



*Eleventh District banks were roughly “twice as good and half as bad” as their counterparts across the nation.*

# Eleventh District Banking Industry Weathers Financial Storms

By **Kenneth J. Robinson**

In 2009, the banking industry continued to feel the fallout from the financial crisis that began in mid-2007. Profitability declined while asset-quality problems continued to mount at banks across the nation and at those based in the Eleventh Federal Reserve District.<sup>1</sup> Some good news was revealed in recently available first-quarter data, however, which showed profitability rebounding and increases in asset-quality problems slowing down. Whether measured by profits or problems, Eleventh District banks were roughly “twice as good and half as bad” as their counterparts across the nation. Most likely, this reflects the fact that the economic downturn was less severe in the district than in other parts of the nation.

Another noticeable difference emerges when comparing district banks’ recent performance with an earlier period when the economy turned south and the industry suffered significant damage—the mid- to late 1980s. At that time, students of banking history may

recall, a sharp decline in oil prices triggered a deep regional recession. Bank failures soared, and the financial landscape in Texas and other parts of the Southwest changed considerably.

This raises the question of why the district’s banking industry has been able to weather the current downturn—so far—with less damage than in the 1980s. The answer likely can be found in the changing nature of the district’s economic environment since then.

## Basic Performance

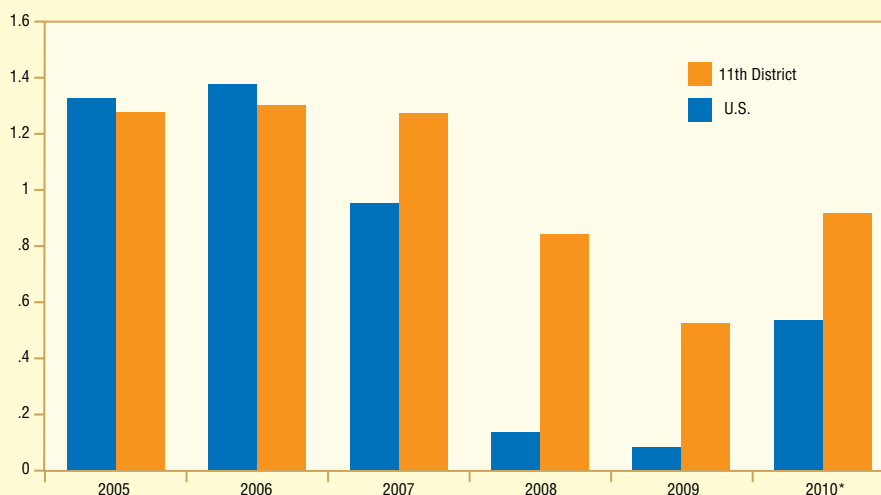
Bank profitability, as measured by return on assets (ROA), continued to decline in 2009 but rebounded in the first quarter of 2010. U.S. banks earned an annualized return of 0.53 percent in the first quarter, up from 0.08 percent for all of 2009. Eleventh District banks recorded an annualized ROA of 0.91 percent in the first quarter, compared with 0.52 percent in 2009 (*Chart 1*).

Reflecting the tough economic environment, almost one-third of all banks nationwide

**Chart 1**

### Recent Bank Profitability Stronger in the 11th District

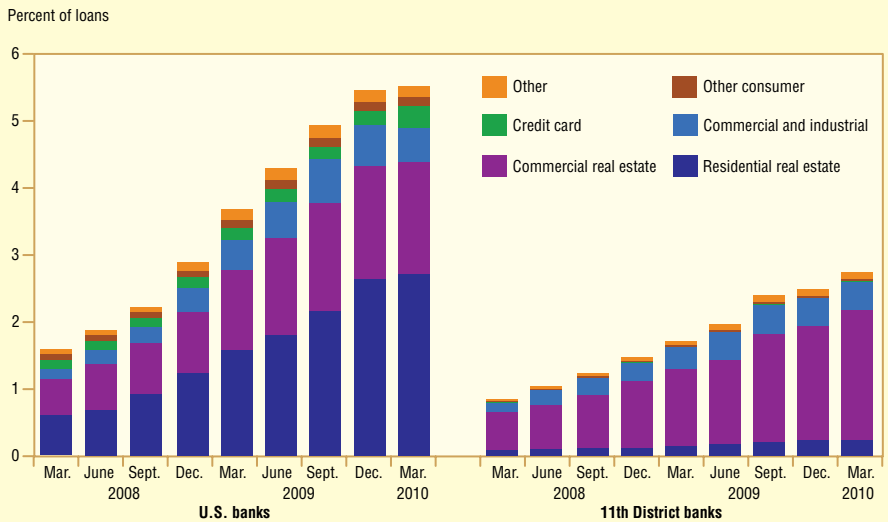
Return on average assets (percent)



\*Data are through March 31, annualized.

SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

**Chart 2**  
**Noncurrent Loans Differ Between U.S. and 11th District Banks**



SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

*The proportion of assets in commercial real estate loans was 24 percent at district banks, almost double the 13 percent at banks nationwide.*

were unprofitable in 2009, while 14 percent in the district suffered losses. For the first quarter, those numbers improved to 19 percent of banks nationwide and 11 percent of district banks that were unprofitable.

The biggest contributor to profitability was net interest income, or the difference between what banks earn on loans and what they pay on deposits. The main factor behind banks' deteriorating performance was a result of increased provisions for loan loss reserves. This "provision expense" is the amount banks set aside out of income to cover estimated future loan losses. Increases in provision expense imply that banks have been attempting to build larger cushions to protect themselves from loans that go bad.

Provision expense at U.S. banks rose to a record annual high of 2 percent of average assets in 2009 but fell back a bit to 1.6 percent (annualized) in first quarter 2010.<sup>2</sup> In the district, provision expense was 1.2 percent in 2009 and declined to an annualized 0.72 percent in the first quarter.

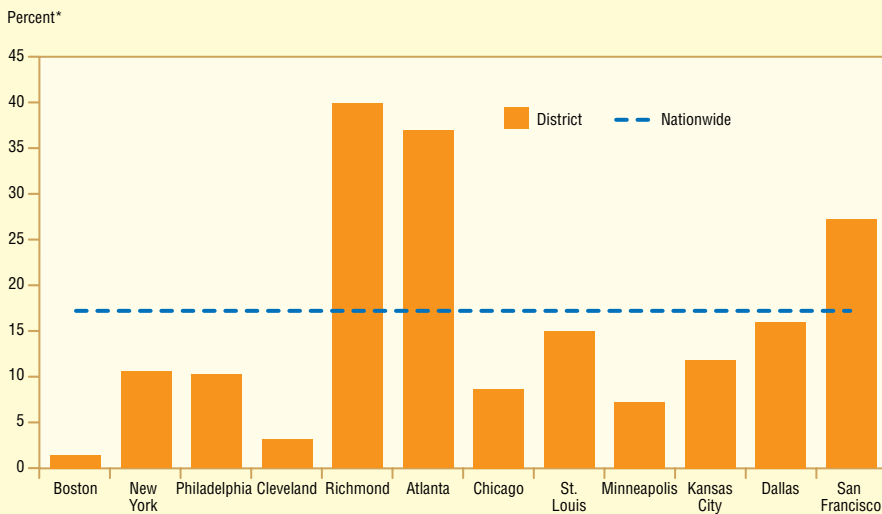
As the economy continued to exhibit weakness, asset-quality problems mounted, mostly in the form of delinquent loans. For U.S. banks, the percentage of loans that were noncurrent—those with payments 90 days or more past-due plus those not accruing interest—increased to slightly more than 5.5 percent in the first quarter, the highest on record. The district noncurrent loan rate also rose but, at 2.7 percent, was much lower than the national figure.

The composition of loans that were noncurrent, though, differed between U.S. and Eleventh District banks (*Chart 2*). At banks nationwide, residential real estate loans represented the bulk of noncurrent loans, followed by commercial real estate loans. In the district, commercial real estate loans were the dominant source of noncurrent loans. A factor in this pattern was district banks' making fewer residential loans and more commercial real estate loans than their national counterparts.

According to the Federal Housing Finance Agency house price index, Texas' annual housing price appreciation peaked at 6.3 percent in early 2007, far below the nationwide peak of almost 12 percent in 2005. Before the onset of the housing bubble, in 2000, residential mortgages accounted for 10 percent of Eleventh District banks' assets, compared with 14.5 percent at U.S. banks. In 2005, residential mortgages accounted for 9.4 percent of district banks' assets, compared with 18.2 percent at U.S. banks. The reduced proportion of residential mortgages at Eleventh District banks could be due to the fact that the housing bubble didn't inflate as much in the district.

At the end of first quarter 2010, the proportion of assets in commercial real estate loans was 24 percent at district banks, almost double the 13 percent at banks nationwide. Within the category, banks report their lending across three main segments—loans secured by nonfarm nonresidential properties,

**Chart 3**  
**Bank Performance on Loan Guidance Varies**  
 (Construction and land development loans)



\*Banks with construction and land development loans greater than total risk-based capital as of March 31, 2010.  
 SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

loans secured by multifamily residential properties, and loans for construction and land development.

As its name implies, the third loan segment finances land improvements prior to building new structures or the construction of industrial, commercial or residential buildings. This is generally considered the riskiest type of commercial real estate lending and has thus been of concern to bank supervisors. In fact, federal regulators issued guidelines in 2007 for banks regarding the extent of their construction and land development lending. The guidance provides a principle-based discussion of supervisory expectations for sound risk-management practices for banks with loans of this type exceeding 100 percent of total capital (adjusted for the riskiness of their assets and off-balance-sheet exposures).<sup>3</sup>

At the end of the first quarter, the percentage of banks that exceeded the guideline varied considerably across the nation. The Richmond, Atlanta and San Francisco districts were well above the U.S. average of 17 percent (*Chart 3*). At 16 percent, the Dallas district was slightly below average. However, the Eleventh District's noncurrent rate for construction and land development loans was roughly half that of banks nationwide.

Banks nationwide and in the Eleventh District have taken steps to deal with their asset-quality problems by writing off bad loans. For U.S. banks, charge-offs net of any

recoveries that have occurred reached an annual record of 2.6 percent of average loans last year, while Eleventh District net loan charge-offs stood at 1.2 percent.

Banks have set aside a record amount of provision expense to try to cover their bad loans. Despite increases in both loan charge-offs and provision expenses, banks

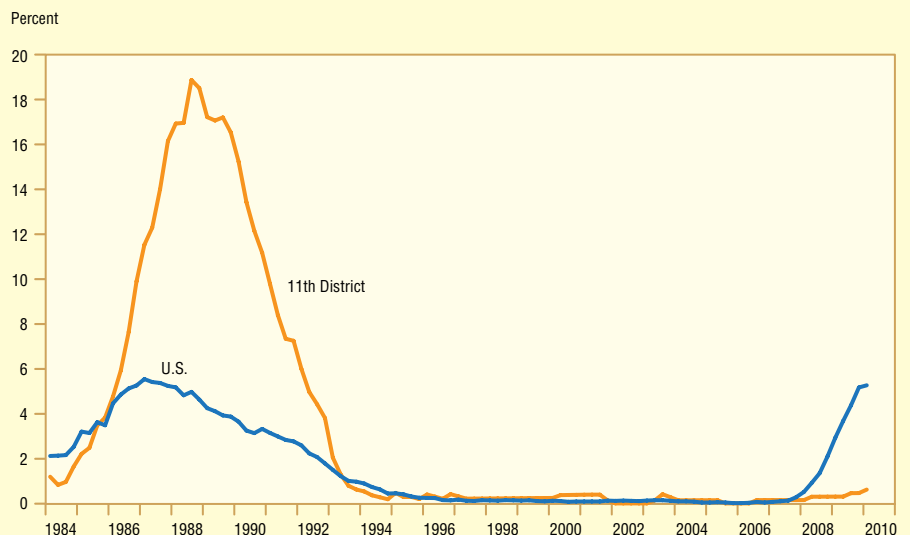
saw further declines in the reserve coverage ratio of noncurrent loans, that is, the cumulative amount of reserves that banks have to cover their bad loans relative to the total amount of bad loans on their books.

For U.S. banks the reserve coverage ratio stood at 67 percent at the end of the first quarter, down from the year-ago level of 71 percent, and at Eleventh District banks the ratio was 59 percent, down from 82 percent a year ago. In other words, banks added more and more to their cushions to protect them from bad loans and continued to write off bad loans; yet, the total amount of loans becoming noncurrent increased even faster.

How do today's banking troubles compare with past ones? One frequently used gauge of overall banking-sector distress is the so-called Texas ratio, which attempts to assess banks' ability to withstand losses. It measures a bank's noncurrent loans and repossessed real estate as a percentage of loan loss reserves and stockholders' capital, including retained earnings but not intangibles such as goodwill. A Texas ratio above 100 percent suggests the potential for troubled assets to wipe out a bank's capital base.

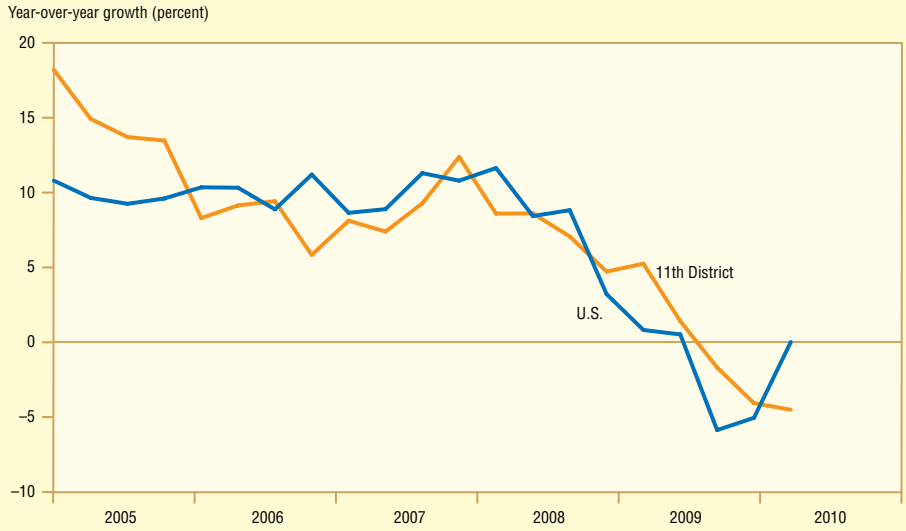
In the 1980s, almost 20 percent of Eleventh District banks had a Texas ratio exceeding 100 percent—thus the origin of its name. In first quarter 2010, though, 0.6 percent of Eleventh District banks were at this danger threshold (*Chart 4*). The percentage of U.S.

**Chart 4**  
**The Texas Ratio Is not About Texas Anymore**  
 (Percentage of banks with a Texas ratio\*  $\geq 100\%$ )



\*The Texas ratio is defined as noncurrent loans plus other real estate owned as a percentage of tangible equity capital plus loan loss reserves.  
 SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

**Chart 5**  
**Pace of Lending Declines at Banks in District and Nationwide**



SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

*Increased lending at community banks is an encouraging sign, especially for small businesses that tend to rely on these institutions for their financing needs.*

banks in danger is approaching national levels of the late 1980s, the last period of major banking-sector difficulties.

### Lending Activity

Declines in profitability and continued asset-quality problems make it difficult for banks to provide the economy much-needed credit. Banks don't report the amount or number of new loans, only the total amount of loans outstanding, net of any charge-offs and loans paid down or paid off. By this measure, lending has been slowing for some time at both U.S. and Eleventh District banks (*Chart 5*).

The willingness or ability of banks to make loans has likely been affected by the recession that began in December 2007. But the demand for bank loans should fall as well. In fact, according to the Federal Reserve's "Senior Loan Officer Opinion Survey on Bank Lending Practices," banks have been reporting weak loan demand from both businesses and households for several years.<sup>4</sup>

It should be stressed, though, that some banks are lending. More than half of all U.S. community banks—defined here as those with assets less than \$1 billion—reported increased lending from first quarter 2009 to first quarter 2010, while 38 percent of larger banks reported increases. The comparable numbers were even higher for Eleventh District banks (*Chart 6*).

Increased lending at community banks is an encouraging sign, especially for small

businesses that tend to rely on these institutions for their financing needs.

### Banks and the Economy

Whether measured by profitability or asset quality, banks based in the Eleventh District have been outperforming their counterparts nationwide, even in the midst of a deep recession. This leads to the first of two interesting questions: Why have district banks been doing better?

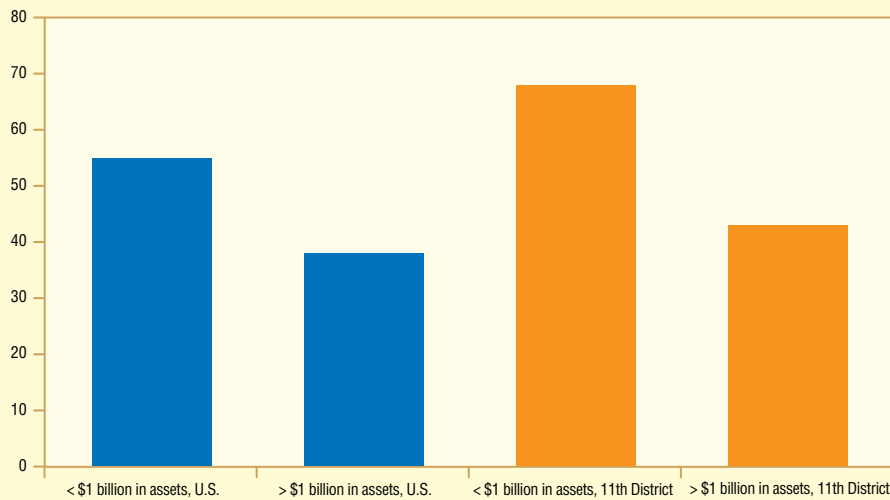
The most plausible answer is the regional economy's performance relative to the U.S. as a whole. The Eleventh District entered the recession later than other parts of the country, and its decline in economic activity was by some measures less severe.

For example, since the recession's start in December 2007, Eleventh District employment has fallen about 2 percent, the smallest job-loss rate among all 12 Federal Reserve Districts and substantially below the nation's 5.3 percent decline. More recently, the Eleventh District's economy has been showing signs of improving, along with the overall U.S. economy.<sup>5</sup>

What's more, the Texas housing market hasn't had the kind of wrenching correction experienced elsewhere—for two reasons. First, the district's housing-price appreciation was relatively muted when compared with other parts of the nation. Second, it was generally more difficult for Texans to use their houses as collateral to leverage up their balance sheets.

## Chart 6 Banks Are Lending

Percent increasing lending\*



\* March 31, 2009, through March 31, 2010

SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

Texas has fairly strict standards concerning mortgage lending. For example, a homeowner's total mortgage debt—the existing mortgage plus projected home-equity loans—can't exceed 80 percent of the home's current fair-market value. Such restrictions provide borrowers and lenders some protection against declines in property values.

In addition to faring better than the nation, the district's banking industry also avoided a repeat of the troubles that accompanied the previous banking crisis in the 1980s.

Those were the worst of times for the region's banks. Declines in oil prices triggered two regional recessions, which led to widespread and deep banking-sector difficulties. Return on assets fell to a low of -3.5 percent in first quarter 1988, and the noncurrent loan rate reached an all-time high of 10 percent in third quarter 1988, far surpassing U.S. banks' current record of 5.5 percent. Nine of Texas' 10 largest banking organizations failed or were acquired, and the casualty rate for Eleventh District banks peaked at about 10 percent in 1989.

Which prompts the second interesting question: Why have Eleventh District banks fared better in the current recession than in the 1980s downturn?

It's not likely a simple matter of a milder recession. For the Eleventh District, the current economic downturn is the worst since the mid-1980s.<sup>6</sup> During the worst of the current recession, from mid-2008 until the

end of 2009, employment plunged 3.7 percent in the Texas economy, which makes up the major part of the Eleventh District. During the 1985-87 recession, employment fell 3 percent.

The Texas Business-Cycle Index fell almost 4 percent in 2009, compared with a 2.7 percent decline in 1986. According to the Mortgage Bankers Association, the delinquency rate—the percentage of mortgages 90 days or more past due—climbed to almost 4 percent in Texas at the end of 2009. It rose to a high of 2.74 percent at the end of 1987.

One explanation for today's healthier banking industry is the changing nature of the regional economy. In the 1980s, the Eleventh District was a much less diversified economy. For example, oil and gas production accounted for almost 20 percent of Texas output. By the early 2000s, that share had declined to only 6 percent. The move away from a heavy reliance on the fortunes of the oil and gas industry gave rise to a more varied regional economy and offered the local banking industry more opportunities for diversification, potentially contributing to lower risk profiles.<sup>7</sup>

### A Closing Caveat

Even though the Eleventh District economy has been showing signs of improvement, it should be emphasized that banking-sector difficulties may not be behind us. One area of concern is commercial real estate exposure.

These loans account for almost one-fourth of district banks' assets—far exceeding the national average of 13 percent and at the upper end of exposures across Federal Reserve districts. During the 1980s, Eleventh District banks' peak exposure to commercial real estate was 16 percent in mid-1986.

Difficulties in the commercial real estate sector in the aftermath of the oil bust contributed appreciably to the deterioration of the Eleventh District banking industry in the 1980s. For example, the office vacancy rate in Dallas hit a high of slightly over 28 percent in 1988; in Houston, it peaked at over 30 percent in 1987.

If the commercial real estate sector weakens further, the performance of Eleventh District banks can be expected to decline—both in absolute terms and relative to banks nationwide. The article titled "Cloud Over Commercial Real Estate Is Slowly Lifting in Texas," on page 10 in this issue of *Southwest Economy*, investigates the current state and likely prospects for the commercial real estate sector.

*Robinson is a research officer in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.*

### Notes

<sup>1</sup> The Eleventh Federal Reserve District consists of all of Texas, the northern portion of Louisiana and the southern portion of New Mexico. Data for the Eleventh District banking industry have been adjusted for structural changes involving recent relocations of banks into the district.

<sup>2</sup> Consistent data for the banking industry are generally available beginning in 1984. In this article, records are relative to that date.

<sup>3</sup> There are other components to the guidance as well. See SR Letter 07-1, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Jan. 4, 2007, [www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm](http://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm).

<sup>4</sup> "Senior Loan Officer Opinion Survey on Bank Lending Practices," Board of Governors of the Federal Reserve System, April 2010, [www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm](http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm).

<sup>5</sup> See "Texas Economy Shakes Off Rough Ride in 2009," by Laila Assanie and Pia Orrenius, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2010.

<sup>6</sup> See note 5.

<sup>7</sup> See "The Effect of High Oil Prices on Today's Texas Economy," by Stephen P.A. Brown and Mine K. Yücel, Federal Reserve Bank of Dallas *Southwest Economy*, no. 5, 2004. Regulatory changes in the banking industry could also have played a role. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed banks to set up branches across state lines, which was generally forbidden in the 1980s. These changes provided banks, especially larger organizations, with even more opportunities for diversification and concomitant declines in risk.