As Economy Flounders, Do We See a Rise in Problem Loans?

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It doesn't take an economist to conclude that the pace of economic activity has slowed sharply during the past year. We hear about this on the news, see the changes in our businesses and may have even felt the effects of a sluggish economy first-hand. As the table below shows, the annual growth rate of real GDP fell from 5.69 percent to 1.34 percent between the second and third quarters of 2000.

Historically, when the pace of economic activity slows, problem loans of banks tend to rise. This article looks at one measure of problem loans—the percentage of commercial and industrial (C&I) loans that are nonperforming—to see whether there has been an increase in problem loans in the past year, as one might expect.

We identify nonperforming loans as those that are 90 days or more past due or no longer accruing interest. Banks report the amount of loans that are nonperforming on a quarterly basis.[1] The table reports nonperforming C&I loans as a percentage of total C&I loans by bank size over the past decade. To examine both the decade-long trend and some recent changes, we'll look at annual nonperforming loan ratios (the means of the quarterly numbers) for 1991 to 1999, and quarterly rates for 2000 and the first half of 2001.

Going back 10 years, we see that nonperforming loan ratios for banks in each size category were higher in 1991—a recession year—than in any subsequent period. As we recovered from the recession, the data show that banks in each size group reported declines in their nonperforming loan ratios through 1997. Since 1997, banks with total assets above $1 billion have experienced a slight rise in nonperforming loan ratios; however, these ratios remain substantially below the 1991 levels. Nonperforming loan ratios among relatively large banks began rising well before the economic slowdown of the past year.

The rise in the nonperforming C&I loan ratio since 1997 has been especially pronounced among banks with total assets in excess of $20 billion. Much of the increase for this group can be attributed to involvement with syndicated loans. A syndicated loan, identified as a loan included in the Shared National Credit program of the federal bank supervisors, is any loan or loan commitment that exceeds $20 million and is shared by three or more nonaffiliated institutions.[2] Syndicated loans are classified in one of four categories (substandard, doubtful, loss or special mention) if, during routine examination, there is determined to be a relatively high risk of default or other credit concerns. The percentage of loans with adverse classifications has been increasing over the past few years.[3]

At the same time that nonperforming C&I loan ratios at the larger banks began to increase after 1997, nonperforming C&I loan ratios continued to decrease among banks with assets below $1 billion—the smallest two categories in the table. This pattern began to change for banks in one of these size categories, however, as the growth of GDP slowed in the last year: Among the banks with total assets between $300 million and $1 billion, nonperforming loan ratios were about 30 percent higher during the first two quarters of 2001, after the economy began to slow, than during the first two quarters of 2000. It appears that the slowing pace of economic activity during the past year has begun to adversely affect the ability of the customers of relatively small banks to repay their bank loans. So far, there has been no corresponding rise in the nonperforming loan ratios among the smallest banks—those with total assets below $300 million.

During economic slowdowns, problem loans at banks tend to rise. As one would expect, we have indeed seen increases in one measure of problem loans at banks of different total asset sizes. Some of these increases occurred before the recent economic slowdown; others occurred concurrently with the slowdown. While the news is not bright for banks affected, it is important to note that the increases in nonperforming C&I loan ratios remain below the levels seen during the last recession. ■

[1] *Nonperforming loans tend to have a seasonal pattern at banks with total assets below $1 billion. These banks tend to charge off more loans in the fourth quarter to "clean up their balance sheets" for year-end accounting statements. Loans charged off as losses are no longer reported as nonperforming.*

[2] *Prior to 1999, syndicated loans were comprised of all loans or loan commitments of $20 million or more held by two or more supervised institutions.*

[3] *For more information on the Shared National Credit Program, see the web site of the Board of Governors of the Federal Reserve System, www.federalreserve.gov/Releases/SNC/.*

Percentage of Commercial and Industrial Loans That Are Nonperforming

Period	Annual Growth Rate of Real GDP	Total assets of banks: Up to $300 million	$300 million to $1 billion	$1 billion to $10 billion	$10 billion to $20 billion	More than $20 billion
1991	–0.47%	4.30%	3.24%	4.06%	5.02%	5.37%
1992	3.05	3.99	2.85	3.24	4.01	4.63
1993	2.65	3.21	2.13	2.17	2.52	2.89
1994	4.04	2.52	1.35	1.27	1.36	1.37
1995	2.67	2.18	1.05	0.95	1.15	1.19
1996	3.57	2.25	1.16	1.02	0.87	0.97
1997	4.43	2.13	1.12	0.92	0.72	0.75
1998	4.28	2.13	1.01	0.92	0.78	0.84
1999	4.09	2.05	0.99	1.00	1.15	1.08
2000:1	2.35	1.85	0.99	1.04	1.21	1.27
2000:2	5.69	1.84	1.00	1.15	1.30	1.43
2000:3	1.34	1.85	1.06	1.23	1.35	1.56
2000:4	1.91	1.73	0.99	1.32	1.56	1.75
2001:1	1.32	1.81	1.30	1.52	1.64	1.95
2001:2	0.31	1.91	1.31	1.58	1.65	2.24

Note: Nonperforming loan rates are calculated as the sum of nonperforming C&I loans as a percentage of total C&I loans in each size category. Banks are placed in a size category based on their total assets for that quarter. Annual nonperforming loan rates are the means of the quarterly numbers.

FedFacts

Fed Offers One-Stop Shopping for Check Clearing

Earlier this year, the Federal Reserve System unveiled a consolidated foreign check clearing service. This new service makes it possible for financial institutions to use the Fed to process checks drawn on depository institutions anywhere outside the 12 Federal Reserve districts. Previously, foreign check clearing through the Fed was available only for Canadian payments.

Foreign check clearing is provided by the Federal Reserve Bank of Richmond's Charlotte office. Per-item prices range from $1.75 to $55, depending on the country in which the paying bank is located. Please contact your local account executive if you are interested in this service.

CRA Lending, HMDA Data Now Available

The FFIEC has made available 2000 data on small business, small farm and community development lending reported by commercial banks and thrifts. Data can be found online at www.ffiec.gov/cra. 2000 HMDA data is also available online at www.ffiec.gov/hmda. ■

CalendarEvents

UPCOMING FED-SPONSORED EVENTS FOR EIGHTH DISTRICT DEPOSITORY INSTITUTIONS

Community and Lender Luncheon
DECEMBER 11—LOUISVILLE
Topic of the program is credit scoring. For more information, contact Faith Weekly at (502) 568-9216.

2002 Federal Reserve Holiday Schedule

DAY	DATE	DAY	DATE
Tuesday	Jan. 1	Monday	Sept. 2
Monday	Jan. 21	Monday	Oct. 14
Monday	Feb. 18	Monday	Nov. 11
Monday	May 27	Thursday	Nov. 28
Thursday	July 4	Wednesday	Dec. 25

Plans Tested

continued from Page 1

via ground hub and spoke network. On that and the following nights, the Fed delivered about 75 percent of its normal volume by truck.

Meanwhile, the Fed worked closely with the FAA and the U.S. Air Force to resume flight of courier planes, and by late Wednesday, these jets returned to the air, even though commercial airports were not yet open. On Thursday, the Fed began working with various check transportation vendors, and through the weekend patched together a network of Fed and charter flights that represented what one Fed employee described as a "whirlwind of improvisation."

And then there were the liquidity and credit issues. (See Feditorial, Page 2.) As lender of last resort, the Fed's discount window not only remained open late, but loans Sept. 12 rose to $45.5 billion, up from $99 million the Wednesday before. The Fed absorbed billions of dollars of float during the two days that it continued to provide credit to depositing banks on money that had not yet been collected. Some banks also reported increased demands for currency, which were honored to maintain public confidence.

Despite our success at providing liquidity, we underestimated the urgency of sending a reassuring message to the public. Should a crisis strike again, banks and the public will not want to wait four hours for official confirmation that the Federal Reserve is up and running, and that the discount window is open.

Testing . . . One, Two, Three

As we were reminded on Sept. 11, we can never "over test" a contingency plan. And each crisis presents an opportunity to learn and improve. What lessons will the Fed and the banking industry take away? Here are some considerations we may all want to revisit:

- Do contingency plans go beyond technology functions?
- Is there more than one alternative site for conducting business, including back-end operations?
- Is there a central location from which to deploy plans of action?
- Are plans tested regularly?
- Are newer staff members familiar with the plans?
- Are contingency plans in writing and easy to find?
- Are data storage and backup efforts up to date with today's technology and operating environment?
- Is there a network of vendors with whom to coordinate alternative plans?
- Is there a clear plan for communicating with your constituents? ■

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News and Views for Eighth District Bankers

Contingency Plans Tested Sept. 11. Did the Fed Pass?

The FAA grounding of all flights on Sept. 11 added an unimaginable dimension to disaster scenarios and could have crippled the nation's payments system. Thanks to contingency planning and a strong network of vendor partnerships, the Federal Reserve overcame this obstacle and kept the payments system running—not always on deadline, but effectively nonetheless. Looking back, the Fed must now evaluate its overall response. Here are some things we learned.

What Worked; What Didn't

As expected, electronic payments operated smoothly. Unlike the Y2K scare, it was the lack of air transportation that impaired the payments system, as every weeknight the Fed relies on this system to move about 43,000 pounds of checks among the 45 Fed processing sites. Aside from the physical disruption, the lag posed settlement and float issues for banks nationwide.

In this respect, the Fed responded quickly. By early afternoon on Sept. 11, organized for the evening—the Fed dispatched several hundred check-filled trucks,

continued on Page 6

Fed Releases Comprehensive Retail Payments Study

American consumers and businesses make 80 billion retail payments annually, according to a market research report just released by the Fed. Nearly 50 billion of these payments are made by check, and the remaining 30 billion are handled by electronic instruments, such as credit cards, debit cards and ACH.

Overall, Americans are increasingly using electronic forms of payment; checks have declined from approximately 85 percent of non-cash payments in 1979 to about 60 percent today.

This information is part of a comprehensive retail payments research project, the first of its kind in more than 20 years. The data collection effort was commissioned by the Reserve banks and consisted of three main studies—the Depository Financial Institution (DFI) Check Study, the Check Sample Study and the Electronic Payment Instruments Study.

The DFI Check Study was designed to count the total number of checks processed in the United States for a 12-month period. The Check Sample Study gathered information on the composition of the check market, namely, who (consumers, businesses or government) writes checks to whom (consumers, businesses or government) and why (remittance, point-of-sale, income or casual payment). The Electronic Payment Instruments Study gathered data on the volume and value of electronic payments processed during 2000.

More than 1,300 financial institutions and 89 electronic payment processors responded to the surveys. Additional details are available on the Federal Reserve System's web site, www.frbservices.org. ■

Feditorial

Banks and the Fed Must Work Together During a Crisis

By William Poole, president and CEO, Federal Reserve Bank of St. Louis

The terrorist attacks of Sept. 11 brought many things in the United States into sharp focus. One of these things was a critical need for the banking industry and the central bank to speak with one voice regarding the public's ability to access its funds.

Although our contingency plans didn't spell out a detailed response to this unforeseen disaster, the Federal Reserve, upon hearing of the attacks, mobilized swiftly to stabilize the payments system and provide needed liquidity. When the news broke, several issues demanded our immediate attention, including the massive volume of checks normally shipped by air (which we got moving by ground later that day), the resulting float (which we absorbed) and the needed short-term credit (which we extended in several different ways). As it turns out, the Fed had no problem providing the liquidity that the financial markets needed, just as it had during the stock market crash of 1987, the Russian default of 1998 and the Y2K scare.

In retrospect, we could have disseminated a reassuring message to the public about the availability of funds earlier than we did. The news would have been welcome in one area of the country, where a financial institution apparently limited the amount of cash its customers could withdraw, protecting what that institution sensed would lead to a demand for currency that could not be met. While such fears of a cash shortage were unfounded, they unfortunately could have triggered an actual bank run similar to the gasoline runs that occurred in some places the afternoon and evening of Sept. 11.

No financial system works well in the face of monetary instability. Happily, our financial system was flexible enough to have adjusted promptly to the events of Sept. 11. The banking industry played a major role in restoring the normal functioning of the payments system and limiting the financial damage of that event.

We sincerely hope that we never see a crisis like Sept. 11 again. But if we experience another shock, bankers and the public should know that the Fed is always on the job. ■

Fed Offers New Electronic Distribution Service

Eighth District customers can expect improved service as the St. Louis Fed prepares to implement an e-mail alert service that will electronically deliver information that District financial institutions currently receive by mail, such as announcements, regulatory materials and operating circulars.

Some of the benefits of the new service include:

- Immediate notification. As soon as a mailing is posted on our public web site, subscribers will be alerted via e-mail and be able to link directly to the information.
- No limits on who can receive information. Anyone in your organization can subscribe, and the information can be passed on electronically to others in the organization.
- Better targeted mailings. Subscribers can determine how many and what type of mailings they receive or access on the Internet.
- Ability to change subscribers or unsubscribe at any time. Individuals will be able to subscribe to this service by completing a profile form accessed through the Federal Reserve Bank of St. Louis' home page.
- The service is free.

The electronic distribution service will begin in December 2001. Customers will soon receive information that explains how the electronic distribution service will work and how to subscribe. We expect all paper mailings to cease once this new electronic notification system is fully in place, which is targeted for third quarter 2002. Customers will continue to receive hard copy mailings until then. For more information, call Tracie Mueller at (314) 444-8810 or 1-800-333-0810, ext. 44-8810. ■

Demographic Data Come in All Shapes and Sizes

Like any business, a financial institution must know its customers to profit in business. Customer knowledge can be acquired through any number of sources, most of which are free and readily available. For bankers, demographic information might come from empirical data derived from census data and research. Just as valuable is first-hand insight, such as employee and customer observation, community reconnaissance, staff knowledge and partnerships with community organizations.

Census Data Track Trends, Provide Empirical Base

Successful strategic market planning identifies trends and determines what is changing, emerging or staying the same. The U.S. Census Bureau is one of the best sources for data on where people live and how households change over time. Historically, it took a professional demographer to compile a simple table from census data. What's more, the data themselves were a one-time collection effort and were stale at best before the decade's end. This is no longer the case, however, thanks to American FactFinder, a new tool offered with census 2000.

American FactFinder now makes the voluminous demographic and economic statistics easy to find by putting them all in one place—the home page of the Census Bureau web site, www.census.gov. It also offers fresh data pulled from annual surveys, estimates and projections. It has full mapping capabilities and offers information never before accessible—detail to the census block level.

With empirical data like the census in hand, bankers are well-positioned to form profitable partnerships. Roland Goicoechea of Arvest Bank, Arkansas, created a unique alliance with businesses in Rogers, Ark., when he saw evidence of a growing Hispanic population. Drawn to the area's thriving poultry industry, this market was generally unbanked and lacked financial literacy. Goicoechea helped form "Creating Hope in the Workplace," a series of financial seminars offered in both Spanish and English and taught where participants work. Since the program's inception in 1994, Arvest Bank of Rogers reports an increase of more than 400 home loans and $40 million in business as a result of the program.

Don't Overlook the Obvious

Southern Commercial Bank, a 110-year-old bank in St. Louis, used community reconnaissance and staff knowledge to adapt its business practices when a swell of Bosnians began settling in nearby neighborhoods in 1995. Bank Vice President Dan Ryan says that paying attention to what was going on in the bank's lobby and the bank's own back yard was essential to tapping increased business.

Staff members at Southern Commercial turned to several sources to help them serve this new population. Information came from the bank's loan applications, from the community generally and organizations like the International Institute, an agency that helps to resettle new Americans. The bank hired 15 Bosnian staff and tailored loan products by using flexible underwriting criteria on credit history, work history and residency. Today, the bank's reach has gone well beyond its own neighborhoods: Satisfied customers have spread the word as far as California that Southern Commercial is the bank of choice for Bosnians.

The Bottom Line

Identifying emerging demographics is one thing; knowing what to do with that information is another. It takes creativity, dedication and good information—both the empirical and the observed—to take advantage of new business opportunities. But the payoffs can be profitable, in more ways than one. ■

Additional information on the 2000 census is available in the July and October issues of the St. Louis Fed's The Regional Economist, *available online at www.stls.frb.org.*

Facts to Figure from the 2000 Census National Data

Race. The Hispanic population increased by more than 50 percent since 1990, and in many areas the growth rate among ethnic minorities outstripped increases in Americans of white European descent. *Are members of your staff multilingual? Do you offer resources in languages other than English? Do you offer Fair Lending or sensitivity training to your staff? Do you participate in outreach to potential homebuyers who represent different ethnic minorities?*

Age. The median age of the population in 2000 was 35.3 years, the highest ever. The 50-54 age group experienced the largest percentage growth. *What products are tailored to the age groups in your community? Are there loan or investment opportunities for senior assisted-living facilities?*

Household Type. The number of nonfamily households rose at twice the rate of family households: 23 percent vs. 11 percent. Families maintained by women with no husband present increased three times as fast as married-couple families, 21 percent vs. 7 percent. Multigenerational family households now represent 4 percent of all households. *What do changes in household composition mean for the types of services and marketing approaches offered by your bank?*

Business. Nonemployer businesses represent 75 percent of all businesses. *What are the implications for small-business loan demand? Do you participate in a loan pool for small-business or mircroenterprise lending?*

Regional Roundup

2002 Prices Available Online

The prices that the Eighth District will be charging for check services as of Jan. 2 are now posted on the Federal Reserve Bank of St. Louis' web site at www.stls.frb.org under Financial Services. Fee information for nationally priced services, including cash, electronic access, etc., can be found on the national Financial Services web site at www.frbservices.org. Letters announcing these changes were mailed recently to all customers. If you have any questions, contact Frank Blacharczyk at 1-800-333-0810, ext. 44-8960. ■

Online Services Directories Updated and Enhanced

The latest online versions of the St. Louis Fed's services directories are now available in printable PDF formats, right from our web site to your printer. They can be found at www.stls.frb.org, under General Information. ■

System Consolidations Result in New Contact Information

As announced earlier this fall, the Federal Reserve System consolidated several operational support areas into centralized sites. As of Sept. 14, the FedACH operations support and the voice response application (EDITH®) for ACH are being handled by the Minneapolis Fed, while the operations support for Fedwire® services is being handled by the Boston Fed as of Nov. 5. Please note the new contact numbers:

FedACH Operations Support
1-888-883-2180

ACH Voice Response
1-888-699-5561

Funds and Securities Operations Support 1-800-327-0147 ■

District Wraps up EWA Conversion

The October conversion to the new Enterprise-Wide Adjustments (EWA) system in Little Rock and Memphis brought the project to a close in the Eighth District. The St. Louis and Louisville offices started using EWA last April.

June 2002 is the target month for all 45 Reserve Bank offices to be using EWA, the Fed's new software platform for check adjustments. This software standardizes and streamlines the adjustment research and resolution process, which will help us resolve cases more quickly and accurately.

EWA is one of four Reserve Bank projects in the Check Modernization initiative, a multiyear project to redesign the Fed's check processing infrastructure for paper and electronic check services. ■

Focus Groups Zero in on Customer Service Issues

In focus groups held this summer, the St. Louis Fed asked customers—from big banks to small ones—how they define excellent customer service. We also asked participants for candid responses about how we're doing and what we could do better. We learned a lot from these sessions.

When asked what key attributes they expect from service providers, participants emphasized providing personalized attention to individual problems, taking ownership of problems and proactively contacting customers to make sure problems have been resolved.

Among the top concerns noted for our Bank was inconsistency among those who provide customer service. Although the Fed has many star service providers, others have room for improvement. We heard you, and we're doing something about it.

To improve our contact information, we've revised our services directories and begun streamlining our telephone systems to make it easier for customers to reach the right person the first time. We've also introduced a seamless transfer process to make sure customers are routed to the appropriate contact quickly and accurately.

To improve the quality and consistency of our service, we're boosting our training efforts to help ensure well-rounded knowledge of all areas of the Fed and consistency in providing the right answers the first time. The training not only focuses on business knowledge but on the softer skills of customer service as well. We expect these changes to go a long way in improving our service.

In the April 2001 issue of *Central Banker*, we announced a comprehensive program to improve the service relationship customers have with the Fed. The changes outlined here are the first steps in that effort. To gauge our progress, we'll introduce additional feedback tools and will proactively contact customers to ask how else we need to improve. For more information, contact Fran Sibley at (314) 444-8394 or 1-800-333-0810, ext. 44-8394. ■