Have Texas Banks Fully Recovered?

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The Texas banking industry has shown strong improvement since the tumultuous economic conditions of the mid- to late 1980s. The industry's recovering health is apparent on its bottom line: 93 percent of Texas banks were profitable in 1992, and the return on assets for the Texas banking industry has exceeded the national average since 1991.

What's more, evidence suggests that Texas is outpacing the nation in its rate of economic growth.[1] This improvement in the state's economy has enabled borrowers to repay their debts to banks and enabled banks to advance funds to new borrowers. But are Texas banks *fully* recovered, and is lending activity expanding?

Although Texas banks have made much progress, they must continue to improve before they can be considered fully recovered. Two measures—financial ratios and aggregate lending—provide insight into the industry's well-being and indicate that Texas banks must increase capital levels and fill their share of the expanding credit needs of the growing Texas economy.

Vital Signs of the Banking Industry

The banking industry's health cannot be observed or measured directly. Instead, financial analysts must look for signals that suggest that banks are healthy, just as medical doctors examine patients by measuring their temperature, heart rate and blood pressure. When the vital signs are normal, the diagnosis is favorable and the patient can resume normal activity.

For banks, normal activity means channeling funds from savers to investors. Banks must choose the best uses of the pooled funds from among the many competing uses. Banks' success at finding these best uses will be reflected in their healthy financial ratios and ample lending and investment activity.

The prosperity of the banking industry is linked to the economy, and the economy is fraught with risks that make allocation decisions difficult. Over the business cycle, borrowers experience changing incomes, which affects their ability to repay loans. As loans become delinquent, banks incur losses, which impair banks' capital position and ability to make future loans. As the economy recovers, businesses and households prosper and regain their ability to repay debt. As repayments climb, bank profits also recover, capital increases and troubled assets fall.

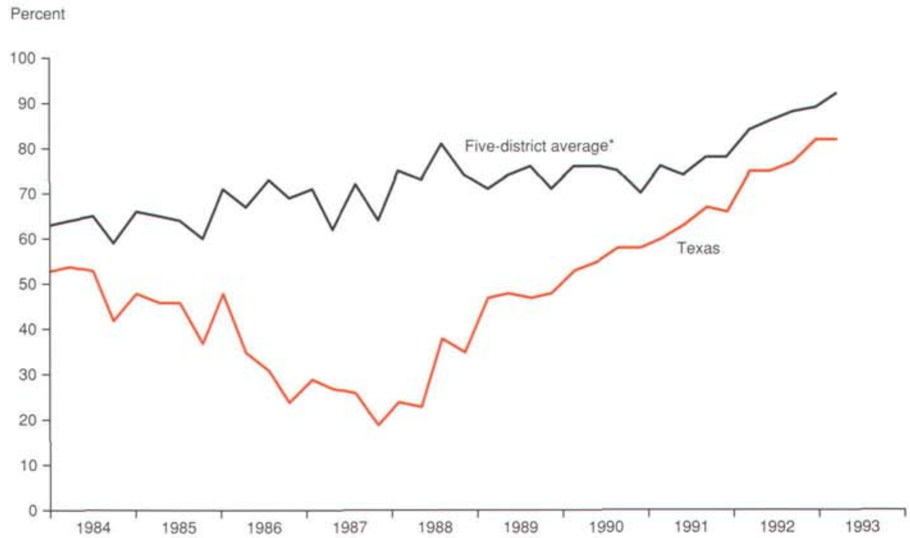
These three items—profits, capital and troubled assets—are closely watched, interrelated but imperfect indicators of the banking industry's performance. Even if all three measures indicate good financial condition, the industry may still be unhealthy if banks deny loans to some creditworthy borrowers. The availability of credit to creditworthy borrowers, although difficult to observe, is another indicator of the banking industry's vitality.

An active, expanding banking sector is another signal of industry health. Growing portfolios indicate that loan officers believe that loans are potentially profitable. When the financial ratios and portfolio expansion are within normal standards, analysts can infer with greater confidence that banks are healthy.[2]

Financial Ratios. One gauge of the banking industry's health is based on three financial ratios: asset quality, capital position and earnings, or ACE. ACE represents the percentage of assets held by healthy banks. The ratios upon which ACE is based identify banks whose financial condition does not constrain them from making quality loans. These healthy banks are earning profits, have a capital ratio that exceeds regulatory standards by at least 0.5 percent and have less than 3 percent of their total assets in the troubled assets category (which consists of past due loans plus repossessed real estate). To be meaningful, the ACE measure for Texas banks must be compared with an objective standard, such as the same measures for banks in other regions. Such a stan-

"Several measures of statewide economic performance indicate that the Texas economy is expanding."

Chart 1
Percentage of Assets in Healthy Banks, Texas and Five Federal Reserve Districts



* Banks served by the Federal Reserve Banks of Cleveland, Chicago, Kansas City, Minneapolis and St. Louis.
SOURCE: Federal Reserve Bank of Dallas.

dard compares Texas banks with healthy banks in prospering regions.

A look at the performance of banks within the nation's 12 Federal Reserve districts provides a basis for comparison. Healthy banks served by the Cleveland, Chicago, Kansas City, Minneapolis and St. Louis Feds hold more than 80 percent of the total bank assets within their district (*Chart 1*). These five districts exhibited the best performance and had the fewest problems during the late 1980s, and banks in four districts had expanding loan portfolios in each of the past five years. The greatest percentage of assets in healthy banks reported since 1988 in any district was 92 percent. If that figure is close to the maximum attainable, then 80 percent seems to be a reasonable cutoff between healthy and unhealthy.

As Chart 1 shows, Texas banks have crossed the 80-percent threshold. With healthy banks holding 82 percent of the assets as of first-quarter 1993, Texas banks are not far behind the levels reported by banks in these other five healthy regions. Texas lies in the Eleventh Federal Reserve District, which is headquartered in Dallas.[3]

One drawback of an interregional comparison of bank performance is that banks in specific regions service different industries and populations with different demographic traits, and these differences can affect credit needs and deposit supplies. For this reason, it is useful to consider another standard of comparison, the current ACE value for Texas banks contrasted with its own past values. This approach takes into account factors specific to this state. Texas banks may have always operated in a unique manner that affects the ACE measure. Texas has no home equity-based lending and no state personal income tax, which may reduce the demand for consumer debt backed by real estate and, in turn, reduce bank earnings.

Another difficulty in the analysis of historical figures arises from changes in the regulatory standards that directly affect the reported numbers. For instance, at the end of 1990 federal regulators implemented new risk-based capital requirements for all U.S. banks. These new standards require banks to hold capital in proportion to the risk taken. Previous capital requirements were a simple proportion of the banks' assets.

Using a historical standard for the state of Texas is difficult because the necessary data for the ACE measure were not reported by banks until Texas was already experiencing its banking crisis. Nonperforming loans, which are used to calculate total troubled assets, have been reported since 1984. During 1984, healthy Texas banks held only about 53 percent of the commercial banking industry's assets, and this percentage declined until 1987. The 1985–90 period does not provide an adequate standard because of the extensive losses and record-setting number of bank failures. From 1990 through 1992, the ACE measure was climbing but was still low. Although this historical measure demonstrates the substantial progress Texas banks have made, analysts will not know if Texas banks' current condition is normal until the next downturn in the business cycle.

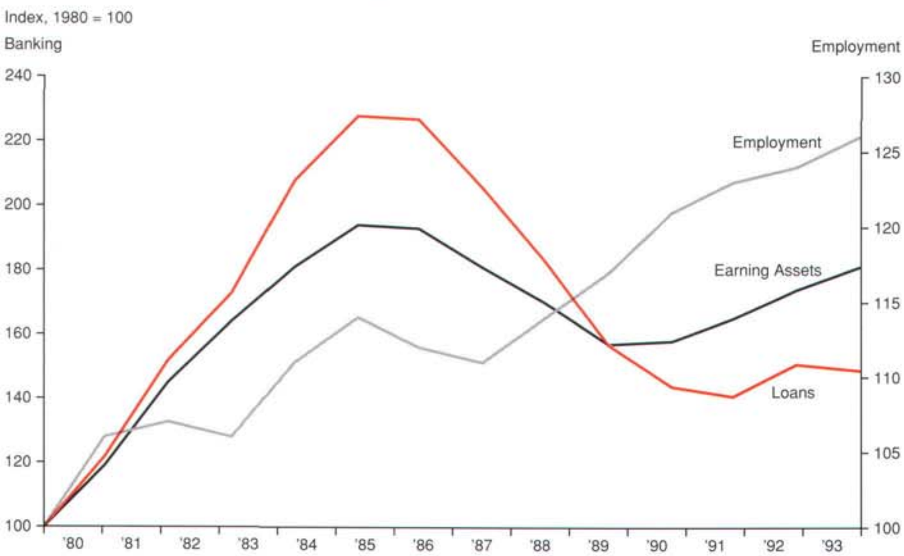
Rate of Expansion. While financial ratios provide one measure of bank performance, banks' rate of increase in earning assets is evidence of a regional economy with growing credit demands and a healthy banking sector performing its role as a financial intermediary. Banks in sound financial condition should be aggressively seeking profitable loan opportunities. If the local economy lacks sufficient loan demand, healthy banks will invest in securities or seek to expand elsewhere. In most instances, healthy banks should have expanding portfolios. Conversely, if banks are in poor financial condition, they may—voluntarily or at the suggestion of supervisory agencies—cut back on additional lending in favor of lower risk securities until their condition improves.

Several measures of statewide economic performance indicate that the Texas economy is expanding. Since the end of the regional recession in 1987, employment has grown by more than 12 percent and nominal personal income has posted consistent, healthy increases that averaged 6.5 percent annually even through the recent national recession. Yet for five years after the nonfinancial-sector recovery began, total loans at Texas banks decreased. Total loans declined from 1986 until the fourth quarter of 1992.[4] Banks, however, have increased the amount of securities that they hold. Chart 2 illustrates changes in loans and earning assets relative to the Texas economy.

Several factors have contributed to this shift in the banks' balance sheets. The higher costs of originat-

"Banks in sound financial condition should be aggressively seeking profitable loan opportunities."

Chart 2
Texas Employment and Banking Indicies



Earning Assets = Loans + Securities.
SOURCE: Federal Reserve Bank of Dallas.

ing and holding loans and better returns on alternative investments, particularly government securities, changed banks' willingness to lend, while constraining risk-based capital requirements changed banks' ability to lend.[5] Federal banking authorities tightened their regulation of banks in response to the savings and loan debacle and the severe difficulties commercial banks experienced in the Southwest and other regions of the country. These new, stricter regulations impose additional costs on lending and other operations without increasing profit opportunities. Deposit insurance premiums have also increased and are now linked to the amount of risk present on banks' balance sheets. And finally, federal bank examiners have scrutinized banks' loan portfolios, off-balance-sheet accounts and other operations more closely to prevent bank failures and reduce the costs of resolving insolvent banks.[6]

Aggregate earning assets at Texas banks have been growing since late 1990, but the growth has come very slowly. Texas banks will be judged more favorably when loans and all earning assets and the Texas economy are moving together.

How Has the State's Economy Adjusted to a Weakened Banking Industry?

Over the past six years, the Texas economy has recovered in spite of a weakened banking sector. As credit relationships broke down due to banks' weak financial condition or outright failure, borrowers sought credit elsewhere or reduced their credit needs.

All signs point to good health for the banking industry in Texas. The state's job growth is predicted to outpace national job growth in most sectors throughout the year. Banks' financial condition continues to improve, and aggregate lending has started to grow. Texas banks soon should be fueling real economic gains in Texas with additional credit. Borrowers may not receive the easy credit they enjoyed in the early 1980s, but creditworthy borrowers should be able to find banks willing to advance prudent amounts of loans at reasonable costs for useful projects. Conditions are definitely suitable for strong, well-managed commercial banks in Texas to supply credit to meet growing business and consumer demands.

—Kevin J. Yeats

[1] Stephen P. A. Brown, Robert T. Clair, D'Ann Petersen, Keith R. Phillips, Harvey Rosenblum and Mine K. Yücel, "Southwest's Economic Growth to Exceed Nation's," Federal Reserve Bank of Dallas *Southwest Economy*, March/April 1993.

[2] Analysts must exercise caution when examining reported financial ratios. During the 1980s, many thrifts took advantage of lax accounting procedures to hide their underlying precarious financial condition. Loose regulatory supervision allowed these thrifts to grow at extraordinary rates. Thus, even though these thrifts were growing and reported strong financial ratios, they eventually collapsed and created losses to shareholders, some depositors and the deposit insurance fund.

[3] The Eleventh District encompasses the northern half of Louisiana and the southern half of New Mexico, along with Texas.

[4] Aggregate loans outstanding may not be the best measure of banking activity since this component does not account for such factors as loan securitization and loan sale activity or loan transfers between banks under a multistate holding company.

[5] Harvey Rosenblum, "Pathology of a Credit Crunch," Federal Reserve Bank of Dallas *Southwest Economy*, July/August 1991.

[6] Robert T. Clair and Paula Tucker, "Six Causes of the Credit Crunch," Federal Reserve Bank of Dallas *Economic Review*, Third Quarter 1993.

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