Houston Business

A Perspective on the Houston Economy

Current tight credit emerges from what has been termed a credit crumble, the deflation of real estate and other assets inside financial institutions. This process destroys lender's equity and can force financial contraction. It is a problem that has been familiar to Texas bankers for several years.

How Credit Crumbled: Houston Banking in the 1980s

The recovery of the U.S. economy from recession, while still under way, continues with growth that's sluggish at best. One key factor hampering the recovery is ongoing cutbacks by banks in their commercial and industrial lending. This *credit crunch*, at work in the Northeast and much of the Southwest, has been prevalent in Houston and the rest of Texas for several years.

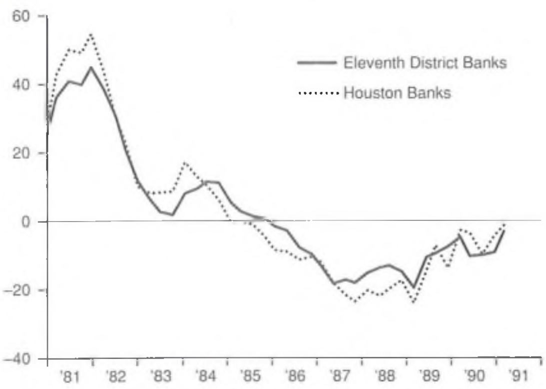
This article provides a look at how tight credit emerged in Houston and why it set a precedent for problems now dogging many banks throughout the United States.

CREDIT CRUMBLES

Growth in U.S. commercial and industrial lending fell from 5.2 percent in 1989 to 1.2 percent in 1990. Weak economic conditions played some role in this decline, but so did stringent credit conditions. A recent study by the Federal Reserve Bank of New York[1] points out that this experience is not the traditional crunch that flows from rising interest rates, financial disintermediation and nonprice rationing of credit. In contrast, interest rates have been falling and ceilings on the interest rates paid by banks and thrifts were eliminated in 1986. Instead of a *crunch*, the New York study terms the current situation a *credit crumble*, a deflation of assets held by financial institutions and a process that destroys equity capital and inhibits bank lending.

Troubled assets in banks throughout the nation are increasingly tied to problems in real estate. Banks are highly leveraged institutions; regulators require them to hold only 5.5 percent of their assets in the form of stock, surpluses, undivided profits or

Figure 1
Commercial Loan Growth, Four-Quarter Growth Rate



SOURCE: Report of Condition and Income.

reserves. Banks typically operate near this minimum capital ratio to extract the greatest possible advantage from leverage. This leveraged position means, however, that damage to assets held by the bank can quickly swallow available equity.

For example, a bank that holds 6 percent of its assets in equity and is forced to write off 2 percent of assets due to bad real estate loans loses 33 percent of its equity stake. This loss causes immediate problems for the bank, because the ratio of primary capital to equity has to be restored to meet regulatory minimums; the options are to raise more capital or shrink the asset base to match available equity. If the first option proves difficult or impossible, the second option requires pricing bank services to let deposits run off, closing branches and sharply curtailing lending. It is this second option, forced by a lack of available capital, from which the credit crumble emerges.

The New York study found a credit crumble to be an essential element of the fall in U.S. commercial lending in 1990. Weak economic conditions also played a role, as both borrowers and lenders grew cautious with the onset of recession. Generally, however, banks with strong balance sheets continued to lend in 1990, and those with weak balance sheets pulled back quite sharply.

HOUSTON COMMERCIAL LENDING

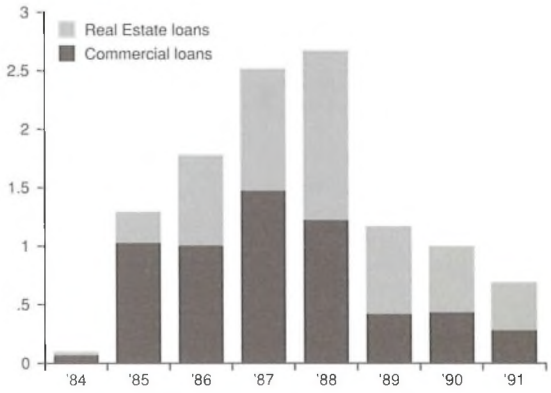
Data represented in Figure 1 show the expansion and contraction of commercial and industrial loan portfolios in Houston and in the Eleventh Federal Reserve District (the Eleventh District data are dominated by Texas). The data show the percent change from four quarters earlier of commercial loans outstanding on bank books. The data span 1981 to early 1991. Houston banks are defined as those with headquarter operations that have a state or national charter residing in the metropolitan area. Branches of these banks, regardless of their location in the state, are counted as Houston banks; banks with branches operating in Houston that have headquarters elsewhere in the state are not part of the Houston total.[2]

The pattern and timing of commercial lending growth is much the same in Houston and the Eleventh District as a whole, and it is a pattern that follows the course of the Texas recession. The periods of sharpest expansion and contraction are attributable to the boom and bust in the energy sector, but the continued contraction into 1990 indicates damage that spread well beyond energy.

Figure 2 shows how nonperforming loans emerged as a problem for Texas banks in the early 1980s, led by problems in commercial energy loans but quickly followed by real estate. The traditional energy lenders in Texas, banks such as Interfirst in Dallas and the First City of Judge Elkins were among the first to be hurt by falling energy prices; the strategy these banks chose for restoring their balance sheet was aggressive diversification into real estate, particularly in the booming Dallas and Austin markets of the mid-1980s. With the benefit of hindsight, it is fair to say that energy problems weakened the Texas banking system, but real estate ultimately pulled down several of its largest holding companies.

Growing energy and real estate problems, and the resulting write-offs of bad assets, led to bank profit margins that turned negative in early 1986.

Figure 2
Nonperforming Loans in Houston, First Quarter of Each Year



SOURCE: Report of Condition and Income.

Apart from the increases in activity normally associated with the holidays, Houston's growth was very slow to flat in November. Holiday hiring in 1991 must be comparable to last year's if Houston's 1991 growth rate for total employment, measured from December to December, is to remain much above 1 percent.

The recent declines in the rig count and oil field activity have bottomed out, although repercussions from cutbacks already made will continue for some time. Any stimulus from the U.S. economy is concentrated in chemicals, paper and other manufacturing activity. In real estate, reports on corporate relocations and a slowdown in new electric utility connections indicate that in-migration to Houston is probably less than half the rate sustained earlier this year. There is little optimism for a short-term increase in energy-related activity, leaving Houston dependent on stimulus from the national recovery to put growth on a stronger track.

RETAIL AND AUTO SALES

The local Christmas shopping season reflects a pattern much like the one seen last year, when retailers made nervous by the Persian Gulf war conducted heavy promotions. This year, retailers —nervous about local layoffs—promoted one- and two-day sales immediately after Thanksgiving. Holiday hiring plans are also comparable or perhaps slightly better than those in 1990. Early indications after the Thanksgiving holiday suggest that retailers are pleased with holiday sales activity; many described sales as up modestly from last year.

Auto and truck sales in October were up 4 percent over a weak October last year. Fleet sales, typically made this time of year, helped the total, as did new manufacturer incentives. For the first 10 months of the year, sales in Houston remain about 5 percent below the 1990 level.

UPSTREAM ENERGY ACTIVITY

Rig count declines that followed depressed natural gas prices appear to have bottomed out, and the rig count is now sustaining normal end-of-year increases. Modest improvements in drilling activity took place in the Gulf of Mexico in mid-November, but only six of every 10 rigs are working. Demand for oil field machinery, which declined over the past year, flattened over the past 30 to 60 days; prices are down sharply, and are hurting profitability, however. Survey respondents predict the domestic rig count will average 800 to 900 in 1992, a level comparable to this year's. International demand is weaker than earlier in the year, but these sales continue to take up slack left by the fall in domestic drilling.

DOWNSTREAM ACTIVITY

Gasoline demand is flat and remains below levels of a year ago. Refiners' margins are generally weak. Cost-cutting remains common at Gulf Coast refineries—as it has most of this year—with measures ranging from delayed maintenance to hiring freezes. Petrochemical demand is level with last year and continues to hold up well. Margins for ethylene were strong, with several plants down with operating problems or for maintenance. But margins will decline due to over-capacity in 1992. Three new, world-scale ethylene plants came on line in 1991, and one more will go into service in early 1992.

WOOD PRODUCTS

Demand for corrugated boxes and linerboard are up strongly, allowing some price increases to be implemented. Demand for lumber is erratic from one month to the next but seems to be continuing an upward trend. Prices for lumber are down sharply from the peak caused by supply constrictions early in the year; as demand improves, however, prices may well jump back up.

CONSTRUCTION AND REAL ESTATE

Comparing this October with last October, new single-family home sales were up strongly and existing home sales fell 10 percent. On a year-to-date basis, both new and used home sales are running at a pace comparable to last year. In September and October, new home sales slightly outpaced starts. But inventories generally remain very thin because starts lagged sales for most of this year. Foreclosures of 472 in October were the lowest rate since 1983, down from a peak of 2,234 in October 1987.

Nonresidential construction spending is up 74 percent over last year. Several new office buildings and a visitor's center at the Johnson Space Center are among the major projects. Construction and rehabilitation of school buildings has provided the biggest boost to nonresidential construction, however.

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A frequently overlooked property of the leverage multiplier is that it continues to work even when net profits carry a negative sign. Figure 3 shows the ratio of equity to assets in Houston and Eleventh District banks throughout the 1980s. Even with massive injections of capital from federal bank insurance and out-of-state bank holding companies, the capital ratio in Houston slipped below 3 percent in early 1988. It has since returned to levels near 6 percent, and profits have remained positive for Houston banks since early 1990.

BALANCE SHEET AND OTHER CONSTRAINTS

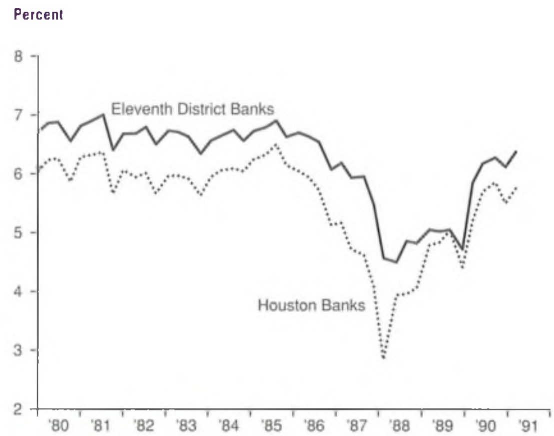
The massive losses of capital sustained by Houston and Texas banks would seem to make a regional credit crumble an inevitable fact of life for the 1980s. Harvey Rosenblum, director of Research of the Federal Reserve Bank of Dallas, put the problem in a slightly different perspective. Someone looking for a business loan in Texas in recent years had to first find a bank free of balance sheet problems so severe that they precluded new loans. Rosenblum suggested three criteria for identifying a potential lender: the bank should show positive profits; it should have a 6-percent capital ratio; and its troubled assets should equal no more than 3 percent of its total assets.

In late 1989, fewer than 45 percent of Texas banks could pass this test, and banks that passed held only 23 percent of the state's bank assets and accounted for 19 percent of the state's total loans. This situation has steadily improved. By mid-1991, 56 percent of the state's banks passed this test, holding 63 percent of Texas bank assets.

The healing process is incomplete, however, and not just in the sense that one-third of Texas bank capital remains in impaired banks. The banks that *can* now be counted as healthy did not, as a group, increase their lending in 1990; instead, growing assets were funneled into security holdings. Rosenblum suggests several reasons for this. First, many of the banks are small, and they may face difficult local economic conditions, despite improvement in the state economy. Second, new risk-based capital standards for banks reduce the capital requirements for low-risk assets while maintaining capital requirements on loans. Finally, perhaps those bankers who survived the 1980s are a more conservative group because they witnessed events or because they survived a winnowing process that eliminated those more aggressive.

Another possibility is that over-regulation might be an unwelcome source of loan constriction. Rosenblum cites a recent Texas Banker's Association survey in which 60 percent of respondents attributed tight credit to over-regulation. Just as bankers focused on bank equity as the line between solvency and insolvency, regulators focused on it as the fire wall between the private sector and federal bank insurance. Conflict between bankers and regulators over the level of capital required—and the pace at which it was to be raised—was inevitable as balance sheets were nursed back to health.

Figure 3
Equity to Asset Ratio



SOURCE: Report of Condition and Income.

CONCLUSION

The credit crunch—both in Houston and throughout Texas—is not over, but there are signs that it is beginning to ease. Although commercial and industrial loan portfolios continue to shrink, several trends indicate a move toward stability. Bank profits have been positive since early 1990, and aggregate capital ratios continue to improve. Two-thirds of the bank capital in Texas is now in banks with a healthy balance sheet, suggesting that the limitations imposed by the credit crumble are now less severe.

[1] Ronald Johnson, "The Bank Credit "Crumble,"" *Quarterly Review* of the Federal Reserve Bank of New York, 16 (Summer 1991), pp. 40–51.

[2] Changes in bank activity measured this way stem from several sources: expansion and contraction of existing institutions, banks being closed, or opening new banks. Consolidation activity affects this measure of local activity, as Houston-chartered banks absorb banks chartered elsewhere or vice-versa. Finally, the transfer of loans, real estate or other assets of failed institutions to the FDIC removes them from the books of the banking system; similarly, injections of fresh capital from deposit insurance creates new capital for the acquiring bank.