Is the Southwest Lending Boom Too Much of a Good Thing?

"Those that cannot remember the past are condemned to repeat it."
—George Santayana

The lending recovery in the Federal Reserve's Eleventh District, while celebrated by most, to some signals trouble ahead.[1] For some observers, the lending recovery rekindles memories of the mid-1980s boom that preceded the biggest wave of bank failures since the Great Depression. Bank failures in the 1980s, however, resulted not from loan growth but from a substantial decline in credit standards that netted huge loan losses when the regional economy fell into recession. In the current recovery, credit standards have eased somewhat but not to the dangerous levels of the past.

The Credit Cycle in the Southwest

Lending in the Eleventh District contracted sharply from 1985 through the early 1990s. The lending contraction, called a *credit crunch*, coincided with the severe regional recession that ran from 1985 to 1987 and the toughest years of the banking crisis—1988 through 1990 (Clair and Tucker 1993). The banking crisis forced District bankers to impose strict underwriting standards and retrench lending operations until their banks' financial condition improved. In many cases, even these efforts could not save banks from failure. The regional recession also lowered the creditworthiness of many would-be borrowers, and numerous business failures pushed some borrowers into default. Both loan supply from banks and loan demand from qualified borrowers were depressed.

Today, loan demand and supply in the Eleventh District have reversed their decline. The District's economy began to improve in 1987 and has since continued on an upward trend. A growing economy generates increased demand for credit. Because the general economic outlook is positive, borrowers look more creditworthy to lenders. In addition, District banks have regained their financial health, with 97 percent of banking assets held at healthy banks.[2] As banks grow stronger and more optimistic about their potential borrowers, they are returning to less severe underwriting standards, and lending is reverting to earlier levels to meet demand.

The credit crunch ended in 1992 when lending activity began to recover. By year-end 1992, the Eleventh District's large banks had begun to report increases in loans (*Chart 1*). By year-end 1993, the recovery had expanded to include small Eleventh District banks as well. During the first three quarters of 1994, District lending was increasing at an annual rate of 6.7 percent.

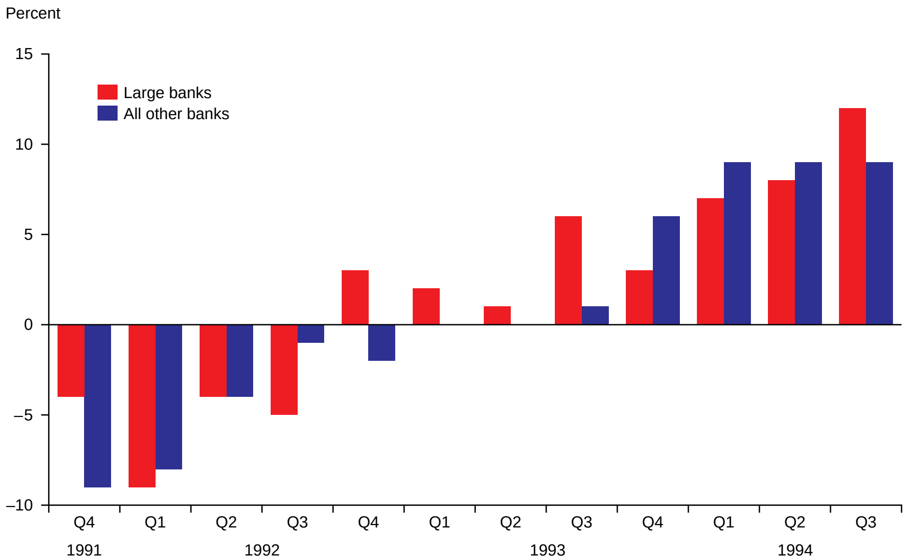
The business lending expansion came as a result of positive shifts in both supply and demand. What has happened in the Eleventh District mirrors what bankers reported in the nationwide Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS), conducted by the Federal Reserve System. That survey reported that the demand for credit began to increase in the second quarter of 1992, and credit standards began to ease significantly by the third quarter of 1993. Demand went up as borrowers sought funds to finance inventory increases, to invest in new plants and equipment and to finance mergers and acquisitions.

Competition and Credit Quality

An alternative view is that loans are expanding because banks have lowered their credit standards in response to competitive pressures. Banker surveys indicate that competition among banks has been intense recently. This view, however, implicitly assumes that the demand for credit from qualified borrowers is constant or growing more slowly than loan supply. And, when faced with excess supply of loanable funds, banks lower their credit standards to unreasonable levels rather than invest the funds in other instruments.

The view that competition leads to ruinous credit standards can be ex-

Chart 1
Growth of Commercial Loans at Large and Other District Banks
(Year-over-year growth adjusted for mergers)



NOTE: Large banks adjusted for mergers.

plained as a *post hoc, ergo propter hoc* fallacy, which translates as "after this, necessarily because of this." Loan defaults do increase following periods of loan growth, but the two are not necessarily related. Lending follows the business cycle with a slight lag. Loan defaults are countercyclical, falling during expansions and rising during recessions. As a result, as the economy proceeds through a series of business cycles, observers of the banking industry see alternating periods of increased loan growth followed by increased loan defaults. They draw the conclusion that the loan growth was the cause of the loan defaults without proving the connection.

There is evidence to the contrary—that is, competition has not lowered credit quality. Banker surveys tell us that competition has lowered loan prices but not underwriting standards. Bank examiners report that they have not seen signs of relaxed loan standards. Finally, while some banking industry analysts are concerned about lower bank stock prices, their expectations are based on forecasts of lower profit margins and not expectations of higher loan losses.

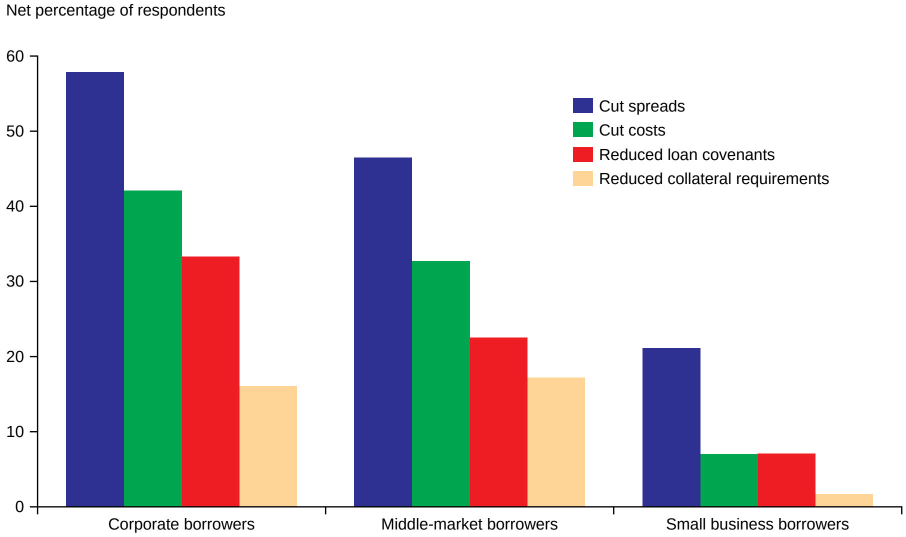
Competition has lowered prices, not lowered credit standards. Nationwide, three times as many banks have cut their profit spreads as have cut their collateral requirements, and nearly twice as many were cutting their spreads as were easing their loan requirements, according to the August SLOOS (*Chart 2*).[3] In addition, surveys of business lending terms show that collateral requirements for short-term business loans are unchanged. Although some loan covenants and collateral requirements have eased, this easing has been less common and probably reflects a return to normal risk–return standards after the excessive tightening caused by the banking crisis.

Although bank examinations are confidential, the Federal Deposit Insurance Corporation (FDIC) has substantially reduced its estimate of the number of problem banks. Since the end of 1991, the number of problem banks nationwide fell from 1,016 to 338 by mid-year 1994.[4] Within the Eleventh District, Federal Reserve bank examiners see no trend toward unsound banking practices among the 51 state-member banks they supervise.

Bank stock analysts at such firms as Dean Witter Reynolds, Smith

"Banker surveys tell us that competition has lowered loan prices but not underwriting standards."

Chart 2
Changes in Terms of Lending at Large U.S. Banks, August 1994



SOURCE: Senior Loan Officer Survey on Bank Lending Practices.

"While recovering from the banking crisis, banks substantially improved their earnings by working off troubled assets and reducing loan losses."

Barney, Salomon Brothers and Merrill Lynch do not cite credit quality issues as a reason for downgrading some large bank stocks. The analysts are worried about the effects of higher interest rates and banks' diminishing opportunities to improve their financial performance in the near term. While recovering from the banking crisis, banks substantially improved their earnings by working off troubled assets and reducing loan losses. Now balance sheets are clean and competition is picking up, leaving banks with narrower profit margins that will slow the growth of future bank profits.

Is Rapid Loan Growth a Problem In the Eleventh District?

Further empirical evidence shows that loan growth is related to deterioration in loan quality only under extreme conditions not currently apparent in the Eleventh District. Research (Clair 1992) shows that rapid growth leads to lower loan quality only if the following conditions are met:

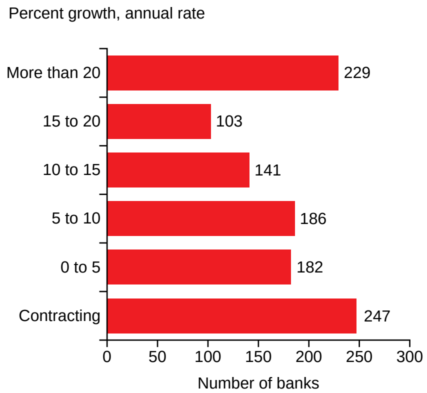
1. The banks had below-average capital ratios.
2. Loans were growing at least four times as fast as state personal income.
3. The increased lending was generated by heightened marketing to new and existing bank customers, called *internally generated lending*, and was not the result of mergers, acquisitions, loan purchases or asset transfers.

Historical data show that rapid growth by banks that met these three criteria experienced a small but statistically significant increase in loan chargeoffs after a three-year lag.

An analysis of current banking conditions in the Eleventh District finds that recent loan expansion does not fit these three criteria and should not cause concern. The rapidly growing banks in the Eleventh District are financially healthy. In addition, a great deal of the loan growth, especially at the largest District banks, is the result of mergers, acquisitions, loan purchases and asset transfers.

Only about one-fifth of banks in the Eleventh District are growing rapidly, and they are financially healthy. Chart 3 shows the distribution of banks by their loan growth rate from the fourth quarter of 1992 to the third quarter of 1994.[5] Only 229 banks grew at an annual rate in excess of 20 percent. By and large, the fastest growing banks are

Chart 3
Distribution of Eleventh District Banks by Loan Growth Rates, Fourth-Quarter 1992–Third-Quarter 1994*



* Excludes banks with more than $1 billion in total loans.

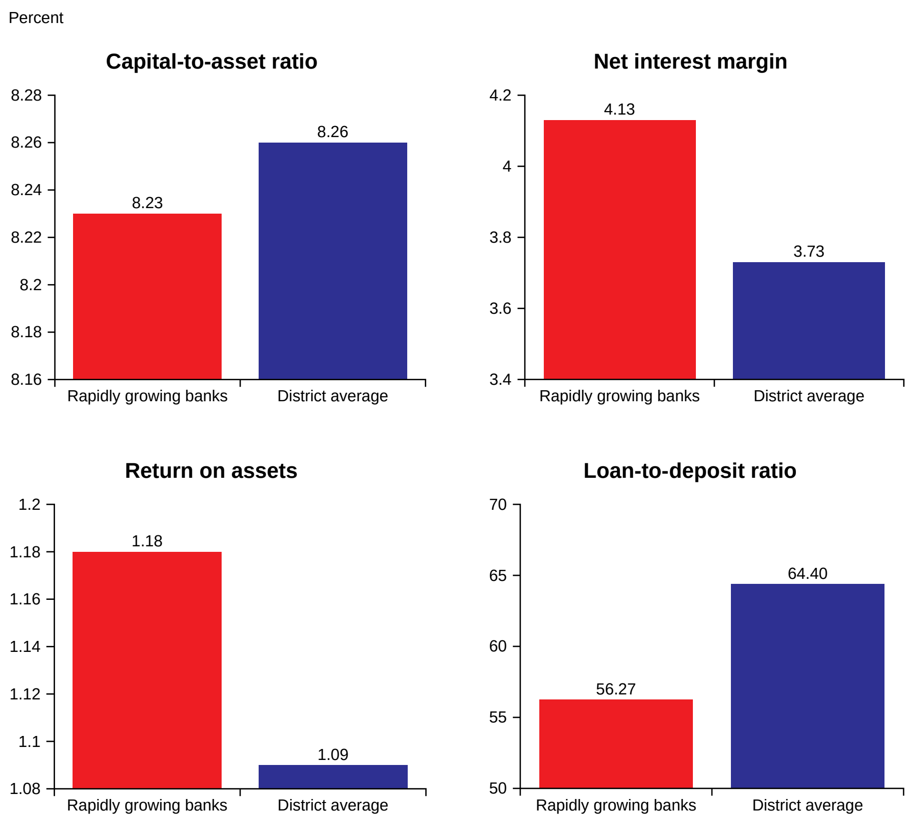
small and financially healthy (*Chart 4*). Furthermore, the expansion of their loan portfolios has been well-diversified across all major types of loans.

Analysis of the 10 largest District banks shows that loan growth has been primarily the result of acquisition. Historically, growth through acquisition is not correlated to declines in loan quality. After adjusting for acquisitions, mergers and net loan purchases, nine of the top 10 banks reported loan expansion generated through increased marketing efforts to new and existing customers of less than 20 percent. Only one large bank reported adjusted loan growth in excess of 20 percent, and it is a financially healthy bank.

A similar study of U.S. banks shows that banks with high-quality loan portfolios are the ones that are growing relatively faster and that banks with above-median growth rates have the greater reserves for absorbing loan losses (Klemme 1994). Among a sample of U.S. banks that were in existence from the first quarter of 1993 through the third quarter of 1994, those with the lowest troubled asset ratios reported higher loan growth. In addition, banks with relatively high loan growth have not reported any decrease in loan quality

"Historically, growth through acquisition is not correlated to declines in loan quality."

Chart 4
Rapidly Growing Banks in the Eleventh District Compared with District Averages, Second-Quarter 1994



"Vigilance in maintaining credit quality is necessary as the first line of defense against future banking crises."

and have a higher ratio of loan loss reserves to noncurrent loans.

Misplaced Concerns or Foresight?

There appears to be little reason to worry about the recovery in business loan demand in the near term. This conclusion is based on the sound financial condition of the rapidly expanding banks. Increased competition for new loans has decreased profit margins, but easing of underwriting terms has been modest. In general, there has been no widespread deterioration of credit standards or credit quality.

Why, then, are some prominent bankers—including Joseph May, the president of Robert Morris Associates, the professional society of commercial lenders—raising concerns about repeating the mistakes of the 1980s? They realize that inevitably, the economy will enter into a recession at some time in the future, causing some borrowers to default. They know that eventually, banks will experience the downside of another credit cycle. Bankers who lived through the last banking crisis want bankers to be ready to weather the next downturn without the turmoil experienced in the past decade.

Preserving the quality of the loan portfolio protects the bank, its shareholders, creditors and depositors from unanticipated losses resulting from borrowers' defaults. While worries about underwriting standards are premature in the current environment, business environments can change during the life of a loan, which is often a long-term commitment. Vigilance in maintaining credit quality is necessary as the first line of defense against future banking crises.

—Robert T. Clair

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Notes

[1] The Eleventh Federal Reserve District includes Texas, northern Louisiana and southern New Mexico.

[2] A healthy bank is defined as profitable, with troubled assets less than 3 percent of total assets and a capital ratio in excess of 6 percent.

[3] Eleventh District SLOOS results are not reported to maintain the confidentiality of the small sample of respondents.

[4] Unfortunately, Eleventh District data on the number of problem banks are unavailable.

[5] Banks with total loans of $1 billion or more have been dropped from this analysis because their extensive merger activity biases the data.

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