Texas Banks Enter This Downturn on Better Footing

Kory Killgo and Robert R. Moore | Annual Report 2015

The oil price plunge that began in mid-2014 is reminiscent of the state's big bust nearly three decades ago, when oil prices declined more than 70 percent in real terms.

More than 700 banks and savings and loans, including nine of the 10 largest, failed in Texas from 1986 through 1990.

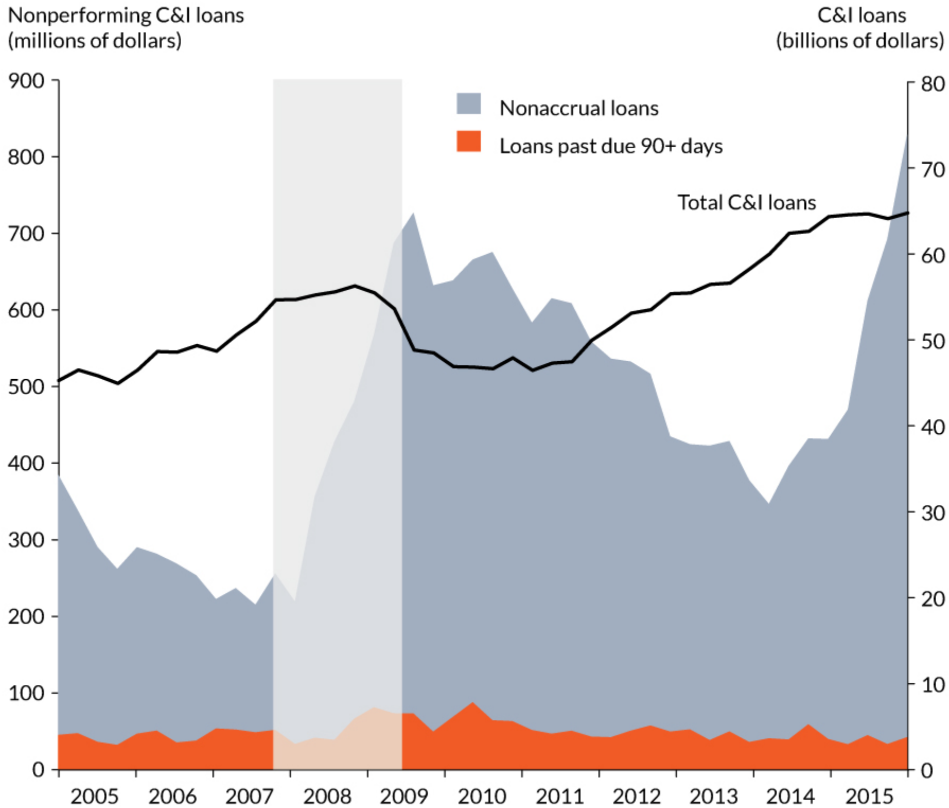
The recent price decline of 65 percent through the end of 2015 raises the specter of history repeating itself. That is a disturbing prospect given that the 1980s banking crisis, whose roots extended beyond energy woes, entailed substantial cost to the Federal Deposit Insurance Corp. and likely contributed to the worst recession in Texas since the Great Depression.

By most measures, Texas banks are on sound footing today. Noncurrent loans as a percent of total loans are roughly 40 percent lower and profitability is higher for institutions in the state relative to those in the rest of the country. But some clouds are gathering. While past-due commercial and industrial (C&I) loans remained low as a percent of total C&I loans in 2015, they increased from 1.08 percent in September to 1.28 percent in December.

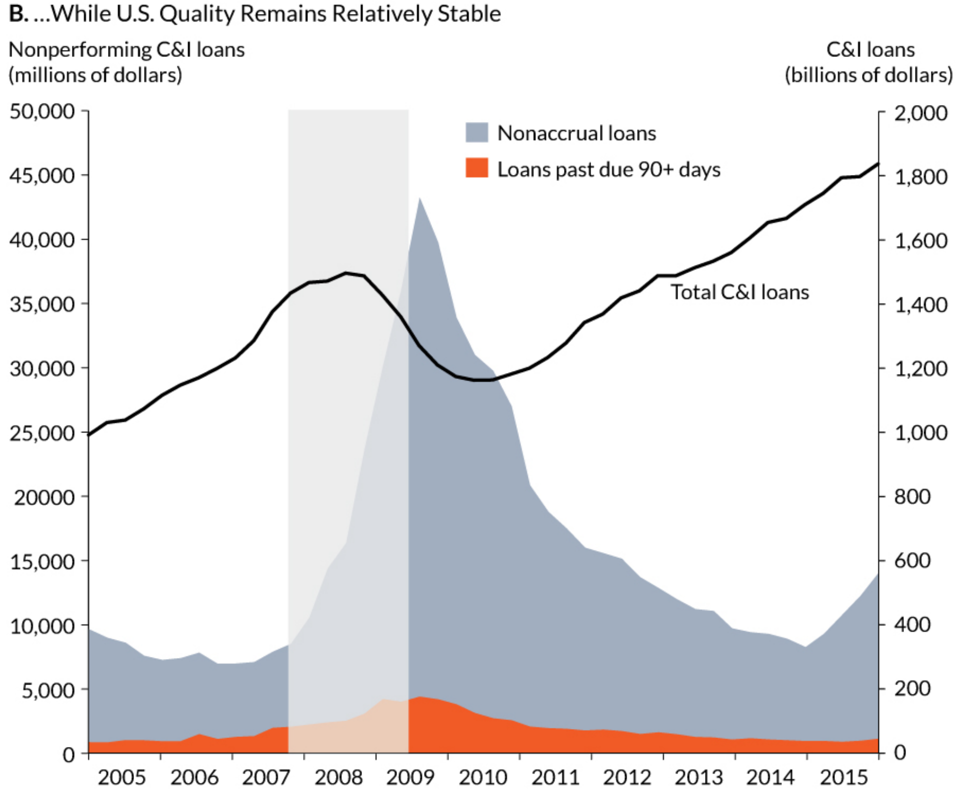
Noncurrent C&I loans—those 90 or more days past due, plus those no longer accruing interest—began increasing at Texas banks in 2014 and were up 92 percent year over year through fourth quarter 2015 (*Chart 1A*). A total of $829 million in C&I loans were noncurrent as of Dec. 31, somewhat more than after the Great Recession. By comparison, noncurrent C&I loans increased 70 percent and were at only 31 percent of their postrecession high in the U.S., where the Great Recession's impact was far greater than in Texas (*Chart 1B*).

Chart 1: Commercial and Industrial Loan Performance a Marker of Bank Health

A. Texas Loan Quality Slips as Oil Retreats…



B. …While U.S. Quality Remains Relatively Stable



NOTE: Shaded bar indicates U.S. recession.
SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

C&I loans include those to energy producers, whose repayment prospects are tied to energy prices. More broadly, bank loan portfolios could be impacted by energy prices indirectly. Many businesses not in that sector have important energy industry customers and operate in geographic areas where energy firms are major drivers of economic activity.

Another cloud on the horizon is the relatively heavy concentration of commercial real estate (CRE) lending. Capital exposure to CRE is 60 percent larger at Texas banks than at banks nationally. And while vacancy rates and banks' past-dues generally remain low, they are moving in the wrong direction and concentrations bear watching.

Despite the unsettled outlook, Texas banks are better positioned today than during the 1980s oil price collapse. The state economy is more diversified, with energy playing a smaller role. The energy sector accounts for about 2 percent of Texas jobs, down from a high of 4.7 percent in 1982. Additionally, risk-management practices have improved considerably at Texas banks since the 1980s, better positioning them to confront economic shocks.

Beyond these important mitigating factors, significant changes in the banking industry's structure since the 1980s have bolstered Texas banks' ability to weather low oil prices. Arguably, the most important of these involves the ability to conduct business across state lines. In the 1980s, Texas-based institutions could not establish branches outside the state; their counterparts from outside Texas could not open branches here.

These restrictions have since loosened, allowing a level of geographic diversification that did not exist in the 1980s.

Today, 18 percent of deposits in banks headquartered in Texas are held outside the state. The freedom to operate in other states allows area banks to limit their exposure to the Texas economy and its associated energy industry ties. Moreover, only 38 percent of deposits in Texas bank branches belong to institutions headquartered in the state.

These structural changes, coupled with the current strength of the regional banking industry, suggest that the clouds on the banking horizon are unlikely to unleash a storm of 1980s proportions.