JANUARY, 2002 NUMBER 02-01

FDIC DIVISION OF INSURANCE

Bank Trends Analysis of Emerging Risks In Banking

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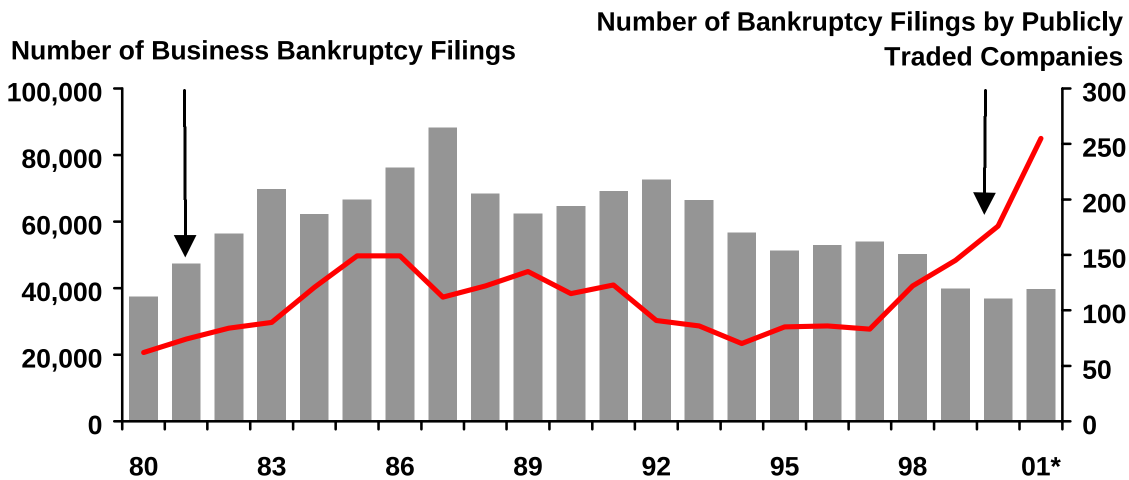
Large and Small Companies Exhibit Diverging Bankruptcy Trends

Publicly traded companies filed for bankruptcy at a record pace in 2001. This trend reflects a more challenging economic environment but nevertheless stands in contrast to overall business bankruptcy trends. Profits at large companies have declined while leverage has increased, and losses from large credits have risen at insured institutions. Now the question is the degree to which credit losses may spread from large company credits to small company credits and consumers and what effect this may have at insured institutions that rely on such lending as a source of income.

Chart 1

Publicly Traded Companies Are Filing for Bankruptcy in Record Numbers While Overall Business Bankruptcy Filings Have Declined



*Note: The number of business bankruptcies in 2001 is an annualized figure based on quarterly filings through the third quarter. The number of filings by publicly traded companies in 2001 reflects totals through year-end.

Source: Administrative Office of the U.S. Courts (Haver Analytics); BankruptcyData.com

Large and Small Companies Exhibit Diverging Bankruptcy Trends

Publicly Traded Companies File a Record Number of Bankruptcies

The number of bankruptcy filings by publicly traded companies has risen sharply since 1997. A record 257 publicly traded companies filed for bankruptcy in 2001, representing a 46 percent increase over the prior year's record of 176 filings (see Chart 1).[1] These companies brought some $258.5 billion in assets into bankruptcy, more than double the assets of public company bankruptcy filings in 2000. In all, 45 companies with assets greater than $1 billion filed for Chapter 11 bankruptcy protection in 2001, more than double the prior year's record of 21 filings. These data include Enron's recent bankruptcy filing, the largest filing in history at $63 billion.

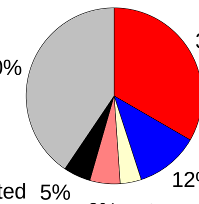
Bankruptcies among publicly traded companies began to run counter to the trend of declining business bankruptcies around 1997. Chart 1 indicates that total business bankruptcy filings after the 1990—1991 recession peaked at 72,650 in 1992 and fell to a cyclical low of 36,910 in 2000. The annualized filing rate based on data through the third quarter of 2001 indicates that business bankruptcy filings in 2001 should rise slightly to nearly 40,000, which would still remain far below historic highs reached during the 1980s.

Analysts at ***BankruptcyData.com*** indicate that, aside from a concentration in the telecom industry, the number of bankruptcy filings by publicly traded companies was distributed fairly evenly across industry sectors in 2001. The telecom industry accounted for 36 of the 257 filings, or 14 percent. The remainder came mainly from firms in the manufacturing sector and other "old economy" firms that are highly leveraged.[2] Examples of

Chart 2

Public Company Assets Entering Bankruptcy in 2001 Have Been Concentrated in Industries Related to Energy, Telecommunications, and Technology

Percentage of Publicly Traded Company Assets Entering Bankruptcy in 2001, by Industry*



*A total of $258.5 billion in public company assets entered bankruptcy in 2001.

Source: BankruptcyData.com

recent filings include familiar companies such as AMF Bowling, Burlington Industries, Converse, Polaroid, and Sunbeam.

Although the number of filings by publicly traded companies was distributed fairly evenly across industries, the assets entering bankruptcy by industry tended to be more concentrated. According to ***BankrupctyData.com***, 33 percent of public company assets entering bankruptcy in 2001 were related to the energy sector, driven mainly by the recent bankruptcy filing by Enron (see Chart 2). Twelve percent of the assets were related to telecommunications firms and Internet service providers. One reason for such large industry concentrations is the predominance of very large firms among recent bankruptcies. In fact, 5 of the top 15 largest recorded filings came during 2001 alone.

Why Have Public Companies Experienced More Problems?

A number of plausible arguments can be made to help explain why recent financial difficulties have been concentrated among larger corporate entities. Profits at firms in the S&P 500, which is dominated by large corporations, fell dramatically in 2001,

[1] Data on publicly traded bankruptcy filings provided by **BankruptcyData.com**.

[2] For more specific information about industry sectors under stress, see the Division of Insurance at http://fdic01/division/doi/RiskTopic/iIND.html.

posting a 49 percent decline in the third quarter of 2001 from the prior year. Overall corporate profits dropped by 22 percent over the same period. This comparison suggests that recent financial performance has tended to be worse at large companies than at small companies, an observation that is generally consistent with the bankruptcy trends reported here.

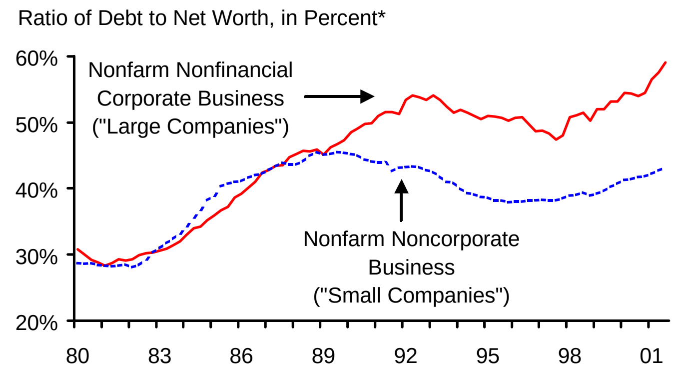
While an economic downturn in the U.S. affects firms of all sizes, economic weakness in overseas markets can particularly hurt revenues at large U.S. companies that export goods abroad and compete with imported goods in the U.S. market. The real value of exported goods fell by nearly 12 percent from the third quarter of 2000 to the third quarter of 2001 as the effects of the global recession spread wider and foreign demand for U.S. produced goods diminished.

Exposure to exchange rate volatility could also be a contributing factor that predates the current recession. The real trade-weighted value of the U.S. dollar against major currencies rose by more than 35 percent from January 1995 through December 2001. A rising value of the dollar makes U.S. goods more expensive overseas and imported goods less expensive at home, squeezing both foreign and domestic revenues. This is particularly true for manufacturing firms that tend to produce commodity goods that face intense competition on the global market. A rising value of the dollar also lowers the exchange value of income that is repatriated from foreign branches or subsidiaries of U.S. multinational companies if these cash flows are not hedged against exchange rate risk.

It is widely accepted that financial leverage has played a significant role in precipitating the financial difficulties of some large firms. The debt burden of nonfarm nonfinancial corporate entities (hereafter "corporate entities") appears to have risen much more than that of nonfarm noncorporate entities (hereafter "noncorporate entities") since the late 1980s. If corporate entities typically represent a larger class of firms than noncorporate entities, then this distinction can be used as a proxy to compare the characteristics of large companies with those of small companies. Throughout most of the 1980s, the ratio of debt to net worth of corporate and noncorporate entities rose approximately in

Chart 3

The Debt Burden at Large Companies Appears to Have Risen Higher and Faster than at Small Companies Since the Late 1980s



*Net worth is stated at its estimated market value.

Source: Federal Reserve Board *Flow of Funds* (Haver Analytics)

tandem. In 1989, however, the ratio of debt to net worth of corporate entities began to rise faster and higher than that of noncorporate entities (see Chart 3). From the first quarter of 1989 to the third quarter of 2001, the ratio of debt to net worth of corporate entities rose from 45 percent to 59 percent. Over the same period, the ratio of debt to net worth of noncorporate entities fell from 45 percent to 43 percent.[3] Nevertheless, it appears that the debt burden of both corporate and noncorporate entities has been trending upward since 1997.

Easy access to the capital markets has proved to be a two-edged sword for some large corporations and may be an important factor in explaining why large companies have experienced higher growth in leverage and bankruptcy rates. During the bull market of the 1990s, large corporations with access to the capital markets could rely on rising equity values to fund investments and justify taking on greater debt. Growth in credit market debt outstanding at corporate entities has generally outpaced growth at noncorporate entities since the late 1980s (see Chart 4, next page). The increase in leverage has been used, in part, to fuel investments in cost-cutting technologies to remain competitive and to fund record-breaking merger and acquisition activity in a variety of industries.[4] In some cases,

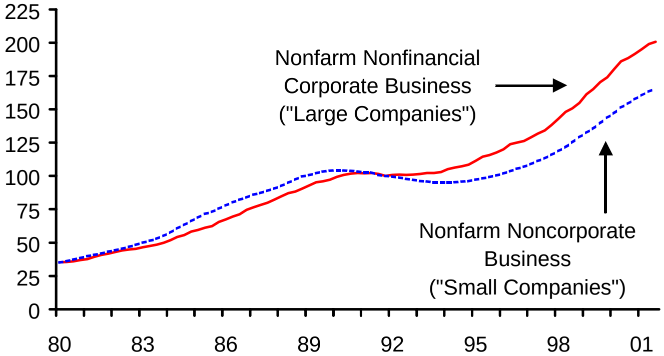
[3] Federal Reserve Board. Net worth is stated at its estimated market value.

[4] According to **Houlihan Lokey's Mergerstat**, the highest dollar volume of merger and acquisition activity on record occurred in the years from 1998 to 2000. The

Chart 4

Debt Outstanding Has Grown Faster at Large Companies than at Small Companies Since the Late 1980s

Index of Credit Market Debt Outstanding (1991:Q4 = 100)



Source: Federal Reserve Board *Flow of Funds* (Haver Analytics)

the increase in leverage may have been used to fund higher risk investments with the potential for a greater return, but also for higher losses.

As equity values fall, however, the ability to refinance debt and restructure deals is impaired, which can lead to liquidity and debt problems. Smaller firms, in contrast, appear to have relied more heavily on bank borrowing during the past expansion, because it is more expensive for those firms to access the public debt and equity markets. The ***1998 Survey of Small Business Finances*** from the ***Federal Reserve Board*** noted that small businesses continue to rely on commercial banks as a prime source of financing. Thus, small firms may be less susceptible to falling from favor in the capital markets.

Other Credit Indicators Mirror Bankruptcy Trends

As the economy has slowed, stress in the corporate sector has been reflected in other indicators as well. ***Standard & Poor's (S&P)*** reports that 211 bond issuers defaulted on $115.4 billion in debt in 2001, posting the highest default volume on record, both in terms of the dollar volume and number of defaults.[5] The distribution of defaults was weighted heavily toward speculative-grade issuers. Some 0.27 percent of investment-grade issuers defaulted in 2001, compared with 8.6 percent of speculative-grade issuers. ***S&P*** noted that the issuer default volume was dominated by companies in the telecom sector, while large companies such as Southern California Edison and Pacific Gas & Electric dominated the dollar default volume.

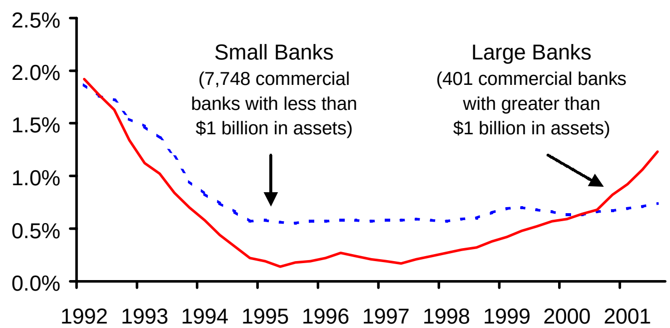
The credit ratings of corporate bond issuers have suffered as default rates have risen, particularly for speculative-grade issuers. In 2001, there were 3.6 times as many downgrades as upgrades among speculative-grade issuers rated by ***Moody's Investors Service***, while downgrades outnumbered upgrades 2.3 to 1 among investment-grade issuers. Moody's attributed the decline in corporate credit quality to the recent slump in revenues, increased debt burdens, and negative shocks such as the September 11 terrorist attacks.[6] It is noteworthy that, although downgrades have exceeded upgrades for 15 consecutive quarters, the recent decline in credit quality is not yet as severe as the decline that occurred during the late 1980s and early 1990s.

Bank Call Report data reflect that financial trouble has appeared more quickly in credits to larger firms. During the 1991—2001 expansion, the charge-off

Chart 5

C&I Loan Loss Rates Are Rising Faster at Larger Banks than at Smaller Banks

Four Quarter Moving Average C&I Charge-off Rate



Note: C&I = commercial and industrial

Source: FDIC Bank Call Reports (Research Information System); adapted from the FDIC *Quarterly Banking Profile*

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dollar volume of activity in 2001 fell close to levels reached in 1997.

5 Standard & Poor's. "Record Corporate Defaults in 2001; Improvement Seen by Year's End." January 14, 2001. (http://www.standardandpoors.com/ProductsAndServices/RiskManagementSolutions/ResearchAndRiskManagement/Articles/011402_corpdefault.html)

6 Moody's Investors Service. "U.S. Corporate Rating Downgrades Exceed Upgrades in 2001; Worst Fall Since 1991." *Moody's Credit Perspectives*, Volume 5, Number 2, January 14, 2002.

rate on commercial and industrial (C&I) loan portfolios at large commercial banks fell more quickly than at small commercial banks and remained lower until late in the expansion (see Chart 5, prior page). Since the second quarter of 2000, however, large banks have experienced higher and more rapidly rising loss rates on C&I loans. In contrast, the loss rate at small banks has remained relatively flat since 1995. Nevertheless, the loss rate on C&I loans has ticked up slightly at small banks in recent quarters, rising for five consecutive quarters through the third quarter of 2001.

Conclusion

The current recession has been largely precipitated by problems in the corporate sector. While consumers have continued to support the economy through healthy spending on durable goods such as furniture and automobiles, slumping corporate profits and rising credit problems have curtailed business investment and led the economic slowdown.

It appears that credit quality will remain a key issue for insured institutions in 2002. As the economic recession at home and abroad plays itself out, banks can expect a period of higher loan losses. A key question going forward is the degree to which credit losses may spread from large company credits to small company credits and consumers and what effect this may have at insured institutions that rely on such lending as a source of income. In particular, it remains to be seen how loan portfolios at small banks will perform in this economic environment and whether the sharp rise in losses at large banks will trickle down to small banks as well.

About the Author

Alan Deaton is a Financial Economist in the Economic and Market Trends Section of the Division of Insurance.