

Chapter 9

Banking Problems in the Southwest

Introduction

The most severe of the regional banking crises was the one in the southwestern region, defined here as Texas, Oklahoma, Louisiana, New Mexico, and Arkansas.¹ Of the total failure-resolution costs borne by the FDIC from 1986 to 1994, half (\$15.3 billion) was accounted for by southwestern bank failures. (This included losses of nearly \$6.3 billion in 1988 and \$5.1 billion in 1989—91.1 percent and 82 percent, respectively, of total FDIC failure-resolution costs for those two years.) From 1987 through 1989, 71 percent of the banks that failed in the United States were southwestern banks (491 out of 689), and so were some of the most significant failures, such as banks within the First City Bancorporation, First RepublicBank Corporation, and MCorp holding companies. The pervasiveness of the problems facing the region's depository institutions is indicated by the fact that the biggest savings and loan debacle also occurred in the Southwest, with Texas alone accounting for 18.3 percent of the Resolution Trust Corporation's resolutions and 29.2 percent of its resolution costs (see Chapter 4).

The banking collapse in the Southwest was especially devastating to the Texas banking industry. From 1980 through 1989, 425 Texas commercial banks failed, including 9 of the state's 10 largest bank holding companies. In 1988, 175 Texas banks failed with assets of \$47.3 billion—25 percent of the state's 1987 year-end banking assets. The following year

¹ The sequence in which the states are listed reflects the severity of each state's banking crisis. From 1980 through 1994, Texas had 599 bank failures and \$60.2 billion in failed-bank assets (43.8 percent of the state's total bank assets); Oklahoma: 122 failures, \$5.8 billion in failed-bank assets (23.8 percent of total state banking assets); Louisiana: 70 failures, \$4.1 billion in assets (17.4 percent of total); New Mexico: 11 failures, \$568 million in assets (9.5 percent of total); and Arkansas: 11 failures, \$161 million in assets (1.5 percent of total). The discussion in this chapter focuses on Texas, Oklahoma, and Louisiana because banking problems were concentrated in those states. However, data for the Southwest cover all five states. (Note: The number of bank failures refers to FDIC-insured commercial and savings banks that were closed or received FDIC assistance. Asset data refer to assets of banks existing in each state at year-end 1979 plus assets of newly chartered banks as of the date of failure, merger, or December 31, 1994, whichever is applicable.)

134 Texas banks failed with assets of \$23.2 billion—13.6 percent of the state's banking assets.

Oil was both the foundation of the region's economy and the primary force behind the region's banking crisis. In January 1973, the U.S. average monthly import price for crude oil was \$2.75 per barrel; after a series of unprecedented international economic and political events, this price rose to a peak of \$36.95 per barrel in April 1981. The soaring price of oil worldwide fueled the oil boom in the Southwest and became the basis for regional economic prosperity, supported by bank lending to the energy markets.

But oil prices peaked in 1981, an event that roughly coincided with the beginning of deterioration in the banking sector. Between 1981 and 1985 the price of oil slowly but steadily declined as a result of several factors: conservation efforts led to decreased demand, oil production increased, and the international political environment changed. This was the initial period of increased southwestern bank failures, caused primarily by problems with energy loans. As oil prices continued to weaken, southwestern banks sought new investment opportunities and therefore increased their lending to the then-booming real estate markets, particularly commercial real estate. In hindsight this strategy proved to be unwise, for the health of the real estate markets was tied to the hitherto-strong energy markets. Indeed, indications of potential problems may have come early: from 1981 through 1983 office vacancy rates were escalating even while commercial real estate construction expenditures remained extremely high. In 1986 oil prices dropped precipitously, devastating the region's economy, and the price decline and subsequent economic devastation contributed to the collapse of the overbuilt southwestern real estate market in the remaining years of the decade. As a result, the region's banks suffered substantial losses on real estate loans. These losses, coming when the banks were already weakened by energy-loan difficulties and by intense competition from recently deregulated savings and loan (S&L) institutions, were largely responsible for the escalating number of southwestern bank failures in the second half of the decade.

Because oil played such an important role in the region's economy, the history and causes of the oil boom and bust are reviewed first. And because bankers reacted to the weakening of oil prices by increasing their real estate lending, helping to support the substantial growth in real estate development in the Southwest, the southwestern real estate markets are discussed next. The emphasis is on Texas, the state most affected by the oil cycle. The final section on the region's economy highlights the effects of agricultural problems, especially in relation to Texas, Louisiana, and Oklahoma. The remaining sections of the chapter focus on banking: the banking environment (new charters, and competition from S&Ls), the effect of the economy on the region's banks, bank failures in the region (the failures of Penn Square and the First National Bank of Midland are looked at in detail), and regional bank data. An analysis of these data suggests that although the number of

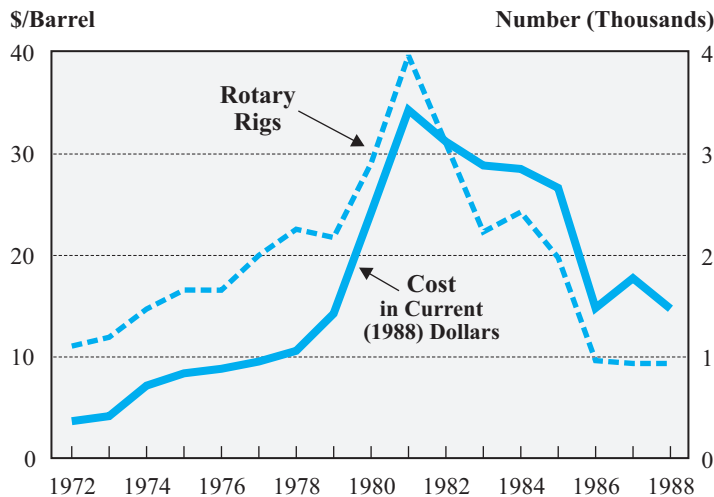
southwestern bank failures did not begin to increase substantially until 1983 and reached a peak in 1988, the beginning of the collapse can be observed in bank data as early as 1981.

Energy and the Southwestern Economy: Boom and Bust

Energy—oil and natural gas—was a vital component of the southwestern economy, and trends in the prices of these two products determined regional economic trends. In the 1970s and 1980s the price of both oil (the cornerstone of the economy) and natural gas (which also played an important role) went through a boom and bust that had a tremendous impact on the region (see figure 9.1). Between 1979 and 1982, when the prices of the two sources of energy were high, the average growth rate in the Southwest exceeded that of the nation as a whole by a substantial margin; from 1985 to mid-1987, when energy prices were depressed, the region's average growth rate was significantly less than the nation's (see figure 9.2).

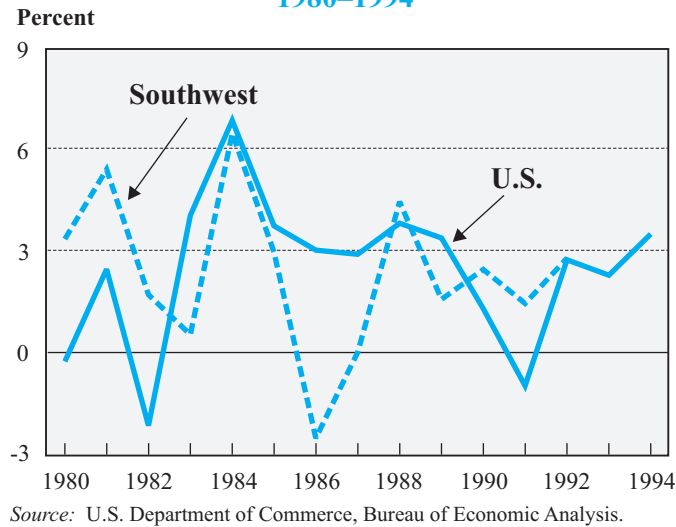
The price of oil was extremely volatile in the 1970s and 1980s. In January 1973 the average monthly import price per barrel was \$2.75, but between then and April 1981 a series of international economic and political events combined to push the price to a peak of

Figure 9.1
Domestic Crude-Oil Refiner Acquisition Cost versus
Average Number of Rotary Rigs, 1972–1988



Sources: U.S. Department of Commerce, International Trade Administration, *Industrial Outlook* (1990), 3-5; and Energy Information Administration, *Annual Energy Review 1988* (Cited in John O'Keefe, "The Texas Banking Crisis," FDIC Banking Review 3, no. 2 (1990), 17.

Figure 9.2
Changes in Southwest Gross Product versus
Changes in U.S. Gross Domestic Product,
1980–1994



\$36.95 per barrel. By August 1986, however, because of energy conservation, increased production, and a drastic change in the world political environment, imported oil prices plunged to \$10.00 per barrel. These substantial movements in the price of oil profoundly destabilized the Southwest's economy and its banks.

Throughout the 1950s and 1960s, oil had been inexpensive and plentiful, partly because new oil fields opened in the Middle East, Southeast Asia, and Africa.² During the 1950s, annual imports of crude oil and refined oil products increased 176 percent and net imports as a share of domestic consumption rose from 6 to 17 percent. In 1959, the low price of oil led domestic producers to persuade the Eisenhower administration to impose import quotas on crude oil and petroleum products as protection against foreign competition. Despite this action, the net import market share continued to grow, reaching 22 percent in 1969. Dependence on imported oil continued to increase as the production of domestic oil peaked in 1970 and then began a gradual but continuous decline (which was interrupted only briefly by the opening of the Trans-Alaska oil pipeline in 1977). By 1972, imported oil

² Information in this section, unless otherwise noted, is from Jack L. Hervey, "The 1973 Oil Crisis: One Generation and Counting," Federal Reserve Bank of Chicago *Chicago Fed Letter*, no. 86 (October 1994): 1–2.

amounted to 28 percent of domestic consumption. The reduction in domestic crude production was accompanied by a 16 percent increase in consumption between 1969 and 1972. As a result, crude oil prices, which had been rising at an average annual rate of approximately 1.25 percent, rose nearly 8 percent in 1971 alone. In response to growing oil shortages and rising prices, the oil import quotas were eliminated by presidential order in 1973. Nevertheless, the U.S. monthly average import price for crude oil rose 23 percent between January and September of that year (from \$2.75 to \$3.38 per barrel).

The political ramifications of the Arab-Israeli war in 1973 had an enormous impact on oil prices. Several Arab members of the Organization of Petroleum Exporting Countries (OPEC) decided to impose a selective embargo on oil shipments to countries that supported Israel.³ However, cartels tend to be unstable, and in this case the embargo's effectiveness was undercut by the Arab nations' dependence upon oil as their primary source of revenues.⁴ Nonetheless, OPEC quadrupled the price of oil from roughly \$3 a barrel in October 1973 to around \$12 by January 1974, causing an "oil shock" that was felt by economies around the world.

After that initial price upheaval, oil prices trended upward and then remained around \$13.50 per barrel throughout 1978.⁵ In response to the higher oil prices, many oil-producing countries, members and nonmembers of OPEC alike, had increased their output by the late 1970s. In addition, crude oil extracted from both the Alaskan North Slope and newly opened fields in the North Sea became available on the world market. At the same time, the United States and other industrial nations had instituted conservation measures that significantly reduced their consumption of oil.⁶

Faced with reduced demand and the prospect of losing some control over the crude oil and petroleum markets, in 1979 OPEC again cut production and raised oil prices by 14.5 percent. OPEC's success was facilitated by the Iranian revolution of 1979, which disrupted crude oil production in that country. OPEC's actions launched the second wave of oil price increases and had a profound impact on the global economy.⁷ By April 1981, the average monthly import price for crude oil in the United States hit a peak of \$36.95 per barrel.

³ OPEC was founded in 1960 for the purpose of coordinating the petroleum policies of member countries and safeguarding their interests. Its charter members were Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela. By November 1973, it had eight additional members: Algeria, Ecuador, Gabon, Indonesia, Libya, Nigeria, Qatar, and the United Arab Emirates. Ecuador and Gabon withdrew from the cartel in 1992 and 1996, respectively, leaving OPEC with 11 members as of June 1997.

⁴ David Ivanovich, "It Was a Disaster; 1973 Arab Oil Embargo Still Scratches at Scar of Distrust," *Houston Chronicle* (October 16, 1993), available: LEXIS, Library: NEWS, File: HCHRN.

⁵ Hervey, "The 1973 Oil Crisis," 1–3.

⁶ Ibid.

⁷ For example, the Organization for Economic Cooperation and Development (OECD) estimated that the level of GNP in the 24 OECD member countries would be some 6 percent, or about \$500 billion, lower by the beginning of 1982 than it would have been in the absence of the oil price rise (*Economic Report of the President, Transmitted to the Congress* [1981], 190.)

In response to these prices, the United States and other industrial nations continued to reduce oil consumption by making stringent conservation efforts, while at the same time non-OPEC countries were further increasing their oil output. As a result, OPEC's ability to maintain a fixed price of oil was under mounting pressure. In addition, the cartel's unity deteriorated as individual members began to boost their own oil output, selling more than their OPEC quota at reduced prices on world markets. This breakdown in the cartel's discipline eventually contributed to a break in oil prices, and by early 1983 the prices of imported oil had fallen below \$30 per barrel.⁸ Then in late 1985, Saudi Arabia unilaterally engineered a substantial reduction in the price of oil by increasing its daily production of crude from two million to four million barrels.⁹ As a result, oil prices that had averaged approximately \$30 a barrel in late November dropped to approximately \$25 a barrel by January 15, 1986.¹⁰ The subsequent flood of OPEC oil caused prices to continue plummeting, falling to less than \$13 a barrel by March 1986 and to \$10 a barrel by August 1986, the lowest price since 1974.¹¹

The explosion and collapse of oil prices had a profound effect on oil drilling, especially in the states of Texas, Oklahoma, and Louisiana. Throughout the 1960s oil drilling had been declining, as U.S. fields were steadily drained of oil that could be profitably extracted at \$2 a barrel. As a result, the rig count in the United States had dropped from 2,000 in the early 1960s to just below 1,000 by the early 1970s.¹² However, the steep increases in oil prices beginning in 1973 quickly affected drilling activity, allowing U.S. producers to reach record levels of drilling for crude oil despite enduring high production costs relative to those in many other oil-producing nations.¹³ In late October 1973, one Houston producer noted: "Drilling is booming. All inland rigs that I know of are booked until after the end of this year. I'll drill about 15 wells this year—about 10 more than I would have had we not

⁸ Hervey, "The 1973 Oil Crisis," 2.

⁹ Saudi Arabia has the world's largest oil reserves and could afford to increase output sufficiently to prevent its oil revenues from declining despite a substantial drop in crude oil prices; this was not the case for other OPEC members. Saudi Arabia increased output and drove oil prices lower to force other OPEC members to adhere to agreed-upon production quotas. See Dermot Gately, "Lessons from the 1986 Oil Price Collapse," *Brookings Papers on Economic Activity* 2 (1986): 237–38, 251–53, 265.

¹⁰ "As Oil Prices Continue to Slide, Texas Banks Confront a Grim '86: Further Deterioration Expected in Energy and Real Estate Lending," *American Banker* (February 11, 1986), 2.

¹¹ David LaGesse, "Banker Predicts Rebound in Oil Prices," *American Banker* (March 27, 1986), 1; and Hervey, "The 1973 Oil Crisis," 2.

¹² James Fallows, "A Permanent Boomtown, Houston," *Atlantic Monthly* 256 (July 1985), available: LEXIS, Library: NEWS, File: ATLANT.

¹³ For example, to extract U.S. oil that was difficult to pump, it was necessary to employ enhanced recovery methods that were unprofitable when oil was priced below \$15 a barrel. In contrast, Saudi Arabian wells were shallow and comparatively free flowing and could be profitable even when oil was sold at \$5 a barrel (Thomas C. Hayes, "West Texas Oilmen Struggle to Endure," *The New York Times* [March 18, 1986], available: LEXIS, Library: NEWS, File: NYT).

gotten the free market price for new oil.”¹⁴ Oilmen bought rigs and added employees without concern in the early 1980s, for both they and many bankers expected oil prices to reach \$60 a barrel in the next few years.¹⁵ As a result, between 1979 and 1981 drilling expenditures increased from \$16.5 billion to \$38 billion.¹⁶ In 1981, the monthly average number of active rotary rigs reached a peak of approximately 4,000 (figure 9.1). When oil prices subsequently crashed, the number of profitable drilling opportunities became severely limited, leading to plunging values of drilling equipment, limited demand for oil-related loans, and losses to banks on outstanding oil-sector loans. The number of active rigs declined along with oil prices, reaching a new postwar low of 757 in May 1986.¹⁷

The plunge in oil prices inflicted severe hardship on many, including oil driller Don Hughes. Hughes had been perhaps the busiest drilling contractor in Oklahoma, but the precipitous drop in oil prices caused drilling in Oklahoma virtually to cease, bringing down the Hughes Drilling Company, which had once employed 400 and grossed \$4 million a month. Hughes reminisced about the glory days while he was in the process of handing over everything he had bought to the Continental Illinois National Bank and Trust Company:

During the boom everybody was screaming and hollerin’ for rigs. There was not a week that at least three bankers from the major banks weren’t here trying to loan me more money for more rigs. They told me I was a shining star. We were written up in Inc. magazine as one of the fastest-growing companies. Bear Stearns tried to get me to go public. I kept believing what all these people were telling me.¹⁸

Other drillers still in business at that time were justifiably worried. Mac McGee, marketing director of the Cactus Drilling Company, one of the largest drillers in West Texas, observed in early 1986 that “everybody geared up and borrowed. The banks can’t afford to carry companies very long. If things don’t pick up some, it’s going to be a real tragedy.”¹⁹ The situation, however, only worsened. The changing times were tellingly reflected in the prevailing bumper stickers. Oil-patch workers’ bumper stickers had read “\$85 [a barrel] in ’85.” In contrast, a slogan displayed in late 1986 read “Chapter 11 in ’87.”²⁰

¹⁴ Darnel Peacock, “Price Boosts Will Hasten Exploration,” *Houston Post* (October 21, 1973), CC4.

¹⁵ See Robert Dodge, “The Long Road Back in Texas,” *United States Banker* (July 1985), available: LEXIS, Library: NEWS, File: USBANK; and Hayes, “Oilmen Struggle.”

¹⁶ U.S. Congress, Joint Economic Committee, *The Economic Impact of the Oil Price Collapse: Hearing before the Subcommittee on Trade, Productivity, and Economic Growth of the Joint Economic Committee*, 99th Cong., 2d sess., March 12, 1986, 68.

¹⁷ Peter Behr and Hobart Rowen, “Fall in Price of Oil Hurts U.S. Fields; Drop in Drilling, Permanent Loss of Production Apparent,” *The Washington Post* (March 9, 1986), available: LEXIS, Library: NEWS, File: WPOST; and Thomas C. Hayes, “Oil’s Plunge Drags Gas Down,” *The New York Times* (May 23, 1986), available: LEXIS, Library: NEWS, File: NYT.

¹⁸ Robert Reinhold, “Desperation Descends on Oklahoma,” *The New York Times* (May 11, 1986), available: LEXIS, Library: NEWS, File: NYT.

¹⁹ Hayes, “Oilmen Struggle.”

²⁰ “A Dream Dies in Texas; Once a Land of Unlimited Promise, the Lone Star State Has Lost Its Shine and Now Has a Barrel of Troubles,” *People* (November 10, 1986), available: LEXIS, Library: NEWS, File: PEOPLE.

Natural gas also went through a boom-and-bust cycle, but here the important factor was federal regulation of natural gas prices. The government had been involved in regulating natural gas prices since passage in 1938 of the Natural Gas Act, which charged the Federal Power Commission (FPC) with regulating rates charged by interstate pipeline companies.²¹ Regulation of rates for intrastate pipelines and local utilities was left to state authorities. Throughout the 1960s wellhead gas prices were frozen at 1959 levels, resulting in a noticeable decline in drilling activities. By 1968, consumption exceeded additions to reserves.

In 1970, the intrastate price of natural gas, which most state regulators had left free of controls, climbed above federal price ceilings. As a result, producers began to reduce their commitments to interstate pipelines and, whenever possible, diverted natural gas to intrastate markets (mainly Texas, Oklahoma, and Louisiana). This response to the federal price-control framework was the chief cause of the so-called energy crisis during the 1970s for natural gas consumers in the Northeast and Midwest. Because of these events, in the winter of 1970–71 the FPC raised ceiling prices from their 1960s level. Then in 1974 the FPC adopted a single national price ceiling for natural gas, superseding the areawide pricing formula adopted in 1960 under which the nation had been carved into five regions, each of which was assigned its own price ceiling. However, because of political pressure, the FPC set a ceiling price about half as high as the market price for natural gas. This caused shortages to continue, since suppliers still had little incentive to commit gas for interstate sales.

Supply problems proliferated and in 1978 nearly 41 percent of the nation's annual gas sales were intrastate sales, which meant that 47 states were sharing less than 60 percent of the nation's delivered natural gas. The distorted supply situation was the impetus behind passage of the Natural Gas Policy Act of 1978. The act provided for a phased deregulation of all types of gas prices through 1985, except for "old" gas (from wells drilled before April 1977), which was to remain controlled, and "deep" gas (from wells below 15,000 feet), which immediately became free of all price controls.

The act had a significant effect on the production and price of natural gas. After its passage, the price of so-called deep gas soared to \$10 per 1,000 cubic feet and higher—more than four times the price of regulated shallow gas.²² As a result, a boom developed in the deep-gas drilling sector. A major beneficiary of the escalating prices was Oklahoma's

²¹ Unless otherwise noted, the information here on natural gas prices and on the industry is from Frederick S. Carns, "The Role of Federal Regulation in the Natural Gas Industry," *FDIC Banking and Economic Review* 4, no. 5 (June 1986): 3–8.

²² Unless otherwise noted, the information in this paragraph and the next is from Douglas Martin, "Penn Square's Oil Connection," *The New York Times* (July 19, 1982), available: LEXIS, Library: NEWS, File: NYT; and "Oklahoma Oil and Gas; This Time the Hurting Won't Heal," *Economist* (August 21, 1982), available: LEXIS, Library: NEWS, File: ECON.

Anadarko Basin, where most of the drilling activity was centered. The expansion in drilling for the basin's higher-priced deep gas is reflected in the increased number of on-shore well completions, which went from 47,413 in 1978 to 77,505 in 1981. These events contributed to the huge natural-gas surpluses of the early 1980s.

Demand for natural gas was subsequently reduced by its rising price and by the national economic recession of the early 1980s. By early 1982, therefore, pipeline companies had halved the price they were prepared to pay for deep gas. Subsequently, natural gas prices collapsed along with oil prices. For example, after a 33 percent decline in natural gas prices in 1985, from January through mid-May of 1986 spot market prices dropped another 34 percent (from \$1.90 to \$1.26 per million British thermal units [BTUs]).²³ These events were devastating to producers, who were already having problems because deep drilling had been more costly than anticipated.

For banks, the erosion of oil prices beginning in 1981 led to problems with energy loans that were largely responsible for the initial increase in the number of bank failures in 1983. Compounding the difficulties caused by the weakening energy markets was the excessive emphasis that some banks had placed on making energy loans to maintain market share in an environment in which the competition to keep oil and gas customers (during 1981 and 1982) was intense. For example, in 1981 officials of Republic Bank of Texas were feeling pressure from members of the board of directors to preserve the bank's market share in energy lending. It was reported that Chairman James D. Berry summoned the bank's top energy lenders to his office and told them he wanted to make more energy loans. The lenders, who knew the industry was gripped by a gold-rush psychology, "all sat there and blinked at the chairman, like a bunch of owls in a tree." But lenders at other institutions were assuming the price of oil would climb to \$60 a barrel or more and had lowered their lending standards to grab new business.²⁴ Republic's customers were going to those other banks.

In hindsight, although bankers might have been more prudent regarding the quality of their energy loans, there appears to have been little they could do to protect themselves from the unexpected and precipitous decline in oil prices that occurred in 1986. In mid-January 1986, when oil futures fell below \$20 a barrel,²⁵ Frank Anderson, an analyst with Weber, Hall, Sale & Associates in Dallas, expressed the following opinion:

²³ Detta Voesar, "Economic Conditions in Oklahoma," *FDIC Banking and Economic Review* 4, no. 8 (November/December 1986): 22. The spot market is a market for buying and selling commodities for immediate—as opposed to future—delivery and for cash payment; a BTU is the quantity of heat required to raise the temperature of one pound of water by one degree Fahrenheit.

²⁴ Robert Dodge, "The Long Road Back in Texas."

²⁵ A futures contract is an agreement to deliver or to receive some commodity (in this instance, oil) at a specified price at some specified future time.

At \$18 a barrel, you'll start seeing a little squirming. . . If oil prices come down gradually, the banks have a number of things they can do to their energy credits, like add more collateral or restructure the loans. They have a lot more flexibility. But if the price drops suddenly to \$15 a barrel, they will have no time to react.²⁶

As noted above, by August 1986 oil prices had plummeted to \$10 a barrel.

Many banks compounded their troubles by presuming that the weakening in oil prices was merely temporary. For example, James Cochrane, chief economist of Texas Commerce Bancshares, argued that the low level of exploration in mid-1985 would result in future shortages of oil and gas supplies and that "by the end of the decade, we will have a serious inability to supply energy products. . . We continue to believe in the long-term future of the industry."²⁷ In March 1986, Eugene C. Fiedorek, executive vice president of RepublicBank of Dallas, told financial analysts that "RepublicBank remains committed to the energy industry; it will make new loans based on expectations that oil prices will soon rebound to about \$18 a barrel."²⁸ In late April 1986, James Bruce, chief financial officer of Banks of Mid-America of Oklahoma, said, "I don't know anyone who in their gut believes that prices will stay at these levels. The feeling here is that Saudi Arabia is going to prove its point [by flooding the market with oil] and then prices will recover. A hell of a lot of money that's fairly smart says they're going to recover."²⁹ Even when a continued fall in oil prices was considered possible, bankers sometimes displayed a relaxed or indifferent attitude toward the eventuality. For example, in late 1985, when oil fell in just a couple of weeks from \$32 to around \$25 a barrel, Larry Helm, executive vice president and head of the energy division of InterFirst Corp. of Dallas, felt that "if the price [of oil] drops to the \$20 range, that might cause some problems on some credits but the magnitude of those problems would not be so great."³⁰

Some analysts, however, did not believe that the drop in oil prices was temporary or of little significance. In late 1985, Sandra Flannigan, a vice president at Paine, Webber, Jackson & Curtis Inc. in Houston, believed that "if we see oil prices go below [\$20 a barrel] and remain there for an extended period, we'll have substantial problems."³¹ Flannigan also observed at the time that the spillover effects of an oil price decline could reach into real estate and other areas of the Texas economy that were dependent on oil. Another warn-

²⁶ Lisabeth Weiner and Richard Ringer, "Falling Oil Prices Could Bleed Portfolios of Energy Banks," *American Banker* (January 22, 1986), 2.

²⁷ Dodge, "The Long Road Back in Texas."

²⁸ David LaGesse, "Banker Predicts Rebound in Oil Prices," 1.

²⁹ John Morris, "Banks of Mid-America Treads Water, Waits for Cheap-Oil Flood to Subside," *American Banker* (April 30, 1986), 8.

³⁰ Lisabeth Weiner and John P. Forde, "Oil Price Drop Having Little Effect on Banks: Industry Well Insulated Against Price Changes, Analysts Say," *American Banker* (December 12, 1985), 8.

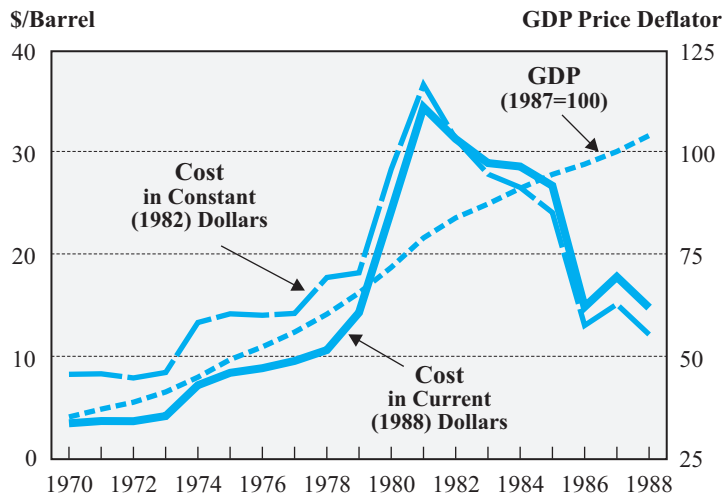
³¹ *Ibid.*

ing came in early February 1986, when James W. McDermott, Jr., a bank analyst with Keefe, Bruyette & Woods, Inc., of New York, cautioned that “we are likely to see a continuation of weak oil prices and a worsening of the financial performance of the Texas banks.”³² Few bankers appeared to heed such warnings.

Southwestern Real Estate Markets

The tremendous rise in oil prices relative to the increases in other prices resulted in a substantial transfer of wealth from oil-consuming to oil-producing areas (see figure 9.3). And even after oil prices weakened, the affluence resulting from the oil boom and expectations that oil prices would rebound kept southwestern real estate markets robust.³³ Moreover, commercial real estate in the Southwest was favorably affected not only by internal but also by external factors.³⁴ Entering the 1980s, the nation’s real estate markets were

Figure 9.3
Domestic Crude-Oil Refiner Acquisition Cost versus
Gross Domestic Product, 1970–1988



Sources: *Economic Report of the President* (1993), 352; and see source to Figure 9.1.

³² “As Oil Prices Continue to Slide,” 2.

³³ For example, Schmidt noted that despite falling oil prices through most of the year, the rapid increase in the rig count in 1981 was based on expectations that prices could rise to \$50 per barrel in the next few years (Ronald H. Schmidt, “The Effect of Price Expectations on Drilling Activity,” Federal Reserve Bank of Dallas *Economic Review* [November 1984], 1–2). Furthermore, one article noted that banks in 1981 were assuming oil prices would go much higher, not lower, and that overly aggressive energy lending was tied to a rosy view of post-1981 oil prices (Brian A. Toal, “Credit Where Credit Is Due,” *Oil and Gas Investor* 7, no. 9 [April 1988]: 30).

³⁴ See Chapter 3.

healthy: elevated inflationary expectations set off speculative demand, which led to attractive returns on real estate investments, and two public policy actions facilitated and probably intensified the demand for commercial real estate. These were the Economic Recovery Tax Act of 1981, which created substantial tax breaks that raised the returns on commercial real estate investments, and the Garn–St Germain Act of 1982, which greatly increased the investment and lending powers of thrift institutions.

The strong southwestern real estate markets attracted investors and bankers who were seeking new investment opportunities for the wealth and liquidity that had been accumulated over the years of oil prosperity, and the result was a financial environment in which lenders were aggressively providing funds for real estate development. This contributed to the substantial growth in such development, especially commercial real estate, and was the basis for the continued expansion of the southwestern economy during the first half of the 1980s. Eventually real estate development itself reached boom proportions, as evidenced by the doubling in the number of residential permits issued, from 211,705 in 1981 to 424,854 in 1983, and the increase in the value of nonresidential permits from \$7.6 billion in 1980 to approximately \$10 billion to \$12 billion annually between 1981 and 1985 (see table 9.1)

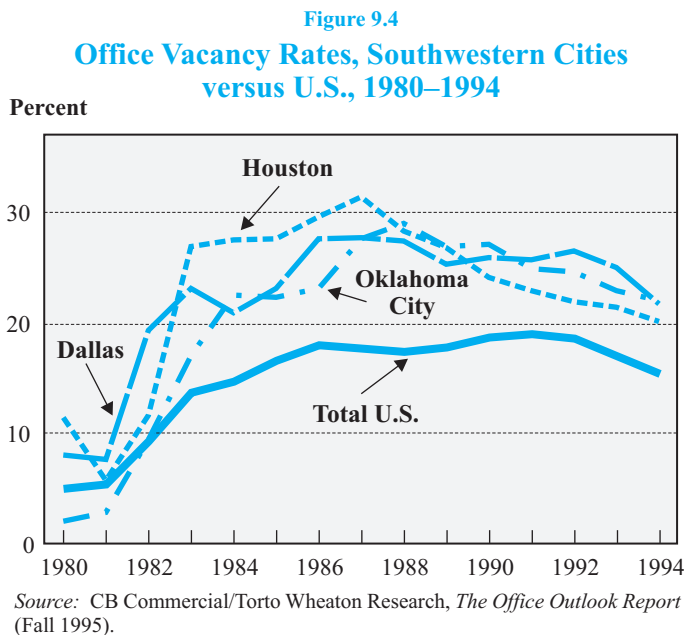
By the mid-1980s, there was concern that the amount of real estate development was becoming excessive. For example, in May 1984 Kenneth Rosen, a real estate expert, told a

Table 9.1
Construction Permits in the Southwest, 1980–1994

Year	Number of Residential Permits Issued	Value of Nonresidential Permits (\$Thousands)
1980	211,096	\$ 7,612,364
1981	211,705	10,402,804
1982	295,365	10,016,236
1983	424,854	9,555,382
1984	342,189	11,767,921
1985	256,160	11,831,367
1986	189,349	8,447,611
1987	114,671	7,210,674
1988	92,074	5,898,880
1989	83,503	6,890,954
1990	87,856	6,166,786
1991	94,544	5,273,940
1992	120,696	6,186,262
1993	145,183	6,777,214
1994	190,246	8,095,027

session of the American Bankers Association's national conference on real estate finance that "commercial developers will take the money and build without looking at demand."³⁵ In the spring of 1985, a *Dallas Morning News* article noted that Dallas had 34 million square feet of unleased office space—more than the total office space in Miami. Such statements indicated the beginning of a slow realization that real estate markets were overbuilt.³⁶ When the sharp contraction in oil prices in 1986 weakened the regional economy, demand for office space was curtailed; this reduced demand, coupled with the huge volume of new properties, put downward pressure on real estate prices.

Although the value of nonresidential permits fell from 1985 through 1988, the decline came too late to prevent serious problems. The office space added during the decade far exceeded demand, and office vacancy rates kept escalating (see figure 9.4). For example, from 1980 to 1987 office vacancy rates in Dallas jumped from 8 percent to 28 percent; in Houston, from 11 percent to 31 percent; and in Oklahoma City, from 2 percent to 28 percent. The oversupply of office space is indicated by the fact that between 1980 and 1987 the square



³⁵ David LaGessee, "Shakeout Forecast for Commercial Real Estate," *American Banker* (May 8, 1984), 3.

³⁶ Frederick E. "Shad" Rowe, Jr., "Texas Has a Lesson for the Rest of Us," *Fortune* (August 1, 1988), available: LEXIS, Library: NEWS, File: FORTUN.

footage of space per office employee increased by 83 percent in Dallas, 65 percent in Houston, and 56 percent in Oklahoma City (as a comparison, the national average increased by just 22 percent). Although vacancy rates reached their highest point in about 1987, as late as year-end 1994 these southwestern cities still had excess office space: vacancy rates in all three exceeded 20 percent, compared with a national average of 15 percent.³⁷

It is noteworthy that from 1981 through 1983, while office vacancy rates were escalating, commercial real estate construction expenditures and bank funding of projects remained extremely high. The explanations for continued heavy lending for commercial real estate construction despite the rising vacancy rates include the following: (1) A substantial increase in the number of newly chartered banks in the Southwest put competitive pressure on existing institutions to retain market share. (2) Commercial real estate credits contained higher underlying risk and could therefore be priced above traditional residential real estate or consumer loans, to increase margins. (3) Perhaps even more attractive to lenders was the “up-front” fee income generated by commercial real estate loans, particularly construction loans. (4) Lenders loosened traditional standards relating to debt-service coverage on the assumption that commercial real estate markets would remain prosperous and demand would keep pace with new construction in progress. (5) Inadequate feasibility studies, which evaluated only an individual project and failed to take into account other activity in progress, might have made imprudent loans appear attractive. (6) A related problem was that the real estate appraisal process failed to act as a check on questionable underwriting practices.³⁸

Agricultural Problems

After energy and real estate, agriculture was a source of problems for many southwestern banks.³⁹ First Oklahoma and then Texas suffered severely from the farm crisis; Louisiana and Arkansas, as well, experienced some agricultural difficulties.

The financial difficulties suffered by Oklahoma’s farmers in the mid-1980s were due to high production, soft export markets, low prices, and diminishing values of farmland.⁴⁰ Compounding these difficulties was the fact that by 1986, farmers could no longer count on receiving oil and gas royalties to supplement their income: when the price of oil plummeted,

³⁷ Information on Dallas, Houston, and Oklahoma City is from “The Office Market in 1995 and the Outlook” (chap. 4, table 4.2) and “Metropolitan Markets: The Office Outlook” (chap. 6, table 7), in CB Commercial Torto/Wheaton Research, *The Office Outlook*, vols. 1 and 2 (1995).

³⁸ According to regulators who were active in the region, many appraisals were apparently out of touch with reality, and some regulators believed that inflated appraisals were easy to obtain. For example, it was not unheard of for a development project that cost \$1 million to be appraised at \$1.8 million. Thus, if a bank lent \$1.3 million on this deal, the loan would appear conservative. For a comprehensive discussion of both the appraisal process and the reasons banks strongly supported the commercial real estate markets, see Chapter 3.

³⁹ For a general discussion of the agricultural crisis of the 1980s, see Chapter 8.

⁴⁰ See Voesar, “Economic Conditions in Oklahoma,” 21–26.

many drillers abandoned wells they had formerly operated on farmers' spare acreage. Ripple effects stemming from farmers' financial problems hit rural towns in Oklahoma particularly hard, causing many merchants to go out of business and many residents to move to urban areas. As one observer noted, small rural towns in Oklahoma rapidly became an endangered species in the mid-1980s.

Texas has substantial agricultural interests, ranking second among all states in farm income and third in farm marketings in 1985.⁴¹ Texas was therefore not immune to the worst farm crisis since the Depression, but felt the effects of the crisis about two years later than the agricultural heartland.⁴² The price of farmland in Texas had not skyrocketed in the 1970s as it had in farm-belt states (James Rogers, president of the Farm Credit Banks of Texas, said, "It was not uncommon for land in the Farm Belt to be worth about \$3,000 an acre at its height, while the very best land in Texas only climbed to around \$1,500 an acre").⁴³ And in 1981–85, when land prices in other farm-belt states declined by as much as 50 percent from their highs, Texas farmland increased by 45 percent—the largest increase in the country.⁴⁴ Nevertheless, by 1986 farmers in Texas were feeling the effects of many years of rising costs and low commodity prices. "The number of farmers with heavy debt has increased dramatically over the last three to four years," said James L. Sexton, the Texas banking commissioner, in 1986. "The small-farm producer is in a pinch trying to make the proceeds of his crop pay off his costs, plus trying to make a living."⁴⁵

The region's agricultural problems had a significant effect on banks, especially in Texas. Until 1985 the state's agricultural banks had escaped many of the problems encountered by farm-bank lenders in the Midwest and Central Plains states, primarily because of the state's diverse economy and the bankers' own cautious lending policies.⁴⁶ But by 1986, the increased burden on farmers caused Texas banks to experience mounting levels of troubled loans and foreclosures.⁴⁷ Between 1977 and 1993, Texas had 36 agricultural-bank failures, the third largest of any state.⁴⁸ During the same period, Oklahoma had 31 agricultural-bank failures, the fifth-largest number. Texas and Oklahoma were two of four

⁴¹ Department of Commerce, Bureau of the Census, *National Data Book and Guide to Sources: Statistical Abstract of the United States* 1988, 108th ed., (1988), 618–19. Farm marketings represent agricultural products sold by farmers multiplied by prices received per unit of production at the local market.

⁴² Andrea Bennett, "Diversity, Caution Help Texas Weather Farm Crisis in Good Shape," *American Banker* (November 18, 1985), 14, 20.

⁴³ *Ibid.*, 14, 18.

⁴⁴ *Ibid.*, 14.

⁴⁵ "Farm Banks in Texas Beginning to Feel Lending Sting All Too Familiar to Their Midwestern Counterparts," *American Banker* (May 1, 1986), 40.

⁴⁶ Bennett, "Diversity, Caution," 14.

⁴⁷ "Farm Banks in Texas Feel Sting."

⁴⁸ Agricultural banks are banks where agricultural loans are at least 25 percent of total loans and leases.

states that each held 10 percent or more of all failed agricultural-bank assets in the U.S. In the rest of the region, Louisiana and Arkansas each had 5 agricultural-bank failures, while New Mexico had none.

The Boom and Bust in Texas

Initially the expansion of construction in Texas was tied to the rapid growth in the state's economy due largely to the escalating oil prices between early 1974 and early 1981. During this period, nonresidential construction activity more than quadrupled, while office vacancy rates fell from 15 percent to 7.6 percent in Dallas and from 7.8 percent to 5.7 percent in Houston.⁴⁹ Beginning in 1982, however, despite falling oil prices and downturns in the Texas and U.S. economies, the construction sector continued to surge. The magnitude of construction activity was tremendous, leading Texans to joke that the construction crane should replace the mockingbird as the official state bird. The divergence between the weak Texas economy and the high levels of construction continued until the mid-1980s, and the space that was added during this period far exceeded demand.

Texas banks, seeking both refuge from problem oil loans and new investment opportunities, strongly supported the real estate boom. Boom conditions often attract poorly qualified participants who see an opportunity to earn easy money, and that happened here. As Ken Sanstead, resident manager of Coldwell, Banker & Co., observed in 1985, "Forty novice developers who can call on little or no experience in the development game are involved in construction projects in Dallas [and] most of the current overbuilding is being done by the novices."⁵⁰

In 1986, however, construction in Texas began a prolonged decline, mostly because of plummeting oil prices and the consequent severe recession in the Texas economy (and partly because of the effects of the 1986 Tax Reform Act).⁵¹ According to one estimate, each \$1 drop in the price of crude oil resulted in the loss of 25,000 jobs and \$100 million in revenue in Texas.⁵² Typically, the layoffs began in the oil fields themselves and were followed by losses in related jobs, such as those held by geologists and engineers. Next, service companies began to fold, including not only oil-related companies but also motels, restaurants, and grocery and clothing stores. By the end of September 1986, 743,000 Texans were unemployed, and the unemployment rate in Houston had reached 10.5 percent, compared with only 7.4 percent in January 1986 (in contrast, the national unemployment rate fell from 7.3

⁴⁹ Information in this paragraph is from D'Ann M. Petersen, Mine K. Yucel, and Keith R. Phillips, "The Texas Construction Sector: The Tail That Wagged the Dog," Federal Reserve Bank of Dallas *Economic Review* (second quarter 1994): 23–24.

⁵⁰ Carl Hooper and Eileen O'Grady, "Overbuilding Softens Dallas Office Market: Projects Canceled, Postponed," *Houston Post* (September 29, 1985), 3E.

⁵¹ See the appendix to Chapter 3 for a discussion of the effects of this legislation.

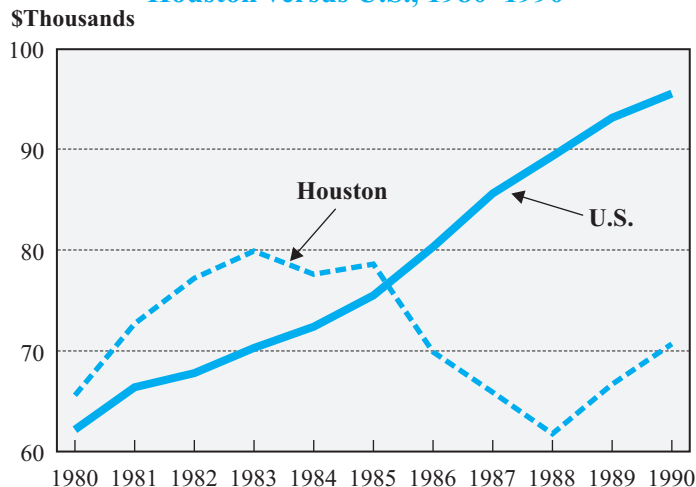
⁵² "A Dream Dies in Texas," *People* (November 10, 1986), 46.

percent in January 1986 to 6.8 percent in September 1986).⁵³ In 1986 employment in Texas fell by approximately 250,000, and people began leaving the state.

With the outward migration adding to the pressure on already high apartment and office vacancy rates, construction activity collapsed. In 1986 the state lost almost 100,000 construction jobs—40 percent of the state's total job decline, even though construction accounted for only 6.7 percent of Texas employment in 1985.⁵⁴ The volume of construction continued to fall throughout the late 1980s despite a turnaround in the Texas economy in 1987.

The commercial markets were not the sole source of the Texas real estate problems. For example, Houston was hit especially hard by a collapse in the residential real estate market.⁵⁵ The single-family housing boom there surpassed that in other oil-patch cities, leading to a greater oversupply of single-family houses and a sharper drop in prices when the bust came. Between 1983 and 1988, median home resale prices in Houston declined by 23 percent, from \$79,900 to \$61,800 (see figure 9.5). This contrasted significantly with the

Figure 9.5
Median Home Resale Prices,
Houston versus U.S., 1980–1990



Source: National Association of Realtors, *Home Sales*.

⁵³ Ibid.; and Frederick S. Carns, "Economic Conditions in Louisiana, Oklahoma and Texas," *FDIC Banking and Economic Review* (April 1986): 12.

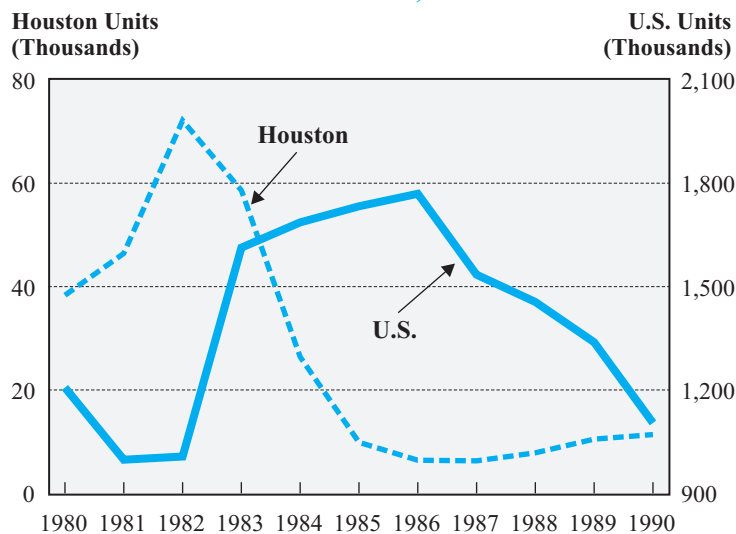
⁵⁴ Petersen et al., "The Texas Construction Sector," 26.

⁵⁵ The discussion of Houston that follows is based on Steve Frazier, "Suburban Blight: Housing-Market Bust in Houston Is Creating Rash of Instant Slums," *The Wall Street Journal* (February 5, 1987), available: WESTLAW, File: WSJ.

national trend, where home prices increased by 27 percent, from \$70,300 to \$89,300, during the same period.

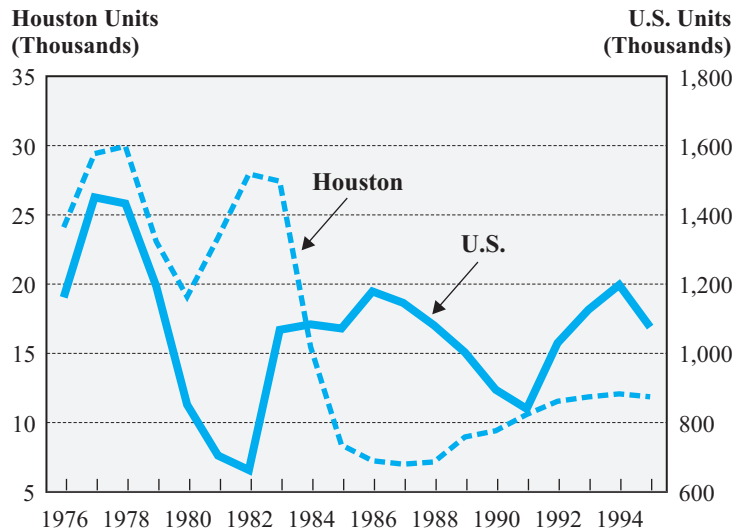
The root cause of Houston's difficulties was the frenetic overbuilding that had continued despite the beginning of the end of the oil boom. Even though employers had laid off 160,000 workers in 1982 and 1983, residential building continued at a record pace. From 1980 to 1982 the number of newly issued building permits for residential construction in Houston jumped 88 percent, and the number of single-family housing starts rose 46 percent. Nationally during the same period, building permits and housing starts were declining 17 percent and 22 percent, respectively (see figures 9.6 and 9.7). The magnitude of Houston's bust is reflected in the 91 percent plunge in the number of permits and the 75 percent drop in housing starts from 1982 to 1987. Nationally during the same period, the number of building permits for residential construction increased by 52 percent, while single-family housing starts climbed by 73 percent. As Pamela Minich, a local real estate analyst, observed, "There were problems in the [Houston] housing market long before the price of oil went through the floor. Builders just went crazy. Many, many of the neighborhoods that are

Figure 9.6
Newly Issued Building Permits (Residential),
Houston versus U.S., 1980–1990



Source: U.S. Department of Commerce, *Construction Review* (data cited in FDIC, *The Real Estate Report*, Dallas Region [January 1, 1992]).

Figure 9.7
Housing Starts, Houston versus U.S., 1976–1995



Source: F. W. Dodge/McGraw Hill, Real Estate Analysis and Planning Service (1992); and U.S. Department of Commerce, Bureau of the Census, *Current Construction Reports*.

having troubles [in 1987] are ones that shouldn't have been built.”⁵⁶ Between 1983 and 1987, numerous attractive Houston communities had been transformed into blighted, declining neighborhoods, representing the costliest housing-market debacle since the Great Depression.

At the beginning of 1987, one in six homes and apartments in Houston stood vacant. In early 1987, because of the associated plunge in property values, the tax rolls of Harris County (where Houston is located) had declined by an estimated \$8 billion. The magnitude of the collapse in property values—more than 50 percent in some suburbs—caused many homeowners simply to walk away from their homes and their mortgage payments. In some communities, foreclosure rates were in excess of 60 percent. Projections at the end of 1985 had indicated that total foreclosures in Houston for 1984–86 would exceed 70,000—about the same number of houses that were built during 1986 in the cities of Detroit, Chicago, and Seattle combined. Later some depressed neighborhoods deteriorated further because of

⁵⁶ Frazier, “Suburban Blight.”

vandalism and other damage to vacant properties. Some properties were damaged so severely that the repossessed dwellings could be unloaded only for their raw-land value.

Although many analysts did not anticipate the damage that real estate loans would inflict on Texas banks,⁵⁷ certainly there were some who foresaw problems. For example, Ronald J. Hoelscher, president of the Horne Co., told the Houston Outlook '83 conference that "declining building permits for office space [in Houston] will continue through 1983 and while developers have slowed the construction of industrial space, the demand is falling so that the supply is still over-abundant."⁵⁸ In addition, a local real estate firm observed in 1984 that "there is already at least a 10-year supply of housing in Dallas County, while normal markets generally carry about a nine-month supply."⁵⁹ Furthermore, in September 1984 the Houston Apartment Association warned that vacancy rates would continue to increase unless leases were signed for a substantial percentage of the 20,000 new units scheduled to be completed in Metropolitan Houston that year.⁶⁰

The Boom and Bust in Louisiana and Oklahoma

Although the multifaceted debacle in Texas was the major story in the Southwest, the collapse of the energy and real estate markets and the accompanying agricultural problems also had devastating effects on the economies of Louisiana and Oklahoma as well as on the banks in those states. Between 1980 and 1994 there were 70 bank failures in Louisiana—22.4 percent of the state's banks. Oklahoma endured 122 bank failures—22.0 percent of its banks.⁶¹ During the same period, assets of failed banks at the time of failure amounted to \$4.1 billion in Louisiana and \$5.8 billion in Oklahoma.

⁵⁷ For example, in 1986 Frank Anderson, a banking analyst with the firm of Weber, Hall, Sale & Associates Inc. in Dallas, stated that "we won't see the debacle in real estate that we have in energy." Such opinions were based on the fact that real estate had a relatively higher value than much of the energy-loan collateral. For example, even Houston properties generally brought at least 50 cents on the dollar, whereas oil rigs and equipment were often valued at pennies on the dollar. See two articles by Richard Ringer: "Real Estate Joins Energy in Harrying Texas Banks: As Energy Chargeoffs Diminish Real-Estate Problems Grow," *American Banker* (May 2, 1986), 3; and "Drop in Oil Prices Worries Banks in Texas and Oklahoma: Biggest Energy Lenders Construct Damage Scenarios While Waiting for Volatile Market to Stabilize," *American Banker* (February 18, 1986), 1, 28.

⁵⁸ "Real Estate's Upturn to Lag, Parley Hears," *Houston Post* (January 21, 1983), D2.

⁵⁹ Andrew Albert and Richard Ringer, "Dallas County Housing Glut Hurts Local Lenders: Empire Savings Cited as One of Several S&Ls That Financed 'Real-Estate Monster,'" *American Banker* (March 20, 1984), 16.

⁶⁰ Carl Hooper, "Tenant Wars Escalate: Year of Free Rent Latest Gimmick," *Houston Post* (September 6, 1984), F10.

⁶¹ The number of bank failures refers to FDIC-insured commercial and savings banks that were closed or received FDIC assistance. The percentage of banks that failed is based on the total number of banks existing in each state at year-end 1979 plus banks newly chartered in each state from 1980 through 1994.

In the mid-1980s, the state economies of Louisiana and Oklahoma (as well as Texas) were five times more dependent on energy production than the nation as a whole.⁶² In 1986, for example, nearly 40 percent of Louisiana's state revenues came from oil and natural gas production, and in 1985 depressed energy prices held economic growth to under 1 percent (in Oklahoma as well). In June of that year, Louisiana's unemployment rate was 11.5 percent, the second-highest in the nation. In addition, residential building permits issued in the state in 1985 declined by more than 25 percent from levels a year earlier.

Despite signs of economic weakness, as of late 1985 Louisiana banks—unlike banks in Texas and Oklahoma—had not had significant problems related to declining energy prices. One reason for this, according to Michael D. Charbonnet, a principal with Lyons, Merrigan & Charbonnet, a New Orleans-based bank consulting firm, was that “Louisiana banks were not big enough to finance the major oil and gas development projects. Texas and Oklahoma banks mainly kept that business to themselves.”⁶³ Instead, Louisiana banks had concentrated on the service companies, such as equipment supplies. But in late 1985 and early 1986, when energy prices collapsed, the state's economic woes escalated. “I haven't seen New Orleans this way since I was a child in the 1930s,” said Ruth McCusker, chairman of the New Orleans Public Library Board, in early 1986. “It's not looking real good around here. People are out on the street. It is depressing.”⁶⁴ Louisiana banks came under increasing pressure as the companies they financed faced mounting difficulties, and bank failures in the state soon escalated.

Unlike Louisiana's economy, Oklahoma's economy was based primarily on energy and agriculture, and boom-and-bust cycles had been part of the state's history.⁶⁵ But in the past, when one of the two sectors weakened, typically the state's economy would be buoyed by the relative health of the other. This general pattern held until 1985, when the energy industry was collapsing at the same time that the agriculture sector was already ailing. The simultaneous weaknesses dealt a severe blow to the state's economy.

In the mid-1980s, Oklahoma was the fifth-ranking state in oil production. But approximately 60 percent of its oil production came from “stripper” wells, which yield 10 bar-

⁶² Information in this paragraph is derived from the following sources: Herbert Swartz and Lan Sluder, “La. Banks Battle Tough Times for Profits, Equity,” *New Orleans Business* (February 3, 1986), available: LEXIS, Library: NEWS, File: BUSDTL; and Bart Fraust, “A Year of Upheaval for Louisiana Banking: State's New Multibank Law Has Spurred a Dramatic Changing of the Guard,” *American Banker* (October 19, 1985), 16–18; testimony by Robert V. Shumway, director of the FDIC's Division of Bank Supervision, before the U.S. Senate Committee on Energy and Natural Resources on March 25, 1986, as reported in: “FDIC,” *American Banker* (April 17, 1986), 4–7.

⁶³ Fraust, “A Year of Upheaval.”

⁶⁴ David Maraniss, “Oil Slump's Damage Spreading; Academic, Social, Cultural Advances Threatened in Three Energy States; Recovery May Take Years,” *The Washington Post* (April 9, 1986), available: LEXIS, Library: NEWS, File: WPOST.

⁶⁵ Unless otherwise noted, the information on Oklahoma is from Voesar, “Economic Conditions in Oklahoma.”

rels or less of oil per day and are expensive to operate. As of May 1986, there were more than 80,000 stripper wells operating in Oklahoma, many of which could not operate profitably with oil prices below \$15 a barrel. The plummeting oil prices therefore had a particularly devastating effect on that state. For example, at the end of 1981, when the number of drilling rigs operating in the state was at its peak, there were nearly 900 of them, but as of May 1986 there were only 128. Oklahoma's gas industry also suffered from plummeting prices, as described above, and producers began to shut down their wells.

The collapse in energy prices caught many Oklahoma bankers by surprise. In early 1986, Fred Moses, president of Liberty National Bank and Trust Co. (Oklahoma City), observed, "This happened so damn quickly—in 90 days. We all expected a dip, but none of us assumed it would be such a precipitous drop."⁶⁶ The extent of the damage in the state in 1986 was indicated by Diane Gower, assistant to the director of Neighbor for Neighbor, a nonprofit social services program in Tulsa, who observed that "we're seeing more and more in the middle-income family bracket. Some are unemployed, some are working at minimum wage. We have a lot where husband and wife are working McDonald's and Arby's type jobs, and it's difficult for them to make it. Some had good jobs and lost them. Oil has made this part of Oklahoma a disaster area."⁶⁷

In addition to the difficulties with energy and agriculture, problems with real estate also affected Oklahoma's economy and banks. Oklahoma State Banking Commissioner Wayne Osborn noted the predicament faced by Oklahoma bankers with regard to the real estate they had acquired through foreclosures: "The dilemma is that banks lose money on earnings if they hold the property because of the upkeep expenses and the significant vandalism problems from abandoned property. A lot of real estate investors are willing to buy the property, but they want a low price and with financing at a preferential treatment. You're sort of damned if you do and damned if you don't."⁶⁸

As has been described, the booming oil markets of the 1970s and early 1980s were the foundation of a prosperous southwestern economy, particularly in Texas, Oklahoma, and Louisiana. This prosperity supported a tremendous expansion in the real estate markets, especially commercial real estate. The southwestern economy was adversely affected when oil prices began drifting downward in 1981, since much of the region's vitality and optimism was based on the expectation that oil prices would continue to rise to ever-higher levels. Then in 1986 oil prices plunged, contributing to the collapse in the real estate markets. The Southwest in general and Texas in particular were forced to cope with serious eco-

⁶⁶ Morris, "Banks of Mid-America Treads Water," 8.

⁶⁷ Maraniss, "Oil Slump's Damage Spreading."

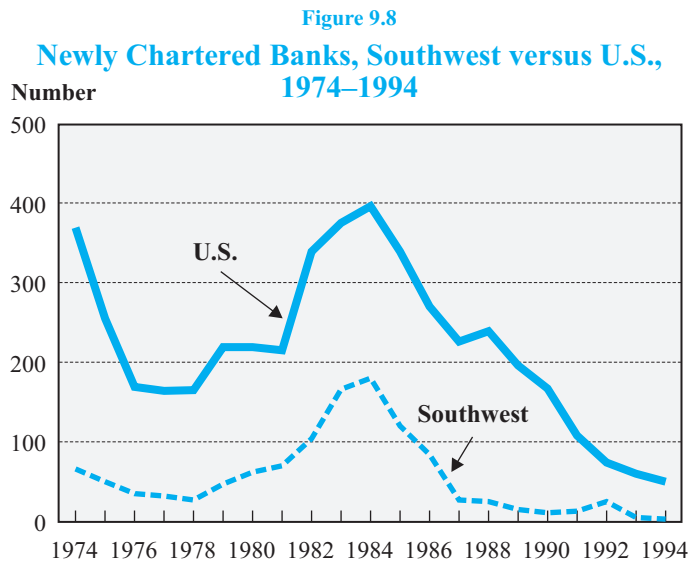
⁶⁸ Teresa McUsic, "Bank Closings to Continue," *Tulsa World* 83, no. 163 (February 26, 1988), available: LEXIS, Library: NEWS, file: TLSWLD.

conomic problems. The 1981 weakening of oil prices and the subsequent oil price crash and real estate debacle (in the mid-1980s) caused substantial losses on the energy and real estate loans made by the region's banks, and the result (as discussed in greater detail below) was an escalation in the number of bank failures later in the decade.

The Banking Environment in the Southwest

Two factors made southwestern banks particularly aggressive participants in the booming regional economy: (1) prosperity caused their numbers to increase, as chartering activity tremendously expanded during the first half of the 1980s, and (2) S&Ls were newly empowered competitors (the Garn–St Germain Depository Institutions Act of 1982 broadened their lending powers).

The increase in the number of newly chartered southwestern banks in the early 1980s was dramatic: the number jumped from 62 in 1980 to a peak of 168 by 1984 (see figure 9.8).⁶⁹ After 1984, however, the rate of chartering declined rapidly, and very few new bank charters were issued in the region from 1987 through 1990. All told, from 1980 to 1990, 745 banks were chartered there. But newly chartered banks tend to fail more frequently than es-



⁶⁹ New southwestern bank charters from 1980 through 1984 were concentrated in Texas, where there were 442. During the same period, Oklahoma had 56 new bank charters; Louisiana, 44; New Mexico, 11; and Arkansas, 5.

tablished banks, and this certainly was what happened in the Southwest. From 1980 through 1994, 33 percent of the southwestern banks that had been chartered from 1980 through 1990 failed, compared with only 21 percent of southwestern banks that were in existence on December 31, 1979. The rapid growth of newly chartered banks, therefore, appears to have contributed to the large number of failures in the region.

The problems that might follow from large increases in the number of new entrants were not ignored by observers at the time. Regulators and bankers noted that part of the reason for the highly competitive banking environment was that so many new banks had been chartered that they seemed to be pursuing the same business. Bob Lehman, president of Charter Bank-Arena, expressed the problem well in 1984 when he pointed out that “too many new independent banks are chasing too few good loans for everyone to succeed.”⁷⁰ Interviews that FDIC researchers conducted with regulators who had been active in the area at the time suggest that the apparently excessive number of new institutions could be at least partly attributed to chartering authorities’ laissez-faire approach to new charters. Among the specific lapses that some regulators observed with regard to the chartering of new institutions were the failure to test for the community need of a new bank, the lack of feasibility studies, and reliance primarily on the availability of certain amounts of capital, with few other requirements.

Chartering activity was especially pronounced in Texas, where the number of commercial banks chartered went from 45 in 1980 to 131 in 1983 but then to 0 in 1989. Commercial banks chartered in Texas were approximately 37 percent of all new commercial banks chartered in the United States in 1983 and 1984 but only 7 percent of the number chartered in 1987. The large number of Texas banks chartered in the 1980s had significant consequences: one study suggests that newly established Texas banks were much more aggressive than their mature counterparts in pursuing high-risk strategies. Specifically, these banks had, on average, a significantly higher concentration of commercial and industrial loans and a substantially lower proportion of assets in U.S. government securities and funded a far higher proportion of their assets with large certificates of deposit. These high-risk strategies help explain why Texas banks established during the 1980s had a relatively high incidence of failure.⁷¹

Intense competition from S&Ls also contributed to the poor financial condition of some southwestern banks.⁷² The savings and loan industry expanded dramatically in the

⁷⁰ Eileen O’Grady, “Soft Real-Estate Market Bad News for Banks,” *Houston Post* (April 23, 1984), F4.

⁷¹ The study results are taken from Jeffery W. Gunther, “Financial Strategies and Performance of Newly Established Texas Banks,” Federal Reserve Bank of Dallas *Financial Industry Studies* (December 1990): 10. For further discussion of chartering policy and Texas banks, see Chapter 2, the section on entry.

⁷² See Chapter 4.

early 1980s after Garn–St Germain gave the industry broader lending powers, and the expansion was especially pronounced in the Southwest because of that region’s strong southwestern energy markets. S&Ls in Texas were particularly aggressive in their pursuit of growth and were willing to pay above-market interest rates to attract funds for new investment activities. This behavior forced even well-capitalized banks to pay the so-called Texas premium, estimated to be 50 basis points or more, in order to maintain their funding base.

S&Ls competed vigorously to initiate commercial real estate loans, and the competitive pressure led some banks to lower their underwriting standards, liberalizing lending terms and minimizing equity requirements. Regulators and bankers who participated in southwestern banking activities observed that developers were receiving loan offers from both banks and S&Ls; bankers seemed to believe it was inadvisable to turn down requests from their customers because the customers could easily obtain credit elsewhere. The S&Ls’ above-market interest rates placed downward pressure on bank profitability, and the lowered lending standards contributed to the excessive real estate development, the oversupply, and the eventual collapse of southwestern real estate values.

The Effect of the Economy on Southwestern Banks

The booming economy was reflected in rising asset growth rates and in increasing ratios to assets of loans, of commercial and industrial loans, and of real estate loans. Thus, the level of risk in the banking system rose. By the same token, the subsequent oil and real estate problems were reflected in the rapidly rising levels of nonperforming assets and charge-offs, in the sharp decline in banks’ return on assets, and in the escalating numbers of bank failures.

With bank loans providing important support to the oil boom, bank asset growth rates for the region increased steadily from an annual rate of 10.8 percent in 1975 to 18.8 percent in 1981 (see figure 9.9). But after oil prices peaked in 1981, the region’s bank asset-growth rate began to decline and, from 1986 through 1988, was actually negative.

Another reflection of the increasing participation of southwestern banks in the energy markets was the substantial rise in the median ratio of commercial and industrial (C&I) loans to assets: between 1979 and 1982, the ratio rose from approximately 12 percent to over 16 percent (see figure 9.10). During the same period, the percentage for the nation as a whole increased minimally, from just under to just over 10 percent. After oil prices plunged, the C&I loans-to-assets ratio dropped from over 16 percent in 1982 to less than 7 percent in 1992. During the same period the ratio for the nation as a whole also declined, but far less dramatically—from approximately 10 percent to 7 percent.

After the energy boom had peaked, real estate loans became an increasingly larger portion of the loan portfolio of the banks in the region. The banks’ median ratio of real es-

Figure 9.9
Asset Growth Rates, Southwest versus U.S., 1975–1994

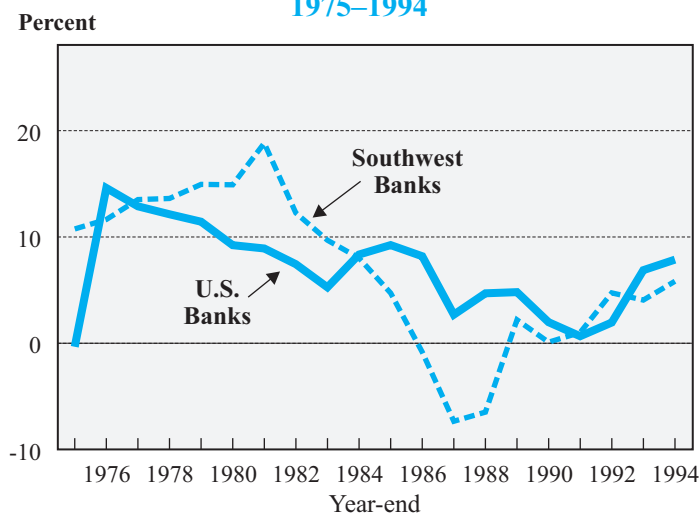
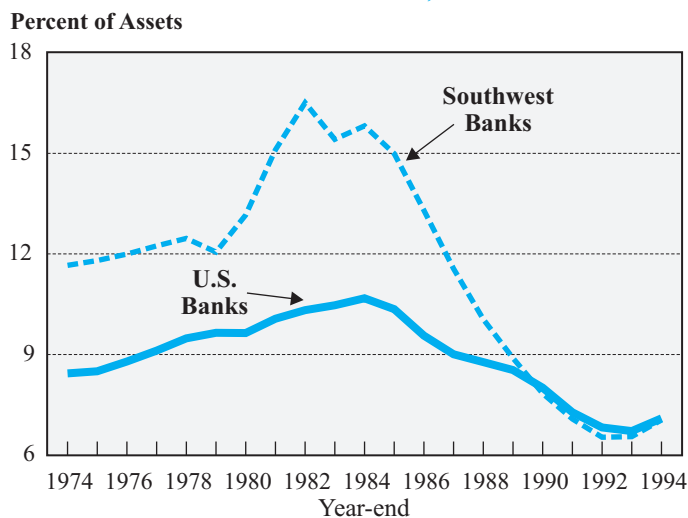


Figure 9.10
Median Commercial and Industrial Loans, Southwest versus U.S., 1974–1994



tate loans to assets rose from 12 percent in 1981 to a peak of 21 percent in 1987 (see figure 9.11). Residential real estate loans increased significantly (from 4.5 percent of bank assets in 1980 to 7.6 percent in 1985 and then to 9.8 percent in 1994), but it was the rise in commercial real estate loans that had the greatest effect on the banks: commercial real estate loans went from just over 4.5 percent of bank assets in 1981 to a peak of 8.8 percent in 1986 (see figure 9.12). The volume of bank lending to the real estate markets appears to have greatly affected loan concentrations: the median loans-to-assets ratio for southwestern banks rose from just under 50 percent in 1980 to 57 percent in 1985 but then declined to 43 percent in 1992 (see figure 9.13). This decline was in noticeable contrast to the national trend, where loan concentrations increased slightly between 1985 and 1990.

The most profitable period for the Southwest's banks was during the oil boom. Between 1978 and 1981 the median return on assets (ROA) for southwestern banks rose steadily from 1.12 percent to 1.32 percent (see table 9.5, on p. 330). However, ROA began to decline in 1982 and fell continuously to 0.32 percent in 1987. This downturn in ROA coincided with the weakening of the oil sector as well as the increased importance of real estate lending, and much of the decline in profitability can be attributed to escalating levels of nonperforming assets between 1982 and 1987 (see figure 9.14) and high loss rates on these assets (see figure 9.15). The especially steep rise in the nonperforming assets of southwest-

Figure 9.11
Median Total Real Estate Loans,
Southwest versus U.S., 1974–1994

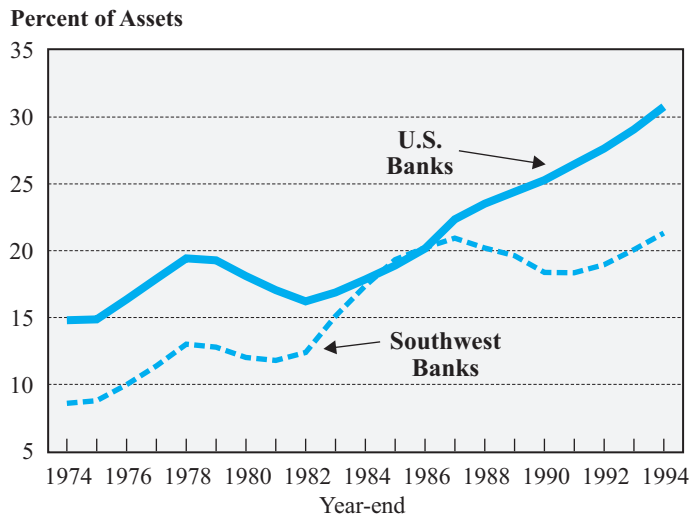


Figure 9.12
**Median Commercial Real Estate Loans,
Southwest versus U.S., 1980–1994**

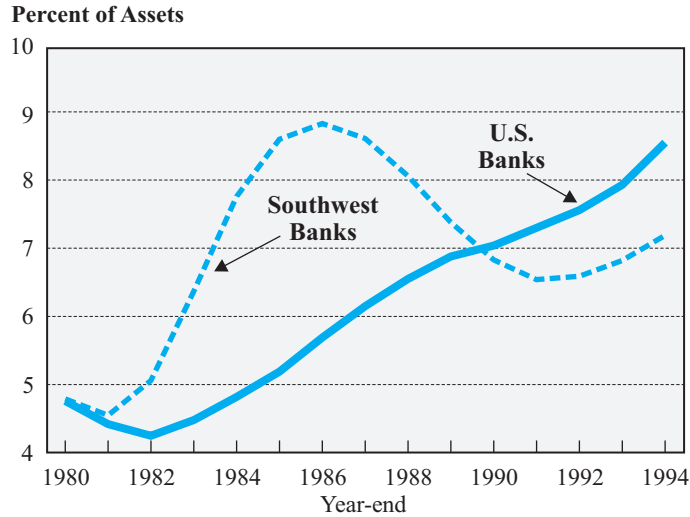


Figure 9.13
**Median Gross Loans and Leases,
Southwest versus U.S., 1976–1994**

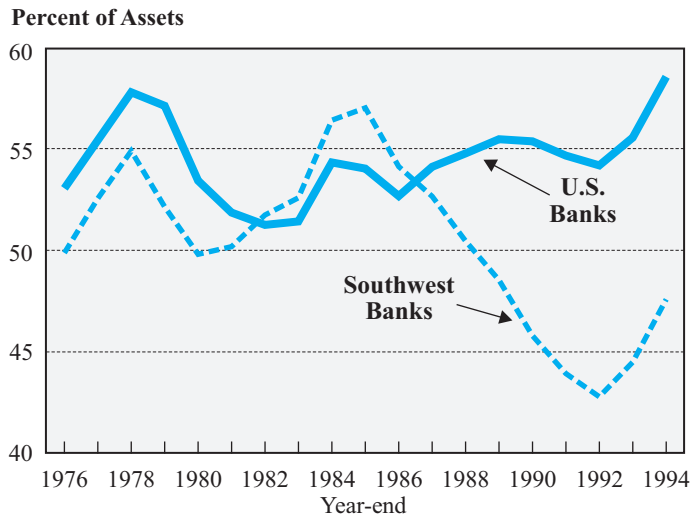


Figure 9.14

**Median Total Nonperforming Assets,
Southwest versus U.S., 1982–1994**

Percent of Assets

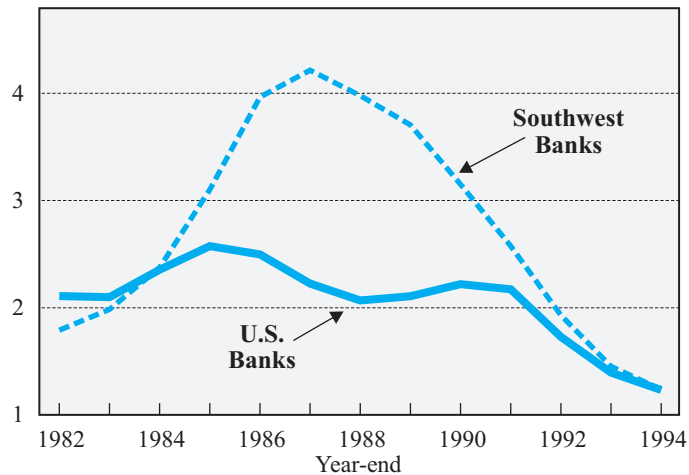
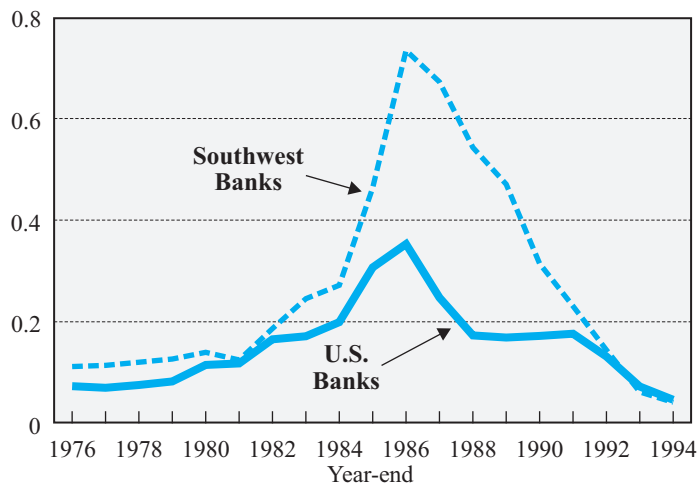


Figure 9.15

**Median Net Charge-Offs on Loans and Leases,
Southwest versus U.S., 1976–1994**

Percent of Assets

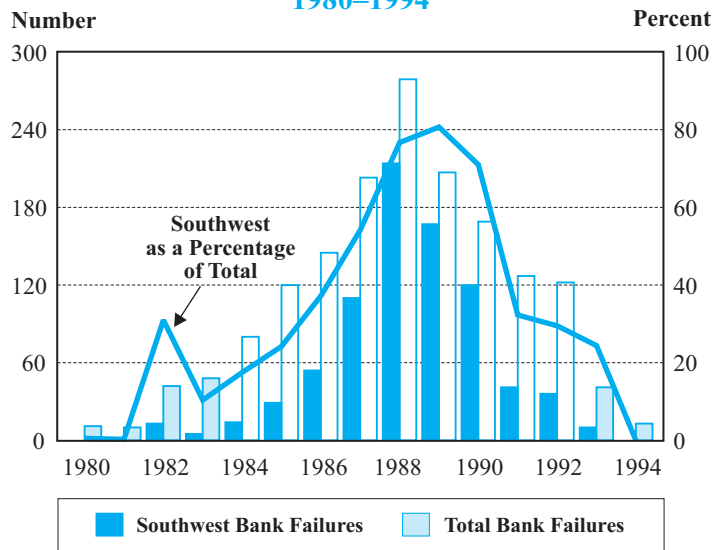


ern banks between 1985 and 1987 indicates how banks were ravaged by both the oil price collapse beginning in late 1985 and the increasing real estate problems. The performance of the region's banks from 1985 to 1987 diverged from the national trend, in which the percentage of nonperforming assets was falling at a moderate rate. In contrast, the rising trend of charge-offs at southwestern banks more closely followed the national trend, although the rate of increase of net charge-offs from 1982 to the peak in 1986 was far greater in the Southwest than nationally.

Bank Failures in the Southwest

The deterioration in the financial health of the southwestern banks eventually led to a dramatic increase in the number of bank failures in the region, from only 5 in 1983 to a peak of 214 in 1988 (see figure 9.16). Southwestern bank failures as a percentage of all bank failures jumped from 10.4 percent in 1983 to a peak of 80.7 percent in 1989. From 1987 through 1989, 71.3 percent of the bank failures in the United States were southwestern banks (491 out of 689). Southwestern banks accounted for the largest portion of U.S. bank failures in the 1980s, not only in number but also in total failed-bank assets. As noted in the introduction to this chapter, in 1988 losses to the FDIC as a result of southwestern bank failures were nearly \$6.3 billion (91 percent of total U.S. failure-resolution costs that year), and

Figure 9.16
Bank Failures, Southwest versus U.S.,
1980–1994



in 1989 were approximately \$5.1 billion (or 82 percent of national failure costs). In 1990 losses from southwestern failures fell to approximately \$1.1 billion, or 38 percent of national failure costs; and in 1991 to only \$282 million, approximately 4.7 percent of failure costs.

The initial surge in the number of southwestern bank failures was caused primarily by problems with energy loans. The second wave of failures of many of the area's banks, in the middle to late 1980s, was caused primarily by the asset-quality problems connected with the expansion of commercial real estate lending, especially among Texas banks. Banks suffered as completion rates and office vacancy rates rose, leading to defaults on many real estate loans. Banks that eventually failed in the Houston, Dallas, and Oklahoma City markets had substantially higher concentrations of commercial real estate loans than did banks that survived (see figure 9.17). The collapse of the southwestern real estate markets in the late 1980s was certainly the final blow to many banks, but it is important to remember that the previous weakening of the energy sector and the declines in energy prices had already caused many banks to suffer loan losses, and these had made the banks too vulnerable to withstand the additional losses on real estate loans.

By far the most severely affected state in the Southwest was Texas. From 1980 through 1989, 367 Texas commercial banks failed. Although in 1983 only three Texas banks failed, in 1988 the number was 175, with assets of \$47.3 billion—24.7 percent of the state's 1987 year-end banking assets. The following year there were 134 failures, with assets of \$23.2 billion—13.6 percent of the state's banking assets. In contrast, in the region's four other states (Oklahoma, Louisiana, Arkansas, and New Mexico), assets of failed banks were less than 3.5 percent of each state's banking assets in any given year. In 1988 and 1989, failed Texas banks accounted for 85 percent of total U.S. failed-bank assets. A list of the Southwest's largest bank failures indicates the severity of the situation in Texas (see table 9.2).

Certain patterns were evident among failed Texas banks.⁷³ Most Texas commercial banks that failed in the 1980s had reacted quickly to oil price movements. Concentrations of C&I loans, which include loans to oil and gas producers, increased from 1978 through 1981 along with oil prices, peaked in 1982 shortly after oil prices began to drop, and subsequently declined along with oil prices. In addition, failed Texas commercial banks had generally increased their concentrations in construction and land development loans long after the local real estate markets began declining. Finally, failed Texas banks had continued to fund completed construction projects even though commercial real estate vacancy rates were growing (traditionally, long-term financing of completed commercial properties was provided by nonbank financiers).

⁷³ These patterns are identified in O'Keefe, "The Texas Banking Crisis," 1.

It is noteworthy that healthy equity ratios in the early 1980s did not prevent large Texas banks from eventually failing. Nine of the ten largest Texas bank holding companies were recapitalized in the 1980s. Between 1980 and 1982 equity capital ratios for those nine organizations were, on average, more than 25 percent higher than the equity capital ratios

Figure 9.17

**Commercial Real Estate Lending in Houston, Dallas, and Oklahoma City,
Failed versus Nonfailed Banks, 1974–1994**
(Median Percent of Assets)

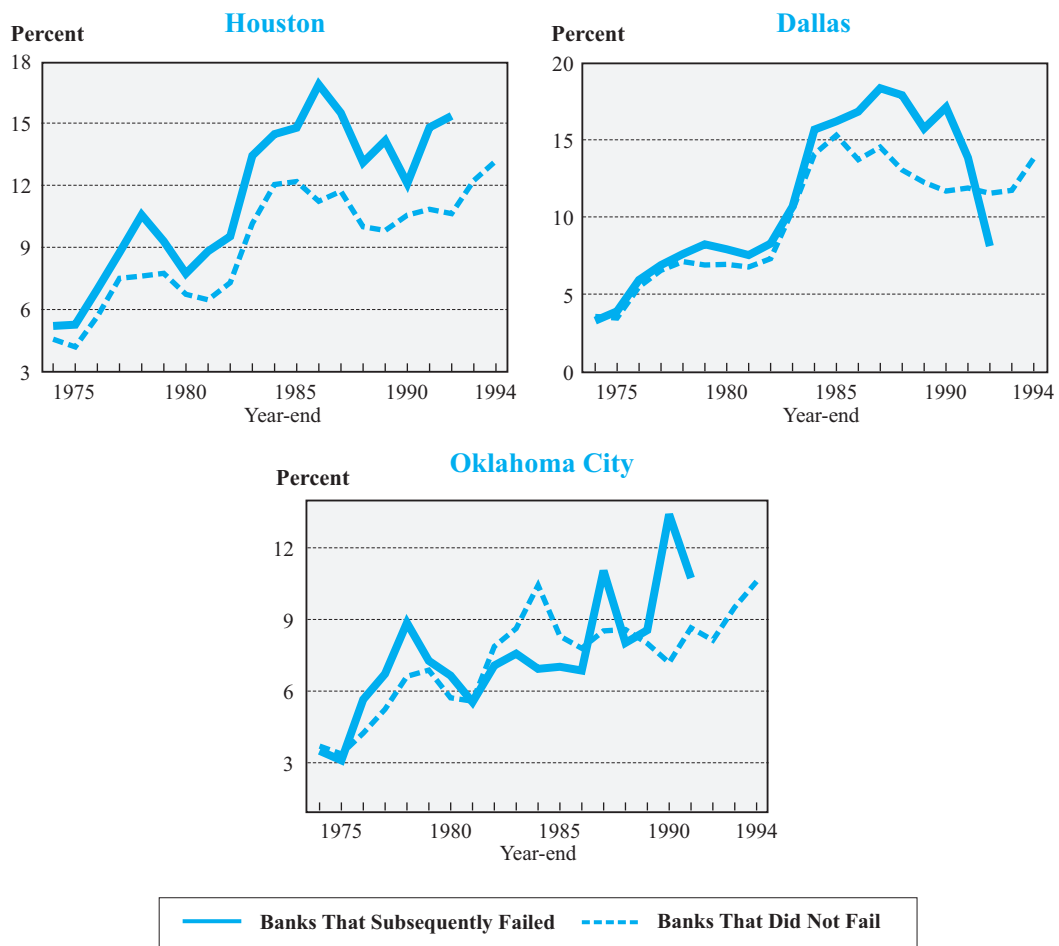


Table 9.2
Large Southwestern Bank Failures, 1980–1994

Name of Institution	Date of Failure	Assets at Failure (\$Millions)	Resolution Cost (\$Millions)	Cost as % of Assets	State
Penn Square Bank, N.A.	07/05/82	\$ 436	\$ 65	14.9%	OK
Abilene National Bank*	08/06/82	437	0	0	TX
The First National Bank of Midland	10/14/83	1,410	526	37.3	TX
First Oklahoma BC	07/11/86	1,754	168	9.6	OK
BancOklahoma Corp	11/24/86	468	79	16.9	OK
BancTexas Group	07/17/87	1,181	150	12.7	TX
First City Bancorp	04/20/88	12,374	1,101	8.9	TX
First Republic	07/29/88	31,277	3,762	12.0	TX
MCorp	03/29/89	15,641	2,844	18.2	TX
Texas American	07/20/89	4,665	1,077	23.1	TX
National Bancshares	06/01/90	1,594	213	13.4	TX

Note: “Large” is defined as more than \$400 million in assets.

* Received open-bank assistance.

of their peers. By 1987, however, this capital cushion had dissipated, and the nine holding companies held a third less capital than their peers.⁷⁴

Generally, stringent regulation prevented the “moral-hazard” problem from affecting banks as it did many thrift institutions during the 1980s.⁷⁵ (Simply put, the moral-hazard feature of deposit insurance is that an insured depository institution’s ability to put at risk funds that are guaranteed by the government may encourage it to participate in risky ventures it might otherwise avoid.) Nevertheless, one study found that moral hazard provides at least a partial explanation for the financial difficulties of so many Texas banks.⁷⁶ This

⁷⁴ Ibid.

⁷⁵ As indicated in Chapters 1 and 12 of this study, problem banks experienced reduced growth and dividend rates and increased capital infusions following regulatory intervention. Another study found that during the 1985–89 period undercapitalized banks generally did not grow rapidly, pay dividends, or make loans to insiders, all of which are behavior patterns normally associated with high-risk strategies (R. Alton Gilbert, “Supervision of Undercapitalized Banks: Is There a Case for Change?” *Federal Reserve Bank of St. Louis Review* 73, no. 3 [May/June 1991]: 17, 21, 24–26). Chapters 1 and 12 of this study also present estimates of the cost savings that might have been gained from earlier closing of failed banks. Another study found no relationship between, on the one hand, the level of capital one year before failure or the length of time a bank was undercapitalized and, on the other hand, its resolution cost (R. Alton Gilbert, “The Effects of Legislating Prompt Corrective Action on the Bank Insurance Fund,” *Federal Reserve Bank of St. Louis Review* 74, no. 4 [July/August 1992]: 10, 12).

⁷⁶ Jeffery W. Gunther and Kenneth J. Robinson, “Moral Hazard and Texas Banking in the 1980s: Was There a Connection?” *Federal Reserve Bank of Dallas Financial Industry Studies* (December 1990): 1–7.

study revealed that as long as Texas banks possessed the ability to expand their lending, lower growth rates of capital were associated with larger increases in lending, as moral hazard would suggest.⁷⁷ The implication of this finding is that managers of Texas banks that were in a weakened financial position, as indicated by a decline in capital growth, had proportionally less of their own equity funds at stake and hoped to increase expected earnings by assuming additional risks. This increase in the risk profiles of many banks, which is consistent with moral hazard, may have led to an expanded number of Texas bank failures.

The Failures of Penn Square and First National

Two significant failures of southwestern banks that occurred during the first half of the 1980s were those of Penn Square Bank, N.A., of Oklahoma City and the First National Bank of Midland, Midland, Texas. The failures of these banks were important not only because at the time the two banks were relatively large and their failures foreshadowed the problems the Southwest would face in the second half of the 1980s, but also because they glaringly illustrated the results of speculative energy lending.

The first major failure of a southwestern bank was Penn Square, a \$436 million bank that was closed on July 5, 1982.⁷⁸ Penn Square was the seventh-largest bank in Oklahoma at the time of closing, and the effect of its failure on other major banks was devastating. The First National Bank of Midland was a \$1.4 billion bank that was closed on October 14, 1983. It was Texas's largest independent bank, the largest bank in the Midland-Odessa oil region, and the second-largest commercial bank (at the time) to fail in FDIC history.⁷⁹

Penn Square, a one-office bank in a shopping mall on Oklahoma City's north side, had been an aggressive lender principally to small oil and gas producers.⁸⁰ (Approximately 80 percent of its loans had been made to energy-related businesses, as compared with the 20 percent favored by the more-conservative Oklahoma City banks.)⁸¹ In the five years ending March 1982, Penn Square's assets grew from \$30 million to a \$436 million.⁸² This phenomenal growth was held by some oil industry and financial sources to be the result of Penn

⁷⁷ Ibid., 6. Gunther and Robinson also note that once banks were more exposed to risk, institutions with lower capital growth recorded statistically insignificant differences in lending from banks with greater increases in capital. Although this finding is inconsistent with moral hazard, it points out the potential importance of both regulatory and liquidity constraints.

⁷⁸ A detailed discussion of Penn Square is available in Phillip L. Zweig, *Belly Up: The Collapse of the Penn Square Bank* (1985).

⁷⁹ The material on the First National Bank of Midland is based largely on the FDIC's *1983 Annual Report* (1984), 10, 12.

⁸⁰ Some of the information on Penn Square is from two FDIC publications: *The First Fifty Years: A History of the FDIC 1933–1983* (1984), 97–98; and *1982 Annual Report* (1983), 6.

⁸¹ Martin, "Penn Square's Oil Connection."

⁸² "Chain Letter from Your Penn Pal in Oklahoma City," *Economist* (July 10, 1982), available: LEXIS, Library: NEWS, File: ECON.

Square's willingness to lend money on almost any oil venture.⁸³ Moreover, Penn Square appears to have had extremely lenient loan standards. One oil executive said that whereas the common banking practice was to accept about half of a company's claimed proven reserves of oil and gas and then base loans on 30 percent of that figure, Penn Square regularly accepted 75 percent of the gross value as collateral.⁸⁴

To support its phenomenal growth, the bank relied heavily on purchased deposits and, to a much greater extent, on a program of selling participations in many of the risky energy loans it originated to large regional and money-center banks. Penn Square then collected fees for servicing the loans.⁸⁵ Two of the more notable banks that purchased loans sold by Penn Square were Chicago's Continental Illinois Bank (\$1 billion) and Chase Manhattan Bank of New York (\$212 million).⁸⁶ Chase would later file a suit claiming it was defrauded when it bought Penn Square loans that were backed with bogus collateral, ranging from oil rigs to thoroughbred race horses.⁸⁷ Continental would later suffer huge deposit withdrawals that were related to the problem loans it had purchased from Penn Square.⁸⁸

The energy loans in which Penn Square was so heavily invested had been based on extremely high oil and gas prices. When the energy markets deteriorated, a huge volume of loans defaulted and the value of supporting collateral was minimized, leading to Penn Square's failure. (Continental Illinois received open-bank assistance two years later.)

Like Penn Square's management, First National's management decided (in early 1980) to invest heavily in energy. At that time the oil-producing area under Midland, known as the Permian Basin, accounted for 20 percent of the hydrocarbon production in the United States.⁸⁹ First National concentrated its loans on drilling and exploration ventures and financed its loan expansion partly by soliciting large deposits from Wall Street investors. By year-end 1981, the bank had doubled its assets.⁹⁰

Euphoric about the energy boom, the bank departed from prudent banking practices in evaluating loans; for example, it allowed customers to determine the value of their own collateral.⁹¹ The bank was known for the "handshake" loans it made on long-shot oil and gas

⁸³ Martin, "Penn Square's Oil Connection."

⁸⁴ Ibid.

⁸⁵ G. David Wallace, "The 'Wild Bunch' at Penn Square; Funny Money," *Business Week* (May 27, 1985), sec. Books, available: LEXIS, Library: NEWS, File: BUSWK.

⁸⁶ Gordon Matthews, "FDIC: Chase Used Threats, Coercion on Penn Square," *American Banker* (October 17, 1983), 1; and Martin, "Penn Square's Oil Connection."

⁸⁷ Matthews, "FDIC: Chase Used Threats."

⁸⁸ For further discussion of Continental Illinois, see Chapter 7.

⁸⁹ John P. Forde, "Republic Begins to Rebuild 'Brand New' Midland Bank," *American Banker* (October 18, 1983), 48.

⁹⁰ "Burying Mother; Oil Woes Break a Texas Bank," *Time* (October 24, 1983), available: LEXIS, Library: NEWS, file: TIME.

⁹¹ "A New Wave of Fear Washes over Midland; Business Community Afraid the FDIC Will Foreclose on Many Loans," *American Banker* (November 9, 1983), 3, 39.

ventures.⁹² (These activities contributed to the bank's energy-related loan losses and eventually to its collapse, a sequence of events that would prove common among energy banks in the Southwest.)

In the 16 months before First National's failure, falling oil prices and the recession of 1982 caused the bank substantial losses on energy-related loans.⁹³ In 1983 the percentage of the bank's nonpaying loans was approximately 25 percent of assets, the highest percentage of any large bank in the United States at the time.⁹⁴ In early October 1983, First National reported that "nonperforming energy loans were the primary contributors to its \$120.8 million in losses over the first three quarters of 1983."⁹⁵ Widespread publicity about the bank's losses eroded public confidence and led to a run on deposits.

Data on Performance of Southwestern Banks

At the beginning of the 1980s, southwestern banks were healthy and compared quite favorably with other banks. As of December 1980, median return-on-assets, return-on-equity, and equity-to-assets ratios for southwestern banks exceeded the ratios for other banks, while equity and reserves to assets was favorable in comparison with the percentages for nonsouthwestern banks. At the same time, a smaller percentage of southwestern banks had negative net income than did other banks. In addition, the earliest data available show that average CAMEL ratings of southwestern banks were higher than the average ratings of all U.S. banks (year-end 1981), while southwestern and nonsouthwestern banks had roughly equal nonperforming loans as a percentage of all loans (year-end 1982).⁹⁶ With regard to risk, southwestern banks had a higher ratio of C&I loans to assets than other banks in 1980. Nevertheless, overall in 1980 the risk exposure of the region's banks was similar to, if not less than, the risk exposure of the other banks because of southwestern banks' lower percentages of loans to assets and real estate loans to assets and comparable percentages of commercial real estate loans to assets.

Analysis demonstrates that during the first half of the 1980s southwestern banks exhibited signs of weakening and then, beginning in the mid-1980s, experienced drastic, pervasive deterioration. As the discussion below indicates, CAMEL ratings degenerated;

⁹² "Burying Mother; Oil Woes Break a Texas Bank."

⁹³ Ibid; and FDIC, Press Release (PR-81-83), October 14, 1983.

⁹⁴ "Burying Mother; Oil Woes Break a Texas Bank."

⁹⁵ Andrew Albert and Robert E. Norton, "Out-of-State Buyers Eyed for Midland: Regulators Set to Deal If Texas Banks Cool," *American Banker* (October 14, 1983), 9.

⁹⁶ The CAMEL rating system refers to capital, assets, management, earnings, and liquidity. In addition to a rating for each of these individual or "component" categories, an overall or "composite" rating is given for the condition of the bank. Banks are assigned ratings between 1 and 5, with 5 being the worst rating a bank can receive. See Chapter 12 for a detailed explanation of CAMEL ratings.

returns on assets and equity, equity to assets, and nonperforming loans compared poorly with those of other banks; and the percentage of southwestern banks with negative net income rose sharply.

CAMEL ratings of the region's banks worsened along with the area's economy (see tables 9.3a and 9.3b). For example, between year-end 1981 and year-end 1989 the percentage of 1-rated banks declined from 54.5 percent of all southwestern banks to 13.5 percent. At the same time, the percentage of 1-rated U.S. banks also declined, but not as dramatically, from 39.3 percent to 21.4 percent (see table 9.4). Similarly, during the same period the percentage of 4-rated southwestern banks rose continually, from 0.8 percent to 17.1 percent (compared with an increase from 1.4 percent to 6.1 percent for all banks); and the percentage of 5-rated banks jumped from 0.2 percent to 7.4 percent (versus a rise of 0.3 percent to 1.9 percent for all banks). Moreover, during the same period the percentage of all 4- and 5-rated banks located in the Southwest rose from 11.6 percent to 54.5 percent.

Table 9.3a
CAMEL Ratings for All Southwestern Banks, 1981–1990

Report Date (Year-end)	Number of Banks/Percentage of Total					
	CAMEL Rating					Total
	1	2	3	4	5	
1981	1,437	1,063	110	21	6	2,637
	54.5	40.3	4.2	0.8	0.2	100%
1982	1,368	1,074	154	78	6	2,680
	51.0	40.1	5.8	2.9	0.2	100
1983	1,269	1,145	273	125	17	2,829
	44.9	40.5	9.7	4.4	0.6	100
1984	1,108	1,324	343	159	25	2,959
	37.5	44.7	11.6	5.4	0.8	100
1985	950	1,330	421	266	54	3,021
	31.5	44.0	13.9	8.8	1.8	100
1986	645	1294	623	415	99	3,076
	21.0	42.1	20.3	13.5	3.2	100
1987	464	1148	629	450	150	2,841
	16.3	40.4	22.1	15.8	5.3	100
1988	349	990	593	430	166	2,528
	13.8	39.2	23.5	17.0	6.6	100
1989	311	940	488	395	170	2,304
	13.5	40.8	21.2	17.1	7.4	100
1990	286	905	481	325	159	2,156
	13.3	42.0	22.3	15.1	7.4	100

Note: Examination ratings were obtained from the FDIC's historical database. In some instances examination ratings were missing, and as a result, the number of CAMEL-rated banks each year was slightly smaller than the total number of southwestern banks in other tables.

Table 9.3b
CAMEL 4- and 5-Rated Institutions, Southwestern Banks versus
Banks in Rest of U.S., 1981–1990

Report Date (Year-end)	Number of 4- and 5-Rated Banks/Percentage of Total		
	Southwestern Banks	Other Banks	Total
1981	27	206	233
	11.6	88.4	100%
1982	84	390	474
	17.7	82.3	100
1983	142	520	662
	21.5	78.6	100
1984	184	708	892
	20.6	79.4	100
1985	320	903	1,223
	26.2	73.8	100
1986	514	946	1,460
	35.2	64.8	100
1987	600	700	1,300
	46.2	53.9	100
1988	596	528	1,124
	53.0	47.0	100
1989	565	472	1,037
	54.5	45.5	100
1990	484	571	1,055
	45.9	54.1	100

Examination of southwestern banks' return on assets and capital ratios is also enlightening (see table 9.5). From 1978 through 1983 southwestern banks had a higher median ROA than other U.S. banks, but for the rest of the decade, a lower ROA. From 1978 through 1983 median return on equity for southwestern banks exceeded the ratios for other banks each year, but for the rest of the decade it was lower. For each year from 1978 through 1985 except 1981, southwestern banks' median equity-to-assets ratios were greater than those of other banks, but for the rest of the decade were lower. Furthermore, the percentage of southwestern banks with very low (less than 5 percent) ratios of equity and reserves to assets was lower than that for other banks from 1978 through 1984, comparable in 1985, and considerably higher from 1986 through 1989 (averaging 7.9 percent annually for southwestern banks and 1.3 percent for other banks) (see tables 9.6a and 9.6b). On the positive side, the percentage of strong southwestern banks—those with equity and reserves to assets exceeding 11 percent—was actually slightly higher during the decade's most troubled years, 1986 through 1989, than during the prosperous years of 1980–82.

Table 9.4
CAMEL Ratings for All U.S. Banks, 1981–1990

Report Date (Year-end)	Number of Banks/Percentage of Total Camel Rating					Total
	1	2	3	4	5	
1981	5,659 39.3	7,651 53.1	863 6.0	194 1.4	39 0.3	14,406 100%
1982	5,281 36.5	7,550 52.2	1,172 8.1	392 2.7	83 0.6	14,478 100
1983	4,908 33.9	7,450 51.5	1,456 10.1	555 3.8	107 0.7	14,476 100
1984	4,474 31.1	7,328 50.9	1,704 11.8	753 5.2	139 1.0	14,398 100
1985	3,857 26.9	7,248 50.5	2,023 14.1	1,033 7.2	190 1.3	14,351 100
1986	3,264 22.8	7,319 51.1	2,270 15.9	1,213 8.5	247 1.7	14,313 100
1987	2,999 21.7	7,400 53.5	2,147 15.5	1,018 7.4	282 2.0	13,846 100
1988	2,879 21.6	7,357 55.3	1,944 14.6	875 6.6	249 1.9	13,304 100
1989	2,769 21.4	7,394 57.2	1,718 13.3	786 6.1	251 1.9	12,918 100
1990	2,625 20.9	7,024 55.9	1,868 14.9	788 6.3	267 2.1	12,572 100

One area of particular weakness for southwestern banks was nonperforming loans (see figure 9.18). Every year from 1982 through 1990 the percentage of nonperforming loans for southwestern banks was greater than for other banks. For example, from 1986 through 1989 the percentage of nonperforming loans of southwestern banks averaged 8.8 percent, compared with 3.1 percent for other banks.

Perhaps the most telling indicator of the pervasive weakness of the southwestern banks is the percentage of those institutions with negative net income in the 1980s (see figure 9.19). From 1980 through 1982 this percentage was lower for southwestern banks than for other banks, but for the rest of the decade it was higher. From 1982 to 1987 the percentage of southwestern banks with negative net income jumped from 8.0 percent to 39.2 percent, while at the same time the percentage for other banks remained in the range of 10 to 15 percent. Incredibly, from 1985 through 1989 an average of 31.5 percent of southwestern banks had negative net income, a percentage illustrating how widespread was the adverse effect of the region's economic problems.

Table 9.5
Median ROA, ROE, and Equity Ratios, Southwestern Banks versus Banks in Rest of U.S., 1979–1990

Report Date (Year-end)	Number of Banks		ROA		ROE		Equity to Assets	
	SW Banks	Other Banks	SW Banks	Other Banks	SW Banks	Other Banks	SW Banks	Other Banks
1978	2,474	12,242	1.12	0.96	13.93	12.32	8.05	7.79
1979	2,517	12,171	1.22	1.06	15.11	13.27	8.08	8.01
1980	2,580	12,178	1.29	1.07	15.47	12.94	8.27	8.19
1981	2,647	12,098	1.32	1.02	15.89	12.26	8.19	8.20
1982	2,737	12,031	1.25	0.99	15.08	11.89	8.35	8.18
1983	2,890	11,857	1.04	0.95	12.52	11.64	8.29	8.10
1984	3,046	11,728	0.89	0.91	10.93	11.06	8.10	8.02
1985	3,125	11,671	0.78	0.92	9.65	11.17	8.07	8.02
1986	3,139	11,529	0.39	0.86	5.41	10.40	7.69	7.90
1987	2,873	11,313	0.32	0.88	4.56	10.33	7.53	8.09
1988	2,557	11,056	0.51	0.92	6.83	10.68	7.37	8.16
1989	2,325	10,871	0.69	0.95	8.74	10.87	7.45	8.26
1990	2,179	10,636	0.72	0.88	9.16	10.04	7.37	8.19

Were there characteristics that distinguished southwestern banks that failed from those banks that survived? Banks generally do not fail suddenly. The process of bank failure takes many years to develop, and failure is the result of decisions and strategies implemented at least four or five years beforehand.⁹⁷ These strategies and decisions are the underlying causes of either success or failure in difficult economic times. To study the effects of these decisions on a bank's subsequent failure or survival, FDIC researchers analyzed various financial ratios, or risk factors, that might identify risky operating strategies.⁹⁸

To determine how these risk factors affected southwestern banks, the researchers ranked each bank from low to high within each financial ratio. They then separated the banks into five risk groups in order to perform the analysis for the years 1982 (for banks that failed or survived in 1986 and 1987), 1984 (for banks that failed or survived in 1988 and 1989), and 1986 (for banks that failed or survived in 1990 and 1991). These correspond to the years during which the greatest number of failures occurred—1986 through 1991. For

⁹⁷ For a discussion of the interval between the time when a strategic decision is made and the time when the effects of the decision become evident—the life cycle of a failed bank—see Chapter 13.

⁹⁸ The eight risk factors are loans-to-assets ratios, return on assets, asset growth from the previous year, loan growth from the previous year, operating expenses to total expenses, average salary expenses, interest on loans and fees, and interest on loans and leases plus fee income on loans and leases.

Table 9.6a
Equity and Reserves to Assets of Southwestern Banks, 1978–1990

Report Date (Year-end)	Number of Banks/ Percentage of Total					Total
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	> 11.0	
1978	27	354	1,124	630	339	2,474
	1.1	14.3	45.4	25.5	13.7	100%
1979	14	346	1,135	668	354	2,517
	0.6	13.8	45.1	26.5	14.1	100
1980	11	284	1,133	730	422	2,580
	0.4	11.0	43.9	28.3	16.4	100
1981	13	296	1,201	704	433	2,647
	0.5	11.2	45.4	26.6	16.4	100
1982	12	298	1,151	758	518	2,737
	0.4	10.9	42.1	27.7	18.9	100
1983	23	384	1,130	739	614	2,890
	0.8	13.3	39.1	25.6	21.3	100
1984	25	436	1,189	743	653	3,046
	0.8	14.3	39.0	24.4	21.4	100
1985	46	427	1,173	781	698	3,125
	1.5	13.7	37.5	25.0	22.3	100
1986	141	594	995	750	659	3,139
	4.5	18.9	31.7	23.9	21.0	100
1987	221	490	917	669	576	2,873
	7.7	17.1	31.9	23.3	20.1	100
1988	269	407	840	540	501	2,557
	10.5	15.9	32.9	21.1	19.6	100
1989	203	366	792	521	443	2,325
	8.7	15.7	34.1	22.4	19.1	100
1990	138	359	824	473	385	2,179
	6.3	16.5	37.8	21.7	17.7	100

each period studied, the banks that failed four or five years later were isolated from the banks that were still in existence at the end of the five-year period and subsequently never failed. Each risk group of each risk variable was analyzed to determine which variable was the best predictor of failure. For each of the three time periods, banks in the highest loans-to-assets group had the highest incidence of failure: 12.5 percent for banks that existed in 1982 and failed in 1986 or 1987, 21.9 percent for banks that existed in 1984 and failed in 1988 or 1989, and 11.3 percent for banks that existed in 1986 and failed in 1990 or 1991. A bank in the highest-risk loans-to-assets group was three to five times more likely to fail than the banks in lower-risk loans-to-assets groups (see figure 9.20). These results indicate that banks with very high loans-to-assets ratios may be at greater risk of failure, on average, than

Table 9.6b
Equity and Reserves to Assets of Nonsouthwestern Banks, 1978–1990

Report Date (Year-end)	Number of Banks/ Percentage of Total					Total
	Equity Capital and Reserves to Total Assets					
	<5.0	5.0–7.0	7.0–9.0	9.0–11.0	> 11.0	
1978	167	2,289	5,458	2,664	1,664	12,242
	1.4	18.7	44.6	21.8	13.6	100%
1979	131	1,811	5,381	2,958	1,890	12,171
	1.1	14.9	44.2	24.3	15.5	100
1980	143	1,563	5,167	3,233	2,072	12,178
	1.2	12.8	42.4	26.5	17.0	100
1981	199	1,576	5,022	3,153	2,148	12,098
	1.6	13.0	41.5	26.1	17.8	100
1982	245	1,655	4,821	3,063	2,247	12,031
	2.0	13.8	40.1	25.5	18.7	100
1983	220	1,957	4,558	2,844	2,278	11,857
	1.9	16.5	38.4	24.0	19.2	100
1984	205	1,813	4,612	2,787	2,311	11,728
	1.7	15.5	39.3	23.8	19.7	100
1985	165	1,657	4,669	2,860	2,320	11,671
	1.4	14.2	40.0	24.5	19.9	100
1986	183	1,808	4,614	2,716	2,208	11,529
	1.6	15.7	40.0	23.6	19.2	100
1987	160	1,259	4,577	2,794	2,523	11,313
	1.4	11.1	40.5	24.7	22.3	100
1988	140	1,110	4,374	2,872	2,560	11,056
	1.3	10.0	39.6	26.0	23.2	100
1989	107	1,024	4,147	2,905	2,688	10,871
	1.0	9.4	38.1	26.7	24.7	100
1990	128	919	4,181	2,790	2,618	10,636
	1.2	8.6	39.3	26.2	24.6	100

banks with lower levels of loans because, for banks in the very high group, a larger percentage of their portfolios can default. This finding is consistent with the findings of the same analysis performed for banks throughout the country in these same years (see Chapter 13).

A review of the data for southwestern banks shows that although the number of southwestern bank failures did not begin to increase substantially until 1983 and reached a peak in 1988, beginning in 1981 banking statistics provided warnings of potential problems. For example, both the asset growth rates and the return on assets began declining in 1981 and fell continuously through 1987. In addition, nonperforming assets increased from 1982

Figure 9.18

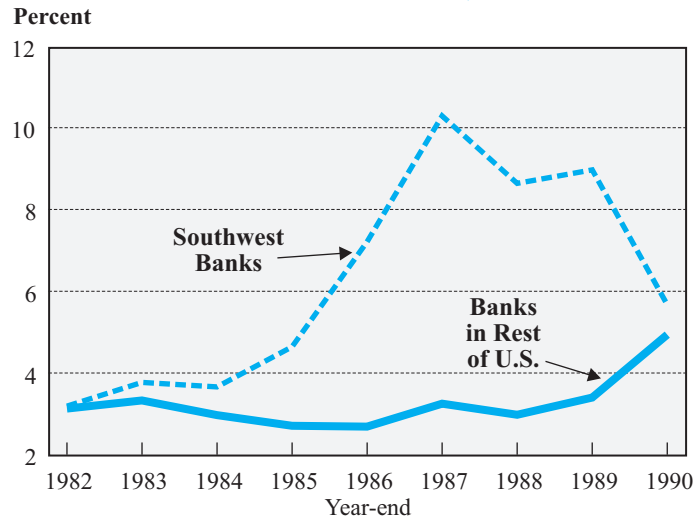
**Nonperforming Loans as a Percentage of All Loans,
Southwest versus Rest of U.S., 1982–1990**

Figure 9.19

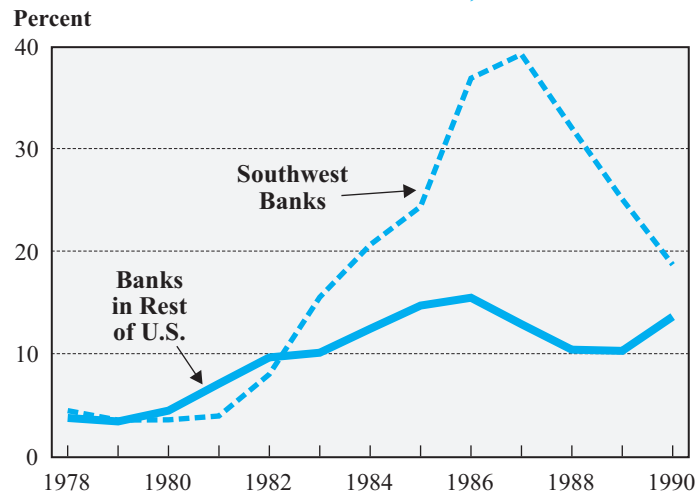
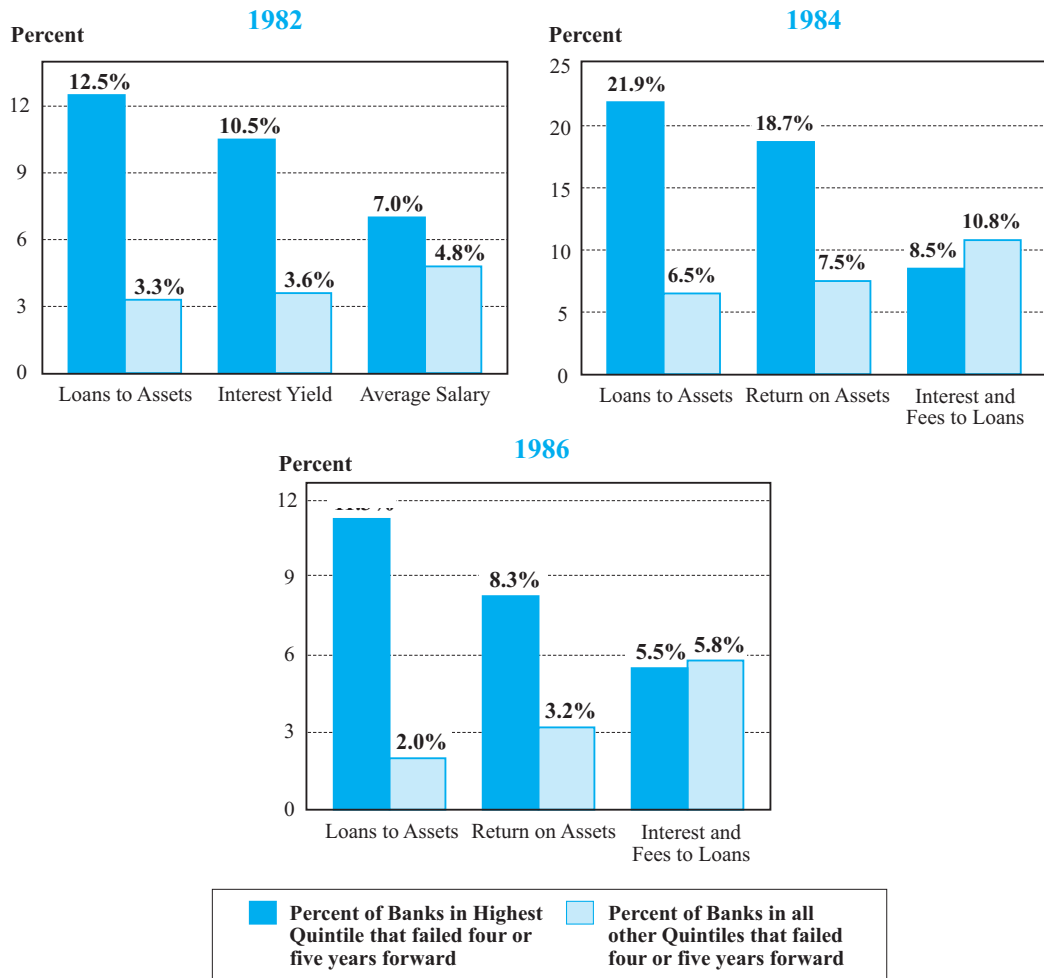
**Percentage of Banks with Negative Net Income,
Southwest versus Rest of U.S., 1978–1990**

Figure 9.20

Comparison of Selected Factors in Predicting Southwest Bank Failures Four and Five Years Forward, 1982, 1984, and 1986



Note: These three factors represent the two highest risk factors (left and center) and the lowest risk factor (right) in predicting bank failures.

through 1987, while charge-offs began rising in 1981 and did not peak until 1986. Similarly, the percentage of banks with negative net income increased consistently from 1981 through 1987. Finally, CAMEL ratings of southwestern banks began their pervasive deterioration in 1981.

When one looks back at the history of the region's economy, it is not surprising to see that 1981 proved to be the beginning of the downturn for southwestern banks. First, as discussed above, 1981 was the peak year for both oil prices and drilling activity. Many oil-related loans were based not only on the high oil prices of 1981 but also on the expectation that oil prices would continue to escalate. A number of banks began experiencing difficulties simply because oil prices failed to continue climbing. Second, 1981 was the year when office vacancy rates in Houston, Dallas, and Oklahoma City began a sharp, multiyear increase, while commercial real estate loans as a percentage of bank assets rose dramatically from 1981 to 1987. The combination of declining oil prices, weakening commercial real estate markets, and high levels of commercial real estate loans was the basis of the eventual demise of many southwestern banks.

Conclusion

A number of factors contributed to the banking debacle that occurred in the Southwest in the second half of the 1980s. The region's economy was highly dependent on oil, a sector heavily supported by the banks; and when a boom occurs in such an important segment of a region's economy, the potential clearly exists for serious difficulties when the boom period ends. The danger was especially acute in the Southwest because many lenders were initiating loans that were based on the assumption of ever-increasing oil prices. Some banks were therefore vulnerable even if oil prices did not decline but simply stopped increasing.

The boom helped create an excessively optimistic mind-set among some southwestern bankers, which led them to make numerous lending errors. For example, overly sanguine expectations about the future of oil prices drew bankers into a destructive competition to keep oil customers in the early 1980s. Then, faced with deteriorating energy loans, many banks only compounded the difficulties by pushing to invest in real estate as an antidote to their energy-loan problems. The boom atmosphere contributed here as well, blinding bankers to the potential adverse effects of weakening oil prices and concomitant increases in vacancy rates on real estate projects as well as making them more liable to base real estate loans on inaccurate feasibility studies and on unrealistic appraisals and income projections. In this area, too, bankers' lending strategies reflected unrealistic beliefs about prices: believing that real estate loans' prices rarely declined, they acted as if real estate loans entailed minimal risk, and extended credit unwisely.

In addition, the intense competition among financial institutions might also have warranted additional vigilance. The competitive intensity was generated both by the striking in-

crease in the number of newly chartered southwestern banks during the first half of the 1980s and by Congress's 1982 broadening of thrifts' powers. The problems could have been contained if regulatory standards in the chartering of new banks had been more stringent and if legislation had been attentive to the implications of deregulation.

In sum, although extraordinary events such as the oil price crash in late 1985 and 1986 and the southwestern real estate debacle are difficult if not impossible to predict, nevertheless the euphoric attitude among many southwestern bankers was highly conducive to critical errors in judgment. The simplest lesson that can be learned from the story of the banking collapse in the Southwest is that obvious excesses, in both expectations and competitive behavior, have the potential to cause serious problems, no matter how favorable a situation may seem at the time.