Risk Management Association

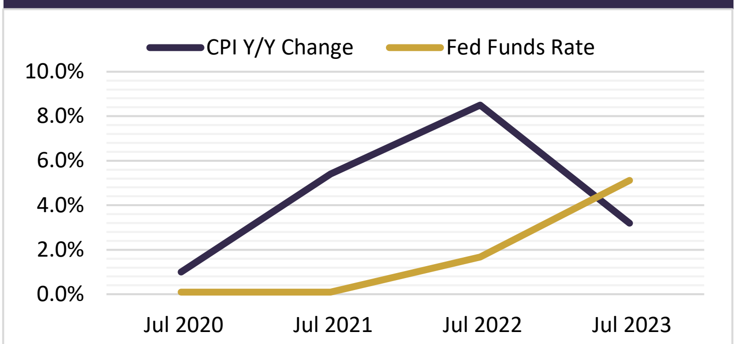
Commercial Credit Quality Bulletin

August 2023

Commercial Credit Quality Buttressed by Better Economic Data, Easing Inflation, Tighter Standards

Bank commercial credit quality remained sound through July 2023. Most major indicators of credit risk – for Commercial & Industrial (C&I) loans and Commercial Real Estate (CRE) loans – remained near historical lows. While pockets of weakness exist, such as office properties, the industry has yet to experience the defaults and charge-offs predicted. The Federal Reserve announced they are no longer predicting an economic recession later this year, although they still project economic growth below long-run potential in 2024. Despite the fact that the worst-case scenario has yet to materialize, lenders remain extremely cautious as new lending continues at the slowest pace in over a decade. Tighter underwriting standards, rising rates, and weak demand have led to several successive months of negative loan growth.

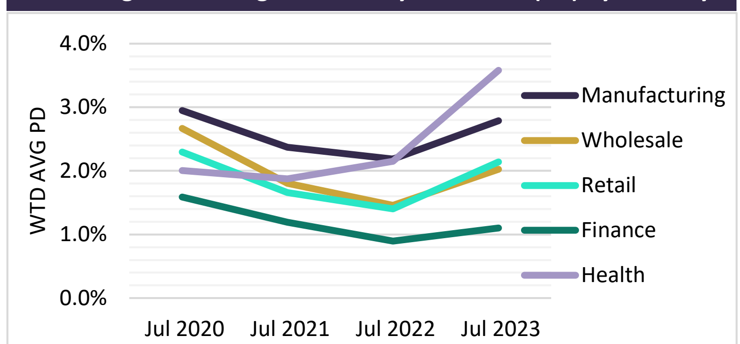
Inflation vs. Interest Rates



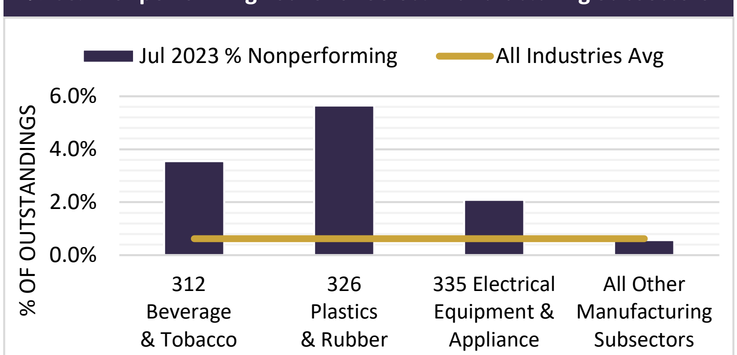
The chart on the left shows the recent trend in inflation and interest rates. For inflation, we are showing the twelve-month change in the Consumer Price Index (CPI) as of July 2020, 2021, 2022 and 2023, compared to the Fed Funds Rate for the same periods. The CPI reached its recent high point of slightly over 9% in the middle of 2022. The Fed's unprecedentedly fast tightening cycle has had the desired effect, driving inflation downwards with the latest CPI level now near 3%. While restoring price stability is essential, the higher rate environment is having a detrimental effect on borrowing costs and corporations and consumers seeking new credit.

On the right we are showing the trend in Weighted Average Probability of Default (WAPD) for the five major industry sectors. Manufacturing is the combination of all three manufacturing subsectors and Retail is the combination of two Retail subsectors. After the initial shock of the pandemic, default estimates improved for all sectors. But over time, the business outlook has started to normalize, especially for the Healthcare and Manufacturing sectors. The Healthcare industry (primarily doctors/doctors' offices) is facing staff shortages that are impacting profits.

C&I Weighted Average Probability of Default (PD) by Industry



% C&I Nonperforming Loans for Select Manufacturing Subsectors



The WAPD Trend chart above shows a significant increase in the WAPD for the combined Manufacturing sector. But the increase is not pervasive across all manufacturing. It is limited to three subsectors, which we are showing with the chart on the left. The worst performing subsector is Plastics and Rubber Manufacturing. The environmental pressures on limiting plastic usage for items such as shopping bags, water bottles, and even straws have caused severe drops in sales and profits for this business. We are also seeing elevated levels of nonperforming loans for soft drink manufacturers and wineries, both consumer discretionary products.

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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