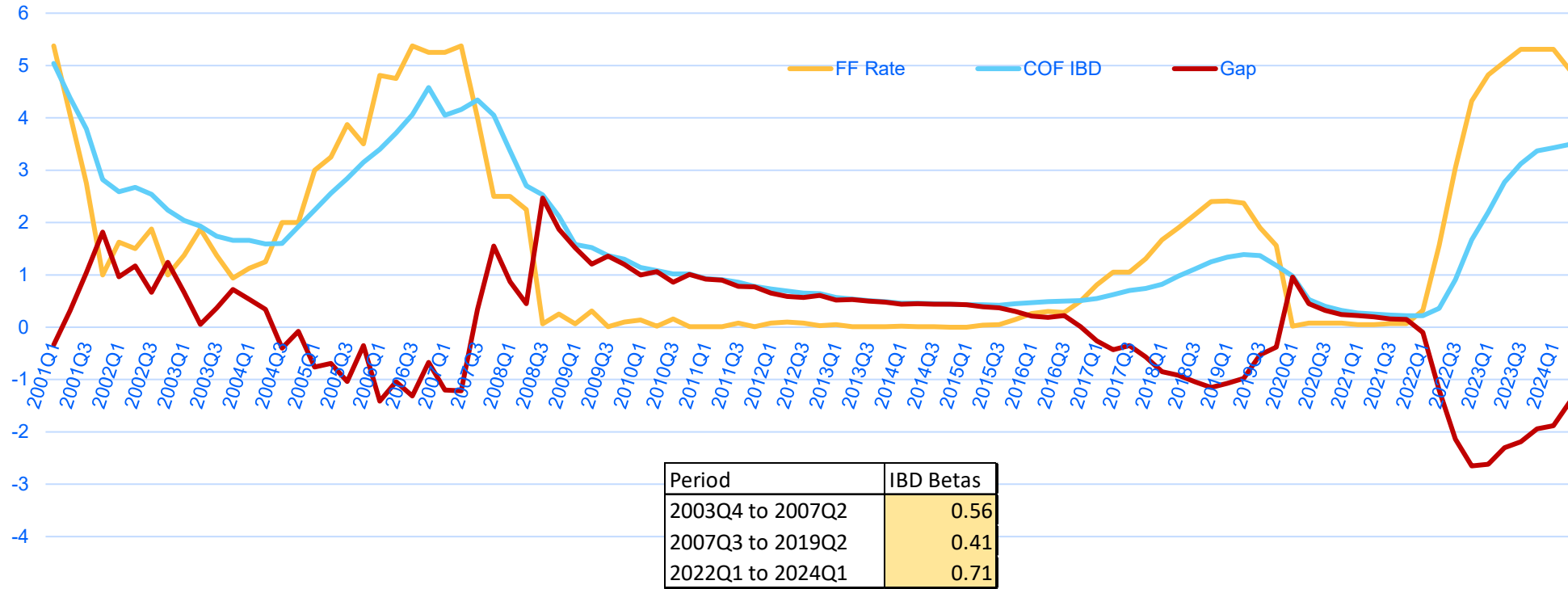


# Community Bank Deposit Costs



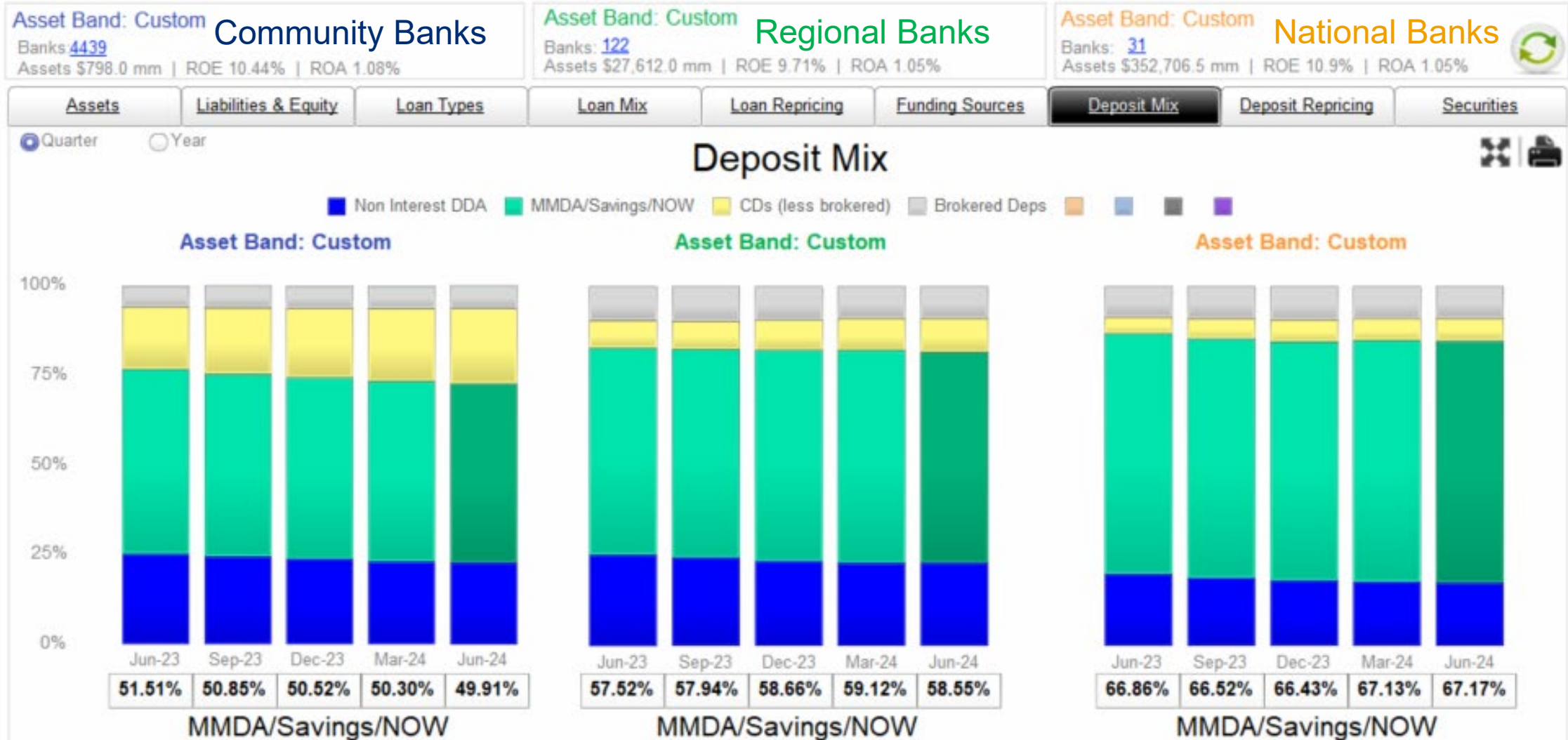
## COF – future costs

US Commercial Banks  
FF vs COF Gap

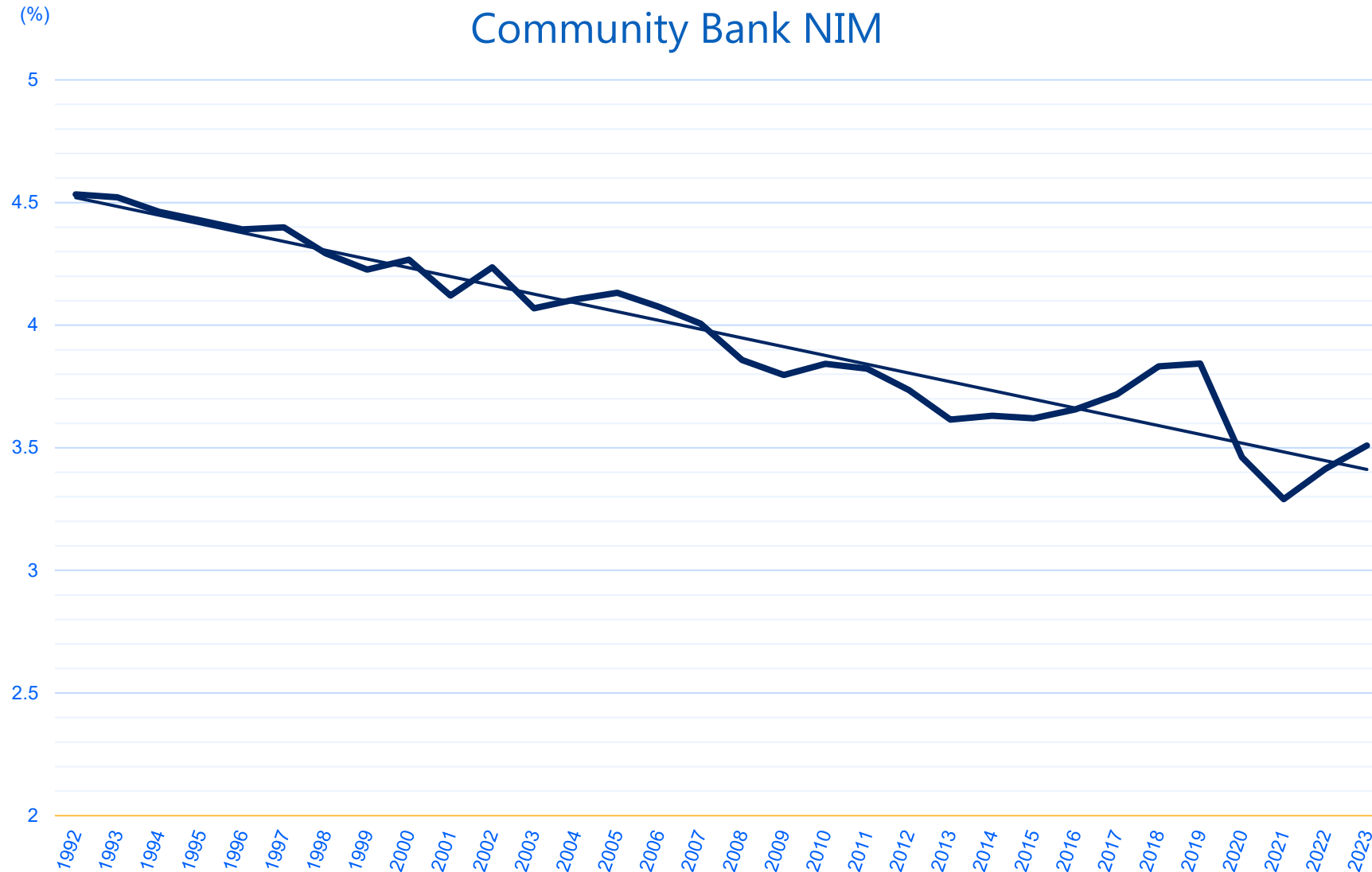


1.43% gap,  
0.01% average

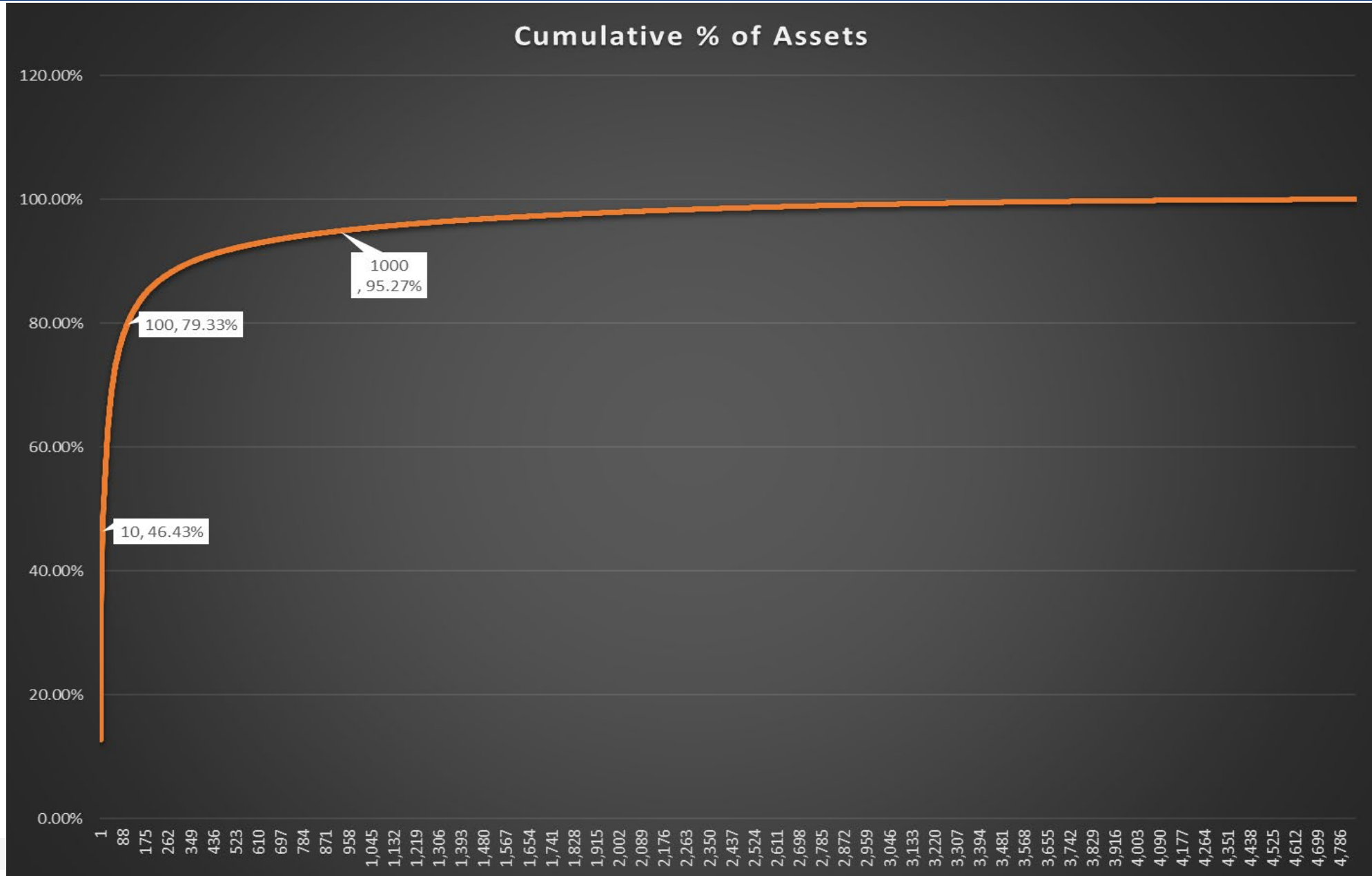
# Turning Point for Deposit Costs



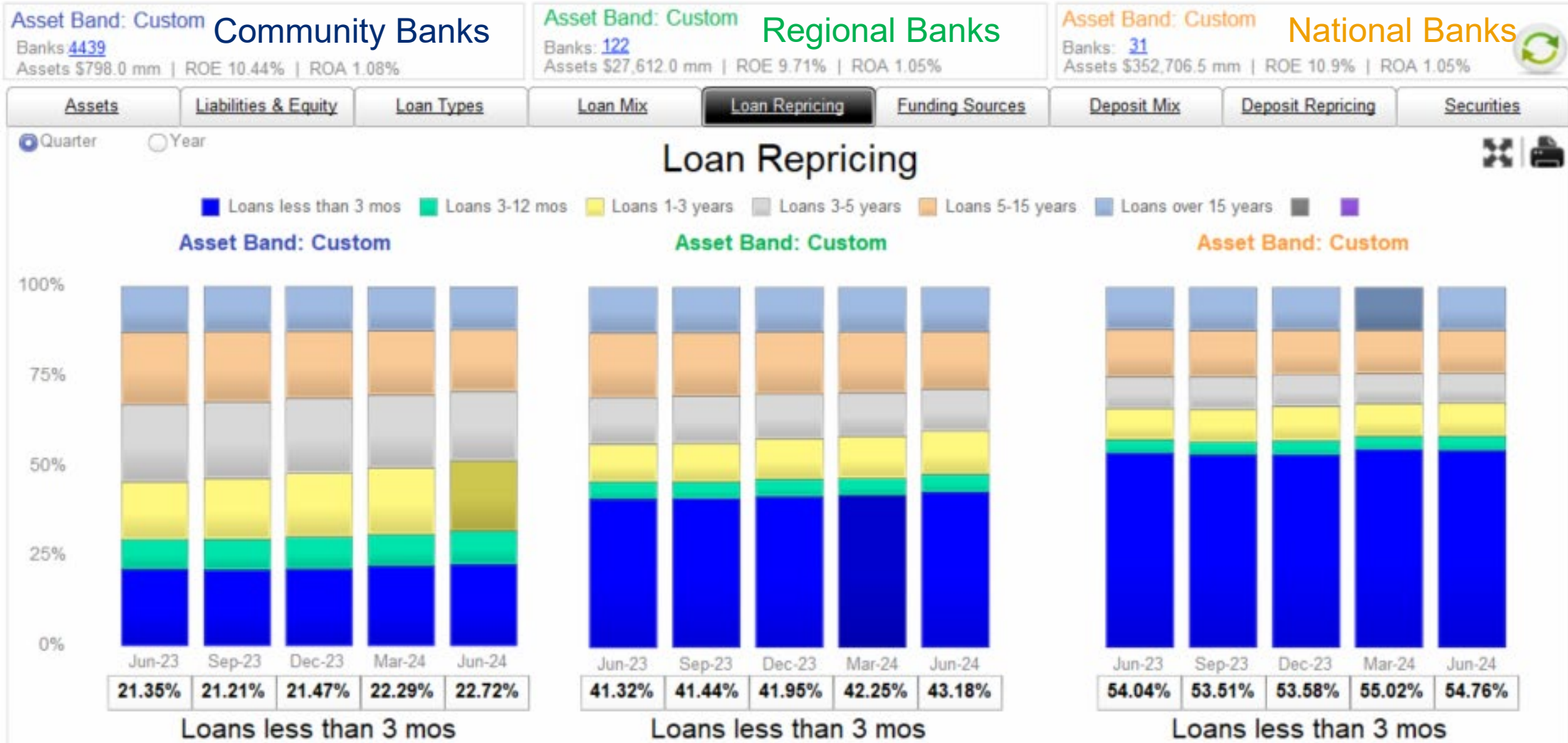
# Direction for NIM



# Competitive Landscape



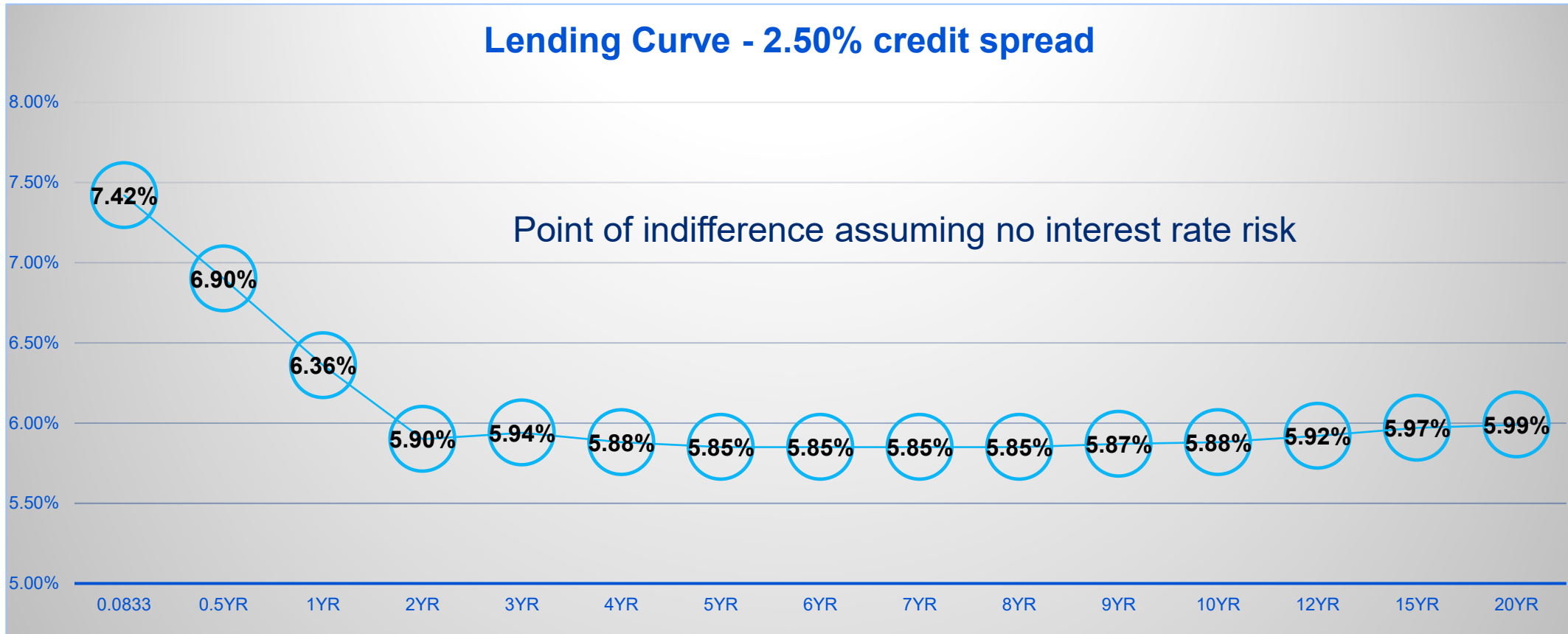
# What Happens to Loan Repricing



# Community Bank Challenges - Lending Curve



An inverted yield curve creating a lending anomaly

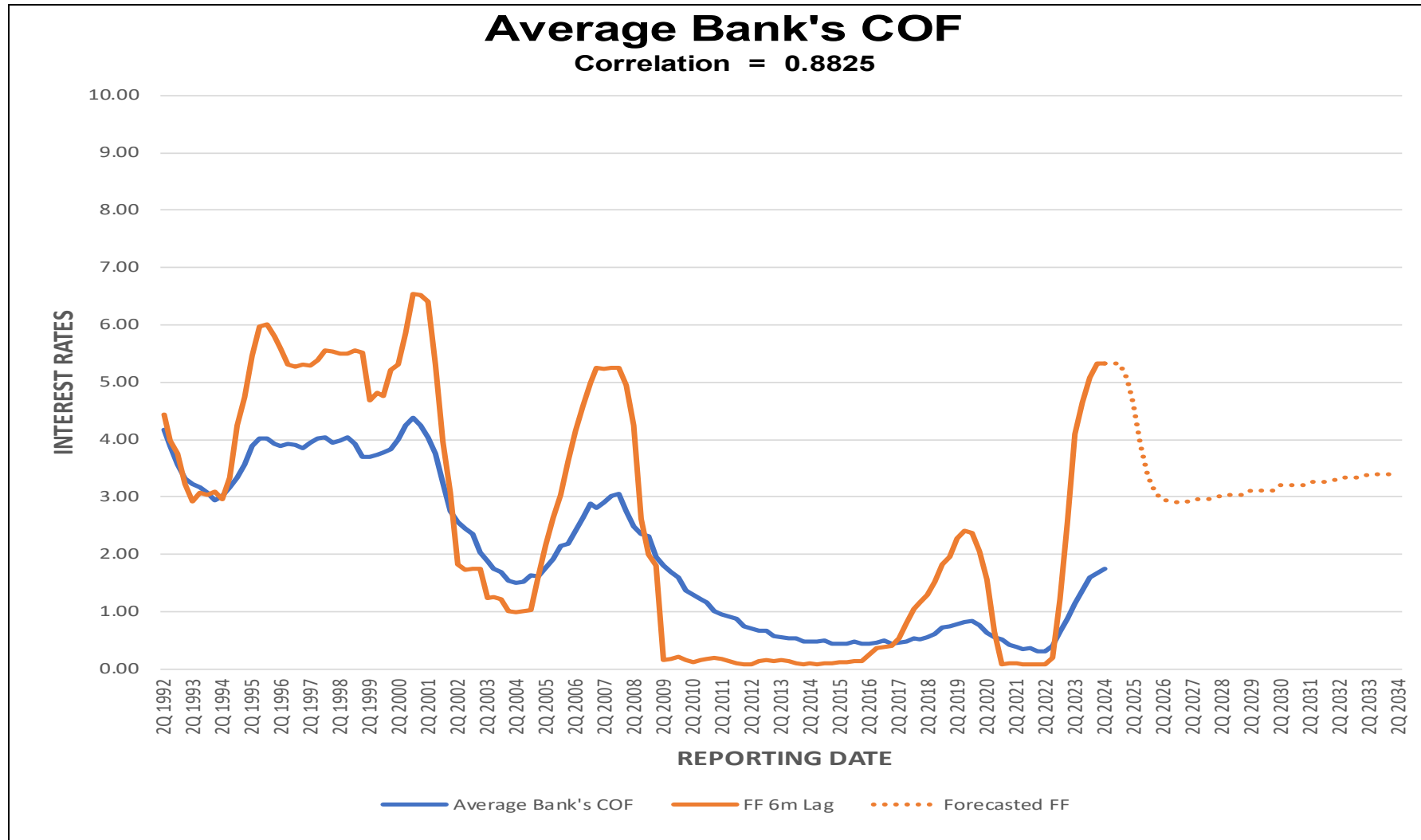




# Banks' COF and Short-term Rates



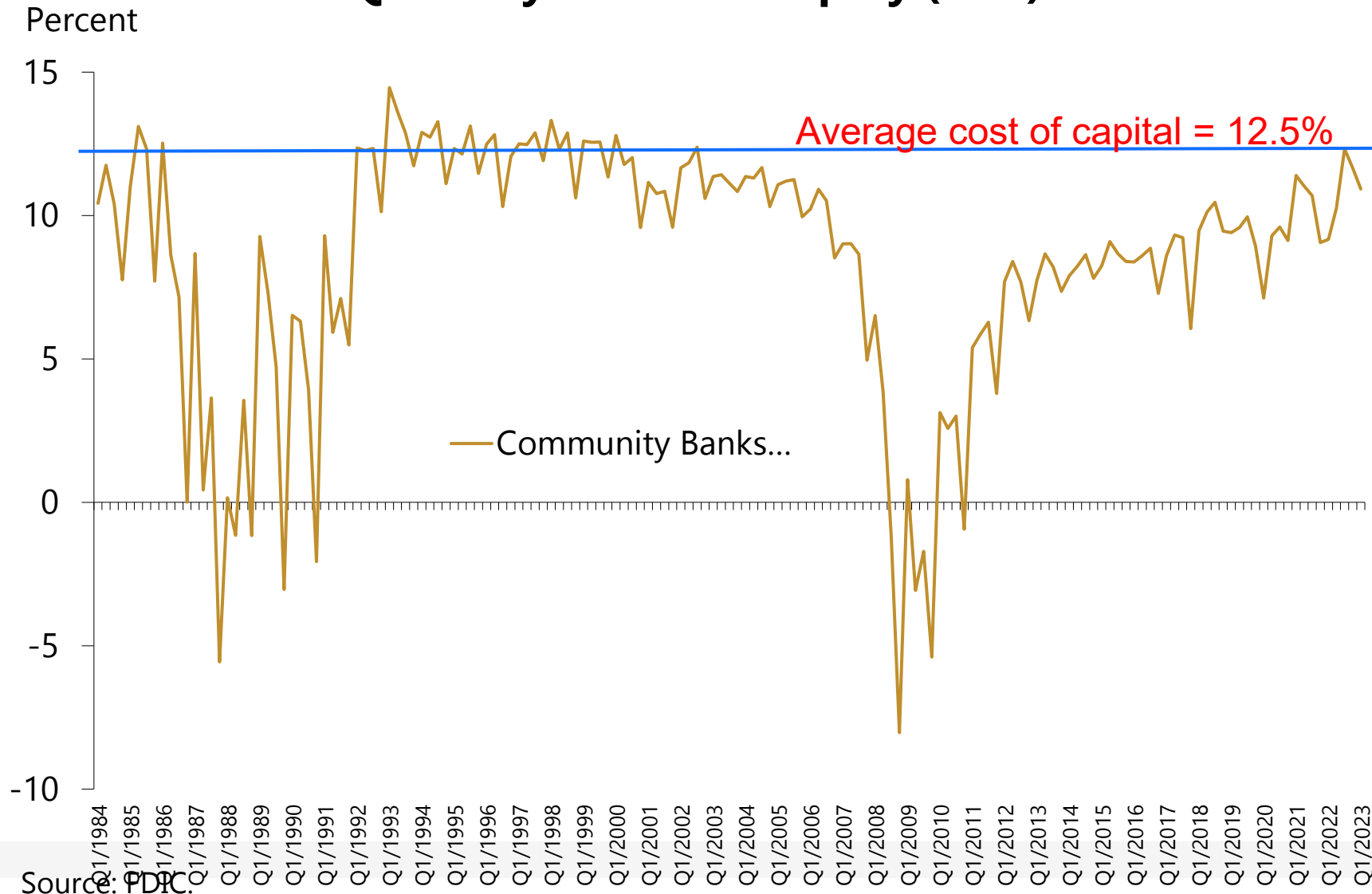
Banks' COF and FF rate (6mo lag)



# Performance Measure



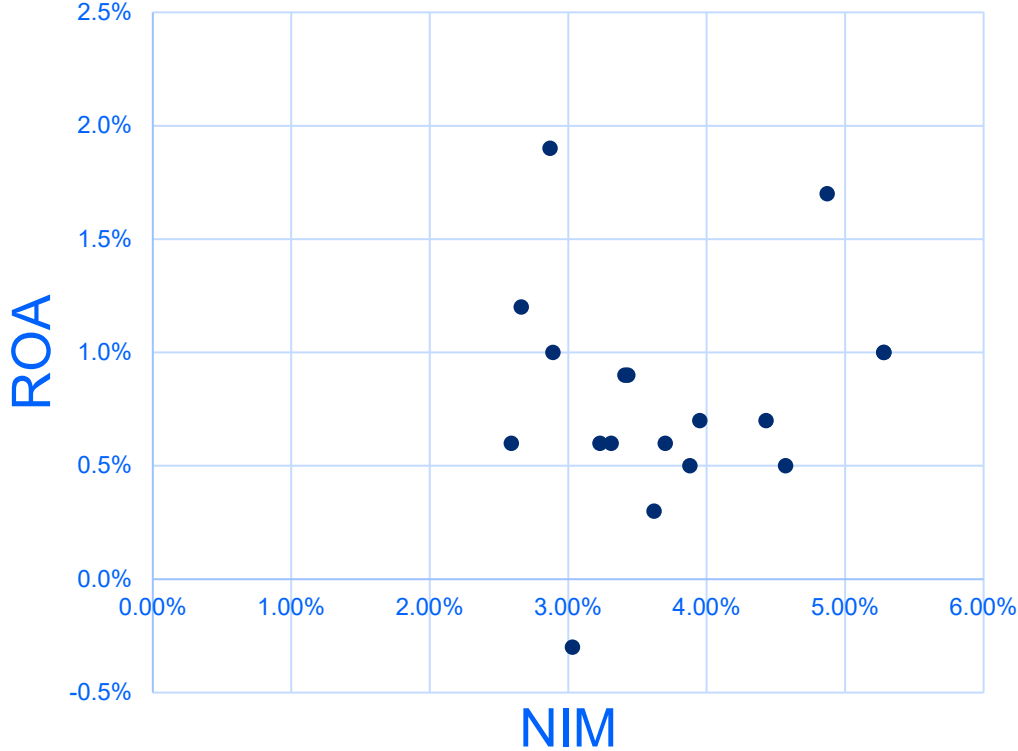
## Community Banks (<\$10Bn assets) Quarterly Return on Equity (ROE)



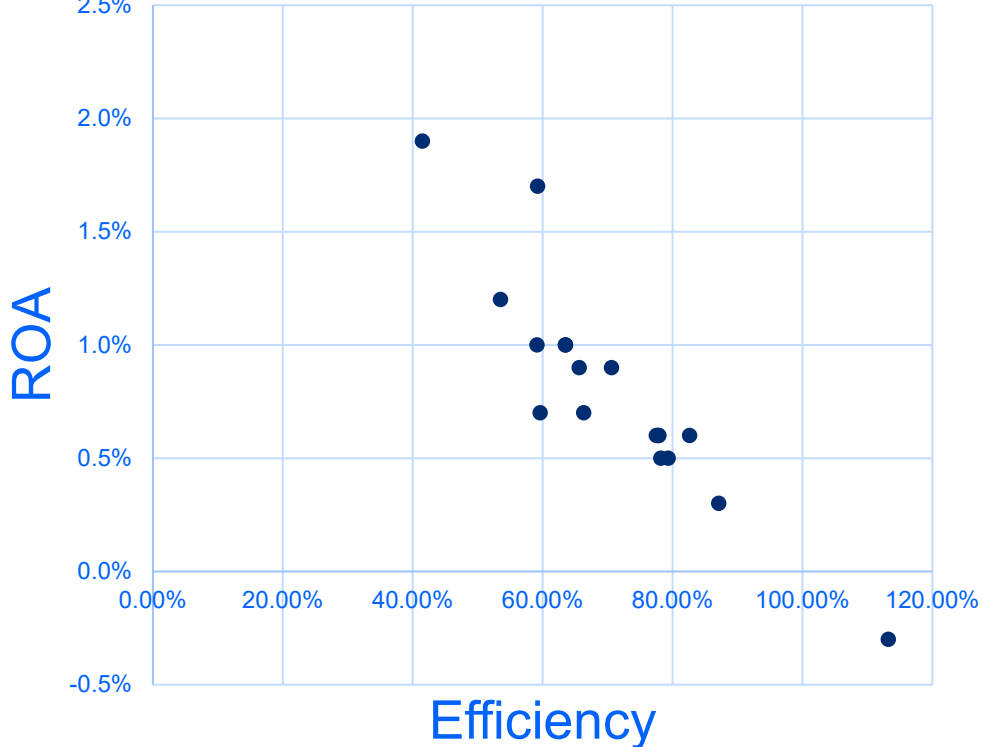
Defunct bank ROE =  
1.66% (~ 12k banks,  
over 40yrs)



NIM/ROA relationship -  $R^2 = 0.125$   
OK Banks at LL

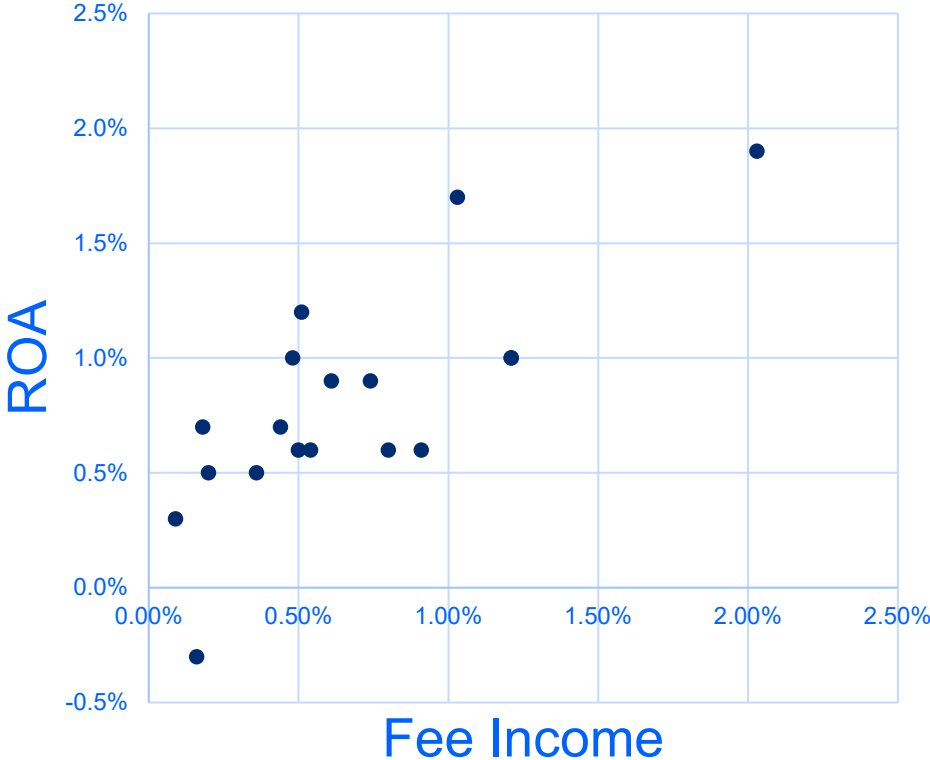


Efficiency/ROA relationship -  $R^2 = -0.911$   
OK Banks at LL





Fee Income/ROA relationship -  $R^2 = 0.760$  OK Banks at LL




# Predictors of Profitability



Loan hedge fees – up to 2.5% of loan amount

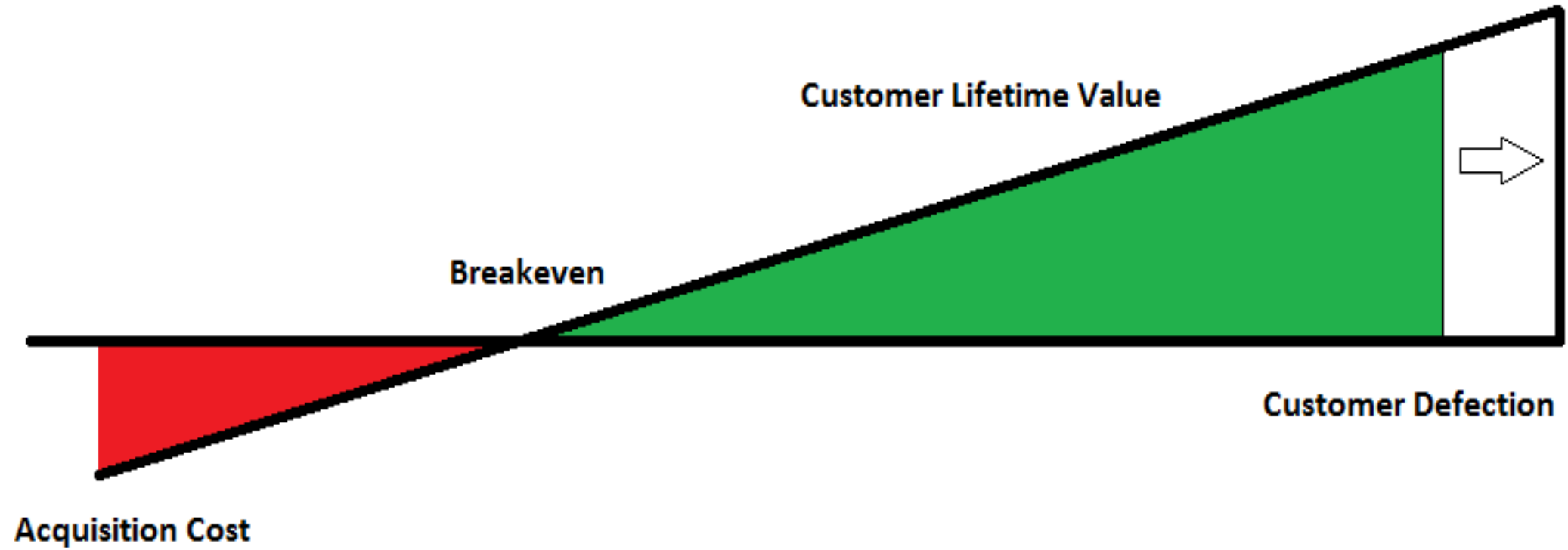
## 5yr Avg - Correlation to ROA - all banks \$100mm to \$10Bn assets

1 Nonint Inc/ Avg Assets	0.901
2 Nonint Exp/ Avg Assets	0.424
3 Net Loan Charge-Offs/ Avg Tot Lns & Lses	0.053
4 Average of Interest Exp/ Avg Assets	-0.049
5 Average of Interest Income/ Avg Assets	-0.033
6 Provision Exp/ Avg Assets	0.032
7 Yield on Earning Assets (%)	-0.028
8 Realized Gains/ Avg Assets	-0.026
9 Net Interest Income/ Avg Assets	-0.020
10 Net Interest Margin	-0.014
11 Net Loan Charge-offs	0.013
12 Total Assets	-0.004

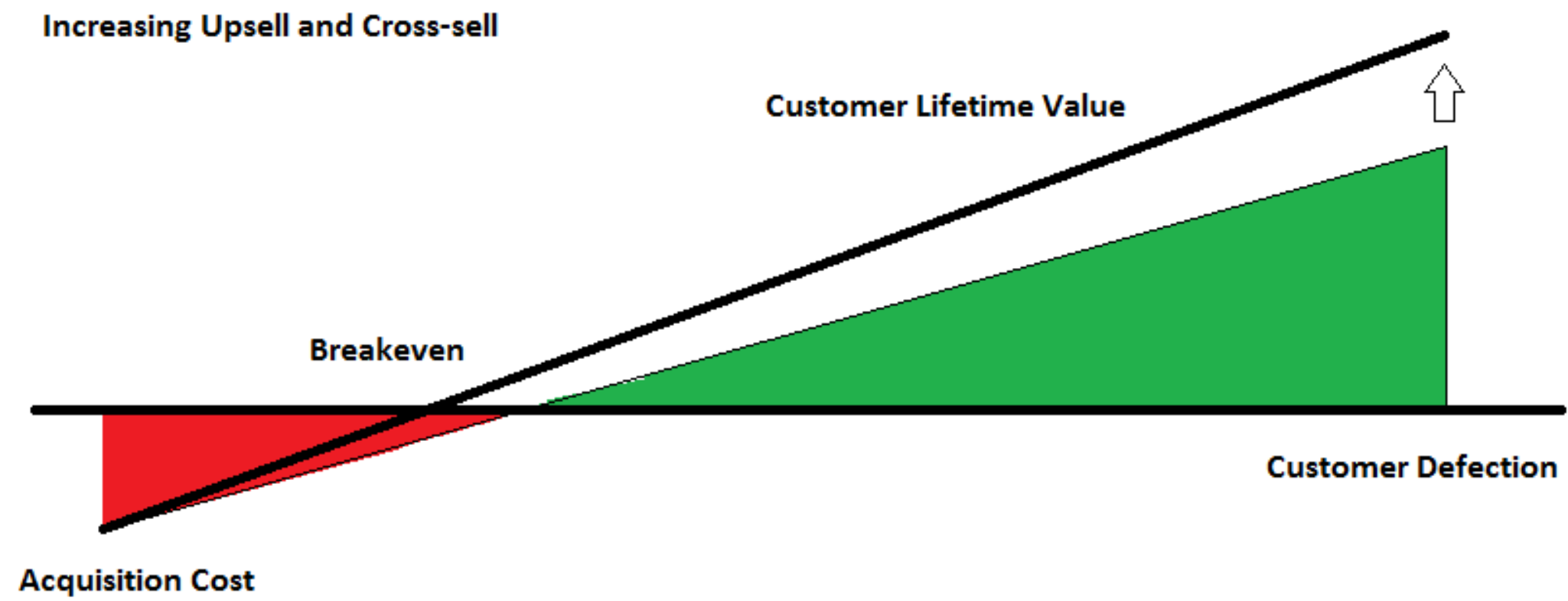
- Size of wallet
- Number of banking products
- Commitment term
  - Loan term  deposits
- Stickiness/switching costs
  - Project vs. balance sheet financing

# Community Bank Opportunities – Relationship Banking

Increasing Retention / Reducing Churn

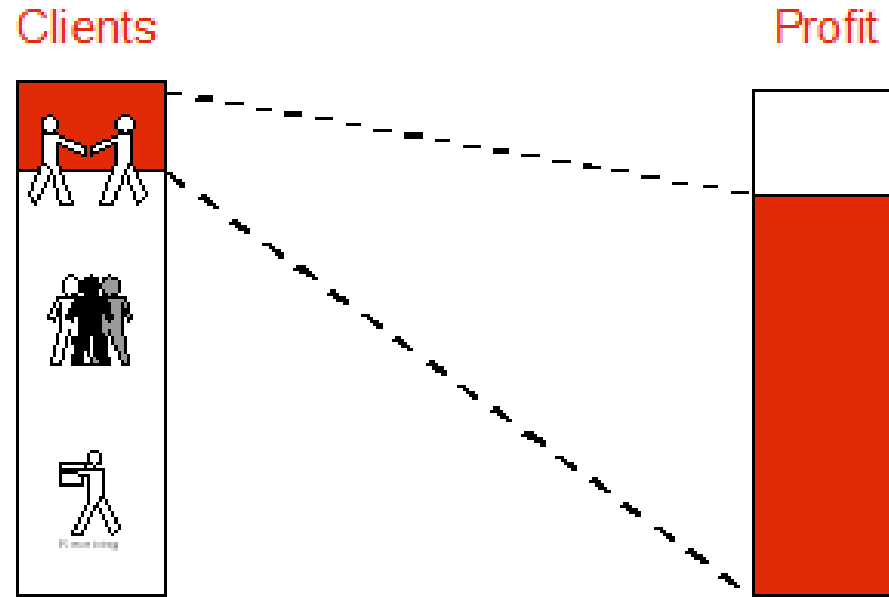


# Community Bank Opportunities – Relationship Banking





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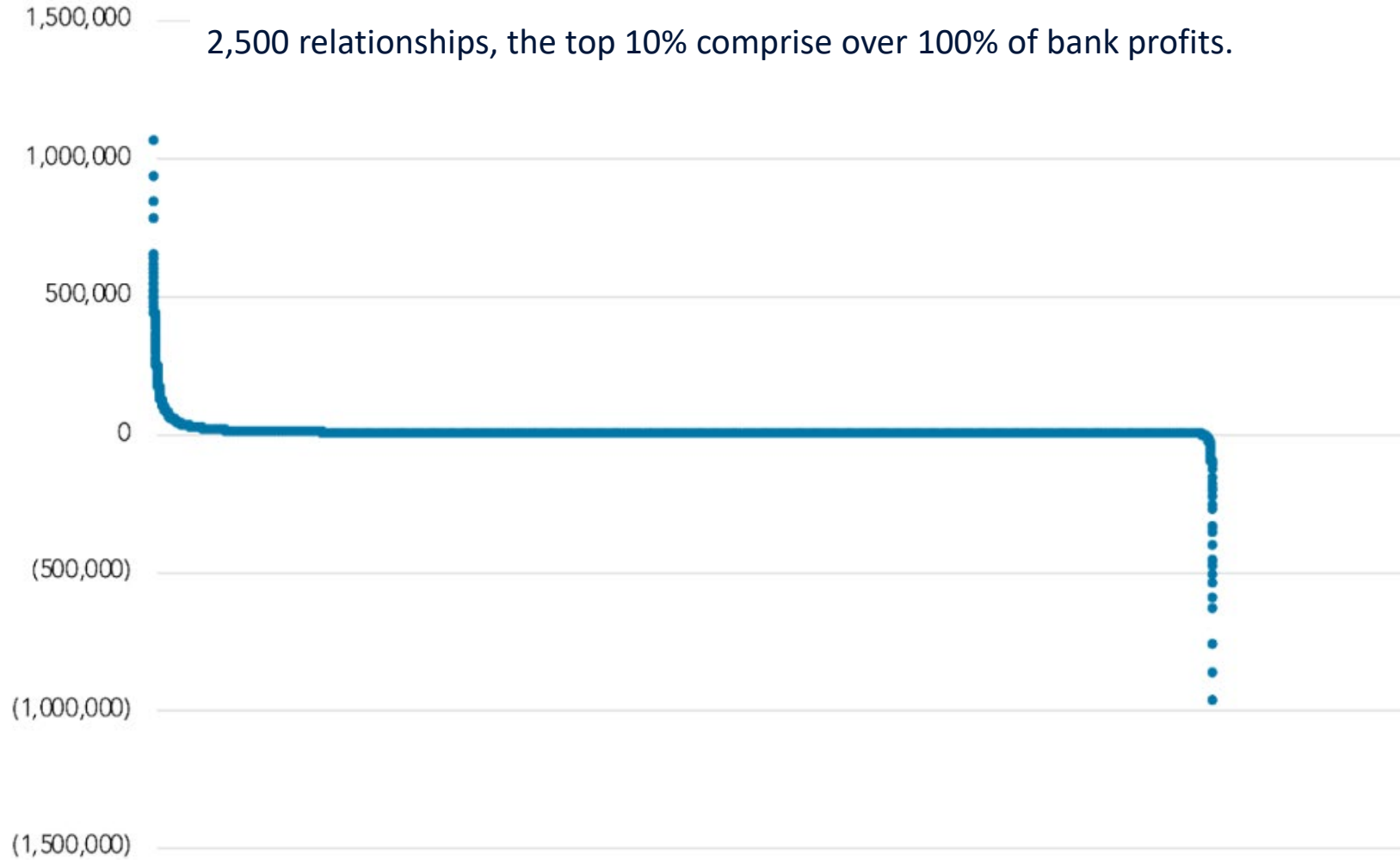


The top 20% of your clients  
Generate 80% of your profit

In banking, 10 % of customers generate 120% of your profit

# Community Bank Opportunities – Relationship Banking

Relationship Profitability



# Why Banks Continue to Offer Hedged Loans



With ARC, lenders may offer long-term fixed rate loans while eliminating interest rate risk to the bank, all without carrying a derivative. However, the benefits offer far more strategic value than simply minimizing risk:

**Help Borrowers But  
Protect The Bank**



**Differentiate From  
Competitors**



**Provide Better  
Service**



**Develop A  
Relationship**



# Questions



# Thank you!

Want more ideas and data?

Sign up at:

[SouthStateCorrespondent.com](https://SouthStateCorrespondent.com)



# Disclaimer

This presentation is for general strategic information only and should not be relied upon as a substitute for independent research before making a material management decision. This presentation does not take into account any particular bank's performance objectives, financial situation or needs. All banks should obtain advice based on their unique situation before making any decision based upon this presentation or any information contained within. In addition, any implied projections or views of the bank market provided by the authors may not prove to be accurate. While all the information contained herein is believed to be accurate as of the date of source or publication, the information is subject to change and constant revision.

In addition to any specific risks discussed herein, there are other factors that may influence the performance of an interest rate hedge product.

Counterparty Risk – the risk that the counterparty will not perform pursuant to the contract terms. Borrowers should carefully assess counterparty risk when engaging in such a transaction as described herein.

Basis Risk – the risk that the floating rate interest payments made on the loan and the floating rate interest payments received on the hedge contract could be mismatched, specifically if the floating rate indices, spreads, and other terms are not exact.

Amortization Risk – the risk of the potential mismatch between the outstanding principal amount of the loan and the outstanding notional amount of the hedge. Amortization mismatches could also result in termination of portions of the hedge prior to maturity and under unfavorable conditions.

Termination Risk – the risk that the hedge could be terminated as a result of certain events including payment default or other defined events of default. A termination of a hedge may result in payment received by the borrower or owed to the Bank depending on the market at the time of termination.

Prior to entering into any interest rate hedge transaction, recipients should determine, in consultation with their own legal, tax, regulatory, and accounting advisors, the economic risks and merits, as well as the legal, tax, regulatory and accounting characteristics and consequences of any transaction.

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