performance differentials are attributable to differences in involvement in consumer rather than commercial lending. The data indicate that S&L commercial lenders are more heavily involved in consumer lending than their peers, and more heavily involved in consumer than commercial lending by a considerable margin. These numbers suggest that commercial lending has had a relatively minor impact on the performance of Ohio's thrifts to date.

■ Summary and Conclusions

The data indicate that while the level of Ohio S&L involvement in commercial lending has been growing, commercial loans continue to account for a relatively small proportion of the loan portfolios and operating income at most institutions. Most of the loan volume is concentrated at the largest S&Ls, but size does not seem to be a necessary prerequisite for this type of activity.

In general, examination of the measures of profitability and risk suggests that commercial lending is generally not associated with superior S&L performance. However, given the typically limited level of S&L involvement in this activity, commercial lending is probably not reponsible for the relatively poor performance exhibited by thrifts making such loans. Alternatively, the evidence suggests that thrifts need not engage in the entire range of permissible activities to survive.

Finally, if an increase in the number of competitors does lead to downward pressure on prices as predicted by economic theory, the analysis of the geographic location of the offices of thrift commercial lenders suggests that S&Ls have had a beneficial impact on competition for commercial loans in a large number of local markets in Ohio. Further research is necessary to determine if this has actually occurred.

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The views stated herein are those of the author and not necessarily those of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

■ Footnotes

1. The number of S&Ls making commercial loans and the total volume of commercial credit extended by S&Ls in Ohio are understated somewhat. Four large S&Ls headquartered in other states operate offices in Ohio. These institutions make substantial amounts of commercial loans, but their Ohio totals are not available.

2. The S&Ls' share of commercial credit extended in the state is probably greater than the percentage reported in the text. One reason is that the S&L total excludes loan volume of four S&Ls with home offices outside the state. The other reason is that the commercial bank total includes loans made to borrowers located outside Ohio.

3. Equity calculated according to generally accepted accounting principles (GAAP).

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ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

Commercial Lending of Ohio's S&Ls

by Gary Whalen

Prior to 1980, the asset and liability powers of thrifts were limited relative to commercial banks. In particular, savings and loans (S&Ls) could not generally make consumer or commercial loans or offer transactions accounts. Because S&Ls were statutorily precluded from providing these important components of the product-service cluster offered by commercial banks, they were not viewed as full, effective bank competitors either by regulators or by the courts when evaluating the antitrust implications of bank mergers.

This situation was fundamentally changed by passage of two pieces of legislation in the early 1980s. The Depository Institutions Deregulation and Monetary Control Act of 1980 permitted S&Ls to make various types of consumer loans and to provide consumer transactions accounts, thus allowing S&Ls to compete head-to-head with banks for virtually the entire range of household business. However, the ability of S&Ls to serve commercial customers remained limited.

The Garn-St Germain Act of 1982 further expanded S&Ls' asset and liability powers, particularly in the commercial area. Although permissible maximums were specified for various loan categories in the Act, S&Ls were authorized to make any type of commercial loan (including unsecured ones) and to offer demand-deposit services to their commercial customers. Thus, the Act allowed S&Ls to enter a product market that, due to regulation, had largely been the private preserve of commercial banks. At least in terms of authorized powers, banks and S&Ls became competitive equals.

Entry into nontraditional activities like commercial lending could either strengthen or weaken thrifts. For example, engaging in such activities might permit an S&L to add assets to its balance sheet that have shorter maturities than the traditional fixed-rate mortgage loan, and so reduce its exposure to rising interest rates. Benefits from increased diversification could be realized. Returns earned in new activities might be higher than those obtainable in traditional mortgage lending. Thus, S&Ls engaging in this activity could become more profitable and/or less risky.

On the other hand, start-up costs could be high and inexperience could result in unintentional, excessive risk-taking and subsequent losses. S&Ls' entry and aggressive competition for incremental business could cause lending margins to shrink or vanish.

Two new laws in the early 1980s fundamentally changed the relationship between thrifts and commercial banks, allowing S&Ls to compete for the full range of household and commercial business. An examination of Ohio S&Ls shows the impact of the expanded commercial lending powers on their performance.

Further, these additional powers were authorized at a time when S&Ls' earnings were generally weak or nonexistent and their capital levels were low and eroding. Thus, even a few lending decisions that proved to be wrong could be fatal.

Similarly, S&Ls' entry into commercial lending could generate public benefits and costs. Attempts by S&Ls to obtain this type of business should theoretically intensify competition, lowering rates and increasing the supply of commercial loan funds in local markets where they operate. However, the existence of flat-rate deposit insurance creates incentives for S&L management to consciously

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TABLE 1 SUMMARY DATA FOR S&L COMMERCIAL LENDERS IN 1987 BY SIZE CLASS

Size Class	Participation Rate*	Total Loan Volume ($Millions)	Commercial Loans/ Total Loans	
			Mean*	S.D.*
Above $1 bill. (N = 12)	85.7	$262.1	1.84	1.61
$250 - $999 mill. (N = 21)	75.9	$147.5	2.42	2.63
$100 - 249 mill. (N = 28)	61.7	$88.1	2.74	3.83
$50 - $99 mill. (N = 13)	29.5	$22.3	3.04	2.55
$25 - $49 mill. (N = 14)	26.9	$9.3	2.02	2.92
Below $25 mill. (N = 8)	21.6	$3.5	2.73	3.48

*Values are percentages. S.D. is an abbreviation for standard deviation.
SOURCE: Federal Home Loan Bank Board financial reports and the author.

engage in high-risk, high-expected-return activities. Under the present deposit insurance system, the risk of such activities can be effectively transferred to the Federal Savings and Loan Insurance Corporation.

In this *Economic Commentary,* the extent to which S&Ls in Ohio have chosen to exercise their expanded commercial lending powers will be examined. The impacts of this decision on their performance will be investigated.

■ Characteristics of Ohio's Thrift Commercial Lenders

The data in table 1 indicate that not all Ohio S&Ls have plunged headlong into commercial lending. At the end of 1987, 96 Ohio S&Ls were making some type of commercial loan. This number represents roughly 43 percent of the S&Ls operating in the state. The participation rate is up from 31 percent in 1984. Eighty-two thrifts had secured commercial loans on their books at year-end; 59 had unsecured commercial loans. Forty-five were doing both types of lending.

The total volume of commercial loans reported by S&Ls headquartered in Ohio was roughly $533 million at year-end 1987.[1] This is approximately double the 1984 total of $276 million. These figures translate into a compound annual growth rate of 24.5 percent over this period. Over the same interval, domestic commercial and industrial loans on the books of Ohio's commercial banks increased to $17.0 billion from $11.3 billion (a compound annual growth rate of 14.4 percent). These numbers imply a slight increase in the S&L share of total commercial lending, from 2.4 percent in 1984 to 3.0 percent in 1987.[2]

Not unexpectedly, the probability that an S&L is involved in commercial lending generally increases with institution size (see table 1). The percentage of institutions making commercial loans increases from roughly 22 percent of the smallest-size group (those with total assets below $25 million) to 86 percent of those with total assets of $1 billion or more.

The largest thrifts account for the bulk of the total volume of outstanding commercial loans. Loan volume at the 12 S&Ls in the largest-size class represents nearly half of the total for all Ohio thrifts. An additional 28 percent of the total outstanding amount is on the books of the 21 commercial lenders in the next-largest size class.

A comparison of 1987 commercial lending totals at individual S&Ls with year-earlier figures shows that volume increased at 57 institutions. Fifteen of these had no commercial loans at all on their books at the end of 1986. At 52 thrifts, the increases outpaced growth in other types of loans, resulting in a rise in the ratio of commercial loans to total loans. Conversely, volume declined at 42 S&Ls. Given the typically small volume of commercial loans outstanding at Ohio S&Ls, the changes in loan totals over the 1986 to 1987 interval translate into relatively large percentage changes at individual thrifts. At 48 institutions the year-to-year percentage change exceeded 25 percent.

However, when commercial loan and total loan volumes are compared at each thrift, the data indicate that the scale of S&L involvement in commercial lending remains quite modest. The commercial-loan total-loan ratio at more than one third of the S&Ls making commercial loans was below one percent in 1987. At roughly another third, this ratio is in the 1 to 4 percent range. Only 21 have ratio values above 4 percent. These values are considerably lower than those of the typical commercial bank.

Interestingly, the data in the second to last column in table 1 reveal that the mean commercial-loan total-loan ratio for S&L commercial lenders does not vary greatly across size classes. In combination with the relatively large standard deviations reported in the last column of table 1, this finding implies considerable variation in the extent of involvement in commercial lending, even within a given size class. Additionally, it suggests that small size does not preclude an S&L from engaging in this activity.

Although the number of S&Ls engaging in commercial lending is not particularly large and the extent of involvement is typically not great, analysis of the geographic location of their offices suggests that these institutions have some impact on competition for commercial loans in a large proportion of local markets throughout the state.

TABLE 2 SELECTED FINANCIAL RATIOS* FOR S&L COMMERCIAL LENDERS AND NONLENDERS**

Size Class	CLIR87	ROA87	CHROA74	EQASR87	SDROA74	CRLR87
Total Assets of $100 Million or More	1.88	0.01 (0.61)	-0.27 (0.33)	3.39 (5.42)	.57 (.40)	5.92 (3.19)
Total Assets Less Than $100 Million	1.56	0.79 (0.81)	0.07 (0.44)	6.02 (8.00)	.64 (.46)	7.74 (2.63)

Ratio Definitions:
CLIR87: Commercial Loan Income/Total Operating Income, year-end, 1987.
ROA87 : Net Income After Taxes/Total Assets, year-end, 1987.
CHROA74: ROA87 minus same ratio calculated at year-end, 1984.
EQASR87: Equity(GAAP basis)/Total Assets, year-end, 1987.
SDROA74: The standard deviation of the ratio of net income after taxes to total assets over the 1984 to 1987 interval.
CLIR87: Consumer Loans/Total Loans, year-end, 1987.

*Values in the table are sample means.
**Mean values for nonlenders appear in parentheses.
SOURCE: Federal Home Loan Bank Board financial reports and the author.

Seventy-three percent of the thrifts making commercial loans are headquartered in metropolitan statistical area (MSA) counties where numerous bank competitors exist. Still, thrift commercial lenders increase the number of suppliers of commercial credit by 10 or more in five Ohio MSAs. In another four, the increase is at least five, but less than 10. Further, since S&Ls can branch statewide in Ohio, the office of a thrift commercial lender is located in 92 percent (46 of 50) of the rural counties in the state, where the number of banks competing for commercial loan customers is typically small. Two or more S&L commercial lenders are operating in 25 rural counties.

■ An Analysis of Performance Differences: Commercial Lenders vs. NonLenders

The mean values of several ratios reflecting various dimensions of performance for S&L commercial lenders and nonlenders appear in table 2. To ease the exposition, the six size classes used in table 1 are collapsed into two—S&Ls larger than $100 million in total assets and S&Ls smaller than $100 million. The numbers in parentheses below various entries in the table are the corresponding value for S&Ls in that size class that had no commercial loans on their books at year-end 1987.

Before proceeding with a discussion of the data in the table, several caveats should be noted. Determining whether or not any observed differences in the financial ratios between lenders and nonlenders are due to commercial lending activity is difficult for a number of reasons. While the gross income earned on commercial loans is reported by S&Ls, loan charge-offs and loan-loss provisions are not. In addition, both the income and expense attributable to current lending activity may impact the income statement and balance sheet with a lag.

Further, a finding that involvement in commercial lending is associated with inferior performance does not necessarily indicate causation running from the former to the latter. It is possible that poor performance due to some other factor (such as interest rate mismatch) could induce an S&L to engage in commercial lending or other types of nontraditional activities with high expected returns.

The statistics in the first column of table 2 suggest that the typical S&L does not derive a large portion of its income from commercial lending. The mean value of the ratio of income earned on commercial loans to total operating income is below two percent for both size groups.

The data in the next column of table 2 are the mean values of the 1987 rate of return on assets, a measure of S&Ls' overall profitability in that year. A comparison of each figure with the counterpart ratio (in parentheses below it) for S&Ls of similar size that did not make commercial loans reveals considerable 1987 profitability differences between large S&Ls making commercial loans and those that did not, but virtually no difference for smaller institutions. Specifically, the profitability of large S&L commercial lenders is well below that of nonlenders.

A similar pattern is evident if one looks at the change in profitability over the 1984 to 1987 period. The mean change in profitability of S&Ls that were not involved in commercial lending exceeds that of commercial lenders in both size classes. Overall, roughly 75 percent of the S&Ls that did not make commercial loans improved their profitability over this interval. Only about two-thirds of the commercial lenders accomplished this feat.

The next two columns in the table contain mean values for two different measures of S&L risk—the ratio of equity (GAAP basis) to assets and the standard deviation of return on assets over the 1984 to 1987 time period.[3] In general, higher risk is indicated by lower equity ratios and larger profit variability. The statistics suggest that S&Ls involved in commercial lending are riskier than their peers that choose not to engage in this activity.

The last column of table 2 contains mean values of the ratio of consumer loans to total loans. This ratio is included to provide additional perspective on the relative importance of commercial lending to Ohio thrifts and so perhaps to allow one to determine whether or not the observed