Regional Outlook

FEDERAL DEPOSIT INSURANCE CORPORATION THIRD QUARTER 2002

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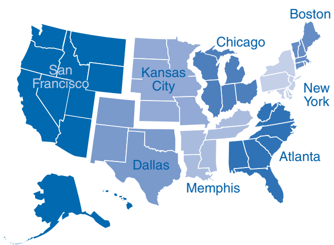

DIVISION OF
INSURANCE
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In Focus This Quarter

◆ ***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 3.*

By Cecilia Lee Barry, Senior Financial Analyst

Regional Perspectives

◆ ***Atlanta*—Rate/volume analysis suggests that community banks were exposed to heightened interest rate risk during 2001. A rapidly changing yield curve contributed to increased optionality in the loan portfolio, and low short-term rates made repricing of liabilities difficult.** *See page 9.*

◆ ***Boston*—The effects of the recession varied widely across the New England states. The Region's insured institutions remained healthy overall but showed elevated credit and earnings risk.** *See page 10.*

◆ ***Chicago*—Most community institutions have weathered the recession fairly well, although moderate credit quality deterioration was widespread and risk management became more of a challenge.** *See page 11.*

◆ ***Dallas*—The 2002 farm bill is a major departure from the market-oriented approach of the 1996 FAIR Act and continues a high level of government payments to the agricultural sector.** *See page 12.*

◆ ***Kansas City*—While many observers believe that Internet technology may enhance the economic viability of rural areas, others suggest that it could increase the ability of larger banks to compete in these areas.** *See page 13.*

◆ ***Memphis*—Weaker loan demand in late 2001 and early 2002 prompted many of the Region's banks and thrifts to seek improved revenues from securities portfolios, often through the acceptance of increased market risk.** *See page 14.*

◆ ***New York*—The characteristics of the recent recession and the economic profiles of the Region's major metropolitan areas help explain differences in employment trends, banking performance, and prospects for economic recovery.** *See page 15.*

◆ ***San Francisco*—Insured institutions have fared better in the recent recession than during the 1990–1991 downturn, despite recurring challenges from weak commercial real estate markets and a large share of newly chartered banks, as well as new risks from subprime lending.** *See page 16.*

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

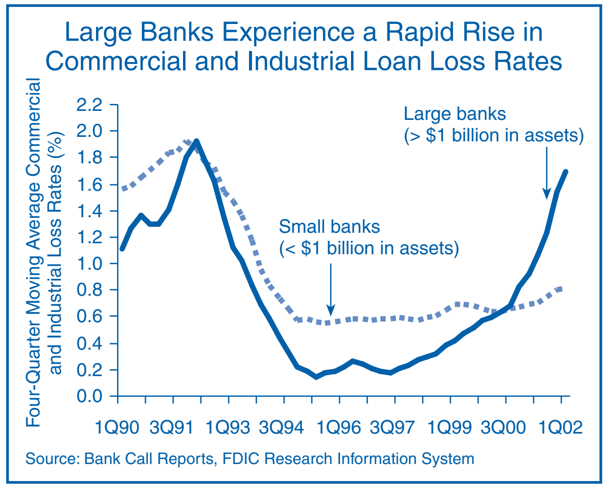
Introduction

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.

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

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

[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

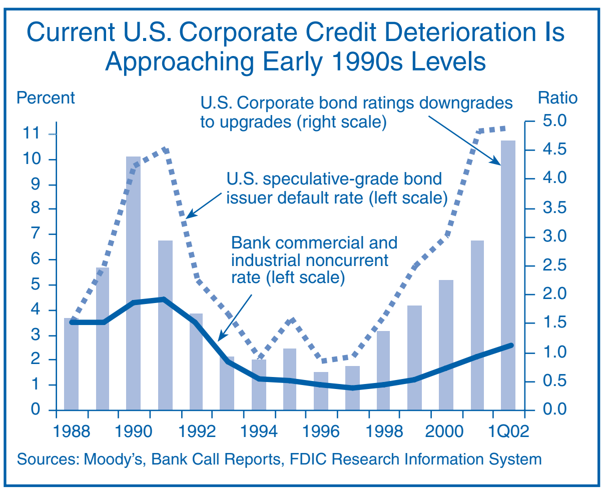
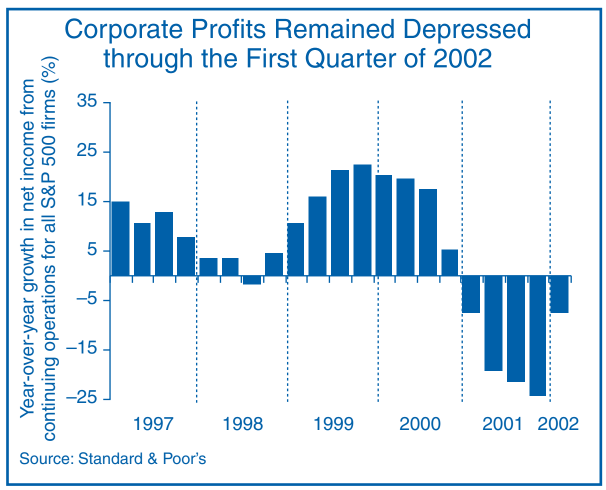


CHART 3



[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

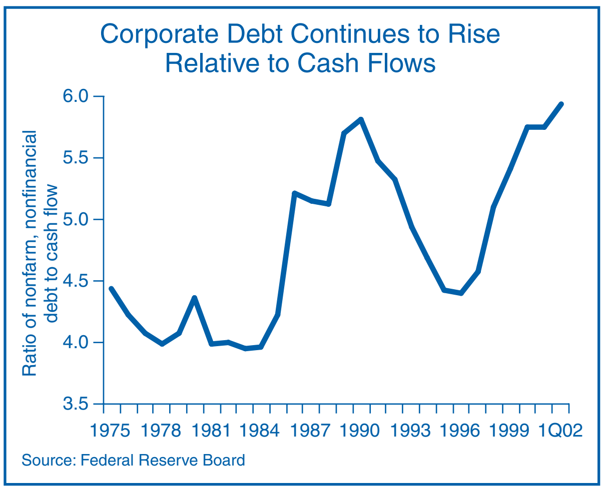
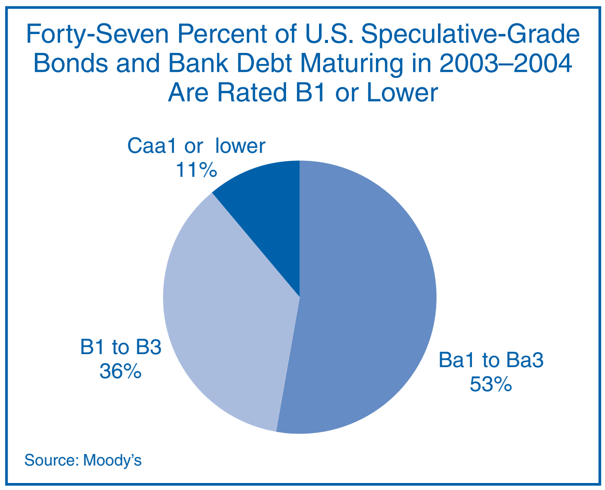


CHART 5



[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

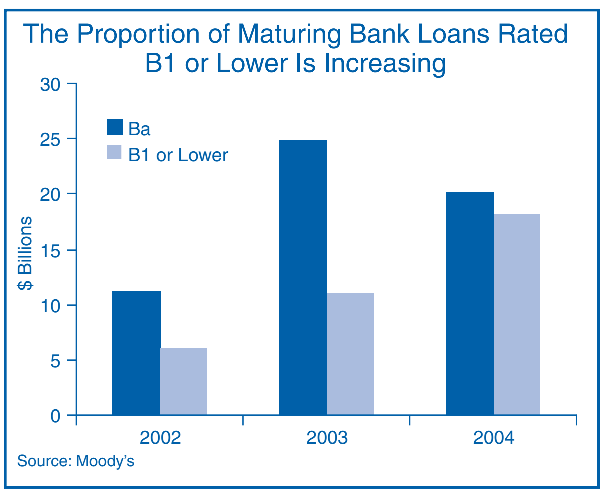


Table 1

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

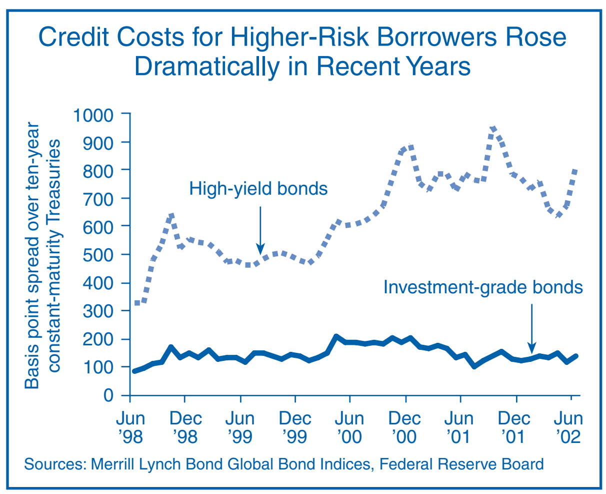
Seniority/Security	Average Recovery per $100 1982–2000	Average Recovery per $100 2001
Senior secured bank loan	$67.06	$54.68
Equipment trust	$64.65	NA
Senior secured bonds	$52.09	$58.00
Senior unsecured bonds	$43.82	$36.20
Senior subordinated bonds	$34.59	$19.90
Subordinated bonds	$31.83	$16.45
Junior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



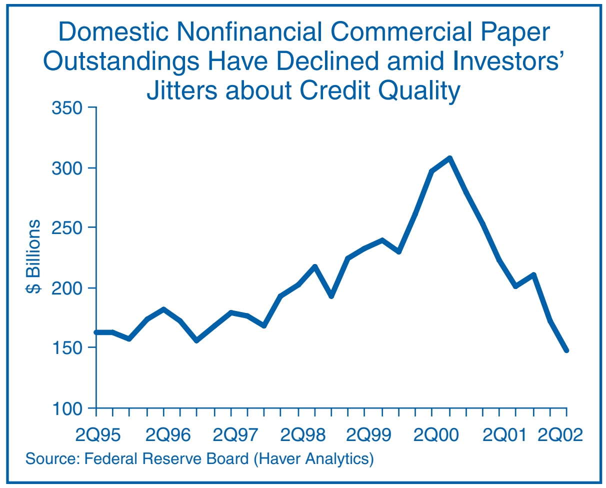
[12] David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research,* Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument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



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

Atlanta Regional Perspectives

Economic conditions have contributed to a rapidly changing interest rate environment that has been challenging for many community banks in the Atlanta Region as net interest margins (NIMs) shrank. The steepening and downward twist in the yield curve in 2001 contributed to an increase in optionality risk, which limited the effectiveness of interest rate risk (IRR) modeling techniques. As an alternative method for assessing exposure to IRR in 2001, an interest rate/volume analysis was used to identify the degree of sensitivity to a changing rate environment of community bank net interest income (NII) and the NIM.

The NIM and NII among many of the Region's community banks declined during 2001. The NIM decline was systemic; 80 percent of community banks reported margin compression. More important, however, NII declined among 41 percent of the Region's community banks; this subset also exhibited a comparatively higher risk profile, as suggested by higher past-due loan and charge-off levels and lower rates of return on assets. The results of the rate/volume analysis suggest that the Region's community banks were exposed to a significant amount of IRR during 2001. Some institutions may have assumed more credit risk to compensate for a lower NIM.

Responses by certain of the Region's community banks to lower NII and margin pressures in 2001 may lead to earnings pressure or heightened liquidity risk if robust economic growth prompts an increase in interest rates. The appeal of nonbank investment alternatives has diminished, contributing to a re-intermediation of funds. The permanence of these flows is open to debate, however, and liquidity risk could arise if these funding sources are short-lived. Extension risk is an increase in the duration of an asset as a result of a rise in interest rates. Community banks have increased holdings of low-rate long-term assets significantly, potentially heightening extension risk going forward.

During 2001, the unprecedented decline in interest rates, the dramatic steepening of the yield curve, and the resulting increase in optionality risk limited the effectiveness of many IRR models. Unsophisticated sensitivity models that assess IRR from a large parallel shift in the yield curve were ineffective in 2001. Even more sophisticated historical Value at Risk (VAR) models, the most frequently used of the VAR models, probably did not include enough abnormal events (large market fluctuations). As a result, most IRR models underestimated the degree of IRR.

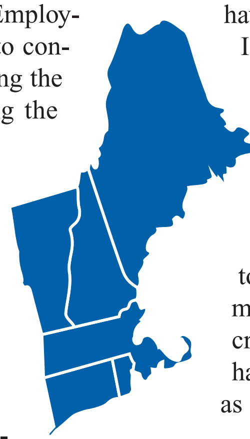
IRR modeling may be challenging going forward. Continued slow economic growth, which restrains rates from rising, would likely benefit community bank NIMs. But stronger economic growth, higher inflation, or a rapid decline in the relative value of the U.S. dollar could lead to an increase in short-term rates. The timing of such increases could have different effects on various types of insured institutions. A rapid rise in short-term rates, paired with a flattening yield curve, would likely be disadvantageous to most insured institutions. Such a rapid rise in interest rates could extend asset durations. Given the various paths in which interest rates may move, IRR managers should use an interest rate forecast that is consistent with an institution's overall strategic planning process. For example, if loan volume is expected to grow robustly because of an economic rebound, short-term rates will likely rise as the economy expands. Under this scenario, it would be inconsistent to use a constant interest rate forecast in IRR models.

Bank managers' attempts to mitigate the negative effects of IRR in 2001 may lead to unexpected challenges. In the case of insured institutions that have relied on significant loan growth (particularly in the real estate loan portfolio) to offset NIM compression, credit risk could arise if slow or negative economic growth contributes to a decline in real estate absorption rates. On the other hand, robust economic growth that leads to higher interest rates could pressure earnings because of longer asset durations. A lesser concern would be an increase in liquidity risk if nonbank investment alternatives become more attractive. Another concern in 2001 is that many banks may not adequately consider embedded options when pricing loans. Insured institutions that may be most vulnerable to an increasing rate environment are those that experienced the greatest drop in NII during 2001. Most of these institutions are community banks headquartered in urban areas, primarily in **Florida, Virginia, Georgia,** and **Alabama.**

Boston Regional Perspectives

Individual states' performances differed during this recession. The performance of the Region's six state economies through this business cycle has differed from their performance during the early 1990s recession, when most of them experienced significant deterioration relative to the nation. The difference this time is that the national recession's adverse impact was amplified only in those states more dependent on technology employment, business investment demand, and spending linked to stock market wealth effects.

Massachusetts and Vermont economies face the greatest challenges. Between January 2001 and June 2002, the weakest labor markets of all the Region's states were in **Massachusetts** and **Vermont.** Employment trends in these two states appear likely to continue deteriorating, whereas employment among the other four states apparently stabilized during the first half of 2002.



Robust economic growth in Massachusetts during the late 1990s strongly reflected the influence of a booming demand for technology products and services and an extremely strong equities market. The absence of these economic catalysts has amplified the state's recent downturn. In addition, with a continued malaise in the national economy a distinct possibility, the state's economic growth may be subdued this year. The continued economic weakness in Vermont reflects the impact of poor conditions nationally in overall business investment, high-end retailing, and tourism—key drivers of business and consumer sales in the Vermont economy.

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 information technology (IT) and financial services employment, nor are they characterized by sizable concentrations of high-worth households. Their economies were not characterized by "boom" conditions during the late 1990s. In addition, long-running consolidation in recession-sensitive industries such as manufacturing has limited the fallout from the recent national recession.

The Region's insured institutions weathered the 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. But other measures of banking performance, particularly loan growth rates, reflect the recent economic slowdown in some cases.

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. 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 has also turned negative for insured institutions in these states.

Unlike consumer lending, state-level commercial loan trends appear less closely linked to local economic trends. Part of the disconnect may be due to the fact that local commercial credit demand has not been driven by firms that have weakened most during this downturn, such as those in the IT and manufacturing sectors.

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, even though weak conditions overall continue in the Region's major office markets. These markets are more likely to have their funding met by public capital market vehicles, such as real estate investment trusts (REITs), than by locally based small and mid-size banks.

Past-due loan levels and charge-offs among the Region's insured institutions remain modest. However, the full effect of the recession may not yet have appeared in loan performance data. Also, with deteriorating 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 become particularly evident in states such as Vermont or Massachusetts, where economic growth is expected to remain sluggish.

Chicago Regional Perspectives

To date, the financial health of the Region's community banks and thrifts[1] has not been significantly strained by the 2001 recession. Profitability, measured by return on assets, held close to 1 percent, and increases in past-due and nonaccrual loans have been moderate. Behind the moderate changes in broad measures of performance, however, is an increase in the number of institutions rated as weak (i.e., having composite CAMELS ratings of 3, 4, or 5).[2] Asset quality and management rating trends are major contributors to the rising number of weak-rated institutions. On the positive side, the current percentage of weak institutions (7.6 percent) is less than half that in the early 1990s, suggesting that industry conditions are healthier thus far than at the end of the previous recession.

Although a variety of economic indicators suggests that a cyclical recovery began in early 2002, output and employment levels in many sectors remain lower than before the recession. In this environment of modest cyclical improvement, accompanied by stock market turmoil, many businesses and households remain vulnerable to financial strains. Household income, for example, is not likely to grow noticeably until employment levels start to rise. Meanwhile, the cushioning effect of last year's decline in interest rates, cut in personal income taxes, modest inflation, and falling energy prices may be waning.

Loan portfolios reflect changing conditions. Although loan quality deteriorated across most business lines in the year ending first quarter 2002, there is considerable variation in how portfolio segments fared. Although commercial and industrial (C&I) portfolios among the Region's community banks are exhibiting some deterioration, they are performing modestly better than those held by community banks nationwide. Credit quality deterioration in commercial real estate (CRE) portfolios has been modest, but rising vacancy rates and significant amounts of space available for sublease in many of the Region's metropolitan areas may foreshadow further weakness.

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

[2] Composite CAMELS ratings reflect examiners' evaluations of institutions' capital, asset quality, management, earnings, liquidity, and sensitivity to market risk.

One- to four-family residential and consumer loans held by the Region's banks and thrifts declined in the year ending first quarter 2002. Some households that refinanced their debt likely did so with larger or out-of-region lenders. Nonbank lenders also are attracting some business that might have gone to community institutions a decade ago. Furthermore, insured institutions themselves may contribute to shrinking mortgage and consumer portfolios by adopting strategies to originate such loans but not hold them. The risk associated with one- to four-family mortgage lending traditionally has been less than for most other loan categories. The credit risk associated with this portfolio may have risen, however, reflecting structural changes in the mortgage business during the 1990s. In fact, one- to four-family mortgage lending is the only major loan category held by the Region's community banks that exhibits a higher percentage of delinquencies than the percentage during the 1990–1991 recession.

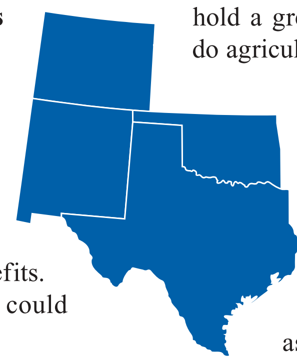
As the economy recovers, challenges remain. The Region's insured institutions appear to be weathering the impacts of the 2001 recession fairly well, but challenges remain. They include an expected increase in interest rates and flattening of the yield curve; structural changes and competitive forces in the financial services industry; and more traditional concerns, such as ensuring adequate risk management and other internal controls and routines.

Meanwhile, credit quality problems may linger as household and business stresses from the recession are resolved and commercial real estate markets adjust to imbalances. In this environment, insured institutions at some point will need to shift gears from asset-liability management strategies that worked well when short-term interest rates were low and falling to strategies more suitable in a rising rate environment. The recent well-publicized accounting and management lapses at some major corporations underscore the importance of continually verifying the effectiveness of internal routines and controls, accounting practices, and adherence to board policies.

Dallas Regional Perspectives

The 2002 farm bill is a major departure from the market-oriented approach of the 1996 Federal Agriculture Improvement and Reform (FAIR) Act, which was designed to reduce payments to the farm sector by decoupling payments from production. The 2002 farm bill makes no pretense of reducing government expenditures and seeks to provide a farm safety net at a relatively higher cost. This change in approach coincides with several other developments, such as major drought conditions and global overproduction at a time of declining demand, that portend even higher government outlays. As a result, the newly enacted farm bill continues the trend toward a high level of government payments to the agricultural sector. In fact, the bill increases spending for commodity support programs by $31.2 billion (compared with the amount legislated in FAIR) over the next six years.

The 2002 farm bill may contribute to excess production of certain commodities and, as a result, continue to depress prices. As producers attempt to maximize benefits under the farm bill, supply and demand forces could become artificially constrained. Consequently, consideration of production costs and commodity price levels could become secondary to concerns about subsidy benefits. As a result, production of certain crops could expand at the same time prices are falling.



Provisions of the 2002 farm bill could have unintended consequences. Some analysts suggest that farm subsidy payments may slow the growth of some rural communities by artificially inflating land prices and diverting capital away from businesses. At the same time government payments are inflating farmland values, insured financial institutions have increased lending secured by farm real estate. If the level of government payments declines at some point in the future and commodity prices remain weak, rural land values likely would be subject to downward price pressure. Subsequently, lenders' collateral and producers' equity and borrowing capacity would be adversely affected.

Enactment of the 2002 farm bill could complicate future international trade negotiations because the legislation represents a shift away from a free market-oriented farm policy. The new farm bill follows closely on the heels of the U.S. decision to impose tariffs on steel and lumber imports. As a result, many countries are appealing for relief to the World Trade Organization and have threatened to respond with tariffs on U.S. goods. Trade disputes could slow or set back negotiations as the U.S. economy struggles to recover.

Relatively high levels of government payments to farmers help explain why the Region's agricultural banks have continued to perform well despite low commodity prices. During the past five years (coinciding with enactment of FAIR in 1996), when commodity prices have been at historically low levels, the return on assets for the Region's agricultural banks has remained relatively stable, averaging a strong 1.28 percent, compared with 1.18 percent for other agricultural banks nationwide and 0.94 percent for small nonagricultural banks nationwide. In addition to relatively high levels of government payments, Dallas Region agricultural banks have benefited from lower funding costs because they hold a greater percentage of noninterest deposits than do agricultural banks outside the Region.

Dallas Region agricultural banks also have reported a declining share of agricultural loans during the past ten years. In part, this is because large insured institutions (assets greater than $1 billion) are holding an increasing share of total farm debt—35 percent of total agricultural loans as of year-end 2001, up from 22 percent ten years earlier. Small insured institutions now hold only 29 percent of total agricultural loans, down from 53 percent during the same period. In addition, agricultural banks in the Dallas Region have reported increasing loan-to-asset ratios; the greatest increase has occurred among loans secured by farmland. If government payments have artificially inflated land prices, collateral margins may be squeezed if subsidy levels decline.

The enactment of the 2002 farm bill alleviated producers' uncertainty about the future of government payment programs. If producers plant more acreage in crops expected to receive the highest level of subsidies, the cost of the farm bill could exceed expectations, as was the case with the FAIR Act. Moreover, agricultural producers and their communities could become increasingly dependent on farm payments, potentially causing problems for agricultural lenders should payment levels decline in the future at the same time commodity prices are low.

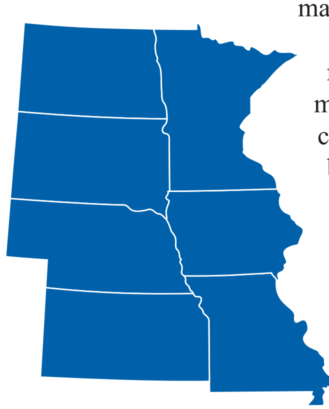
Kansas City Regional Perspectives

Will communications technology be the salvation of rural communities? Many observers believe emerging telecommunications technology, including the Internet, may provide the means to maintain or restore the vitality of many of America's rural areas. According to this line of thinking, improved telecommunications will improve the quality of life in sparsely populated areas and allow rural businesses to compete more effectively over wider areas. Closer analysis suggests, however, that while there is some truth to these beliefs, Internet technology may prove to be less than a "magic bullet" to revitalize rural economies.

Access to the Internet has diffused rapidly in rural America, closely tracking national trends. According to surveys conducted by the ***U.S. Census Bureau*** in September 2001, access to the Internet in rural households is only slightly less than that in urban households.

Communications-related improvements substantially reduce historical incentives to locate firms in urban areas. The advantages traditionally associated with rural areas will loom larger in the decision about where to locate a business: lower labor and land costs and less stringent environmental regulations.

Those who are more dubious of the benefits of modern telecommunications to rural areas see the technology as a "bridge to" rural areas, opening local businesses to competition. The Internet may enhance urban firms' access to rural consumers, because telecommunications are more likely to be used to reach into the rural community customer base from outside. When the Internet offers rural customers more choices, they may be less likely to bring their business to local merchants.



What does this situation imply for community banks? Community banks have embraced Internet technology rapidly. A series of annual surveys of community bank presidents by a major accounting firm found that the proportion of banks with a website increased from 29 percent in 1998 to 75 percent in November 2001. More significant, 43 percent of the community banks surveyed had some transactional capabilities in 2001, and 77 percent expected such capability by 2003.

Certainly, the Internet provides rural banks with many of the advantages ascribed to other rural businesses, including the ability to employ telecommuters, use outsourcing services more efficiently, and buy inputs, including deposits, more competitively. Community banks may be able to use the Internet to reduce unit costs of delivering many services while continuing to provide the personalized attention to their customers that is their comparative advantage over larger institutions.

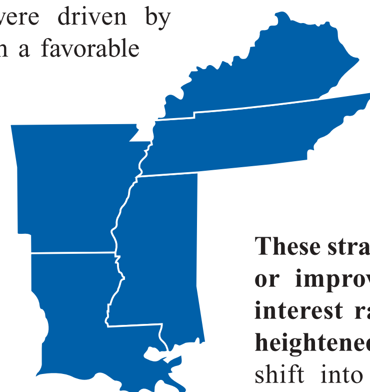
But the development of Internet technology may allow the largest banks headquartered in urban areas to pursue a "less than a branch" strategy in rural areas. As more rural customers become conversant with using the Internet for commercial transactions, large banks may have greater opportunities to gain business in rural areas.

Conclusion: Technology is a two-edged sword. Evidence indicates that the diffusion of the Internet may be a double-edged sword for the rural economy: It can be expected to increase the efficiency and market reach of many rural businesses, but it may also expose these businesses to competitors that can now reach more easily into the rural community, perhaps providing services more cheaply than rural businesses can. Rural banks may also find the Internet to be a mixed blessing: While the Internet may enable them to improve operational efficiency and extend market reach, the technology may also provide a means for large banks and other financial services providers to compete more aggressively in rural areas.

Memphis Regional Perspectives

The Memphis Region economy has stabilized and appears poised for growth. Rising factory orders and an increase in average employee hours worked in the beleaguered manufacturing sector indicate a likely rebound in employment in the second half of 2002. The transportation/distribution sector, which is also important to the Region's employment base, is showing signs of recovery, with increased air and ground shipment activity. Improvement in manufacturing and transportation/distribution employment should spill over into other sectors of the Region's economy.

Bank and thrift credit quality deterioration abated and earnings performance improved in early 2002. Loan loss rates were down from prior levels but remained high. Past-due and nonaccrual loans fell modestly, signaling that credit problems, at least in the aggregate, may have peaked for this cycle. Stronger earnings in first quarter 2002 were driven by increased net margins resulting from a favorable interest rate environment.



Insured financial institutions continued to face difficult asset allocation decisions, however. Loan demand in early 2002 remained weak, and loan balances fell among the Region's community banks and thrifts for the second consecutive quarter. Throughout 2001 and in early 2002, deposit inflows at many community banks increased as consumers, shaken by weaknesses in the stock market, sought a safe haven for their money. The sharp decline in interest rates during 2001 led to the exercise of embedded call features and prepayment options, resulting in considerable asset turnover. Consequently, banks found themselves with excess funds to invest in 2001 and early 2002.

Many banks chose to invest heavily in mortgage-related securities during recent periods, in effect purchasing loans to compensate for weak local loan demand. Aggregate holdings of mortgage-related securities among the Region's community banks grew by a remarkable 59 percent in 2001. The share of investment portfolios composed of mortgage-related securities surged from 18.8 percent on December 31, 2000, to 28.2 percent on March 31, 2002. The popularity of these investments is a function of higher yields. Because of the increasing risk premium associated with the inherent optionality, mortgage-related securities yields improved compared with yields on most other investment alternatives during this period.

Similarly, some institutions sought higher yields by investing in longer-term securities or those with complex embedded options. Although mortgage-related securities gained favor in recent quarters, other securities, such as U.S. government, agency, and municipal bonds, continue to comprise the bulk of the investment portfolio for most community banks. Some institutions elected to accept increased market risk in these segments of their investment portfolios by extending reinvestment horizons and purchasing structured notes. While the aggregate changes in these investments have not been as extreme as the shift into mortgage-related securities, the changes added to the growing market risk apparent in many community bank investment portfolios.

These strategies not only helped institutions preserve or improve net interest margins in the current interest rate environment but also contributed to heightened market risk in investment portfolios. A shift into mortgage-related securities, longer-term securities, or securities with complex embedded options is not an inappropriate or undesirable strategy. For many insured financial institutions, this increase in investment portfolio market risk represents a well-understood component of a sound overall asset/liability management strategy. For others, however, the significant and rapid shift in portfolio composition may result from a simple pursuit of higher yields.

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

New York Regional Perspectives

Different MSAs weathered the recession differently. A political axiom states that "where you stand depends on where you sit." Similarly, your view of the economy may depend largely on the location of your window. The Region's largest metropolitan statistical areas (MSAs) weathered this recession differently, and the timing of the recoveries may vary—a reflection of the disparate economic and industrial makeup of these MSAs.[1]

The Region's MSAs that lost jobs early in this downturn, such as **Buffalo-Niagara Falls, Rochester, Syracuse, Bergen-Passaic, Newark,** and **Scranton-Wilkes-Barre,** generally are more dependent on manufacturing jobs than the nation is. Credit quality weakened for institutions headquartered in some of these MSAs to a greater extent than in the Region and the nation. Trends in the manufacturing sector will influence the recovery in these MSAs. Analysis of the ***Institute for Supply Management's*** (ISM) manufacturing index shows a lag of 6 to 12 months at the national level between the manufacturing index and the employment index.[2] The lag tends to increase when the economy is on the upswing because employers hesitate to add workers until they are confident that the recovery "has legs." The overall manufacturing index turned positive in February 2002, suggesting that employment growth may be months away.

Job losses in **New York City** also occurred early in this downturn and accelerated after September 11. However, the preponderance of job losses occurred in the city's financial, insurance, and real estate and services sectors. Despite early entrance into this recession and relatively high job losses, credit quality for insured institutions in the New York City area remained favorable through first quarter 2002. New York City's recovery will be closely linked to conditions in the financial services sector.

Six of the Region's 21 major MSAs arguably were pulled into recession by September 11. Institutions in these MSAs reported higher past-due ratios at year-end 2001, consistent with the economic decline following September 11. Economic recovery for these MSAs is likely to be on par with that of the nation, reflecting their highly diversified job base. Average employment changes in this MSA group correlate at a 98.3 percent rate with the United States, reinforcing the expectation that the economic recovery of this MSA group will track the nation's.[3]

Eight of the Region's MSAs experienced minimal or no job losses between March 2001 and May 2002. The primary commonality among these MSAs is the relatively high growth in government and service sector jobs, particularly in the health care industry. Not surprisingly, credit quality reported by insured institutions headquartered in these MSAs has been more favorable during this economic downturn than that reported by institutions in the Region's other MSAs. The recovery apparently is further along in these MSAs; however, it likely will take time for any economic recovery to be reflected in insured institution credit quality trends.

After declining in the second half of 2001, profitability among the Region's large banks increased in first quarter 2002.[4] Most of the Region's large banks reported stable or moderately increasing net interest margins in first quarter 2002 compared with the previous quarter. Large banks' average cost of funds, which is highly sensitive to changes in short-term interest rates, reached the lowest recorded level at approximately 2 percent in first quarter 2002.[5] Profitability also was aided by a moderate increase in noninterest income, although certain business lines did better than others. Profitability among the Region's large banks also increased because problem loan costs abated in first quarter 2002. Nonetheless, loan delinquency[6] and charge-off rates remained elevated in first quarter 2002, a situation that could require additions to loan loss reserves.

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[1] For the purposes of this analysis, the Region's MSAs are categorized into three groups: MSAs that experienced job losses early in this business cycle, MSAs whose economies were more directly affected by the events of September 11, and MSAs that experienced minimal or no job losses. Analysis was limited to MSAs with a labor force of at least 200,000 and at least six insured institutions with total assets less than $10 billion, excluding credit card banks. Twenty-one of the Region's 45 MSAs met these criteria as of March 31, 2002. Employment data are through May 2002.

[2] The ISM manufacturing index measures the overall health of the nation's manufacturing index and has several components, including new orders, shipments, and employment.

[3] Correlation between January 2000 and April 2002.

[4] Large banks are defined as institutions with total assets greater than $25 billion, excluding credit card banks. Median figures are used unless otherwise noted.

[5] Data available from first quarter 1984.

[6] Loans 30 days or more past due or in nonaccrual status.

San Francisco Regional Perspectives

The Region's insured institutions have fared better in the recent recession than during the 1990–1991 downturn. The confluence of events that led to the last banking crisis, most of which predated the 1990–1991 recession, did not play out in the same way during the current cycle. Troubled and failed insured institutions were far fewer in number as of first quarter 2002 than during the early 1990s, and a repeat of the last banking crisis is not anticipated. Nevertheless, the recent downturn has had mild adverse effects on credit quality among the Region's insured institutions. In addition, the recent slowdown was more economically and geographically widespread than the 1990–1991 recession, and the banking industry remains vulnerable to some recurring as well as new risks.

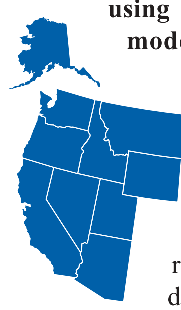
The recent downturn has been more geographically widespread than the prior recession. The adverse effects of the 1990–1991 economic downturn primarily were focused on defense and lumber-related employment in **Southern California** and **Oregon.** In contrast, the effects of the recent downturn were felt across the more geographically dispersed high-tech manufacturing, business services, and tourism sectors. Through March 2002, 7 of the Region's 11 states reported year-over-year job losses, in part because of weakness in these important industries.

Rapidly increasing commercial real estate (CRE) vacancy rates have been a common theme in both recessions, although reasons for supply and demand imbalances differ. During the 1990–1991 recession, buildup of excess space was associated with national tax law changes and regional overbuilding. In contrast, current CRE imbalances relate to unrealistic estimates of future demand, fueled by an expanding high-tech industry and free-flowing venture capital. The boom and bust environment in some of the Region's high-tech centers has led to problems in the office and industrial subsectors in particular.

During the 1990–1991 downturn, soft CRE markets, weak underwriting standards, and high CRE loan[1] concentrations contributed to severe asset quality problems among the Region's insured institutions, especially those based in Southern California and Arizona. Improvements in underwriting and appraisal standards likely will forestall a repeat of the CRE loan problems of the early 1990s. Nevertheless, most of the Region's insured institutions reported high CRE loan exposures as of first quarter 2002. In particular, insured commercial banks headquartered in most of the Region's states report higher construction loan concentrations now than during the early 1990s.

Brisk bank chartering activity in the ten years before both recessions, which contributed to the magnitude of failures during the early 1990s, remains a key concern. The recent downturn was the first economic contraction experienced by nearly 30 percent of the Region's community institutions. During the 1990–1991 recession, newly chartered[2] institutions headquartered within the Region were primarily between three and ten years old, an age group that experienced high average annual failure rates during the early 1990s. Currently, a larger proportion of the Region's newly chartered institutions are less than three years old. Although relatively strong capital positions might help to mitigate the effects of the business cycle on these very young institutions, the high proportion of institutions less than three years old is a concern because these institutions have relatively untested risk management practices.

Since the last recession, several of the Region's insured institutions have pursued concentrated consumer[3] and subprime lending niches, often using non-recession–tested credit scoring models to achieve large, high-yielding loan portfolios. The Region's concentrated consumer and subprime lenders reported weakened asset quality as of first quarter 2002, and they experienced higher loan loss rates during the recent recession than during the 1990–1991 downturn. Credit quality problems among subprime loan securitizers could have an adverse effect on residual interest valuations and limit these institutions' access to capital markets.



[1] CRE loans include commercial credits secured by multifamily, nonfarm-nonresidential, or construction projects.

[2] Newly chartered institutions are defined as insured institutions in operation less than ten years with assets of less than $1 billion.

[3] 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.

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