Inquiry & Insight: Lenders Staying Financially Fit

lending commercial industrial CRE

Summary: Lenders have lots of questions these days. We shed some light on a few of them.

A recent study from the University of Copenhagen shows that after exercise, a body automatically cleans up its muscles so they stay healthy. While staying healthy physically is important, lenders know that it is also important to stay healthy financially.

With this in mind, in this issue of Insight & Inquiry, we share some questions from lenders nationwide and provide you with our insight.

Q: When are lenders going to start charging off loans?

A: The St. Louis FRED database provides charge-off rates on Commercial and Industrial ("C&I") and Commercial Real Estate ("CRE") loans for "banks not among the 100 largest in size (by assets)." Looking at the data for the last three recessions, CRE charge-offs lagged slightly behind C&I charge-offs. Awareness of historic trends may help shed some light on what to expect.

- In the **Great Recession**, C&I charge-offs started to rise in late 2006 and then peaked at 2.28% in Q2 2009; whereas CRE charge-offs began to rise in early 2007 and then peaked at 2.73% in Q1 2010 -- **CRE peak was three quarters behind C&I**.
- In the **dot.com bust**, C&I charge-offs peaked at 1.56% in Q4 2001; whereas CRE charge-offs peaked at 0.22% in Q1 2002 -- **CRE peak was 1 quarter behind C&I**.
- In the **early 1990s**, C&I charge-offs peaked at 2.01% in Q1 1991; whereas CRE charge-offs peaked at 1.25% in Q4 1991 -- **CRE peak was 3 quarters behind C&I**.

Q: My bank has a lot of CRE and I know it will get hit, but how badly?

A: Nareit recently surveyed rent collection rates for certain property types for 43 US REITs. The rent collection rates were not too disparate from April to May; however, there is a notable variance between industrial properties and retail properties. Industrial properties saw a rent collection rate of 95.7% in May and offices were not too far behind with 92.1%. Yet, freestanding retail's rent collection rate was 70.1% and worse yet, shopping centers had a rate of 47.7%.

To add to this picture, Trepp's April 2020 CMBS survey data showed a similar trend, with about 10.5% of retail properties in their payment grace period or beyond, compared to approximately 4.5% of industrial properties.

Q: What's the new "gold standard" borrower and where is it safe to lend?

A: The reality is that we will see some permanent shifts in behavior that will result in the displacement of some of the businesses that have historically been "gold standard" borrowers. Businesses that rely on a high volume of in-person interactions may need significant innovation and/or heavy capital expenditures, in order to return to healthy levels. This is a topic that we are all learning more about as new information and innovation arise.

As you work through your loan portfolios, these questions may arise for you too. Hopefully, we have given you some food for thought to help guide you.

HAVE A QUESTION FOR INQUIRY AND INSIGHT?

Send any questions to me at steve.brown@pcbb.com and I will try to address them in one of the upcoming issues. I look forward to hearing from you!