Regional Outlook

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FDIC
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Regional Perspectives

◆ *In a departure from the market-oriented approach that characterized the 1996 FAIR Act, the 2002 farm bill continues to provide significant subsidies to producers.*

◆ *Agricultural producers and their communities could become increasingly dependent on government payments, potentially causing problems for agricultural lenders should payment levels decline at some point in the future at the same time commodity prices are low.*

◆ *Relatively high levels of government payments to farmers help explain how the Region's agricultural banks have continued to perform well despite low commodity prices.* *See page 3.*

By the Dallas Region Staff

In Focus This Quarter

◆ *The Road to Recovery for Commercial Credit Quality: Not without a Few Hurdles Ahead*—**The recession that began in March 2001 has been especially hard on the corporate sector. Banks that made loans to affected firms felt the immediate effects of the recession through rising problem commercial loans. Large banks took the brunt of this commercial credit deterioration, as indicated by a somewhat larger uptick in problem commercial loans among large banks compared with smaller banks. This credit deterioration was more apparent at banks that participated in loan syndications, one of the financing vehicles available primarily to large corporate customers. Various indicators pointing toward economic recovery, as well as an apparent decline in rating downgrades and default rates among corporate bond issuers in recent weeks, suggest that improvement in commercial credit quality may be just ahead. This recovery, however, faces a few hurdles, including continued high leverage, weak earnings, and prospects for a more difficult funding environment, particularly for speculative-grade corporations with maturing debt.** *See page 8.*

By Cecilia Lee Barry, Senior Financial Analyst

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Regional Perspectives

Implications of the 2002 Farm Bill for Agricultural Farm Policy, Producers, and Lenders

Overview

The 2002 Farm Security and Rural Investment Act, signed into law on May 13, 2002, ended the prolonged farm policy debate and the uncertainty of many producers and their lenders about the nature and level of government payments. The legislation allocates $190 billion over ten years and differs markedly from the previous farm bill (the Federal Agriculture Improvement and Reform Act of 1996 [FAIR]), which was intended to promote a free-market approach. Provisions of FAIR ended a history of acreage restrictions that controlled the supply of commodities when production outstripped demand. FAIR removed these acreage restrictions to allow producers to react to market signals when they decide what crops to plant. FAIR also established transition payments to help offset the cost of changing crops or to allow farmers to exit the agricultural industry.

The 2002 farm bill is a major departure from the market-oriented approach of FAIR. In principle, FAIR was designed to reduce payments to the farm sector by decoupling payments from production and providing transition payments to aid in a new market-based approach. In fact, government expenditures have increased markedly since FAIR was enacted in 1996. The 2002 farm bill makes no pretense of reducing government expenditures, and it 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 new farm bill continues the trend toward a high level of government payments to the agricultural sector.

The existence and level of government subsidies may determine whether many farmers remain profitable. Therefore it is critical that farmers and their lenders be aware of and understand the provisions and long-term implications of the new farm legislation. This article discusses the major components of the 2002 farm legislation and their potential economic effects on the Region's producers and agricultural banks.

Total Government Expenditures Will Rise under Provisions of the 2002 Farm Bill

The new farm bill increases spending for commodity support programs during the next six years by $31.2 billion over the amount legislated in FAIR, of which $24.4 billion will be targeted at traditional program crops (corn, wheat, soybeans, and cotton). The bill provides for income support to producers through three main provisions: direct payments, counter-cyclical income support payments, and loan deficiency payments. Direct payments will serve the same purpose as the production flexibility contract (PFC) payments introduced in FAIR. PFC payments were fixed payments based on a particular farm's historical acreage and yield; they were intended to ease producers' transition to a free-market approach.

In addition to direct payments, the 2002 law also introduces a counter-cyclical income support payment program intended to support and stabilize farm income when commodity prices are low (below target prices). These payments are counter-cyclical because the payments will increase as commodity prices fall. These payments also are intended to alleviate the need for ad hoc federal emergency assistance, which became a major source of unplanned spending under FAIR.

Both direct and counter-cyclical payments under the 2002 legislation will be influenced by incentives that were in place under FAIR. These incentives prompted many producers to plant crops that received higher subsidy payments, primarily cotton and soybeans. Consequently, total planted acreage increased for crops that received the highest subsidy levels. Under the 2002 legislation, producers can reestablish their "base acres" based on their past four years of production. Base acres are used to calculate direct and counter-cyclical payments. The increased acreages brought about by provisions of FAIR will likely result in higher subsidies going forward under the new legislation.

The 2002 legislation also raises loan rates used to determine floor prices for loan deficiency payments for

wheat, feed grains, and upland cotton. The difference between these loan rates and current cash prices would result in large subsidy payments. Consequently, if prices fall below current levels, subsidies will increase further, and these outlays could deplete appropriated funds sooner than projected.

The 2002 legislation strengthens three other programs: conservation programs, value-added agricultural grants, and Farm Service Agency (FSA) loan programs. Conservation and grant programs fund conservation initiatives (significantly expanded under this legislation) and establish agricultural cooperatives that allow producers to stabilize farm income. The bill also increases benefits under the FSA loan guarantee programs—for example, waiving eligibility time limits on direct and guaranteed farm operating loans; increasing the number of producers who qualify for FSA emergency financing; and increasing and making permanent interest rate assistance for guaranteed loans. In addition, the bill streamlines application documentation procedures.

Provisions of the New Farm Bill Are Expected to Prompt Producers to Continue High Production of Specific Commodities

Provisions of 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, 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, as was the case after the enactment of FAIR.

As mentioned earlier, after FAIR was enacted in 1996, producers responded to the expected payment levels by increasing production of certain crops that garnered the greatest subsidies, rather than following market signals. Cotton is a good example. As cotton prices fell 31 cents per pound (47 percent), cotton acreage *increased* by almost 2 million acres (13.7 percent) following enactment of FAIR (see Chart 1). During 2001, cotton prices averaged 35 cents per pound, 37 cents below the break-even price. Although prices for all four commodities—corn, wheat, soybeans, and cotton—have declined since FAIR was implemented, cotton prices have declined the most (see Chart 2). As a result of increased production and declining prices, government payments rose substantially, from $7.3 billion in 1996 to $22.8 billion in 2000 (the 2000 figure included $8.4 billion in ad hoc emergency assistance).

CHART 1

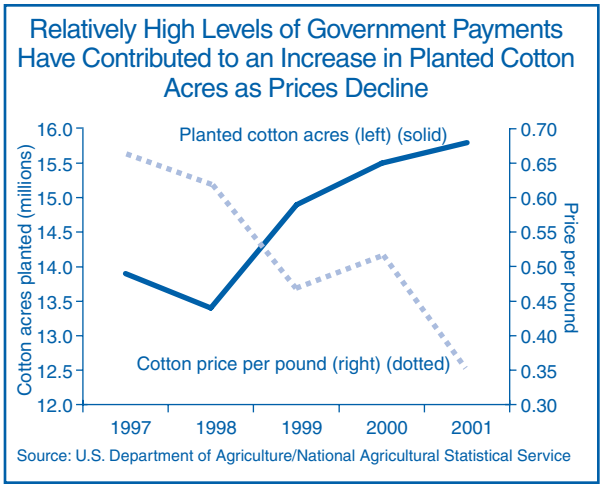
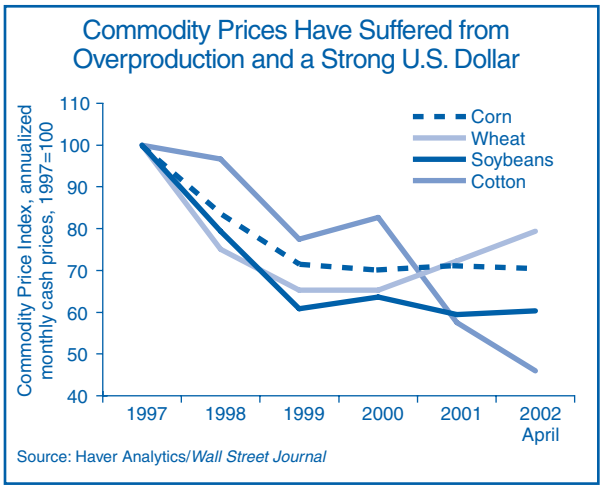


CHART 2



The 2002 Farm Bill Will Boost Farm Income but May Have Other Consequences as Well

U.S. Department of Agriculture (USDA) analysts say that provisions of the 2002 farm bill will increase farm income, but there may be other consequences as well. A USDA analysis found that producers would be expected to respond not only to market prices, but also to expectations of how the programs may change in the future.

Direct payments resemble and replace PFC (Production Flexibility Contract) *payments which led to higher crop production. Since producers have the*

option of updating base payment acres in 2002 from 1996 levels and the addition of soybeans to this payment scheme, farmers may have an incentive to continue producing crops and/or to expand production in order to maintain a production history in anticipation of future government payments.[1]

The expectation of pending legislation can dramatically affect producers' planting decisions. For example, an amendment to cap payments, proposed by Senator Charles E. Grassley of Iowa, which was adopted by the Senate but failed in conference committee, could have resulted in lost payments to an estimated 50 percent of cotton producers.[2] This amendment was debated when producers were making 2002 planting decisions. As a result of producers' reaction to this anticipated amendment, the number of acres planted in cotton is projected to decline by 12 percent during the 2002 crop year. Even though the legislation was enacted without the caps, members of the Senate Appropriations Committee are continuing to debate payment caps as this article is being written. If Congress decided to implement payment caps through the appropriations process, producers still could face substantially reduced payments on certain commodities. Moreover, the recent enactment of trade promotion authority could contribute to a reduction in government subsidies to U.S. agriculture; the Bush administration has indicated its desire to lower agricultural subsidies worldwide as part of the World Trade Organization negotiations.[3]

Some analysts suggest that government farm payments may slow the growth of rural communities in certain cases, by artificially inflating land prices and diverting capital away from businesses.[4] A ***USDA/Economic Research Service*** report attributes $62 billion of U.S. farmland values to payments from the FAIR farm commodity programs.[5] Alternative uses for these agricultural lands—residential, commercial, or industrial—might have promoted local economic diversification and faster growth. However, such efforts were constrained, at least in part, by the fact that farmland values were supported by relatively high levels of government payments.

At the same time that government payments are artificially inflating farmland values, insured financial institutions have increased lending secured by farm real estate. Insured institutions nationwide reported a 90 percent increase in farmland loans for the ten-year period ending March 31, 2002, in contrast to 68 percent growth for all real estate loans. If the level of government payments declines at some point, and if commodity prices remain weak, rural land values likely would be subject to downward price pressure. The result would be an adverse effect on lenders' collateral and producers' equity and borrowing capacity.

Provisions of the 2002 farm bill also could complicate future international trade negotiations. Because the legislation represents a shift away from a free market-oriented farm policy, many global trading partners are criticizing the United States for what could be characterized as a protectionist strategy. The farm bill follows closely on the heels of tariffs imposed 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.

Of particular interest to the Dallas Region are discussions about the creation of a Free Trade Area of the Americas. The proposed Free Trade Area would function much the way the NAFTA agreement does, but it would expand the trading partners to North, South, and Central America. In 2001, a little more than 50 percent ($39.7 billion) of Dallas Region exports were destined for nations in the proposed Free Trade Area of the Americas, compared with 41.7 percent ($272.1 billion) for the rest of the nation. Together with recently imposed tariffs on lumber and steel imports, current U.S. farm policy could complicate the completion of the Free Trade Area of the Americas agreement.

The Dallas Region's Dependence on Government Payments Has Grown but Still Remains below the National Average

As a share of net farm income, the Dallas Region's dependence on government payments grew from almost 30 percent in 1996 to 43.2 percent in 2000. This increase is attributable primarily to the heavily subsidized cotton

[1] USDA/Economic Research Service (ERS), *Farm Bill 2002: Analysis of Selected Provisions: Counter-Cyclical Payments, www.ers.usda.gov/Features/farmbill/analysis/countercyclicalpayments2002act.htm.*

[2] Agricultural and Food Policy Center, "Farm Level Comparison of H.R. 2646 and S. 1731," Working Paper 02-4, March 2002, p. 5.

[3] *Washington Post,* "WTO Negotiations May Hold Key to Bush's Legacy on Free Trade," July 28, 2002. Section A, page A06.

[4] USDA/ERS, "How Important Are Farm Payments to the Rural Economy?" *Agricultural Outlook,* October 2000.

[5] USDA/ERS, "Higher Cropland Value From Farm Program Payments: Who Gains?" *Agricultural Outlook,* November 2001.

industry, which plays a substantial role in Dallas Region agriculture. Although significant, the share of Dallas Region farm income attributed to government payments remains below that of the nation because of the predominance in the Region of livestock production, which does not receive government payments. Specifically, 69 percent of the Region's agricultural cash receipts are derived from livestock products, compared with 51 percent for the nation.

The livestock sector is not without its problems. Severe drought has led to poor grazing conditions this year. Consequently, many producers are liquidating herds, placing downward pressure on livestock prices. Cattle (feeder) prices declined about 18 percent from April 2001 to June 2002. Higher cattle prices have shielded the Region from losses caused by low bulk commodity prices during the past four years, and any further decline in livestock prices could have a particularly adverse effect on the Region's agricultural economy.

The Region's Agricultural Banks Continue to Perform Well despite Troubled Agricultural Sector Fundamentals

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. The average return on assets (ROA) was 1.31 percent for Dallas Region agricultural banks in first quarter 2002, compared with 1.23 percent for all other agricultural banks nationwide and 0.90 percent for nonagricultural banks that hold less than $100 million in assets (small banks).[6] During the past five years (coinciding with enactment of FAIR), at a time when commodity prices have been at historically low levels, the ROA for the Region's agricultural banks has remained relatively stable, averaging a strong 1.28 percent, compared with 1.18 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 these institutions hold a greater percentage of noninterest deposits than agricultural banks outside the Region. Additionally, the Region has the highest percentage of agricultural banks electing Subchapter S tax status (47 percent), boosting the aggregate ROA relative to other parts of the nation. The influence of the Subchapter S status does not entirely explain the performance of the Region's agricultural banks. Pretax ROA shows that the Region's agricultural banks have outperformed agricultural banks outside the Region and small nonagricultural banks nationwide during the past four years. While the Region's agricultural banks reported higher past-due and charge-off rates during the past five years, they also reported a higher loan loss reserve to total loan ratio than their peers (see Table 1).

A review of examination ratings shows that as of December 31, 2001, 6.3 percent of the Region's agricultural banks were classified as "weak" (composite examination rating of 3, 4, or 5), the lowest level since 1995. While this percentage is slightly higher than that for all U.S. agricultural banks, it is lower than the

Table 1

Statistics of Agricultural Banks Compare Favorably to Other Small Banks

	Five-Year Average		
	U.S. Agricultural Banks (%)	Dallas Region Agricultural Banks (%)	Other Small NonAgricultural Banks (%)
Return on assets	1.18	1.28	0.94
Leverage ratio	10.26	10.36	11.01
Past-due ratio	2.38	2.97	2.67
Charge-off ratio	0.25	0.40	0.32
Loan loss reserve to total loans	1.52	1.56	1.25

Source: Bank and Thrift Call Reports, annual results 1997–2001

[6] Small banks are useful for comparison purposes because agricultural banks tend to be relatively small institutions, with 84 percent holding less than $100 million in assets.

10.0 percent reported for all nonagricultural small banks nationwide.

Loan Exposure Has Risen among the Region's Agricultural Banks

Nationwide, the average agricultural bank loan-to-asset ratio increased from 48 percent at year-end 1991 to 61 percent ten years later. Concurrently, agricultural loans as a percentage of total loans fell nationally from 46 percent to 43 percent. Dallas Region agricultural banks also reported increasing loan-to-asset ratios and a declining share of agricultural loans during this period. This situation can be attributed, in part, to the fact that 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 ten years ago.

As large banks take on more agricultural loan volume, Dallas Region agricultural banks are diversifying into other loan types, primarily real estate. Real estate loans represented 40 percent of total loans as of year-end 2001, up from 29 percent ten years earlier. Single-family residential mortgages represent the largest single real estate category; however, loans secured by farmland sustained the largest increase among the Region's agricultural banks during this period.[7] If government farm payments have inflated land prices, collateral margins may be squeezed if subsidy levels decline—as would happen, for example, if payment caps were implemented.

For more information on specific provisions of the 2002 farm bill, refer to these resources.

Farm Bill Frequently Asked Questions
www.fsa.usda.gov/pas/farmbill/fbfaqhome.asp

USDA 2002 Farm Bill Glossary of Terms:
www.ers.usda.gov/features/farmbill/2002glossary.htm

USDA 2002 Farm Bill Page
www.usda.gov/farmbill/index.html

The Agricultural and Food Policy Center:
Base and Yield Update Option Analyzer
www.afpc.tamu.edu/models/bya/

Summary

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

Dallas Region Staff

[7] Dallas Region farmland loans increased (as a percentage of total loans) by 4.5 percentage points during this ten-year period, while agriculture production loans decreased by 10.4 percentage points, causing the overall agriculture exposure to decrease to 41 percent of total loans, down from 47 percent ten years earlier.

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

Introduction

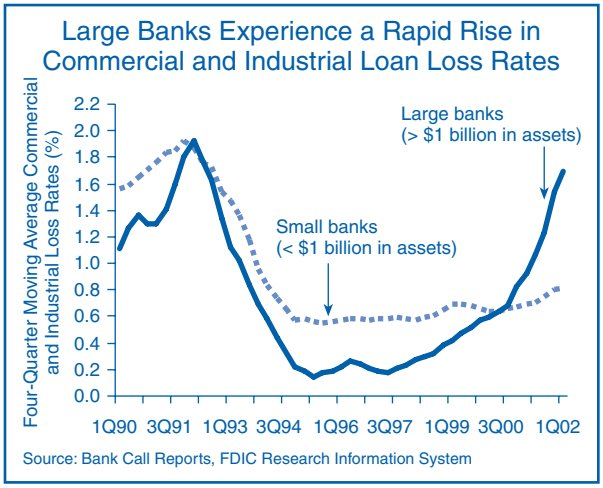
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic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

Commercial Credit Deterioration Should Subside with the Economic Recovery

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

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

CHART 1



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

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

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

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

High Default Rates, Rating Downgrades, and Bankruptcies Persist

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

Corporate Profitability Remains Fragile

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

CHART 2

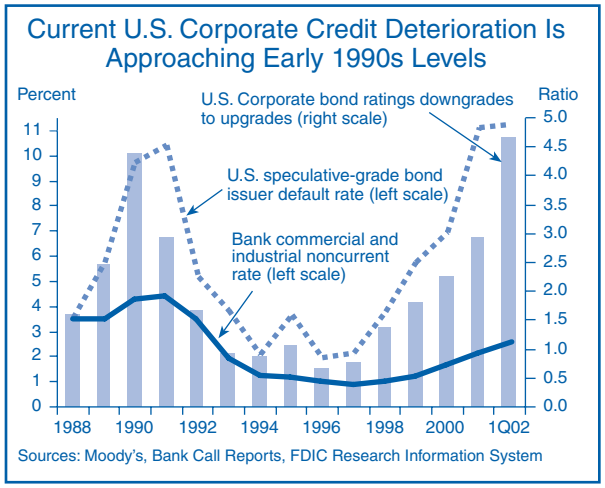
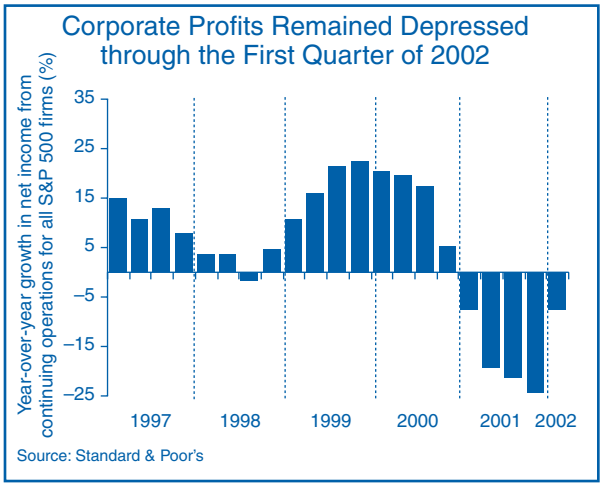


CHART 3



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

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

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

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

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

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

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

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

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

Chart 4

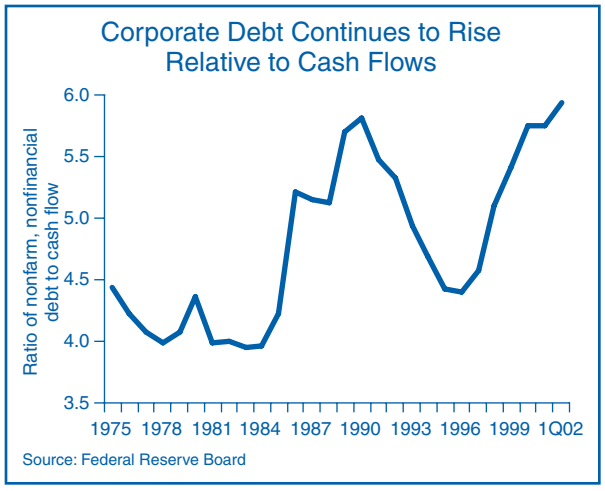
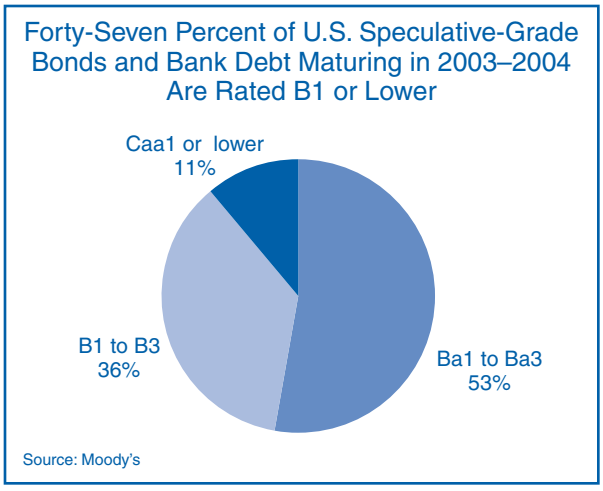


Chart 5



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

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

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

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

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

Loss Severity Has Increased with Higher Default Rates

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

CHART 6

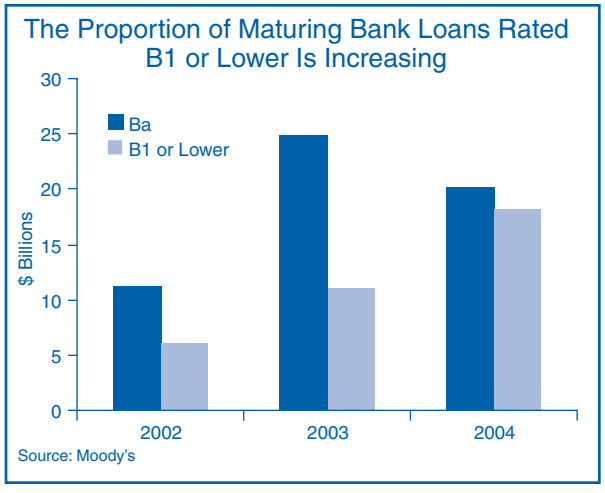


TABLE 1

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

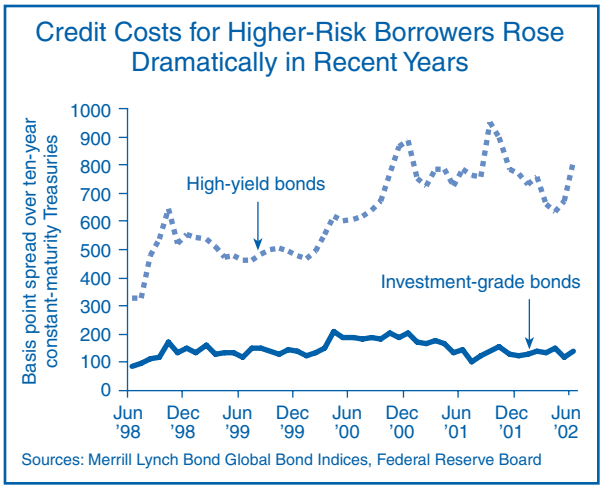
SENIORITY/SECURITY	AVERAGE RECOVERY PER $100	
	1982–2000	2001
SENIOR SECURED BANK LOAN	$67.06	$54.68
EQUIPMENT TRUST	$64.65	NA
SENIOR SECURED BONDS	$52.09	$58.00
SENIOR UNSECURED BONDS	$43.82	$36.20
SENIOR SUBORDINATED BONDS	$34.59	$19.90
SUBORDINATED BONDS	$31.83	$16.45
JUNIOR SUBORDINATED BONDS	$22.48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

NOTE: NA=NOT AVAILABLE
SOURCE: MOODY'S

Higher-Risk Borrowers Pay High Premiums

A speculative-grade company refinancing debt today will face a much higher price, in terms of spreads over a cost of funds index or risk-free instruments, compared to several years ago. Yield spreads between investment-grade and speculative-grade bonds have widened significantly since early 2000 (see Chart 7), in part because of lower investor tolerance for risk, rising

CHART 7



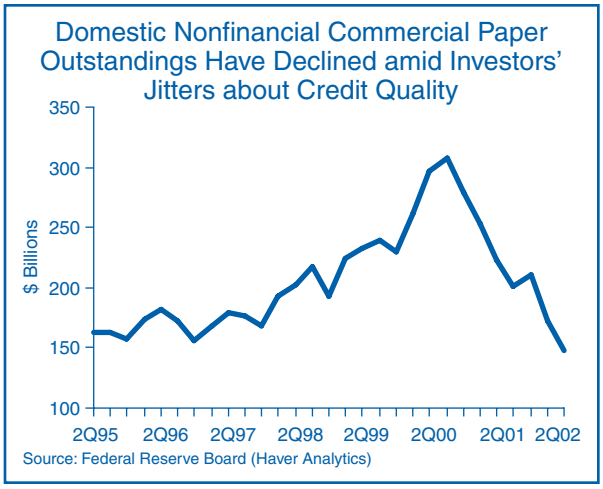
[12] David Hamilton, et al., "Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Ratings Performance 1970–2001," *Global Credit Research,* Moody's Investors Service, February 2002. The recovery rate is defined as the secondary market price of the defaulted instrument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

defaults, and weakening corporate cash flows. After narrowing a bit in first quarter 2002, spreads have widened again on renewed concerns about accounting irregularities and the realization that the economic recovery may come at a slower pace than anticipated. Lower investor tolerance for risk has affected not only speculative-grade borrowers but also some investment-grade borrowers. For example, the commercial paper (CP) market, which many investment-grade borrowers have used as a cheap source of funding, is no longer readily available to all investment-grade borrowers.[13]

Drawn-Down Commercial Paper Back-up Lines Heighten Commercial Bank Exposure[14]

Since its peak at the end of 2000, the CP market for domestic nonfinancial companies has shrunk by almost 50 percent (see Chart 8). A reduction in the need for working capital and heavy refinancing activity have contributed to this contraction. However, the record number of downgrades among issuers of CP in 2001 also contributed to this decline. Money market funds cannot hold more than 5 percent of assets in CP graded less than A1/P1/F1.[15] Thus, the recent flux of downgrades effectively squeezed some issuers out of this market and forced them to refinance with fixed-rate bonds.[16] Also, fears of deteriorating credit quality have shut some investment-grade companies out of the CP market. Since the collapse of Enron, investors have been reluctant to hold the debt of certain companies. Some of these companies reported accounting irregularities, and the restatement of financial statements revealed previously hidden losses. In some cases, issuers that were not involved with accounting irregularities were forced to draw on bank credit lines when they were unable to roll over their CP because of the lack of demand or extreme-

CHART 8



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.

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