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.

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.

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.