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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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MARCH 2021

Bank Watch

ARTICLE

One Year Later: An Update to Our Pandemic Credit Risk Analysis

In This Issue

ONE YEAR LATER

An Update to Our Pandemic Credit Risk Analysis

In the **April 2020 *BankWatch*,** we offered our first impressions of a then inchoate, or "imperfectly formed," credit environment. With a year of hindsight, it is worth revisiting the credit risk outlook. In April 2020, we were cautious, aware of signals provided by collapsing of bank stock prices, widening corporate credit spreads, and rating agency loss expectations that approached Great Financial Crisis levels.

However, we leavened this dire outlook with some optimism. Banks' loan portfolios appeared better positioned to weather recessionary economic conditions than when entering the Great Financial Crisis; smaller, more rural markets served by many community banks seemed more resilient than larger markets; and governmental actions offered hope of dampening the credit cycle.

We did not, however, foresee the magnitude of the economic stimulus programs. *The Economist* noted that the $6 trillion of announced federal pandemic-related spending equates to nearly 30% of pre-pandemic GDP, representing a much larger federal response than during the Great Financial Crisis. Meanwhile, the Federal Reserve has assured investors that interest rates will remain near zero, while also expressing comfort with inflation overshooting its 2% target. The result is an experimental fiscal and monetary policy response to the crisis that mirrors the novel approaches used to develop COVID-19 vaccines.

A year after declaration of the pandemic, investment-grade corporate bond spreads are virtually equal to year-end 2019. Rating agencies have reduced expected loss rate estimates for high yield bonds and leveraged loans, reflecting both better than expected economic activity and highly accessible capital markets that have allowed even troubled issuers to raise new capital to boost liquidity and extend debt maturities.

Table 1

	A Rated		BBB Rated		BB Rated	
Option-Adjusted Spreads	**Corporate Bonds**	**CMBS**	**Corporate Bonds**	**CMBS**	**Corporate Bonds**	**CMBS**
12/31/19	76 bps	171 bps	130 bps	252 bps	202 bps	n/a
3/31/20	232 bps	660 bps	396 bps	743 bps	641 bps	n/a
6/30/20	120 bps	534 bps	207 bps	740 bps	469 bps	n/a
9/30/20	108 bps	426 bps	184 bps	613 bps	400 bps	n/a
12/31/20	79 bps	369 bps	130 bps	503 bps	279 bps	n/a
3/23/21	79 bps	275 bps	124 bps	382 bps	262 bps	n/a
12/31/19 - 3/23/21 Change	**3 bps**	**104 bps**	**-6 bps**	**130 bps**	**60 bps**	

Source: ICE BofA index system

Commercial mortgage-backed security spreads, though, remain wider than at year-end 2019. A significant proportion of the securitized CRE loan universe remains in special servicing or under some form of payment forbearance, especially hotels and retail properties.

Reviewing bank asset quality metrics in isolation, one would hardly recognize that a severe economic downturn occurred in 2020. Table 2 below presents nonperforming loan/total loan ratios for community banks.

For community banks in aggregate, nonperforming loans barely budged in 2020, rising by six basis points to 0.79% of total loans. Banks in the Southeast region actually reported a lower year-over-year NPL ratio, with the relative change in NPL ratios between Southeast and Midwest banks (down 7 bps and up 1 bp, respectively) and their peers in other regions (up 10 to 20 bps) perhaps attributable to divergent responses to the pandemic.

Our concern in April 2020 about C&I loan growth leading to higher credit losses apparently was misplaced, as C&I NPL ratios increased by only eight basis points. The larger uptick in C&I NPL rates in the Southwest region may be attributable to energy industry concentrations. Decomposing the 14 basis point change in CRE NPL rates, multifamily NPL rates decreased by four basis points, while owner-occupied and nonowner-occupied NPL rates increased by 11 basis points and 22 basis points, respectively.

Table 3 (page 3) tells a similar story for charge-off rates, which actually decreased slightly for four regions in 2020.

Nonperforming loan and net charge-off rates, however, are lagging credit quality indicators. Loan risk ratings may provide a more forward-looking measure of potential credit exposure. Table 4 (page 3) and Table 5 (page 4) present criticized and classified loan data, as obtained from publicly traded banks' SEC filings.

Table 2

Non-Performing Loans / Total Loans	Residential Real Estate			Commercial Real Estate			Commercial & Industrial			Total Loans		
	2019	2020	Change	2019	2020	Change	2019	2020	Change	2019	2020	Change
Mid-Atlantic	0.71%	0.82%	11 bps	0.64%	0.95%	31 bps	1.15%	1.19%	4 bps	0.74%	0.91%	17 bps
Midwest	0.77%	0.72%	-6 bps	0.59%	0.75%	15 bps	0.92%	0.84%	-7 bps	0.79%	0.80%	1 bps
Northeast	0.66%	0.70%	4 bps	0.59%	0.85%	26 bps	0.63%	0.86%	23 bps	0.60%	0.77%	16 bps
Southeast	0.82%	0.73%	-9 bps	0.60%	0.55%	-4 bps	0.67%	0.74%	7 bps	0.75%	0.68%	-7 bps
Southwest	0.92%	0.85%	-7 bps	0.69%	0.85%	16 bps	1.17%	1.42%	26 bps	0.81%	0.93%	12 bps
West	0.49%	0.59%	10 bps	0.27%	0.35%	8 bps	0.95%	1.38%	43 bps	0.49%	0.61%	13 bps
National	**0.75%**	**0.74%**	**-1 bps**	**0.58%**	**0.72%**	**14 bps**	**0.93%**	**1.01%**	**8 bps**	**0.74%**	**0.79%**	**6 bps**

Analysis includes 2,053 banks with total assets between $250 million and $3 billion at 12/31/20, excluding certain banks with non-traditional loan portfolios

Non-performing loans consist of (a) nonaccrual loans and (b) loans 90+ days delinquent. PPP loans are excluded from C&I loans and total loans.

Mid-Atlantic = DE, DC, MD, NJ, NY, PA, and PR. Midwest = IL, IN, IA, KS, KY, MI, MN, MO, NE, ND, OH, SD, and WI. Northeast = CT, MA, ME, NH, RI, VT.

Southeast = AL, AR, FL, GA, MS, NC, SC, TN, VA, and WV. Southwest = CO, LA, NM, OK, TX, and UT. West = AK, AZ, CA, HI, ID, MT, NE, OR, WA, and WY.

Source: S&P Global Market Intelligence

Table 3

Net Charge-Offs / Average Loans	Residential Real Estate			Commercial Real Estate			Commercial & Industrial			Total Loans		
	2019	2020	Change	2019	2020	Change	2019	2020	Change	2019	2020	Change
Mid-Atlantic	0.04%	0.01%	-2 bps	0.08%	0.06%	-2 bps	0.28%	0.32%	4 bps	0.10%	0.08%	-1 bps
Midwest	0.04%	0.02%	-2 bps	0.05%	0.10%	5 bps	0.40%	0.40%	0 bps	0.11%	0.11%	0 bps
Northeast	0.02%	0.01%	-1 bps	0.03%	0.05%	2 bps	0.21%	0.11%	-10 bps	0.06%	0.04%	-2 bps
Southeast	0.04%	0.02%	-1 bps	0.04%	0.03%	0 bps	0.24%	0.21%	-2 bps	0.11%	0.08%	-3 bps
Southwest	0.04%	0.03%	0 bps	0.05%	0.07%	3 bps	0.55%	0.62%	7 bps	0.16%	0.16%	0 bps
West	-0.01%	-0.01%	0 bps	0.01%	0.01%	0 bps	0.44%	0.26%	-18 bps	0.11%	0.06%	-5 bps
National	**0.03%**	**0.02%**	**-1 bps**	**0.05%**	**0.06%**	**2 bps**	**0.37%**	**0.36%**	**-1 bps**	**0.11%**	**0.10%**	**-1 bps**

Analysis includes 2,053 banks with total assets between $250 million and $3 billion at 12/31/20, excluding certain banks with non-traditional loan portfolios

Non-performing loans consist of (a) nonaccrual loans and (b) loans 90+ days delinquent. PPP loans are excluded from C&I loans and total loans.

Source: S&P Global Market Intelligence

Table 4

Criticized Loans / Total Loans	Classified Loans			Special Mention Loans			Criticized Loans		
	2019	2020	Change	2019	2020	Change	2019	2020	Change
Mid-Atlantic	1.5%	2.3%	81 bps	1.2%	2.4%	118 bps	2.7%	4.7%	199 bps
Midwest	2.0%	2.3%	38 bps	1.9%	2.7%	84 bps	3.8%	5.1%	122 bps
Northeast	1.6%	2.0%	38 bps	4.2%	4.2%	6 bps	5.8%	6.2%	44 bps
Southeast	2.4%	2.3%	-6 bps	1.3%	3.0%	170 bps	3.7%	5.3%	164 bps
Southwest	1.6%	2.0%	43 bps	1.2%	1.3%	10 bps	2.8%	3.3%	53 bps
West	1.3%	1.8%	58 bps	1.4%	2.4%	94 bps	2.7%	4.2%	152 bps
National	**1.8%**	**2.2%**	**41 bps**	**1.6%**	**2.6%**	**97 bps**	**3.4%**	**4.8%**	**138 bps**

Analysis includes 130 publicly-traded banks with total assets between $500 million and $5 billion at 12/31/20

Classified Loans = Loans Graded Substandard, Doubtful, or Loss. Criticized Loans = Classified Loans + Loans Rated Special Mention

PPP loans are excluded from the denominators used in the calculations

Source: S&P Global Market Intelligence

Table 5

Year-Over-Year Change in Criticized & Classified Loan/Total Loan Ratio	Classified Loans		Criticized Loans	
	No. Banks	% of Total	No. Banks	% of Total
Decline	46	35%	36	28%
Up 0 - 99 bps	53	41%	26	20%
Up 100 - 199 bps	14	11%	30	23%
Up 200 - 299 bps	10	8%	9	7%
Up 300 - 399 bps	3	2%	9	7%
Up 400 - 499 bps	1	1%	8	6%
Up > 500 bps	3	2%	12	9%

Source: S&P Global Market Intelligence

Unlike NPLs and charge-offs, some (not unexpected) increase occurred in criticized and classified loans. Despite the scale of the economic, societal, and health and wellbeing implications of the pandemic, bank credit performance appears remarkably resilient. In 2020, approximately one-third of banks reported lower criticized and classified loan/total loan ratios (Table 5), relative to year-end 2019, with most of the remaining two-thirds reporting increases of less than 200 basis points. Only three banks reported that the classified loan/total loan ratio increased by more than 500 basis points. One of these banks appeared to classify their entire hotel loan portfolio—a more conservative treatment than we have observed—and the other two provided insufficient disclosures to identify any particular issues.

Looking Forward

In the next update to this analysis, which hopefully will be a post-pandemic review, what might the industry expect? The most significant community bank credit exposures remain to borrowers for which changes to business and consumer behavior wrought by the crisis result in permanent demand reductions. In other words, borrowers for which the economy simply moved away from them over the last twelve months. This may include, for example, businesses unable to adapt to the growth of e-commerce, with a second order effect on properties occupied by those businesses.

Another lingering issue involves loans remaining under some form of payment forbearance. Surveillance of CMBS transactions indicates that a large number of securitized loans are under forbearance, whereas a smaller share of bank CRE loans appear to face the same circumstance (although data is limited for the entire banking industry). In our experience, CRE borrowers requesting second or third payment adjustments often are being downgraded to criticized status. The resuscitation of economic activity in 2021 will clarify which CRE projects are non-viable and at risk of producing credit losses to banks. Some consumers received residential mortgage loan payment adjustments extending beyond three or six months. Since these loans are not reported as troubled debt restructurings, the expiration of these forbearances in 2021 also could affect credit quality metrics for banks that granted these types of modifications more frequently.

Over the long-term, we question how the fiscal and monetary response to the pandemic could affect the pricing of risk. Absent some constraints on the Federal Reserve's monetary policy or a significant bout of inflation from enacted (or to be enacted) fiscal and monetary policies, it is hard to imagine that a future economic downturn will not be accompanied by a much larger federal response than occurred in recessions prior to the COVID-19 pandemic. That is, a response to future recessions that resembles the COVID-19 pandemic becomes the norm. One implication of such a policy shift is an attenuation of the credit cycle, with asset quality metrics remaining stable despite economic volatility. Like interest rates, credit losses could remain "lower for longer."

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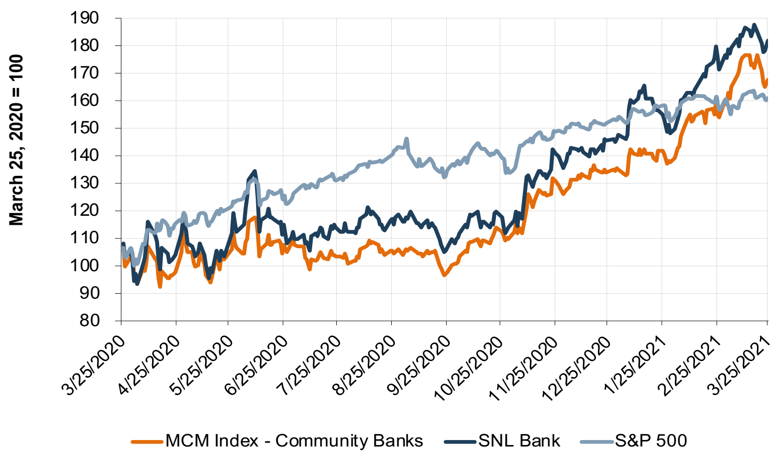
WHAT WE'RE READING

Kiah Lau Haslett at *Bank Director* reviews the effects and implications of **nearly four quarters of coronavirus loan modifications** for bank credit quality and financial reporting.

As the Fed has announced that looser capital rules implemented to relieve pressure on banks' balance sheets will expire soon, **Matthew Klein at *Barron's*** reviews the effects of the pandemic on the banking system's capital and reserve positions and what this could mean going forward.

Fintech startup Social Finance Inc. ("SoFi") recently agreed to purchase San Francisco-based Golden Pacific Bancorp Inc. ($150 million in assets) for approximately $22 million. SoFi opted to purchase a small bank rather than build a bank from scratch and plans to contribute an additional $750 million in capital to the bank for national, digital expansion.

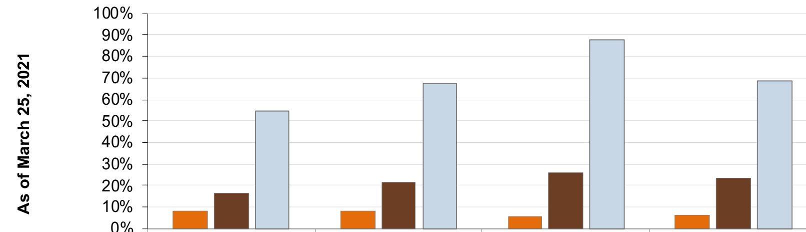
Mercer Capital's Bank Group Index Overview



Source: S&P Global Market Intelligence

Return Stratification of U.S. Banks

by Asset Size



	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	7.87%	8.38%	5.31%	6.21%
Quarter-to-Date	16.49%	21.37%	26.10%	23.43%
Last 12 Months	54.54%	67.23%	87.82%	68.68%

Source: S&P Global Market Intelligence

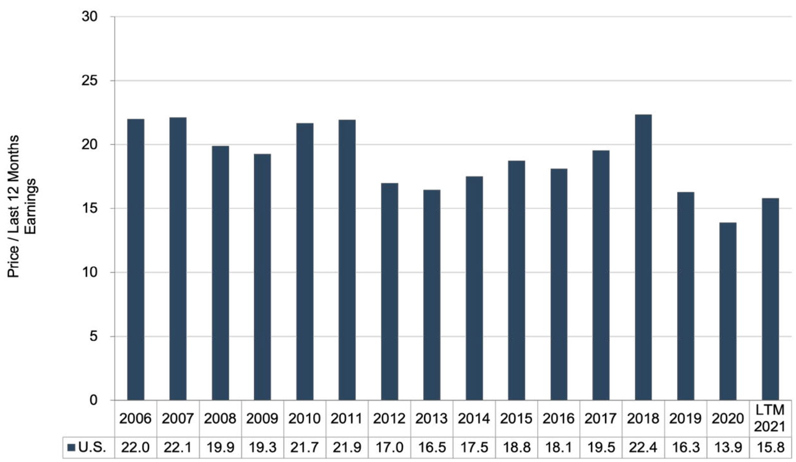
Regional Index Data

	Total Return			Median Valuation Multiples as of March 25, 2021					
	Month-to-Date	Quarter-to-Date	Last 12 Months	Price/LTM EPS	Price / 2021 (E) EPS	Price / 2022 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	10.0%	26.7%	52.9%	12.7x	13.3x	13.3x	108%	119%	2.8%
Midwest Index	9.2%	15.1%	50.9%	11.8x	11.3x	11.4x	110%	123%	2.5%
Northeast Index	8.5%	18.4%	44.9%	11.6x	10.3x	10.6x	101%	114%	3.2%
Southeast Index	9.8%	20.3%	66.3%	13.7x	10.8x	11.6x	103%	123%	2.1%
West Index	8.6%	42.2%	144.6%	13.7x	11.8x	12.7x	120%	130%	2.3%
Community Bank Index	9.1%	24.5%	67.6%	12.5x	11.6x	11.9x	107%	121%	2.6%
SNL Bank Index	**6.2%**	**23.5%**	**81.8%**						

Source: S&P Global Market Intelligence

Median Price/Earnings Multiples

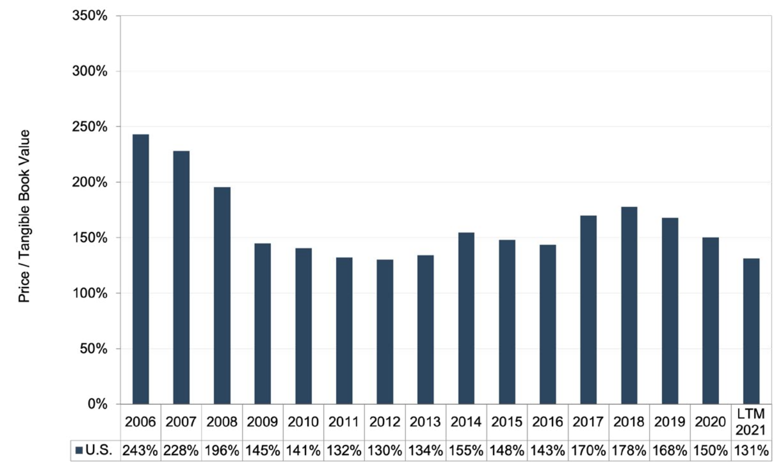
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Price/Tangible Book Value Multiples

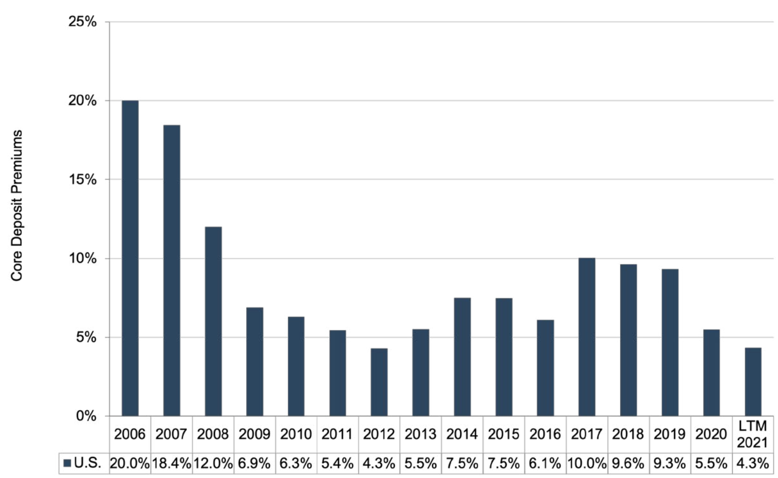
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Core Deposit Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Valuation Multiples for M&A Deals

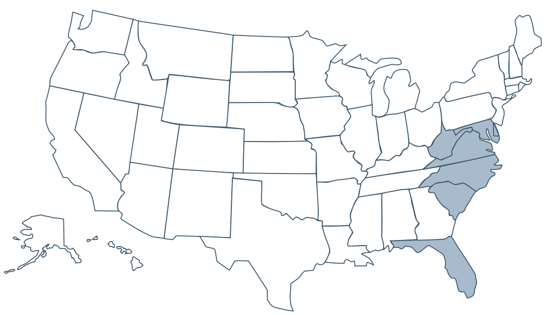
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended March 26, 2021

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	17.1x	112%	2.1%	4	62.2	455,834	8.4%
Midwest	16.1x	164%	8.1%	24	91.4	123,439	9.1%
Northeast	14.0x	140%	10.4%	2	62.8	517,018	10.5%
Southeast	18.6x	152%	8.4%	12	74.7	175,641	9.1%
West	14.7x	151%	4.6%	6	47.4	253,886	9.4%
National Community Banks	**15.9x**	**152%**	**6.7%**	**48**	**62.8**	**193,596**	**8.9%**

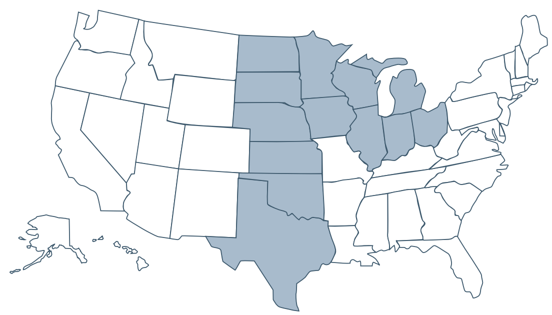
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

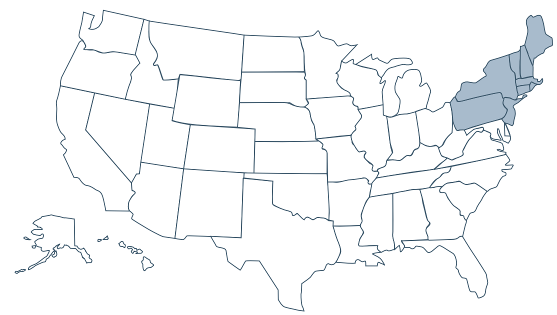
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



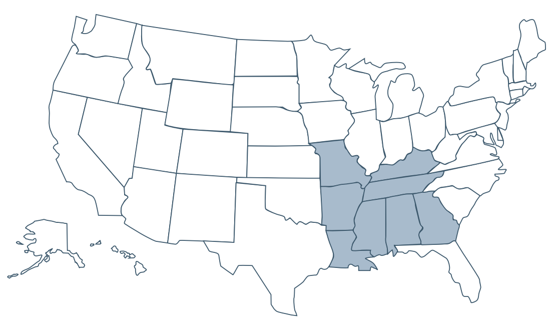
Atlantic Coast



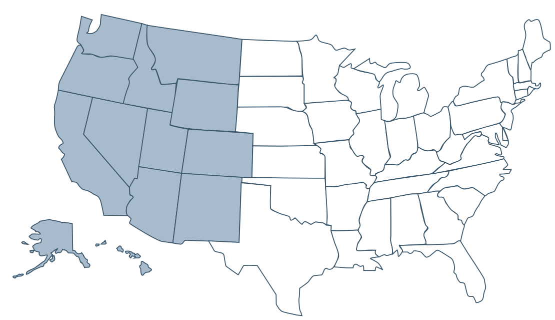
Midwest



Northeast



Southeast



West

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