In the Face of an Economic Recession, Commercial Loan Credit Quality Remains Strong

Overall commercial loan credit quality remains strong despite conflicting economic signals, according to data from the RMA Credit Risk Navigator, powered by AFS. June saw the hiring of almost 400,000 people, and the national unemployment rate remains near the 50-year low. However, in the face of inflation reaching a new 41-year high – and real GDP contracting for two consecutive quarters, according to early estimates by the Atlanta Fed – concerns about an economic recession and a deterioration in credit quality have intensified. Federal Reserve-engineered increases in interest rates are beginning to buffet home and auto sales as well as decrease demand in other sectors. For C&I loans, the industry-average one-year probability of default improved modestly in H1 2022, although scores deteriorated across several subsectors within the Manufacturing industry. In the CRE space, improvements in nonaccrual levels for the Lodging sector were offset by increases for Retail, Office, and Multifamily properties.

In June, C&I loans on nonaccrual and the percentage of deal volume risk rated Criticized were both trending near service lows. However, the national trends mask several emerging risks seen at a subsector level. One-year probability of default projections increased during the first half of the year for several subsectors in the broader Manufacturing industry (note that these estimates exclude loans that have already defaulted). Since the Manufacturing industry is central to supply chains, the rating trends for this sector raise concerns about future economic conditions and credit performance.

On the right, we compare the risk profile of C&I loans originated in the final month of 2021 to the new deal flow in June of this year. In recent months, total C&I loan growth has been unusually robust, fueled in large part by inflationary pressures. Much of the demand has come from the larger end of the market, as evidenced by the change in the C&I risk rating distribution. The percentage of new C&I loans risk rated “High Pass” (03 and 04) increased in June when compared to the beginning of the year. Conversely, new C&I loan volume rated “Average” (05) or “Low Pass” (06) declined over the same period.

For the CRE loan market as a whole, nonaccrual levels have been flat for some time, still trending above the pre-pandemic average. Whereas nonaccrual levels for the Lodging sector improved during the first half of 2022, the credit performance of several other major property types is beginning to deteriorate. For example, Health Care and Mixed Use properties displayed sharp increases in nonaccruing loans, with nonaccrual levels for Retail, Office, and Multifamily properties also rising modestly.