

# Regional Lending in a World of Interstate Banking

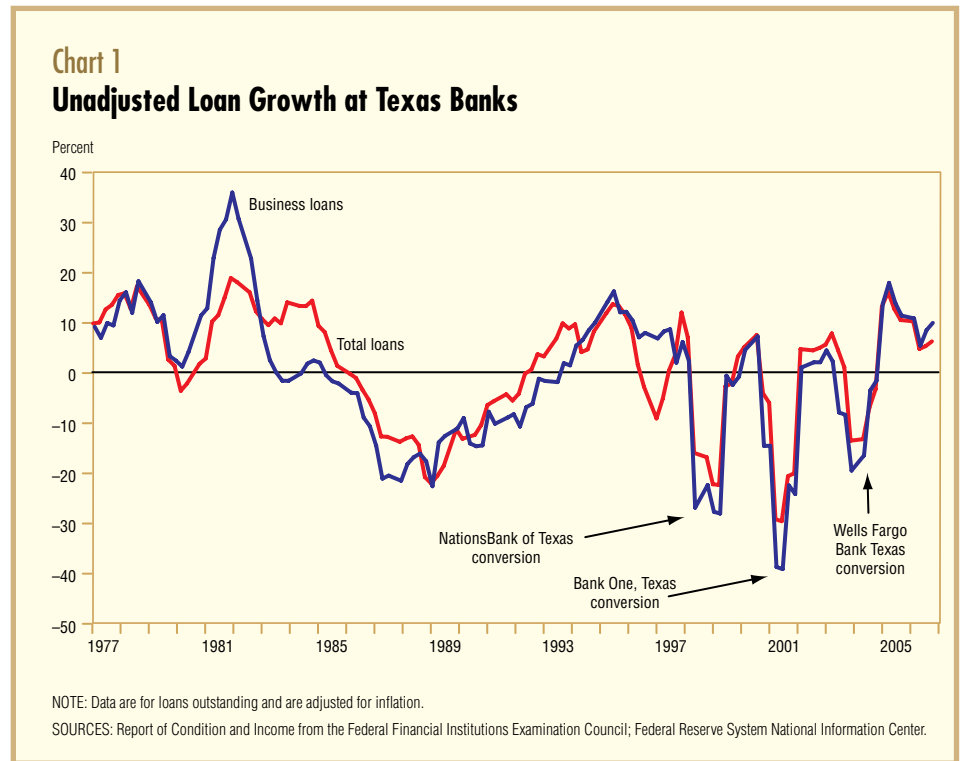
By Kenneth J. Robinson

Texas today can obtain banking services from an institution based in Muleshoe or from one headquartered as far away as New York City. But this wasn't always possible. Federal law once prohibited most banks from branching across state lines. It wasn't until Congress passed the Riegle–Neal Interstate Banking and Branching Efficiency Act of 1994 that institutions and their customers could enjoy the full benefits of interstate banking (see “*Banks vs. Branches*” on page 13).<sup>1</sup>

Unfortunately, the same legislation that increased the U.S. banking system's efficiency also muddled the regional lending picture. In Texas, official data on loan volume—which represents the activity of institutions headquartered in the state—was skewed when many Texas-based banks became branches of banks based elsewhere.

Loan growth at Texas banks has been erratic since the late 1990s, giving the illusion of an industry in flux. But when the data are adjusted for interstate branching, a more positive growth pattern emerges.

Lending trends are closely watched because they provide insights into economic activity. Growth and employment reflect capital flows that go to businesses to fund operations and to consumers to buy houses, cars and other durables. If the data don't capture loan activity from outside the state, we can't get a clear picture of the Texas economy.



## Measuring Loan Activity

The inflation-adjusted stock of total loans and business loans at Texas banks experienced a sharp run-up in year-over-year growth in the late 1970s and early 1980s, corresponding to the state's oil boom (Chart 1).<sup>2</sup>

The sustained lending decline that

followed reflects the collapse in oil prices and the regional recession beginning in the mid-1980s. Lending bounced back as the economy recovered in the early 1990s. Despite a booming economy, loan activity became highly erratic in the late 1990s.

Banks that have only branches in Texas aren't required to report their lending in the state. Major players such as NationsBank of Texas, Bank One, Texas and Wells Fargo Bank Texas fell out of state data in the late 1990s and early 2000s, when they converted their operations to branches (Table 1). This resulted in a misleading picture of state loan activity.

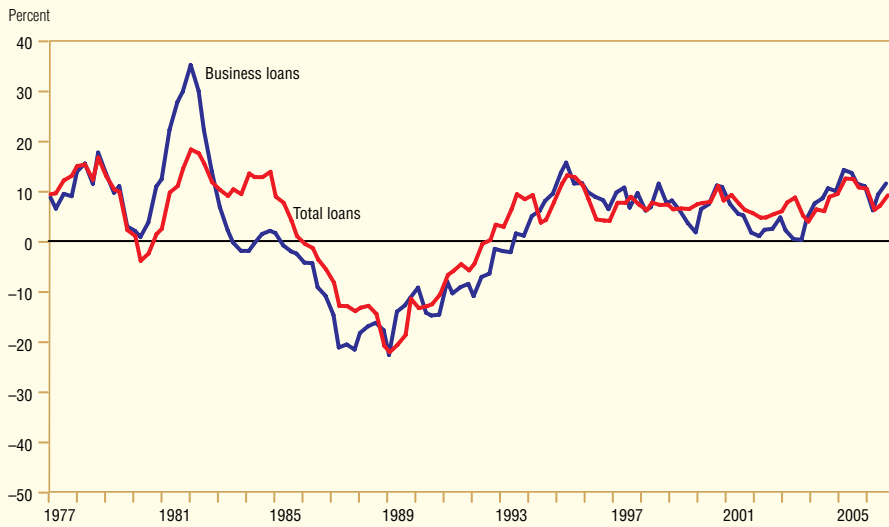
As banks became branches, Texas experienced negative loan growth in percentage terms. However, the downward spikes are an accounting artifact. When accounting changes due to branching are not allowed to affect lending growth rates, the spikes disappear and the lending series display a

**Table 1**  
**Major Texas Conversions: Banks into Branches**

Bank	Parent location	Assets	Conversion date
NationsBank of Texas	Charlotte, N.C.	\$63 billion	May 6, 1998
Compass Bank Houston	Birmingham, Ala.	\$7 billion	Oct. 23, 1998
Chase Bank of Texas	New York	\$25 billion	July 31, 2000
Bank One, Texas	Chicago	\$31 billion	Feb. 7, 2001
Comerica Bank Texas	Detroit	\$5 billion	June 29, 2003
Wells Fargo Bank Texas	San Francisco	\$24 billion	Nov. 20, 2003

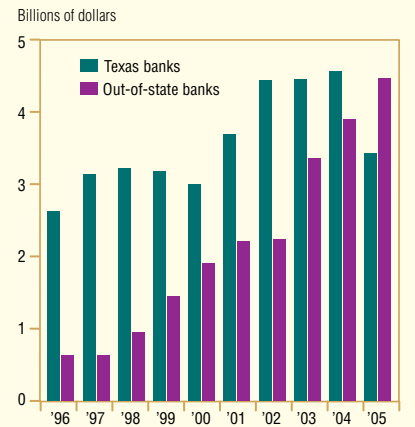
SOURCE: Federal Reserve System National Information Center.

**Chart 2**  
**Adjusted Loan Growth at Texas Banks**



NOTE: Data are for loans outstanding and are adjusted for inflation.  
SOURCES: Report of Condition and Income from the Federal Financial Institutions Examination Council; Federal Reserve System National Information Center.

**Chart 3**  
**Small Business Lending in Texas**



NOTE: Small business loans are defined as loan originations to businesses with gross revenues of \$1 million or less. A reporting change in 2005 affects comparability with prior years.  
SOURCE: Federal Financial Institutions Examination Council.

more regular pattern (*Chart 2*).<sup>3</sup>

Data on small-business loans also point to a more stable lending environment during the interstate branching period.

Under the Community Reinvestment Act, some banks are required to report the location of their small business lending. From 1996 through 2004, institutions with assets of \$250 million and higher reported the geographic distribution of loan originations to businesses with gross annual revenues of \$1 million or less. Beginning in 2005, only banks with assets of \$1 billion or more were

required to report this information.<sup>4</sup>

While not a complete picture of activity in Texas, these data reveal that until 2005, when smaller institutions dropped out of the sample, the dollar amount of loan originations for both Texas-based and out-of-state banks generally rose (*Chart 3*).

### Assessing Economic Impact

Do important inflation-adjusted measures of lending growth at Texas banks—total loans and business loans—correlate with Texas economic activity?

Before interstate branching, loan growth tended to move in tandem with regional economic activity. The volatile, unadjusted lending data don't track as closely with economic activity in Texas after branching arrived in 1998. When the data are adjusted for interstate branching, however, some fairly strong correlations appear.

Correlation coefficients, which measure the extent to which two series move together, provide a straightforward method of determining what regional lending patterns might reveal about the economy. A coefficient of 100 percent means the series move in an identical fashion. A coefficient of zero indicates no relationship between the series. If the coefficient is negative, the series move in opposite directions.<sup>5</sup>

In Table 2, correlation coefficients are calculated for lending activity and year-over-year growth in gross state product, employment growth and changes in the Texas Business-Cycle Index. The first period covers the pre-interstate branching era in Texas, from 1977 to 1997. The second period begins with the introduction of branching in 1998 and runs through 2006. Two sets of correlations are given for this latter time frame. One shows the correlation coefficients using data unadjusted for interstate branching; the other uses the adjusted data series.

In the period before interstate

**Table 2**  
**Correlations Between Growth in Texas Bank Lending and Texas Economic Activity**  
(Correlation coefficients, percent)

	1977–1997 Pre-interstate branching			1998–2006 Post-interstate branching					
	Gross state product	Employment	Texas Business-Cycle Index	Unadjusted data			Adjusted data		
				Gross state product	Employment	Texas Business-Cycle Index	Gross state product	Employment	Texas Business-Cycle Index
Total loans	36	38	36	28	22	23	30	47	48
Business loans	38	48	46	43	32	33	64	68	70

NOTE: Bank data are adjusted for branch conversions and inflation. Gross state product is also adjusted for inflation.  
SOURCES: Report of Condition and Income from the Federal Financial Institutions Examination Council; Federal Reserve System National Information Center; Haver Analytics; Federal Reserve Bank of Dallas.

## Banks vs. Branches

A bank is a separately chartered institution, with its own management, board of directors, accounting statements and capital. A branch, on the other hand, is a bank office. While branches have managers, they don't have their own charters, accounting statements or boards of directors, and they aren't subject to capital requirements. Branches are cheaper and generally more efficient to operate than banks, yet they offer many of the services head offices do.

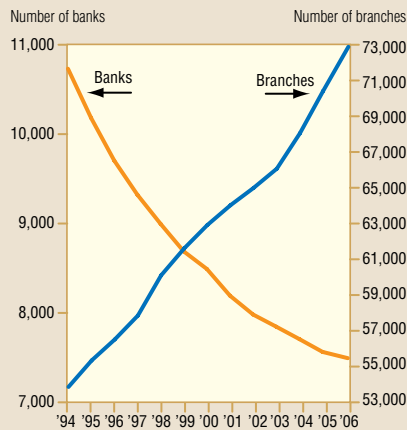
With the advent of interstate banking in 1994, the number of banks declined across the nation (*Chart A*). But banking services didn't go away. The number of branches began to grow dramatically, and they now total over 70,000.

The 1994 legislation removing restrictions on interstate banking allowed states to opt out, which Texas and Montana originally did. In 1998, however, Texas relented.\* Montana allowed branching in 2001.

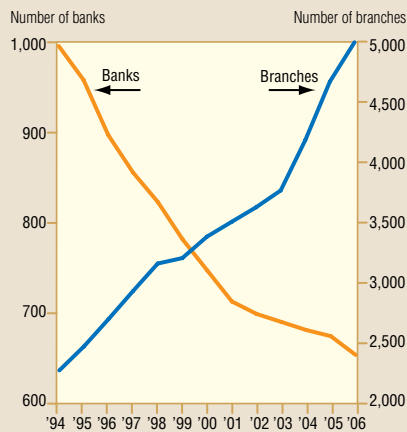
Texas, like the nation, has seen a decline in the number of banks, but it now has more than 5,000 branches in operation (*Chart B*).

\*The Riegle-Neal Act authorized interstate branching to begin in 1997. The act also imposed a 10 percent nationwide concentration limit for a single institution's control of deposits and a 30 percent statewide limit, but states were free to choose a different limit. Texas has a 20 percent concentration limit. Moreover, Texas law generally prohibits out-of-state institutions from establishing new, or de novo, branches. It requires that any bank they purchase be at least five years old.

**Chart A**  
**U.S. Banks and Branches**



**Chart B**  
**Texas Banks and Branches**



NOTE: Data are for FDIC-insured commercial banks.  
SOURCE: FDIC Summary of Deposits.

*Only by adjusting for the effects of interstate banking can we avoid understating the amount of lending taking place in the state.*

evidence suggests that interstate banking has helped dampen regional business cycles.<sup>6</sup> As a result, the U.S. banking industry is likely in better shape now than when it was regionally constrained.

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### Notes

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<sup>1</sup> Prior to interstate branching, many states allowed out-of-state bank holding companies to operate banks within their borders. Even prior to these agreements, banks could lend across state lines by establishing loan production offices in different states. Also, many states set up agreements with each other to allow an out-of-state banking presence.

<sup>2</sup> Some of the lending reported at Texas banks could be extended to customers located outside the state. Loans outstanding are used because all banks report these series, while only larger banks report originations.

<sup>3</sup> The adjustment entails removing a bank from the prior year's calculations if it was converted to a branch of an out-of-state bank. In this way, the transformation does not affect the growth rates of the loan series.

<sup>4</sup> Under the Community Reinvestment Act, banks also report their small business loans based on the size of the loan. These data show Texas banks reported more small business loans in Texas than out-of-state institutions did until 2004.

<sup>5</sup> It is important to keep in mind that correlation does not imply causation. That is, just because two series are highly correlated does not mean that one series is the result of or causes movements in the other.

<sup>6</sup> "Bank Integration and State Business Cycles," by Donald P. Morgan, Bertrand Rime and Phillip E. Strahan, *Quarterly Journal of Economics*, November 2004, pp. 1555-84.

branching, the correlations are generally higher for business loans than total loans, as expected, and range from 36 percent to 48 percent. After branching is allowed in Texas, the correlation coefficients using unadjusted data drop off—with one exception. The correlation between gross state product and business loans goes up from 38 percent to 43 percent.

The results using the adjusted data show how interstate branching can affect the data. The correlation coefficients are all higher—in some cases substantially so—than those calculated with the unadjusted data. Again, business loans show the highest correlations, reaching 70 percent when using the business-cycle index as the measure of economic activity.

### Overall, a Good Thing

Conventional measures of local lending are inadequate to see the true picture of loan volume on a regional basis. Branches of banks based elsewhere lend in Texas, but their activity is difficult to gauge because they aren't required to report. Only by adjusting for the effects of interstate banking can we avoid understating the amount of lending activity actually taking place in the state.

While interstate branching may render regional lending measures inadequate, it has brought a number of benefits to banks and their customers through reduced restrictions and costs. It also has allowed banks to diversify, so that they are less vulnerable to regional economic shocks. Some