# A Region-by-Region Look at U.S. Banking

While the nation continues in what appears to be a weak economic recovery, various regions are experiencing differing degrees of economic growth or contraction. The Northeast and most of the Southeast and Central regions continued to suffer employment declines in 1991 (*Chart 1*). In contrast, most states in the West reported employment increases, with the important exceptions of California and Oregon. The Southwest reported increases in employment, as did most of the states in the Midwest.

Similarly, banks in various regions are also experiencing differing degrees of financial difficulty or success. Banking performance is greatly affected by regional economic conditions, especially since U.S. banks are limited in their ability to diversify geographically.[1] Recovery in the banking industry following a severe downturn appears to lag the recovery substantially in the regional economy, perhaps by as long as three years.[2] The lag in the banking industry's recovery may also create an additional drag on the regional economy by inhibiting the extension of credit.[3]

## Banking Conditions Around the Country

The Northeast clearly had the nation's poorest-performing banking industry in 1991. One out of every four Northeast banks was losing money last year (*Table 1*). The return on assets of Northeastern banks was 0.30 percent, compared with 0.56 percent nationally.[4] The region's banking problems stem from loan losses, primarily involving loans for real estate and loans to foreign governments and institutions.

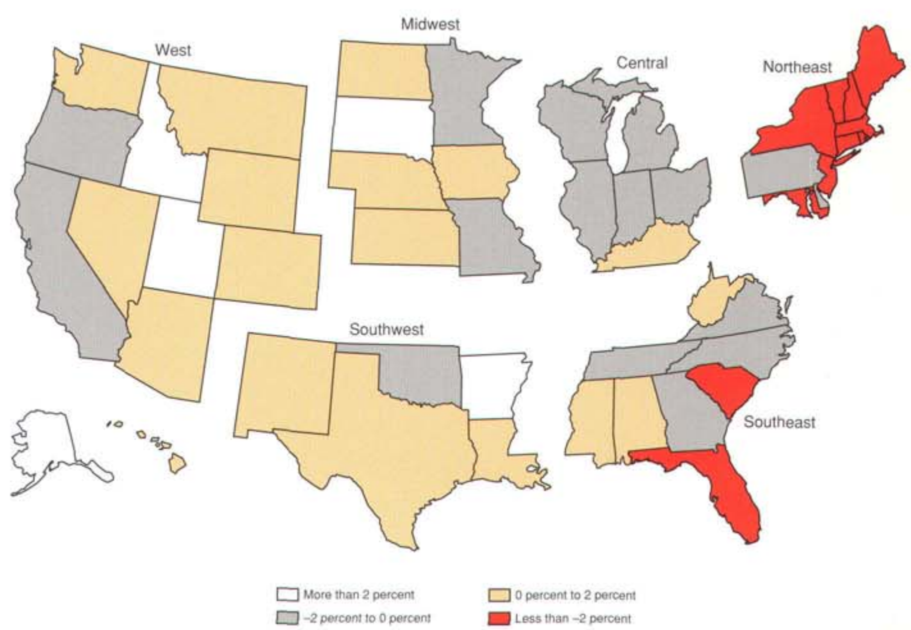
It is unclear whether the downturn in Northeastern banking has reached its trough. On the positive side, the return on assets of Northeastern banks is up from 1990, and the regional economy shows signs of improvement.[5] On the negative side, the troubled-asset ratio of Northeastern banks is still high, and their net chargeoff rate rose in 1991 and was the highest of any region in the nation.

Farther south on the eastern seaboard, performance of banks in the Southeast, while still relatively good, has been declining for several years. The return on assets at these banks has been headed downward since 1985 but was still 0.64 percent, just above the national average. The deterioration in performance is the result of increases in both troubled-asset ratios and chargeoff rates, especially in the past two years. The real estate problems that have plagued the Northeast do not appear to be nearly as severe in the Southeast, although they have had a negative effect on bank performance.

The West reported the second-poorest banking performance of any region, with a return on assets of only 0.45 percent. Problems in the West appear to be concentrated in California, which accounts for more than 60 percent of total banking assets in the West and is beginning to show signs of asset-quality problems.[6] The return on assets for California banks was only 0.19 percent, compared with 0.88 percent for the other states in the West. Banks in Arizona and Colorado are still recovering from asset-quality problems that developed in the late 1980s. Like the Northeast, losses on real estate loans explain much of the performance of these banks. At the end of 1991, the troubled-real-estate-asset ratios were 10 percent in Arizona and nearly 7 percent in Colorado. In California, this ratio was over 7 percent and rising rapidly.

States in the center of the nation report banking conditions that are much better than those on either coast. Banks in the Midwest reported a return on assets of 1.10 percent, the highest of any region. Furthermore, Midwestern banks have the

**Chart 1**
Nonfarm Payroll Employment Percentage Change by State
(December 1990–December 1991)



lowest troubled-asset ratio and the second-lowest chargeoff rate. More than 95 percent of the banks in the Midwest earned profits in 1991. Similarly, banks in the Central region also reported a healthy return on assets of 0.90 percent, and 94 percent of these banks earned profits in 1991. The troubled-asset ratio for Central banks was only 1.63 percent, far below the national average, and these banks had the lowest chargeoff rate in the nation.

Banks in the Southwest continued to recover from the financial crisis that devastated the region's banks and thrifts in the late 1980s. Return on assets for Southwest banks was 0.66 percent, just above the national average in 1991, giving the region's banking industry its second consecutive year of profitability. In fact, more than 89 percent of Southwest banks earned a profit in 1991. Asset quality problems declined during 1991 with both the troubled-asset ratio and the chargeoff rate falling.

## Funding the Recovery

The performance of banks can be particularly important at the early stages of a recovery. Loan demand, especially high-quality loan demand, has been weak thus far in the recovery.[7] In an average recovery, lending begins to increase in the third quarter following the trough of the economic cycle. When loan demand does recover, however, banks across the country may not be capable of extending credit. Recovery in some regions may be hindered by the weak condition of their banks.

The ability of banks to extend credit is fundamentally related to their financial health. In a previous *Southwest Economy* article, unhealthy banks were defined as those with either low capital ratios, high troubled-asset ratios, or negative earnings.[8] Unhealthy banks are limited, if not completely constrained, in their ability to extend credit.

Financial health of banks is not, however, the only factor explaining the lack of loan growth. Evidence from the Texas banking crisis indicates that after a severe downturn in both the regional economy and the banking industry, even healthy banks in an expanding economy may not increase lending. In 1990, a year in which Texas nonagricultural employment grew 2.8 percent, 40 percent of the healthy Texas banks did not increase their lending.[9]

Regional economic strength is also insufficient to explain loan growth rates. While economic conditions were quite different across the country in 1991, commercial and industrial loans contracted in all regions. In the Midwest, a healthy and growing region, these business loans contracted 7.2 percent, compared with a contraction of 9.8 percent in the Northeast, a region with severe employment declines.

Supply, in the economic sense, is the willingness and ability to provide a good or service, and banks are the source of loan supply. It is unclear what factors might be affecting the banks' *willingness* to supply loans, but their *ability* to supply loans can be established. A region-by-region analysis of the ability of banks to supply loans follows.

**Central and Midwest.** Banks in the Central and Midwest regions should have little trouble in extending credit to qualified borrowers once the recovery gains momentum and loan demand increases. Banks in both of these regions are well capitalized, profitable, liquid and relatively unburdened with troubled assets. Their equity capital ratios were the highest of any region and increased in 1991. Healthy banks controlled 85 percent of the banking assets in the Central region and 76 percent in the Midwest. Their loan-to-deposit

**Table 1**
Key Financial Ratios for FDIC-Insured Commercial Banks, 1991
(Percentages)

| | Northeast | Southeast | Central | Midwest | Southwest | West |
|---|---|---|---|---|---|---|
| Share of total U.S. banking assets | 37 | 15 | 17 | 7 | 8 | 16 |
| Return on assets | .30 | .64 | .90 | 1.10 | .66 | .45 |
| Troubled-asset ratio | 4.13 | 2.21 | 1.63 | 1.51 | 2.39 | 3.36 |
| Charge-off rate | 2.36 | 1.22 | .88 | 1.05 | 1.25 | 1.31 |
| Equity-capital ratio | 6.07 | 7.25 | 7.34 | 8.15 | 6.88 | 6.74 |
| Loan-to-deposit ratio | 78.96 | 73.04 | 73.31 | 64.78 | 50.89 | 82.81 |
| Percentage of banks losing money | 26.1 | 14.1 | 6.1 | 4.2 | 10.5 | 18.3 |
| Percentage of banking assets held by healthy banks* | 32 | 66 | 85 | 76 | 65 | 34 |

*Banking assets held by healthy banks is based on third-quarter 1991 data.

SOURCES: *The FDIC Quarterly Banking Profile*, fourth quarter, 1991; and Federal Reserve Bank of Dallas.

ratios were quite low, indicating that these banks were very liquid. New loan demand could be funded by either converting securities to loans or by raising new deposits to fund additional lending.

**Southwest.** In the Southwest, banks should be able to support additional lending even though they are still recovering from their previous losses. The percentage of banking assets held at healthy banks has risen to 65 percent. Southwest banks are extremely liquid, with a loan-to-deposit ratio of only 51 percent, compared with a national average of 74 percent. If high-quality loan demand increases, these banks can fund the lending by selling off securities. Southwest banks could increase their lending by nearly $33 billion, a 27-percent increase, by reducing their liquidity to the level of Midwest banks. Shifting assets from securities to loans would increase risk-based capital requirements, which might limit lending to some degree.

**Southeast.** The ability of the Southeastern banks to support a recovery is less clear than that of banks in the Midwest, Southwest or Central regions. Southeastern banks are profitable, but their profitability has been declining. Southeast banks are about as well capitalized and as liquid as banks in the Central region, though only 66 percent of the Southeast's banking assets are held at healthy banks. The asset quality of these banks, however, has deteriorated over the past two years. Continued deterioration of asset quality in 1992 would limit the ability of these banks to extend credit.

**Northeast.** If the economic recovery were to begin in the Northeast during the summer of 1992, banks in the region would not be positioned to encourage the recovery with further extensions of credit. Unhealthy banks hold 68 percent of all banking assets in the Northeast. The Northeastern banks are one or two years behind Southwestern banks in dealing with credit problems, and the worst may be yet to come. The profitability of Northeastern banks is still low. Their capital position and liquidity are weak, and their troubled assets are still on the rise.

**West.** Banks in the Western region, especially those in California, are on a decline and, in all likelihood, have not yet reached their trough. Unhealthy banks control 66 percent of banking assets in the West and 88 percent of the banking assets in California. When the economic recovery begins, these unhealthy banks will be unable to be aggressive in helping the recovery by extending credit. Profitability of banks in the West took a sharp decline in 1991, and this decline appears to be caused by the early stages of dealing with credit problems, that is, troubled assets are reducing income. Further declines in profitability will be expected when many of these assets are eventually charged off.

## Conclusions

The national economic recovery may be slowed by the degree of banking problems in important regions of the country. Banks in the Northeast and the West account for more than half of all banking assets in the United States. If the ability of these regions to recover is limited by the weakness of their banks, the recovery of the entire nation will be slowed.

Fortunately, the Southwest demonstrated that economic recovery is possible even when the regional banking industry is weak. To some extent, however, the Southwest's recovery, which began in 1987, was financed by outside sources of funds, such as out-of-state banks, foreign banks and the money markets. These potential sources of funds may not be as readily available for financing economic recoveries in the Northeast and the West in 1992 as they were in the Southwest in the late 1980s.

— Robert T. Clair

[1] For a study of the relationship between economic performance and banking performance, see Gunther, Jeffery W., and Kenneth J. Robinson (1991), "The Texas Credit Crunch: Fact or Fiction?" *Financial Industry Studies*, Federal Reserve Bank of Dallas, June, pp. 1–10.

[2] For a discussion of the lagged relationship between economic recovery and banking performance recovery, see Yeats, Kevin J. (1991), "A Return to Profitability: The Performance of Eleventh District Commercial Banks," *Economic Review*, Federal Reserve Bank of Dallas, July, p. 19.

[3] For a discussion of credit shortages see Clair, Robert T., and Kevin J. Yeats (1991), "Bank Capital and Its Relationship to the Credit Shortage in Texas," presented at the Western Economics Association Meetings, July.

[4] The bank financial data used are the preliminary data for the full year of 1991. Data revisions are common. The data are published in "The FDIC Quarterly Banking Profile," Fourth Quarter, 1991.

[5] For further insight into banking conditions in the Northeast, see Vogelstein, Fred (1992), "New England Banks on Rise, Economy Drags," *American Banker*, March 3, p. 1.

[6] For a more extensive discussion of banking in the West, see Zimmerman, Gary C. (1992), "Red Ink," *FRBSF Weekly Letter*, Federal Reserve Bank of San Francisco, Jan. 24. Also see Zuckerman, Sam (1992), "While California Stumbles, Rest of West Keeps Pace," *American Banker*, Feb. 11, p. 1.

[7] Banks have reported weak loan demand for some time. See Wilcox, James A. (1992), "The January 1992 Senior Loan Officer Opinion Survey on Bank Lending Practices," mimeo published by the Division of Monetary Affairs, Board of Governors of the Federal Reserve System, Feb. 5.

[8] Specifically, unhealthy banks have a capital ratio below 6 percent, a troubled asset ratio above 3 percent, or negative net income.

[9] For a more complete development of the problems of unhealthy banks and credit crunches see Rosenblum, Harvey (1991), "Pathology of a Credit Crunch," *Southwest Economy*, Federal Reserve Bank of Dallas, July/August, p. 6.