The So-Called Texas Ratio
by Thomas F. Siems

Bankers, particularly those in Texas, cringe at any reference to the Texas ratio. Of all the metrics used in finance, the Texas ratio is among the most feared because it can be used as an early warning signal to identify financial institutions at the greatest risk of failure. So what is this ratio and what does Texas have to do with it? And is the Texas ratio still an accurate measure to assess the riskiness of banks, where potential problems might reside and the overall health of the banking industry?

To calculate the Texas ratio, the book value of all nonperforming assets (including other real estate owned) is divided by equity capital plus loan-loss reserves. Only tangible equity capital should be counted in the denominator—the intangible parts, like goodwill, are excluded. In the simplest terms, the Texas ratio measures a bank’s likelihood of failure by comparing its bad assets to available capital. When this ratio exceeds 100 percent, a bank’s capital cushion is no longer adequate to absorb potential losses from troubled assets. In other words, the bank is at greater risk of going bust. And as shown in Chart 1, the Texas ratio seems to be a good early indicator of bank failures, even if it does tend to overpredict the number of problem institutions.

The Texas ratio earned its name in the late 1980s when many financial institutions in Texas got in trouble by lowering lending standards and overextending credit to the booming energy and real estate sectors. As shown in Chart 2 (next page), by the end of 1988, slightly more than 20 percent of the banks in Texas had a Texas ratio that exceeded 100 percent. And in 1989, Texas had a record 133 failures. Indeed, Texas led the nation in bank failures every year from 1986 through 1992. During this time, there were a few other states with larger proportions of their banks with Texas ratios greater than 100 percent; however, Texas had a very large and more visible banking sector with roughly 1,500 banks, so the name of the metric, unfortunately, became attached to Texas.
Chart 2 also shows the percentage of banks with Texas ratios over 100 percent for three other states: California, Florida and Georgia. While the Texas ratio may have been a descriptive moniker when the measure was created, it could have been called the California ratio in the mid-1990s and the Georgia ratio—or perhaps even the Florida ratio—once the financial crisis began in 2008.

California led the nation in bank failures each year from 1993 to 1995, and then a long period of relative calm set in, during which the nation experienced few, if any, bank failures each year. By June 2008, the so-called Texas ratio was signaling that 7.5 percent of Georgia’s 333 banks were in danger. Using this measure, the number and percentage of Georgia institutions at risk of failure rose rapidly until the end of 2010, peaking at more than 32 percent of Georgia’s banks. Since 2008, Georgia has led the nation with 84 bank failures. By way of comparison, Florida has had 67 bank failures during this period, California has had 41 failures and Texas has had nine.

Today, there are about 220 banks in Georgia, and 23 percent are at risk of failure, with a Texas ratio exceeding 100 percent. In contrast, Texas currently has about 550 banks—more than any other state in the union—with less than 0.75 percent at risk of failure, according to this metric.

The maps in Chart 3 (next page) show that over the past three years, progress has been made in reducing the percentage of banks with Texas ratios above 100 percent. The areas with the largest concentrations of banking problems today appear to be mainly in the western and the southeastern parts of the United States. But overall, the proportion of banks with bad debts that are greater than their reserves is shrinking, and the health of the banking industry continues to improve.

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Chart 3
Bank Health Is Generally Improving

Percentage of banks with a Texas ratio > 100%, as of June of each year

2010


2011

2012

Noteworthy Items

Richard Fisher’s speech at State of the West Symposium at Stanford University
President Fisher begins this address by reminding the audience that monetary authorities cannot adopt Buzz Lightyear’s approach of “To infinity and beyond” with regard to purchasing Treasuries and agency debt, but that Congress must lead our nation out of this fiscal situation. The majority of his comments compare job performance between the “West” and the “Rest” as defined by Federal Reserve districts. In terms of job creation, the “West” (Fed districts including Dallas, Kansas City, Minneapolis and San Francisco) has outpaced all other Fed districts combined since 1997. And going further, he contrasts the “dynamism” of Texas versus the “dysphorism” of California over that same period.

www.dallasfed.org/news/speeches/fisher/2012/fs121115.cfm

Richard Fisher’s remarks at the conference “México: How to Tap Progress” in Houston
In opening this two-day conference at the Dallas Fed’s Houston Branch, President Fisher compares the U.S. economy with our neighbor to the south, Mexico. Mexico is growing robustly, and its policymakers are committed to fiscal discipline, unlike the United States.


Fed Governor Elizabeth Duke’s speech on “Community Banks and Mortgage Lending” at Community Bankers Symposium in Chicago
In this speech, Governor Duke shares her support for a different approach to regulatory capital proposals and advises policymakers to abandon the one-size-fits-all approach. Her research into community banks and mortgage lending indicates that community banks are important to the mortgage industry, that mortgage products are important to community banks’ balance sheets and profitability and that they are a responsible source of lending in this area.

www.federalreserve.gov/newsevents/speech/duke20121109a.htm

Fed Chairman Bernanke’s speech on “The Economic Recovery and Economic Policy” at the Economic Club of New York
The Chairman’s remarks focus on the reasons for the disappointingly slow pace of economic recovery in the United States and the policy actions that have been taken by the Federal Open Market Committee (FOMC) to support the economy. He argues that the U.S. economy continues to be hampered by the lingering effects of the financial crisis on its productive potential and by a number of headwinds that have hindered the normal cyclical adjustment of the economy. Uncertainties about the situation in Europe and the prospects for federal fiscal policy seem to be weighing on household and business spending decisions, as well as on financial conditions. Even so, a plan for resolving the nation’s longer-term budgetary issues without harming the recovery could help make the new year a very good one for the American economy.

www.federalreserve.gov/newsevents/speech/bernanke20121120a.htm