◇ Regional Outlook ◇

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 2002

FDIC
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Regional Perspectives

◆ *Economic and Banking Conditions*—**The Region's economy appears poised for growth in the second half of 2002, with indications of improved employment conditions in the important manufacturing and distribution sectors. Banking conditions improved in early 2002, as credit quality stabilized and earnings increased as a result of stronger net interest margins.** *See page 3.*

By Harry W. John and Robert L. Burns

◆ *Market Risk Rises in Investment Portfolios*—**Dramatic changes during 2001 and early 2002 in the composition of community bank securities portfolios likely increased market risk. Now may be an opportune time for managers to review investment strategies and portfolio holdings to ensure compliance with board-approved tolerances for sensitivity to changing interest rates.** *See page 5.*

By Robert L. Burns

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 10.*

By Cecilia Lee Barry, Senior Financial Analyst

DIVISION OF
INSURANCE
AND RESEARCH

GARY L. BEASLEY,
REGIONAL MANAGER

HARRY W. JOHN,
REGIONAL ECONOMIST

ROBERT L. BURNS,
SENIOR FINANCIAL
ANALYST

F. MIGUEL HASTY,
FINANCIAL ANALYST

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Regional Perspectives

Regional Economic and Banking Conditions

- **Although employment growth remained stagnant in early 2002,[1] the Region's economy appears primed for growth in the second half of 2002. Leading indicators suggest that job formation in the beleaguered manufacturing sector could improve soon.**

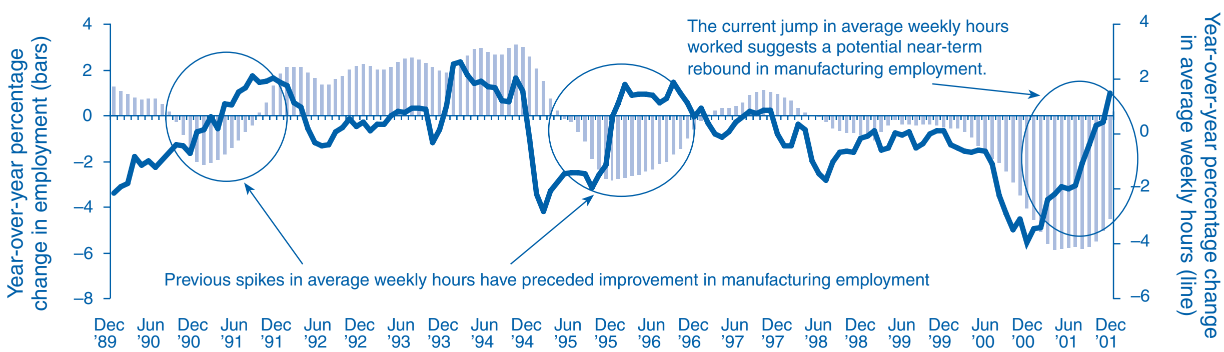
- **Banks and thrifts in the Region reported stable credit quality in early 2002 and stronger earnings performance as a result of higher net interest margins.**

The Regional Economy Is Likely to Improve as the Manufacturing Sector Appears Poised for a Rebound

The Region's economic downturn, which began in late 2000, stemmed from a severe contraction in manufacturing that subsequently spread to other sectors. Slowing demand for goods led manufacturers to reduce capital investment in new equipment and ultimately precipitated layoffs and plant closings. As shown in Chart 1, regional job cuts in the sector significantly exceeded losses experienced during previous manufacturing slumps in 1990–1991 and 1995–1996.

The Region's manufacturing sector began to strengthen in early 2002 as manufacturers continued to pare bloated inventories, and new orders for goods climbed. But despite rising production, many manufacturers hesitated to expand payrolls without evidence of a sustained rebound in demand for goods. Instead, they increased existing employees' hours to achieve higher production levels (see Chart 1). However, a natural limit exists on the expanded use of existing employees. When this limit is reached, manufacturers must hire new employees (or rehire displaced employees) before production levels can increase. As shown in Chart 1, in the past, spikes in average hours worked among manufacturing employees have preceded stabilizing employment conditions. The current rebound in average hours worked suggests that area manufacturers may soon expand payrolls to meet increasing demand.[2]

CHART 1



Note: "Months of Job Losses" is the total number of months in which the MSAs lost jobs, irrespective of when they started losing them.
Source: Bureau of Labor Statistics, Haver Analytics

[1] Memphis Region payroll employment fell 0.2 percent in first quarter 2002, compared with a decline of 0.1 percent in first quarter 2001. The nation reported a year-over-year payroll employment decline of 1.0 percent in first quarter 2002, compared with growth of 1.2 percent during the same period in 2001.

[2] As discussed in previous articles, not all of the Region's manufacturing sector is likely to expand with an economic recovery. Because of long-term structural changes, recent job losses in certain industries, such as textiles and apparel, are unlikely to be reversed.

Any improvement in manufacturing, which comprises almost 18 percent of total regional employment, likely would spill over into other areas of the economy. The transportation/distribution sector, another important segment of regional payrolls, also began to recover from a slump associated with the national downturn. Shipments and travel have begun to increase, which could lead to expanded payrolls in the sector.

Banking Conditions Improved in Early 2002

Banks and thrifts in the Region reported stronger earnings performance, while credit quality was largely unchanged in first quarter 2002. Some weaknesses remain, however, as many institutions continue to grapple with credit quality concerns that linger from the prolonged downturn during late 2000 and throughout 2001.

Credit quality indicators were mixed in first quarter 2002 but showed initial signs of improvement. Loan loss rates were down from levels reported during 2001, although they were high relative to longer-term trends, as many banks and thrifts continued to identify and address problem credits. The past-due and nonaccrual loan ratio fell modestly, as shown in Table 1, signaling that credit problems for most of the Region's banks and thrifts may have peaked for this cycle. Institutions with weak underwriting practices or those operating in particularly hard-hit areas of the Region, however, may continue to experience high loan delinquencies and loan loss rates.

Earnings performance improved in early 2002, with approximately 60 percent of the Region's banks and thrifts reporting higher returns on assets compared with one year ago. The higher returns, reported by both large institutions and community institutions, were driven by stronger net interest margins. Wider margins were primarily the result of a favorable interest rate environment, particularly the steepness of the yield curve. Many bank and thrift managers in the Region have made asset allocation decisions that take advantage of the steep yield curve. As discussed in ***Regional Perspectives, Memphis Regional Outlook,*** first quarter 2002, some of these strategies could make an institution's earnings more vulnerable to any rise in interest rates. See **Community Banks Report Increased Market Risk in Investment Portfolios,** which follows, elsewhere in this publication for a discussion of how such strategies have affected securities holdings at many of the Region's insured institutions.

Table 1

Loan Delinquency Ratios Declined Regionwide in Early 2002

	Median PDNA Loan Ratio	
	Mar-2002	Dec-2001
Memphis Region	2.65	2.84
Arkansas	2.88	3.17
Louisiana	2.30	2.47
Kentucky	2.51	2.64
Tennessee	2.84	3.02
Mississippi	3.50	3.65

Note: PDNA = Past-due and nonaccrual
Source: Bank and Thrift Call Reports

Harry W. John, Regional Economist
Robert L. Burns, Senior Financial Analyst

Community Banks Report Increased Market Risk in Investment Portfolios

- **Faced with weak loan demand, many managers of insured financial institutions have tried to boost revenues from securities portfolios.**

- **Investment alternatives in the current interest rate environment require managers to weigh the pursuit of higher yields in the short term against the potential adverse effects such strategies could have on future earnings.**

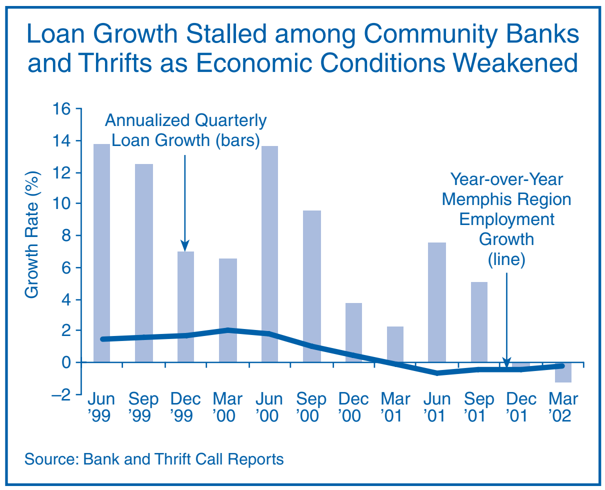
Although economic conditions improved, loan growth among the Region's banks and thrifts remained weak in late 2001 and early 2002, prompting many insured financial institutions to buy loans in the form of mortgage-backed and mortgage derivative securities. Similarly, some institutions sought higher yields by investing in longer-term securities or those with complex embedded options. These strategies helped institutions preserve or improve net interest margins in the current interest rate environment, but they added to investment portfolio market risk. For many insured institutions, the increase in investment portfolio market risk is a well-understood component of a sound overall asset/liability management strategy. For others, however, the increase in market risk may result from a simple pursuit of higher yields without adequate prepurchase investment analysis. Managers focused on such short-term results could impair the future earnings potential and economic value of their institutions.

With Anemic Loan Growth, Banks and Thrifts Turn to Securities

Weak economic conditions led to slowing loan growth in 2001 and early 2002. During 2001, median loan growth among established community banks and thrifts,[1] adjusted for merger activity, was 4.3 percent, less than half the rate reported in the previous year. Large institutions reported an even more pronounced drop in loan growth. The most dramatic slowing occurred in fourth quarter 2001 and first quarter 2002, as loan volumes at established community institutions *declined* (see Chart 1).[2] While the decline in both quarters was modest, the fact that median loan balances at community banks and thrifts declined undoubtedly had a significant influence on financial institution asset allocation decisions.

With flat loan demand, community banks and thrifts shifted funds into investment portfolios during the second half of 2001 and early 2002.[3] This growth in securities among the Region's community banks and thrifts reverses the trend of growing loan-to-asset ratios and steadily declining investment portfolios during the early 1990s. In community bank securities portfolios, mortgage-related securities (mortgage-backed and mortgage derivative securities) were the preferred investment choice during 2001 and early 2002.

Chart 1



[1] Established community institutions are banks and thrifts with less than $1 billion in total assets in operation for more than three years during the period reviewed.

[2] The loan growth trends in Chart 1 follow expected seasonal borrowing patterns, primarily affecting agricultural and construction lending, that typically result in stronger loan growth in the second and third quarters. A comparison of quarterly loan growth ratios with the ratios reported during the same period in the previous year, however, confirms a significant slowdown in loan growth throughout 2001 and during the first quarter of 2002.

[3] Securities as a percentage of aggregate assets among the Region's community banks and thrifts increased modestly in third quarter 2001. In fourth quarter 2001, securities portfolios jumped from 21.3 percent of aggregate assets to 22.5 percent, a significant shift in balance sheet composition in a single quarter. Securities portfolios increased again in first quarter 2002, to 23.0 percent of aggregate assets. The previous period of sustained growth for more than two consecutive quarters in securities relative to total assets was in 1992.

Mortgage-Related Securities Return to Favor

During 2001, aggregate holdings of mortgage-related securities among the Region's community banks grew by a remarkable 59 percent. As a result, mortgage-related securities as a share of total assets increased sharply (see Chart 2). Similarly, the share of the investment portfolio comprising mortgage-related securities surged from 18.6 percent on December 31, 2000, to 28.2 percent on March 31, 2002.[4]

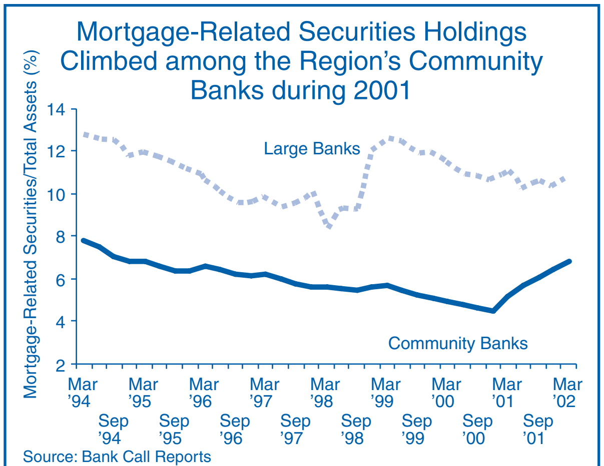
This dramatic shift in investment portfolio composition was facilitated by a number of factors. As noted earlier, loan growth slowed significantly during 2001. At the same time, deposit inflows at many community banks increased as consumers, shaken by weaknesses in the stock market, sought a safe haven for their money. Also, the sharp decline in interest rates during 2001 led to the exercise of embedded call features and prepayment options, which resulted in significant asset turnover at many banks. Consequently, banks found themselves with considerable funds to invest in 2001.

Mortgage-related securities became a popular investment choice for community banks because of yield.[5] Yields improved compared with most other investment alternatives during this period because of the increasing risk premium associated with the inherent optionality of mortgage-related securities (discussed below). Spreads over funding costs also widened considerably (see Chart 3). The difference between current coupon 15-year mortgage rates and six-month certificate of deposit rates climbed from approximately 75 basis points at year-end 2000 to more than 450 basis points by year-end 2001. The steepening of the yield curve that occurred throughout 2001 was the primary factor driving this increase.

While the higher yields available on mortgage-related securities make them attractive investments in the current environment, these securities introduce additional portfolio management complexity, primarily in the form of increased optionality. When interest rates decline, mortgage holders prepay existing loans and refinance at lower rates. The cash passes through to the bondholder, who must then reinvest the funds in a lower interest rate environment. Conversely, rising interest rates trigger a slowdown in refinancing activity and, consequently, a reduction in pass-through payments on mortgage-related securities, effectively lengthening the reinvestment horizon for these securities and locking in below-market returns for an extended period. It is this potential for ongoing contraction or extension of the life of the bond that causes the price of mortgage-related securities to be more sensitive to changes in interest rates than many other investment alternatives.[6]

In mortgage-backed securities portfolios,[7] community banks invested more heavily in bonds with longer reinvestment horizons, either maturity or earliest repricing opportunity (see Chart 4). This trend reflects not only bank purchasing preferences but also changes in mortgage origination patterns that favor longer-term fixed-rate mortgages over adjustable rate

CHART 2



Source: Bank Call Reports

[4] This reverses a long-term trend, dating from the early 1990s, of declining mortgage-related securities balances relative to total securities.

[5] Also noteworthy, mortgage-related securities became more abundant during this period. An active housing market and record refinancing activity led to a high volume of mortgage originations and subsequent securitizations, making ample mortgage-related securities available for purchase.

[6] Not all mortgage-related securities exhibit the same degree of increased optionality. Certain mortgage derivative securities, for example, are structured to reduce cash flow variability, and therefore price sensitivity, by shifting cash flows among various classes of bonds that are all collateralized by the same underlying mortgages.

[7] Information collected on mortgage derivative securities in Bank Call Reports is based on the average life of the security rather than on maturity or next repricing opportunity. While the average life is a more meaningful measure of a bond's reinvestment horizon, average life calculations change from quarter to quarter, potentially changing dramatically during periods of rapid interest rate movement such as that experienced during 2001, and therefore do not provide a useful gauge of investment purchase decisions. Thus, only mortgage-backed securities are discussed here.

CHART 3

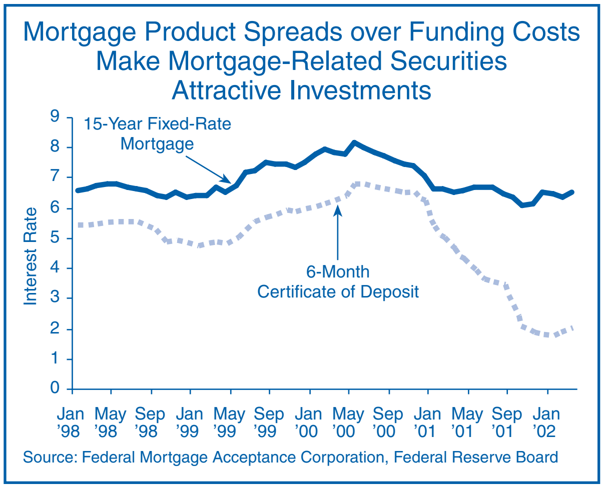
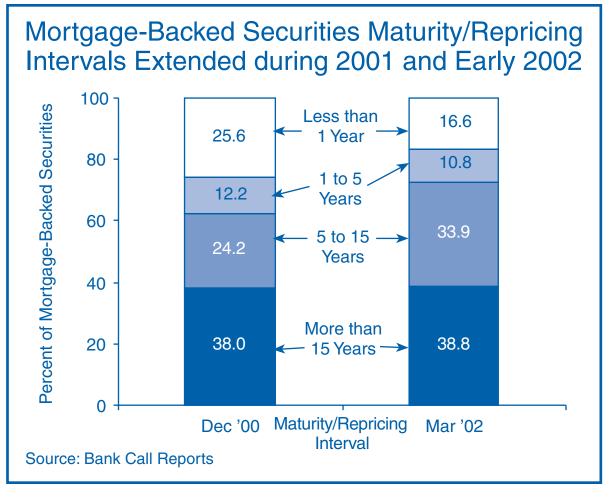


CHART 4



mortgages (ARMs).[8] While the stated maturity of mortgage-related securities does not provide an appropriate measure of the expected repayment of principal on the bond, the shift from an ARM-based product to a fixed-rate product suggests an increase in the cash flow variability and price volatility of mortgage-related securities portfolios.

Market Risks Climb for Other Community Bank Investment Holdings

Although mortgage-related securities have gained favor in recent quarters, other securities, such as U.S. government, agency, and municipal bonds, continue to comprise the bulk of the investment portfolio for most community banks. Some institutions appear to have elected to accept increased market risk in these segments of investment portfolios by extending reinvestment horizons and purchasing structured notes.

Extended Reinvestment Horizons: The steep yield curve during 2001 and early 2002 offered considerable incentive for banks to invest in securities with longer maturities or repricing intervals in return for higher yields (see ***Regional Perspectives, Regional Outlook,*** first quarter 2002, for a more detailed discussion of the yield curve shifts and resulting incentives for asset extension). Non-mortgage-related securities maturing or repricing in less than one year declined from almost 20 percent of all non-mortgage-related securities at year-end 2000 to under 15 percent by early 2002. Community banks primarily shifted these funds into intermediate investments maturing or repricing in the next three to five years. Longer-term investments also increased somewhat, with the percentage of non-mortgage-related securities maturing in over five years inching up from 34.8 percent to 36.1 percent during this period. While the aggregate shift to intermediate and longer-term reinvestment horizons has not been extreme, it adds to the growing market risk apparent in many community bank investment portfolios.

Structured Notes: Structured notes frequently contain complex embedded options that often significantly increase the cash flow variability and price volatility of these instruments. While the reported volume of these securities[9] comprises only a small portion of total securities, the level has grown in recent quarters. The number of community banks reporting a significant portion of investment portfolios in structured notes (at least 10 percent of total securities) has climbed from 3 institutions at year-end 2000 to 32 institutions in early 2002.

[8] The underlying collateral for the shorter-term mortgage-backed securities shown in Chart 4 is primarily ARMs. With historically low interest rates prevailing throughout much of 2001, consumers migrated from ARMs to longer-term fixed-rate mortgages. The limited availability of ARMs available for securitization likely influenced the shift by community banks to longer-term fixed-rate mortgage pass-through products.

[9] The reported volume of structured note holdings has increased from 0.6 percent of aggregate securities holdings at year-end 2000 to 1.1 percent by first quarter 2002, with only 20 percent of community banks in the Region reporting any holdings of structured notes in early 2002. Structured notes are reported only as a memorandum item in Bank Call Reports and are frequently not readily identified by bank investment portfolio management reports. As a result, the volume of structured notes held may be underreported.

Most Institutions That Have Invested Heavily in Mortgage-Related Securities Accepted Increased Market Risk Elsewhere in Investment Portfolios

Table 1 compares selected investment portfolio information for a group of banks that reported a substantial increase in mortgage-related securities during 2001[10] and all other community banks in the Memphis Region. As the table shows, banks that significantly increased mortgage-related securities holdings exhibited additional market risk factors than were reported by other community banks.

Both groups of banks began with similar concentrations in mortgage-related securities—at just under 19 percent of total investment portfolios. This suggests that banks subsequently investing heavily in mortgage-related securities were not predisposed to do so; the investment portfolios of these banks were not previously disproportionately weighted toward mortgage-related securities. As these banks shifted portfolios, they also extended the maturity and repricing intervals on mortgage-related securities to a greater extent than did other community banks, further adding to cash flow variability and price volatility.

Furthermore, banks that invested heavily in mortgage-related securities reported a more significant increase in non-mortgage-related securities with longer-term investment horizons. The ratio of non-mortgage-related securities maturing or repricing in over five years as a percentage of all such securities at these banks increased by 420 basis points, compared with a 100-basis-point increase in this ratio at other community banks in the Region. These institutions also reported a

Excerpt from Office of the Comptroller of the Currency Bulletin 2002–19 on investment portfolio practices, issued May 22, 2002

"For investors trying to enhance yield, a steeply sloping yield curve provides an incentive to extend maturities. The current yield curve environment is similar to the one that prevailed during 1993, when banks faced a similar dilemma concerning how to replace the yields on called/prepaid assets. At that time, some banks made the mistake of investing a disproportionate amount of funds within a short time period and locked in a large volume of earning assets at a cyclical low point in yields. Then, as now, many banks chased yields to avoid investing excess liquidity at very low overnight rates."

Table 1

Community Banks Reporting a Significant Increase in Mortgage-Related Securities Also Exhibited Other Indications of Increased Investment Portfolio Market Risk

Sample reporting significant increase = 141 banks Other community banks = 668 banks	Banks Reporting Significant Increases in MRS Holdings		Other Community Banks in the Memphis Region	
Percent	Dec-00	Mar-02	Dec-00	Mar-02
MRS/Total Securities	18.6	45.9	18.7	22.9
Mortgage-Backed Securities Maturing in over 5 Years/Mortgage-Backed Securities	58.8	74.0	62.3	71.9
Non-Mortgage Securities Maturing in over 5 Years/Non-Mortgage Securities	40.3	44.5	33.3	34.3
Structured Notes/Non-Mortgage Securities	0.7	2.2	0.7	1.3

Notes: MRS = mortgage-related securities. A significant increase in MRS is defined as an increase in MRS equivalent to 5 percent of total assets during 2001.
Source: Bank Call Reports

[10] Defined as an increase in mortgage-related securities equivalent to 5 percent or more of total assets during 2001.

Large Banks in the Region Have Followed a Different Investment Strategy

Large banks headquartered in the Memphis Region have not reported a significant increase in mortgage-related securities holdings. In aggregate, such investments increased modestly, from 10.1 percent of assets at year-end 2000 to 10.8 percent by first quarter 2002. This situation contrasts with the substantial increase in mortgage-related assets reported by community banks during this period.

As shown in Chart 2, large banks reported a sharp increase in mortgage-related securities in late 1998, when credit concerns led to a brief pullback in loan exposure at many larger institutions. But why the difference in investment strategies at large banks in late 1998 compared with today? The shape of the yield curve and expectations concerning future interest rates likely played a role in such decisions. At the end of third quarter 1998, the yield curve was relatively flat, with only a 45-basis-point spread between short-term and long-term rates, suggesting limited expectations for higher interest rates. In early 2002, the yield curve was steep, with a 400-basis-point spread between short- and long-term rates.

Consistent with limited increases in mortgage-related securities, large banks contracted non-mortgage-related securities reinvestment horizons in recent quarters. In aggregate, non-mortgage-related securities holdings among large banks with a maturity or earliest repricing opportunity exceeding five years declined from 41.4 percent of all such securities at year-end 2000 to 32.3 percent by first quarter 2002. In general terms, this decline has served to reduce the sensitivity of large bank investment portfolio earnings to potential adverse effects from rising interest rates.

Some large banks may be inclined to reduce market risk in investment portfolios to compensate for the sensitivity of certain other revenue sources to rising interest rates. For example, large institutions concerned about a potentially lower volume of origination fees from mortgage banking activities in a climate of rising interest rates may try to reduce the potential effects of higher rates on securities portfolio earnings.

greater increase in structured note holdings during the period, although both groups of banks held similar levels of structured notes at year-end 2000.

Changes in investment portfolios should be measured as part of an institution's overall asset allocation and funding structure, as higher market risk in investment portfolios can be offset elsewhere on the balance sheet. However, the significant and rapid shifts in portfolio composition reported by many of these banks suggest that

- these institutions may have significantly increased investment portfolio risk tolerances, or

- yield considerations have assumed increased significance for these institutions, underscoring the need for thorough prepurchase analysis.

Conclusion

A shift into mortgage-related securities, longer-term securities, or securities with complex embedded options does not represent an inappropriate or undesirable strategy. In the current interest rate environment, such a strategy can translate into improved returns. However, better returns are often achieved only through the acceptance of increased risk, which must be well understood and properly managed.

With credit concerns understandably paramount for most bankers and regulators during 2001 and early 2002, attention to investment portfolios may have waned. Now may be an opportune time for bank and thrift managers to review investment strategies and securities portfolios to ensure that current holdings and future purchases are within board-approved tolerances for sensitivity to changes in interest rates.

Robert Burns, CFA, CPA
Senior Financial Analyst

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

Introduction

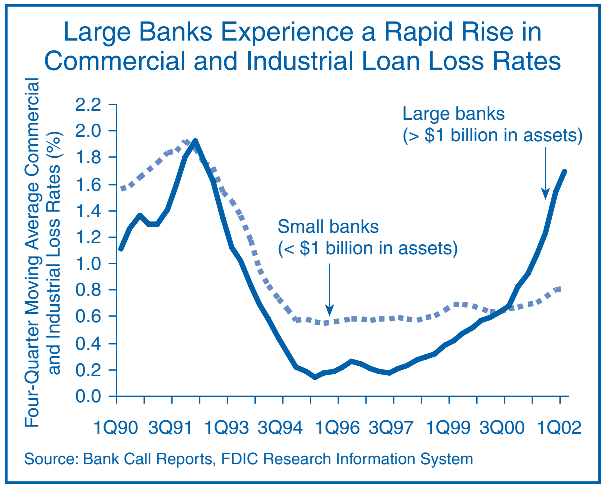
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic 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



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

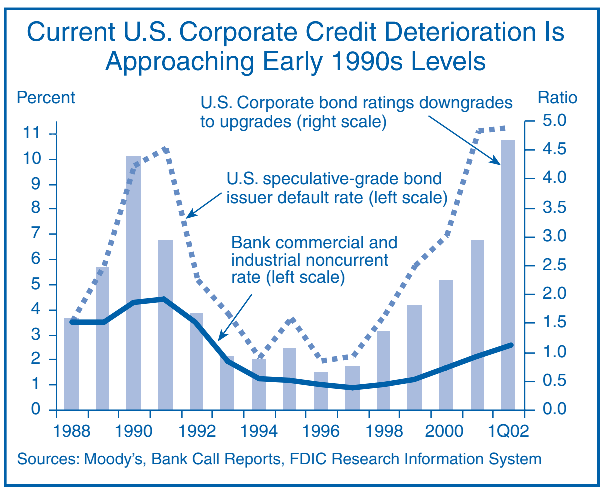
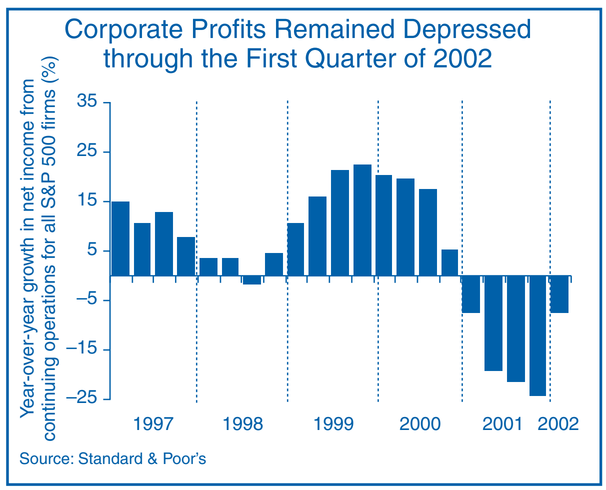


CHART 3



[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.

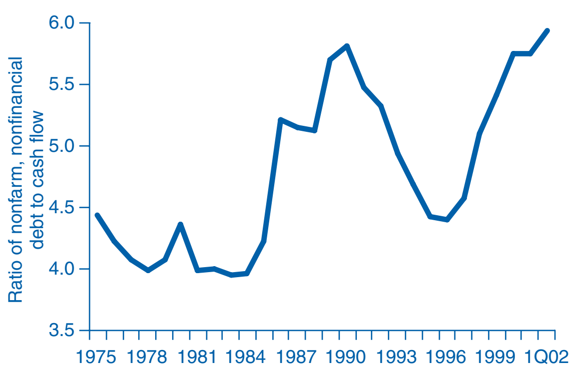
The prospect of slow earnings growth could be particularly problematic for many highly leveraged corporations. Debt levels relative to cash flow have been rising because of anemic earnings (see Chart 4). Negative earnings news also comes at a time when several well-publicized accounting irregularities 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

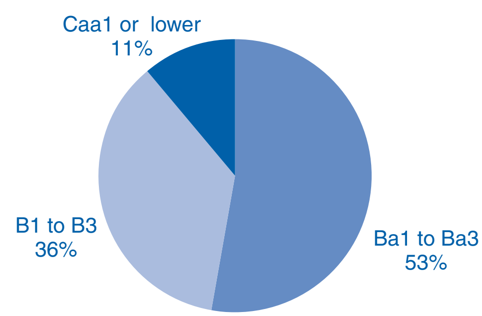
Corporate Debt Continues to Rise Relative to Cash Flows



Source: Federal Reserve Board

CHART 5

Forty-Seven Percent of U.S. Speculative-Grade Bonds and Bank Debt Maturing in 2003–2004 Are Rated B1 or Lower



Source: Moody's

[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

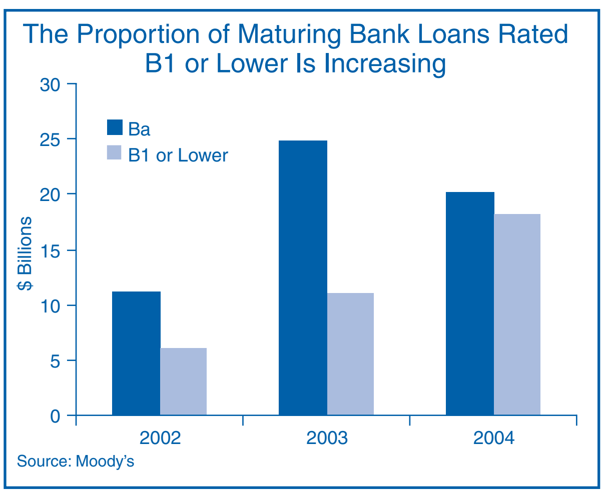


TABLE 1

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

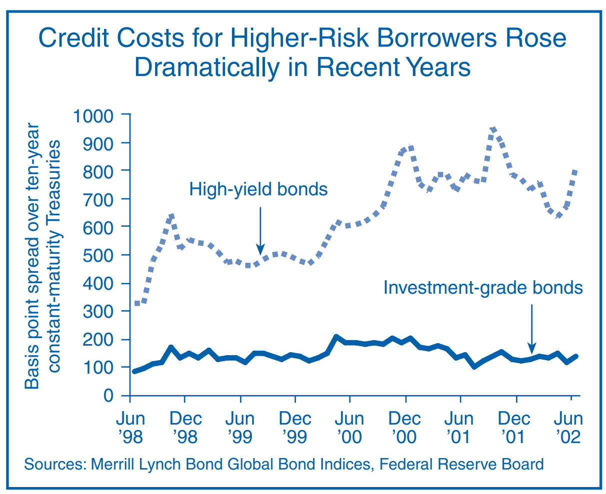
	AVERAGE RECOVERY PER $100	
SENIORITY/SECURITY	1982–2000	2001
SENIOR SECURED BANK LOAN	$67.06	$54.68
EQUIPMENT TRUST	$64.65	NA
SENIOR SECURED BONDS	$52.09	$58.00
SENIOR UNSECURED BONDS	$43.82	$36.20
SENIOR SUBORDINATED BONDS	$34.59	$19.90
SUBORDINATED BONDS	$31.83	$16.45
JUNIOR SUBORDINATED BONDS	$22.48	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



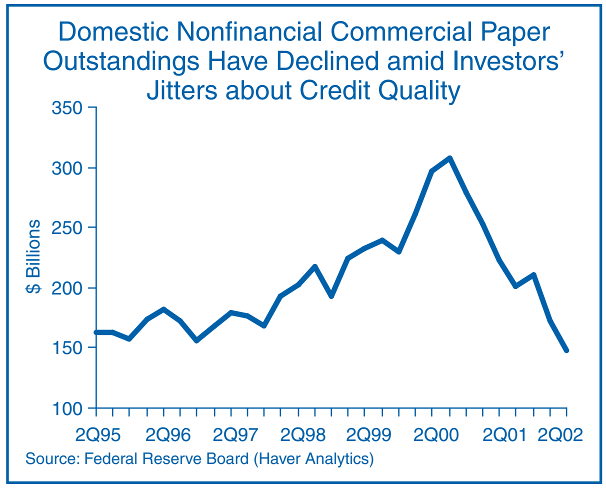
[12] David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research,* Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument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

Chart 8



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

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