Risk Management Association

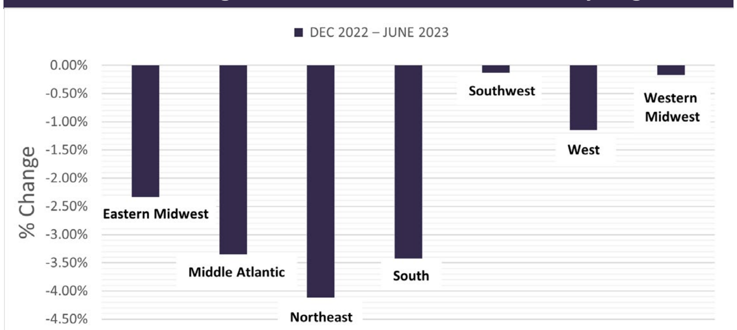
Commercial Credit Quality Bulletin

July 2023

Adverse Ratings Migration Continues Although Commercial and CRE Loan Losses Have Yet to Materialize

Commercial loan performance through June remained steady, although we are seeing some gradual migration in the form of risk rating downgrades. Noncurrent C&I and Commercial Real Estate (CRE) loans – loans past due 90 days or more or on nonaccrual – were 0.7% and 1.2%, respectively, compared to trailing twelve-month average figures of 0.6% and 1.1%. Anticipated losses in the form of charge-offs have yet to materialize, although the banking industry is expected to accelerate reserve builds in 2Q23, particularly for office properties. While the economy remains resilient in many ways and inflation continues to moderate, this resiliency could result in “lower for longer” interest rates, which would continue to stress borrower cash flow as more and more maturing loans reset in a much higher rate environment.

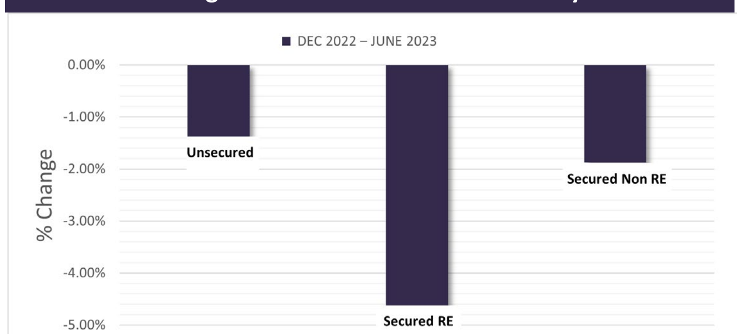
Absolute Change in Distressed C&I Loan Ratio by Region



Borrowers within the Credit Risk Navigator are assigned a credit risk rating based on the RMA 10 point scale, with ratings 1 through 6 being gradations of acceptable or “pass” ratings and 7 through 10 representing criticized loan categories. With the chart on the left we are illustrating the six-month change in the percentage of loans to borrowers that are risk rated 6 or worse, which we are labeling distressed. Risk ratings are a reflection of credit quality, and the deterioration we see for every geographic region across the country is reflective of banks’ uncertainty about future economic conditions and their borrowers’ ability to cope.

The chart on the right is showing the six-month change in the distressed ratio by collateral type. We have segmented the portfolio into unsecured loans, loans secured by real estate and loans secured by non-real estate (primarily receivables and inventory). Credit quality has deteriorated for all types of loans. The collateral type most impacted has been real estate secured loans, as the outlook for real estate has declined and the possibility of collecting the full amount of the collateral has been impaired.

Absolute Change in Distressed C&I Loan Ratio by Collateral



Change in Distressed CRE Loan Ratio by Property Type

This last chart examines the change in the CRE distressed ratio by major Property Type. The most notable changes are (1) the improvement for Lodging, as occupancy rates continue to improve leading to higher revenue per available room and cash flow for hotels; and (2) the deterioration for Office, Multifamily and Industrial properties. The slow return to office and lease renewals for considerably less space have negatively impacted Office occupancy. Further, a large number of new properties coming on line has led to a decline in prices for apartments and warehouses.

Why RMA and AFS?

RMA and AFS are committed to providing relevant, timely, and practical credit risk solutions to banks. Combining the strengths of each to offer information and insight, RMA and AFS are ideally situated for collaborations aimed at identifying and responding to the credit risk needs of financial institutions.

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