



Robust Regional Banking Sector Faces New Economic Hurdles

By Kelly Klemme and Edward C. Skelton

ABSTRACT: Profitability held steady at Eleventh District banks in 2014 as they continued outperforming their counterparts nationwide. However, rising interest rates and lower oil prices have emerged as potential tests for the region's institutions.

Community banks enjoyed a good 2014, particularly in the Federal Reserve's Eleventh District, continuing the steady improvement seen over the past five years.¹ Profitability was stable, loan growth was strong and balance sheets grew more resilient.

During the financial crisis and its aftermath, from 2007 to 2013, almost 500 U.S. banks failed and about one in eight nationwide was considered a "problem bank" by the Federal Deposit Insurance Corp. (FDIC), based on a measure of financial well-being that includes capital adequacy, asset quality and liquidity.² A return toward precrisis levels for bank failures and problem banks provides an indicator of improved system health (*Chart 1*).

Although institutions overall appear well-positioned, challenges loom. They include rising interest rates and, particularly for Texas banks, the effects of the oil price decline.

Outperforming U.S. Banks

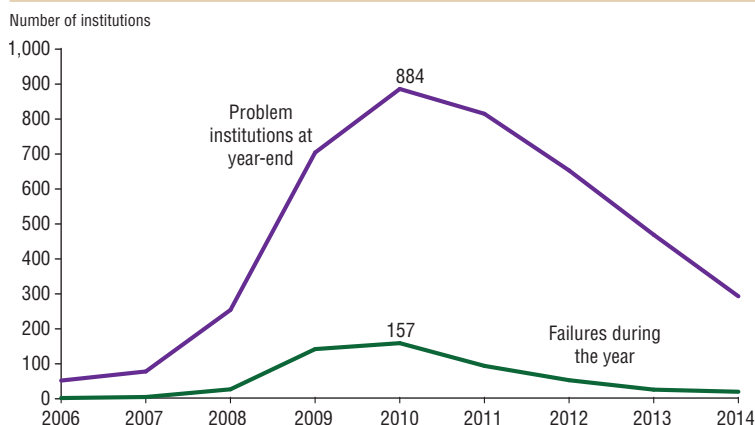
Nationally, banks' net income as a percent of average assets shrank

slightly in 2014, the first drop in five years (*Chart 2*). The largest institutions drove the profitability decline, reflecting diminished revenue from mortgage sales, securitizations and servicing as well as an increase in litigation expense. The latter includes fines for manipulating benchmark interest rates such as the Euro Interbank Offered Rate (EURIBOR) and the London Interbank Offered Rate (LIBOR) and faulty loan sales, particularly involving mortgages, leading up to the financial crisis.

The six largest U.S. banks paid approximately \$115 billion in fines between 2009 and September 2014, with U.S. regulators assessing 98 percent of all fines, according to the Boston Consulting Group.³ About half of the penalties were assessed in the first nine months of 2014.

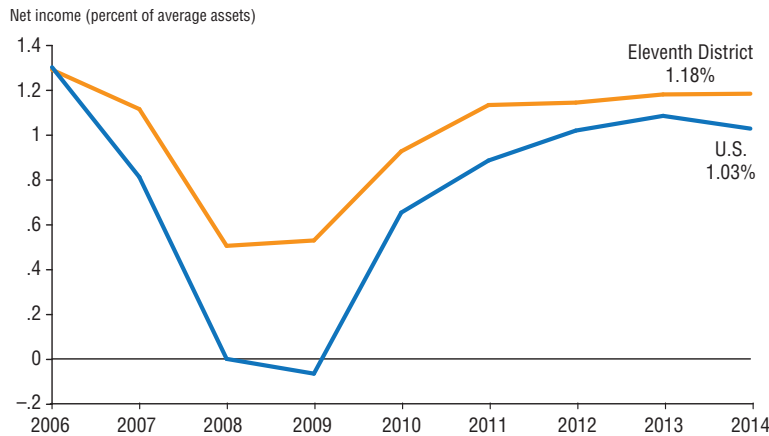
Although the struggles of large banks dominated headlines, the vast majority of banks and savings and loans reported increased earnings. Profitability held steady in 2014 at Eleventh District banks as they continued outperforming their counterparts nationwide.⁴

Chart 1 Problem Institutions and Failures Near Precrisis Lows



SOURCE: Federal Deposit Insurance Corp.

Chart 2 District Banks Continue to Outperform U.S. Banks



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

Increased profitability over the five-year period beginning in 2009 reflected declining set-asides for expected losses in loan portfolios, known as provision expense (Chart 3).

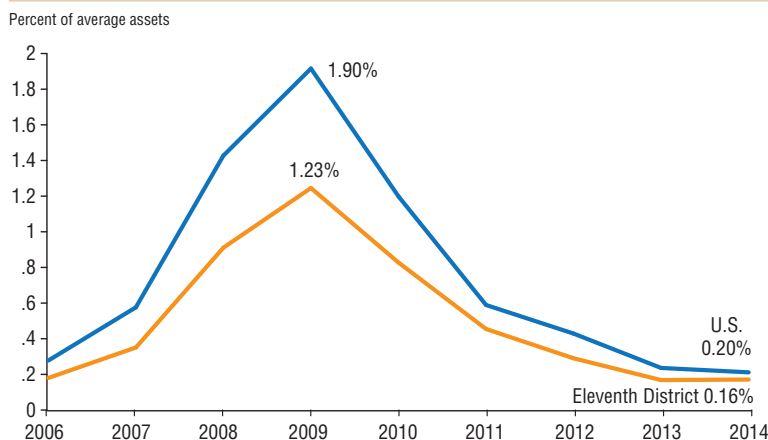
Nationally, provision expense peaked in 2009 at \$248 billion (1.9 percent of average assets), falling to \$29 billion (0.2 percent of average assets) in 2014. Thus, the decline in provision expense alone contributed 170 basis points (1.7 percentage points) to banks' improved return on assets over the period.

Similarly, provision expense in the district fell from \$5 billion, or 1.23

percent of average assets, in 2009 to \$703 million, or 0.16 percent of average assets, last year. The decline was driven by improved asset quality; banks' balance sheets have strengthened as problem loans and impaired assets continue falling.

Not only have district banks achieved greater profitability than their counterparts nationwide, but their loan portfolios also have grown twice as fast (Chart 4). District banks returned to lending sooner than banks in the rest of the country and experienced more rapid loan growth due to the region's economic strength.

Chart 3 Provision Expense Declines Contribute to Profitability



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

While nationwide loan growth has accelerated the past few years, it remains more subdued, mostly because U.S. economic and labor market conditions have not been as robust as those locally. Overall, community banks were responsible for more than a quarter of industry loan growth in 2014 despite accounting for less than 18 percent of all bank assets.

Rising Interest Rate Risk

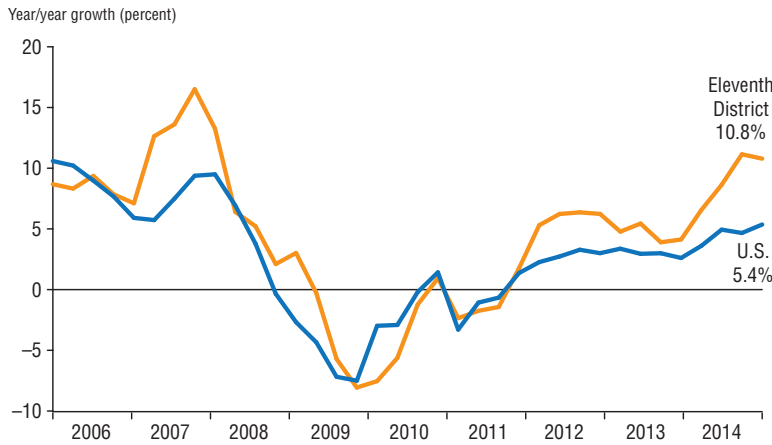
The Federal Open Market Committee's federal funds rate (the policy rate) has been near the zero lower bound since December 2008, leading to a five-year period of very low interest rates. Falling or very low rates may encourage banks to reach for yield, tempting them to acquire more long-term assets—which carry a higher nominal or stated rate of return—to boost profits.⁵

Possibly reflecting banks' quest for yield in a low-interest-rate environment, the so-called three-year asset/liability gap has been growing, particularly for district banks (Chart 5). This measure subtracts liabilities with maturities greater than three years (certificates of deposit, for example) from loans and securities with maturities greater than three years and divides the difference by total assets. A bigger gap means that banks would be hurt by rising interest rates because their assets are tied up for a longer time relative to their liabilities. Consequently, when interest rates rise, banks' funding costs could rise while interest income remains stagnant, squeezing profitability.

Conversely, a shrinking gap, such as that experienced from 2004 through 2006, suggests that banks were responding to the then-rising interest rate environment by trying to hold more long-term liabilities, increasing their exposure were interest rates to fall.

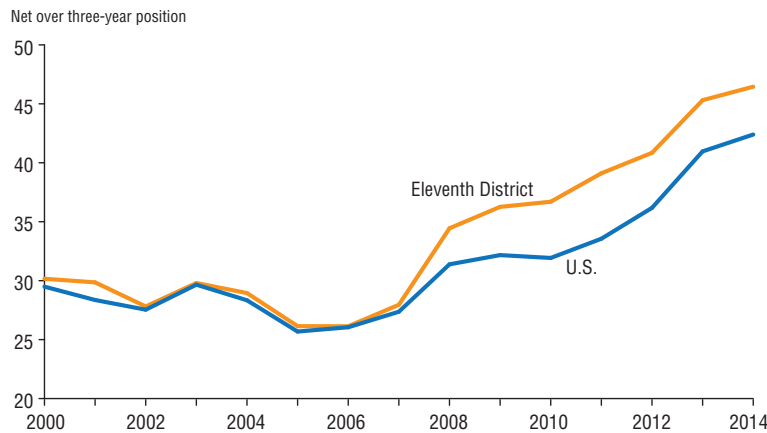
Still, the analysis is a static exercise, essentially taking a picture of the current balance-sheet structure and doesn't include the adjustments banks would make were interest rates to rise. Also, the gap doesn't reflect hedges (either on or off balance sheet) held by banks. While community banks generally don't use hedges, the banks that

Chart 4 | Loan Growth Is Picking Up



SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

Chart 5 | Banks May Have More Exposure to Rising Interest Rates



NOTE: The "net over three-year position" is equal to loans and securities repricing in more than three years, less liabilities repricing in more than three years, as a percent of assets.

SOURCE: Uniform Bank Performance Report, Federal Financial Institutions Examination Council.

▶ While the state's economy has become more diverse and thus less reliant on the oil and gas industry, the oil price drop has still negatively affected the Texas economy and labor market.

do find them to be an effective tool for managing interest rate risk.

Low Energy Prices

The other big concern is potential fallout from recent dramatic oil and gas price declines, which affects Texas banks in particular. In July 2014, the West Texas Intermediate (WTI) spot price exceeded \$105 a barrel; by March, it had tumbled to below \$50 before bouncing back to near \$60 at the start of May. The size and rapidity of the decline raised concerns about the impact on the Texas economy and Texas

banks, especially given the experiences of the energy and financial collapses of the 1980s.⁶

While the state's economy has become more diverse and thus less reliant on the oil and gas industry, the price drop has still negatively affected the Texas economy and labor market.⁷ Some pockets of the state remain heavily dependent on the energy sector, making local industries vulnerable to spillover effects. And because of community banks' close ties to the areas they serve, they are more exposed than large banks.

Lessons from the Past

While the Texas economy has diversified, it can be helpful to look at the effect of past oil price slides on area banks to estimate the potential fallout from the recent drop. Specifically, the WTI spot price can be plotted alongside the number of failed and distressed banks in the state (*Charts 6 and 7*).

One measure of potential distress is the so-called Texas ratio, the book value of an institution's nonperforming assets as a percent of its tangible equity capital and its loan-loss reserves.⁸ Essentially, the Texas ratio compares an institution's bad assets to its available capital. A Texas ratio above 1 (expressed as 100 percent) indicates that probable and potential losses exceed an institution's immediate loss-absorbing cushion, putting it at greater risk of bankruptcy. There have been two instances of dramatic oil price declines since 1980; one gives rise to concern and the other to hope.

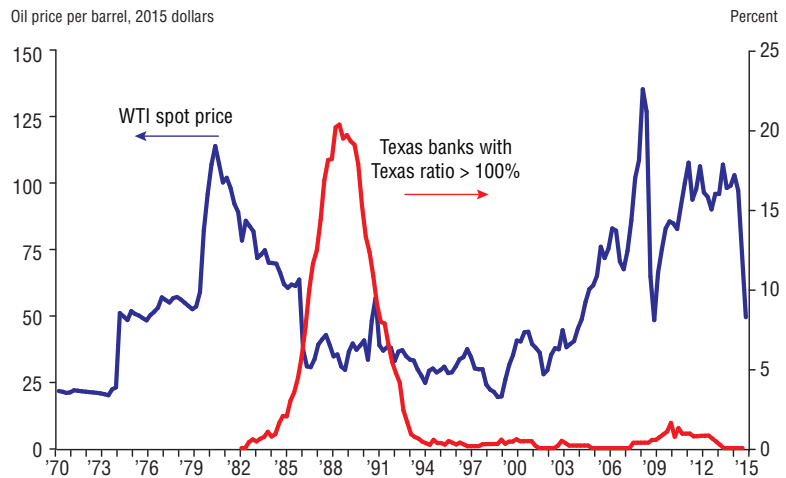
Between June 1980 and September 1986, the WTI price declined 74 percent in real (inflation-adjusted) terms. Roughly 20 percent of all Texas institutions had a Texas ratio greater than 100 percent by year-end 1988. A staggering 706 Texas banks and thrifts failed—including nine of the 10 largest banking institutions—between September 1986 and year-end 1990.⁹

A more recent oil price decline, in the second half of 2008 and early 2009, was also dramatic, but in a different way. Over a nine-month period beginning in June 2008, the price fell more than 71 percent. Yet less than 1 percent of Texas banks had a Texas ratio exceeding 100 percent and only seven failed in 2008–09. The slight pickup in bank troubles in 2010 is likely attributable to generally difficult financial and economic conditions that year.

From June 2014 through March 2015, the price of WTI fell 58 percent. Nevertheless, not one Texas bank had a Texas ratio greater than 100 percent as of the first quarter and only one bank had failed as of March.

The bottom line: The persistence of low oil prices seems to matter more

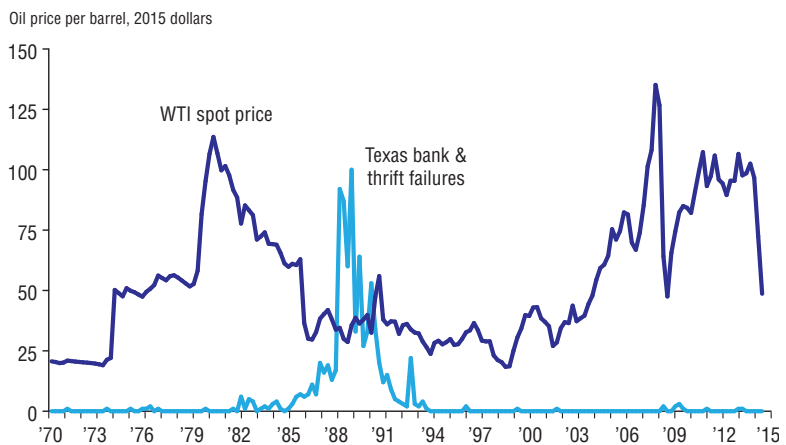
Chart 6 Latest Oil Price Plunge Hasn't Caused Texas Bank Distress



NOTE: The Texas ratio is equal to loans past due 90 days or more, nonaccrual loans and other real estate owned as a percent of tangible capital plus loan loss reserves.

SOURCES: Energy Information Administration, CME Group; Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

Chart 7 Texas Bank Failures Follow Oil Price Decline in the 1980s



SOURCES: Energy Information Administration, CME Group; Federal Deposit Insurance Corp.

for banks than the magnitude of falling prices. A precipitous, but short-lived, decline is likely to have only a minor impact on the banking industry. Even a longer-term decline similar to that seen in the 1980s is unlikely to provoke the same scope of disruption now as it did then.

In the 1980s, the Texas economy was more tied to energy and was also experiencing a mortgage and commercial real estate lending boom.¹⁰ As oil prices fell and the state went into

recession, the economy suffered from an oversupply of housing and other buildings constructed in anticipation of strong growth. Banks were hit not only by the inability of underemployed borrowers to make loan payments, but also by a decline in the value of lender collateral in the real estate and energy sectors. The excess real estate inventory in much of Texas continued into the early 1990s.

The regulatory environment has also improved in recent years. Capital

and loan loss standards are stricter, and there are new rules limiting banks' ability to use short-term deposits to fund long-term lending.

Reducing Immediate Risk

Mitigating factors also make Texas banks better able to weather falling oil prices. Memories of the 1980s crisis linger, and the 2008–09 financial crisis is also fresh in the minds of bankers and regulators. Apart from regulatory changes, Texas bankers manage their risks more prudently, using better risk diversification. The Shared National Credit (SNC) program is one example. Generally, large loans are held by multiple institutions through the SNC program, allowing individual institutions to spread the risk of large credit exposures.¹¹

While the SNC program has been around since 1977, it has grown in importance and coverage. SNC industry trends by sector show that commodities credits, including those tied to the oil and gas industry, increased from \$395 billion in 2002 to \$798 billion in 2014. Regulatory filings and investor conference calls suggest that energy exposure at the larger banks in Texas is now predominantly through these shared credits.

The increased use of shared credits helps the state's banks diversify geographically so they are not as exposed to regional downturns. In the 1980s, Texas banks couldn't open branches outside the state, leaving them unable to diversify their asset mix beyond the state's borders. But these limits largely disappeared, permitting Texas banks to open branches and operate outside the state and thus better manage local risk.

Hedges provide additional cushion against falling oil prices. Hedging can lock in prices, protecting investors and creditors from declines, but only in the short to medium term. Therefore, the longer oil prices remain relatively low, the less effectively hedges function.

Industry Challenges

Banks in the region have outperformed those nationwide since 2006, and business conditions have improved markedly over the past five years. Profits

are up, balance sheets are stronger and banks seem to have overcome the problems that plagued the industry before and during the financial crisis. Recently, new challenges have appeared.

The low-interest-rate environment and a flat yield curve with relatively little difference in interest rates across various maturities have pressured bank earnings over the past five years. Banks have responded by extending their maturity profile in an attempt to generate more robust returns. As interest rates normalize, regulators will need to monitor banks' ability to restructure their maturity profiles and adapt to the new environment.

The impact of recent oil price declines on banks also bears watching, particularly in Texas. While banks appear to be managing their energy exposure well—and a relatively short spell of low energy prices is not expected to have a severe, adverse effect on local banks—the importance of energy in certain regions points to the possibility of relatively large localized disruptions.

The banking system has navigated a postcrisis path to recovery. Conditions have improved markedly, but the industry must remain vigilant to potential risks to its financial health and stability.

Klemme is a financial industry analyst and Skelton is a business economist and manager in the Financial Industry Studies Department at the Federal Reserve Bank of Dallas.

Notes

¹ Community banks are defined as banks with assets of less than \$10 billion. The banking industry as discussed here includes commercial banks and savings associations, or thrifts.

² The FDIC defines problem banks according to its CAMELS rating system. The CAMELS rating assesses bank condition by grading an institution according to its capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk. The rating is from 1 to 5. Banks with a 1 or 2 rating are judged to present few, if any, supervisory concerns. Banks rated 3, 4 or 5 present moderate to extreme degrees of supervisory concern; a problem bank is rated 4 or 5. For more detailed information about the CAMELS rating system and methodology, see www.fdic.gov/regulations/laws/rules/5000-900.html.

³ The six banks are JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley. The Boston Consulting Group study included only fines and settlements exceeding \$50 million.

⁴ The Eleventh Federal Reserve District consists of Texas, northern Louisiana and southern New Mexico.

⁵ See "Banking Recovery Could be Vulnerable to Interest Rate Increases," by Kenneth J. Robinson, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter 2014.

⁶ For a detailed analysis of the 1980s crisis, see "Banking Problems in the Southwest," by Brian Lamm and John O'Keefe, in *History of the Eighties—Lessons for the Future*, vol. 1, Federal Deposit Insurance Corp., December 1997, www.fdic.gov/bank/historical/history/291_336.pdf.

⁷ See "Lower Oil Prices Weaken Prospects for Job, Economic Growth in Texas," by Michael D. Plante, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2015, and "Regional Economy Moderates," by Emily Gutierrez and Anil Kumar, Federal Reserve Bank of Dallas *Regional Economic Update*, March 19, 2015.

⁸ Nonperforming assets include loans past due 90 days or more, nonaccrual loans and other real estate owned. The calculation of tangible equity capital excludes intangible assets such as goodwill.

⁹ For detailed information on the costs of the 1980s crisis, see "The Cost of the Savings and Loan Crisis: Truth and Consequences," by Timothy Curry and Lynn Shibut, Federal Deposit Insurance Corp., *FDIC Banking Review*, vol. 13, no. 2, 2000.

¹⁰ See "Texas Real Estate: From the 1980s Oil Bust to the Shale Oil Boom," by John V. Duca, Michael Weiss and Elizabeth Organ, and "The Evolution of Texas Banking," by Kory Killgo and Kenneth J. Robinson, in *Ten-Gallon Economy: Sizing Up Economic Growth in Texas*, Pia Orrenius, Jesus Cañas and Michael Weiss, ed., New York: Palgrave Macmillan, forthcoming September 2015.

¹¹ Formally, SNC is any loan or formal loan commitment that totals at least \$20 million and is shared by three or more unaffiliated, supervised institutions. For more information on the SNC program, see www.federalreserve.gov/bankinforeg/snc.htm.