FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Scott McCallum & Jon Bruss
DATE: June 15, 2018
SUBJECT: **Commercial Lending for Community Banks: Headwinds or Tailwinds?**

According to a recent pronouncement from the Office of The Comptroller of the Currency ("OCC"), the easing of commercial-loan standards is a top risk in the industry. The Comptroller himself weighed in with this: "The worst loans are often made in the best of times." The tailwinds—the best of times—for community banks include tax reform, regulatory reform, rising rates (from a net interest margin perspective), excellent asset quality and rising profits. Economic growth has been a plus, although not as strong as expected.

What's the current regulatory environment for safety and soundness?

If you are an OCC bank, should you have any concerns? Plenty, according to "Looser Lending Worries Regulators" from the May 30, 2018 edition of the **Wall Street Journal ("WSJ")**. In 2016, commercial lending slowed for unclear reasons. Furthermore, "faced with tepid loan growth and heated competition for clients, banks are sweetening their deals on loans to businesses, a development that concerns regulators. (As we *all* know, federal regulators generally watch each other closely.) And, "Lenders are giving corporate borrowers lower rates and looser terms, even if they operate in industries that are under strain, according to regulators and a WSJ analysis of lending data."

In 2017, annual commercial loan growth rate was only 1.3% at the end of 2017, down from 12% three years earlier. Banks since then have been loosening standards, according to the OCC. Banks have extended interest-only periods, allowed businesses to draw down bigger portions of their collateral and relaxed loan covenants meant to protect from losses. Furthermore, many large banks have lowered their lending spreads over their cost of funds. These appear to have revived commercial loan growth to 3% as of mid-May 2018.

According to the WSJ article, regulators have clamped down, with the OCC issuing 24% more "Matters Requiring Attention" ("MRAs") involving commercial loan underwriting, from the first quarter 2017 until the first quarter of 2018. In addition, MRAs involving exceptions to loan policies are up 45% over the same time frame.

The OCC is also worried about rising interest rates and their impact on "affordability of current debt service requirements or refinanceability".

It's important to note that the WSJ article mentions that banks aren't necessarily going back into the riskier categories of business loans that they gave up after the crisis. Instead, banks are becoming more aggressive in making the types of loans they consider safe, recent lending practices show. The shift is turning up in businesses in industries that banks were recently wary of like retail and energy. Those particular industries might be more the case for large or regional banks than for community banks.

The article goes on to mention that nonbank asset based lenders, such as Encina Business Credit states that in the past year, banks are increasingly outbidding Encina and other lenders on loans to struggling retailers.

The article also mentions a 2017 WSJ analysis of bankruptcy documents, even in cases of where retailers went bankrupt, banks have generally been repaid in full.

The WSJ article is based on a lot of OCC and Fed regulatory perspectives, which skews toward larger banks. We don't have a lot of data from community banks or FDIC-regulated institutions. We suspect the FDIC would chime in in a similar way, especially given today's clean asset quality for most banks, particularly when discussions on troubled loans are minimal.

As for community banks, we believe the tailwinds will continue to enable them to sustain a positive performance in the coming year. But, banks need to be sensitive to not getting caught up in the lightening of loan pricing, the easing of covenants and the loosening loan policy. Avoiding those pitfalls will help assure that today's asset quality is sustained, and help them steer through the headwinds.

What do you think about the headwinds and tailwinds impacting your commercial lending activity and what concerns are you hearing from regulators? We'd like to know! Contact us at info@fortresspartners.com.

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NOTE TO OUR READERS: *Since we began sending our E-Memos every other month, we've been distributing them at the month end. Two of the six issues hit June 30 and December 31—not the best time to be reading our thoughts about Community Banks and community banking. For the next several issues, we will be sending our notes at or about the middle of the month rather at the end. We hope this timing will turn out to be better for you. And, we hope you will let us know if it isn't.*

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