Quarterly Update October 2022

Loan and lease charge-offs: nowhere to go but up

By Brett Boehm

Commercial loans and leases that have gone into default and reached the charge-off stage are like gentle ripples of ocean current right now. Charge-off levels have been trending lower than normal for many commercial lenders and lessors. But there are signs the ripples could become waves in the months ahead for equipment finance companies, banks and fintech lenders. Not tidal waves, but higher volumes than we have seen in recent years, and closer to historic averages.

- A recent *American Banker* article noted expectations that inflation and rising interest rates will make it harder for small-business customers to repay existing loans.
- An Equifax report said small-business delinquencies and defaults continue to edge up. “All told, financial stress among small businesses remains low, but Equifax data suggest that it is on the rise,” the report added.

Charge-off trends

The Federal Reserve estimates average charge-off rates based on data available in the call reports filed each quarter by commercial banks. Charge-off rates are defined as the flow of a bank's net charge-offs (gross charge-offs minus recoveries) during a quarter divided by the average level of its loans outstanding over that quarter.

Charge-off rates for commercial and industrial (C&I) loans by commercial banks, not seasonally adjusted, were 0.14% in Q2 2022, up from 11% in Q1 but less than the 0.21% recorded a year earlier, according to Federal Reserve data. It was the fourth quarter in a row registering charge-off rates in the teens and, looking back at Fed data, that is unusually low. In 2018 and 2019, before the pandemic, quarterly charge-off rates for C&I loans ranged from 0.24% to 0.42%.

In the equipment leasing and finance industry, average losses (charge-offs) as a percentage of net receivables were estimated at 0.17% in August, down from 0.18% the previous month and 0.23% in the year earlier period, according to the Equipment Leasing and Finance Association's Monthly Leasing and Finance Index. Again, this is well below pre-pandemic monthly industry averages in 2018 and 2019, which ranged from 28% to 55%, according to data from the January 2020 index.

Looking at data trends and current market reports, it appears charge-off rates are destined to rise in the coming months. This is not cause for concern as long as rates stay within historic industry averages. In fact, a pattern of unusually low charge-off rates is not healthy. It can signal that lenders or lessors are being too cautious about approvals, at the expense of originations and business growth.

Clear the decks

Equipment finance companies, banks, fintech lenders and merchant cash advance businesses often sell all or a portion of their non-performing commercial loans, leases and lines of credit to us after charge-off, once the accounts have been worked internally.

This is an established practice in the finance industry with obvious payoffs for sellers — immediate cash for dead accounts. But there is also a secondary benefit that becomes increasingly important when charge-off volume is expected to rise.

Commercial debt selling enables lenders and lessors to keep internal efforts focused on younger, more lucrative accounts. By doing so, finance companies can increase overall recoveries and manage workloads more efficiently.

Contact me or explore our website if you'd like to learn more about commercial debt selling.

Brett Boehm is CEO for TBF Financial. He can be reached at bboehm@tbfgroup.com, 847-267-0660 or via LinkedIn or Twitter.

Attending the ELFA Convention or NEFA Funding Symposium? Brett looks forward to seeing you there.

Need strategies for managing charged-off commercial loans, leases and merchant cash advance? Visit our website.

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