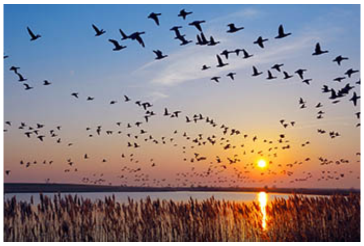

Credit Migration Trend – Where Is It Heading?

lending risk management

Summary: Credit migration is always a concern for bankers and the uncertainty around the pandemic has only increased it. Deferrals seem to be less prevalent, yet criticized loans have increased. We look at the current credit migration trend to keep you updated.

Birds have been known to migrate up to 16,000 miles and reach speeds of 30mph to reach their destination at the right time. That means it could take some birds 66 days to reach their destination. Talk about perseverance! Bankers also need perseverance in dealing with their own migration — credit migration.

Bankers are always on the lookout for credit migration trends, even more so now as deferrals are less prevalent and lenders hone in on loans that show more persistent performance issues. With a new round of stimulus coming, the full impact of the ongoing pandemic may be tamed; however, we continue to keep our eyes on the loan market for you.

Bank fundamentals look good. Fitch Ratings reported that bank fundamentals have done well against the firm's downside scenarios. One factor feeding this health could be that loan risk rating downgrades haven't been as pervasive as first expected when the pandemic hit. Capital ratios have held up with fewer risk-weighted assets on bank balance sheets too.

Deferrals decrease. While deferral balances hit $1.03T on June 30, 2020, they plummeted almost 60% to $407B by the end of Q3 2020. Since the latest stimulus package extended the deadline to classify loan deferrals due to COVID-19 to January 1, 2022, certain credit migration may not show up in call reports until next year. Deferrals dipped a median 69.8%, according to S&P Global's analysis from Q2 to Q3 of 2020. Several community and regional banks in the analysis experienced deferrals decreasing around 95% in the same period.

Still, some bankers are not waiting for that and are already paying special attention to those borrowers asking for an extended deferral period. S&P Global Market Intelligence forecasts that 45% of the outstanding deferrals will reach nonperforming status.

Criticized loans increase. Criticized loans — loans considered special mention, substandard, doubtful, or loss — have already increased and may grow more later this year. S&P Global assessed that criticized loans increased to 4.04% of loans, not including PPP loans, in Q3 vs. 3.51% in Q2. The good news is that several bankers have not experienced criticized loans migrating into the territory where they would be considered losses. With some careful planning and risk mitigation, CFIs could find themselves in better shape than some bigger financial institutions.

Nevertheless, the extent of the vaccine rollout, the continuing distribution and impact of stimulus funds, and the velocity of economic recovery will all play into the credit migration trend. Bankers will be watching as each of these events unfold. In the meantime, make sure that you watch your loan portfolio carefully, talk to your borrowers regularly, and mitigate the risk of any credit migration coming in the next few months.

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