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Warning Signs From Increases in Non-Performing Loans

I. INTRODUCTION

Over the past year, many banks have reported large increases in the amount of non-performing loans they hold.[1] These disclosures have sent bank stocks tumbling and raised concerns about future deterioration in credit quality.[2] Increases in non-performing loans are significant, as changes in the levels of these loans send important signals about the future health of both the banking sector and the economy.[3] Deterioration in credit quality can lead to tighter lending standards, which reduces credit and can exacerbate a recession.[4] This Note analyzes the impact and importance of changes in non-performing loans, in particular their predictive value for the future of the banking sector. Further, the Note analyzes the current situation in the banking sector and attempts to give some outlook towards the future of bank credit quality.

The Note first provides background information on the accounting for and monitoring of loans in a bank portfolio.[5] Next, the Note examines the economics behind changes in non-performing loans[6] and the effect on the banking sector and the economy.[7] The Note then reviews the current situation in the banking sector.[8] Finally, the Note provides an analysis of the impact non-performing loans will have on both the economy and the banking sector in 2001.[9]

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1. *See infra* notes 81-105.
2. *Banks in Trouble*, ECONOMIST, Oct. 28, 2000, at 65.
3. *Id.*
4. *Id.*
5. *See infra* notes 10-37 and accompanying text.
6. *See infra* notes 38-47 and accompanying text.
7. *See infra* notes 48-64 and accompanying text.
8. *See infra* notes 64-109 and accompanying text.
9. *See infra* notes 110-138 and accompanying text.

II. BASIC INFORMATION ON NON-PERFORMING LOANS

In order to discuss the trends in loan portfolio quality, it is important to understand the basic terminology, bank classifications, and accounting practices regarding loan portfolios. Both accounting rules and internal ratings criteria play important roles in understanding a bank's loan portfolio.[10]

A. Accounting Treatment

There are four basic terms of bank portfolio accounting. First, "loan-loss reserves" are the total amount that has been set aside by the bank for future charge-offs.[11] Generally accepted accounting principles (GAAP) and regulatory accounting policies (RAP) require a bank's loan-loss reserves to reflect management's best estimate of expected future loan losses.[12] Second, "loan-loss

10. Ethan M. Heisler & Jeffrey Frankel, *Does Your Bank Have Quality Assets?*, SALOMON SMITH BARNEY U.S. CORPORATE BOND RESEARCH, July 2000, at 29 (on file with N.C. Banking Inst.).

11. *Id.*

12. Stephen G. Ryan & Liu Chi-Chun, *Differential Valuation Implication Of Loan Loss Provisions Across Banks And Fiscal Quarters*, 72 ACCOUNTING REVIEW, at 133, 135 (1997). The requirement that loan loss provisions reflect management expectations of future loan losses makes them largely discretionary. *See also The Allowance for Loan and Lease Losses: Hearing Before the Fin. Inst. and Consumer Credit Subcomm. of the Comm. on Banking and Fin. Services*, 105th Cong. (1999) (testimony by Emory W. Rushton, Senior Deputy Comptroller for Bank Supervision Policy) [hereinafter Rushton Testimony]:

> A bank's reserve should represent the best estimate its management can make of how much money the bank will lose on the loans it has made... Periodically, but not less frequently than quarterly, each bank must reassess whether the amount remaining in the reserve is appropriate, given the amount of estimated losses inherent in its remaining loans.

Id. As a side note, the SEC is currently reviewing a proposal by the American Institute of Certified Public Accountants that would require banks to only set up a reserve against potential losses for specific loans that were already in or near default. Robert A. Bennett, *Logical But Dangerous*, 110 U.S. BANKER 8 (Aug. 2000). This proposal is designed to eliminate the ability of banks to "smooth earnings" by managing their loan loss reserve, increasing it during good earnings quarters and letting it run down to offset weaker earnings. *Id.* The SEC argument is that allowing banks to set reserves qualitatively makes it difficult for investors to understand what they are getting when they buy bank stocks. *Id.* Bank regulators and most banks are arguing against the proposal, stating that reserves are meant to be put aside as a cushion against future losses—losses that are somewhat predictable as a percentage

provisions" are increases made to the loan loss reserve.[13] When bank management determines that the bank does not have sufficient loan-loss reserves to protect it against future charge-offs, the loan-loss reserve is increased through a loan-loss provision.[14]

Third, "non-performing loans" are typically loans which have not paid interest in over ninety days or are no longer accruing interest.[15] Both GAAP and RAP give bank managers some discretion in determining when to classify a loan as non-performing.[16] Once a loan is designated as non-performing, a bank may not continue to accrue the interest due on the loan as income.[17] The loan is then accounted for under cash-based accounting principles.[18] Under cash accounting principles, only interest that is collected is recognized as income.[19] Further, a loan may not be reclassified as performing until it has paid interest for a regular period of time, usually a minimum of three cycles.[20]

Finally, a "charge-off" describes a reduction in the loan loss reserve that is made to reflect a loan that is recognized as a loss.[21]

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of a bank's portfolio but are very difficult to predict in advance on an asset by asset basis. *Id.* The banks and bank regulators are concerned that a change of this nature could lead to wildly fluctuating bank earnings, and thus undermine stability in the banking system. *Id.*

13. Heisler & Frankel, *supra* note 10, at 30.

14. *Id.*

15. Fred Furlong & Simon Kwan, *Rising Bank Risk*, 99 FED. RES. BANK S.F. ECONOMIC LETTER, 1 (Oct. 22, 1999). Banks can stop accruing interest on loans "for which payment in full of principal and interest is not expected" or "because of a deterioration in the financial condition of the borrower." Heisler and Frankel, *supra* note 10, at 26 (quoting regulatory report instructions). These allowances give banks flexibility in determining whether to stop accruing income and classify a loan as non-performing. *Id.* In addition, banks can continue accruing interest on a loan more than ninety days past due if "the asset is both well secured and in the process of collection." *Id* at 27. This discretion makes it difficult to compare two banks' portfolio quality unless the analyst has some understanding of the credit culture of each bank. *Id.*

16. Heisler & Frankel, *supra* note 10, at 11. Although rules set ninety days of non-performance as the trigger for classifying a loan as non-performing and using cash accounting, banks may decide to use an earlier deadline. *Id.* at 27.

17. *Id.* at 28.

18. *Id.*

19. *Id.*

20. *Id.* A cycle is a payment period specified for a loan. *Id.* For example, most loans pay interest quarterly. *Id.* Generally, the loan must have some period of normal performance (usually at least three pay cycles) to return the loan to accrual accounting. *Id.*

21. *Id.* at 30.

If a loan is determined to be uncollectable, it is recorded as a loss and charged against the bank's loan loss reserve.[22] Gross charge-offs represent the total amount charged against the reserve in a period, while net charge-offs reflect the recovery of principal for any loans that were previously charged against the reserve.[23] However, it is important to note that recording a loan as a loss does not mean that the loan has no value, as banks will typically recover some portion of the loan amount.[24] Over the last few years, banks have recovered slightly more than twenty-five percent of gross charge-offs, a number that has dropped significantly in the last five years.[25] Although a loan may be charged off directly from current status, most loans are classified as non-performing for some period of time before they are charged off the bank's books as a loss.[26] Thus, changes in the amount of non-performing loans are a good indicator of future bank portfolio credit quality, as increases in the amount of loans classified as non-performing typically will lead to increases in the amount of future charge-offs.[27]

B. *Internal Classifications*

Additionally, banks and bank examiners have a classification system for rating loans.[28] Although classifications can vary, a loan is either rated pass, special mention, substandard,

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22. *Id.*

23. James M. Wahlen, *The Nature of Information in Commercial Bank Loan Loss Disclosures*, 69 ACCT. REV. 455, 455 (1994). Even though a loan is recognized as a loss, and charged off the bank's books, banks still can recover some of the value of the loan through collection of collateral or restructuring. *Id. See also* Heisler & Frankel, *supra* note 10, at 32.

24. Heisler & Frankel, *supra* note 10, at 44. Many troubled loans are restructured, and the lender eventually receives some sort of payment from the borrower. *Id.* In addition, bank loans are typically a senior position in the credit structure and are often secured, so the company's assets can be sold to provide some recovery to lenders. *Id.*

25. *Id.* The average recovery percentage for major U.S. bank holding companies in 1999 was twenty-six percent, down from forty-eight percent in 1994, and thirty-nine percent in 1995. *Id.*

26. *Id.*

27. Wahlen, *supra* note 23, at 457. Changes in non-performing loans are largely non-discretionary items and are expected to lead to lower future cash flows. *Id.*

28. Heisler & Frankel, *supra* note 10, at 32.

doubtful, or loss.[29] A loan is rated as pass if it is considered to be in sound financial condition with no current or expected weaknesses that could threaten its ability to be repaid.[30] A loan rated "special mention" may have some weakness that could lead to a deterioration in the future.[31] A "substandard" loan is one that is judged to be inadequately protected by the borrower and that has a well-defined weakness that jeopardizes the liquidation of the debt.[32] A loan is rated "doubtful" if it is highly questionable and improbable that the loan will be paid back.[33] Finally, a loan is rated as a "loss" when it is no longer considered collectible; therefore, it must be taken off a bank's books.[34]

Loans in the special mention, substandard, doubtful and loss categories are grouped together into a category known as either criticized or adversely rated assets.[35] Further, loans in the

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29. OCC Release 2000-78, Summary of Shared National Credit Program (2000), at 3 [hereinafter 2000 SNC Results].

30. *Id.*

31. Heisler & Frankel, *supra* note 10, at 33. Loans listed for *Special Mention* (also known as "Other assets especially mentioned") are "generally considered to be loans that have potential weaknesses that may, if not checked or corrected, weaken the asset or inadequately protect the bank's credit position at some future date." 2000 SNC Results, *supra* note 29, at 3.

32. 2000 SNC Results, *supra* note 29, at 3.

> *Substandard*—A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Id.

33. *Id.* "*Doubtful*—An asset classified Doubtful has all the weaknesses inherent in those classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable." *Id.*

34. *Id.*

> *Loss*—Assets classified Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off a basically worthless asset even though partial recovery may be effected in the future.

Id.

35. Heisler and Frankel, *supra* note 10, at 33.

last three classifications (substandard, doubtful, and loss) are defined as classified loans.[36] Non-performing loans are typically part of the classified group, with total criticized assets historically exceeding non-performing assets by approximately three times.[37]

III. ECONOMICS OF NON-PERFORMING LOANS

A. *Causes*

Increases in non-performing loans can be the result of a variety of factors. Rising interest rates make it difficult for some borrowers to repay their debts, as incoming cash flows are no longer enough to cover rising debt payments.[38] Additionally, an economic slowdown or an industry specific downturn can make it difficult for companies and individuals to repay their obligations.[39] Today, a more relevant problem is looser credit standards, which are a significant contributor to deterioration in asset quality.[40] As banks relax their lending standards, they make loans that are less likely to be repaid.[41]

Looser credit standards are often caused by increased competition in the lending business and by strong periods of

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36. *Id.*

37. *Id.*

38. Andy Gotlieb, *Non Performing Loans On The Rise,* PHILA. BUS. J., Aug. 11, 2000, at 1.

39. Michael Braga, *Bad Loans Sour Banks' Portfolios,* TAMPA BAY BUS. J., Dec. 1, 1995, at 1. "Among the domestic and foreign respondents that tightened standards or terms on C&I loans, a sizable majority of both pointed to a less favorable or more uncertain economic outlook as an important reason. In addition, about three-quarters of the foreign banks noted a worsening of industry-specific problems." *August 2000 Senior Loan Officer Opinion Survey on Bank Lending Practices,* Board of Governors of the Federal Reserve (Aug. 2000), *at* http://www.federalreserve.gov/boarddocs/SnLoanSurvey/20008/default.htm (last visited Mar. 3, 2001) [hereinafter *August 2000 Survey*].

40. Barbara Pinckney, *Banks Must Guard Against Loose Lending In Competitive Market,* CAP. DISTRICT BUS. REV., May 3, 1999, at 19 (quoting Julie L. Williams, Remarks before the Federal Financial Institutions Examination Council (Oct. 16, 1998), *at* http://www.occ.treas.gov/ftp/release/98-104.wpw) (last visited Mar. 3, 2001) [hereinafter Williams 1998 Remarks]. Williams warned lenders that underwriting standards have been slipping for the past few years. *Id.*

41. *Beneath That Healthy Exterior,* ECONOMIST, July 29, 2000, at 45.

economic growth.[42] As banks face more competition for loans, they face pressures to lower prices and make loan covenants more appealing to borrowers.[43] Further, during periods of strong economic growth, potential borrowers generate cash flows and growth rates that may not be sustainable during slower economic periods.[44] These borrowers may be subjected to less stringent stress testing and credit analysis than that used during more difficult economic times.[45] Recently, the increased use of the capital markets by corporations has left banks fighting over less desirable loan prospects.[46] In addition, market pressures for revenue and income growth often result in banks increasing their overall risk profile in order to increase the size of their loan portfolio.[47]

B. *Effects on the Banking Sector and Economy*

Increases in the amount of non-performing loans can have significant effects on bank performance as well as larger impacts on the economy.[48] First, increases in non-performing loans usually spell trouble for future bank earnings.[49] Non-performing loans

42. Pinckney, *supra* note 40, at 19 (discussing the reasons for increased competition in the commercial lending market). Bank lending grew at a far greater pace than GDP in 1998 and 1999, suggesting that banks were taking on more risk in their portfolios "in order to generate the fifteen percent or so in earnings-per-share growth that investors demand". *Beneath That Healthy Exterior, supra* note 41, at 46.

43. *Survey of Credit Underwriting Practices 2000*, Office of the Comptroller of the Currency, (Washington, D.C.), Sept. 2000, at 8 [hereinafter Credit Practice 2000]. Banks have two main ways to improve their competitiveness for loans: improve (reduce) their price and/or relax their covenants. *Id.*

44. Pinckney, *supra* note 40, at 20.

45. *Id.* Stress testing involves analyzing a borrower's ability to repay a loan under different economic and/or business circumstances (higher interest rate environments, lower revenue and earnings growth, slowing economic conditions, etc.) in order to determine whether the loan will be repaid under less favorable scenarios. Stephen H. Penman, FINANCIAL STATEMENT ANALYSIS & SECURITY VALUATION 473 (McGraw-Hill Irwin 2001).

46. *Beneath That Healthy Exterior, supra* note 41, at 47.

47. *Id.*

48. Pinckney, *supra* note 40, at 19 (quoting a speech by OCC Chief Counsel Julie Williams). Ms. Williams stated "the strength of our economy does not depend upon bankers making bad loans. In fact, poorly underwritten loans are one of the best ways that I know of to weaken financial institutions and the communities that depend upon them". *Id. See also* Williams Remarks 1998, *supra* note 40.

49. Gotlieb, *supra* note 38, at 2.

have multiple effects on bank earnings.[50] First, banks lose income from non-performing loans, and this loss directly impacts the bottom line.[51] The more loans that are non-performing in a bank's portfolio, the fewer loans that are accruing income.[52] This decrease in loan income typically results in depressed earnings and poorer bank performance.[53] In addition, as loans classified as non-performing do not recover, banks may be forced to write off the loans as actual losses.[54] Finally, banks typically tighten their lending standards in response to credit quality concerns and make fewer loans.[55] This tightening of lending standards impacts their ability to continue to grow revenues and earnings.[56] Further, increases in non-performing loans have the potential to cause a deterioration in bank asset quality, which can lead to increased bank failures in extreme cases.[57]

In addition to the effect on banks' individual and collective performance, increases in non-performing loans have a significant impact on the economy.[58] When banks have problems in their portfolio, they must tighten their underwriting standards and decrease their lending until the problems are worked out.[59] Thus, access to credit is reduced for both businesses and individuals, resulting in lower investment and spending; consequently, the

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50. *See Beneath That Healthy Exterior*, *supra* note 41. *See also* Heisler & Frankel, *supra* note 10, at 22.

51. *Beneath That Healthy Exterior*, *supra* note 41.

52. *Id.*

53. *Id.* *See also* Heisler & Frankel, *supra* note 10, at 22. Foregone interest at twenty-five major U.S. bank holding companies in 1999 totaled over $1.1 billion dollars, which equaled approximately 0.6% of gross interest income. *Id.*

54. Heisler & Frankel, *supra* note 10, at 22. Banks have typically averaged about twenty-five percent recovery rates the last several years. *Id.*

55. Pinckney, *supra* note 40, at 19.

56. *Id.*

57. Rushton testimony, *supra* note 12, at 1: "Loan losses that exhausted a bank's reserve, and ultimately wiped out equity capital, have been the primary cause of almost all bank failures." *See also* Bennnett, *supra* note 12, at 8 (discussing New York's mutual savings banks and reserve policy in the 1970's). During the mid-70's, banks were "flush with reserves" and pressure was placed on them to reduce reserves; however, when times worsened, many of the thrifts were driven out of business and only those with significant reserves survived. *Id.*

58. *See* Pinckney, *supra* note 40, at 20 (looking at bank lending in the first half of the 1990's). Banks tightened lending standards to clean up deteriorating credit concerns, worsening the economic recession. *Id.*

59. *Id.*

economy experiences slower growth.[60] In a worst-case scenario, a "credit-crunch" is created, resulting in a severe slowdown in business activity.[61] In addition, since increases in non-performing loans are often the result of business troubles on the part of the borrower, non-performing loans are often indicative of future economic slowdowns.[62] Increases in non-performing loans are often viewed as a recessionary signal.[63] This is partly the result of decreased lending due to tighter credit standards and partly the result of weaker performance in the business sector that causes the initial increase in non-performing loans.[64]

IV. CURENT SITUATION

A. *Trends*

According to national lending surveys, over the past several years banks have eased their lending standards.[65] Recently, this

60. *Id.*

61. Antonio Fins, *Souring Loan Portfolios Bode Ill for Economy*, S. FLA. SUN-SENTINEL, Dec. 19, 2000. A severe tightening of lending standards by financial institutions is viewed by many economists as a significant factor in worsening the 1990-1991 recession. *Id. See also* Jim Gallagher, *Banks are Starting to Worry About Bad Loans Now That The Economy Is Slowing*, ST. LOUIS POST-DISPATCH, Dec. 17, 2000, H1 (highlighting concerns that banks may decrease lending too much and worsen the current economic situation). In a speech on December 5, 2000, Federal Reserve Chairman Alan Greenspan stated that "[b]oth bankers and their supervisors should now guard against allowing the pendulum to swing too far the other way by adopting policy stances the cut off credit to borrowers with credible prospects." *Id.*

62. *See* Gotlieb, *supra* note 38, at 2. Levels of non-performing loans often begin to rise several quarters before the economy is in recession, as companies in certain segments of the economy first begin to feel the pinch of a slowdown. *Id.*

63. *Id.*

64. *Id.* Due to delays in collecting macroeconomic data, banks may be aware of credit quality issues in their portfolios before conclusive evidence of a recession exists. *Id.*

65. Pinckney, *supra* note 40, at 19. *See also* Credit Practices 2000, *supra* note 43, at 8. *See also August 2000 Survey*, *supra* note 39. Both surveys showed some tightening of credit standards in the most recent period, after several years of easing. *See also* Julie L. Williams, Remarks before the Robert Morris Associates Lending and Risk Management Conference (Oct. 5, 1999), *at* http://www.occ.treas.gov/ftp/release/99-90a.doc (last visited Mar. 3, 2001) [hereinafter Williams Remarks 1999] (commenting on tightening standards for commercial loans for the first time in five years.) "Easing continues in some important loan markets. And today's improvements cannot mitigate the overhand of credit risk created by weaker

trend has slowed and reversed to some extent.[66] In the most recent Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices, banks reported tightening their lending standards.[67] However, the results of these recently eased standards coupled with a slowing economy have begun to catch up with many banks.[68]

In addition, growth in syndicated lending has impacted the amount of non-performing loans in bank portfolios.[69] Syndicated lending has also resulted in larger loans that are spread across multiple banks.[70] Although most banks claim they utilize the same credit analysis and underwriting procedures for syndicated loans as other loans, regulators and some bank analysts have criticized banks for participating in syndicated loans led by another bank without putting the loan through as rigorous an underwriting and credit review process.[71] Therefore, the increased number and dollar volume cause concern for regulators and bank analysts, who contend that poor underwriting in syndicated loans makes credit problems more expansive.[72]

Another trend that causes concern among analysts and regulators is the rise of committed lines of credit for customers.[73]

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standards used in previous years." *Id.*

66. *See August 2000 Survey*, *supra* note 39.

67. *Id.*

68. Chris Serres, *Bad Loans a Growing Problem for Banks*, NEWS & OBSERVER, (Raleigh, N.C.) Oct. 1, 2000 at E1 (highlighting recent disclosures of problem loans at Southeastern banks). *See also* Sara Lacy, *Danger Signs Put Focus on Asset Quality*, MEMPHIS BUS. J., July 16, 1999, at 1. *See also* Laura Mandaro, *Loan, Fee Results Can't Erase Credit Concerns*, AM. BANKER, July 19, 2000, at 1 (highlighting quarterly earnings announcements from several banks and noting the increasing problems with credit quality apparent in many banks announcements). Most of today's non-performing loans were made two or three years ago, when loan covenant requirements were weaker. John Hintze, *Increase in Problem Loans Could Impact Banks*, BANK LOAN REP., Dec. 4, 2000.

69. *Banks in Trouble*, *supra* note 2, at 66. A loan syndication involves two or more lenders who make a loan to a borrower under a common loan agreement. Megan Jones, *Bankers Beware: The Risks of Syndicated Credits*, 3 N.C. BANKING INST. 169, 173 (1999). Typically, one member of the loan syndicate, who is known as the lead arranger or book runner of the transaction, will bear the primary responsibility for structuring and pricing the loan. *Id.*

70. Serres, *supra* note 66, at E1.

71. *Id.*

72. *Id.*

73. *The Extraordinary Edginess Of The Crowds*, ECONOMIST, Jan. 13, 2001, at 72. A committed line of credit is an agreement by a bank to loan money to a client in the

Banks often use these lines of credit to help win mandates in competitive situations.[74] At the end of the third quarter, unused loan commitments were a record $4.3 trillion, half a billion dollars more than the $3.8 trillion of total outstanding loans.[75] Lines of credit expose banks to the risk that a struggling firm, unable to borrow money in the markets, will draw down their lines of credit, thereby increasing the bank's exposure to these struggling companies.[76]

Finally, an increase in leveraged lending is another trend that concerns bank analysts and regulators.[77] Leveraged lending has increased markedly at many banks over the last several years.[78] Because of the higher debt-to-equity ratio and lower relative cash flows of leveraged borrowers, leveraged loans are considered riskier and have higher rates of default than investment grade credits.[79] In a speech before the Lending and Risk Management Conference in October 1999, Julie Williams, Chief Counsel of the Office of the Comptroller of the Currency ("OCC") stated that recent guidance from the OCC on leveraged lending "reflected our growing concerns with the developing trend toward higher leverage in lending markets overall. . .[and] our concerns have

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future. *Id.*.

74. *Id.*

75. *Id.*

76. *Id.* For example, Xerox drew down approximately $3 billion from lines with various banks at a time when it would have had extreme difficulty raising money. *Id.*

77. *Banks in Trouble*, *supra* note 2, at 68. Leveraged lending is defined by regulators as loans where the borrower has debt of three and a half times equity or more. *Id.* at 66.

78. *Id.* at 66. In 1993, seven percent of new syndicated loans were leveraged; in the first quarter of 2000, that percentage rose to thirty-six percent. *Id.* Additionally, the debt-to-equity ratio of non-financial companies rose from seventy-two percent to eighty-three percent from 1997 to 2000, evidence that banks are lending to companies that are putting more and more debt on their balance sheet. *Id.* *See also* Williams Remarks 1999, *supra* note 65.

79. *Banks in Trouble*, *supra* note 2, at 70. "Even in the best of times, companies make mistakes and do poorly. If they're leveraged they're likely to default. The more leveraged they are, the more likely they'll default." John Hintze, *Rise in Problem Loans May Impact Banks*, HIGH YIELD REP., Dec. 4, 2000 (quoting Jeff Werbalowsky, senior managing director and co-head of restructuring at Houlihan Lokey Howard & Zukin). Companies do fine with large costs associated with high debt as long as the economic outlook is good. Sharon Rosenberg, *Credit Squeeze*, BROWARD DAILY BUS. REV., Dec. 27, 2000 at A1. However, a slowdown in the economy could hamper the ability of some local borrowers to handle large debt loads and higher interest payments. *Id.*

particularly escalated about the increasing reliance on so-called 'enterprise values' to justify collateral shortfalls common to many leveraged financing packages."[80] Comptroller of the Currency John Hawke, Jr. echoed those comments again this year in a statement released with the 2000 Survey of Underwriting Practices, stating that "we are also apprehensive about the continued growth of various types of highly-leveraged and sub-prime lending in the system, and the frequency with which these activities are being undertaken without adequate analysis and risk management systems at some banks."[81] Regulators are clearly concerned about the growing volume of leveraged loans and, in particular, the increasing numbers of them that are considered criticized.[82]

B. *Recent Results*

Since late 1999, there have been several signs that non-performing loans are increasing and that the increase is due in large part to increases in syndicated loans and leveraged lending.[83] Banks first started announcing increases in non-performing loans in the first and second quarters of 2000.[84] These problems generally worsened in the third quarter of 2000, and banks announced additional bad news in fourth quarter earnings

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80. Williams Remarks 1999, *supra* note 65, at 5.

81. *Credit Practices 2000*, *supra* note 43, at 2.

82. *Id.*

83. *See* Serres, *supra* note 66, at E1 (reporting that eight out of thirteen North Carolina banks reported increases in non-performing loans in their last earnings announcement). *See also* Furlong, *supra* note 15 ("non-performing loans started to creep up in recent quarters.") *See also* Gotlieb, *supra* note 38 (reporting that as of March 31, 1.38% of all business loans were in trouble, up from 1.27% one year earlier and 1.15% two years prior).

84. *See* Seres, *supra* note 66. In the second quarter of 2000, non-performing loans as a percentage of total assets increased by eighteen percent at Wachovia Bank, sending its stock plummeting almost twenty percent in one day. *Id.* In the same quarter, non-performing loans were up seven percent at Bank of America, which also included a $257 million pre-tax reduction in income related to the deterioration of auto lease residual value in the 3rd quarter. *Id.* First Union's non-performing loans increased from $306 million as of March 31, 1999 to $532 million as of March 31, 2000. *Id. See also* Mandaro, *supra* note 66. Comerica Bank reported non-performing assets increasing by twenty-four percent in the second quarter, KeyCorp Bank, reported that non-performing assets increased eight and a half percent. *Id.*

reports.[85] These increases in non-performing loans forced many banks to increase their loan-loss reserves or take charges against the reserve.[86] In addition, many of these banks cited problems with syndicated loans as a reason for increasing their reserve.[87] This connection would suggest that their credit quality problems could be more widespread, since other banks are sitting on the same loans in their portfolio.[88]

Further, the most recent Shared National Credit Review showed increased cause for concern.[89] Every year, the Federal Reserve ("Fed"), the OCC and the Federal Deposit Insurance Corporation ("FDIC") undertake an annual review of syndicated loans called the Shared National Credit Program.[90] This annual review tracks and evaluates all loans over $20 million which have more than three banks participating.[91] For the second straight year both the dollar volume and the percentage of problem credits increased.[92] Adversely rated shared credits have risen from $45 billion in 1998 to $100 billion in 2000, while the percentage of these

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85. Mellisa Allison, *Bad Loans Have Banks Facing A Difficult Year; Bank Stocks Already Slipping*, CHIC. TRIB., Dec. 26, 2000 at B1. The percentage of banking assets represented by loans at least ninety days past due increased from 0.6% in the third quarter of 1999 to 0.7% in the third quarter of 2000, a change which represents billions of dollars in overdue loans. *Id.* *See also* Patrick Reilly, *Once Again, Bad Loans Hurt Profits at Hibernia*, AM. BANKER, Dec. 22, 2000, at 1. Hibernia Corp. announced that its loan-loss provision would be $70 million in the fourth quarter. *Id.* *See also* Carrick Mollenkamp, *Bank of America Warns of $1 Billion of Bad Loans*, WALL ST. J., Dec. 7, 2000 at A3. Bank of America wrote off $435 million in bad loans in the third quarter and expects to write off over $1 billion in the fourth quarter. *Id.*

86. *See* Seres, *supra* note 66. In the second quarter of 2000, Wachovia Bank took a $200 million charge to increase its reserves. *Id.* *See also* Marshall, *supra* note 83. Bank of America announced it expected to earn between eighty-five and ninety cents a share in the fourth quarter, down from $1.23 in the prior year. *Id.* A large portion of the decline in earnings was due to credit related charges against earnings. *Id.*

87. Seres, *supra* note 66.

88. *Bad Loans: Is the Situation Likely to Worsen or is There an End in Sight?*, 11 HIGH YIELD REP., Aug. 14, 2000, at 5 (discussing Bank of America's net charge-offs and position in the syndicated lending market). *See also* The Street.com, which discusses write-offs in auto leases taken by some banks and the positions in similar securities held by other banks that have not yet announced any provisions for these securities. *at* http://www.thestreet.com_iwon/stocks/banking/1114642.html (last visited Mar. 2, 2001).

89. 2000 SNC Results, *supra* note 29, at 3.

90. *Id.* A shared national credit is a loan of more than $20 million shared by three or more banks. *Id.*

91. *Id.*

92. 2000 SNC Results, *supra* note 29, at 2.

loans more than doubled from 2.5% in 1998 to over 5% in 2000.[93] Even more distressing, the amount of classified loans, the worst of the adversely rated categories, totaled $63 billion, an increase of seventy percent from 1999.[94] In addition, regulators expected the numbers to increase again in 2001.[95] Finally, in its Survey of Credit Underwriting Practices 2000, the OCC found that the level of embedded credit risk in banks' portfolios rose for the fifth straight year.[96] The survey also indicated that the levels were expected to increase further in the next twelve months.[97] In addition, the OCC found that fourteen percent of adversely rated loans were to new borrowers.[98] "In other words, banks are booking new loans that are weak at their inception."[99]

One step several banks have taken recently to clean up their loan portfolios is to sell packages of troubled loans to investors.[100] The strategy is based on the model regulators used to clean up and strengthen banks during previous financial system troubles.[101] The sale gets the troubled loans off the bank's balance sheet permanently, which reduces the need for the bank to

93. *Id.*

94. *Banks in Trouble, supra* note 2, at 66. In addition, the seventy percent increase was on top of an over sixty percent increase in 1999. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* Even though banks generally tightened their lending standards in the most recent survey, "It takes time for risk to work its way through a loan portfolio," and the embedded risk from prior years "will not wane based on the modest tightening done to date." *Id.*

98. *Id.*

99. Williams Remarks 1999, *supra* note 65, at 4.

100. Paul Sherer & Jathon Sapsford, *FleetBoston Plays 'Good Bank/Bad Bank,' Dumps $1.35 Billion in Troubled Loans.* WALL ST. J., Jan. 10, 2001, at C1. FleetBoston sold $1.35 billion in problem loans for $928 million in cash and securities to Patriarch Partners. *Id.* Other banks are taking similar steps as well. *Id.* First Union moved $719 million in commercial loans to held for sale status, moving them from the non-performing loan category but leaving them on the bank's books until they are sold. Heather Timmons, *Bad Loans, What Bad Loans?* BUS. WK., Nov. 20, 2000, at 158. Once the loans are sold, they are bundled together, insured and sold to investors in a secondary market. *Id.* Over $18.5 billion of "distressed" paper traded in the secondary market in the first three quarters of 2000, compared with only $8.9 billion of all of 1999. *Id.*

101. Sherer and Sapsford, *supra* note 98, at C1. Variations of the good bank/bad bank model were used during financial system crises in Mexico, the United States, and Asia during the 1980's and 1990's. *Id.*

increase its reserve, preventing a drain on the bottom line.[102]

On January 3, 2001, the Federal Reserve cut interest rates by one-half of one percent.[103] This surprise move was seen as both positive and negative news for the financial sector.[104] Lower rates result in lower cost of funds for banks and make it easier for borrowers to repay their debts.[105] However, the suddenness of the Fed's move caused many analysts to wonder if the situation in the weakening economy is even worse than predicted.[106] The Fed cut rates by half a percent again on January 31, citing "deteriorating conditions across the economy".[107] The two rate cuts in one month left interest rates in the same position they were in one year before.[108] Many analysts believe the Fed will continue to cut rates, possibly before its next scheduled committee meeting in March, which would further help banks with credit concerns.[109]

C. *Outlook*

Non-performing loans will continue to increase in 2001.[110] Several banks have already given guidance that they expect credit concerns to worsen, at least through the first half of 2001.[111] In addition, several bank analysts predict that credit quality will

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102. Timmons, *supra* note 98, at 158. Banks usually sell the loans at a loss, which is charged against earnings immediately. *Id.* This allows the banks to cut off the problem and move forward, instead of having a recurring problem asset on its books draining revenues each quarter. *Id.*

103. *Greenspan's Big Surprise*, ECONOMIST, Jan. 6, 2001, at 15. *See also* Jacob M. Schlesinger, *Fed's Surprise Move Sparks Market Rally, Sets Off New Jitters*, WALL ST. J., Jan. 4, 2001, at A1.

104. *Id.* The financial markets initially rallied, with the NASDAQ up over 14% on the day of the announcement, recording its largest percentage increase in one day in its history. *Id.*

105. *See* Sam Ali, *Banks Write Off More Loans as Higher Interest Rates Create More Bad Debts*, STAR-LEDGER (Newark, NJ), Nov. 26, 2000, LEXIS, Market Library, PROMT File.

106. *Greenspan's Big Surprise*, *supra* note 101, at 15.

107. Richard W. Stevenson, *Fed Cuts Key Rates By Half A Point, Citing Slowdown*, N.Y. TIMES, Jan. 31, 2001, at A1.

108. *Id.*

109. *Id.*

110. Mark Bruno, *Blaming Wall Street*, U.S. BANKER, Nov. 2000, at 11. *See also* Ali, *supra* note 103 ("regulators and investors fear this recent spate of bad loan confessions might mask a far deeper crisis.")

111. Fins, *supra* note 61.

continue to deteriorate next year.[112] Although most of the coverage regarding the increases in non-performing loans has been negative, not everyone thinks the current situation is a harbinger of future problems.[113] Some analysts believe that the rising trend in non-performing loans is peaking and that performance should improve in the future.[114] Certainly, the last several years of strong economic performance have allowed banks to clean up their portfolios.[115] As a result, the large increases in non-performing loans are driven from a very low beginning base of non-performing assets.[116] However, as the 2000 Shared National Credit Review and August 2000 Senior Lending Survey indicate, most banks did not tighten their underwriting standards until the second half of 2000, making these analysts' predictions appear overly optimistic.[117] Further, the high level of embedded credit risk in bank portfolios is expected to increase over the next twelve months, also making the prospect of additional problem loans more likely.[118] Finally, many analysts are now predicting a slowdown in economic growth during the first half of 2001, making it increasingly more difficult for highly leveraged borrowers to generate the cash needed to repay debt.[119]

In addition, if problems in syndicated loans continue to increase, a large number of banks will be affected with loans that tend to be larger than a bank could extend to a borrower on its own.[120] Eventually, banks with less conservative credit standards

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112. Bruno, *supra* note 106 at 62, 63. Analyst Richard Bove of Raymond James Financial, Inc expects that because of loan problems, "instead of banks growing earnings at ten percent to twelve percent they are going to grow at one percent to two percent." Barbara Etzel, *Bad Loans, Junk Woes Turn Tide Against The Street*, INVESTMENT DEALERS DIGEST, Nov. 16, 2000, at 4. Goldman Sachs analyst Lori Applebaum expects problem loans to grow at an average of twelve percent at twelve of the banks she covers. Hintze, *supra* note 66.

113. *Bad Loans, supra* note 108, at 5.

114. *Id.*

115. Heisler & Frankel, *supra* note 10, at 5.

116. *Id.* at 4.

117. *See 2000 SNC Results, supra* note 29.

118. *Credit Practices 2000, supra* note 43.

119. Constance Mitchell Ford, *Economic Growth is Expected to Slow to a Crawl in 2001,* WALL ST. J., Jan. 2, 2001, at A2. Most economists don't expect a full-blown recession this year, but nearly all of them warn that the risk of recession is substantially higher this year than it has been in many years. *Id.*

120. Heisler & Frankel, *supra* note 10, at 11. The default rate for syndicated loans

will have to account for the loans against which more conservative banks have already taken reserves.[121] As discussed earlier, bank management has some leeway in determining when to categorize a loan as non-performing; consequently, different banks holding a portion of the same loan may have it classified differently.[122] However, if the loan continues to deteriorate, all banks will have to declare it non-performing.[123]

One probable result of an increasing number of problem loans is a tighter lending environment.[124] As the results of the August 2000 Senior Lending Officer survey indicate, this tighter credit environment is already beginning to materialize, as more banks tightened their lending standards than eased them for the second straight time, pointing largely to both worsening economic conditions as well as reduced tolerance for risk as significant factors in their decision.[125] As previously discussed, tighter lending criteria are also a typical result of credit quality deterioration, as banks tighten standards in order to clean up their books and restore their portfolio credit quality.[126]

Increases in problem loans and the resulting decreases in bank lending will continue to have a negative impact on bank earnings and revenue growth.[127] Several banks have already given negative guidance for 2001, and many analysts are predicting very small or flat earnings growth for 2001, based largely on charges due to problem loans.[128] In addition, banks will continue to sell bad loans in order to move them off their books, taking an immediate write-down rather than having the loan continue to be

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rose to 5.1% from a record low of 2.5% in 1998. *Holed,* ECONOMIST, Nov. 11, 2000, at 96. *See also* Hintze, *supra* note 66.

121. Heisler & Frankel, *supra* note 10, at 11.

122. *Id.* at 6.

123. *Id.*

124. *August 2000 Survey*, *supra* note 39.

125. *Id.*

126. Pinckney, *supra* note 40, at 20.

127. *See supra* notes 48-57 and accompanying text.

128. Etzel, *supra* note 108. In a presentation to investors, Bank of America Chief Financial Officer Jim Hance stated "We're pessimistic about the economy, we're pessimistic about the capital markets and the ability of companies to refinance, and it's very easy for companies to throw in the towel. We're taking a very conservative outlook." Ina Cordle, *Bad Loans Vex Bank of America,* MIAMI HERALD, Dec. 12, 2000, LEXIS, Market Library, PROMT File.

a drag on their earnings.[129]

On a larger scale, tighter lending criteria by banks could accelerate a slowdown in the economy.[130] Tighter lending standards make it harder for companies to get loans, as companies that would qualify for loans in a looser lending environment either no longer meet lending criteria, or have their borrowing amounts decreased.[131] This in turn leads to decreased business investment and can lead to a worsening of already weakening economic conditions.[132] There are already a number of analysts concerned about an impending credit crunch.[133] If the economy continues to slow and banks continue to reduce their lending, the Federal Reserve will need to continue to reduce interest rates in order to introduce additional liquidity into the economy.[134]

Finally, if credit concerns worsen more significantly at some banks than others, a new wave of bank consolidation could also result.[135] Recently, FleetBoston Financial Corp. announced it expected to have between four and five billion dollars in excess capital by the end of 2001, fueling speculation of potential acquisitions.[136]

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129. *See supra* notes 100-102 and accompanying text.

130. Pinckney, *supra* note 40, at 20. In a credit crunch, banks cut back on loans, good companies can't borrow money, and economic growth stalls. Gallagher, *supra* note 61.

131. Jeff Harrington, *Banks Warn Businesses Credit Will Be More Difficult to Obtain,* ST. PETERSBURG TIMES, Dec. 13, 2000.

132. Pinckney, *supra* note 40, at 20.

133. *The Clenching of U.S. Credit Markets*, BUS. WK., Dec. 4, 2000, at 182. In an editorial, Business Week warned "Add it all up, and a nascent credit crunch is increasing the chances of a hard landing for the economy." *Id.* Due to the six to twelve month time lag for changes in monetary policy to affect the economy, Business Week expressed concern that if the Fed waits too long to act, "the momentum for a hard landing could become unstoppable." *Id.*

134. *Id.*

135. John Hechlinger & Carrick Mollenkamp, *FleetBoston May Look South to First Union*, WALL ST. J., Jan. 18, 2001 at C1.

136. Tim McLaughlin, *FleetBoston Considers Acquisitions,* REUTERS NEWS SERVICE, Jan. 18, 2001. FleetBoston CFO Eugene McQuade denied reports of an impending merger bid for First Union but said that Fleet would be looking aggressively for acquisitions. Tim McLaughlin, *FleetBoston To Have 'Boatload of Capital,'* REUTERS NEWS SERVICE, Jan. 18, 2001. McQuade said "this is actually a time where we think there will be a lot of opportunities as companies begin to feel pressure, whether it be budget pressure, credit quality pressure. . .We think there will be a lot of opportunities and the bidding won't be so great." *Id.*

V. CONCLUSION

Non-performing loans are clearly an important factor in banking sector performance and they are also a very useful tool to help predict the direction of bank portfolio quality, performance, and earnings. More importantly, non-performing loan data provides helpful insights into the larger economy as well, giving early signs of an economic slowdown or other problems in the private sector. As an example, warnings about increases in non-performing loans began to surface in the first quarter of 2000, long before the rest of the country became focused on a potential slowdown in the economy.[137]

Clearly, after many years of strong loan portfolio performance, recent increases in non-performing loans point to a decline in credit quality within the banking sector.[138] In particular, the large increases in criticized assets by the Shared National Credit Review point to potentially serious trouble if interest rates rise or the economy continues to slow.

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137. *See supra* notes 83-99 and accompanying text. Concerns about a recession did not generate much publicity until late fall and became most prevalent in December of 2000. *See* Dina Temple-Raston, *Specter of U.S. Recession rises from Mid-east, Euro Turmoil,* USA TODAY, Oct. 16, 2000, at 1B. In October, several analysts increased their forecasted probability of a recession, and the stock markets tumbled as interest rates and energy prices increased. *Id.; see also* Patricia Hill, *Greenspan Warns Plunging Markets a Recession Threat; Fed Chief Hints Lower Rates Will Help Wall Street,* WASH. TIMES, Dec. 6, 2000, at A1. Chairman Greenspan acknowledged the threat of a recession for the first time, while "private economists . . . increasingly warned of a heightened risk in recent days." *Id. See also* Floyd Norris, *Speaking of Recession,* N.Y. TIMES, Dec. 10, 2000, at D2.

138. *See supra* notes 83-99 and accompanying text.