Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION | THIRD QUARTER 2002

FDIC
BOSTON
REGION

DIVISION OF INSURANCE AND RESEARCH

PAUL M. DRISCOLL, REGIONAL MANAGER

NORMAN WILLIAMS, REGIONAL ECONOMIST

CAMERON TABOR, SENIOR FINANCIAL ANALYST

ANDREA PLANTE, ECONOMIC ANALYST

Regional Perspectives

◆ ***The Region's six state economies have performed differently through this business cycle than during the early 1990s recession***—**when most experienced significant deterioration relative to the nation. The divergence in performance among the Region's states during this downturn may be due to varying degrees of dependence on technology employment and the equity market wealth effect.**

◆ ***Past-due loan levels have remained in check among the Region's insured institutions***—**but the full effect of the recent recession may not yet have appeared in loan performance data. Thus, credit quality could deteriorate further this year. Also, with weakening consumer lending conditions and generally sluggish demand for business credit in recent quarters, insured institutions may find it harder to increase revenues until the economy returns to a stronger footing. Over the near term, these trends may be particularly evident in states such as Vermont or Massachusetts, where economic growth is expected to remain sluggish.** ***See page 3.***

By the Boston 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

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 Boston Region's ***Regional Outlook,*** please call Paul Driscoll at (781) 794-5502 or send an e-mail to *pdriscoll@fdic.gov.*

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

- **Economic performance has varied widely among the New England states during this recession.**
- **Massachusetts and Vermont have been hardest hit, while Rhode Island and Maine have been spared the worst of the recession's effects.**
- **The Region's insured institutions have performed well through the recession; loan growth rates differed by state, likely a reflection of individual state economic performance.**

The Effects of the Recession Varied Widely across New England, with the Region's Insured Institutions Remaining Healthy but Showing Elevated Credit and Earnings Risk

Individual State Performance Has Varied during This Recession

The fallout from the most recent economic downturn in New England should prove mild compared to the effects on the national economy and to the severity of the recession (both absolute and relative to the nation) during the early 1990s. The Region's six state economies have performed differently through this business cycle than during the early 1990s recession, when all the states experienced at least one annual decline in gross state product and two consecutive annual declines in per capita income. The difference this time is that the national recession's adverse impact was amplified only in some states—those more dependent on technology employment, national business investment, and spending linked to stock market wealth effects.

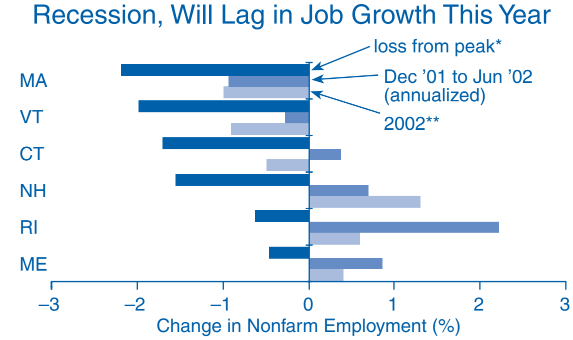
Massachusetts and Vermont Economies Face the Greatest Challenges

Trends in nonfarm payrolls illustrate how the recent downturn differed among the Region's states. Between January 2001 and June 2002, **Massachusetts** and **Vermont** experienced the greatest number of monthly declines in payrolls as well as the longest consecutive runs of falling employment (17 months in the case of Massachusetts). Further, labor markets in these two states appear likely to continue deteriorating, while employment in the other four states apparently stabilized during the first half of 2002. For example, recently announced sizable layoffs at IBM, Vermont's largest employer, are not expected to show up in that state's labor statistics until late summer. In addition to the number of "down" months, Massachusetts led the Region, followed closely by Vermont, in the magnitude of the peak-to-trough percentage job loss during this business cycle. Although **Connecticut** and **New Hampshire** also experienced a fair number of down months, as well as meaningful peak-to-trough declines in jobs, these two states have shown renewed job growth since year-end 2001 (see Chart 1).

Unemployment rates also confirm the relative economic performance of the Region's states. Except in **Rhode Island** (and, to a lesser degree, **Maine**), unemployment rates across the Region entered this recession at very low levels and rose sharply. After holding at or above the national average for four years in the early 1990s, Massachusetts (along with Connecticut) went on to post

CHART 1

Massachusetts and Vermont, Hit Hardest by the Recession, Will Lag in Job Growth This Year

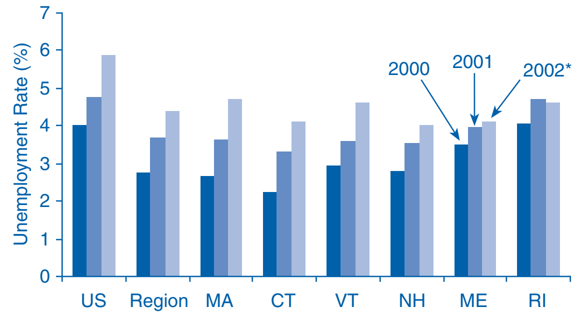


* Minimum seasonally adjusted monthly employment recorded after January 2001 versus maximum monthly employment 2000–2001
** 2002 forecast from the New England Economic Project
Source: Bureau of Labor Statistics and New England Economic Project

one of the lowest unemployment rates in the country by 2000. Although unemployment rates across the Region have risen from the 2000 lows, rates are not expected to exceed the national average by much, if at all, in any of the Region's states—this was not the case during the early 1990s. However, unemployment rates have risen further in some states since 2000 (see Chart 2). As a result of this recent divergence in performance, the states' relative unemployment rate rankings may shift noticeably this year from 2000. For instance, Massachusetts, which had the Region's second lowest rate in 2000, is expected by the ***New England Economic Project*** to post the Region's worst rate this year. Connecticut, which boasted the lowest unemployment rate in New England during 2000, is forecast to rise to the middle of the pack in 2002.

CHART 2

Recession Most Affected Unemployment Rates in Massachusetts, Vermont, and Connecticut



* May 2002 forecast from the New England Economic Project
VT does not include IBM layoffs announced in June
Source: Bureau of Labor Statistics and New England Economic Project

Massachusetts benefited greatly from the strong stock market and information technology (IT) investment boom during the late 1990s because of the state's significant concentrations of employment in IT and financial services firms, as well as in ancillary businesses. Robust economic growth in Massachusetts in the late 1990s was strongly influenced by the boom, and the absence of these economic catalysts now has further amplified the state's economic decline. In addition, with a continued malaise in the national economy a distinct possibility, the recent weakness in the IT and financial services sectors seems likely to linger and impede the state's economic growth this year.

Unlike the swing in the Massachusetts economy from boom to bust, the relative severity of the economic weakness in Vermont, for the most part, does not reflect a hangover effect from the late 1990s IT and stock market booms. The state's largest employer, IBM, has been affected negatively by the downturn in IT, and ongoing layoffs are expected to accelerate as the year continues, but Vermont has experienced other problems as well. For example, overall business investment, high-end retailing, and tourism—key drivers of business and consumer sales in the Vermont economy—also were affected adversely during this recession.

Maine and Rhode Island: No Booms, but No Busts, Either

In contrast, Maine and Rhode Island appear to have escaped the adverse effects of the recession because they do not have significant concentrations in IT and financial services employment, nor are they characterized by sizable concentrations of high-worth households. The overall economic effect of these concentrations shows clearly in relative income growth trends. Real income growth in Maine and Rhode Island during the late 1990s boom was far less than that in Massachusetts—a state that exemplified the surge in IT and capital gains–driven income (see Chart 3). In fact, from 1997 through 1999, Maine and Rhode Island reported the Region's slowest average rates of real income growth, while Massachusetts (and New Hampshire) led the Region.

While IT-dependent states such as Massachusetts saw income growth decelerate sharply in 2001 as the effects of a weak stock market and an abrupt halt in business investment took hold, Maine and Rhode avoided such wide swings. Furthermore, Massachusetts is likely to post its first loss in real per capita income since the early 1990s, while Maine and Rhode Island are expected to experience continued, though somewhat slower, income growth this year (see Chart 4).

Unlike the Region's other states during the 1990s, Rhode Island's average unemployment rate matched or exceeded the national average every year except 1996. During 2000, just prior to the recent recession, the state's unemployment rate was the highest in the Region. Rhode Island's more recession-sensitive factory sector was already in a prolonged period of contraction, and the state's economic growth in recent years has lacked any boom-like qualities. As a result, the recent recession's cyclical impact was limited.

The downturn's cyclical effects also were muted in Maine, where the recession-sensitive manufacturing

CHART 3

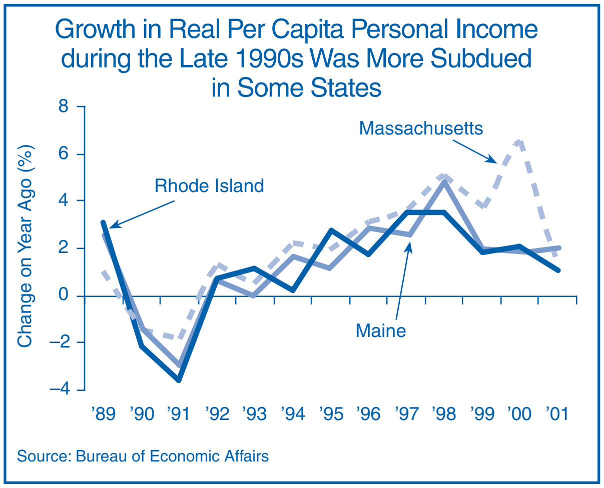
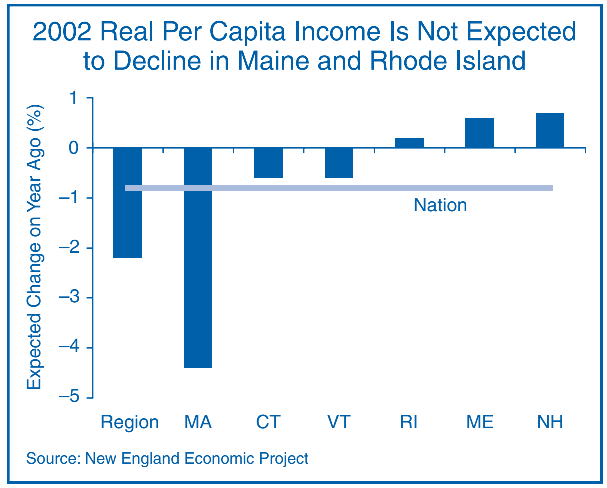


CHART 4



sector had already retrenched somewhat during the 1990s. Maine's reliance on factory employment is less than that of most other states in the Region but historically has centered on the production of less cyclical nondurable goods, such as pulp and paper, shoes, and textiles. Further, the state's nonfarm job growth benefited little from the booming IT sector late in the past decade.

Insured Institutions Weathered the Recent Recession, but Credit and Earnings Risks Remain

The recent economic downturn appears to have had limited effects on the Region's insured institutions thus far. For example, the boost in net interest margins late in 2001 and early 2002 from cheaper funding sources helped insured institutions remain profitable. However, other measures of banking performance—particularly loan growth rates—reflect the recent economic slowdown and, in some cases, track the relative economic performance of individual states. Table 1 presents median profitability and loan growth rates for the nation, the Boston Region, and the New England states. Medians are useful as an approximation for trends at "typical" small to midsize banks, whose performance likely is tied most closely to local economic trends.

Consumer loan growth (excluding credit card loans) decelerated sharply at the end of 2000, ultimately turning negative for insured institutions in those New England states first affected by the recent recession, such as Connecticut and Massachusetts (see Table 1). Banks and thrifts in other states (such as New Hampshire) that have been hit harder by the recent downturn in IT employment continued to post respectable consumer loan growth until late last year; however, loan growth also has turned negative for insured institutions in these states. Meanwhile, the milder effects of the recession on the Maine economy are clear as loan growth continued through mid-2001, with only modest deterioration in consumer lending since then. Although Rhode Island's economy has also been spared the worst of this recession, consumer loan trends indicate some recent sharp declines. These declines may be due, in part, to the fact that many of the state's residents commute to jobs in the struggling **Greater Boston** area, where IT industries have come under increasing pressure in recent months to reduce pay and bonuses and cut staffing levels.

In recent years, many of the Region's insured institutions have begun to target increased concentrations of higher-yielding, traditionally higher-risk commercial loans.[1] Despite this fact, (aggregate) median commercial loan growth has decelerated in recent quarters, which could reflect increasing head winds from a slumping economy. However, unlike consumer lending, state-level commercial loan trends appear less closely linked to local economic trends. For example, commercial loan growth has not faltered significantly in Connecticut, though this state's economy has been one of the Region's poorest performers. Also, commercial lending has turned negative in Rhode Island during a time when that state's economy has performed relatively well. Part of the disconnect may be due to the fact that local commercial credit demand has not been driven by the firms that have weakened most during this downturn. For instance, many of the Region's struggling IT firms were not big users of

[1] For a discussion of this trend, see *Boston Regional Perspectives,* First Quarter 2001.

Table 1

New England Insured Institutions Have Reported Varying Loan Growth Trends during the Past Two Years									
Median Return on Assets									
	Mar-02	Dec-01	Sep-01	Jun-01	Mar-01	Dec-00	Sep-00	Jun-00	Mar-00
Nation*	1.06	0.94	1.04	1.03	1.01	0.94	1.11	1.14	1.09
Boston Region	0.84	0.90	0.88	0.81	0.81	0.91	0.93	0.91	0.91
Connecticut	0.84	0.86	0.85	0.73	0.80	0.89	0.90	0.95	0.98
Maine	0.78	0.86	0.89	0.75	0.82	0.78	0.94	0.83	0.77
Massachusetts	0.81	0.90	0.84	0.77	0.78	0.89	0.89	0.91	0.90
New Hampshire	0.97	0.95	0.97	0.93	0.84	1.03	1.03	0.94	0.98
Rhode Island	0.80	0.84	1.35	0.84	0.71	1.26	1.29	1.05	1.17
Vermont	1.02	1.01	1.05	1.09	0.99	1.04	1.09	1.05	0.93
Median Consumer Loan Growth Growth									
	Mar-02	Dec-01	Sep-01	Jun-01	Mar-01	Dec-00	Sep-00	Jun-00	Mar-00
Nation*	–2.69	–1.95	0.07	1.37	0.48	0.27	1.97	2.97	0.67
Boston Region	–4.15	–4.28	–1.64	0.90	0.99	1.24	3.30	3.90	1.03
Connecticut	–3.11	–4.74	–1.63	–0.65	0.56	1.44	2.07	3.59	0.81
Maine	–1.46	–2.46	–0.16	2.35	0.78	0.58	3.40	4.02	1.11
Massachusetts	–4.79	–5.10	–2.27	0.36	1.16	1.30	3.59	3.68	1.23
New Hampshire	–5.83	–2.34	1.06	3.76	2.64	2.18	3.77	5.34	–1.75
Rhode Island	–7.03	–2.39	–2.91	–0.30	9.08	9.04	0.95	2.43	8.07
Vermont	–2.14	–2.96	–0.73	2.55	–2.13	0.52	3.73	3.14	0.01
Median Commercial Loan Growth									
	Mar-02	Dec-01	Sep-01	Jun-01	Mar-01	Dec-00	Sep-00	Jun-00	Mar-00
Nation*	0.68	0.65	0.00	2.64	2.53	2.49	1.51	4.01	3.57
Boston Region	1.31	1.45	0.54	4.17	3.71	2.79	2.67	6.20	4.18
Connecticut	2.39	5.84	2.50	6.81	1.82	4.15	3.33	3.86	3.86
Maine	2.03	2.39	–0.95	7.91	7.90	3.73	–1.06	11.32	7.30
Massachusetts	0.82	1.99	1.26	1.15	0.42	0.35	0.60	6.18	4.09
New Hampshire	3.22	–3.26	0.82	8.20	5.45	0.28	–1.38	6.65	0.72
Rhode Island	–4.95	–2.82	–2.05	4.60	3.63	2.09	2.55	1.46	10.38
Vermont	1.30	0.72	–4.04	1.34	0.86	0.34	1.97	7.68	5.44
Median Commercial Real Estate, Construction, Multifamily Loan Growth									
	Mar-02	Dec-01	Sep-01	Jun-01	Mar-01	Dec-00	Sep-00	Jun-00	Mar-00
Nation*	2.15	2.93	3.46	2.99	2.18	2.48	3.00	3.49	3.12
Boston Region	2.61	2.84	3.29	3.47	1.81	2.57	2.79	3.28	2.57
Connecticut	5.21	3.37	6.52	3.22	2.67	2.32	3.52	3.08	3.66
Maine	4.39	2.96	3.40	2.60	0.96	3.21	1.50	4.74	2.27
Massachusetts	2.05	2.91	2.81	4.07	2.38	2.71	2.85	3.28	2.57
New Hampshire	2.38	2.89	2.53	2.22	1.10	2.45	1.99	2.26	1.24
Rhode Island	–0.52	1.25	2.26	2.58	0.19	–0.01	1.65	0.96	1.62
Vermont	1.07	0.83	3.91	0.44	–0.38	1.09	2.44	4.41	1.64

* Excludes the Boston Region
Source: Bank and Thrift Call Reports

local bank credit, seeking funding instead in public equity markets, through bond sales, or from large lenders via syndicated credits. Likewise, many of the area's manufacturing operations may be part of larger organizations based outside the Region, also with access to public capital markets or nonlocal bank funding.

Combined construction and development, commercial real estate, and multifamily real estate loan portfolios have continued to grow modestly among insured institutions in all the Region's states. Particularly in Massachusetts, this trend does not appear consistent with the fact that the state's dominant Boston office market is showing high vacancy rates and sluggish sales activity. However, the commercial real estate and construction lending trends shown in Table 1 reflect activity by small to midsize banks, which are not significantly involved in large-scale office projects in the Region's major metro areas. Rather, commercial construction and mortgage lending in these metro areas is likely dominated by public capital market vehicles, such as real estate investment trusts (REITs).

Employment trends may provide a better indication than Boston's office vacancy rate of the health of local commercial real estate and construction markets. Construction employment has been one of the few bright spots for the Region's economy through the recent recession. June year-to-date job growth in the construction industry continued to outperform the nation, rising 2.3 percent for the Region while declining 2.2 percent for the nation versus a year ago.

Past-due loan levels among the Region's insured institutions remained in check during the recent downturn, and deterioration in credit quality was not widespread. Charge-offs also remain at low levels. While insured institutions appear to have come through the recession in relatively good shape, challenges remain. Credit quality problems often lag the business cycle, so the full effect of the recent recession may not yet have appeared in loan performance data. Thus, credit quality among the Region's banks and thrifts could deteriorate further this year. Also, with weakening consumer lending conditions and generally sluggish demand for business credit in recent quarters, insured institutions may find it harder to increase revenues until the economy returns to a stronger footing. Slower loan growth will also make any existing credit quality problems more apparent, as new loans typically have lower average loss rates than seasoned credits.

Over the near term, these trends may become particularly evident in states such as Vermont and Massachusetts, where economic growth is expected to remain sluggish. In addition, should the recovery be slow or should the national economy fall back into recession, the regional economy would be expected to falter as well. Local insured institutions could find it more difficult to sustain revenue (loan) growth, while delinquencies and charge-offs might worsen appreciably.

Boston Region Staff

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

Introduction

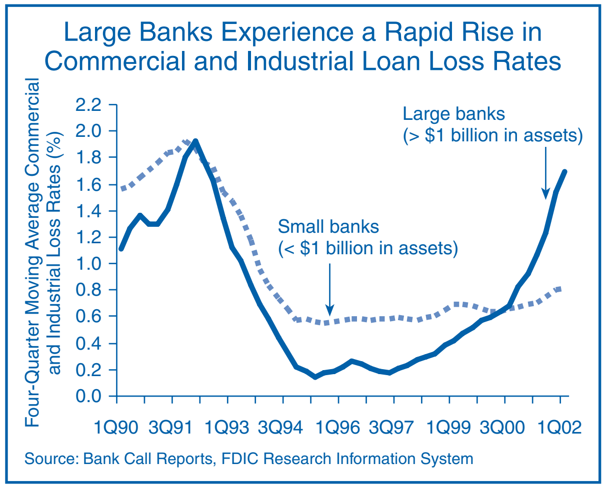
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic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



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

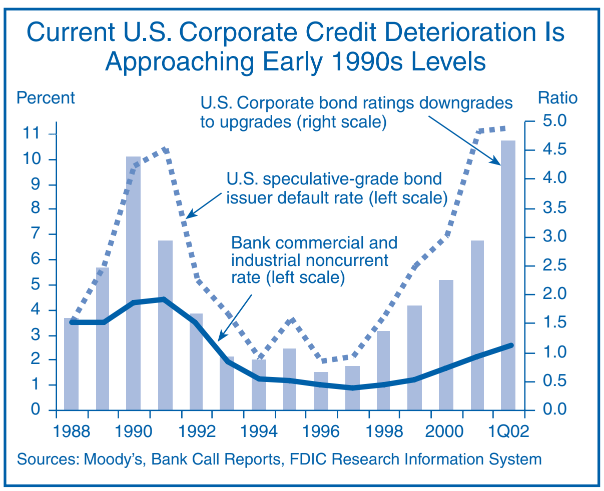
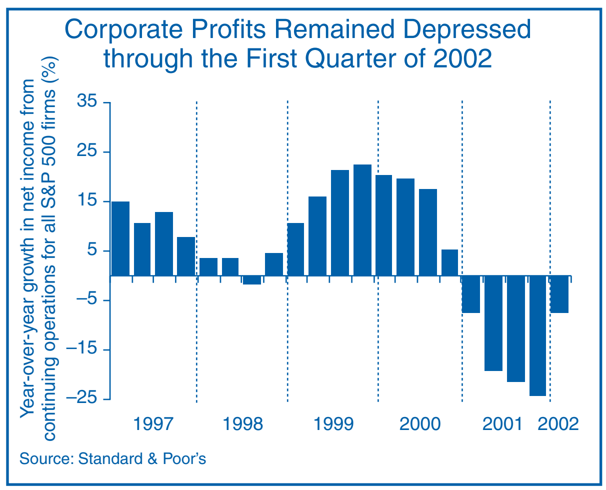


CHART 3



[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

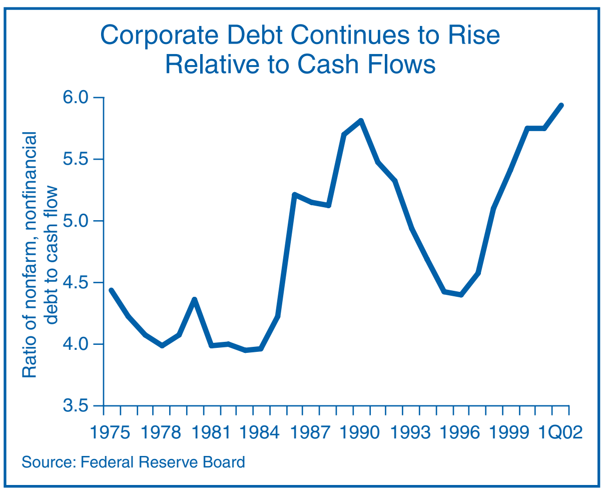
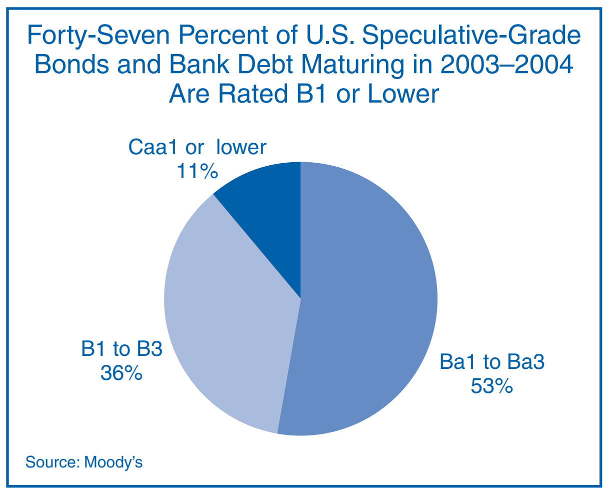


CHART 5



[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

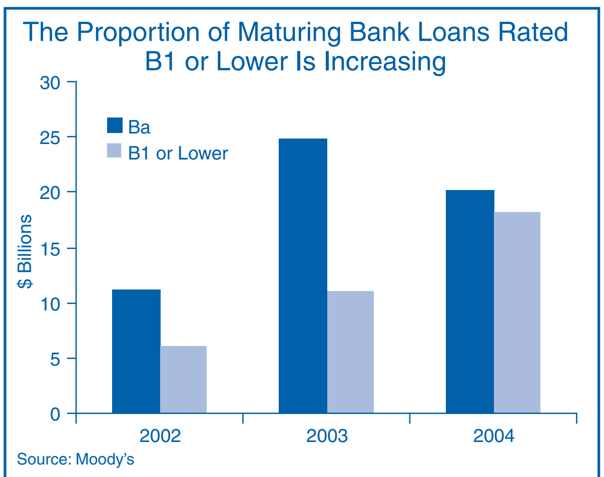


TABLE 1

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

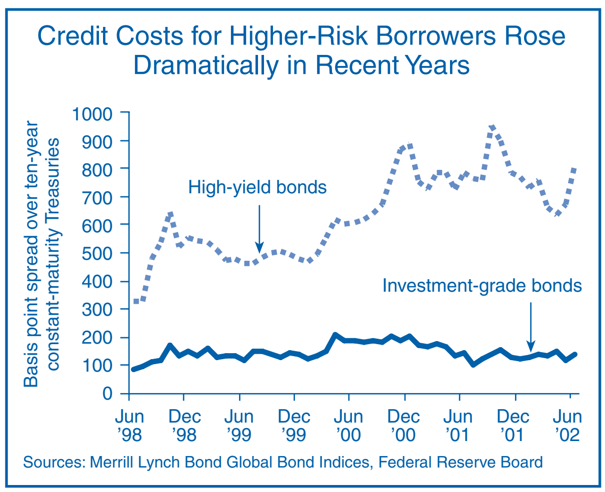
	AVERAGE RECOVERY PER $100	
SENIORITY/SECURITY	1982–2000	2001
SENIOR SECURED BANK LOAN	$67.06	$54.68
EQUIPMENT TRUST	$64.65	NA
SENIOR SECURED BONDS	$52.09	$58.00
SENIOR UNSECURED BONDS	$43.82	$36.20
SENIOR SUBORDINATED BONDS	$34.59	$19.90
SUBORDINATED BONDS	$31.83	$16.45
JUNIOR SUBORDINATED BONDS	$22.48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



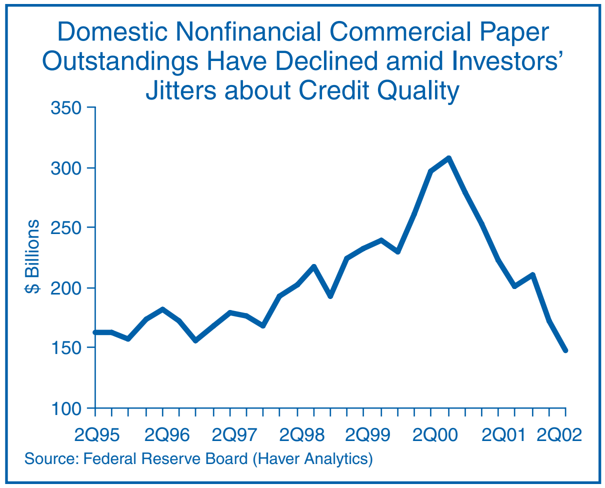
[12] David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research,* Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument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



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