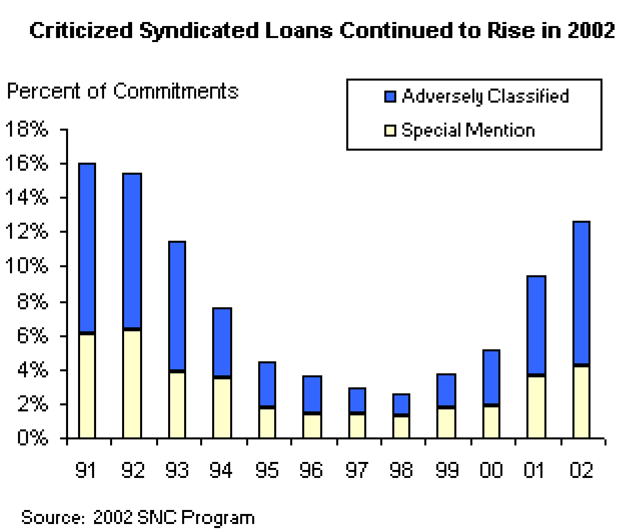
Syndicated Credits Deteriorate, But at a Slower Pace

October 8, 2002

Large banking organizations are continuing to feel the effects of the recession, as syndicated loan quality remains generally weak. In recent years, the results of annual interagency Shared National Credit (SNC) reviews have shown how problems in the corporate sector have hurt large bank commercial credit quality.[1]

The results of the 2002 SNC review, released today, show this year's program covered a total of $1.9 trillion in loan commitments, of which 12.6 percent were criticized (Chart 1). This year's volume of criticized loans represents a 23 percent increase from the previous year, while the 2001 review, which showed 9.4 percent of total commitments as criticized, revealed a 93 percent increase in criticized loans from the previous year. Criticized loans include those adversely classified by examiners as Substandard, Doubtful, or Loss and loans rated Special Mention. Adversely classified loans have well defined weaknesses, including default in some cases, while Special Mention loans exhibit potential weaknesses which may result in further deterioration if left uncorrected.

Chart 1



Of particular note in this year's review was a record $19.6 billion in credits classified as Loss, up $11.6 billion from the prior year. Thirty-nine percent of that amount was attributable to the telecommunications and cable industries. These two industries contributed 75 percent of the total increase in adversely classified loans. In addition to the sluggish recovery, accounting irregularities and the after-effects of the September 11 attacks also contributed to weaknesses in syndicated credits.

The 2002 SNC results also suggest that deterioration has been particularly evident for credits to leveraged and speculative grade borrowers that are having difficulty generating sufficient cash flow to service debts. These issues were analyzed in the FDIC's Third Quarter 2002 edition of the *Regional Outlook*, which pointed to the rapid increase in speculative bond defaults since 1996 and the recent high ratio of bond ratings downgrades to upgrades.[2] The *Regional Outlook* noted that ***Moody's*** expects $141 billion of U.S. speculative grade corporate bonds and rated bank debt will come due in 2002 through 2004. Some of these corporations may face difficulty rolling over maturing credits if market conditions remain risk averse.

Banks continue to show signs that they are, in general, effectively managing the credit risks in commercial loan portfolios. Regulatory surveys suggest that banks have tightened underwriting standards for commercial loans in recent years. In an address last month to the Risk Management Association, FDIC Chairman Donald E. Powell discussed how innovations in loan syndication and securitization have also allowed banks to diversify their asset holdings.[3] In addition, nonbanks, which include institutional investors, have come to play a larger role in the syndicated loan market, driving the share of SNC credits held by U.S. banks steadily downward, to 45 percent in 2002. Nonbanks also hold a proportionally higher share of problem SNCs. For example, 6.5 percent of U.S. banking organizations' SNC commitments were adversely classified during the 2002 review. In contrast, nonbanks, which held 10 percent of total commitments in 2002, had 23 percent of their commitments adversely classified.

Despite the continued weaknesses of the corporate sector and commercial credit quality, the outlook may be improving. Declining default rates for speculative grade bonds appear to bode well for the future performance of syndicated loans, which tends to follow bond default trends over the credit cycle. Nevertheless, recent disappointing economic news and reductions in corporate earnings forecasts suggest that the economic recovery could take time to gather steam. While commercial credit quality remains weak at present, the slowing rate of deterioration in the performance of SNC credits is a hopeful sign that the worst may be behind us.

The full text of the Interagency Press Release on the 2002 Shared National Credit review can be found at: http://www.fdic.gov/news/news/press/2002/pr10402.html.

The Chairman's statement on the 2002 National Credit Review can be found at: http://www.fdic.gov/news/news/press/2002/pr10502.html.

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[1] The SNC program was established in 1977 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency to provide an efficient and consistent review and classification of large syndicated loans. The annual program covers loans or loan commitments of at least $20 million that are shared by three or more regulated institutions.

[2] "The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead." *FDIC Regional Outlook*, Third Quarter 2002.

[3] The full text of Chairman Powell's September 23rd remarks to the Risk Management Association is available at: http://www.fdic.gov/news/news/speeches/archives/2002/sp23sep02.html.

Chart 1

Chart 1:Criticized Syndicated Loans Continued to Rise in 2002

	Percent of Commitments			Classification Volume ($ Billions)		
Review Year	Special Mention	Adversely Classified	Total Criticized	Special Mention	Adversely Classified	Total Commitments
1991	6.10	9.90	16.00	49.2	79.8	806.0
1992	6.32	9.09	15.41	50.4	72.5	798.0
1993	3.90	7.52	11.42	31.4	60.6	806.0
1994	3.53	4.04	7.57	31.5	36.1	893.0
1995	1.77	2.65	4.42	18.8	28.2	1,063.0
1996	1.40	2.26	3.66	16.8	27.1	1,200.0
1997	1.37	1.55	2.92	19.6	22.2	1,435.0
1998	1.30	1.25	2.55	22.8	22.0	1,759.0
1999	1.71	2.04	3.75	31.3	37.4	1,829.0
2000	1.86	3.25	5.11	36.3	63.4	1,951.0
2001	3.68	5.74	9.42	75.4	117.6	2,050.0
2002	4.22	8.40	12.62	79.0	157.1	1,871.0

Source: 2002 SNC Program