Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 2002

FDIC
CHICAGO
EDITION

Regional Perspectives

◆ *Although an economic recovery is under way, the levels of employment and output in the Region at midyear 2002 remained below their previous peaks.*

◆ *To date, the financial health of the Region's community banks and thrifts has not been significantly strained by the 2001 recession. Although past-due and nonaccrual loans rose modestly, median return on assets and allowance for loan losses relative to total loans rose slightly in the year ending first quarter 2002.*

◆ *As the economic recovery unfolds and reduces some strains on borrowers and their lenders, insured institutions continue to face such challenges as ensuring adequate risk management, effective corporate governance, and adherence to internal controls and routines.* *See page 3.*

By the Chicago Region Staff

In Focus This Quarter

◆ *The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead*—**The recession that began in March 2001 has been especially hard on the corporate sector. Banks that made loans to affected firms felt the immediate effects of the recession through rising problem commercial loans. Large banks took the brunt of this commercial credit deterioration, as indicated by a somewhat larger uptick in problem commercial loans among large banks compared with smaller banks. This credit deterioration was more apparent at banks that participated in loan syndications, one of the financing vehicles available primarily to large corporate customers. Various indicators pointing toward economic recovery, as well as an apparent decline in rating downgrades and default rates among corporate bond issuers in recent weeks, suggest that improvement in commercial credit quality may be just ahead. This recovery, however, faces a few hurdles, including continued high leverage, weak earnings, and prospects for a more difficult funding environment, particularly for speculative-grade corporations with maturing debt.** *See page 8.*

By Cecilia Lee Barry, Senior Financial Analyst

DIVISION OF
INSURANCE
AND RESEARCH

JOHN M. ANDERLIK,
ACTING REGIONAL
MANAGER

JOAN D. SCHNEIDER,
REGIONAL ECONOMIST

MICHAEL ANAS,
SENIOR FINANCIAL
ANALYST

The ***Regional Outlook*** is published quarterly by the Division of Insurance and Research of the Federal Deposit Insurance Corporation as an information source on banking and economic issues for insured financial institutions and financial institution regulators. It is produced for the following eight geographic regions:

Atlanta Region (AL, FL, GA, NC, SC, VA, WV)
Boston Region (CT, MA, ME, NH, RI, VT)
Chicago Region (IL, IN, MI, OH, WI)
Dallas Region (CO, NM, OK, TX)
Kansas City Region (IA, KS, MN, MO, ND, NE, SD)
Memphis Region (AR, KY, LA, MS, TN)
New York Region (DC, DE, MD, NJ, NY, PA, PR, VI)
San Francisco Region (AK, AS, AZ, CA, FM, GU, HI, ID, MT, NV, OR, UT, WA, WY)

The first and third quarter issues of the ***Regional Outlook*** feature in-depth coverage of the economy and the banking industry in each Region and consist of a national edition and eight regional editions. The second and fourth quarter issues are a single national edition that provides an overview of economic and banking risks and discusses how these risks relate to insured institutions in each FDIC Region. These issues tell the national story and, at the same time, alert the reader to specific trends and developments at the regional level.

Single copy subscriptions of the ***Regional Outlook*** can be obtained by sending the subscription form found on the back cover to the FDIC Public Information Center. Contact the Public Information Center for current pricing on bulk orders.

The ***Regional Outlook*** is available on-line by visiting the FDIC's website at www.fdic.gov. For more information or to provide comments or suggestions about the Chicago Region's ***Regional Outlook,*** please call John M. Anderlik at (816) 234-8198 or send an e-mail to *janderlik@fdic.gov.*

The views expressed in the ***Regional Outlook*** are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Some of the information used in the preparation of this publication was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

Chairman	Donald E. Powell
Director, Division of Insurance and Research	Arthur J. Murton
Executive Editor	George E. French
Writer/Editor	Kim E. Lowry
Editors	Lynn A. Nejezchleb Maureen E. Sweeney Richard A. Brown Ronald L. Spieker
Publications Manager	Teresa J. Franks

Regional Perspectives

- **Although an economic recovery is under way in the Region, the levels of employment and output at midyear 2002 remained below their previous peaks.**

- **To date, the financial health of the Region's community banks and thrifts has not been significantly strained by the 2001 recession. Although the ratio of past-due and nonaccrual loans has risen modestly, the median return on assets and allowance for loan losses relative to total loans rose slightly in the year ending first quarter 2002.**

- **As the economic recovery unfolds and reduces some strains on borrowers and their lenders, insured institutions continue to face such challenges as ensuring adequate risk management, effective corporate governance, and adherence to internal controls and routines.**

More than six months after the end of the 2001 recession, the Region's economy at midyear 2002 is experiencing higher unemployment, elevated business and personal bankruptcies, and reduced activity in some key sectors relative to a year earlier, despite some gains in 2002. Even so, any net adverse effect of the economic slump on the financial health of the Region's community banks and thrifts[1] appears limited. Although insured institutions are experiencing higher loan delinquencies, they also are benefiting from such developments as reduced funding costs and a steeply sloped yield curve.

A variety of economic indicators at midyear 2002 suggest that a cyclical recovery began in late 2001 or early 2002, although output and employment levels in many sectors remain lower than before the recession. For example, the Midwest Manufacturing Index[2] in May 2002 was more than 3 percent higher than its recession low in October 2001; however, it remains about 12 percent below its peak in 2000 (see Chart 1). Employment in the Region has yet to turn up, because increases in output to date reflect productivity gains and longer workweeks of existing employees.

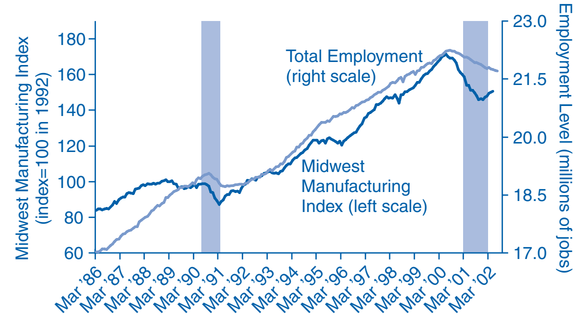
In this environment of modest cyclical improvement and slumping stock valuations, many businesses and households remain vulnerable to financial strains. Household income, for example, is not likely to grow noticeably until employment levels start rising, while the aggregate value of households' financial assets is 11 percent lower than two years earlier. Meanwhile, the cushioning effect of last year's decline in interest rates, reduction in personal income taxes, modest inflation, and drop in energy prices may be waning.

Despite the cyclical recovery under way, adverse effects from the recession on lenders' loan portfolios may linger. Some borrowers were operating with thin financial cushions when the recession began, and the slump may have absorbed that cushion and challenged their economic viability. The increasing number of households and businesses filing for bankruptcy, for example, provides an indication of financial stress among borrowers, which is contributing to rising loan delinquencies among lenders.

Rising numbers of corporate bond defaults and debt-rating downgrades in 2002, along with first quarter 2002 corporate profits from current operations that were slightly lower than two years earlier, suggest that

Chart 1

Regional Economic Activity Remains Subdued Relative to Conditions prior to Recession



Source: Federal Reserve Bank of Chicago and Bureau of Labor Statistics, via Haver Analytics, Inc.

[1] Banks and thrifts that hold less than $1 billion in assets, excluding de novo and specialty institutions.

[2] The Midwest Manufacturing Index, produced by the Federal Reserve Bank of Chicago, reflects the output of four major industrial groups in the Federal Reserve System's Chicago District.

banks will continue to face challenges from some business borrowers. Some households face parallel challenges in light of their relatively high debt obligations and the slow improvement in job markets and income growth.

On another front, owners of commercial and industrial properties—or other businesses where income is shaped by multiyear leases and contracts—may face reduced cash flows despite the cyclical upturn in the economy as a whole. In response to relatively weak demand for commercial space, property owners reportedly are renegotiating existing leases or entering new ones on terms less favorable to them than in recent years.

Through first quarter 2002, the Region's insured community institutions appeared to be weathering the 2001 economic recession relatively well (see Table 1). Profitability, as measured by aggregate return on assets, held close to 1 percent, and the rise in past-due and nonaccrual (PDNA) loans has been moderate. Tier 1 leverage remained near 9.3 percent, and the ratio of allowance for loan and lease losses (ALLL) to total loans rose in the year ending first quarter 2002. However, the ALLL did not keep pace with the 37 percent rise in nonperforming loans, leading to a decline in the reserve coverage of nonperforming loans.

Table 1

Performance of Community Institutions Changed Modestly during the 2001 Recession

	1Q01	1Q02
	Percent	
Return on Assets	0.99	1.09
Past-Due and Nonaccrual Loan Rate	2.20	2.42
Tier 1 Leverage Ratio	9.34	9.29
ALLL to Total Loans	1.10	1.17
ALLL Coverage of Nonperforming Loans	135.65	110.07

ALLL = allowance for loan and lease losses
Note: Merger-adjusted aggregate data are shown.
Source: Bank and Thrift Call Reports, March 31, 2002

Behind the fairly moderate changes in broad measures of the financial condition of the Region's banks and thrifts has been an increase in the number of institutions with weak composite CAMELS[3] ratings of 3, 4, or 5. At the end of first quarter 2002, 139 institutions in the Region were rated weak, up from 116 a year earlier. Despite some current strains and problems, the 7.6 percent share of institutions with weak composite ratings is less than half the percentage recorded at the end of the 1990–1991 recession. Geographically, these banks and thrifts are spread throughout the Region. Asset quality and management ratings are major contributors to the recent deterioration in composite CAMELS ratings, as roughly 10 percent of the Region's institutions had weak asset quality or management ratings (or both) at the end of first quarter 2002.

While weak economic conditions likely affected the health of most banks and thrifts, no failure has been directly attributed to the recession. However, eight insured financial institutions failed nationwide in the first six months of 2002, a number that exceeds the annual failure rate since 1999. These failures underscore the continued importance of prudent management oversight, regardless of economic trends.[4] Critical shortcomings among lending institutions that failed tended to involve a lack of effective internal routines and controls; concentration in business lines where the market value of assets fell considerably below valuations used internally (e.g., auto lease portfolios or residuals from securitization of loan portfolios); entry into a line of business that carried operational or other risks not fully understood by management; or outright fraud. Several other insured institutions faced similar shortcomings but were able to continue operating despite significant losses.

Community Bank Loan Portfolios Reflect Changing Conditions

Recent developments in commercial and industrial (C&I) portfolios among large lending institutions are highlighted in this quarter's *In Focus* article. The remainder of this article evaluates conditions among

[3] CAMELS examination ratings reflect insured institutions' capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.

[4] The importance of such traditional concerns was highlighted in a speech titled "Internal Controls, Fraud, and Other Red Flags" by Eugene Ludwig, former comptroller of the currency, at the 2002 Interagency Bank Supervision Conference, April 2002.

community institutions in the Chicago Region, whose loan portfolios are typically insulated from some of the factors or sectors (e.g., telecommunications) causing problems at large institutions.

Segments of loan portfolios in the Region's community institutions fared differently during the recession. Aggregate loan growth among community banks and thrifts slowed to 5.5 percent in the year ending first quarter 2002, from 12 percent in 2000. Growth in C&I and commercial real estate (CRE) lending slowed but remained fairly healthy, while consumer and mortgage loan volume fell. Deterioration in loan quality occurred across most business lines, as illustrated in Table 2.

Commercial and Industrial Portfolios: Although C&I loans at the Region's community banks deteriorated somewhat, they are performing modestly better than C&I credits nationwide. C&I portfolios at the Region's community banks grew 6 percent through the year ending March 31, 2002. Although C&I past-due and charge-off rates have increased during the past year, the level of delinquencies and charge-offs remains below the national level.[5] Net C&I loan charge-offs at the Region's community banks were 0.71 for 2001, up from 0.47 for 2000 but well below the peak of 1.12 percent during the 1990–1991 recession.

Commercial Real Estate Portfolios: Combined loans for construction and development (C&D), multifamily housing, and nonresidential building among the Region's community banks rose by more than 15 percent in the year ending first quarter 2002. This strength may seem surprising in light of soft demand for commercial and industrial space and rising vacancy rates. However, rather than representing rising commercial real estate exposures (where properties' cash flows are the basis for loan repayments) in a weak market, in some cases CRE loan growth may reflect caution by lenders as they take liens on borrowers' real estate as collateral to back operating loans. In other cases, CRE loan growth may reflect that commitments made in the past few years are now being drawn upon as projects progress.

Table 2

Past-Due and Nonaccrual Rates Have Increased across Major Loan Categories

Loan Segment	Share of Loans (percent)	Past-Due and Nonaccrual Rate (percent)		
	Mar-02	Mar-02	Mar-01	Mar-91
Commercial and Industrial Loans	14.3	3.44	3.17	6.49
Commercial Real Estate Loans				
Construction and Development	5.9	3.13	2.51	5.99
Nonresidential Real Estate	20.4	2.16	1.93	2.98
Multifamily Residential	3.3	1.36	0.89	1.36
Residential Loans				
1- to 4-Family Residential	36.5	2.35	2.10	1.29
Home Equity	4.0	0.85	1.27	1.17
Loans to Individuals	8.7	2.41	2.40	2.93
Credit Card Loans	0.3	3.48	3.13	3.18
Other Consumer Loans	8.3	2.42	2.42	2.92
Farm Real Estate Loans	3.1	2.35	2.17	3.47
Farm Production Loans	2.4	2.10	2.00	0.43

Source: Bank and Thrift Call Reports for Community Institutions

[5] Community banks in the Chicago Region reported a first quarter PDNA rate of 3.44 percent for C&I loans (up 27 basis points from a year ago) compared with 3.70 percent (up nearly a full percentage point) for community institutions nationwide.

All categories of CRE lending—construction and development, multifamily housing, and nonresidential buildings—experienced rising delinquency rates during the year ending first quarter 2002, although net charge-offs for each subcategory are well below the peaks seen in the last recession, when real estate problems were widespread and sometimes extensive. Current credit quality deterioration in this portfolio has been modest; however, rising vacancy rates and an increase in office space available for sublease in many metropolitan statistical areas (MSAs) may foreshadow further weakness.

Construction-and-development loans exhibit the second highest delinquency rate and the largest percentage point rise in delinquencies among major loan segments. Although C&D loans make up only 6 percent of the Region's community institution loan portfolio, the median level of C&D exposure to capital has been trending higher. As of March 31, 2002, 135 institutions held C&D concentrations greater than 100 percent of Tier 1 capital, up from 123 institutions one year earlier. Many of the Region's institutions with C&D concentrations are located in the **Chicago, Grand Rapids,** and **Indianapolis** markets. Although the risks associated with C&D lending vary greatly—from the minimal risk of presold residential construction to speculative development of commercial properties—the rising concentration levels underscore the need to monitor conditions in this loan category.

Credit quality weakness also is apparent in loans secured by office, industrial, retail, and other commercial buildings. Although the increase in this loan category's delinquency rate during the past year was modest, further weakness may develop in the near term. Property owners in buyers' markets (where supply exceeds demand) may continue to experience weakened cash flows in coming quarters, because they either lose tenants or grant rent and other concessions in order to keep current tenants.

Mortgage and Consumer Loan Portfolios: In contrast to the growth in C&I and CRE lending, mortgage loans held by the Region's community institutions fell during the past year. One- to four-family residential loans, the Region's largest loan category, declined 2.4 percent. Other forms of consumer lending, such as credit card, revolving credit line, and other consumer loans, followed suit, declining by 1.6 percent.

The decline in mortgage and consumer loan volumes in part could reflect refinancing triggered by lower interest rates. Some consumers who refinanced existing debts likely used their improved cash flow to finance spending that otherwise would have boosted credit card and other consumer loans. Also, households that refinanced their debt may have done so with larger or out-of-region lenders in the increasingly competitive nationwide lending industry. Nonbank lenders are attracting some business that would have gone to community institutions a decade ago. More insured institutions also may be adopting a strategy of originating, but not holding, mortgage and consumer loans; this strategy limits growth in such loans on their books.

The losses associated with one- to four-family mortgage lending traditionally have been less than those for most other loan categories. However, the credit risk associated with this portfolio may have risen, reflecting structural changes in the mortgage business during the 1990s. These changes include the increasing involvement by insured institutions in the higher-risk subprime credit market, the acceptance of higher leverage on home purchases, and the greater use of automated underwriting and collateral valuation processes (see *In Focus, **Regional Outlook,*** First Quarter 2002). Furthermore, many insured institutions are frequent sellers of highly liquid conforming mortgage loans, a strategy that could lead to a higher share of nonconforming, potentially higher-risk loans on bank balance sheets.

Indeed, among the Region's community insured institutions, the level of PDNA one- to four-family mortgage loans rose 25 basis points, to 2.35 percent, during the year ending first quarter 2002. This is the only major loan segment with a current delinquency rate higher than the peak experienced during the 1990–1991 recession. The highest mortgage delinquency rates in the Region were reported among community banks headquartered in the **Springfield, Milwaukee, Rockford,** and **Decatur** MSAs, where exposure to mortgage loans is relatively modest. Mortgage PDNA rates are higher for the Region's community banks than for comparable banks outside the Region, which reported a 2.07 percent PDNA ratio, up only 7 basis points from a year ago.

Ahead: Although most of the credit quality deterioration experienced to date has been modest, uncertainty surrounding the economic recovery leads to questions about which loan categories may present the most risk going forward. The 1990–1991 recession clearly demonstrated that C&I and CRE lending categories, particularly construction lending, have the potential for high delinquencies and charge-offs in a weak economic environment. Also, the risk profile of mortgage lending—the largest loan category—has certainly increased; however, the ultimate risk of loss in this category remains relatively low overall.

As the Economy Recovers, Challenges Remain for the Region's Insured Institutions

Economic indicators suggest that the recession is over and insured institutions have weathered it well, but some challenges remain. These challenges, while not new to cyclical recoveries, include expected increases in interest rates and a flattening of the yield curve, structural changes and competitive forces in the financial services industry, and more traditional concerns, such as ensuring adequate risk management and other internal controls and routines. Meanwhile, credit quality problems may linger as household and business stresses from the recession are resolved and commercial real estate markets adjust to recent imbalances. Other potential challenges include the continuing financial fragility of some household and business borrowers.

In this environment, insured institutions at some point will need to shift gears from asset-and-liability management strategies that worked well when short-term interest rates were falling and low to strategies more suitable in a rising rate environment. The recent well-publicized accounting and management lapses at some major corporations underscore the importance of continually verifying the effectiveness of internal routines and controls, accounting practices, and adherence to board policies.

Chicago Region Staff

The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead

Introduction

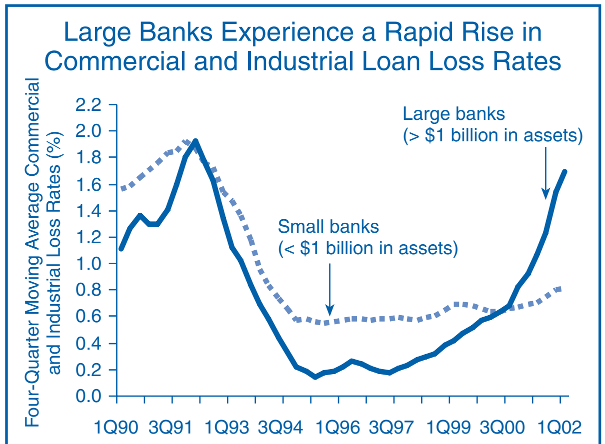
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic indicators pointing toward recovery, the volume of problem commercial loans held by insured institutions could plateau during 2002. Many banks tightened business loan underwriting standards beginning in early 2000, a trend that should contribute to an eventual turnaround in commercial loan quality. Nevertheless, several factors could delay this improvement. Corporate profitability has yet to recover fully, and many firms continue to operate with significant financial leverage. Highly leveraged firms are especially vulnerable to declining revenues, which reduce the cash flow available to service debt obligations. More significantly, lower investor tolerance for risk has created a far less hospitable financing market for speculative-grade firms, possibly straining liquidity and increasing the likelihood that these companies could default as debts mature.

Commercial Credit Deterioration Should Subside with the Economic Recovery

While the banking industry has fared well through the latest recession, it did not escape the effects of the troubled corporate sector. Large banks (those with assets greater than $1 billion), in particular, have seen a significant rise in noncurrent commercial and industrial (C&I) loan and loss rates.[1] While total C&I loans represented 25 percent of all outstanding loans held by all insured commercial banks as of March 31, 2002, net C&I loan losses comprised 32 percent of all loan losses. In first quarter 2002, noncurrent C&I loans reached 2.6 percent of outstanding loans (2.8 percent for large banks), the highest level since fourth quarter 1993. The four-quarter moving average C&I loss rate also rose among small and large banks; however, the rate of increase for large banks was significantly higher, as shown in Chart 1.

[1] Noncurrent loans are defined as loans 90 or more days past due or on nonaccrual status.

CHART 1



Source: Bank Call Reports, FDIC Research Information System

Improving economic conditions and tighter underwriting standards suggest that commercial credit quality should improve. A range of indicators suggests that economic recovery is under way, albeit more slowly than some expected earlier this year. The housing sector remains robust, job conditions have stabilized, and real gross domestic product (GDP) grew 5.0 percent in first quarter 2002. Although GDP grew at a slower pace of 1.1 percent in second quarter 2002, business equipment spending increased 2.9 percent, in contrast to a decrease of 2.7 percent in first quarter 2002. Also, the manufacturing sector began to show signs of recovery with the ***Institute for Supply Management*** (ISM) index for manufacturing reaching 56.2 and 50.5 in June and July 2002, respectively. The ISM index has remained above 50, which signals an economic expansion, for the six consecutive months since February 2002. Also, the index of coincident indicators, a gauge of current economic activity, rose 0.3 percent in June 2002. Furthermore, a survey of 50 leading corporate economists by ***Blue Chip Economic Indicators*** shows that analysts expect the U.S. economy to grow at a rate of 3.3 percent in third quarter 2002.[2]

Recent changes in underwriting standards also bode well for credit quality at commercial banks. The Federal

[2] *Blue Chip Economic Indicators,* July 2002. Also see *Regional Outlook,* Second Quarter 2002, "Back to the Future: How This Downturn Compares to Past Recessions." See http://www.fdic.gov/bank/analytical/regional/ro20022q/na/index.html.

Reserve Board's ***Senior Loan Officer Opinion Survey on Bank Lending Practices,*** which focuses on changes in the supply of and demand for bank loans to businesses and households over the previous three months, has shown consistent tightening of business loan standards during the past two years. The April 2002 survey indicated some further tightening of standards, but the percentage of banks reporting this tightening has declined since the January survey, consistent with the anticipation of a continued economic rebound.[3] Since credit quality typically lags the business cycle, near-term recovery appears more likely, provided the economy continues to improve. This recovery in commercial credit quality, however, is not without a few hurdles ahead.

High Default Rates, Rating Downgrades, and Bankruptcies Persist

While the U.S. economy is showing signs of recovery and underwriting standards have tightened, corporate credit quality could continue to be affected by several adverse trends. The number of bankruptcies filed by public companies this year is on pace to challenge the record set in 2001.[4] Furthermore, default rates for U.S. speculative-grade corporate bond issuers remained high at 10.3 percent in June 2002, and the high ratio of corporate rating downgrades to upgrades indicates continuing weakness in the corporate sector (see Chart 2).[5] The main reasons for rating downgrades have been poor profitability and high leverage.

Corporate Profitability Remains Fragile

Corporate profitability has been depressed since first quarter 2001 (see Chart 3). However, this trend is improving slowly in 2002. U.S. corporate profits rose during second quarter 2002 for the first time in five quarters.[6] However, the rate of recovery is not expected to be strong in 2002, as some 93 companies in the Standard & Poor's 500 have announced that third quarter earnings will be less than expected, more than twice the number of companies that have announced they will beat estimates.[7] In fact, earnings forecasts have been revised downward consistently for the past several months, and analysts have warned recently that earnings estimates for the second half of 2002 are likely to be reduced. The bright spot in earnings continues to be the consumer sector, with automobile manufacturers and certain retail areas posting strong sales. The worst-performing sectors on a

CHART 2

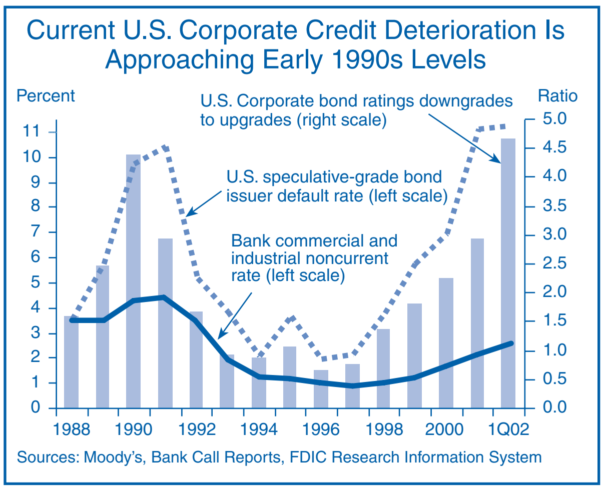
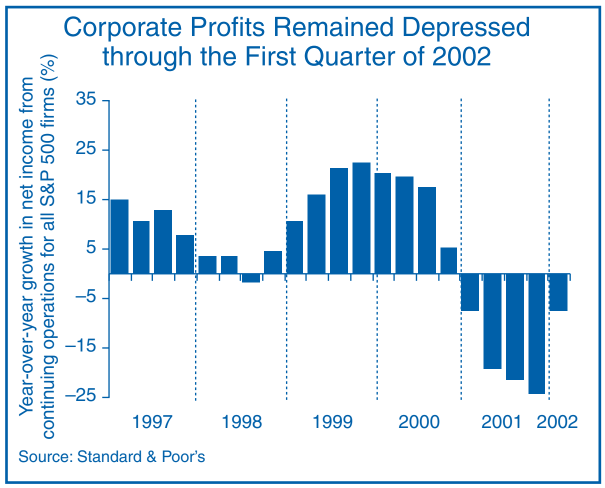


CHART 3



[3] *Senior Loan Officer Opinion Survey on Bank Lending Practices,* The Federal Reserve Board, April 2002. The survey reported that the percentage of domestic banks that reported tightened standards on C&I loans to large and middle-market firms (annual sales of at least $50 million) since the January survey declined to 25 percent from 45 percent. The percentage of domestic banks that report tightened standards on business loans to small firms declined more, from 42 percent in January to 15 percent in April.

[4] *Bankruptcydata.com* reports that 257 publicly traded companies filed for bankruptcy in 2001, while 114 companies had filed by June 30, 2002.

[5] In the first half of 2002, Moody's downgraded 262 companies and upgraded 59, producing a downgrades to upgrades ratio of 4.4:1.

[6] On a year-over-year basis, 371 companies in the Standard & Poor's 500 Index that reported earnings through July 26, 2002, posted profits.

[7] Danielle Sessa, "U.S. Stocks Slide as Johnson & Johnson, Pepsi Shares Tumble," *Bloomberg.com,* July 19, 2002.

year-over-year basis appear to be energy, transportation, utilities, capital goods, and communications services.[8] The latest recession was driven primarily by the sharp decline in the demand for capital goods. With the slow economic recovery, businesses have continued to limit capital spending. The rate of recovery for corporate profitability will depend in large part on how soon and to what extent businesses resume spending.

The prospect of slow earnings growth could be particularly problematic for many highly leveraged corporations. Debt levels relative to cash flow have been rising because of anemic earnings (see Chart 4). Negative earnings news also comes at a time when several well-publicized accounting irregularities have shaken investors' confidence in corporate earnings reports. A ***Huron Consulting Group*** study of financial restatements indicates that during the past five calendar years, the number of restated financial statements filed by public companies has grown from approximately 120 in 1997 to 270 in 2001.[9] The number of restatements continued to grow in 2001, despite a reduction in the number of public companies. That study found that the largest source of restatements relates to how companies recognize revenue. With depressed corporate profits and diminishing investor confidence, some firms with debts maturing in the near term may have difficulty refinancing.

Firms with Maturing Debts Could Face a Critical Period in the Near Term

Moody's estimates that $141 billion worth of U.S. speculative-grade corporate bonds and rated bank debt will come due over the next three years: $27 billion (19 percent) in 2002, $54 billion (38 percent) in 2003, and $60 billion (43 percent) in 2004.[10] To put these numbers into perspective, total U.S. corporate bond defaults were $115 billion in all of 2001, of which 95 percent of those defaulting were speculative-grade borrowers. Although Moody's expects the bulk of high-yield debt maturing in 2002 to be refinanced despite unfavorable market conditions, concern exists about the large percentage of issues rated B1 or lower that will come due in 2003 and 2004 (see Chart 5).[11]

CHART 4

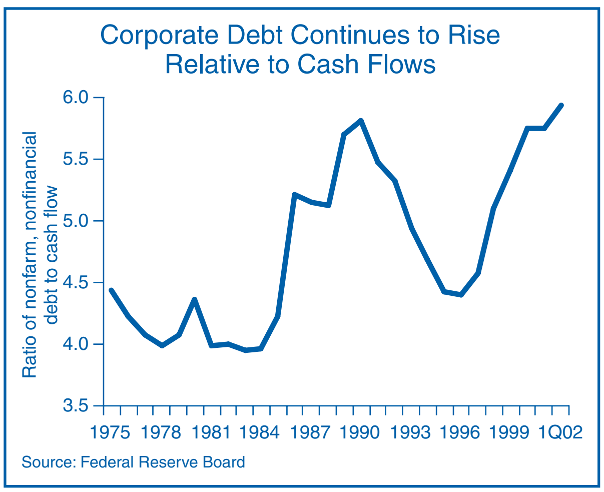
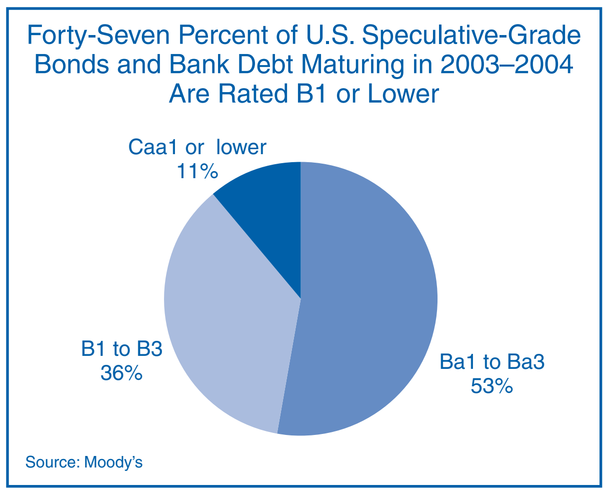


CHART 5



[8] Charles L. Hill, et al., *This Week in Earnings,* Thomson First Call, July 22, 2002.

[9] *A Study of Restatement Matters, for the five years ended December 31, 2001,* Huron Consulting Group, June 2002. This study excluded restatements caused by changes in accounting principles and nonfinancial-related restatements.

[10] Tom Marshella, et al., "Refunding Risk for U.S. Speculative Grade Borrowers, 2002–2004," *Global Credit Research,* Moody's Investors Service, December 2001. Figures related to refunding risk presented throughout this article are taken from Moody's refunding risk studies, conducted annually since November 1998.

[11] Speculative-grade debt ratings assigned by Moody's in the order of declining credit quality are as follows: Ba, B, Caa, Ca, and C. Moody's also applies numerical modifiers 1, 2, and 3 in each generic rating classification. The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category, while the modifier 3 indicates a ranking in the lower end of that generic rating category.

Credit deterioration of bank loans is similar to the current trend in corporate bonds. Migration of maturing loans into lower grade categories has accelerated in recent years (see Chart 6). This ratings decay reflects the borrowers' deteriorated financial condition and the effects of liberal underwriting conditions from 1996 to 1998, when speculative-grade originations were more common. For example, the 1999 and 2000 refunding risk studies conducted by Moody's noted that 16 percent and 17 percent, respectively, of all rated bank loans maturing in 2002 were rated B1 or lower. The trend worsened significantly in 2001, when the study noted that 39 percent of bank loans maturing in 2002 were rated B1 or lower. When firms have to refinance low-grade debts in today's environment, they may face additional pressure on earnings and liquidity.

Loss Severity Has Increased with Higher Default Rates

Moody's credit ratings reflect the likelihood of default and the severity of loss given default. As a result, the migration of maturing bonds and loans into lower grades implies a greater risk of default or increased loss severity upon default, or perhaps both. Moody's notes, as part of its 15th annual study of global corporate defaults and ratings performance, that average recovery rates fell for the third straight year in 2001.[12] The recovery rate has deteriorated for all levels of security and subordination except for senior secured bonds (see Table 1).

CHART 6

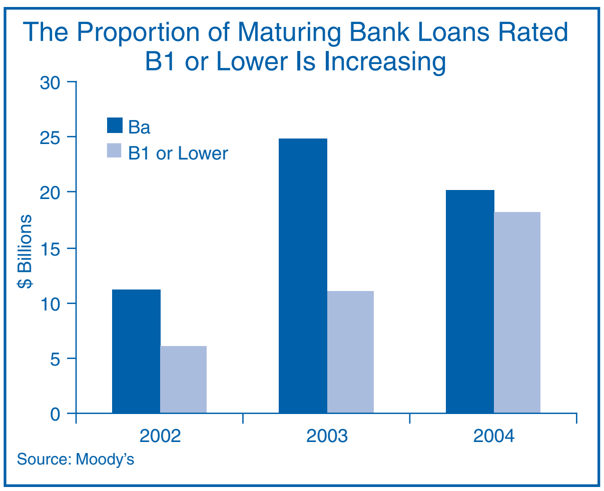


TABLE 1

AVERAGE SPECULATIVE-GRADE RECOVERY RATES IN 2001 SHOW A DECLINING TREND IN NEARLY ALL LEVELS OF SECURITY AND SUBORDINATION

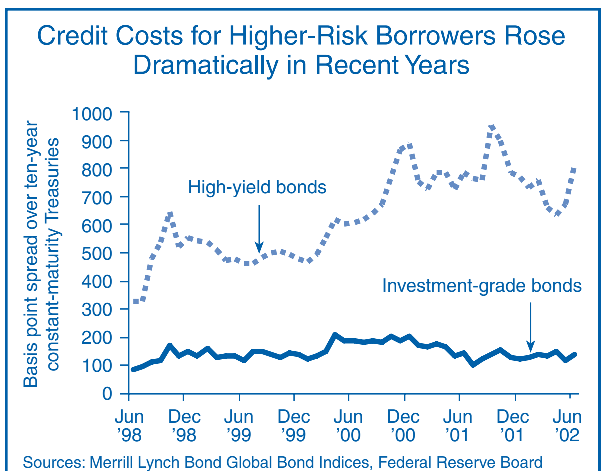
	Average Recovery per $100	
Seniority/Security	1982–2000	2001
Senior secured bank loan	$67.06	$54.68
Equipment trust	$64.65	NA
Senior secured bonds	$52.09	$58.00
Senior unsecured bonds	$43.82	$36.20
Senior subordinated bonds	$34.59	$19.90
Subordinated bonds	$31.83	$16.45
Junior subordinated bonds	$22.48	NA

Note: NA=not available
Source: Moody's

Higher-Risk Borrowers Pay High Premiums

A speculative-grade company refinancing debt today will face a much higher price, in terms of spreads over a cost of funds index or risk-free instruments, compared to several years ago. Yield spreads between investment-grade and speculative-grade bonds have widened significantly since early 2000 (see Chart 7), in part because of lower investor tolerance for risk, rising

CHART 7



[12] David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research,* Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument approximately one month after the time of default.

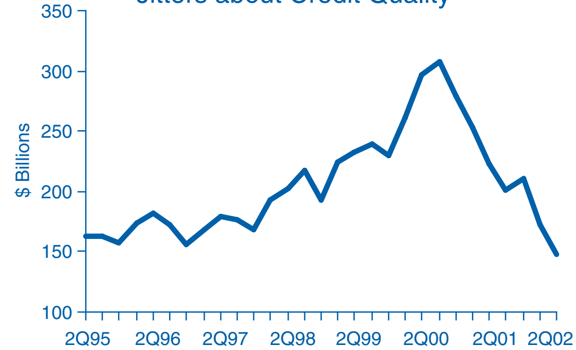
defaults, and weakening corporate cash flows. After narrowing a bit in first quarter 2002, spreads have widened again on renewed concerns about accounting irregularities and the realization that the economic recovery may come at a slower pace than anticipated. Lower investor tolerance for risk has affected not only speculative-grade borrowers but also some investment-grade borrowers. For example, the commercial paper (CP) market, which many investment-grade borrowers have used as a cheap source of funding, is no longer readily available to all investment-grade borrowers.[13]

Drawn-Down Commercial Paper Back-up Lines Heighten Commercial Bank Exposure[14]

Since its peak at the end of 2000, the CP market for domestic nonfinancial companies has shrunk by almost 50 percent (see Chart 8). A reduction in the need for working capital and heavy refinancing activity have contributed to this contraction. However, the record number of downgrades among issuers of CP in 2001 also contributed to this decline. Money market funds cannot hold more than 5 percent of assets in CP graded less than A1/P1/F1.[15] Thus, the recent flux of downgrades effectively squeezed some issuers out of this market and forced them to refinance with fixed-rate bonds.[16] Also, fears of deteriorating credit quality have shut some investment-grade companies out of the CP market. Since the collapse of Enron, investors have been reluctant to hold the debt of certain companies. Some of these companies reported accounting irregularities, and the restatement of financial statements revealed previously hidden losses. In some cases, issuers that were not involved with accounting irregularities were forced to draw on bank credit lines when they were unable to roll over their CP because of the lack of demand or extreme-

CHART 8

Domestic Nonfinancial Commercial Paper Outstandings Have Declined amid Investors' Jitters about Credit Quality



Source: Federal Reserve Board (Haver Analytics)

ly high rates demanded by investors. When a CP issuer draws down on the back-up line, rating agencies often view this as a weakness in the company's liquidity, and a rating downgrade can occur. In turn, lower ratings lead to higher funding costs for the borrowers.

The steepness of the current yield curve also results in significantly higher refinancing costs for investment-grade corporations that no longer have access to short-term funding through the CP market. As these companies are forced to borrow longer term, they face higher refinancing costs in the long-term end of the current yield curve.[17] For example, if a Tier 1 corporation formerly issuing 90-day CP was forced to issue ten-year fixed-term debt in mid-July 2002, the cost would have been almost 350 basis points higher than issuing 90-day CP.

Using back-up lines of credit when companies cannot roll over maturing CP has become expensive for some issuers. Bankers are realizing that initial pricing does not reflect the risk inherent in drawn-down lines. As a result, bankers have started to impose high utilization premiums on BBB-rated CP back-up lines. Also, borrowers recently have been seeking term-out options, another sign that refunding risk is a concern.[18] Recent transactions reported by ***Loan Pricing Corporation*** show that some investment-grade companies are seek-

[13] Commercial paper is short-term promissory notes issued by large firms, generally maturing in nine months or less. It is an important source of short-term funding for corporations that need a steady stream of working capital.

[14] A CP back-up line is a commitment to provide a liquidity support for a company's CP program. It is typically a revolving credit, a 364-day facility. The rationale is that the borrower does not intend to use the back-up line, which generally costs more than issuing CP, unless the CP cannot be rolled over or repaid.

[15] The CP market can be divided into three tiers: Tier 1 (A1/P1/F1 or better), Tier 2 (A2/P2/F2), and Tier 3 (A3/P3/F3). The first two groups make up the bulk of the market. The first rating refers to a rating assigned by Standard & Poor's, while the second and third reflect ratings assigned by Moody's and Fitch, respectively.

[16] Moody's Investors Service, *Moody's Credit Perspectives,* December 31, 2001. Moody's downgraded 38 commercial paper programs from P1 in 2001.

[17] Bloomberg Fair Market Sector Curves, July 5, 2002. The spread between 60-day and five-year Treasury instruments was nearly 300 basis points.

[18] Once the back-up line has been drawn down, the borrower again has to repay or roll over the debt. A revolving facility can be "termed out" so that it becomes an installment loan with a much longer maturity, such as three to five years. Such an option, however, can be costly.

ing term-out options even at a fee of 200 basis points. The higher premiums demanded reflect both the volatility in the market and deteriorating credit quality indicated by high default rates and rating downgrades in recent quarters.

Conclusion

During the boom times of the late 1990s, corporations enjoyed an abundance of liquidity sources and easy access to capital. Many corporations used debt to finance business expansions, and rolling over maturing debt was not a significant concern. Recently, however, stock prices have been declining and investors have been concerned about the possibility of more corporate financial restatements. In this environment, highly leveraged borrowers worry about maturing debts and refunding risk implications. Lenders are demanding higher spreads because of the volatile financial markets and the deteriorated financial condition and debt ratings of many borrowers. In general, firms seeking to roll over maturing debt clearly face a less hospitable financing market today. With corporate profitability not yet strong, highly leveraged companies may find it increasingly difficult to meet debt service requirements and loan covenants. Despite these hurdles, the economy appears to be improving, and more companies are beginning to report higher earnings. With an economic recovery and tighter underwriting standards, the deterioration in commercial credit quality should stabilize and turn around.

Cecilia Lee Barry, Senior Financial Analyst

Subscription Form

To obtain a subscription to the FDIC ***Regional Outlook***, please print or type the following information:

Institution Name ______________________________

Contact Person ______________________________

Telephone ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Please fax or mail this order form to:

FDIC Public Information Center
801 17th Street, N.W., Room 100
Washington, D.C. 20434
Fax Number (202) 416-2076

Please indicate below each Region's issue you wish to receive:

Atlanta ________	Dallas ________	New York ________	National ________
Boston ________	Kansas City ________	San Francisco ________	All ________
Chicago ________	Memphis ________		

FDIC

Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

PRESORTED
STANDARD
MAIL
Postage &
Fees Paid
FDIC
Permit No. G-36