Economic Commentary

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The Texas Credit Crunch

Most economic analysts agree that economic growth in a region will be slower and more difficult to achieve if bank lending is shrinking rather than growing. In Texas, a decline in credit from the commercial banking industry exacerbated the depth and duration of the downturn in the state's economy. Pinpointing the exact source of the credit shortage is difficult, but analysis suggests that only a minority of Texas banks were capable of expanding loans in 1990. The situation was worse in 1986, when even many of those banks deemed capable of expanding loans did not or could not do so. In the future, as the Texas economy continues to improve, the availability of credit will increase and, in turn, encourage further growth.

Troubled Banks and Dwindling Loans

Since year-end 1986, the number of Texas banks has fallen by one-third, due in significant part to bank failures. Aggregate assets, loans, deposits and capital of the Texas banking industry also declined by about one-third. The decline in aggregate assets diverges from the trend prevalent in the rest of the nation where, despite a decline in the number of banks, the size of the industry's balance sheets has grown for several years.

During 1987–89, total loans by the Texas banking industry fell by $39 billion, or more than 30 percent, despite modest growth in personal income and employment during these years. Both commercial and industrial loans and equity capital fell by more than one-third. During the same period, the liquidity of Texas banks increased and the ratio of loans-to-deposits fell to well below the national average.

The volume of lending reflects forces of both supply and demand. Loans can contract if suppliers withdraw from the market or if customers demand less credit, or for both reasons. Determining which conditions dominate is difficult, but the record of the past three years suggests that the poor health of much of the Texas banking industry has served to constrain the speed of recovery of the rest of the Texas economy.

Evidence of the Dearth

Analysis of data from the fourth quarter of 1989 indicates that 55 percent of Texas banks, accounting for 81 percent of Texas banking industry loans and 77 percent of Texas banking industry assets, were *not* in a position to expand credit in 1990. The remainder—only about 600 banks holding less than 20 percent of industry assets—are sufficiently healthy to expand their loan portfolio in 1990.

During the early phase of the Texas economic recovery (1987–89), the credit shortage was even more critical. At year-end 1986, 45 percent of banks (the same percentage as in 1989) were capable of expanding loan capacity if loan demand of satisfactory quality emerged. In the three intervening years (1987–89), however, loans at banks that were not suffering from impaired lending capacity fell by half, from $30 billion to $15 billion. While this suggests that banks may have the potential to expand credit, it does not necessarily imply that they should or will do so.

Prognosis: Credit Expansion and Economic Growth

Over the past few years, the performance of the Texas economy and the future economic outlook have improved considerably. This improvement should provide a better environment for credit expansion if for no other reason than that continued growth in the economy should serve to strengthen appraisal values of loan collateral and the underpinnings of cash flow projections, both of which are important considerations in loan approvals or denials.

Several other factors also will contribute to improvement of the lending capacity of Texas banks. First, several of the state's largest banking organizations are close to overcoming their impaired lending status. This will probably allow some of these significant players to expand loans in 1990. Second, the recent shrinkage of the savings and loan industry has improved the availability of funds for commercial banks and, more important, has reduced the cost of core deposit funding. The resulting increased profit margins should allow for higher risk-adjusted returns from lending than was the case when Texas banks had to pay a premium to attract deposits. Recently, the deposit rates at Texas banks have ranked among the lowest in the country. Finally, continued growth in the Texas economy, especially against the backdrop of weakening economies in many other states, should improve the willingness of some out-of-state banks to fund loans in Texas. Faced with the potential loss of clientele to outside competitors, many Texas banks with some measure of lending capacity may be induced to utilize that capacity.

For all these reasons, as the recovery of the Texas economy continues in the next few years, the credit shortage will fade. Increasing credit availability will reinforce the economic growth already underway. Together, credit expansion and economic growth will work to propel Texas business and banking into full recovery.