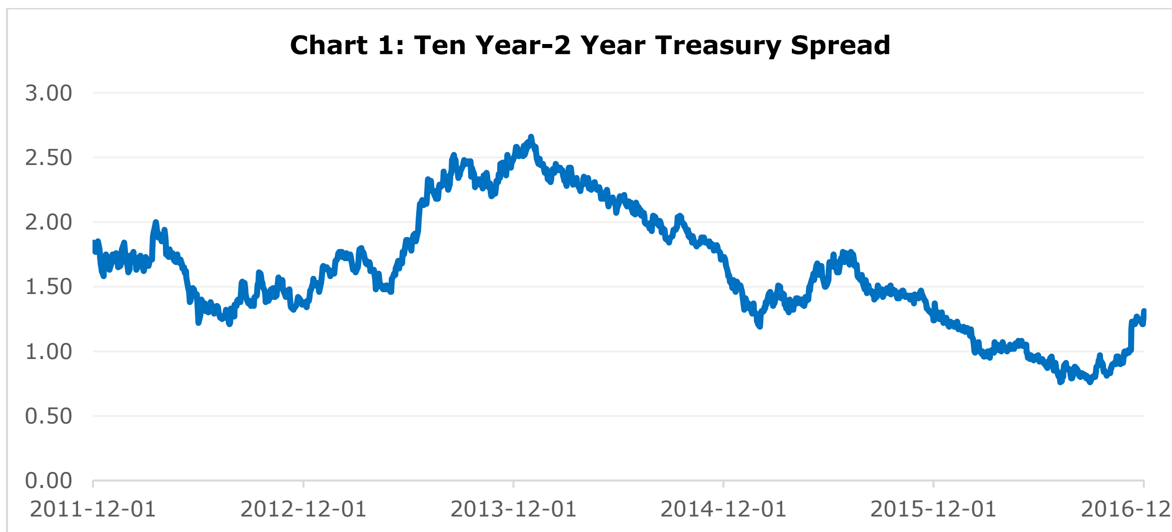
Credit Outlook Q4 2016: As Benign Environment Ends, Bank Portfolios Suggest Future Stress

As U.S. markets near the release of Q4 2016 earnings, Kroll Bond Rating Agency (KBRA) notes again that credit conditions for financial institutions continue to be stable and reflect a benign environment overall. It is increasingly apparent, however, that the increase in asset prices engineered by the Federal Open Market Committee (FOMC) over the past five years is nearing a conclusion and that bank credit costs are slowly rising—albeit from very low levels. Prices for 1-4 family homes have reached record levels for the post 2008 period and, as we noted in our recent macro-market comment, **"Declining Mortgage Lending Volumes Ahead,"** lending in the residential sector by banks and nonbanks alike probably will peak around $2 trillion this year and likely will decline 20-30 percent in 2017.

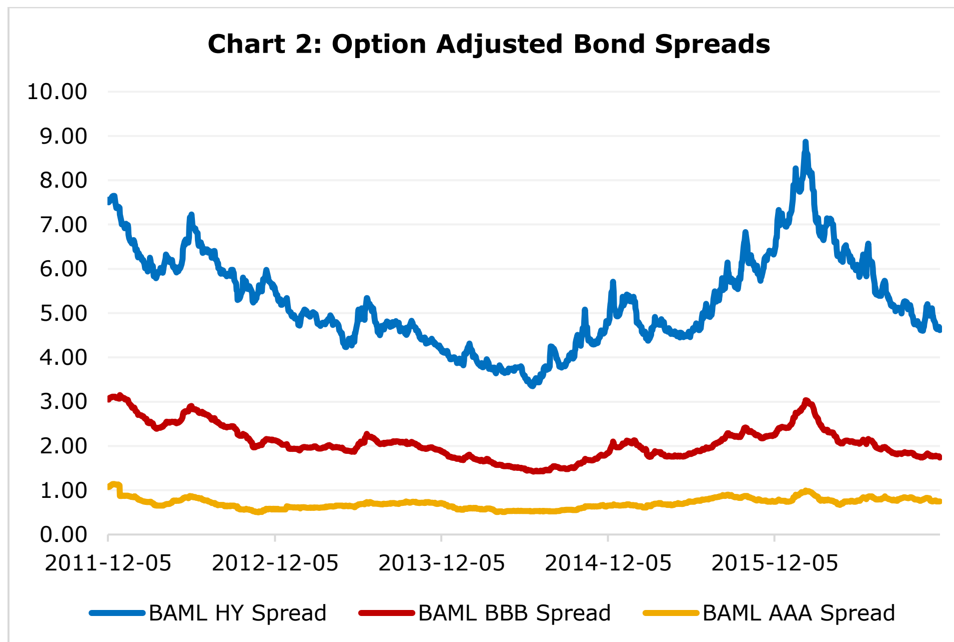
The big change since our last credit outlook is that the election of Donald Trump has brought a dramatic and somewhat disparate change in the direction of interest rates and credit spreads. We noted in our last report that the question was not so much whether we have seen elevated assets prices in many markets and asset classes, but "rather how and when the markets will adjust to a gradual cessation of central bank intervention, especially given flat income growth and gross domestic product growth rates." Yet the change has come not because of actual or prospective action by the FOMC, but from the election of a Republican who proposes to cut taxes *and* increase government spending. The government bond market has reacted accordingly, as shown in Chart 1 below.



Source: Federal Reserve Data

After reaching a low in the spread relationship between the 10-year and the 2-year Treasury note back in August of 76bp, the relationship has since almost doubled to 131bp last week. This spread is still less than half of the 2.5% 10s vs 2s difference seen in 2013 and the almost 3% spread in 2009, but the change is large in percentage terms and has occurred in a relatively short period of time, basically the five weeks from the end of October to the start of December.

What is even more notable, KBRA believes, is the fact that as Treasury spreads have widened, corporate spreads have actually tightened, as evidenced by the strong execution enjoyed by KBRA rated banks. Compared with the more than 800bp spread between high yield and "AAA" corporates in Q1 of 2016, today that spread is around 475bp and falling, as shown in Chart 2 on Page 2.



Source: BAML

Even as the yield on Treasury and agency benchmark has risen, spreads for investment grade and high-yield securities have remained stable and even declined, suggesting that investors do not yet see the prospect of a Trump administration as heralding a bear market in corporate debt. Our colleague Fred Feldkamp, who has spent decades tracking the relationship between corporate bond spreads and economic performance, believes that the movement in the Treasury benchmarks is a leading indicator. "Remembering the Carly Simon song **'Anticipation,'**" Fred notes, "a widening of long-short Treasury spreads is often associated with eventual corporate spread expansion. This time I think the word is simple inflation."

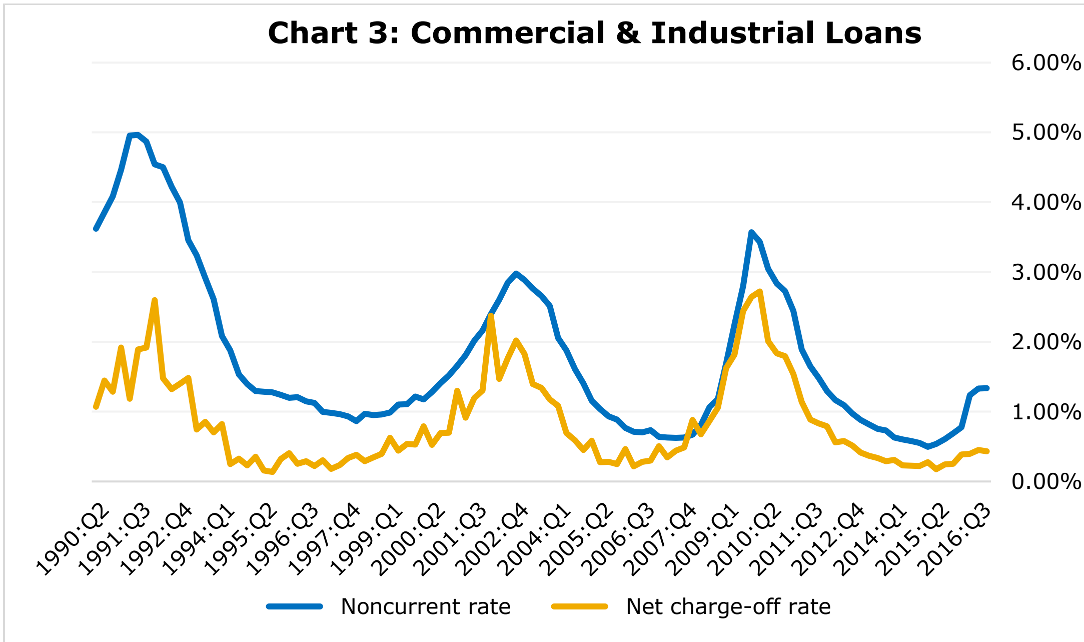
In the Treasury bond market, at least, investors are certainly anticipating an increase in inflation compared with previous levels seen over the past decade. This change in the cost of funding and inflation expectations has not yet translated into elevated corporate spreads or default rates, although a number of observers have postulated that credit costs must rise after the lengthy period of FOMC market intervention.

The latest data from the Federal Deposit Insurance Corporation for U.S. banks bears out this idea, with default rates generally continuing to fall in many asset classes other than commercial loans, but other indicators suggesting that the increase in asset prices has distorted these same markets. While overall revenue for the U.S. banking system rose almost 10% to $47 billion in Q3 2016, net interest margins fell under the continued downward pressure of the FOMC's low interest rate policy regime. Yet as we note in our **Rating Outlook for US Banks**, credit performance continues to be stable at most U.S. banks.

Net loan losses totaled $10.1 billion in Q4 2016, up $1.5 billion (16.9 percent) from a year earlier, the FDIC reports. The bank insurance agency notes that this is the fourth quarter in a row that net charge-offs have posted a year-over-year increase. Meanwhile, loan loss provision continue to rise, up now nine quarters in a row. Charge offs for multifamily and residential real estate loans continue to fall, but defaults on commercial and industrial (C&I), credit card, and auto loans rose.

Looking at the $9.2 trillion in total loans and leases held by U.S. banks, default rates are continuing to rise slowly at 0.15% after bottoming out at 0.14% in Q3 of 2015. Non-current loans are 10x default rates at 1.45% and trending lower, but loans 30-89 days past due are steady at 0.65%. Loss given default (LGD) is likewise stable at 73.75%, indicating a recovery rate of just over 26% for all US bank loans.

After rising for several quarters following the drop in oil prices, the rate of change in non-current C&I loans has slowed considerably. Net charge-offs of loans to C&I borrowers rose $946 million or about 83% in Q4 2016. The $1.9 trillion C&I category is an important asset class for U.S. banks and seems to be stabilizing after the sharp drop in oil prices in 2015. At 1.43%, the non-current rate for C&I loans seems to have stabilized and the net-charge off rate as a proportion of total loans has actually declined slightly, suggesting that the energy related surge in bank credit losses that began in 2015 in the aggregate bank C&I portfolio may have peaked.



Source: FDIC

Chart 3, above, shows non-current and net charge-offs for all C&I loans. While LGD did rise some 20 points to over 80% starting last year, net charge-offs rose far less than was feared by many market observers, in part because of new inflows of private equity into the energy sector. Indeed, many of the banks in KBRA's rated universe with significant energy exposures have seen better than expected experience in terms of managing these credits.

Bank-owned auto loans have shown an increase in charge-offs, with Q4 2016 at 0.75% the highest net default rate since 2011. Yet the level of default for prime bank owned auto paper is quite low compared to default rates on below prime loans generally found in asset-backed securities. In the third quarter, 2 percent of subprime auto loan balances became at least 90 days delinquent, up from 1.6 percent in the third quarter of 2014, according to the Federal Reserve.

Total auto loans outstanding in the U.S. reached $1.1 trillion in the second quarter, according to Federal Reserve data, but less than $500 billion is held by banks and the rest is held in ABS. The Fed reports that auto-loan originations in the period were $149 billion, close to the record $151 billion in the third quarter of last year. Loss given default on bank-owned auto loans rose to just under 70%, reflecting softness in the auto sales channel and the fact that many borrowers are under water on loans and leases.

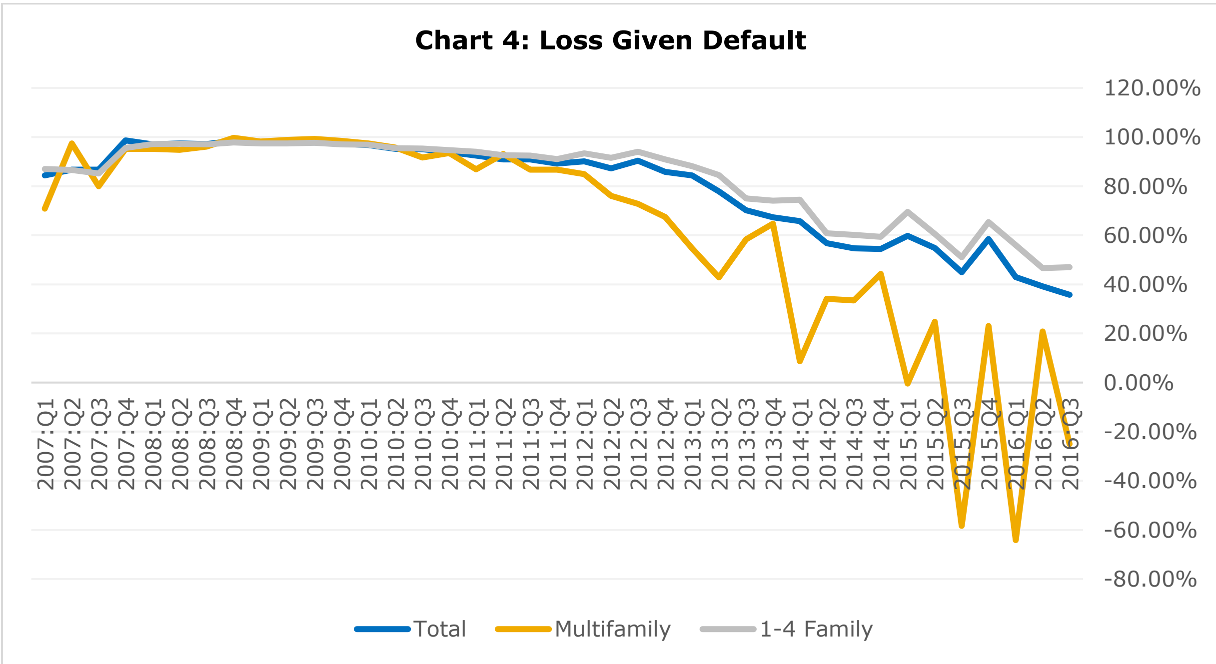
Finally, trends in the real estate sector suggest that the best days in terms of credit performance are behind U.S. banks. Although currently the credit picture regarding bank-owned real estate loans remains quite benign, the image is in many ways too good to be true. The data released by the FDIC suggests that the FOMC's efforts to manipulate asset prices may have created a potential credit problem in real estate for U.S. banks in the future. Key indicators such as defaults, recoveries and non-current rates are at levels not seen since before the 2008 financial crisis. For example:

- One worrisome statistic is LGD for all real estate loans, which has fallen to just 37% for this $4.5 trillion asset class, the lowest level since the FDIC started collecting statistics in the 1980s.

- Net charge off rates for multi-family loans were again negative in Q3 2016 while LGDs were -25%, up from -64% in Q2 2016 as recoveries exceeded credit costs by a huge degree. Net charge-off rates for the $2.4 trillion in 1-4 family loans held by US banks, were again just 0.1% in Q3 2016, the lowest default rate since 2006.

- LGDs for 1-4 family residential loans were again below 50% for the second quarter in a row, the lowest rate of loss given default going back three decades and an illustration of the strength of the US real estate market as it reached a ten-year peak in home price appreciation.

Chart 4 below shows the LGDs for 1-4 family loans, multifamily loans and total real estate loans held by U.S. banks at the end of Q3 2016. As we've noted in previous missives, when banks are reporting negative credit costs on trillions of dollars' worth of real estate loans, we generally consider that to be a red flag regarding future credit performance of these portfolios.



Source: FDIC

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Analytical Contact:

Christopher Whalen, Senior Managing Director
(646) 731-2366
cwhalen@kbra.com

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