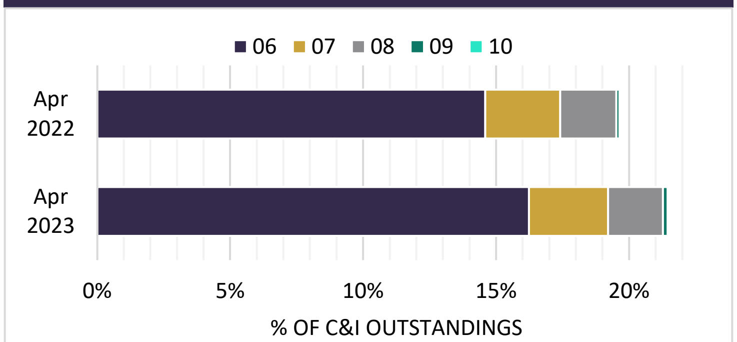
Commercial Credit Quality Bulletin

May 2023

Risk Migration Continues for both C&I and Commercial Real Estate; Credit Conditions Tighten Further

Key risk indicators for commercial credit continue to normalize in 2023. While in many respects levels of nonperforming and criticized loans remain manageable by historical standards, they continue a steady ascent. The Federal Reserve's highly anticipated senior loan officer opinion survey (SLOOS) was released this month. The SLOOS is unique in that it can be more forward looking than many traditional indicators of credit risk. And the May SLOOS update confirmed that credit conditions are still broadly becoming tighter, particularly with the credit shock to the system post Silicon Valley Bank and Signature Bank failures. Some of the more common reasons given for tightening referenced concerns about liquidity, reduced risk tolerance, and industry-specific problems. Demand for loans remained weak across all loan categories.

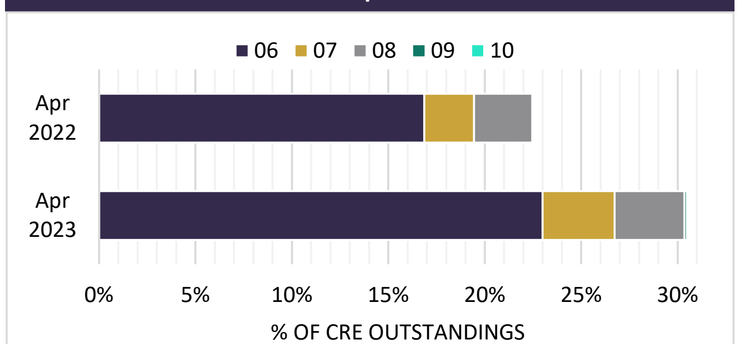
C&I Risk Composition Trend



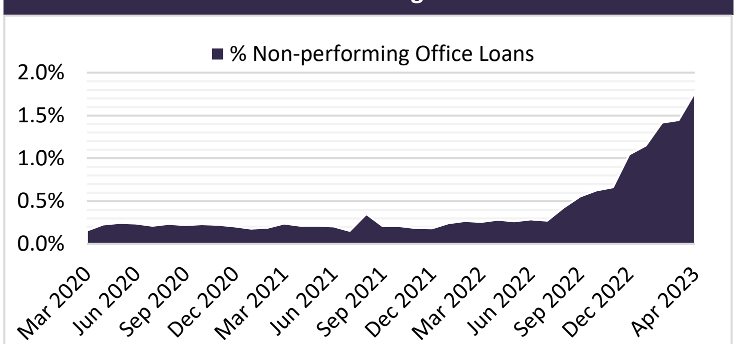
The chart on the left compares the percentage of C&I outstanding balances that are distressed as of April 2022 versus April 2023. We are defining distressed borrowers as companies with the lowest passing grade or a Criticized grade on a 10-point scale. Over the past twelve months, the distressed portion of the C&I portfolio has increased slightly, especially balances for the Low Pass borrowers. Industry sectors that have experienced substantial jumps in ratings include Construction, notably subcontractors, and Agriculture, primarily in the crop production subsector.

On the chart on the right, we display the percentage of outstanding Commercial Real Estate balances that are to distressed borrowers, April 2022 versus April 2023. As of April 2023 month end, 30.5% of total CRE balances met our distressed criteria, up 35.3% year over year. Leading the increase are CRE borrowers with the lowest passing grade (6 on our 10-point normalized scale), which now represent 23% of all CRE exposure, up from 17% just one year ago, so the adverse migration is evident. Adverse migration is occurring across all property types except Lodging, which continues to recover from COVID-era highs. Rising interest rates and waning RTO levels continue to pressure the sector.

CRE Risk Composition Trend



Percent of Non-Performing Office CRE Loans



The chart on the left shows the trend in non-performing CRE loans (90+ days past due plus nonaccruals) for Office properties. Recently there have been many articles discussing emerging issues with Office properties. Non-performing Office loans rose for the 9th consecutive month through April 2023 and now total 1.8% of total outstanding balances. This represents a 22% increase month over month and a 70% increase since the first of the year. A large number of leases expired in 2022, and the effects of vastly different market conditions are now reverberating throughout the sector.

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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