In Focus This Quarter

◆ **Subprime Lending: A Time for Caution**—The extent of subprime lending is increasing as strong competition for high-quality borrowers has some lenders moving down the credit quality spectrum. Subprime lending requires a commitment of resources and expertise beyond that required in more conservative lending, and the consequences of deficiencies in underwriting, servicing, and collection can be severe. *See page 3.*

  *By Kathy R. Kalser, Debra L. Novak*

◆ **Retail Shakeout: Causes and Implications for Lenders**—Despite favorable economic conditions, the retail industry is experiencing slow revenue growth in a highly competitive environment. The confluence of rapid change in store formats and slow revenue growth has led to an ongoing shakeout among both large and small retail chains, and this shakeout may adversely affect credit quality at some insured institutions. *See page 6.*

  *By Richard A. Brown, Diane Ellis*

Regular Features

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  *By Alan C. Bush, Jeffrey A. Ayres*
The *Regional Outlook* is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation for the following eight geographic regions:

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**Subprime Lending: A Time for Caution**

- Subprime lenders specialize in lending to borrowers with blemished or limited credit histories.
- The consequences of deficiencies in underwriting, servicing, and collection can be severe with subprime lending. Lenders that fail to dedicate the necessary resources in these areas likely will have trouble succeeding in the increasingly competitive market for subprime loans.
- Some institutions insured by the FDIC have failed to properly assess and control the risks associated with their subprime lending programs.

**What Are Subprime Loans?**

Faced with strong competition and shrinking margins on loans to high-quality borrowers, some lenders are moving down the credit quality spectrum. The strategy to extend loans to borrowers perceived as less creditworthy is referred to as “subprime” lending. Subprime lending is most commonly associated with auto, home equity, mortgage, and secured credit card loans to borrowers who have blemished or limited credit histories. Generally, the characteristics of a subprime borrower include a history of paying debts late, personal bankruptcy filings, or an insufficient credit record.

Subprime loans also are referred to as marginal, nonprime, or below “A” quality loans. There are no established guidelines for determining the degree to which a borrower is considered subprime, so one lender’s “B” customer could be another lender’s “C” customer. Definitional variations aside, some general market parameters on ranking loans are presented in Table 1.

<table>
<thead>
<tr>
<th>GRADE</th>
<th>PAYMENTS LATE 30 DAYS</th>
<th>BANKRUPTCY FILING</th>
</tr>
</thead>
<tbody>
<tr>
<td>PRIME</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>A-</td>
<td>Less than 2</td>
<td>None in 5 years</td>
</tr>
<tr>
<td>B</td>
<td>Less than 4</td>
<td>None in 3 years</td>
</tr>
<tr>
<td>C</td>
<td>Less than 6</td>
<td>None in 2 years</td>
</tr>
<tr>
<td>D</td>
<td>Constantly Late</td>
<td>None in 1 year</td>
</tr>
</tbody>
</table>

**How Big Is the Market?**

The lack of a standard definition for a subprime loan makes it difficult to accurately determine the extent of the market. However, some industry experts estimated that during 1996, subprime loans secured by residences, including both home equity and mortgage loans, amounted to between $100 billion and $150 billion compared to the estimated $800 billion in originations of conventional mortgages. Subprime auto loans have been estimated to range between $75 billion and $100 billion, or about 20 percent of total auto loans outstanding.

**Who Makes Subprime Loans?**

In the past, subprime lending was primarily the domain of a limited number of finance companies. These firms specialized in making high-priced loans to borrowers with limited access to credit.

The number of subprime lenders, however, has surged in recent years as more companies have been attracted by the significantly higher rates and fees earned on subprime loans. In some cases, yields on these higher risk assets have been as high as 15 percent to 30 percent. The new subprime participants include finance companies that traditionally served prime borrowers, new specialized subprime lenders, and banks.

The increase in the number of subprime lenders has been fueled by strong demand from investors for asset-backed securities (ABS). This method of funding enables the lender to effectively raise cash at a lower rate to fund loan growth. In addition, the subprime ABS market has attracted lenders that previously refrained from making subprime loans because they did not want to maintain these high-risk loans or the associated reserves on their balance sheet. By issuing securities backed by subprime loans, lenders now have the ability to originate subprime loans and sell them to ABS investors.

Favorable stock market conditions also helped to fund the growth of subprime lenders. Approximately 30 subprime lenders raised nearly $3 billion from stock offerings from January 1995 through April 1997, according to market watchers. This financing avenue may become less accessible, as investors’ concerns over financial
problems of several major market participants have caused stock prices of subprime lenders to decline significantly during the first part of 1997.

Financial Difficulties of Some Subprime Lenders

Market participants have observed that, as in credit card lending, increasing competition may be compelling some subprime lenders to compromise underwriting standards and lower pricing in order to protect market share. Financial difficulties reported by major subprime auto lenders Jayhawk Acceptance Corporation and Mercury Finance Company highlight these concerns.

Problems in subprime lending are not limited to auto loans. Lenders that specialize in subprime home equity loans and mortgages also are showing signs of stress. In April 1997, Moody’s Investors Service lowered the rating on subordinated debt issued by a leading originator of subprime mortgage and home equity loans. The reason was concern over the increasing level of delinquencies in the issuer’s loan portfolio and the highly competitive environment for subprime home equity loans (see Financial Markets).

Differences between Prime and Subprime Lending

There are key differences between the underwriting, servicing, and collection methods used for prime and subprime lending programs. The goal of the subprime underwriting process is to differentiate those subprime borrowers whose past credit problems were due to such temporary events as illness or job loss from the habitually bad credits. Subprime lenders often supplement a prospective borrower’s credit bureau report with such additional information as income, employment history, and the nature of prior credit problems. This process allows the lender to better determine the credit risk or “grade” of the borrower. If this determination is successful, the lender can better establish the price at which the loan will be profitable.

Servicing and collection of subprime loans tends to be more labor intensive and costly than in prime lending. Subprime lenders tend to monitor payments more closely than prime lenders. Some purportedly call their borrowers regularly to remind them when a payment is due. In addition, while prime lenders may be willing to work with late borrowers by adjusting minimum amounts or payment schedules, subprime lenders generally pursue collections more aggressively and repossess collateral more quickly.

Insured Institutions and the Subprime Market

Bank involvement in subprime lending is difficult to quantify because subprime loans are not delineated in bank and thrift Call Reports. However, both large and small banks reportedly are participating in credit card, auto, home equity, and mortgage subprime lending. Insured institutions have used various strategies to establish a presence in the subprime market. Some have:

- acquired or formed joint ventures with companies specializing in subprime lending;
- built subprime lending programs internally, using existing resources; and
- tapped a network of loan brokers with access to subprime borrowers. Smaller banks entering the market for subprime mortgages may use this method more commonly.

Through these strategies, insured institutions have:

- extended loans directly to subprime borrowers or purchased subprime loans from loan brokers;
- lent to subprime specialty lenders in the form of loan participations, warehouse lines, liquidity facilities, or dealer lines; and
- serviced subprime loans or invested in asset-backed securities secured by subprime loans.

Risks Associated with Subprime Lending Need to Be Considered Carefully

According to a Financial Institutions Letter (FIL), FIL 44-97 issued by the FDIC’s Division of Supervision, recent examinations revealed that a number of financial institutions involved in subprime lending have failed to properly assess and control the risks associated with subprime lending. Because of the relatively high default rates on such loans, the FIL indicates that this type of
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lending warrants particular caution and management attention.

Institutions need to be thoroughly aware of the increased risks and costs associated with lending to higher risk borrowers. Some of these risks include:

- Delinquencies and defaults tend to be more frequent and occur sooner on lower quality loans (see Chart 1).
- Loan loss reserves that would have been adequate for prime lending may not properly cover higher loss rates associated with subprime loans.
- Strains on underwriting and collection resources may emerge.
- Because selling collateral is more frequently the source of repayment on subprime loans, failure to accurately estimate recovery values could severely affect the profitability of subprime lenders. For example, several subprime auto lenders recently reported lower profits when the supply of better quality cars coming off leases depressed the prices they received on repossessed cars.

Insured institutions that rapidly increase subprime exposures also may need to reevaluate delinquency measurement methodologies. Rapid loan growth can make it more difficult to accurately track delinquency and default trends. Generally loans do not default immediately, but “season” or reach peak loss rates over a period of time. Delinquency and default rates can be deceptively low if the proportion of new loans exceeds the proportion of seasoned loans in a lender’s portfolio. Calculating default rates over time for loans originated in a particular period or lending program, instead of as a percentage of total outstanding loan balances, helps reduce the distortion caused by rapid loan growth. This method of computing delinquency and default rates, known as “static pool” or “vintage analysis,” is a common measurement tool among investment analysts.

Banks involved in subprime lending also should realize that the recent increase in subprime lending has occurred during relatively healthy economic conditions. The repayment capacity of subprime borrowers may be more susceptible to downturns in the economy, which could further exacerbate the already high level of delinquencies and defaults typically recorded on subprime loans.

In addition, banks that lend to subprime specialty lenders, who rely heavily on securitization, should evaluate the accounting treatment of securitization and the effect securitization may have on earnings (see Financial Markets).

Conclusion

The extent of involvement by insured institutions in subprime lending is difficult to quantify. To be successful in subprime lending requires a commitment of resources and expertise. Conversely, deficiencies in assessing and controlling the risks of subprime lending can have serious consequences. Such deficiencies have surfaced at a number of FDIC-insured institutions. Striking an appropriate balance between the risks and rewards of subprime lending is a challenge for bankers and merits the continued attention of bank supervisors.

Kathy R. Kalser, Chief
Financial Sector Analysis Section
Debra L. Novak,
Division of Resolutions and Receiverships
In Focus This Quarter

Retail Shakeout: Causes and Implications for Lenders

• Changes in the marketplace, technology, and finance are transforming retailing.

• These trends have given rise to rapid growth in the new “big box” store format.

• Consolidation in retailing is evident in mergers, acquisitions, and bankruptcies.

• The potential for overbuilding in retail real estate markets may pose a risk for insured depository institutions.

For the past two decades, construction of retail space has outstripped many indicators of demand such as growth in retail sales, population, and income. The broadest measure of the industry’s health is sales per square foot, and, for shopping centers, it has fallen by around 35 percent in real terms since 1972. Chart 1 shows how growth in leasable shopping center space has exceeded growth in shopping centers’ sales since 1972.

Based on signs of “overstoring,” a number of retail industry analysts have concluded that too many stores are chasing too few consumer dollars, indicating an emerging shakeout in the retail sector. To the extent that insured depository institutions provide financing to retailers or for retail real estate, they are exposed to heightened credit risk as the shakeout unfolds.

New Forces Are Reshaping the Retail Landscape

A combination of demographic and economic forces has reduced growth in demand for retail goods from the boom days of the 1970s and mid-1980s. Meanwhile, technology is reconfiguring the way retail goods are marketed and delivered, and a low cost of capital has stimulated investment in new retail space and new retailing concepts.

A retail industry boom began roughly in 1970 when baby boomers and women began entering the work force in record numbers. At the same time, proliferation in general-purpose credit cards facilitated an extension in consumer borrowing power. As a result, there was a 98 percent increase in inflation-adjusted retail sales from 1967 to 1994.

To meet this demand and serve expanding suburban communities, developers built shopping centers at a rapid pace. The number of shopping centers, from small neighborhood strip centers to huge regional malls, grew from about 13,000 in 1972 to over 41,000 in 1995.

Despite economic conditions that seem favorable for the retail sector, revenue growth has been painfully slow in the 1990s. Payrolls have seen net growth of 13.4 million jobs since mid-1991, while real disposable personal incomes and consumer confidence have risen commensurately. An optimistic household sector has shown a willingness to take on debt under these favorable conditions and has done so with the benefit of lower interest rates compared to the 1980s.

Even with generally positive economic conditions, retail demand has grown slowly in the 1990s (see Chart 2, next page). Annual rates of increase in real expenditures on many durable and, especially, nondurable goods have lagged behind rates of the previous two decades.

Slow growth in retail revenues can be explained in part by the fact that retail goods overall have risen in price at only around two-thirds of the general rate of inflation during the 1990s, while the appliance, electronics, and personal computer sector has seen actual price deflation.
An aging consumer base is another factor holding down retail sales growth. The total number of households headed by persons age 20 to 35—the age at which families are getting established and acquiring household durable goods—is the same now as it was in 1980. The lack of growth in this key demographic group has limited growth in retail demand and should continue to do so for the foreseeable future. The total population in the 20 to 35 age bracket is projected to decline slightly by 2007.

Other broad trends have contributed to slower retail sales growth. Retail sales as a percentage of personal income fell from 46 percent to 38 percent between 1967 to 1996 as consumers shifted more of their disposable income to the purchase of personal services, housing, education, travel, and entertainment. A Standard and Poor's Industry Survey reports that consumers have reduced their number of trips to shopping malls by 35 percent since 1980, while total shopping hours are down 70 percent.

Looking ahead, mail-order retailing through electronic media, including cable television and the Internet, may be poised to gain significant market share at the expense of shopping centers. “Virtual shopping malls” such as Amazon.com, an Internet bookseller, have made headlines with their initial successes, although analysts caution that widespread adoption of high-tech shopping may be some years down the road.

Technology has become a key to distribution and marketing. Faced with slower revenue growth, retailers have been investing in technology to cut their expenses and boost their bottom lines. For example, point-of-sale scanning delivers a vast amount of information that can be used to target marketing efforts and manage and control inventories—providing a distinct competitive advantage for large retail chains with vast marketing and distribution networks.

A low cost of capital has fueled investment. Low interest rates and a booming stock market have made market financing plentiful and cheap. This environment has allowed retailers to overhaul retail strategies and invest heavily in technology, inventory, and retail space—investments that might otherwise have been infeasible. Since 1991, around 1.13 billion square feet of new retail space has been added nationwide representing an increase of about 12 percent to the total stock of retail real estate over five years. Net additions to retail inventories since 1991 have totaled almost $33 billion in inflation-adjusted dollars, an increase of over 18 percent. No figures are available on investments made in information systems, although they are known to be sizeable.

Growth of the “Big Box” Format

Leading retailers have responded to these forces with aggressive expansion in the “big box” store format. Big box retailers are typically discount stores and superstores, such as Circuit City, PetSmart, and The Home Depot, Inc., which tend to cluster in large strip malls called “power centers.” In many towns and cities, the arrival of big box stores has left smaller, local retail establishments with only a small fraction of their former share of the local market.

The big box format has a number of advantages. Among the most important is the ability to offer a large, diverse on-shelf selection. This approach enables a single location to dominate that retail category in the local market, which is why the big box chains are often referred to as “category killers.” Large retail chains also have more leverage over suppliers. They can negotiate more favorable prices and demand cooperative advertising from manufacturers. Large retailers typically have the financial resources to invest in the latest distribution methods and technology. Finally, unlike smaller traditional retailers, these large chains can obtain financing through the capital markets.

Chart 2

Inflation-Adjusted Retail Sales Have Grown Slowly in the 1990s

<table>
<thead>
<tr>
<th>Real Growth in Retail Sales*</th>
<th>Compound Annual Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000s</td>
<td>3.0%</td>
</tr>
<tr>
<td>1990s</td>
<td>2.5%</td>
</tr>
<tr>
<td>1980s</td>
<td>2.0%</td>
</tr>
<tr>
<td>1970s</td>
<td>1.5%</td>
</tr>
<tr>
<td>1960s</td>
<td>1.0%</td>
</tr>
<tr>
<td>1950s</td>
<td>0.5%</td>
</tr>
</tbody>
</table>

* Retail sales excluding autos, deflated by the consumer price index. Source: Bureau of the Census and Bureau of Labor Statistics.
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Industry Consolidation to Continue

Rapid expansion among the large retail chains has contributed to a highly competitive retail sector marked by intense battles for domination of the major retail categories. The result of this competition, analysts say, will be consolidation in the industry as weaker chains give way to market leaders.

One sign of this consolidation is in multibillion dollar acquisitions, such as Federated Department Stores’ acquisition of R.H. Macy. The five largest department store chains (JC Penney, Federated, May, Dillard, and Nordstrom) now account for 87 percent of department store sales nationwide. The top three discount department store chains (Wal-Mart, K-Mart, and Target) account for 87 percent of full-line discount department store sales.

Intensely competitive conditions also are reflected by retail bankruptcies and restructurings. Both Woolworth Corp. and K-Mart Corp. recently closed a number of stores in restructurings that reflect the loss of market share to Wal-Mart. Smaller companies that have fewer restructuring options are more likely to be forced into bankruptcy. Dun & Bradstreet reports that domestic business failures among retail establishments rose in 1995 by 2.8 percent to 12,952. While most of these failures were individual stores and small chains, a number of larger chains also filed for bankruptcy during 1995, including Barney’s, Bradlees Inc., Caldor, The Clothestime Inc., Edison Brothers Stores, Elder-Beerman, Herman’s Sporting Goods, Jamesway, and Today’s Man.

As the retail shakeout moves forward, any credit losses on commercial and industrial loans to retailers are more likely to arise from bankruptcies and restructurings than from mergers and acquisitions. Unfortunately, it is difficult to say in advance exactly how consolidation in the industry is likely to take place.

Overbuilding Is a Risk for Retail Real Estate

Retail industry analysts are particularly concerned about the potential for overbuilding of retail space. Because of this concern, lenders and examiners should be alert to possible credit quality problems with commercial real estate loans secured by retail properties.

Although a vacancy rate of 7.7 percent does not suggest that the U.S. retail market is vastly overbuilt at present, there are warning signs. One is that the U.S. aggregate vacancy rate has begun to tick upward since 1995 as net completions of new retail space have caught up to and surpassed the absorption of that space by retailers (see Chart 3). Another frequently cited indicator of overbuilding is a falling ratio of sales per square foot in the industry, reflecting the fact that additions to retail space have outpaced sales growth for some time. In any case, local market conditions may be somewhat more volatile than the national figures would suggest, particularly in areas where a great deal of construction activity has recently taken place (see inset, Retail Vacancy Rates Rose throughout the Dallas Region in 1996).

Besides market conditions, underwriting is the other major determinant of credit quality in retail real estate lending. Market analysts report that many of the problems resulting from local market downturns have been on loans with 1980s-vintage underwriting, particularly those with high loan-to-value ratios. Analysts also voice concern that the rapid expansion of space may be putting downward pressure on lease rates. In light of an ample supply of space and a number of large chains continuing to add space, any valuations that assume future growth in lease rates should be closely reviewed. The viability of rapid expansion on the part of the large retail chains would undergo a particularly severe test in the event of a recession.

Richard A. Brown, Chief, Economic Analysis Section
Diane Ellis, Senior Financial Analyst
Retail Vacancy Rates Rose throughout the Dallas Region in 1996

After declining throughout much of the early to mid-1990s, retail vacancy rates rose in 1996 in all eight of the Dallas Region metropolitan areas covered by The Real Estate Report of the FDIC. The upward trend in retail vacancy rates was not unique to the Dallas Region. The national retail vacancy rate also increased last year, to 7.7 percent from 7.4 percent in 1995. Table 1 compares vacancy rates for the eight Dallas Region metro areas with the national average over the past four years. Retail vacancy rates in the Region are generally higher than the national average, with the exception of Tulsa.

Higher than average growth in population, jobs, and incomes in the Region during this expansion have attracted greater retail development than in most other parts of the country. Now that the Dallas Region is shifting from robust to moderate job growth, the Region could see a cutback in retail construction in 1997 and possibly 1998.

Charts 4 and 5 show the annual changes in the supply and absorption of retail space in the Dallas Region's two largest retail markets: Dallas and Denver. Despite a gradual slowing in job growth for the state of Texas, employment growth remains very strong in Dallas, where the unemployment rate is near a 20-year low. Nonetheless, absorption of retail space cooled off slightly in Dallas in 1996, while the retail vacancy rate increased from 11.1 percent in 1995 to 11.3 percent in 1996. Furthermore, M/PF—a Dallas-based real estate firm—estimates that absorption of Dallas-area retail space was down 60 percent in the first quarter of 1997 compared to a year ago. But M/PF attributes the drop in absorption to a decline in the availability of new retail space rather than a significant drop in demand for store space on the part of retailers. The amount of new space added to the market was about 77 percent less in the first quarter of 1997 than the same time a year ago. M/PF also notes that sluggish retail sales growth is likely to slow future retail development in the Dallas retail market.

The Denver retail market (Chart 5, next page) experienced a large jump in its vacancy rate to 14.9 percent in 1996 from 13.1 percent in 1995, giving it by far the highest rate in the Region. Denver job growth shifted from extremely rapid in 1994 and 1995 to merely strong in 1996. Nevertheless, retailers appear to be planning new retail projects as if metropolitan area

Table 1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>NATIONAL</td>
<td>9.0</td>
<td>7.6</td>
<td>7.4</td>
<td>7.7</td>
</tr>
<tr>
<td>AUSTIN, TX MSA*</td>
<td>12.4</td>
<td>10.1</td>
<td>9.3</td>
<td>10.8</td>
</tr>
<tr>
<td>DALLAS, TX PMSA*</td>
<td>15.5</td>
<td>12.0</td>
<td>11.1</td>
<td>11.3</td>
</tr>
<tr>
<td>DENVER, CO PMSA</td>
<td>13.8</td>
<td>9.8</td>
<td>13.1</td>
<td>14.9</td>
</tr>
<tr>
<td>FORT WORTH-ARLINGTON, TX PMSA</td>
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<td>12.9</td>
<td>12.2</td>
<td>14.0</td>
</tr>
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<td>HOUSTON, TX PMSA</td>
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<td>11.9</td>
<td>11.8</td>
<td>12.3</td>
</tr>
<tr>
<td>OKLAHOMA CITY, OK MSA</td>
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<td>10.9</td>
<td>9.2</td>
<td>9.7</td>
</tr>
<tr>
<td>SAN ANTONIO, TX MSA</td>
<td>13.1</td>
<td>11.2</td>
<td>9.8</td>
<td>9.9</td>
</tr>
<tr>
<td>TULSA, OK MSA</td>
<td>6.8</td>
<td>7.6</td>
<td>7.9</td>
<td>9.6</td>
</tr>
</tbody>
</table>

*MSA = METROPOLITAN STATISTICAL AREA, PMSA = PRIMARY METROPOLITAN STATISTICAL AREA
SOURCE: FDIC REAL ESTATE REPORT, APRIL 1997

Chart 4

Has Dallas Retail Vacancy Rate Bottomed Out in 1996?

Source: FDIC, The Real Estate Report, April 1997
employment were still growing at 5 percent per year or more. Given rising vacancy rates and declining rates of job growth, developers might shelve some projects currently in the planning phase. Even so, Denver’s retail market is drawing a lot of attention, with more than one real estate expert having described it as overbuilt. According to these experts, new entrants to the market have made retailing intensely competitive, threatening the long-term viability of some established local retail chains.

*Adrian R. Sanchez, Regional Economist*
Favorable Conditions Return to the Region’s Oil and Gas Industry

• First-quarter employment numbers continue to point toward a slowing of the Dallas Region’s economy.

• The Region’s oil and gas industry is thriving once again and should be an important source of economic growth in 1997.

• Major employment revisions reveal a significantly weaker New Mexico economy.

First-Quarter 1997 Employment Summary

The Region’s economy continued last year’s slower growth pattern into 1997. Job growth in the Dallas Region peaked in the first quarter of 1995 at 4.4 percent on a year-over-year basis. Since then job growth has cooled, falling below 3 percent by the first quarter of 1996 to 2.6 percent in the first quarter of 1997. This marks the Region’s slowest job growth since 1992. Among the states in the Region, Oklahoma has replaced Colorado as the fastest growing economy, with a job growth rate of 3.2 percent.

Table 1 shows that for each state in the Region, year-over-year job growth slowed during the first quarter of 1997. Similarly, Table 2 reveals that the major industry sectors grew more slowly on a quarterly basis compared with their year-over-year growth rates, with the notable exception of the Region’s mining sector (which includes the oil and gas industry).

Table 1

<table>
<thead>
<tr>
<th>State</th>
<th>Employment (thousands)</th>
<th>% Change from Previous Quarter</th>
<th>% Change from Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Colorado</td>
<td>1,930</td>
<td>2.6</td>
<td>3.0</td>
</tr>
<tr>
<td>New Mexico</td>
<td>700</td>
<td>0.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>1,381</td>
<td>2.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Texas</td>
<td>8,366</td>
<td>1.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Region</td>
<td>12,377</td>
<td>1.7</td>
<td>2.6</td>
</tr>
<tr>
<td>United States</td>
<td>121,238</td>
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<td>2.3</td>
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</tbody>
</table>

Table 2

<table>
<thead>
<tr>
<th>Industry</th>
<th>Employment (thousands)</th>
<th>% Change from Previous Quarter</th>
<th>% Change from Previous Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>652</td>
<td>0.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Government</td>
<td>2,224</td>
<td>0.8</td>
<td>1.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>1,482</td>
<td>0.8</td>
<td>1.5</td>
</tr>
<tr>
<td>Mining</td>
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<td>3.0</td>
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<tr>
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<td>1.5</td>
<td>2.5</td>
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</table>

Optimism and economic activity are surging once again in the oil and gas industry across the Dallas Region. Many of the Region’s major oil companies reaped record profits in 1996, despite oil prices that were only half of what they were 15 years ago, after adjusting for inflation.

The oil and gas industry continued strengthening during the first half of 1997 despite oil prices that have fallen since reaching a single-day peak of $28.10 per barrel on Christmas Eve 1996. A mild winter and increased oil supplies from Iraq helped push oil prices down once again. The price of West Texas Intermediate (WTI) oil as of June 13 was $18.83 per barrel. The Energy Information Administration (EIA) of the U.S. Department of Energy is forecasting fairly stable crude oil and natural gas prices—allowing for normal seasonal differences—for the remainder of 1997 and through-
out 1998 (see Chart 1). Monthly crude oil prices (WTI) are projected to range between $18 and $20 per barrel. Meanwhile, monthly average wellhead natural gas prices are projected to hover between $2.00 and $2.25 per million cubic feet.

Better recovery methods and investment in other technological advances have facilitated expansion into previously untapped oil- and gas-rich areas, according to the EIA. These advances have stabilized energy prices. Stable prices, in turn, should lead to steady development and production of crude oil and natural gas. The Gulf Coast and east Texas have seen tremendous upturns in drilling activity, particularly for natural gas. At their current levels, oil and gas prices have benefited downstream businesses, such as refineries and petrochemical producers, boosting profitability and improving margins substantially.

Analysts report favorable long-term prospects for the oil and gas industry, citing factors such as:

- **Strong demand domestically and in developing nations.** The EIA, in its May 1997 update, is forecasting strong worldwide energy demand (see Chart 2, next page). Rapid growth in Asia (e.g., China), along with strong demand in the mature economies (e.g., the United States), will be the driving forces behind demand. Natural gas is expected to be the fastest growing primary energy source over the forecast period, gaining share relative to oil and coal (see Chart 3, next page).

- **Lower costs.** Producers are able to remain profitable despite lower prices because they have managed to cut expenses significantly, reducing their break-even costs. Producers also have managed to keep a tight rein on inventories and survive on tighter margins.

- **New technologies.** New technologies like three-dimensional seismic mapping and advances in drilling technology allow producers to be far more efficient. Companies are able to find deposits overlooked in the past, increase recoveries from existing fields, and acquire oil and gas from nonconventional sources. Moreover, new technologies and higher oil prices have allowed producers to engage in offshore drilling in deeper waters and other hard-to-reach places.

- **The deregulation of the electricity market.** Efforts at both the federal and state levels are under way that would open up the sale of electricity to free market forces. Natural gas firms could benefit from deregulation, since natural gas is cheap and widely used in the Southwest to generate electricity. Mergers between electric and natural gas firms could increase, with firms jockeying for market share based on rates and service. Sellers may offer one-stop shopping for gas, electricity, and other energy sources.

The Region may be becoming less sensitive to swings in oil prices as a result of diversification. Gary Preuss, an economist with the Texas Comptroller’s Office, estimated energy’s share of state economic output at 10 percent in 1996, down sharply from 26 percent in 1981.

**Obstacles Still Remain:** The oil and gas industry is still faced with problems on several fronts. First, oil and gas firms are having difficulties finding experienced workers, such as machinists. Moreover, prices for certain supplies and materials have increased sharply as demand has risen. Second, oil refineries already are operating at near capacity. In the short run, increased demand can be met only by importing oil from overseas unless new refineries come on line. Furthermore, some analysts contend that years of underinvestment, U.S. environmental regulations, and higher compliance costs relative to other nations have resulted in a shift of new
refinery capacity overseas. Third, a wave of consolidation within the industry is likely to continue. Some analysts expect the high cost of new technology and resources to lead to a more concentrated industry. Oil and gas firms that have disciplined their operations to thrive on narrower profit margins will have a greater likelihood of surviving this consolidation.

Implications for Banking: Once again, commercial banks are aggressively lending to small and middle-tier oil and gas exploration and production companies. Loan volumes in the industry have more than doubled—from $15.7 billion in 1992 to $33.4 billion in 1996—according to Loan Pricing Corporation, a Reuters company based in New York. The implications for bank risks are uncertain. Factors that reportedly have lowered the risk in oil and gas exploration include (1) technological advancements that reduce dry-hole risk and (2) market-hedging techniques that help smooth the effect on revenue from price volatility.

In addition, the lessons of the 1980s are still fresh in the minds of many in this Region. Prudent bankers likely will avoid lending on the expectation of rapidly rising oil prices and will look for companies with good management experience, knowledge of the industry, and proven track records.

Economic Update: Data Revisions Show Slower Growth in New Mexico

Since 1993, New Mexico has vaulted into the ranks of the top ten fastest growing states in the nation, as measured by job growth. As early as this year, payroll employment data continued to characterize the New Mexico economy as robust, with job growth well above the national average. However, when this year’s benchmarked numbers were released in early April, they told a much different story. New Mexico’s employment numbers for both 1995 and 1996 were revised downward, significantly in the case of the latter.

Revisions were greatest in construction, retail trade, and services (see Table 3, next page), industries dominated by small businesses where employment numbers are hard to estimate. The size of the downward revision, and the rate of decline, could be providing an early warning signal of a possible weakening in the state’s economy. At the very least, a large subtraction from growth has altered perceptions about the strength of the New Mexico economy.

In retrospect, the large downward revision in New Mexico’s employment numbers merely reflected what New Mexico’s other economic indicators were already showing—that the state’s economy was slowing. The state’s unemployment rate jumped sharply in 1996, peaking at 8.5 percent in the third quarter—3 percentage points above the nation. Personal income growth decelerated sharply, from 8.3 percent in 1995 to 4.8 percent in 1996. Homebuilders reported a 14 percent drop in permit activity during the second half of 1996, and retailers complained of weak gross receipts during the all-important fourth quarter.

Implications for New Mexico Banking: Despite the revised job numbers, commercial banking in New Mexico...
Mexico turned in another strong profit performance in 1996 with a 1.33 percent return on assets, exceeding the national average of 1.19 percent. Profitability continued to be based upon high and rising net interest margins and good credit quality. Meanwhile, nonperforming assets were in line with the national average. Slowing growth in 1997, however, could make it more difficult for bankers to continue to achieve such a strong performance.

Adrian R. Sanchez, Regional Economist
Financial Markets

- Deteriorating credit quality trends in the rapidly growing home-equity backed securities market could portend trends in bank residential mortgage lending.

- Financial asset securitization investment trusts, known as FASITs, promise to change the asset-backed securities market significantly and could make securitization more accessible to community banks.

- The Treasury yield curve is steeper and higher than it was at year-end 1996.

- During the first quarter of 1997, the Dallas Region’s Community Bank Index gained steadily despite disturbance in the broad market and other bank indices.

Trends in the Home-Equity Asset-Backed Market Are Important to Banks

The home-equity loan (HEL) asset-backed securities (ABS) market has grown by over $20 billion or 251 percent since 1993, with total issuance of HEL ABS topping $27 billion in 1996 (see Chart 1). The rapid growth of the market, which has been driven largely by consumer debt consolidation lending, has been accompanied by abnormally early and high levels of delinquencies. Banks that are investing in HEL ABS, considering securitizing HELs, or lending significantly for debt consolidation should be aware of credit quality developments in the HEL ABS market.

The distinction between HELs and first-lien residential mortgages is eroding in the HEL ABS market. The refinancing boom spurred by the decline in rates during 1993 and early 1994 resulted in a change in the makeup of the HEL ABS market, causing much higher percentages of the securities to be backed by first-lien HELs than previously had been the case. First-lien home-equity lending, know as cash-out refinancing, grew substantially when home-equity borrowers were motivated by lower rates to refinance their first mortgages for amounts greater than the remaining principal balance instead of adding a second mortgage.

Debt consolidation is the primary reason for home-equity borrowing. Nonbanks that expanded their mortgage lending capacity during 1993 have been aggressively marketing to an increasing number of borrowers who desire to consolidate their growing debt burdens. According to the Consumer Bankers Association 1997 Home-Equity Loan Study, debt consolidation accounted for 36 percent of home-equity lines of credit and 40 percent of closed-end loans. Prior to 1992, home improvement was the primary reason for home-equity borrowing. This trend toward debt consolidation as the reason for home-equity borrowing has significant risk implications because, unlike funds lent for home improvement, the proceeds of a debt consolidation loan do not enhance the lender’s collateral value.

The rapid growth of the HEL securitization market has been attended by signs of relaxed underwriting. Adverse credit quality trends have been particularly prominent for loans that were originated in 1995. Chart 2 (next page) shows the total delinquency rates for closed-end loan pools originated in 1995 versus 1994. The sharp upward path of delinquency rates for loan pools originated in 1995 raises concern that aggressive competition for volume, and apparently relaxed underwriting standards, could lead to unprecedented default levels. Furthermore, HEL originations in 1996 more than doubled 1995 levels, causing market observers to suspect that underwriting standards continued to lapse.

Chart 1

Securitization of Home Equity Loans Has Risen Substantially

Source: Moody's Investors Service
The trends in the HEL ABS market may portend credit quality trends in nonsecuritized cash-out refinancing. If similar unfavorable trends exist in bank-originated cash-out refinancing, evidence of these trends would be obscured by banks’ larger and less risky portfolios of purchase mortgage loans. The trends would be obscured because banks report all first mortgage lending on 1 to 4 family residential properties without distinguishing between purchase mortgages and cash-out refinancings. The unfavorable trends in the HEL ABS market suggest that banks that engage in significant cash-out refinancing and other forms of home-equity lending should be able to monitor trends in the credit quality of these loans separate from purchase mortgage loans.

A Combination of Several Factors Could Induce More Banks to Securitize HELs

Although the present volume of bank-originated HEL securitizations is relatively small, banks have recently entered this finance company-dominated market, and a combination of several factors is likely to cause more to follow: First, home equity lines of credit are currently growing at rates exceeding total consumer lending, and, by and large, the deposit growth to fund this lending is less robust. In addition, according to Moody’s Investors Service, investor demand is high for bank-originated home-equity line of credit securitizations because bank-originated lines are perceived to have lower credit risk. The funding benefits and profitability of securitizing bank-originated home-equity lines of credit could entice more banks into the securitization market. Finally, the combination of these factors with the potential cost savings provided by using the new financial asset securitization investment trust (FASIT) structure (see discussion below) could produce momentum that will result in banks, large and small, securitizing home equity loans in significantly increased amounts.

Securitizing HELs can change the balance sheet and income statement of the securitizer significantly, resulting in significant servicing assets and gains on sale. Beginning in 1997, when a company sells loans, it must comply with the requirements of Financial Accounting Standard (FAS) 125. If the company retains servicing rights on the assets sold, FAS 125 requires the seller to book an asset related to the gain on sale that represents the future income derived from servicing the loans. This asset is similar to mortgage servicing rights in that it represents the present value of future expected cash flows derived from loan servicing. One major home-equity securitizer, which indicated that FAS 125 would not materially affect its financial statements, reported servicing assets at almost 90 percent of equity, and gains associated with the sale of serviced assets at 71 percent of total revenue.

The value of servicing assets is based on management’s assumptions about the future cash flows to be generated by the assets. Because these assumptions are based largely on historical performance, unexpected deterioration, like that associated with 1995- and possibly 1996-originated loans, that results in charge-offs or early repayment through foreclosure of serviced assets, could require the adjustment of the valuation assumptions and the write-down of the servicing assets.

FASITs Promise to Change the ABS Market

The Small Business Job Protection Act of 1996 created two new sections of the Internal Revenue Code that create and govern FASITs. The FASIT provisions, patterned in part on the real estate mortgage investment conduit (REMIC) rules issued in 1986, are intended to provide tax certainty for ABS issuers and purchasers and enhance the flexibility of asset securitizations. The FASIT provisions take effect on September 1, 1997.

The advent of the FASIT is likely to change the ABS market in important ways. First, the FASIT will clarify the tax treatment of securitizations. Because of the current tax ambiguity, designing ABS structures to avoid
taxation is administratively costly, and it restricts the forms that securitizations can take. The higher administrative cost associated with current securitization techniques establishes a practical minimum size for asset pools that can be feasibly securitized. With FASITs and the reduced costs associated with tax clarity, the economically feasible pool size may be significantly smaller. The lowering of this threshold could result in more community banks entering the securitization market.

ABS issuers believe that the market for their product has been hampered by the restrictive nature of current asset-backed tax ambiguity, which prevents them from responding to investor preferences for varying maturities, coupon types, and prepayment and credit risk profiles. FASITs allow sponsors the flexibility to create multiple-class securities that satisfy these preferences with the certainty that the securities will count as debt and that the FASIT will not be treated as a taxable corporation. This combination of flexibility and tax certainty could lead to the kind of innovations in ABS structures that followed the 1986 REMIC legislation, which brought analogous benefits to the mortgage-backed market.

FASITs will bring to the ABS market the ability to add and remove assets throughout the life of a securitization. This feature could be applied by securitizing revolving construction loans and then replacing the revolving loans with permanent financing when construction is completed. A FASIT also will be able to contain a mixed pool of assets such as real estate, non-real estate assets, and unsecured credit, allowing exposures to very different markets from the same security. Finally, a FASIT can hold swaps and other hedging instruments. Using this feature, an issuer could combine a mortgage passthrough security with a hedging instrument that is designed to offset mortgage prepayment risk, such as a reverse-index amortizing swap.

The increased flexibility that the FASIT promises to bring the ABS market comes with the potential for greatly increased complexity and risk. Banks that invest in FASIT securities will need to understand fully not only the risk characteristics existing at the outset of security but also the risk that could arise throughout the security’s life if assets are to be removed and replaced.

Changes in Interest Rates and Bond Values

The Treasury yield curve (see Chart 3) rose following March 25, 1997, when the Federal Open Market Committee (FOMC) met and raised the target federal funds rate 25 basis points to 5.50 percent. The yield on the 30-year Treasury bond rose above 7 percent on the Thursday following the meeting and remained there for the next 23 days. The FOMC met again on May 20, 1997, and left the target rate unchanged.

The model portfolio responded to the rise in rates, but only modestly (see Table 1). The relatively short weighted average maturity of the portfolio served to moderate the effect of the 54 basis point rise in the five-year Treasury between December 31, 1996, and March 31, 1997. As discussed in Regional Outlook, Second Quarter 1997, changes in the value of the model portfolio correlate more with changes in the five-year Treasury rate than with the 30-year bond rate.

The yields along the April 30, 1997, yield curve imply that the market expects the curve to continue to flatten through the remainder of the year with short rates rising somewhat. In order to gauge what affect a 25 basis point rise in the yield curve could have on bank fixed-income portfolios, the model portfolio has been “shocked” to simulate the effect of an instantaneous 25 basis point shift in the yield curve on May 28, 1997.

Again, the interest rate risk benefits of maintaining a portfolio of relatively short weighted average life are apparent. The U.S. Treasury and the agency, the shortest lived instruments, and the floating-rate ABS demon-
Table 1

<table>
<thead>
<tr>
<th>Type of Security</th>
<th>Par Value</th>
<th>Percent of Portfolio</th>
<th>Maturity or WAL as of 12/31/96</th>
<th>Percent Change from 12/31/96 to 3/31/97</th>
<th>Change Resulting from a 25 bp Rate Increase on 5/28/97</th>
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<tbody>
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<td>U.S. Treasury 5.6%</td>
<td>2,000</td>
<td>20%</td>
<td>1 YR</td>
<td>-0.30%</td>
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<tr>
<td>FNMA Agency 5.8% Callable</td>
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<td>12%</td>
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<td>-0.50%</td>
<td>-0.38%</td>
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<tr>
<td>State County Municipal GO 4.8%</td>
<td>800</td>
<td>8%</td>
<td>11 YR</td>
<td>-2.05%</td>
<td>-2.03%</td>
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<td>FNMA Mortgage PassThrough 7.5%</td>
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<td>30%</td>
<td>8 YR</td>
<td>-1.78%</td>
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<tr>
<td>FNMA (REMIC) 8.0% PAC</td>
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<td>20%</td>
<td>2.5 YR</td>
<td>-1.27%</td>
<td>-0.50%</td>
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<tr>
<td>Credit Card Asset-Backed Security</td>
<td>1,000</td>
<td>10%</td>
<td>5 YR</td>
<td>-0.09%</td>
<td>0.00%</td>
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<tr>
<td>TOTAL</td>
<td>10,000</td>
<td>100%</td>
<td>4.85 YR</td>
<td>-1.08%</td>
<td>-0.77%</td>
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</table>

Note: Portfolio composition based on estimates derived from aggregated Bank Call Report information.

strate the least price sensitivity. The municipal bond is the most sensitive to rate changes owing to its longer maturity. The mortgage passthrough security also is more sensitive to rising rates because its weighted-average life (WAL) extends as rising rates discourage the underlying mortgage holders from prepaying their loans. The decline in prepayment rates results in extending the maturity of the security while rates are rising, a combination unfavorable to the security’s value.

Community Bank Stocks in the Dallas Region Performed Smoothly Despite Turmoil in the Broad Market during the First Quarter of 1997

Both the Standard & Poor’s (S&P) Composite Bank Index and the Dallas Regional Bank Index have been subject to similar performance swings this year, but the Dallas Regional Bank Index underperformed the S&P 500 through May 2, 1997 (Chart 4). The S&P Composite Bank Index, with an almost 13 percent gain by May 2, 1997, was still short of its year-to-date high on March 7, 1997, at which time it was up almost 20 percent on the year. The Dallas Region’s Community Bank Index was spared much of the influence of a gyrating market, rising in value steadily to a 10.27 percent gain through May 2, 1997, enough to outperform the Dallas Regional Bank Index but not the S&P Composite Bank Index.

Allen Puwalski, Banking Analyst
Regional Banking Conditions

- Favorable performance continues into 1997 for banks and thrifts in the Dallas Region

- Recent weather conditions pose yet another challenge to farm banks in western Oklahoma and the Texas Panhandle

- Home equity lending may soon arrive in Texas

- Institutions in the Dallas Region take advantage of the subchapter S corporation tax structure

Overall Conditions Are Favorable

First-quarter results show continuing favorable performance for banks and thrifts in the Dallas Region (see Chart 1). Banks and thrifts in the Region have outperformed the national average in return on assets (ROA) for ten consecutive quarters; however, the Region’s 1.22 percent ROA for the first quarter of 1997 has narrowed to only 2 basis points above the national average. In addition, the Region’s institutions:

- enjoyed an eighth consecutive quarter of widening in the net interest margin, now at 4.32 percent of average assets, in contrast to the second quarterly decline in the nation’s average—now at 4.05 percent;

- increased the leverage capital ratio to 8 percent; and

- continued to modestly increase past-due and noncurrent loans.

The Region’s asset quality has shown modest deterioration in recent years, but it is difficult to know whether this marks the beginning of a trend.

Although Chart 2 shows a slight but continuing rise in past-due and noncurrent loans over the past three years, the current levels remain well within historical norms. For example, during 1987 through the second quarter of 1997, past-due and noncurrent loans in the Region ranged from 14.79 percent of total loans in 1987 to 2.06 percent in 1995 and averaged 6.45 percent.

A More Focused Look at Farm Loans in Western Oklahoma and North Texas

In the second-quarter 1997 Regional Outlook, we commented on potential asset quality problems for farm banks, particularly those in the wheat-growing areas of western Oklahoma and the Texas Panhandle. Farm banks are defined as institutions with agricultural loans...
of 25 percent or more of gross loans. Interestingly, asset quality for farm banks in both states held steady, and overall performance indicators showed improvement during the first quarter of 1997 (see Table 1).

These recent performance trends are encouraging, considering the succession of adverse events affecting area farmers over the past few years. These have included several years of adverse weather conditions, poor wheat harvests, and, until recently, weak cattle prices. More recently, a freeze struck Kansas, Oklahoma, and the Texas Panhandle on April 11 and 12, and many wheat farmers’ crops have been hit by hail, once again jeopardizing wheat production, particularly in southwest Oklahoma. Early harvest results and agronomist surveys are indicating much better results than were feared after the April freeze. However, cash wheat prices (Kansas City hard red winter wheat) have dropped from $5.94 per bushel to $3.92, or 34 percent over a 12-month period ending June 19, 1997, reflecting anticipation of higher production. While improved production should help alleviate pressures on farm bank asset quality, the price decline is decreasing the profit potential for many farmers.

Even though cattle prices have increased by over 50 percent since April 1996, many cattle producers have not reaped the full benefit since they were forced into sale at last summer’s low prices by drought conditions, or were otherwise forced to pay higher feed costs. However, looking forward, prospects appear to be improving for the cattle sector, which accounts for 48 percent of agricultural revenues for Oklahoma and 47 percent for Texas. Prices are more favorable, feed costs are lower, and drought conditions have eased.

### Table 1

<table>
<thead>
<tr>
<th></th>
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<tr>
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<td>1.42</td>
<td>1.15</td>
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<tr>
<td>NPA</td>
<td>1.26</td>
<td>1.26</td>
<td>1.01</td>
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<tr>
<td><strong>Full Year 1996</strong></td>
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<tr>
<td>ROA = net income to total assets</td>
<td>1.06</td>
<td>1.42</td>
<td>1.15</td>
</tr>
<tr>
<td>NPA = nonperforming assets to total assets</td>
<td>1.26</td>
<td>1.26</td>
<td>1.01</td>
</tr>
</tbody>
</table>

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### Home Equity Lending in Texas

Unlike any other state in the nation, Texas prohibits borrowers from using equity in their homes as collateral for loans other than home improvement loans. This prohibition, part of the “homestead exemption,” was written into the state’s constitution upon Texas’s induction into statehood in 1845, with the idea of helping protect homeowners against losing their homes through foreclosure. Currently, the only encumbrances allowed on residential real estate designated as a homestead are purchase money mortgages, home improvement loans, tax liens, or court-imposed partitions to divide a property into shares of unequal value, whereby a lien is imposed for the difference.

After many years of unsuccessful effort, the Texas House of Representatives and the Senate passed House Joint Resolution #31 by the required two-thirds vote necessary to place the issue before Texas voters on November 4, 1997. A simple majority vote would amend the state’s constitution and place the bill into law effective January 1, 1998. Many politicians, lenders, and analysts now believe the chances for passage are high because the resistance to permitting this type of lending has weakened. In addition, a Wall Street Journal poll found that 62 percent of Texans would vote for allowing borrowing against the equity in their homes. Only 24 percent said they would vote against the measure.

The proposed amendment contains a variety of restrictions:

- Home equity lines of credit (revolving balances) would not be allowed.
- Fees and charges to make the loan would be limited to 3 percent of the loan amount.
- A homeowner would be able to borrow only to 80 percent of the fair market value of the residence.
- There would be a 12-day waiting period between the application date and the date the loan could be funded.
- In the event of default, foreclosures would have to be reviewed by a state judge.
Except in the event of fraud, lenders would not be able to seek personal liability from the homeowner for any deficiency between the amount of the home equity loan and the eventual sale price of the home following foreclosure.

This last restriction, which forbids a bank from pursuing deficiency judgments, is a key reason why the Independent Bankers Association of Texas—generally composed of smaller institutions—opposed the bill in its final form. In contrast, large nationwide companies have been lobbying hard for home equity lending in Texas and are expected to support the bill, given the perceived advantage to their branch networks of marketing and originating these loans.

Home equity loans nationwide account for approximately 6 percent of bank lending. At March 31, 1997, Texas banks reported $139.9 billion in total loans. While the numerous restrictions make it difficult to draw analogies to the broader national experience, some analysts estimate that the volume of home equity loans could grow to approximately $8 billion if Texas were to approximate national averages. State authorities estimated last year that the total equity in Texas homes was $123.4 billion. Other analysts’ estimates are much higher, in the $200 billion range. The state’s estimate of $8.7 billion as a potential market for home equity lending in Texas is consistent with the estimate based on the national experience.

Home equity lending would not necessarily represent new lending, but could replace to some extent other types of consumer lending such as credit card debt. The advantages of home equity lending include a stable collateral source for the lender and tax deductibility of interest payments for the borrower. According to a Federal Reserve Bank of Dallas study, the primary uses of home equity loans are to pay off other debts (40 percent) and to make home improvements (38 percent).

For lenders in Texas, the advent of home equity lending could present an opportunity to expand their collateralized consumer lending business and could provide a source of additional fee income and a way to expand the customer base to cross-sell other products and services. Should home equity lending become available in Texas, competition will likely be intense as lenders of all types endeavor to capture market share. For example, one large consumer finance company has already obtained state approval to open 100 offices in Texas. (For related information on home equity lending, see Financial Markets.)

### Table 2

Subchapter S Corporation Banks

<table>
<thead>
<tr>
<th></th>
<th>MUTUAL INSURED</th>
<th>NATIONAL</th>
<th>NON-MEMBER</th>
<th>STATE MEMBER</th>
<th>TOTAL</th>
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<td>1</td>
<td>55</td>
<td>72</td>
<td>3</td>
<td>131</td>
</tr>
<tr>
<td>ASSETS ($MILLIONS)</td>
<td>$1,324</td>
<td>$5,020</td>
<td>$4,068</td>
<td>$94</td>
<td>$10,506</td>
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<tr>
<td>U.S. #</td>
<td>3</td>
<td>132</td>
<td>344</td>
<td>30</td>
<td>509</td>
</tr>
<tr>
<td>ASSETS ($MILLIONS)</td>
<td>$2,791</td>
<td>$12,408</td>
<td>$20,735</td>
<td>$2,246</td>
<td>$38,180</td>
</tr>
</tbody>
</table>

Source: Bank Call Reports as of 3-31-97

Institutions in the Dallas Region Take Advantage of the Subchapter S Corporation Tax Structure

In the first-quarter 1997 Regional Outlook we reported that the Small Business Job Protection Act of 1996 allows closely held banks, thrifts, and holding companies to take advantage of various pass-through benefits of the subchapter S corporation tax structure. In less than one year’s time since passage, 3.9 percent, or 509 banks and thrifts nationwide with $38.3 billion in assets, have elected to switch to subchapter S status. In the Dallas Region, 8.3 percent, or 131 banks and thrifts with $10.5 billion in assets, have changed tax structures. Of these, 85 percent have total assets under $100 million. Table 2 shows a distribution by charter type of the banks in the Region that have made this election as compared with those in the nation.

The Region’s greater use of the subchapter S election may be attributable to its large number of small, closely
held banks. At March 31, 1997, 1,102 banks, or 70 percent of the Region’s total, had assets under $100 million. Moreover, an American Bankers Association/ABA Banking Journal Community Bank Competitiveness Survey (American Bankers Association / ABA Banking Journal, April 1997) reports that 53 percent of the community banks surveyed in the Southwest (assets under $1 billion) feature a controlling interest held by one family, compared with 38 percent nationwide.

At this writing, there is a proposed federal budget measure that would impose initial taxes upon banks and thrifts adopting S corporation status that, according to CFO Alert (May 12, 1997), “would make the status unfeasible to pursue.” Given the large number of eligible banks in the Region, there may be accelerated activity in S corporation adoption in advance of this potential “entry tax.”

Alan C. Bush, Senior Regional Analyst
Jeffrey A. Ayres, Financial Analyst
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