Loan Participations Plant the Seeds for Lending Growth

lending loan participations

Summary: Why is now a beneficial time to consider a loan participation? Peter Dewes, PCBB's Senior Vice President and Senior Lending Officer, shares his insights for community financial institutions to consider.

The first evidence of a commercial loan goes back 4K years to Mesopotamia. Farmers would borrow seeds and when their crops flourished, they would pay the lender back by giving them a portion of the seeds created by the new plants. For those who borrowed an animal, lenders were repaid in the form of a new calf.

Lending, of course, has become so much more sophisticated, and loan amounts have grown enormously. Regulations, however, set limits on how much funding lenders can provide borrowers. Community financial institutions (CFIs) have options however to meet these regulatory requirements and still meet the needs of their customers. They can partake in these larger loans by entering into loan participations with other institutions — as well as with PCBB. While you're likely familiar with loan participations, your CFI may not be focused on products like this, instead emphasizing increased deposits and other immediate streams of liquidity. However, there are some very valid reasons that you should be considering more loan participation deals right now. We asked PCBB's Senior Vice President and Senior Lending Officer Peter Dewes for his advice on why now could be an ideal time to ink some loan participation deals.

Current Challenges for the Banking Industry

- **Deposit competition.** According to the FDIC's latest Quarterly Banking Profile published March 7, Q4 2023 was the first time in seven quarters that deposits experienced growth. Yet, for community banks, deposit costs still outpaced loan yields for all of 2023.
- **Liquidity struggles.** "In the last year or so, institutions have seen deposit outflows, which limits the ability for them to lend as much as they would like to," Dewes says. Higher deposit costs will challenge banks, even after interest rates drop, according to a Deloitte report. The consultant firm predicts the average cost of interest-bearing deposits for the US banking industry in 2024 and 2025 will remain elevated at 1.7% and 1.5%, respectively, even as the fed funds rate declines from the recent peak. This may crimp bank profitability in the medium term.

Three Benefits of Loan Participations in the Current Market

1. **Minimize liquidity issues amid deposit competition.** Participating out existing loans already in an institution's portfolio provides "liquidity space" for them, Dewes says. "It opens up additional capacity to lend because a participant is buying a portion of an existing loan, which frees up those dollars for other loan opportunities," he says. "It also allows them to continue to work with their borrower and bring in a participant so they can conclude a loan with a borrower."
2. **Enhance customer relationships.** Institutions may seek a loan participation to ensure they don't lose their best customers due to lending limits for a single borrower. "They want to provide the loan to their borrower," Dewes says, "but it's too big for them. In this instance, the CFI could reach out to another financial institution, or a correspondent bank like PCBB, to participate in the loan. This would allow the CFI

to meet the needs of their customer by offering them the larger loan amount they need while still staying within their per-loan maximum dollar amount."

3. **Boost profitability.** Entering into loan participations allows CFIs to conduct regular business without interruption. "That's what's so critical for institutions," Dewes says. "For them to operate and to be profitable, they have to lend money. By using a participant, this allows them to seamlessly continue to lend to their borrowers regardless of their liquidity position."

Considering Your Participant

Loan participations themselves can be very beneficial to helping your CFI maintain relationships with good customers and increase their lending. When it comes to choosing a participant, though, Dewes has some words of caution. "There is the risk that the participant bank that has the financials on the borrower might think that they'd be a good target, so they start marketing to them to try and effectively steal the client away."

For this reason, it's prudent to consider alternatives to other banks when you are deciding on a partner. For instance, a correspondent bank, such as PCBB, cannot originate loans to the general public. "This eliminates the risk of competition with the lead institution that's offering the participation," says Dewes. "That's your insurance. A correspondent bank will never talk to the borrower unless the lead institution allows them to."

Consider entering into a loan participation to minimize liquidity issues amid deposit competition, enhance customer relationships, and boost profitability. At PCBB, we're here to help you take advantage of this opportunity, as market conditions are ripe.

EXPAND YOUR LENDING

ECONOMY & RATES

Rates As Of: 04/03/2024 09:29AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.42	-0.04	0.02
6M	5.34	-0.04	0.08
1Y	5.03	0.01	0.26
2Y	4.68	0.06	0.43
5Y	4.34	0.13	0.49
10Y	4.37	0.16	0.49
30Y	4.52	0.18	0.49

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**
5.34	8.50	5.32