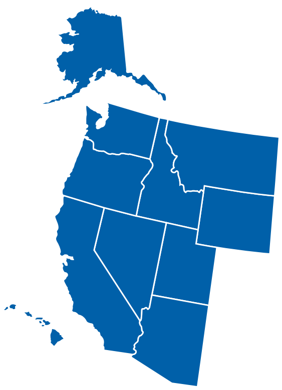
// Regional Outlook //

FEDERAL DEPOSIT INSURANCE CORPORATION — THIRD QUARTER 2002

FDIC
SAN FRANCISCO
REGION



Regional Perspectives

◆ ***More states in the San Francisco Region experienced layoffs during the recent downturn than during the 1990–1991 recession*****—Industries affected by the current recession—particularly high-tech manufacturing, software development, and tourism—are broadly dispersed across the Region.**

◆ ***Despite the greater geographic breadth of the recent recession, a repeat of the banking crisis of the 1980s and early 1990s is not anticipated*****—However, two key factors that affected insured institutions in the Region during the previous recession—increasing concentrations in commercial real estate loans during a period of softening real estate conditions and a high share of newly chartered institutions—are concerns in the current downturn.**

◆ ***Stress in the Region's consumer sector could particularly challenge the Region's subprime and concentrated consumer lenders*****—Some of these lenders have not experienced subprime lending through a full economic cycle.** *See page 3.*

By the San Francisco Region Staff

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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 9.*

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:

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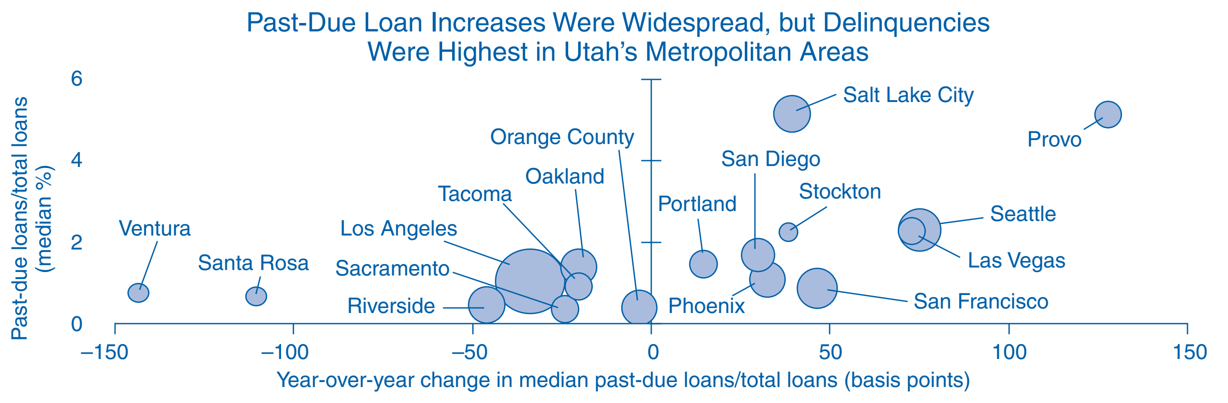
Regional Perspectives

The San Francisco Region Economy Continued to Experience the Effects of the National Recession and Downturns in the High-Tech and Tourism Sectors through April 2002

The combination of the slumping high-tech sector and the negative effects of the national recession and the September 11 attacks resulted in increasing economic weakness in the San Francisco Region from March 2001 through April 2002. During this period, the Region's unemployment rate jumped from 4.9 percent to 6.4 percent, slightly above the 6.0 percent national rate. Employment growth was negative for the year ending April 2002 in all states in the Region except **Wyoming, Nevada, Alaska, Montana,** and **Idaho.** Nevada's growth rate, although positive, slowed significantly, declining from 6.8 percent at year-end April 1999 to 1.2 percent at year-end April 2002. The state experienced pronounced employment contraction during fourth quarter 2001 and first quarter 2002 compared to year-ago levels, attributed to the adverse effects of the terrorist attacks on travel and tourism. In addition, nonbusiness bankruptcy filings rose throughout the Region and the nation in 2001. Bankruptcy rates in Nevada, **Oregon, Utah,** Montana, Wyoming, and **Washington** increased more rapidly than the national rate of 19.3 percent. Furthermore, weakness in the high-tech sector continued to dampen demand for commercial real estate (CRE), contributing to increasing office vacancy rates, particularly in formerly fast-growing high-tech markets such as the **San Francisco, San Jose,** and **Seattle** metropolitan statistical areas (MSAs). Industrial vacancy rates also rose in most areas, and planned CRE projects have been slowed or shut down.

Through first quarter 2002, the effects of the recent recession on the Region's insured institutions were limited. As of March 2002, earnings and capital positions among most institutions remained strong. Most of the Region's community banks[1] were able to mitigate the negative effects of narrowing net interest margins and rising credit losses by controlling overhead costs or recognizing securities gains, or both. Nevertheless, the year-over-year median return on average assets ratio declined slightly, to 1.04 as of first quarter 2002. Asset quality indicators also deteriorated in some markets, particularly among established community institutions[2] headquartered in the San Francisco MSA, where the median delinquent loan ratio more than doubled year-over-year, albeit from a very low level (see Chart 1). Established community institutions[2] headquartered in Seattle, **Las Vegas,** and **Stockton** also reported

CHART 1



Note: Includes metropolitan areas with at least five insured institutions that hold less than $1 billion each in assets and have been in business for at least three years. Size of bubble denotes institution count.
Source: Bank and Thrift Call Reports (March 31, 2002)

[1] Defined as insured commercial banks with less than $1 billion in total assets.
[2] Defined as insured institutions with less than $1 billion in assets that have been in operation more than 3 years.

increases; median past-due loan ratios in these markets topped 2 percent as of first quarter 2002. Established community institutions headquartered in the **Salt Lake City** and **Provo** MSAs continued to report the highest median delinquency rates. Delinquency rates among established community institutions headquartered in Utah have increased concurrent with bankruptcy rate increases since 1996, but they rose further during the past year in the wake of construction and manufacturing sector job losses. Softening real estate conditions have also translated into higher CRE loan delinquency levels[3] among established community institutions in the Region's major MSAs, with the largest increases occurring in the Provo, Salt Lake City, Stockton, and Seattle markets. Although signs of credit quality weakening have emerged, problem asset levels remain far below those experienced during the 1990–1991 recession.

Some Similarities and Important Differences Exist between the 1990–1991 Recession and the Recent Downturn

While we do not expect this downturn to be as severe as the last, a comparison offers insights into how insured institutions might fare in the face of the latest recession. It is important to note that more than 40 percent of the San Francisco Region's banks and thrifts examined during the 1990–1991 recession earned a Uniform Financial Institution Rating (UFIR) of 3, 4, or 5. Also, the Region was home to 91 failed insured institutions in the five years following the 1990–1991 downturn. In contrast, 3-, 4-, and 5-rated institutions represented less than 10 percent of the Region's rated institutions as of first quarter 2002, and only one of the Region's insured institutions failed in the first six months of this year.

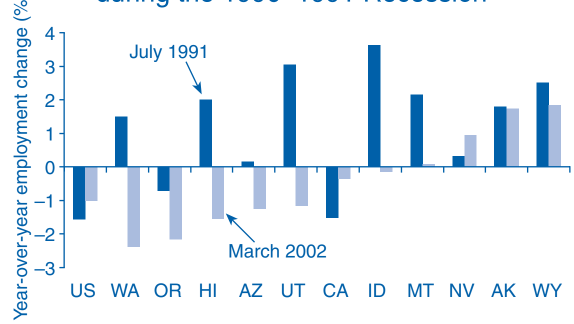
Insured institutions have fared better through the recent recession, in part because the confluence of events that led to the last banking crisis did not play out in the same way this time. Some key elements contributing to the last wave of failures (most of which actually predated the 1990–1991 recession) were high interest rates and back-to-back recessions in the early 1980s, weak capital levels among many institutions, CRE overbuilding, and aggressive new chartering activity. Although the current level of troubled and failed institutions remains far below that experienced in the early 1990s, the effects of the downturn are more widespread in the Region. Furthermore, the industry remains vulnerable to some recurring risks: in particular, high CRE loan concentrations amid softening real estate conditions and elevated proportions of newly chartered institutions. In addition, insured institutions have embraced some new risks that were not present to the same degree during the last recession, the most important of which is subprime consumer lending.

During 1990 and 1991, only **California** and Oregon experienced declining employment, while 7 of the Region's 11 states reported job losses during 2001 and early 2002 (see Chart 2). Oregon and Washington experienced the greatest employment declines in the Region and reported the highest unemployment rates in the nation during first quarter 2002.

The effects of the 1990–1991 economic downturn were focused in the highly concentrated defense and construction-dependent sectors. During the 1990–1991 recession, the rapid drop in national defense spending following the end of the Cold War and the Persian Gulf conflict was a pivotal issue in the San Francisco Region. The center of the defense-contracting sector, **Southern California,** was particularly hard hit, although military bases were closed throughout the Region. In addition, the falloff in construction activity in the Region and across the nation adversely affected the lumber sector in the **Pacific Northwest,** particularly in Oregon.

CHART 2

Employment Declined in More States in the Region during the Recent Downturn than during the 1990–1991 Recession



Note: States ordered by year-over-year growth as of March 2002.
Source: Bureau of Labor Statistics

[3] Includes construction, nonfarm/nonresidential real estate, and multifamily real estate loans 30 days or more past due or on nonaccrual status.

In contrast, the effects of the recent downturn were more widely felt across the Region, because employment declines occurred in the more geographically dispersed sectors of high-tech manufacturing, business services (which includes software development and temporary workers supplied to high-tech companies), and tourism (see Chart 3). These same sectors were the primary drivers in the Region's phenomenal economic expansion during the 1990s. A significant influx of venture capital investment into the Region, primarily into dot-com companies in the San Francisco Bay Area and secondarily into Southern California and Seattle, increased high-tech industry employment in these metropolitan areas. Consequently, the sharp decline nationwide in demand for capital goods, including software, during 2001 and early 2002 and the pullback in venture capital investment contributed to the Region's economic slowdown. Employment in the Region's high-tech manufacturing and business services sectors declined 10 percent from the peak in September 2000 through March 2002.

A decline in tourist and business travel, particularly after the September 11 attacks, adversely affected many of the Region's visitor-dependent states and metropolitan areas (see Chart 4). Travel-related job losses have been greatest in the Region's larger metropolitan areas that are most dependent on tourism or the high-tech business sector: **Honolulu,** Las Vegas, and San Francisco. Revenue per available room (RevPAR) fell significantly through early 2002 in these key visitor destinations. ***Smith Travel Research*** reports that year-over-year RevPAR in San Francisco, for example, was down 32 percent in March 2002.

CRE Remains a Serious Concern for the Region's Banking Industry

Rapidly increasing CRE vacancy rates have been a common theme in both recessions, although the reasons for overbuilding differ. During the 1990–1991 recession, the buildup of excess space was associated with national and regional factors. Although federal legislation in 1986 reversed favorable tax treatment implemented in 1981 for CRE development, long planning and permit times resulted in continued high levels of construction.[4] Investment by Japan and other Asian countries in West Coast and Hawaiian real estate also drove up values in the late 1980s. Subsequent weakness among Asian economies significantly dampened investment and adversely affected values during the 1990s. In addition, the defense cutbacks in Southern California negatively affected area real estate markets. During the current slowdown, unrealistic estimates of future demand for commercial real estate in the San Francisco Region, fueled by the booming high-tech industry, have been the primary drivers of increases in office and industrial vacancy rates.

The boom-and-bust environment in some of the Region's high-tech centers has led to problems in CRE markets, particularly in the office and industrial subsectors. Rapid

CHART 3

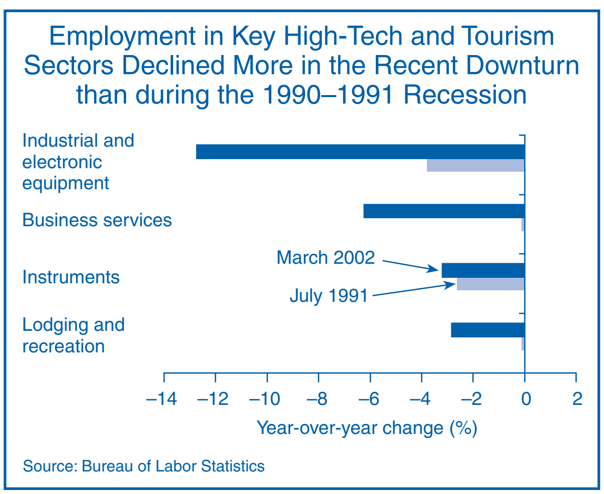


CHART 4

[4] Federal Deposit Insurance Corporation, *History of the Eighties—Lessons for the Future. Vol. 1: An Examination of the Banking Crises of the 1980s and Early 1990s,* Washington, DC: FDIC, 1997, chapters 3 and 11.

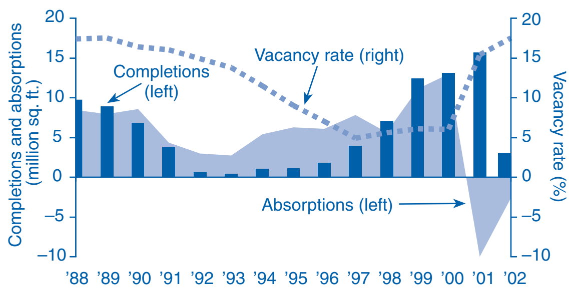
employment declines in the semiconductor, software development, and dot-com sectors have pushed up office vacancy rates in major high-tech-dependent MSAs, including **Phoenix, Portland,** San Francisco, San Jose, and Seattle. Between early 2000 and first quarter 2002, the average office vacancy rate in these five MSAs rapidly increased to 18 percent, the highest level since 1989, according to estimates by ***Torto Wheaton Research*** (see Chart 5). During the recent downturn, negative net absorption of office space (i.e., return of previously leased space to the sublease market) occurred at the same time that new space was coming online.

During the 1990–1991 downturn, CRE market softening, weak underwriting standards, and high CRE loan concentrations contributed to severe asset quality problems and failures among insured institutions, especially those based in Southern California and **Arizona.** Improvements in underwriting and appraisal standards during the 1990s and the increased availability of CRE market supply and demand data likely will forestall a repeat of these problems. However, a much larger share of the Region's institutions now hold high CRE loan concentrations than during the last recession. As of March 1991, nearly 30 percent of the Region's insured institutions reported CRE loan-to-total asset ratios exceeding 25 percent. As of March 2002, more than half the Region's insured institutions reported these high concentrations. Although CRE loan delinquencies remain at manageable levels and are far below the default rates reported during the early 1990s, continued CRE market weakness could, in time, contribute to a further weakening in credit quality.

The change in CRE market conditions increases the challenges facing construction and development (C&D) lenders,[5] which represent a larger share of the Region's insured institutions now than during the previous recession.[6] C&D lending traditionally has been one of the riskier categories of CRE, because loan repayment depends on the timely sale or leasing of the project at completion. A higher proportion of the Region's commercial banks—except those headquartered in California and **Hawaii**—reported C&D loan-to-total-asset ratios exceeding 10 percent in first quarter 2002 than during the 1991 recession (see Chart 6). More than 10 percent of these concentrated C&D lenders experienced UFIR downgrades between first quarter 2001 and first quarter 2002. Some could experience further rating deterioration; for example, even though the last recession ended in 1991, the share of concentrated C&D lenders in the San Francisco Region with a UFIR rating of 3, 4, or 5 did not peak until 1993, when nearly half of all concentrated construction lenders were deemed weak. In addition, more than 40 percent of the Region's institutions that currently hold elevated C&D loan concentrations were chartered since the 1990–1991 recession and might not have the risk management systems in place to mitigate vulnerabilities in the portfolio.

CHART 5

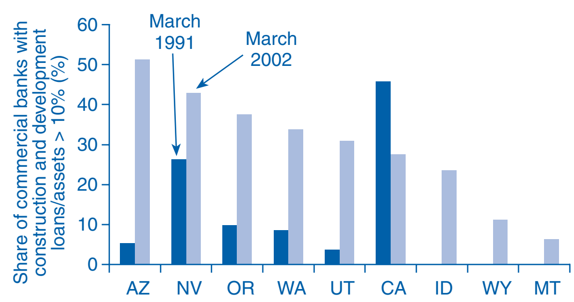
Average Office Vacancy Rates in High-Tech Centers Rapidly Reached Late 1980s Levels



Note: Combined data from Phoenix, Portland, San Francisco, San Jose, and Seattle.
Source: Torto Wheaton Research

CHART 6

High Concentrations of Construction Loans Are Now More Widespread among the Region's Banks than during the 1990–1991 Recession



Note: Excludes thrifts and states with fewer than ten insured commercial banks.
Source: Bank Call Reports

[5] Defined as insured institutions with C&D loan-to-total-asset ratios exceeding 10 percent.

[6] For more information, refer to the *San Francisco Regional Outlook,* first quarter 2002.

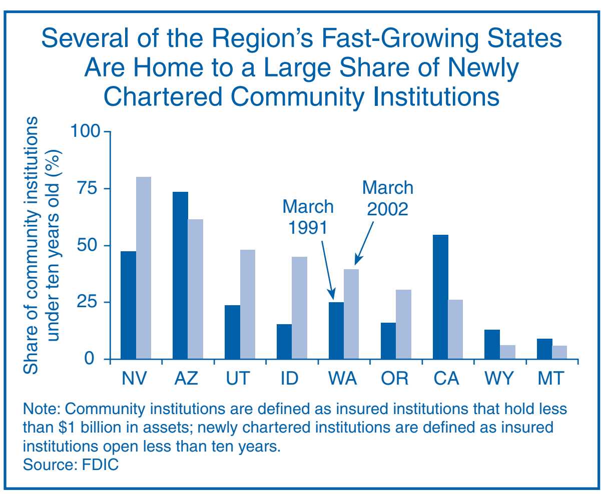
De Novo[7] *Formation Rates Were High Preceding Both Recessions*

Brisk bank chartering activity in the years before a recession, which contributed to the high number of failures during the early 1990s, remains an area of concern for the Region. For 30 percent of the Region's community institutions, the recent downturn is the first economic contraction they had experienced. The proportion of institutions open ten years or less is only slightly lower now than during the previous recession. States that experienced rapid job growth in the second half of the 1990s—Nevada, Arizona, Utah, Washington, Idaho, and Oregon—had particularly high concentrations of newly chartered[8] institutions as of March 2002. At least 30 percent of insured community institutions in these six states were established during the past ten years (see Chart 7). The proportion of newly chartered institutions in these states contrasts sharply with the distribution during the previous recession, when newly established institutions dominated fewer banking markets. It is noteworthy that newly chartered institutions in California, which accounted for 30 of 78 failures in the state between 1991 and 1995, represent a smaller share of the state's community institutions now than during the previous recession.

The age composition of newly chartered institutions differs from the last downturn, which could affect how they perform following this recession. In the Region, institutions between three and ten years old experienced a higher average annual failure rate during the last banking crisis than either less- or more-seasoned institutions. A ***Federal Reserve*** study suggests that insured institutions between three and ten years old might be most vulnerable to failure, because these institutions experience the effects of loan portfolio seasoning (and higher loan delinquencies and losses) as excess capital levels, maintained during the formative years, are depleted.[9] During the 1990–1991 downturn, 79 percent of newly chartered community institutions were between three and ten years old, largely because banking deregulation in the early 1980s prompted new chartering activity. In contrast, as of March 2002, only 57 percent of newly chartered community institutions had been doing business for three to ten years (see Chart 8). Although the proportion of three- to ten-year-old institutions remains high, the current age composition of newly chartered institutions could blunt some of the effects of this recession on the Region.

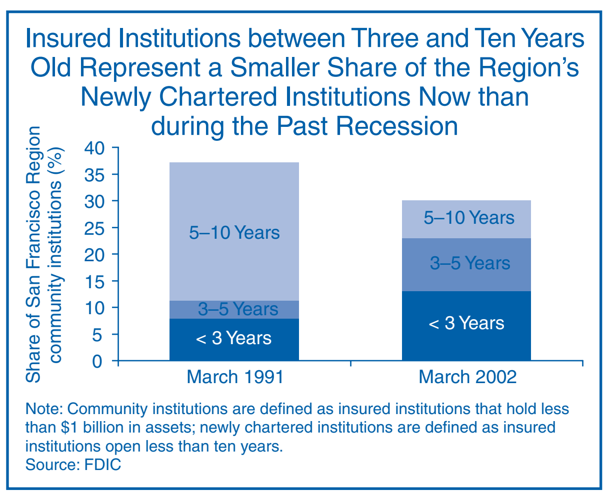
Institutions less than three years old constituted 43 percent of the Region's newly chartered community institutions as of first quarter 2002, more than double the proportion in first quarter 1991. Capital ratios among community institutions less than three years old generally compare favorably with those reported by more established institutions, a fact that could insulate them from the vagaries of the business cycle. Nevertheless, these very young institutions are characterized by untested underwriting, newly developed risk management systems, and unseasoned loan portfolios. Additionally, sus-

CHART 7



Note: Community institutions are defined as insured institutions that hold less than $1 billion in assets; newly chartered institutions are defined as insured institutions open less than ten years.
Source: FDIC

CHART 8



Note: Community institutions are defined as insured institutions that hold less than $1 billion in assets; newly chartered institutions are defined as insured institutions open less than ten years.
Source: FDIC

[7] Defined as insured institutions open for three years or less.
[8] Defined as insured institutions chartered in the past ten years.

[9] Robert De Young, "Birth, Growth, and Life or Death of Newly Chartered Banks," *Economic Perspectives,* Federal Reserve Bank of Chicago, 1999, p. 26.

tained economic weakness could limit growth and earnings opportunities for these institutions at a time when they most need to attain profitability. Thus, although institutions less than three years old might, ironically, be better able to withstand the downturn because of higher capital levels, these institutions might have booked most of their early loans during the prerecession boom period, when lenders were optimistic about future economic conditions. As these loans season during a slowing economy, credit quality could deteriorate.

Large Consumer and Subprime Lenders Pose a New Dimension of Risk

Since the last recession, several of the Region's insured institutions have pursued concentrated consumer[10] and subprime lending niches, often using non-recession-tested credit scoring models to achieve large, high-yielding loan portfolios. As of first quarter 2002, nearly 44 percent of the Region's concentrated consumer lenders had total assets of over $500 million each, compared with only 11 percent in 1991. Improved computer processing speeds and the increased popularity of credit scoring models have contributed to increased efficiency in underwriting and a concentration of consumer assets into fewer, larger institutions.

The ability of subprime credit card yields, in particular, to compensate for heightened risk was tested during 2001, when personal bankruptcy filings and consumer leverage reached record highs and consumer loan quality deteriorated. The Region's 32 concentrated consumer lenders—approximately half of which held significant[11] subprime consumer loan exposures—reported median consumer loan delinquency and net charge-off ratios of 3.37 and 3.62 percent, respectively, as of first quarter 2002. Although the median delinquency ratio was comparable to that reported during the last recession, the median net loss rate far exceeded the 1.25 percent reported by the Region's niche consumer lenders during first quarter 1991. Asset deterioration contributed to the February 2002 failure of Nextbank, one of the Region's larger subprime lenders. Nationally, these niche lenders represent a disproportionately large share of problem banks and recent failures.

The growth of the secondary loan market has mitigated some of the increased risk experienced by consumer lenders by allowing many lenders to securitize riskier assets. While securitization affords liquidity to some consumer lenders, most securitizers retain relatively volatile "residual interests" in the securitized assets. Residual interests typically involve a first-loss position, and current values are assumption driven. Unexpected increases in prepayments, defaults, or interest rates could affect the value of these assets. Liquidity from securitized consumer assets is readily available only if purchasers remain receptive to these investments. An unexpected, significant deterioration in consumer credit quality would invalidate residual interest valuation assumptions and diminish the attractiveness of these assets to secondary market participants. As a result, it could be more difficult for some consumer lenders to use securitization vehicles as a source of liquidity.

While Widespread Failures Are Not Anticipated, Some Insured Institutions Face Heightened Risk

The current recession has had broad geographic and sectoral effects in the Region, which could pose new challenges to insured institutions. On the whole, insured institutions are better capitalized and more profitable, and have better risk management practices in place, than they did during the 1990–1991 recession. Nevertheless, patterns that contributed to the wave of banking problems during the late 1980s and early 1990s have persisted and, in some cases, were more widespread during this recession. For example, during the recent downturn, CRE and C&D loan concentrations were higher among insured institutions in the Region, and several of the Region's markets were characterized by a higher proportion of de novo institutions. Furthermore, the increased popularity of concentrated consumer and subprime lending adds to the challenges some insured institutions face. While newly established insured institutions, concentrated CRE lenders, or niche subprime institutions could experience additional asset quality weakening, a repeat of the last banking crisis is not anticipated.

San Francisco Region Staff

[10] Concentrated consumer lenders are defined as insured institutions with credit card and other non-real estate–secured consumer loans exceeding 25 percent of total assets. As of March 2002, these lenders held $89.9 billion in assets—nearly 8 percent of all assets controlled by insured institutions headquartered in the Region.

[11] Defined as holding direct or indirect interests in subprime consumer loans in excess of 25 percent of Tier 1 capital.

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

Introduction

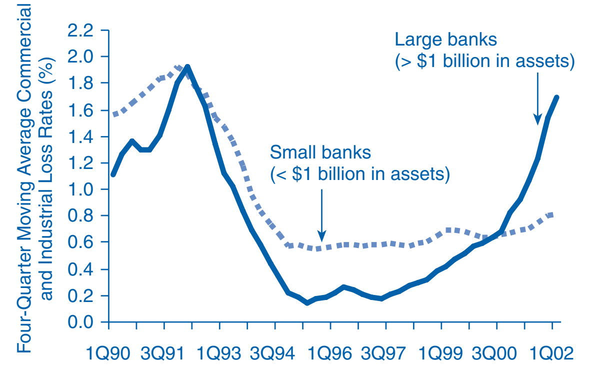
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic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

Commercial Credit Deterioration Should Subside with the Economic Recovery

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

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

CHART 1



Source: Bank Call Reports, FDIC Research Information System

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

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

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

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

High Default Rates, Rating Downgrades, and Bankruptcies Persist

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

Corporate Profitability Remains Fragile

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

CHART 2

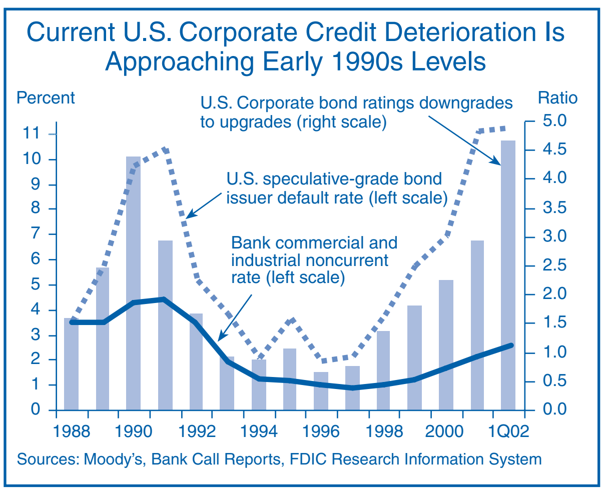
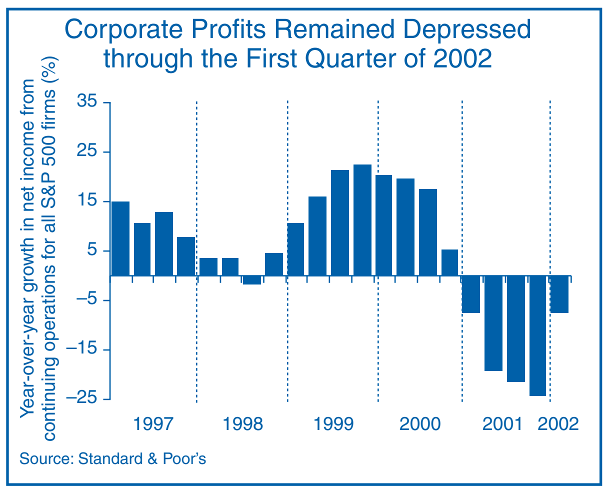


CHART 3



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

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

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

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

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

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

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

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

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

CHART 4

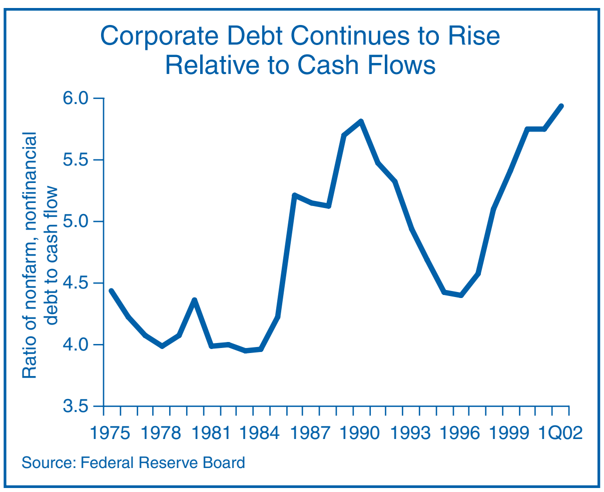
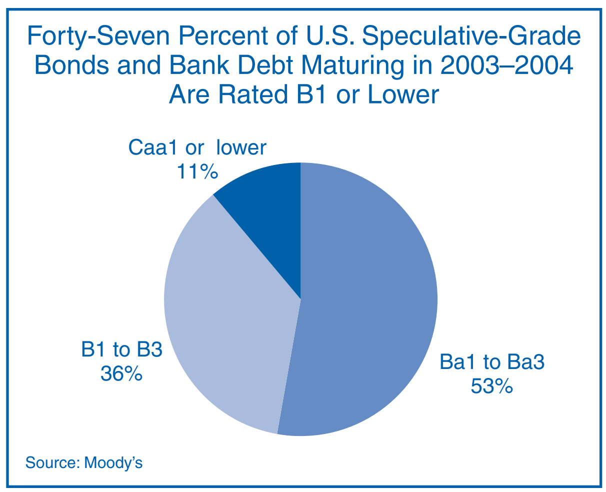


CHART 5



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

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

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

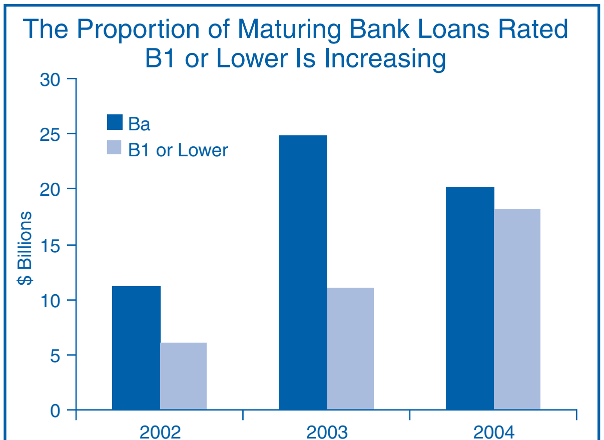
[11] Speculative-grade debt ratings assigned by Moody's in the order of declining credit quality are as follows: Ba, B, Caa, Ca, and C. Moody's also applies numerical modifiers 1, 2, and 3 in each generic rating classification. The modifier 1 indicates that the obligation ranks in the higher end of its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

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

Loss Severity Has Increased with Higher Default Rates

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

Chart 6



Source: Moody's

[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.

Table 1

Average Speculative-Grade Recovery Rates in 2001 Show a Declining Trend in Nearly All Levels of Security and Subordination

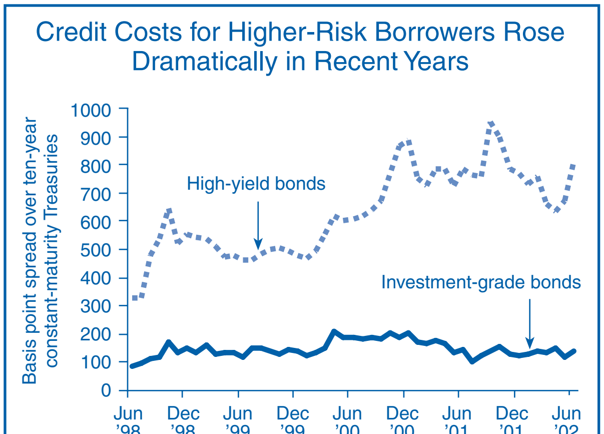
Seniority/Security	Average Recovery per $100 1982–2000	Average Recovery per $100 2001
Senior secured bank loan	$67.06	$54.68
Equipment trust	$64.65	NA
Senior secured bonds	$52.09	$58.00
Senior unsecured bonds	$43.82	$36.20
Senior subordinated bonds	$34.59	$19.90
Subordinated bonds	$31.83	$16.45
Junior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

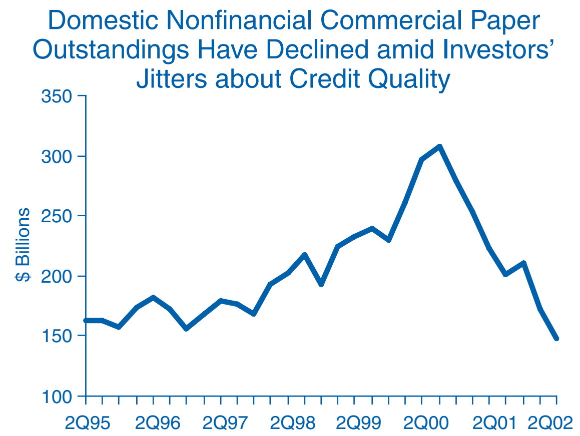


Sources: Merrill Lynch Bond Global Bond Indices, Federal Reserve Board defaults, and weakening corporate cash flows. After narrowing a bit in first quarter 2002, spreads have widened again on renewed concerns about accounting irregularities and the realization that the economic recovery may come at a 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

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