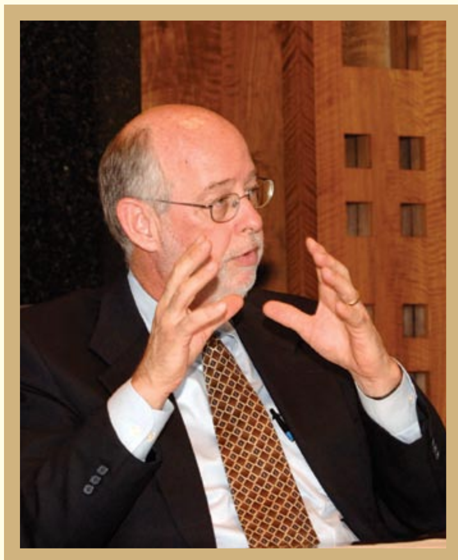
OnTheRecord

A Conversation with **Bob Hankins**

Taking Stock of the District Banking Industry

Dallas Fed Senior Vice President Bob Hankins, who oversees bank regulation in the Eleventh District, discusses the district's banks—from the risks posed by today's faltering housing markets to lessons from the turbulence of the 1980s.



Q: Nationally, a lot has been written about the housing downturn and financial market stresses. How have they affected Texas banks?

A: So far, Texas banks haven't been affected much by the housing slump. That's probably due to the fact that the state's real estate markets haven't seen the kinds of difficulties other regions have.

If you look at banking profiles, you'll see some clear differences between the Eleventh District and the rest of the country in terms of asset quality. As things stand, only about one-half of 1 percent of the mortgages held by district banks aren't being paid on schedule. That's a better track record than banks in the rest of the country, where a little over 1 percent of mortgages aren't current.

But I like to think that there's more to the strength of the district's banking sector than just the region's economy. Though the economy is responsible for much of the relative better performance, it also comes down to having enough bankers around who remember the hard times of the 1980s.

Q: What do you remember about the 1980s?

A: I've been in banking regulation for over 34 years, 28 of them here in Dallas. I like to say that I arrived on the scene in 1979 and had two good years before we saw the worst crisis in banking since the Great Depression.

Between 1982 and 1993, the district had more than 600 banks fail. In the peak years of 1988 and 1989, Texas banks alone accounted for about two-thirds of all failures in the country, and Texas banks recorded losses for four straight years, from 1986 through 1989. Only one of the top 10 banking organizations—Cullen/Frost—survived the crisis intact.

As bad as all that sounds, it helps to understand that the number of failures was inflated because Texas still barred branch banking at the time. So in a multibank holding company, one failure could take down all of the banks in the organization.

Q: What caused the crisis?

A: It was really a confluence of a number of things. It started with the bust in energy prices. The energy crisis was followed closely by the real estate crisis. At the time, it seemed the banks that weren't exposed to the energy sector were exposed to real estate. It didn't help that we saw the removal of some tax laws that had benefited the real estate market. The deregulation that took place in the savings and loan industry only served to exacerbate real estate investors' euphoria.

Q: Does anything about today's environment take you back to the 1980s?

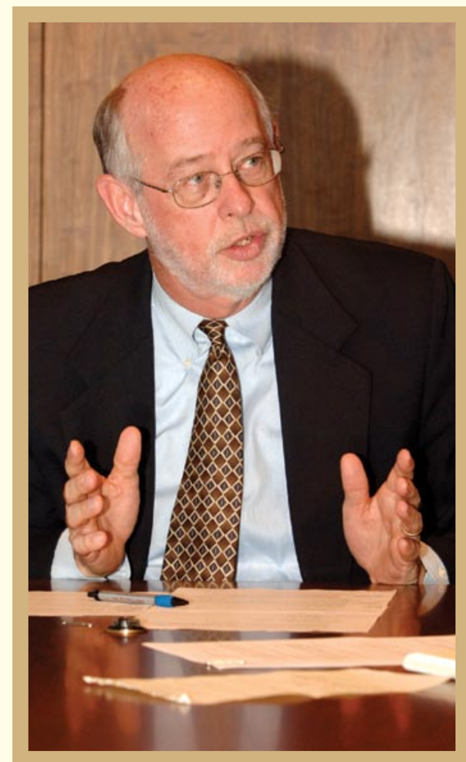
A: What I talk about today and have been talking about for over five years now is banks' exposure to commercial real estate. I'm not making any judgments but simply looking at the numbers. Right now, commercial real estate makes up some 28 percent of district banks' assets. That's significantly greater than the 16 percent we saw at the height of our real estate problems in 1987.

Although I recognize that banks have better risk management practices in place than they did in the 1980s, it doesn't stop me from worrying. If we have a major economic downturn, banks' exposure to commercial real estate could have a significant impact on the overall condition of the industry.

Q: How did the 1980s crisis change banking regulation?

A: At the state level, the crisis helped provide the impetus for changes in Texas' banking landscape. Because the industry was in such a weakened condition, we ended up letting out-of-state organizations acquire Texas banks. That started in 1988, when NCNB bought First Republic. Many others followed, leaving Texas without any big homegrown banks.

For the nation, the FDIC Improvement



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Act was passed in 1991, introducing a number of reforms that address such issues as the safety and soundness of the insurance funds, prompt regulatory action and the need to resolve failures in the most cost-efficient way.

Another important change came with the passage in 1994 of the Riegle-Neal Interstate Banking and Branching Efficiency Act. It's a mouthful to say, but the law for the first time allowed banks to set up branches outside their home states—although Texas didn't opt in to the law change until 1998.

Since then, the number of district banks has fallen from about 900 to about 650, but customers still have ample opportunity to receive banking services. The number of branches in the district has grown from 3,500 to more than 6,000.

By the way, vestiges of the old system are still with us. Even today, institutions can't come into Texas with de novo branches. They have to acquire an existing charter that's at least five years old and convert it to a branch.

Q: Are there other ways to set up shop in Texas?

A: A bank can also relocate to Texas by establishing a new charter here. The most recent example of this is Comerica, which is merging its current Michigan charter into its new Texas charter.

Comerica—the nation's 21st-largest bank, with assets of about $60 billion—is by far the largest bank to relocate to the state, and its arrival sends a strong signal of the viability of the Texas banking market.

Q: What will your jurisdiction encompass after Comerica finalizes its move?

A: Today, the Dallas Fed directly supervises 38 state-chartered banks that have elected to be members of the Federal Reserve System. We refer to them as state member banks. As of the end of the second quarter, those 38 banks represented 6 percent of the 679 banks headquartered in the Eleventh District and 10 percent of the 387 state-chartered banks headquartered here.

Those 38 banks held $19.2 billion in assets—10 percent of the district's total banking assets of $194.7 billion and 20 percent of its state-chartered banking assets of $94.9 billion. We also supervise about 450 bank holding companies and 30 agencies and representative offices of foreign banks.

After the Comerica move, that $19.2 billion figure will bump up to nearly $80 billion. So you can see it's quite important for the district.

Q: Are there other risks to the banking system outside of real estate?

A: Banks typically borrow or take in deposits at lower short-term rates and then lend out that money longer term at higher rates. The difference between those two rates is what they pocket and can affect their profitability.

The challenge for banks in recent years has been the narrowing gap between these two rates, putting pressure on their profit margins. The longer that environment has persisted, the more I worry about banks struggling to sustain their earnings. What I have been cautioning against is letting the squeezed profit margins lead to too much cost cutting in such areas as internal controls, compliance, loan review and personnel.

On top of that, I worry that banks are having a hard time attracting the right talent to their management ranks. But, then, I am paid to worry.

Q: Does the recent rate cut by the Fed imply that banks are entering a better earnings environment?

A: In theory, declining interest rates should be beneficial to the banking industry. But in reality, it depends on an individual bank's position. If a bank's liabilities reprice faster than its assets, then that bank's net interest margin will increase, and so should earnings. If, on the other hand, a bank's assets reprice quicker than its liabilities, its profits might fall.

If the industry as a whole plays true to form—funding long-term assets, or loans, with short-term liabilities, or deposits—it's probably better off today than it was before the Fed cut interest rates.