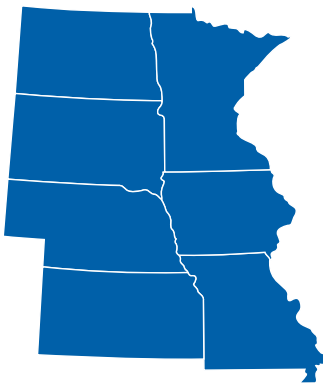

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

THIRD QUARTER 2002

Regional Perspectives

FDIC KANSAS CITY REGION



◆ *Some observers have viewed the Internet as an important means of improving the economic condition of rural areas*—The rapidly diffusing technology allows rural consumers faster and cheaper access to a wider variety of information, goods, and services, and provides rural businesses with the means to operate more efficiently and reach wider markets.

◆ *At the same time, the Internet may enhance the ability of non-local businesses to compete in isolated rural areas*—Evidence suggests that an increasing number of farmers are purchasing inputs online from suppliers outside their areas.

◆ *Internet technology may also be a double-edged sword for rural banks*—On one hand, it may allow them to provide a broad range of services over wider areas, but it may also expose these institutions to competition from large banks that could not previously afford to deliver services to rural areas. *See page 3.*

By Jeffrey Walser

DIVISION OF INSURANCE AND RESEARCH

JOHN M. ANDERLIK,
REGIONAL MANAGER

JEFF W. WALSER,
REGIONAL ECONOMIST

RICHARD D. COFER, JR.,
SENIOR FINANCIAL
ANALYST

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 10.*

By Cecilia Lee Barry, Senior Financial Analyst

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Regional Perspectives

The Information Superhighway: Panacea or Threat for Rural America?

In the second half of the 1990s, Internet technology dawned, bringing with it the promise of “abolishing distance” and creating a truly global marketplace. Many observers believe emerging telecommunications technology may provide the means of maintaining or restoring 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 will 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 the “magic bullet” hoped for by those who are searching for means to revitalize rural economies. This article explores potential effects of recent advances in telecommunications on rural economies, with special attention to the experience of community banks as these institutions adopt Internet technology.

Many Rural Areas Face Continuing Economic Decline

As discussed in the *Kansas City Regional Outlook*, first quarter 2002, a majority of the Region’s counties have declined in population since the 1970s, with a significant fraction declining at an increasing rate during the 1990s.¹

Analysis of recently released data from the 2000 Census shows that these trends are continuing. The United States, along with all industrialized countries, has experienced rural-to-urban migration throughout its history, as technological advances in agriculture have reduced the demand for farm labor. The relative importance of agriculture in the Kansas City Region has heightened the visibility of this phenomenon in recent decades.

As rural populations decline, the economic viability of many small towns and rural areas becomes increasingly threatened. Low and declining population densities

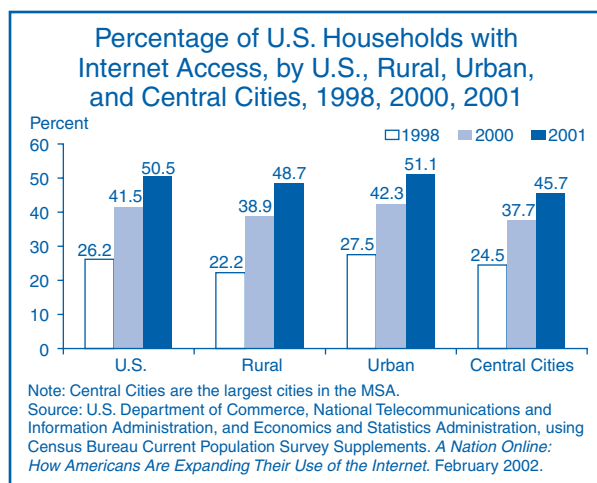
make it more difficult for rural businesses to grow or even survive. It also becomes increasingly expensive to provide roads, schools, and health care. The decline in rural populations has not gone unnoticed, however, as individuals from the rural business community, academia, and state, federal, and county governments search for ways to maintain the economic viability of rural areas.

Some observers have viewed recent advances in telecommunications as a means of improving the economic condition of rural areas. The instantaneous transfer of information allowed by the Internet reduces historic pressures on firms to locate in urban areas, increases the competitiveness and efficiency of rural businesses, facilitates telecommuting, and provides opportunities for distance learning.

The Internet in Rural America—A Reason for Optimism?

Access to the Internet has diffused rapidly in rural America, closely tracking national trends. According to surveys conducted by the *United States Census Bureau* in September 2001 (see Chart 1) access to the Internet in rural households is only slightly less than that in urban households.

CHART 1



¹ Depopulation Threatens the Viability of Many of the Region’s Rural Counties. *Kansas City Regional Outlook*, first quarter 2000, 20–28.

As of September 2001, 48.7 percent of rural households had access to the Internet, compared with a national rate of 50.5 percent. From 1998 to 2001, growth in Internet use in rural households was particularly strong—24 percent at an average annual rate.² Adoption of the Internet in rural areas has closely tracked the rate in the nation as a whole, suggesting, at least at first glance, that the countryside is fully participating in the so-called “Internet Revolution.”

Independent research conducted by the *United States Department of Agriculture’s Economic Research Service* in June 2001 indicates that Internet use by farmers is comparable to that by small manufacturers. The survey found that 43 percent of farmers use the Internet in their business, compared with 47 percent of manufacturers with fewer than five employees.³ The results of this research confirm earlier studies that found the rate of adoption of computers by farm households to be similar to that of U.S. households in general.⁴

What are the possible benefits of this significant presence of Internet technology in the rural sector? Clearly, the defining characteristics of rural areas are low population densities and distances from urban areas. Historically, these characteristics have increased costs for farmers and rural businesses. While it may be an overstatement to claim that the Internet will “abolish distance,” it clearly has the potential to reduce the costs of doing business in geographically isolated areas. The Internet’s ability to transfer large volumes of information nearly instantaneously can mitigate some of the disadvantages inherent in geographical isolation.

For farmers, the Internet has already increased access to business-related information. According to the USDA survey cited above, 82 percent of the farmers using the Internet in 2001 used it to track prices of the commodities they were producing, 56 percent used it to access commercial agricultural information services, and 33 percent used it to access USDA information.⁵ These statistics sug-

gest that the Internet can provide farmers with more information sources in a more timely fashion. Potentially, the Internet will give farmers the means to purchase inputs from a greater variety of sources. Many in the farming sector have embraced the new communications technology enthusiastically. As of early 2002, thousands of Internet sites offer agriculture-related information and access to products such as fertilizer, chemicals, seed, farm equipment, and livestock. The *Federal Reserve Bank of Kansas City* estimates that the value of online agriculture-related purchases will be in the range of \$70 billion by 2003, with significant growth in subsequent years.⁶

Improvements in communications technology will also enhance the feasibility of locating businesses in rural areas:

*The growth of the Internet, ubiquitous computing, and instantaneous communication from anywhere to anyplace have made geographic locations and distances less relevant....Markets that were closed due to geographic constraints have become accessible and global dissemination of information from the most remote corners of the world has become feasible. Rural businesses can compete with their urban counterparts in the same market.*⁷

All these communications-related improvements substantially reduce historical incentives to locate firms in urban areas. The advantages traditionally associated with rural areas—lower labor and land costs and less stringent environmental regulations—will loom larger in the decision about where to locate a business.⁸

Additionally, the Internet enhances the ability of rural firms to participate in supply chain networks, a business model of increasing importance in the U.S. economy. Over the past five years, an increasing number of manufacturing and wholesale firms have adopted Internet technology to organize and coordinate the flow of inputs and products, the process known as the “supply chain” from raw materials to finished products. As more businesses have embraced this technology, business-to-business (B2B) communication has resulted in the development of business networks. B2B communication is important in several industries traditionally located in

² U.S. Department of Commerce, Economics and Statistics Administration and National Telecommunications and Information Administration. February 2002. “A Nation Online: How Americans Are Expanding Their Use of the Internet,” 20.

³ Economic Research Service. November 2001. Farms, the Internet, and E-Commerce: Adoption and Implications. *Agricultural Outlook*, 19.

⁴ Abbott, Eric A., J. Paul Yarbrough, and Allan G. Schmidt. 2000. Farmers, Computers, and the Internet: How Structures and Roles Shape the Information Society. In *Having All the Right Connections—Telecommunications and Rural Viability*. Eds. Peter F. Korsching, Patricia C. Hipple, and Eric A. Abbott. Westport, CT: Praeger Publishers, 220.

⁵ Economic Research Service, 17.

⁶ Staihr, Brian. May 2000. Rural America’s Stake in the Digital Economy. *The Main Street Economist*. Center for the Study of Rural America. Federal Reserve Bank of Kansas City, 3.

⁷ Premkumar, G. 2000. Rural Businesses and Telecommunications Technologies. In *Having All the Right Connections*, 83.

⁸ Korsching, Peter F., and Sami El-Gharini. 2000. Telephone Companies: Providing All the Right Connections for Viable Rural Communities. In *Having All the Right Connections*, 40.

rural areas, including food processing, agricultural machinery, and agricultural chemicals.⁹ The Internet is also being used to facilitate the management of vertically integrated livestock production industries, such as pork and poultry. By helping rural businesses participate in supply chain networks, the Internet increased the probability that these businesses would achieve sustained economic success.

Thus, the argument that the Internet has the potential to improve the economic climate in rural areas has considerable merit, but it is also useful to consider some issues on the other side of the ledger.

Rural Areas Face Important Impediments to Comparable Internet Access

While Chart 1 suggests that access to the Internet in rural areas is comparable to that in urban areas, these statistics do not address differences in quality. Rural areas have traditionally lagged cities in the adoption of new technologies, and the Internet is no exception.¹⁰ Additional data from the *Department of Commerce* suggest that rural areas lag the rest of the nation in availability of broadband and other high-speed access to the Internet (see Chart 2).

The Federal Communications Commission defines “broadband” as an Internet connection that delivers data at speeds more than four times faster than 56 kilobits per second, the maximum speed achievable through conventional phone lines. Today, broadband connection is available over a digital subscriber line (DSL) provided by telephone companies or through a cable modem.¹¹

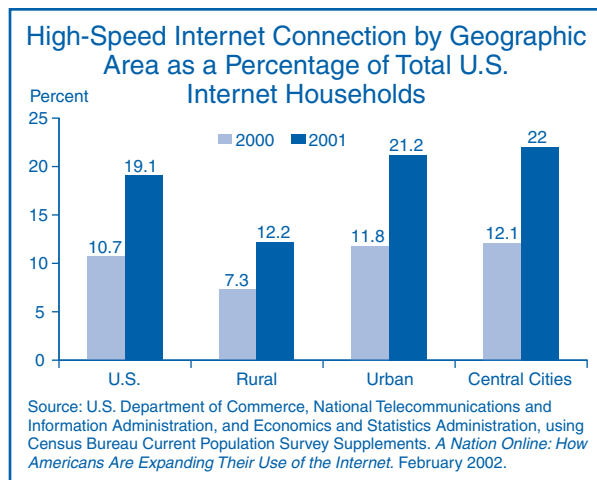
Communities require a minimum size or “critical mass” to justify expenditures for the infrastructure necessary to support the most modern, high-quality technologies. Businesses and institutions in rural areas often lack this critical mass, and insufficient scale may discourage telecommunications providers from bringing services to some rural areas. Many rural communities may not have

⁹ Henderson, Jason R. September 2001. Networking with E-commerce in Rural America. *The Main Street Economist*. Center for the Study of Rural America, Federal Reserve Bank of Kansas City, 3.

¹⁰ Dilman, Don A. February 2000. Some Thoughts About the Impact of E-commerce on Rural America. Presentation at the Iowa Farm Forum. Iowa State University.

¹¹ Staihr, Brian. August 2000. The Broadband Quandary in Rural America. *The Main Street Economist*. Center for the Study of Rural America, Federal Reserve Bank of Kansas City, 2.

CHART 2



enough customers to allow providers to recoup the fixed costs associated with providing up-to-date services.¹²

It seems, then, that while improved telecommunications have the potential of bringing significant benefits to rural areas, the technology will not completely erase the disadvantages of isolation and distance.

History Suggests that Technological Advances Have Not Prevented Rural Depopulation

While some observers believe that advances in telecommunications technology hold the promise of revitalizing rural economies, the history of earlier technological innovations suggests otherwise. When the telephone began to be widely adopted in rural areas early in the 20th century, many observers saw it as a means of keeping people “down on the farm.” According to an advertisement run by a telephone equipment manufacturer in *Wallaces' Farmer* in 1905, “The former isolation, which drove many of the young men and women from the farm to the city, has been banished by the many telephone lines now in use all over this country.”¹³ Similarly, the 1909 *Cyclopedia of Agriculture* stated that the “striking contrast between city and country life is perhaps today the greatest single cause of that so-called rural depopulation which is attracting the attention of statesmen and reformers the world over. It

¹² Korsching, Peter F., Patricia C. Hipple, and Eric A. Abbott. 2000. On-Ramps and Roadblocks to the Information Superhighway. In *Having All the Right Connections*, 287.

¹³ Quoted in Kline, Ronald R. 2000. *Consumers in the Country: Technology and Social Change in Rural America*. Baltimore, MD. Johns Hopkins University Press, 24.

is reasonable to suppose that it can be done away with by perfecting the agencies of rural communication.”¹⁴ Similar claims were made when the automobile became available in rural areas in the 1920s and when rural electrification became widely available after World War II. According to this line of thinking, such technological advances narrowed the gap between the perceived quality of life in rural areas and that in the cities and would, as a consequence, halt or slow the pace of rural-to-urban migration.

These hopes were not to be realized, however, as rural-to-urban migration proceeded steadily throughout the 20th century. More than 40 percent of the country’s population lived on farms at the beginning of the century; that proportion had declined to less than 3 percent by its end.¹⁵ Perhaps the technological improvements embedded in the telephone, automobile, and rural electrification were not enough to overcome the strong economic incentives drawing people from the countryside to the cities. Others have argued that these innovations actually *increased* the pace of rural-to-urban migration. The automobile allowed farmers to visit cities more often and more conveniently; the telephone allowed them to maintain commercial and personal relationships with a wider circle of urban people; and rural electrification allowed them to experience the conveniences already common to city-dwellers.¹⁶ While each of these advances improved the quality of life in the country, they also increased the flow of information between the two sectors, perhaps motivating more country people to seek their fortunes in the cities.

Similar to their counterparts earlier in the century, present-day proponents of technological solutions see the new communications technologies as a “bridge from” rural communities to the wider world. According to this line of the thinking, the Internet will enhance the ability of farmers, rural consumers, and rural businesses to access information, goods, and services from faraway sources, increasing the economic viability of rural areas. While this argument may have some merit, the historical examples cited above suggest that technology alone may not be sufficient to reverse the decline of rural areas.

Those who are more dubious of the benefits of modern telecommunications to rural areas see the technology as a “bridge to” rural areas, opening businesses in these areas to competition. In many ways, the economic

effects of the interstate highway system are an apt analogy for the effects of bringing the information superhighway to rural areas. Many rural communities received no direct benefits from the interstate highway system and lost business because the highways opened access to larger trade and service areas.¹⁷ Similarly, the Internet may enhance urban firms’ access to rural consumers, as “telecommunications are more likely to be used to reach into the rural community customer base from outside.”¹⁸ When the Internet provides rural customers with more choices, they may be less likely to bring their business to local merchants.¹⁹

Researchers who have studied the use of the Internet by Iowa farmers confirm that larger-scale farmers are already using the technology to shop for inputs outside their traditional market areas:

*Commercial farmers are actively seeking ways to use their computers and the Internet to link beyond their communities to access favorable credit [emphasis added], lower-cost inputs, better market prices, and contacts with agricultural experts. As agricultural enterprises increase electronic links for marketing and regulatory purposes, farmers who are large enough to negotiate favorable terms and sophisticated enough to know where to look for the best deals will benefit most. These...large commercial farms... are using their computers to negotiate with bankers, suppliers, and marketers.*²⁰

In the opinion of these researchers, not only will the Internet weaken the economic ties between large farmers and the local economy, it is also likely to enhance the advantages of larger, more technologically sophisticated farmers relative to smaller farmers, accelerating the consolidation of agriculture.²¹

It seems likely that not all of rural America will benefit equally from advances in telecommunications technology. Clearly, farmers and businesses that perceive and embrace the advantages provided by the new technologies have the

¹⁴ Ibid.

¹⁵ Garkovich, Lorraine. 1989. *Population and Community in Rural America*. Westport, CT: Greenwood Press, 98.

¹⁶ Kline. 25.

¹⁷ Korsching, Peter F., Patricia C. Hipple, and Eric A. Abbott. 2000. Rural America and the Information and Communications Revolution. In *Having All the Right Connections*, 4.

¹⁸ Korsching, Hipple, and Abbott. On-Ramps and Roadblocks to the Information Superhighway, In *Having All the Right Connections*, 283.

¹⁹ Korsching and El-Gharini. Telephone Companies: Providing All the Right Connections for Viable Rural Communities. In *Having All the Right Connections*, 40.

²⁰ Abbott, Yarbrough, and Schmidt. Farmers, Computers, and the Internet: How Structures and Roles Shape the Information Society. In *Having All the Right Connections*, 223.

²¹ Ibid.

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potential to improve their profitability and long-term viability. However, the technologies could exacerbate the risks faced by farmers and rural businesses that are slow to embrace the new methods. Those who do not adopt new communications technologies, or come late to the game, could fall behind their more savvy competitors.

What Does Internet Technology Imply for Community Banks?

Community banks have embraced Internet technology rapidly. According to a series of annual surveys of community bank presidents by a major accounting firm, the proportion of banks with a website increased from 29 percent in 1998 to 75 percent in November 2001. More significantly, 43 percent of the community banks surveyed had some transactional capabilities in 2001, with 77 percent expecting such capability by 2003. Table 1 provides a more detailed presentation of current and projected online capabilities reported by the survey's respondents.²²

Why has the community bank sector adopted this new technology so rapidly? In autumn 2000, the Federal

Deposit Insurance Corporation interviewed several community banks that were early adopters of Internet technology and concluded that "Community banks view Internet banking primarily as a retail customer retention strategy—a 'must-have' service much like automated teller machines. Banks that are seeking to achieve a competitive edge or are responding to customer demand generally institute Internet banking." Although the banks interviewed hoped to earn revenue or achieve cost advantages from adopting the Internet, none of them had achieved these goals in the early stages.²³

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. Some rural bankers have said that they might use Internet technology to retain the deposits of young people who migrate away from their hometowns. Table 1 indicates that community bankers plan to use the technology to increase the menu of services that they offer their customers. Community banks may be able to use the Internet to reduce unit costs of delivering many services while continuing to provide the

TABLE 1

FROM CASH TO CLICKS		
PERCENTAGE OF COMMUNITY BANKS WITH INTERNET BANKING SERVICES THAT OFFER THE FOLLOWING FEATURES TODAY AND PLAN TO OFFER THEM IN THREE YEARS		
	OFFER TODAY	PLAN TO OFFER IN THREE YEARS
TRACK ACCOUNT BALANCES	65	91
TRANSFER FUNDS AMONG ACCOUNTS	63	89
BILL PAYMENT	49	81
E-MAIL-BASED CUSTOMER SERVICE	35	58
CASH MANAGEMENT AND OTHER SMALL BUSINESS SERVICES	32	65
PERSON-TO-PERSON ELECTRONIC PAYMENTS	26	54
LOAN APPLICATIONS	21	70
NEW DEMAND DEPOSIT ACCOUNT APPLICATIONS	18	61
NEW CDs, IRAs, ETC.	17	59
BILL PRESENTMENT	16	54
BUSINESS-TO-CUSTOMER PORTAL FOR NONBANK PRODUCTS	11	39
E-MORTGAGES	9	37
BROKERAGE TRADES	9	33
BUSINESS-TO-BUSINESS PORTAL FOR NONBANK PRODUCTS	5	28
SELL INSURANCE	5	27
AGGREGATION SERVICES	4	37

NOTES: CD = CERTIFICATE OF DEPOSIT, IRA = INDIVIDUAL RETIREMENT ACCOUNT
SOURCE: GRANT THORNTON. NINTH ANNUAL SURVEY OF COMMUNITY BANK EXECUTIVES. MARCH 2002.

²² Grant Thornton. March 2002. *Ninth Annual Survey of Community Bank Executives*. March 2002.

²³ FDIC Bank Technology Group. 2001. Report on Internet Banking Experiences Interviews.

personalized attention to many of their customers that is their comparative advantage over larger institutions.²⁴

Many early proponents of Internet technology for smaller banks argued that the Internet could “level the playing field” between large banks and community banks by enabling the smaller players to reach more customers and remain competitive with the services they offer. However, some observers, including a leading European banker, hold a contrary view:

Technology is an even greater source of opportunity for the large banks, which already have an immense client base and brand image the new competitors do not possess and could take years to acquire. [From an operational and cost perspective, of course,] e-business is a volume, not margins business, and volume is determined by the number of clients. The Internet is a classic example of a technology that is ideally suited to mass market applications. Firms applying this technology that already have a wide client base can win an almost unassailable competitive advantage. So technology, far from representing a threat to the leading banks, is an instrument that, if exploited well, can boost their efficiency and competitiveness [sic] even more.²⁵

According to this line of argument, the Internet will allow the largest banks to deliver commoditized services over a wider area without incurring the costs of building branches.²⁶

If this line of thinking is correct, it could have significant implications in the Kansas City Region, where geographic isolation protects many community banks from competition by large banks. Table 2 provides some striking evidence of the phenomenon.

According to the FDIC’s Summary of Deposits data, only 8.1 percent of the branches in counties nonadjacent to urban areas belong to large banks with more than \$10 billion in assets. Large banks have not found it economically prudent to acquire or build branches in the most rural areas, so the community banks in these areas have not been subject to competition from them. As is apparent in the bottom half of the table, the relative

presence of large bank branches declines substantially as counties become more rural.

But the development of Internet methods may allow the largest banks to pursue a “less than a branch” strategy in rural areas. Some large insurance companies that acquired bank charters are using a combination of local insurance agents and Internet technology to provide banking services in some of the nation’s most rural areas. As more rural customers become conversant with using the Internet for commercial transactions, large banks may have increasing opportunities to gain business in rural areas.

The results of a 2002 Grant Thornton survey provide some evidence of how community bankers currently perceive their competition.²⁷ (See Table 3.)

The community bankers surveyed consider other community banks their most significant competition. The decline from 2001 to 2002 in the perceived threat from Internet-only banks reflects the lack of success of that business model. In 2000, many industry observers argued that Internet-only banks would quickly render the bricks and mortar versions obsolete; however, a consensus has evolved that the Internet is an additional, rather than an alternative, distribution channel and that “bricks and clicks”—a combination of traditional methods and the Internet—will be the preferred method of delivering services in the foreseeable future. In this evolving competitive environment, rural banks will be challenged to assess their strengths, identify competitive advantages, and carefully assess how advances in communications technology will affect the competitive landscape.

Conclusion

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 who can now more easily reach into the rural community, perhaps providing more services more cheaply than rural businesses can. Rural banks may find the Internet to be a similarly mixed blessing: while many may use the Internet to improve operational efficiency and extend market reach, the technology also may provide a means for large banks and other financial services providers to compete more aggressively in rural areas.

²⁴ DeYoung, Robert, and William C. Hunter. 2002. *Deregulation, the Internet and the Competitive Viability of Large Banks and Community Banks*. Federal Reserve Bank of Chicago working paper, 15.

²⁵ Corcostegui, Angel, chief executive of Banco Santander Central Hispano. 2000. Quoted in *The Future of Banking*. Ed. Henry Engler and James Essinger. London. Reuters, 29.

²⁶ DeYoung and Hunter. 15.

²⁷ Grant Thornton.

TABLE 2

COMPETITION FROM LARGE BANKS DECLINES AS COUNTIES BECOME MORE RURAL				
COUNTY TYPE (ENTIRE NATION)	COUNTIES	TOTAL BRANCHES	LBBs	% OF BRANCHES THAT ARE LBBs
METROPOLITAN	836	60,955	30,151	49.5
RURAL ADJACENT	1,001	12,429	2,746	22.1
RURAL NONADJACENT	1,303	11,511	1,970	17.1
REGION TOTALS	3,140	84,895	34,867	41.1
<i>RURAL NONADJACENT BREAKOUT</i>				
URBAN POPULATION OVER 20,000	114	2,746	727	26.5
URBAN POPULATION 2,500-20,000	656	6,572	1,066	16.2
URBAN POPULATION UNDER 2,500	533	2,193	177	8.1
	1,303	11,511	1,970	17.1

NOTES: LBB = LARGE BANK BRANCH; LBBs ARE BRANCHES OF FDIC-INSURED INSTITUTIONS WITH OVER \$10 BILLION IN ASSETS.
RURAL ADJACENT COUNTIES ARE RURAL COUNTIES THAT ARE ADJACENT TO A METROPOLITAN COUNTY.
RURAL NONADJACENT COUNTIES ARE RURAL COUNTIES THAT ARE NOT ADJACENT TO A METROPOLITAN COUNTY.
SOURCE: FDIC SUMMARY OF DEPOSITS; BANK AND THRIFT CALL REPORTS; USDA (FOR COUNTY CODES)

TABLE 3

SOURCES OF COMPETITION			
PERCENTAGE OF COMMUNITY BANKS THAT SAY THE FOLLOWING SOURCES OF COMPETITION ARE A MAJOR CONCERN			
	2002	2001	2000
OTHER COMMUNITY BANKS	70	57	66
CREDIT UNIONS	63	63	60
BROKERAGE FIRMS	56	66	65
REGIONAL OR MEGA-BANKS	47	45	47
MORTGAGE COMPANIES	42	36	45
MUTUAL FUND COMPANIES	37	49	51
FARM CREDIT BANKS	23	17	22
INSURANCE COMPANIES	21	31	*
GOVERNMENT-SPONSORED ENTITIES (E.G., FREDDIE MAC, FANNIE MAE, FHLB)	18	16	
FINANCE COMPANIES	8	7	32
INTERNET BANKS (E.G., NETBANK, ETRADE BANK)	19	30	*
INTERNET PORTAL SITES (E.G., YAHOO, MSNBC)	13	22	*
U.S. POSTAL SERVICE (E.G., EBILLPAY)	11	13	*
TELECOM COMPANIES (VIA PURCHASES ADDED TO TELEPHONE BILL)	6	10	*
OTHER NONFINANCIAL COMPANIES (E.G., MOBIL SPEED PASS, FREQUENT SHOPPER/FREQUENT FLYER PROGRAMS, WAREHOUSE/DISCOUNT STORES)	6	10	*

* QUESTION NOT ASKED IN 2000
SOURCE: GRANT THORNTON. NINTH ANNUAL SURVEY OF COMMUNITY BANK EXECUTIVES. MARCH 2002.

Jeffrey Walser
Regional Economist

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

Introduction

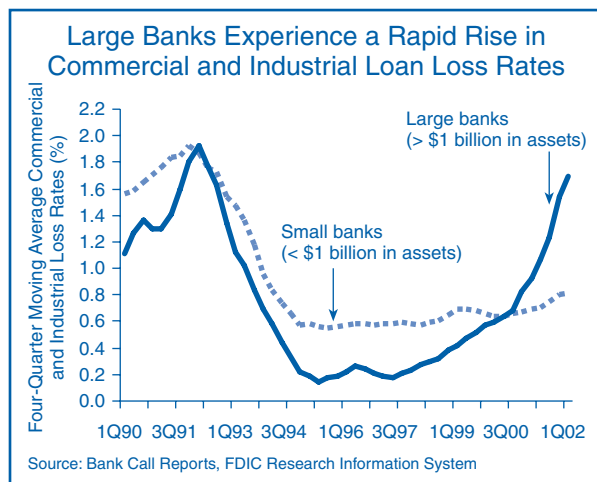
The banking industry as a whole has performed well in recent years, despite increasing loan delinquencies, notably in commercial credits. Although the extent of commercial loan deterioration has not reached levels experienced in the early 1990s, it nonetheless warrants scrutiny. With a variety of economic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

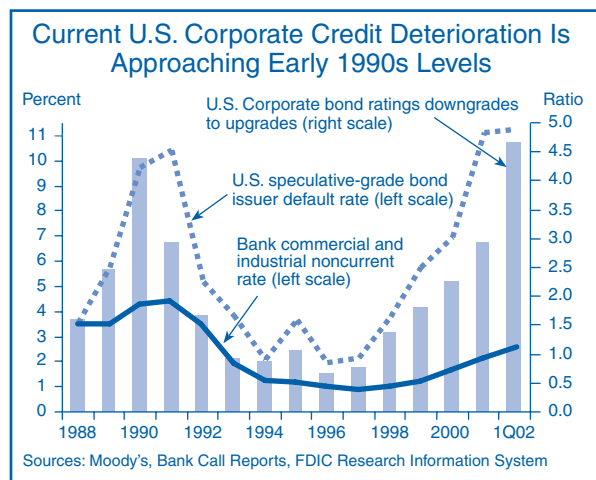
While the U.S. economy is showing signs of recovery and underwriting standards have tightened, corporate credit quality could continue to be affected by several adverse trends. The number of bankruptcies filed by public companies this year is on pace to challenge the record set in 2001.⁴ Furthermore, 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

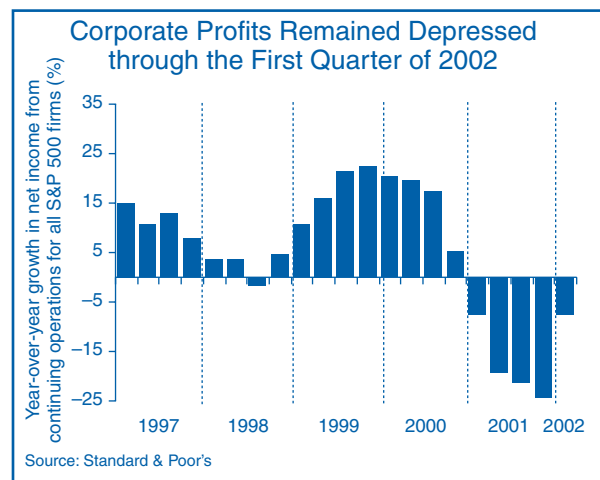
CHART 2



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.

CHART 3



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

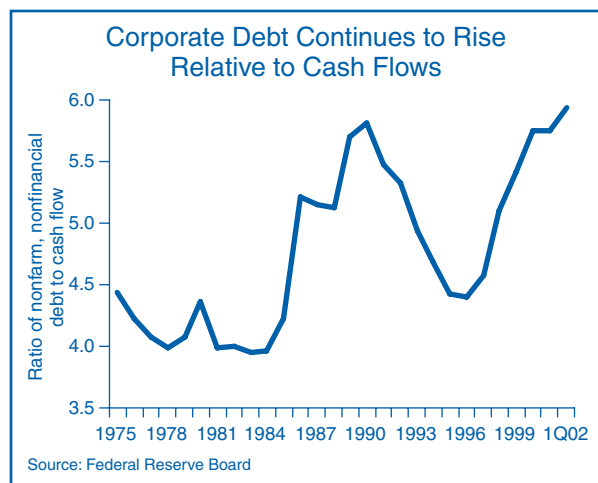
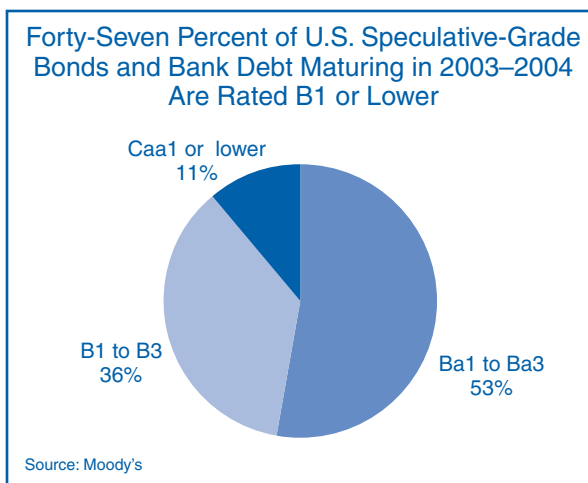


CHART 5



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.

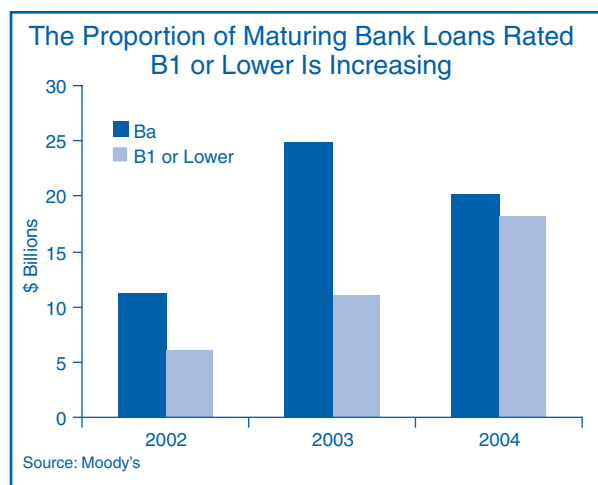
¹¹ Speculative-grade debt ratings assigned by Moody's in the order of declining credit quality are as follows: Ba, B, Caa, Ca, and C. Moody's also applies numerical modifiers 1, 2, and 3 in each generic rating classification. The modifier 1 indicates that the obligation ranks in the higher end of its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

CHART 6



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

TABLE 1

AVERAGE SPECULATIVE-GRADE RECOVERY RATES IN 2001 SHOW A DECLINING TREND IN NEARLY ALL LEVELS OF SECURITY AND SUBORDINATION		
SENIORITY/SECURITY	AVERAGE RECOVERY PER \$100	
	1982-2000	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

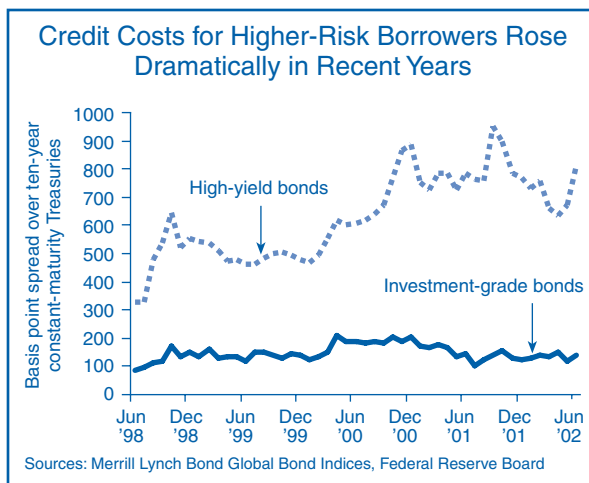
NOTE: NA=NOT AVAILABLE
SOURCE: MOODY'S

subordination except for senior secured bonds (see Table 1).

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



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 Exposure¹⁴

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-

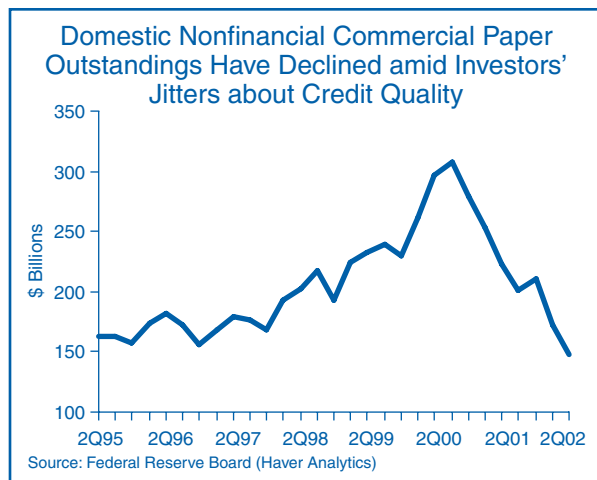
¹³ Commercial paper is short-term promissory notes issued by large firms, generally maturing in nine months or less. It is an important source of short-term funding for corporations that need a steady stream of working capital.

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.

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-

¹⁷Bloomberg Fair Market Sector Curves, July 5, 2002. The spread between 60-day and five-year Treasury instruments was nearly 300 basis points.

¹⁸ Once the back-up line has been drawn down, the borrower again has to repay or roll over the debt. A revolving facility can be "termed out" so that it becomes an installment loan with a much longer maturity, such as three to five years. Such an option, however, can be costly.

ing term-out options even at a fee of 200 basis points. The higher premiums demanded reflect both the volatility in the market and deteriorating credit quality indicated by high default rates and rating downgrades in recent quarters.

Conclusion

During the boom times of the late 1990s, corporations enjoyed an abundance of liquidity sources and easy access to capital. Many corporations used debt to finance business expansions, and rolling over maturing debt was not a significant concern. Recently, however, stock prices have been declining and investors have been concerned about the possibility of more corporate financial restatements. In this environment, highly

leveraged borrowers worry about maturing debts and refunding risk implications. Lenders are demanding higher spreads because of the volatile financial markets and the deteriorated financial condition and debt ratings of many borrowers. In general, firms seeking to roll over maturing debt clearly face a less hospitable financing market today. With corporate profitability not yet strong, highly leveraged companies may find it increasingly difficult to meet debt service requirements and loan covenants. Despite these hurdles, the economy appears to be improving, and more companies are beginning to report higher earnings. With an economic recovery and tighter underwriting standards, the deterioration in commercial credit quality should stabilize and turn around.

Cecilia Lee Barry, Senior Financial Analyst

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