Pathology of a Credit Crunch

ECONOMIC COMMENTARY

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Concern about a credit crunch spread beyond the Southwest over the past year. As the nation entered a recession and banking conditions in areas outside the Southwest deteriorated, the topic gained national attention.

One year ago, I argued in this commentary that a significant number of Texas banks were unable to extend credit because of their poor financial condition. My prognosis then was that over the next few years the credit crunch would fade as the Texas banking industry recovered and the economy continued to expand. My prognosis now is slightly less optimistic than it was a year ago because many financially healthy banks are choosing not to increase their lending, even as their financial condition improves.

The health of the Texas banking industry has improved substantially since year-end 1989. At that time, only 45 percent of the banks—accounting for 23 percent of Texas banking assets and 19 percent of Texas banking loans—were financially healthy and in a position to expand credit. By the first quarter of 1991, however, 54 percent of the banks—accounting for 61 percent of assets and 55 percent of loans—were financially healthy. The improvement in the number of healthy banks is the result of Federal Deposit Insurance Corporation resolutions of failed banks, a recovery in bank profits and the continued expansion of the Texas economy.

Despite the improvement in the health of the banking industry, lending has not recovered. Total loans at Texas' unhealthy banks dropped $7.25 billion in 1990, with large declines in both real estate lending and commercial and industrial lending. This drop was partially offset by a lending increase of $3.6 billion at healthy Texas banks, which have taken market share away from the weaker banks and thrifts.

But not all healthy banks have increased their lending activity, which indicates an important pathology. Solvent banks can be categorized as being either healthy enough to lend or too sick to lend. Banks healthy enough to lend can be further classified as banks reporting increases in lending or banks choosing not to increase lending. I think the term pathology applies to this situation because a bank in good financial condition in a growing region would normally be expected to increase its lending activity.

The healthy banks that are not building their loan portfolios represent a significant share of the healthy banks in Texas. Of the 619 banks that were healthy as of the first quarter of 1991 and that have reported data for the past 10 quarters, nearly 40 percent did not increase their lending from the first quarter of 1990 to the first quarter of 1991. These banks account for 40 percent of the assets in healthy Texas banks and 35 percent of the loans in healthy Texas banks.

Several reasons could explain why these banks are not lending, but the banks' financial condition is not one of them. These banks' capital ratios are well above regulatory requirements; their troubled assets ratios are low, and they are earning profits. Their loan-to-asset ratios are low and their liquidity is high. In fact, these banks are growing in total assets by increasing their holdings of securities.

Why are these banks not lending? They may be unable to find high-quality borrowers. The average bank in this category has $77 million in assets. Banks of this size are typically dependent on very local economic conditions. While Texas is in a recovery, some individual counties still face economic stagnation.

Another possibility is that these banks are responding rationally to the changes in capital requirements for banks. The new risk-based capital standards reduce the capital requirements on low-risk assets, such as Treasury securities, while maintaining the capital requirements on loans and adding capital requirements on many off-balance-sheet items, such as loan commitments. Because raising capital is expensive compared with raising liabilities as sources of funds, these new capital requirements raised the cost of extending loans relative to investing in securities. Risk-based capital requirements were designed to encourage banks to better manage their credit risk by raising the cost of taking these risks and by increasing the banks' exposure to the financial risk inherent in these decisions. While banks realign their asset portfolios away from loans and toward securities, a decline in loan activity could occur.

A more disturbing explanation is that these banks could be too scared to lend. After the shocks of the past few years, these banks may be unwilling to take the risk required to extend loans. What is unclear is whether the bankers are more afraid of the economic shocks that drove down oil prices and real estate values or of the bank regulators' responses to these shocks. In a recent Texas Bankers Association survey of bankers, nearly 60 percent of the respondents attributed the credit crunch to over-regulation of banks.

Unless overly conservative institutions alter their lending policy, they will lose market share to banks that do take prudent risks. Unfortunately, the lag between these banks' improved financial condition and increased lending suggests that the recovery from the credit crunch will take longer than I anticipated a year ago. We must wait for banks to improve both their financial condition and their confidence level.