inside small-balance

By Randy Fuchs, principal and co-founder, Boxwood Means Inc.

Delinquencies show gain

It's no secret that residential loan delinquencies and foreclosures increased sharply this year. The Federal Deposit Insurance Corp. reported that loan delinquencies for one-to-four family homes increased to 4.3 percent in the second quarter — the highest rate in at least 17 years.

By contrast, loan performance for small-balance commercial mortgages — i.e., those of $5 million or less — continues to hold up as the income-producing capacity of these assets supports the servicing of debt and bolsters collateral values. But a few cracks are forming in the foundation.

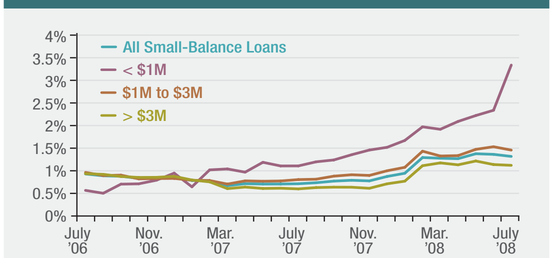
Take, for instance, the trends in small-balance delinquencies for various small-loan sizes. In aggregate, loan delinquencies of 30 days or more have been ticking up of late with an overall rate of 1.3 percent this past August. This rate is on par with levels witnessed during the 2001 recession.

That said, loan performance in the two smaller loan ranges tells a somewhat different story. The delinquency rate for loans between $1 million and $3 million is 1.5 percent. More concerning is the sharply increasing delinquency rate for loans of less than $1 million, which now stands at 3.4 percent. This is this sector's highest rate since 1998.

Randy Fuchs, a principal and co-founder of real estate research and consulting firm Boxwood Means Inc., writes a monthly column on small-balance commercial loans for *Scotsman Guide*. Boxwood provides lenders with strategic mortgage reports, direct-mail lists, portfolio analytics and other services based on its proprietary database of small-balance transactions. E-mail randy.fuchs@boxwoodmeans.com.

We can speculate on the reasons behind the variances in loan performance. But the fact is that many lending programs — particularly those focused on smaller balances — shifted heavily into riskier stated-income and "low doc" loans earlier this decade. Though often well-intentioned, numbers of these "residential style" loans are now approaching residential-like loan performance.

Delinquency Percentage by Loan Size



Source: Trepp LLC

On the other hand, underwriting for larger small-balance loans earlier this decade tended to emphasize the property's cash flow and the borrower's credit. Thus, the performance of $3-million-to-$5-million loans was comparatively solid this past August, with a delinquency rate of 1.1 percent.

If there's a lesson to this story, it's that effective short-cuts to underwriting the credit risk of smaller loans remain elusive.