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Slowing Economy Threatens Credit Quality

While credit quality is still relatively strong, the trend may have turned toward deterioration in conjunction with the onset of slowing U.S. economic growth, the latest Shared National Credit data suggest.

Indeed, the industry may be at the cusp of its cycle, as the combination of "classified" and "special mention" credits—the adversely rated credits—as a percentage of total commitments notched higher in 2006 to 5.1% from 4.8% in 2005. This was the first increase seen since the lingering effects of the 2000/2001 recession worked their way through the financial system.

The detailed report, issued jointly by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corp. (FDIC), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS), covered 7,009 syndicated credits among 4,833 borrowers, totaling $1.9 trillion in credit commitments as of the second quarter of 2006.

Examiners for the federal bank and thrift regulators noted "a continued easing of underwriting standards in the syndicated lending market in general, particularly in non-investment grade or leveraged credit facilities." If that pattern remains in place, and if the economy continues to soften, as suggested by recent employment, retail sales and industrial production numbers, then the upturn in the relative portion of adversely rated credits is just beginning.

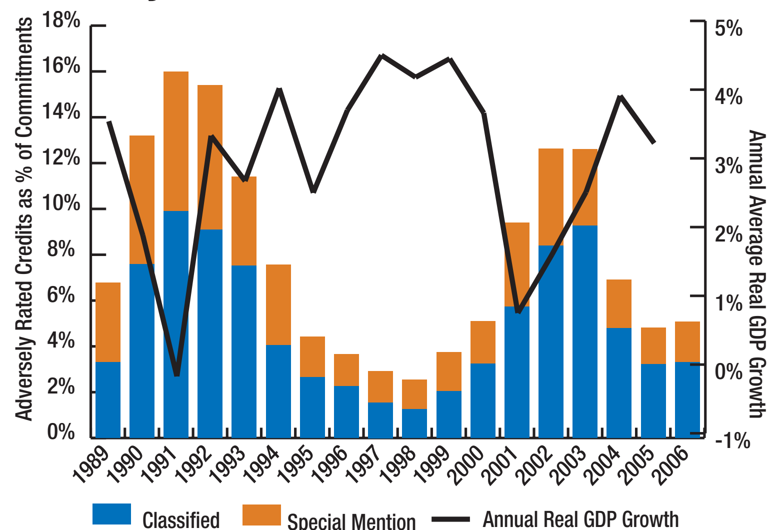
The accompanying graph shows the strong inverse relationship (a negative correlation of 70%) between the portion of credit commitments that are adversely rated and annual GDP growth, adjusted for inflation. In particular, sharp spikes in the proportion of troubled credits are evident during and following the recessions of 1990/1991 and 2000/2001.

By industry sectors, the relative deterioration in credit quality from 2005 to 2006 was seen in the manufacturing, lodging and transportation, and financial services and insurance sectors. Credit quality improvement was seen in the telecommunication and cable; construction and real estate; professional, scientific and other services; and oil, gas, pipelines and utilities sectors.

The regulators noted that the deterioration in the manufacturing sector "overshadowed" other developments and was tied largely to the automotive industry.

As part of its bank rating process, A.M. Best closely reviews a bank's underwriting standards, the nature of its clients and the broad background of economic conditions that materially could affect performance and/or asset quality.

Adversely Rated Credits Versus GDP Growth



Sources: FRB, FDIC, OCC, OTS and BEA.

The report was written by John Williams, senior business analyst with the Analytical Services Group at A.M. Best Co.

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