THE RISK MANAGEMENT ASSOCIATION

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UNDERWRITING ANALYSIS – 2Q2014

AN RMA/AFS® RISK ANALYSIS SERVICE (RAS) SPECIAL REPORT

Enterprise Risk • Credit Risk • Market Risk • Operational Risk • Regulatory Compliance • Securities Lending

GLOBAL CREDIT BENCHMARKING: UNDERWRITING ANALYSIS

2Q14 RESULTS

Regulators have become increasingly worried that commercial underwriting standards have weakened over the last several quarters, which would suggest an increasing risk appetite. According to the Fed's July 2014 Senior Loan Officer Opinion Survey, a small, but not immaterial, sample of the respondents reported that they had eased collateralization standards for both the larger and smaller customers.

We looked at the RMA/AFS Risk Analysis Service C&I data to see if we could find any concrete evidence that such relaxation in underwriting criteria—and in particular, collateralization standards—had in fact taken place for C&I loans.

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The following table provides some context around the potential for losses as they relate to collateral type. It shows the weighted average loss given default (LGD) for each collateral type in the RAS database at both the loan and commitment level. In the shaded columns, we list the recovery rates for these same collateral types, where the recovery rate is defined as 100% less the weighted average LGD. Essentially, the recovery rate is a more intuitive measure of a particular collateral type's strength in protecting the lender.

The data is sorted by the highest recovery rates at the loan level to the lowest recovery rates.

	Total Loan Outstandings		Total Exposure	
	Weighted Average LGD	Recovery Rate	Weighted Average LGD	Recovery Rate
Cash & U.S. Treasuries	14.02%	85.98%	20.83%	79.17%
Marketable Securities	16.07%	83.93%	14.52%	85.48%
Accounts Receivable & Inventory	25.01%	74.99%	24.22%	75.78%
Commercial Real Estate (building)	26.37%	73.63%	26.95%	73.05%
Residential Real Estate 1-4 Family	27.49%	72.51%	28.84%	71.16%
Deposits	29.45%	70.55%	29.27%	70.73%
Non-Marketable Securities	30.83%	69.17%	30.25%	69.75%
Total C&I	**31.08%**	**68.92%**	**32.21%**	**67.79%**
Secured - Other	31.27%	68.73%	30.09%	69.91%
All Assets/Blanket Lien	31.56%	68.44%	30.26%	69.74%
Residential Real Estate 5+ Family	31.93%	68.07%	34.41%	65.59%
Farmland/Agriculture Asset	34.69%	65.31%	35.10%	64.90%
Equipment	35.40%	64.60%	34.52%	65.48%
Land	38.14%	61.86%	38.36%	61.64%
Unsecured	40.62%	59.38%	42.20%	57.80%

Not surprisingly, cash and U.S. treasuries rank at the top of the list in terms of recovery rates, reflecting the liquid value of these assets. And it also shouldn't come as surprise that at the bottom of the table unsecured loans display the lowest recovery rate, with banks in our database forecasting that they will be able to recover only about half of the loan value for unsecured balances that do default.

In the second quarter of 2014, weighted average probabilities of default (PD) were at their lowest value since the end of the recession. With PD's trending low at the moment, the perceived risk of unsecured lending may seem like a secondary concern. But when default projections do eventually begin to rise, recovery rates will become a stronger focus.

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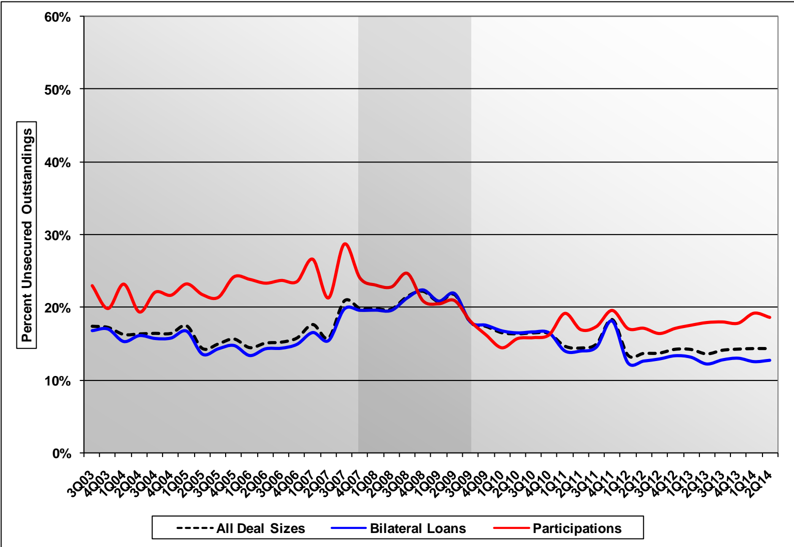
In other words, a build-up in unsecured lending *now* could translate into high losses—and low recoveries—during the next eventual downturn.

So how vulnerable to credit losses are banks from a collateral perspective? And perhaps more importantly, how does the ratio of unsecured loans to total outstandings in the current period compare to the levels seen before the recession?

The following chart illustrates the ratio of unsecured loans to total C&I outstandings as a trend over the entire time-span captured by the RAS database. So that's nearly 11 years of history, encompassing the last financial downturn, a period which is shown by the gray-shaded zone.

We've broken out the trend between bilateral loans—a one bank, one borrower lending relationship— and participations, the latter which in recent quarters has seen the highest levels of total balance growth on a percentage basis. Bilateral loans are indicated by the blue line, while the participations trend is shaded red. The average between the two segments is plotted as the dotted black line.



Shaded area indicates official length of the recession

If we trace these trends back for the entire 11-year timeframe, we end up with a very flat line of best fit for bilateral loans.

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For bilateral loans, the ratio of unsecured loans to total outstandings plateaued slightly during the recession but has trended downward since the end of the downturn.

> In 2Q2014, unsecured loans made up approximately 13% of total bilateral outstandings in the RAS database, a lower ratio than seen for most periods prior to the official start of the recession.

The unsecured ratio for participations generally trended above this same ratio for bilateral loans over the last 11 years. This isn't too surprising, because the higher-end customers tend to display strong enough credit characteristics to justify unsecured lending.

For participations, the ratio of unsecured loans to total outstandings declined throughout the duration of the downturn, reaching the lowest ratio in early 2010. Following this point, however, the unsecured ratio for participations displayed an overall upward trend, increasing to a ratio of 19% in 2Q2014 from the low watermark of 14% in 1Q2010.

So in terms of collateral standards, we're seeing a slight divergence in the market, with collateral standards tightening for bilateral loans since the end of the recession and easing somewhat for participations.

It's worth noting that positive balance growth in recent quarters was heavily driven by participations, so even a slight increase in the unsecured ratio for participations can have major implications for future credit risks.

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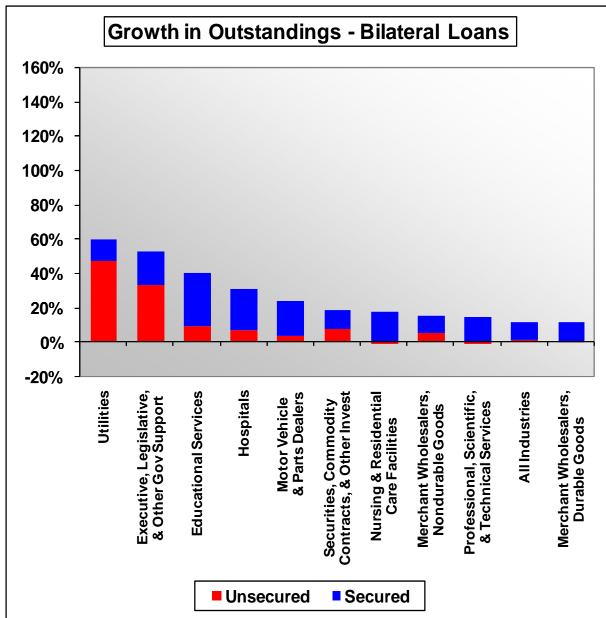
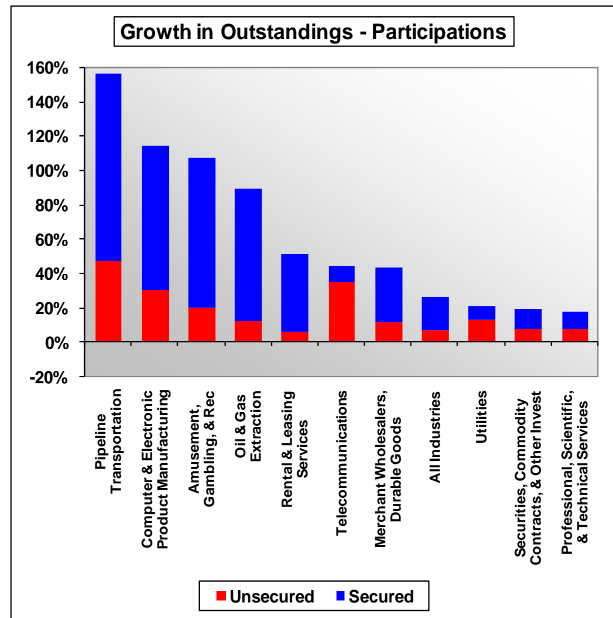
WHAT ABOUT THE SECTORS WHERE WE HAVE SEEN THE MOST BALANCE GROWTH OF LATE? COULD SOME OF THE GROWTH BE DRIVEN IN SOME PART BY THE AVAILABILITY OF UNSECURED CREDIT?

The following charts show the unsecured vs. secured composition of balance growth across the fastest growing industry sectors in the RAS database. The chart on the left represents the bilateral loans segment. (Again, a bilateral loan is a one bank, one borrower lending relationship.) While bilateral loans in aggregate have seen only modest growth in total balances over the last few quarters, there are some industry sectors that are growing at a brisk pace for bilateral loans.

For example, on the far left we can see that the Utilities and Executive, Legislative, and Other Government Support industries have displayed tremendous bilateral balance growth in 2Q2014 when compared to 3Q2012. When we look at the collateral composition of these increases, we can see that more than half of the bilateral loan growth in these same industries was driven by unsecured loans.





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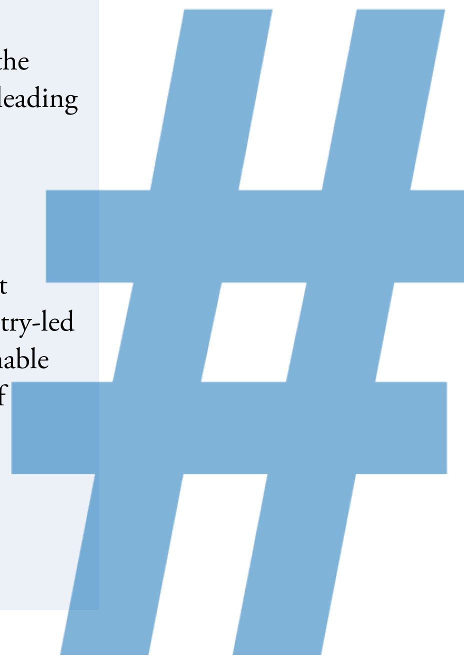
The chart on the right provides this same collateral breakout for participations. Balance growth for participations has been broad-based over the last 3 years, with Pipeline Transportation and Computer and Electronic Product Manufacturing experiencing the highest growth on a percentage basis. Over this timeframe, unsecured lending contributed a material amount to the total balance growth for both industries. For participations across the other industries, unsecured lending in Telecommunications contributed to more than half of the total participations growth seen for this industry over the last three years.

So for many industries, the availability of unsecured credit is correlated to some extent with positive balance growth for both the bilateral loans and participation segments.

In sum, while the RAS data does not indicate a broad deterioration in collateralization standards for C&I loans, growth in unsecured lending for particular industry segments could represent a potential risk from a recovery standpoint during a future economic downturn.

This special report is an extract from the September 2014 Credit Trends in Commercial Lending, a quarterly recorded Web seminar presented by RMA and Automated Financial Systems, Inc. (AFS). The Web seminar highlights quarterly market insights from the Risk Analysis Service (RAS), the industry-leading credit risk management data consortium.

The RMA and AFS® Risk Analysis Service (RAS) is global banking's only comprehensive industry standard for credit risk benchmarking. Representing an industry-led consortium, RAS members perform actionable comparisons of their own data with that of peer banks and the industry as a whole across multiple asset types and segmentations.



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The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country's banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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Phone: 800-677-7621

Fax: 215-446-4101

Website: www.rmahq.org

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