Balancing Current & Future Credit Trends

lending credit risk

Summary: We are in "uncharted territory" in the economic cycle. Credit reminders for banks during this uncertain time.

A University of Toronto study finds a strong correlation between career accomplishments and depression in lawyers. This finding seems to go against the general trend of greater success leading to lower depression. Maybe that's because one of the main drivers was the lack of work-life balance from long hours at work. Many bankers work long hours too, but maybe the idea of working with money every day will help you ease the burden a bit.

To help protect your bank and its money, we point out that while things still look good out there, it has been a long recovery cycle and we are likely past the peak.

Since we are also in "uncharted territory", it may be difficult to manage some of your credit risk. After all, no one knows when the cycle will turn because no one has ever been here before. Regardless, it makes sense for bankers to be prepared.

As things sit now, valuations are running high and cap rates are low. Retail cap rates are <= 6.0% while historically they are around 7.5%. Multi-family/apartments meanwhile typically have around a 7.0% cap rate and now they are below 4.0%. Of course, geography, class and a host of other factors matter, but the gist of this discussion is there.

Look no further than the July FOMC minutes where it was noted that "the pace of increase in real estate prices in the multifamily segment" could perhaps lead to increased financial volatility. Needless to say, as valuations continue to rise, regulators want banks to exercise more and more caution.

Community banks deeply know their commercial real estate markets. Bankers are familiar with the various developing areas and how the local economy can impact them. But, in order to stay on top of subtle market changes, drive the neighborhoods every now and again and talk to local businesses. If you notice areas are becoming overvalued it may be time to pass on deals in that area at this time. Ramp up discussions with brokers as well and ask them what they are seeing and hearing. All of these sources can provide your team with important insight and facilitate your bank's preparations.

Of course, bankers know they need to embed the level of risk into deal calculations. However, simply looking at each deal in isolation has holes. Without taking into consideration the long 9Y current economic cycle and rising valuations, such a narrow focus could create an unsatisfactory or even disastrous result. In this low interest rate environment, it may be difficult to do this and stay competitive, but bankers should keep trying.

As part of any potential loan exit plan strategy, think about tightening your parameters before you need to do so. That way you won't be caught off guard and forced to downgrade deals later as property values soften.

As a reminder example, let's take a 5Y loan. The originating 75% LTV has increased to 82%, due to a decrease in the property's value. This can be due to vacancy increases, softer rents and cap rates. Once the loan is due and sitting at 82% it can be too late to take much action. However, by tightening loan parameters to 70%, in this example, the pile of such loans stays manageable. The key as always is not to wait for the loan to come due to evaluate this. You may even want to do so on some loans as often as semiannually perhaps.

Reviewing your deals on a regular basis is just one of the elements that should be included in any potential exit plan. Doing so gives you the flexibility to decide whether to sell a loan and to have the ability to do so quickly.

Thinking about such things may be early at this point, but it is important to remind the team to keep their eyes and ears open to avoid issues when the credit cycle eventually turns. It can also help keep your attorneys from having to work on problem credits in the future and that should help everyone sleep better.

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