

the Southwest ECONOMY

THE FEDERAL RESERVE BANK OF DALLAS

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Credit Shortage Slows Texas Recovery

Texas businesses are facing a credit squeeze. Sometimes these businesses are unable to find a lender. And if they find a lender, interest rates are higher and the terms of the loan are more restrictive than the rates and terms for businesses with similar risks elsewhere in the country.

Besides hurting business profits, credit problems are restraining the state's economic recovery. Businesses unable to obtain credit may have to scale back expansion plans. These credit-starved businesses miss opportunities for new business—opportunities that are lost to producers in other states with readily available credit. While not the sole reason, the credit shortage played a part in explaining why the Texas recovery slowed to a crawl in mid-1988.

The problem of insufficient credit has prompted several proposals for policies to eliminate or reduce the credit shortage. We need to understand what caused the credit shortage so that we can design effective policies. The desirability of implementing any particular policy depends on two things: the importance of credit availability to state economic growth, and the policy's expected effectiveness and possible side effects.

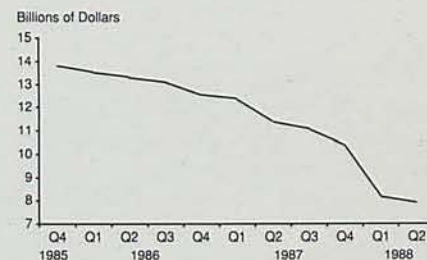
Decline in Bank Capital Creates Credit Shortage

Texas' current credit shortage began with a sharp decline in bank capital. This decline resulted from

large loan losses associated with the downturn in the energy and real estate industries. As a result of extraordinary loan losses, Texas bankers reported net losses for several years. These losses reduced equity capital, which declined \$5.9 billion from the fourth quarter of 1985 to the second quarter of 1988, a drop of over 40 percent (See Chart 1).

Compounding the problem of loan losses, Texas banks have to pay more for deposits. Texas banks became more risky as their equity capital declined, reducing their ability to absorb losses. With higher risk, depositors demanded higher interest

Chart 1
Total Equity Capital at Texas Banks



rates, which increased interest expense, reduced net interest margins, and ultimately cut back bank profits.

As bank capital is reduced, banks must either replenish capital or reduce total assets. If they are unable to raise capital, they must reduce assets, typically by reducing loans.

Bank capital comes from retained earnings, sale of stock, merger with an-

"The credit shortage is having a large impact on small businesses."

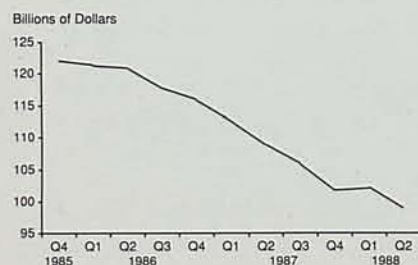
other bank, or capital injection from the deposit insurance funds. Most Texas banks have been unable to raise new capital through retained earnings or issuance of new equity. Loan losses and reduced interest margins left no earnings to be retained. Because the quality of financial institutions and the future of the Texas economy was uncertain, investors were skittish about purchasing new issues of Texas bank stock.¹ The October 1987 stock market crash also hurt the possibilities for raising new capital.

Texas Banks Recapitalize

Reduction in total assets and the injection of new capital from both private and public sources is resolving the capital shortage at weak Texas banks. Lending has declined 19 percent or \$23 billion from the end of 1985 to the second quarter of 1988, accounting for the bulk of the reduction in assets (See Chart 2). Several Texas banks have merged with out-of-state banks that injected new capital. The FDIC closed other Texas banks, injected new capital, and sold them to either new management or an existing healthy bank. Most of the large Texas banks have recapitalized through mergers and capital injections (See Box).

As weak banks contract their asset base, healthy banks typically expand

Chart 2
Texas Bank Loans



their assets to offset the contraction. Poor underwriting standards have resulted in weak banks' loan losses, and these banks have responded by adopting stricter credit policies. At the same time, healthy banks with strong underwriting standards are able to increase their market share. In a normal market adjustment, the competitive force of the healthy banks keeps weak banks from pushing credit standards and interest rates too high.

The recapitalization has begun. An analysis of business loan growth suggests that the shift in assets from weak to healthy banks is taking place (See Chart 3). I sorted banks into 10 groups based on their capital-asset ratios. Banks in the first group have the highest or healthiest capital-asset ratio and banks in the tenth group, the lowest or weakest ratios. Banks with weak capital ratios are contracting their business lending at a rapid rate while banks with healthy capital ratios are expanding.

Recapitalization is a Slow Process

The shifting of assets from weak to healthy banks has been slow, and the growth that has occurred at the healthy banks is not sufficient to offset the contraction occurring at the weak institutions. Consequently, total business lending at Texas banks is contracting. The shift in assets is inhibited by the large number of weak banks and the relatively small number and size of healthy banks in Texas. In the first quarter of 1988, 61 percent of the banking assets in Texas were held by banks with significant problems. Even many of the healthy banks do not have sufficient capital to support rapid asset growth.

The competitive forces that usually prevent credit standards and interest

rates from rising too high were suppressed by the slow shift in assets. As a result, businesses needing credit from Texas banks are faced with credit standards likely to be higher than would prevail in a normal market. Moreover, businesses that obtain credit are likely paying a higher interest rate than competitors from outside the state. The above-market loan rates result from a lack of competition from healthy banks and permits Texas banks to pass on at least part of the cost of the higher interest rates these banks must pay.

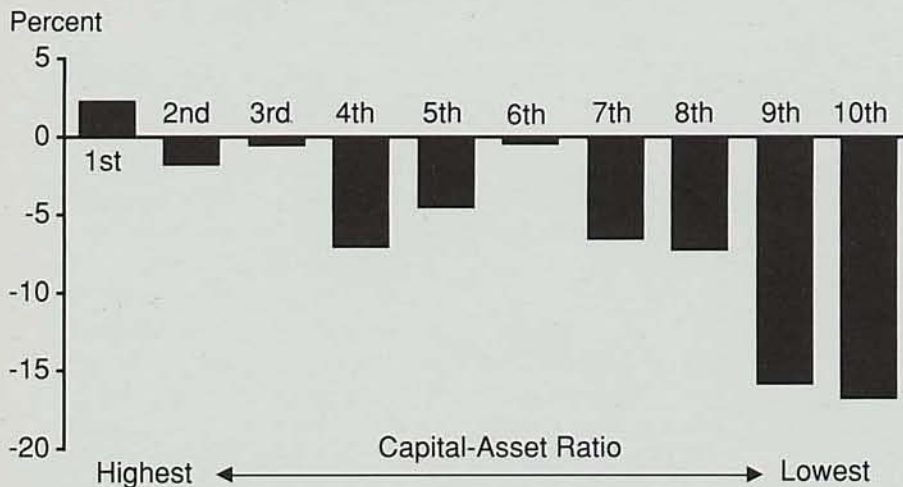
Bank mergers and injections of FDIC capital have also proved to be a slow way to recapitalize. The process of soliciting bids for failed banks takes time. Plus, after a bid has been accepted, the acquisition requires more time. In response, many bankers argue that weak loan demand from good borrowers—not a credit shortage—is reducing total lending. And this argument has some merit. Given the regional recession, a decline in loan demand would be expected. The Texas economy, however, has been recovering for over a year. If the problem were only weak loan demand, lending would be contracting at all banks and would not be as closely related to bank capital-asset ratios.

Small Businesses Bear Brunt of Credit Shortage

The credit shortage resulting from Texas' bank capital shortage is having a large impact on small businesses. Large businesses are not affected by the problems at Texas banks nearly as much as small businesses because large businesses can obtain credit from sources other than local banks. Corporate borrowers can obtain funds directly from savers by issuing debt securities such as commercial paper

"The quick closure of insolvent institutions would also speed the transition and aid the healthy institutions."

Chart 3
Business Loan Growth Rate at Texas Banks, 1987
by Decile of Capital-Asset Ratios



and corporate bonds. Also, large businesses can obtain bank loans from healthy out-of-state banks or foreign banks.

Small businesses have fewer options. Their borrowing needs are too small to interest most out-of-state or foreign banks and too small to make issuance of debt securities economical. Out-of-state and foreign banks with operations in Texas reported that their minimum credit relationship was \$5 million. As a result, small businesses depend on local banks to obtain credit.

Small businesses have sought other sources of funds to alleviate their credit problem. One important source is trade credit, the credit extended to purchasers when immediate payment for goods and materials is not required. While trade credit is expensive, many small businesses may find it the only source of credit. A recent survey by the Federal Reserve Bank of Dallas reported that 47 percent of the small

businesses were making greater use of trade credit. Small businesses in Texas now often forego the substantial discounts offered for early payment in making greater use of trade credit.

How Policy Should Respond

Since the credit shortage originated from a temporary bank capital shortage, the most effective policies encourage market-driven corrections already taking place—not policies that fundamentally change the nature of the market for credit. In short, policy responses should seek to speed bank recapitalization.

The most effective policy for eliminating the bank capital shortage and the subsequent credit shortage has already been adopted—the 1986 passage of an interstate banking bill for Texas. Interstate banking has increased the ability of out-of-state banks to inject new capital into Texas banks through

acquisition. Other policies that promote faster recapitalization of Texas banks could help. Encouraging the FDIC and the FSLIC to speed up the process of closing insolvent institutions should be the first step. Not only would the disposition of these failed institutions inject new capital into the industry, but closing insolvent institutions would help reduce the premium that *healthy* Texas banks and savings and loans associations (S&Ls) must pay for deposits. A study published by the Federal Reserve Bank of Dallas reported that healthy banks and S&Ls in Texas paid an average premium of 18 and 33 basis points, respectively.²

Improving the information available on Texas banks would speed the recapitalization process. Lack of information is the primary obstacle to the expansion of healthy banks in the state. If their current condition were known and the future looked promising (as suggested in the November 1988 issue of this publication), healthy Texas banks could obtain deposits without paying a premium and could more easily raise new equity in the capital markets.

Current accounting standards and the continued operation of insolvent institutions cloud the status of healthy institutions. Because current accounting standards do not provide the most accurate picture of a bank's condition, potential investors and depositors are unsure about the actual value and safety of the bank. Accounting rule changes requiring a more realistic valuation of assets and liabilities would help eliminate distortions. The quick closure of insolvent institutions would also speed the transition and aid the healthy institutions.

In contrast to these proposals, some have suggested that the state establish an agency to lend directly to

businesses in a manner similar to that of the Reconstruction Finance Corporation of the 1930s. Such a proposal would fundamentally change the nature of the market for credit and, since financed by taxes, it would have an uncertain long-term impact on the overall welfare of Texas citizens. In circumventing the banking industry, such a policy would cripple its recovery and, given the nature of bureaucracy, might outlive the already receding capital shortage.

—Robert T. Clair

¹ Of course, new equity could have been raised at some price. Bank management, with its superior information concerning the quality of the bank, may have been of the opinion that the price offered in the market may have been below their estimated value of the stock and acted in the stockholders' best interest not to raise new equity.

² See Genie D. Short and Jeffery Gunther, "The Texas Thrift Situation: Implications for the Texas Financial Industry," Financial Industry Studies Department, Federal Reserve Bank of Dallas (Dallas, Texas, September 1988).

Recapitalization of Major Texas Banks

(as of November 21, 1988)

Much of the recapitalization of the large Texas banks has already occurred or is currently underway. These recapitalizations have two important effects. First, a large portion of the banking assets in the state will be held in institutions that have been recapitalized and are capable of extending new credit to support further expansion of the Texas economy. Second, the newspaper headlines of major Texas bank failures will likely be a thing of the past. Bank failures will continue at smaller banks, but these failures will be less likely to generate national attention. Many of these recapitalizations are relatively recent or have yet to be completed. Consequently, while their positive effects are not yet evident, they will be in the future.

First RepublicBank	—acquired by NCNB through an FDIC-assisted merger —new name: NCNB Texas
MCorp	—requested FDIC assistance and is negotiating a possible assistance package
Texas Commerce Bank	—merged with Chemical Bank of New York
Allied Bankshares	—merged with First Interstate Bancorp —new name: First Interstate Bank of Texas
First City Bancorporation of Texas, Inc.	—injection of capital from FDIC and private sources has been completed
Texas American Bancshares, Inc.	—potential acquirers are bidding on an FDIC-assisted merger
National Bancshares Corporation of Texas	—potential acquirers are bidding on an FDIC-assisted merger
Banc TEXAS Group, Inc.	—injection of capital from FDIC and private sources has been completed

ECONOMIC COMMENTARY

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Deposit Insurance and the Credit Shortage in Texas

One strategy to ease the present credit shortage in Texas—and to boost state economic growth—would be to close or recapitalize bankrupt financial institutions, thereby speeding the transfer of assets from weak financial institutions to healthy ones. Once this shift occurs, normal lending can resume. Problems inherent in the banking system are delaying the adjustment process. Bankrupt and capital-impaired financial institutions are offering depositors above-market interest rates to attract the funds necessary to remain afloat. They can do this because present banking regulations and insurance do not adequately restrict or price risk.

When Congress passed the Depository Institutions Deregulation and Monetary Control Act in 1980, the intent was to allow banks and savings and loans to pay market rates of interest on deposits. Banks and savings and loans were having a difficult time competing with other institutions that were not similarly constrained by interest rate regulations. By phasing out interest rate ceilings on deposits and allowing the introduction of interest-bearing deposits with some transactions capabilities, Congress enhanced the ability of banks and thrifts to compete in attracting deposits.

Unfortunately, some banks went well beyond the intent of Congress by offering exceptionally high interest rates. Because they wanted to pursue high growth strategies, some institutions often paid deposit interest rates considerably above those prevailing on U.S. Treasury securities or on deposits being paid by other banks and thrifts in their local market. This strategy was more difficult to pursue before deposit-rate deregulation because price ceilings on deposits required greater reliance on uninsured sources of funding which were sensitive to the potential riskiness of the institution.

Partly due to the comparative lack of external controls, many of these high growth depository institutions find themselves in a troubled financial condition. In a desperate attempt to survive, some troubled institutions are taking on high-risk investments. Their ability to do this has been aided and abetted by their continued access to insured deposits, although at rates as high as several hundred basis points above Treasury rates.

Insured financial institutions incur increased risk because they do not bear the full costs of their risk taking. Rather, the flat-rate insurance provided by the FDIC and FSLIC spreads the cost of any one institution's actions across the entire system. In the absence of any ceiling or tax on interest rates that a financial institution can pay on deposits, the federal deposit insurance safety net gives individual financial institutions an ability comparable to a license to print money, or when losses are incurred, a *de facto* license to levy taxes on society.

Several modifications to the pricing of federal deposit insurance would help reduce these moral hazard risks by shifting the costs back to those financial institutions taking the risks. Unfortunately, assessing the overall riskiness of a bank is an extremely difficult task. The true risks of many loans and investments are not discovered until *after* troubles are experienced. Similarly, a bank's interest rate risk exposure is not known with certainty until after interest rates actually change. Some risks, however, such as those associated with paying above market interest rates, can be gauged and taxed more easily.

One simple modification to the present flat-rate deposit insurance system would be to require higher insurance premiums from financial institutions that paid well above market rates to attract deposits. As interest rates offered on deposits rose above Treasury rates, insurance premiums also would rise proportionately. This simple change in deposit insurance would force institutions pursuing exceptionally high-growth strategies to bear a greater proportion of the costs of their actions. In addition, this change would indirectly reduce the impact of the perverse incentive structure inherent in the deposit insurance system; currently, insured depositors' only incentive is to seek the highest return without regard to the riskiness of the financial institution.

Such a modification would discourage excessive risk-taking in this one area of bank activity by more accurately pricing the costs individual institutions impose on other members of the financial system. In the long run, the overall safety and soundness of the banking system would be enhanced somewhat by this redirection of economic incentives. In addition, this modification would speed up the closure of troubled institutions because it would increase their short-run losses, thereby accelerating the deposit insurance agencies' need to resolve the problems.

Ultimately, the recapitalization and closure of bankrupt financial institutions, together with appropriate modifications of the deposit insurance system, should lower the cost of funds that *healthy* Texas institutions must pay. Making individual institutions bear the full cost of their actions would speed-up the rate at which deposits are rechanneled from financially weak institutions to healthy institutions. By reallocating deposits to banks and thrifts with a real capacity to lend, this deposit insurance modification would enhance the ability of the Texas banking system to once again function normally in the creation of credit to support the growth of commerce and industry.

Eleventh District Agricultural Land Values Turn Around At Last

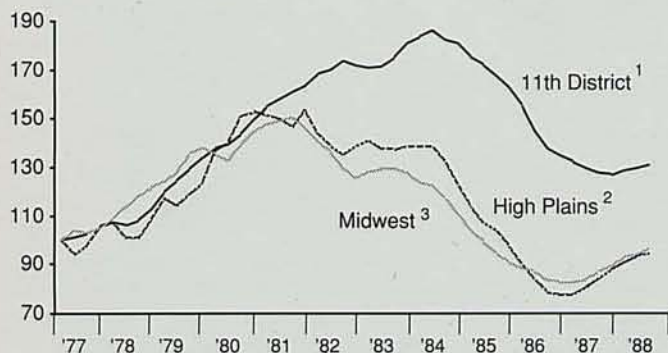
In the 1970s, an agricultural export boom brought prosperity to the farm sector nationwide. Agricultural land values rose rapidly. In 1981, the export boom faded and farmers' asset values rapidly eroded in many parts of the U.S., particularly in the Midwest. By early 1987, land values bottomed out in the Midwest and then headed back up. In the Eleventh District, however, average farmland values did not start to decline until 1984, and only recently have turned up.

Land Values and Regional Economies

When the agricultural export boom fizzled in 1982, current farm income and the expectations of future growth in income fell. In the Midwest and the Texas High Plains, where agriculture is the dominant use of rural land, land values declined (*See Chart*). In the Eleventh District, however, land values in rural areas close to urban centers continued to rise. This increase

The Rise and Fall of Farmland Values

(Index—1977:Q1 = 100)



1. Eleventh Federal Reserve District (Texas, northern Louisiana and southern New Mexico)

2. Midwest is the Seventh Federal Reserve District (Iowa, plus portions of Wisconsin, Michigan, Illinois and Indiana)

3. Texas Southern High Plains—16 counties near Lubbock, Texas

was driven by nonagricultural demands for commercial development, rural residences, and hobby farms and ranches. The higher values for farmland close to urban centers more than offset the declines elsewhere, and Eleventh-District-average values rose. District-average land values topped out in July 1984, as the construction sector of the economy nosedived. Although the District continued to grow for another year, after that it headed down, sealing the downturn in average farmland values.

Farmland Values Rebound

Nationally, the recovery of farmland values was practically guaranteed by three events. One was the

passage of the Food Security Act of 1985, which ushered in a period of generous income support for farmers. The second was overseas economic growth, which restored foreign demand for U.S. farm output. The third was the decline of the U.S. dollar, which made U.S. agricultural products more competitive on world markets. In early 1987, farmland values began to rise in areas where land values are determined primarily by agricultural income streams, like the Midwest or the High Plains. District average values continued to fall, however, pulled down by the slumping economy. Given that rural land close to major urban areas was valued above its agricultural-use value, the recovery of the agricultural economy was not enough to offset the loss of nonagricultural demand for this land. In 1987, for example, farmland values in North Central Texas declined 8 percent while they rose 7 percent in the High Plains.

By early 1988, District average farmland values finally started to rise. This turnaround was the result of continued growth in farmland values in regions like the High Plains, combined with the bottoming out of farmland values in several of the regions close to urban areas. At least three additional points are worth noting: one, farmland values in some areas of the District are still falling; two, the farmland values in regions influenced by nonagricultural demand not only increased more but also retained a greater percentage of their peak value than did land values in mostly agricultural areas; and three, the bottoming out of rural land values around areas like Dallas-Fort Worth is likely another sign that the region's economy is recovering.

—Hilary Smith

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