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. 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 engaged in this activity could become more profitable and/or less risky.

On the other hand, start-up costs could be high and experience 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. Moreover, they could have difficulty retaining the personnel necessary to cope with nontraditional activities.

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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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.

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

<table>
<thead>
<tr>
<th>Size Class</th>
<th>Participation Rate</th>
<th>Total Loan Volume (Millions)</th>
<th>Commercial Loans/ Total Loans</th>
<th>Mean #</th>
<th>SD #</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above $1 billion</td>
<td>85.7</td>
<td>$262.1</td>
<td>1.84</td>
<td>1.50</td>
<td></td>
</tr>
<tr>
<td>$250 - $999 million</td>
<td>75.9</td>
<td>$197.5</td>
<td>2.24</td>
<td>2.63</td>
<td></td>
</tr>
<tr>
<td>$100 - 249 million</td>
<td>61.7</td>
<td>$88.1</td>
<td>2.74</td>
<td>5.85</td>
<td></td>
</tr>
<tr>
<td>$50 - $99 million</td>
<td>29.5</td>
<td>$22.3</td>
<td>3.04</td>
<td>2.55</td>
<td></td>
</tr>
<tr>
<td>$25 - $49 million</td>
<td>26.9</td>
<td>$9.9</td>
<td>2.02</td>
<td>2.92</td>
<td></td>
</tr>
<tr>
<td>Below $25 million</td>
<td>21.6</td>
<td>$3.5</td>
<td>2.73</td>
<td>3.48</td>
<td></td>
</tr>
</tbody>
</table>

Values are percentages. S.D. is an abbreviation for standard deviation.

SOURCE: Federal Home Loan Bank Board financial reports and the author.

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

<table>
<thead>
<tr>
<th>Size Class</th>
<th>CLIR87</th>
<th>ROA87</th>
<th>CHROA74</th>
<th>EQASR87</th>
<th>SDROA74</th>
<th>CRLR87</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less Than $100 million</td>
<td>0.89</td>
<td>0.01</td>
<td>0.27</td>
<td>3.39</td>
<td>0.57</td>
<td>5.92</td>
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<tr>
<td>$250 - $999 million</td>
<td>1.56</td>
<td>0.79</td>
<td>0.07</td>
<td>6.02</td>
<td>0.64</td>
<td>7.74</td>
</tr>
<tr>
<td>$100 - 249 million</td>
<td>0.81</td>
<td>0.44</td>
<td>0.68</td>
<td>8.00</td>
<td>0.65</td>
<td>13.88</td>
</tr>
<tr>
<td>$50 - $99 million</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$25 - $49 million</td>
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</tr>
<tr>
<td>Below $25 million</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Ratio Definitions:
CHROA74: ROA87 minus same ratio calculated at year end, 1964.
EQASR87: Equity GAAP basis/Assets, year end, 1986.
SDROA74: The standard deviation of the ratio of net income after taxes to total assets over the 1984 to 1987 interval.

Values in the table are sample means. *Mean values for nonlenders appear in parentheses. **Table 1 contains the same data for all thrifts.

SOURCE: Federal Home Loan Bank Board financial reports and the author.

Seven percent of the thrifts making commercial loans are headquarted 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 in Commercial Lenders vs. Nonlenders**
The means of several ratios reflecting various dimensions of performance for all 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 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) 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&Ls commercial lenders is better than 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 last two columns in the table contain mean values for two different measures of S&Ls' risk—measured by the ratio of equity (GAAP basis) to assets and the standard deviation of return on assets over the 1984 to 1987 time period. In general, higher risk is indicated by lower equity ratios and larger volatility. 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

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 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, 56 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 mean change in profitability over the 1984 to 1987 interval translates into a proportion 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.*

*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 percent 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 46 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 for more than one third of the S&Ls making commercial loans was below one percent in 1987. At roughly another third of the S&Ls, this ratio is between 1 and 4 percent. 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 last two columns in table 1 reveal that the 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.