



SECOND QUARTER 2010

# Southwest Economy

FEDERAL RESERVE BANK OF DALLAS

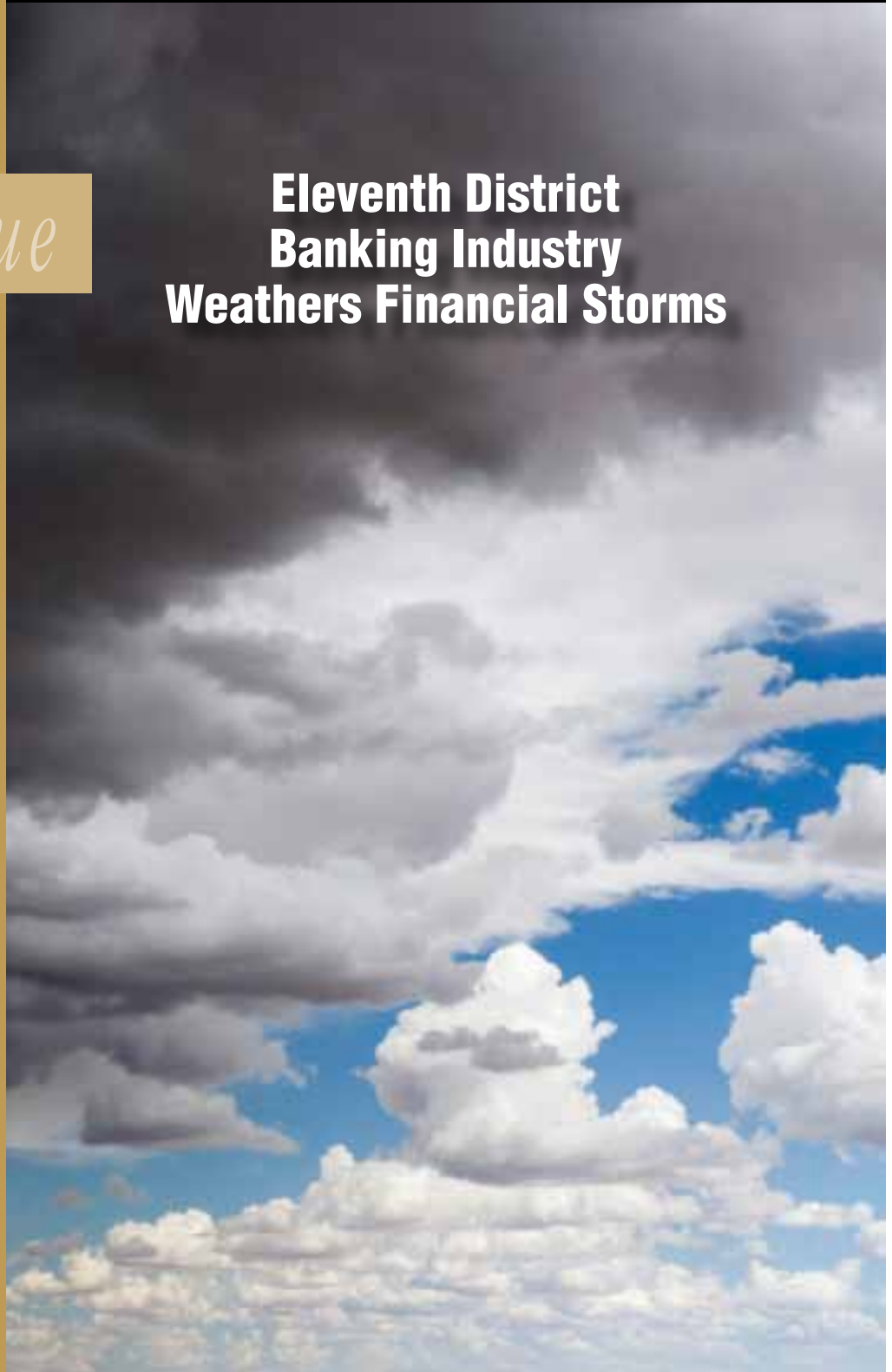
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# President's Perspective



*Given the reach and impact of community banks, it is essential for the formulation of sound monetary policy that we understand the ins and outs of their industry.*

The financial crisis put a spotlight on the health of the largest financial institutions and their impact on the economy. While these enormous entities dominate the financial system, they are by no means the only game in town. Often overlooked is the economic impact of the relatively small banks on Main Street—community banks.

These institutions—locally owned and operated banks with total assets of less than \$10 billion—have stepped in to support, and in many cases even become, the local banking system.

Since they do not answer to distant directors, community banks can make decisions quickly, giving them the flexibility to extend credit in places larger institutions may miss. Community banks are an important source of credit for local enterprises, holding close to 60 percent of small business loans outstanding. Most important, community bankers truly “know their customers,” as the old banking adage goes—not just from interactions in the office but from contacts at civic clubs, restaurants and churches.

Community banks have a fairly large national presence—despite holding only about a quarter of total industry deposits, they account for about 99 percent of all U.S. banking institutions.

Community banks have a substantial presence in the Eleventh District, matching the nation’s 99 percent of banking institutions. In contrast to the nation, community banks hold close to 40 percent of the district’s total deposits and almost two-thirds of its outstanding small-business loans. This extensive community bank presence—when combined with the larger regional banks that call the district home—adds to the diversity of our banking industry.

Given the reach and impact of these banks, it is essential for the formulation of sound monetary policy that we understand the ins and outs of their industry. To gain that insight, I rely heavily on input from the local bankers on the Dallas Fed’s board of directors, our regional research team and our bank supervision staff, which interacts with community and regional banks on a routine basis.

Regular, in-depth assessments of our smaller, local banks—a sample of which *Southwest Economy* readers will see in the pages that follow—better prepare me to participate in Federal Open Market Committee deliberations on national monetary policy.

Richard W. Fisher  
President and CEO  
Federal Reserve Bank of Dallas



# Eleventh District Banking Industry Weathers Financial Storms

By **Kenneth J. Robinson**

*Eleventh District banks  
were roughly “twice as  
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In 2009, the banking industry continued to feel the fallout from the financial crisis that began in mid-2007. Profitability declined while asset-quality problems continued to mount at banks across the nation and at those based in the Eleventh Federal Reserve District.<sup>1</sup> Some good news was revealed in recently available first-quarter data, however, which showed profitability rebounding and increases in asset-quality problems slowing down. Whether measured by profits or problems, Eleventh District banks were roughly “twice as good and half as bad” as their counterparts across the nation. Most likely, this reflects the fact that the economic downturn was less severe in the district than in other parts of the nation.

Another noticeable difference emerges when comparing district banks’ recent performance with an earlier period when the economy turned south and the industry suffered significant damage—the mid- to late 1980s. At that time, students of banking history may

recall, a sharp decline in oil prices triggered a deep regional recession. Bank failures soared, and the financial landscape in Texas and other parts of the Southwest changed considerably.

This raises the question of why the district’s banking industry has been able to weather the current downturn—so far—with less damage than in the 1980s. The answer likely can be found in the changing nature of the district’s economic environment since then.

## Basic Performance

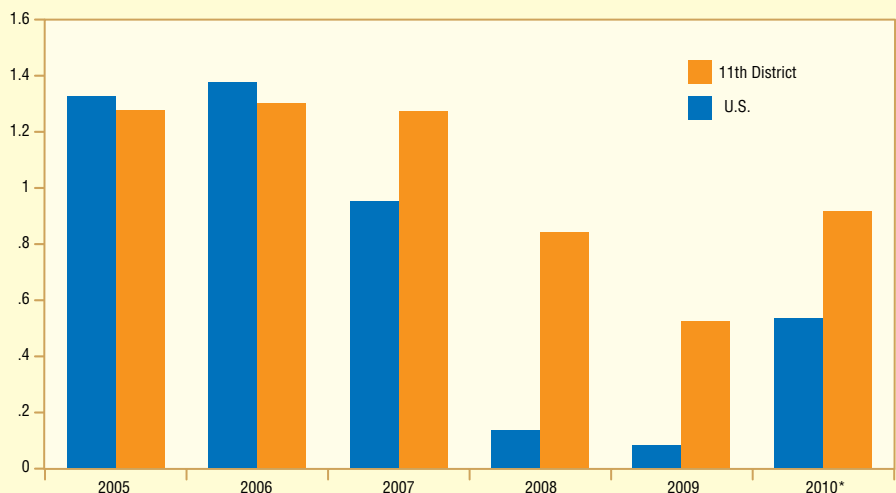
Bank profitability, as measured by return on assets (ROA), continued to decline in 2009 but rebounded in the first quarter of 2010. U.S. banks earned an annualized return of 0.53 percent in the first quarter, up from 0.08 percent for all of 2009. Eleventh District banks recorded an annualized ROA of 0.91 percent in the first quarter, compared with 0.52 percent in 2009 (*Chart 1*).

Reflecting the tough economic environment, almost one-third of all banks nationwide

Chart 1

### Recent Bank Profitability Stronger in the 11th District

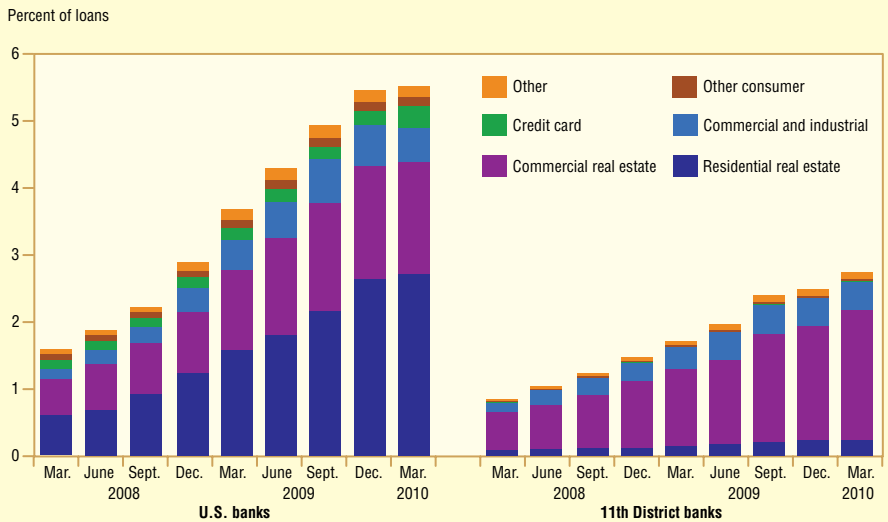
Return on average assets (percent)



\*Data are through March 31, annualized.

SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

**Chart 2**  
**Noncurrent Loans Differ Between U.S. and 11th District Banks**



SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

*The proportion of assets in commercial real estate loans was 24 percent at district banks, almost double the 13 percent at banks nationwide.*

were unprofitable in 2009, while 14 percent in the district suffered losses. For the first quarter, those numbers improved to 19 percent of banks nationwide and 11 percent of district banks that were unprofitable.

The biggest contributor to profitability was net interest income, or the difference between what banks earn on loans and what they pay on deposits. The main factor behind banks' deteriorating performance was a result of increased provisions for loan loss reserves. This "provision expense" is the amount banks set aside out of income to cover estimated future loan losses. Increases in provision expense imply that banks have been attempting to build larger cushions to protect themselves from loans that go bad.

Provision expense at U.S. banks rose to a record annual high of 2 percent of average assets in 2009 but fell back a bit to 1.6 percent (annualized) in first quarter 2010.<sup>2</sup> In the district, provision expense was 1.2 percent in 2009 and declined to an annualized 0.72 percent in the first quarter.

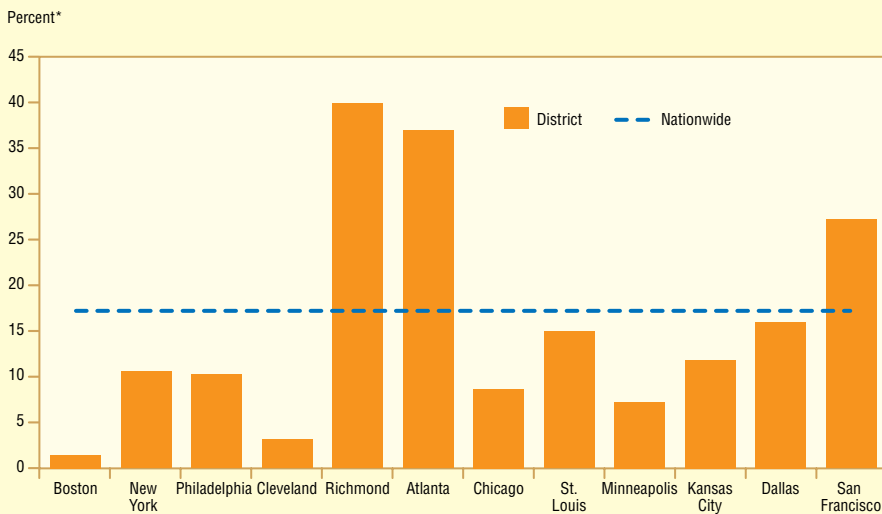
As the economy continued to exhibit weakness, asset-quality problems mounted, mostly in the form of delinquent loans. For U.S. banks, the percentage of loans that were noncurrent—those with payments 90 days or more past-due plus those not accruing interest—increased to slightly more than 5.5 percent in the first quarter, the highest on record. The district noncurrent loan rate also rose but, at 2.7 percent, was much lower than the national figure.

The composition of loans that were noncurrent, though, differed between U.S. and Eleventh District banks (*Chart 2*). At banks nationwide, residential real estate loans represented the bulk of noncurrent loans, followed by commercial real estate loans. In the district, commercial real estate loans were the dominant source of noncurrent loans. A factor in this pattern was district banks' making fewer residential loans and more commercial real estate loans than their national counterparts.

According to the Federal Housing Finance Agency house price index, Texas' annual housing price appreciation peaked at 6.3 percent in early 2007, far below the nationwide peak of almost 12 percent in 2005. Before the onset of the housing bubble, in 2000, residential mortgages accounted for 10 percent of Eleventh District banks' assets, compared with 14.5 percent at U.S. banks. In 2005, residential mortgages accounted for 9.4 percent of district banks' assets, compared with 18.2 percent at U.S. banks. The reduced proportion of residential mortgages at Eleventh District banks could be due to the fact that the housing bubble didn't inflate as much in the district.

At the end of first quarter 2010, the proportion of assets in commercial real estate loans was 24 percent at district banks, almost double the 13 percent at banks nationwide. Within the category, banks report their lending across three main segments—loans secured by nonfarm nonresidential properties,

**Chart 3**  
**Bank Performance on Loan Guidance Varies**  
 (Construction and land development loans)



\*Banks with construction and land development loans greater than total risk-based capital as of March 31, 2010.  
 SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

loans secured by multifamily residential properties, and loans for construction and land development.

As its name implies, the third loan segment finances land improvements prior to building new structures or the construction of industrial, commercial or residential buildings. This is generally considered the riskiest type of commercial real estate lending and has thus been of concern to bank supervisors. In fact, federal regulators issued guidelines in 2007 for banks regarding the extent of their construction and land development lending. The guidance provides a principle-based discussion of supervisory expectations for sound risk-management practices for banks with loans of this type exceeding 100 percent of total capital (adjusted for the riskiness of their assets and off-balance-sheet exposures).<sup>3</sup>

At the end of the first quarter, the percentage of banks that exceeded the guideline varied considerably across the nation. The Richmond, Atlanta and San Francisco districts were well above the U.S. average of 17 percent (*Chart 3*). At 16 percent, the Dallas district was slightly below average. However, the Eleventh District's noncurrent rate for construction and land development loans was roughly half that of banks nationwide.

Banks nationwide and in the Eleventh District have taken steps to deal with their asset-quality problems by writing off bad loans. For U.S. banks, charge-offs net of any

recoveries that have occurred reached an annual record of 2.6 percent of average loans last year, while Eleventh District net loan charge-offs stood at 1.2 percent.

Banks have set aside a record amount of provision expense to try to cover their bad loans. Despite increases in both loan charge-offs and provision expenses, banks

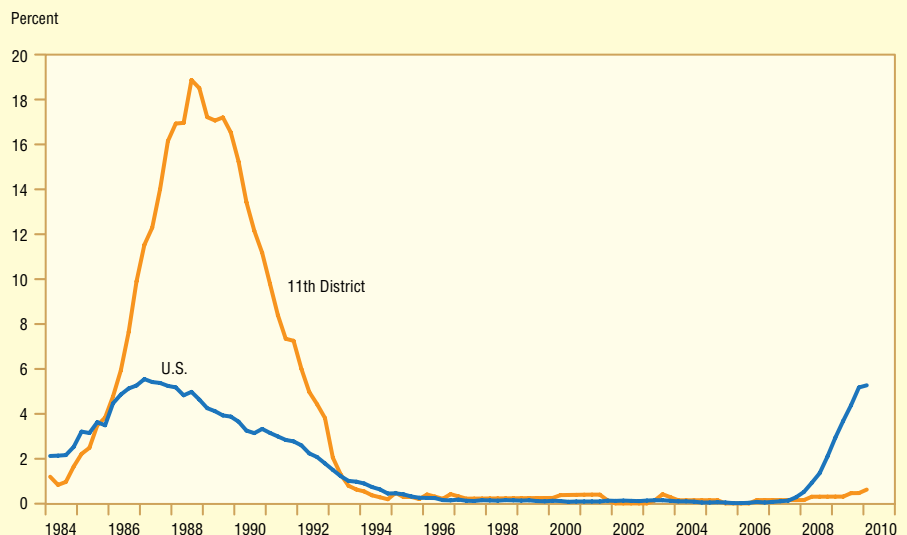
saw further declines in the reserve coverage ratio of noncurrent loans, that is, the cumulative amount of reserves that banks have to cover their bad loans relative to the total amount of bad loans on their books.

For U.S. banks the reserve coverage ratio stood at 67 percent at the end of the first quarter, down from the year-ago level of 71 percent, and at Eleventh District banks the ratio was 59 percent, down from 82 percent a year ago. In other words, banks added more and more to their cushions to protect them from bad loans and continued to write off bad loans; yet, the total amount of loans becoming noncurrent increased even faster.

How do today's banking troubles compare with past ones? One frequently used gauge of overall banking-sector distress is the so-called Texas ratio, which attempts to assess banks' ability to withstand losses. It measures a bank's noncurrent loans and repossessed real estate as a percentage of loan loss reserves and stockholders' capital, including retained earnings but not intangibles such as goodwill. A Texas ratio above 100 percent suggests the potential for troubled assets to wipe out a bank's capital base.

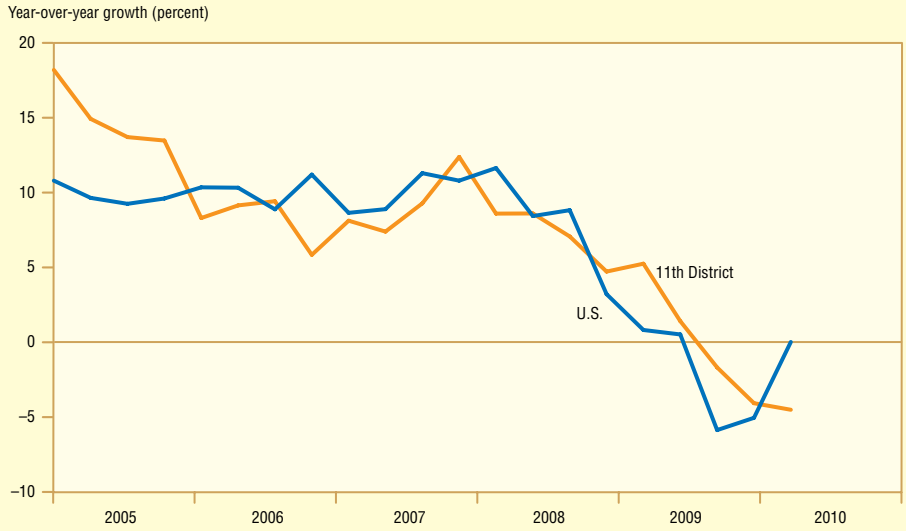
In the 1980s, almost 20 percent of Eleventh District banks had a Texas ratio exceeding 100 percent—thus the origin of its name. In first quarter 2010, though, 0.6 percent of Eleventh District banks were at this danger threshold (*Chart 4*). The percentage of U.S.

**Chart 4**  
**The Texas Ratio Is not About Texas Anymore**  
 (Percentage of banks with a Texas ratio\*  $\geq 100\%$ )



\*The Texas ratio is defined as noncurrent loans plus other real estate owned as a percentage of tangible equity capital plus loan loss reserves.  
 SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

**Chart 5**  
**Pace of Lending Declines at Banks in District and Nationwide**



SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

*Increased lending at community banks is an encouraging sign, especially for small businesses that tend to rely on these institutions for their financing needs.*

banks in danger is approaching national levels of the late 1980s, the last period of major banking-sector difficulties.

### Lending Activity

Declines in profitability and continued asset-quality problems make it difficult for banks to provide the economy much-needed credit. Banks don't report the amount or number of new loans, only the total amount of loans outstanding, net of any charge-offs and loans paid down or paid off. By this measure, lending has been slowing for some time at both U.S. and Eleventh District banks (*Chart 5*).

The willingness or ability of banks to make loans has likely been affected by the recession that began in December 2007. But the demand for bank loans should fall as well. In fact, according to the Federal Reserve's "Senior Loan Officer Opinion Survey on Bank Lending Practices," banks have been reporting weak loan demand from both businesses and households for several years.<sup>4</sup>

It should be stressed, though, that some banks are lending. More than half of all U.S. community banks—defined here as those with assets less than \$1 billion—reported increased lending from first quarter 2009 to first quarter 2010, while 38 percent of larger banks reported increases. The comparable numbers were even higher for Eleventh District banks (*Chart 6*).

Increased lending at community banks is an encouraging sign, especially for small

businesses that tend to rely on these institutions for their financing needs.

### Banks and the Economy

Whether measured by profitability or asset quality, banks based in the Eleventh District have been outperforming their counterparts nationwide, even in the midst of a deep recession. This leads to the first of two interesting questions: Why have district banks been doing better?

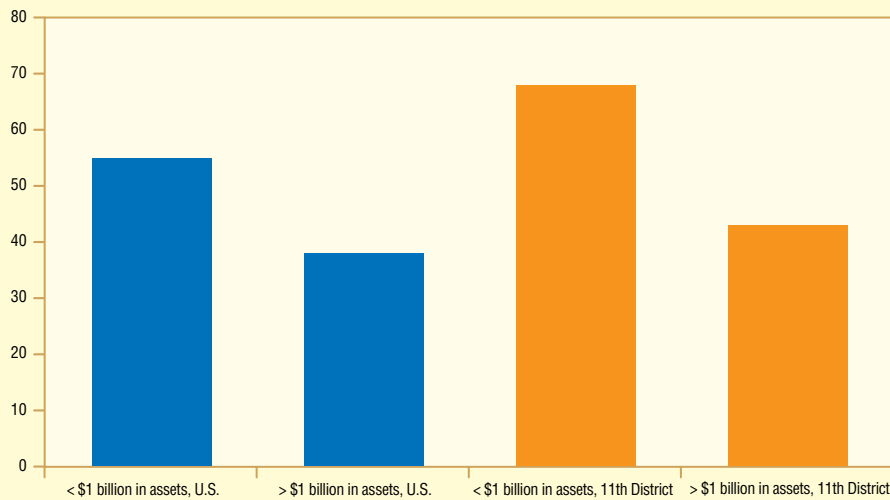
The most plausible answer is the regional economy's performance relative to the U.S. as a whole. The Eleventh District entered the recession later than other parts of the country, and its decline in economic activity was by some measures less severe.

For example, since the recession's start in December 2007, Eleventh District employment has fallen about 2 percent, the smallest job-loss rate among all 12 Federal Reserve Districts and substantially below the nation's 5.3 percent decline. More recently, the Eleventh District's economy has been showing signs of improving, along with the overall U.S. economy.<sup>5</sup>

What's more, the Texas housing market hasn't had the kind of wrenching correction experienced elsewhere—for two reasons. First, the district's housing-price appreciation was relatively muted when compared with other parts of the nation. Second, it was generally more difficult for Texans to use their houses as collateral to leverage up their balance sheets.

## Chart 6 Banks Are Lending

Percent increasing lending\*



\* March 31, 2009, through March 31, 2010

SOURCE: Report of Condition and Income from the Federal Financial Institutions Examination Council.

Texas has fairly strict standards concerning mortgage lending. For example, a homeowner's total mortgage debt—the existing mortgage plus projected home-equity loans—can't exceed 80 percent of the home's current fair-market value. Such restrictions provide borrowers and lenders some protection against declines in property values.

In addition to faring better than the nation, the district's banking industry also avoided a repeat of the troubles that accompanied the previous banking crisis in the 1980s.

Those were the worst of times for the region's banks. Declines in oil prices triggered two regional recessions, which led to widespread and deep banking-sector difficulties. Return on assets fell to a low of -3.5 percent in first quarter 1988, and the noncurrent loan rate reached an all-time high of 10 percent in third quarter 1988, far surpassing U.S. banks' current record of 5.5 percent. Nine of Texas' 10 largest banking organizations failed or were acquired, and the casualty rate for Eleventh District banks peaked at about 10 percent in 1989.

Which prompts the second interesting question: Why have Eleventh District banks fared better in the current recession than in the 1980s downturn?

It's not likely a simple matter of a milder recession. For the Eleventh District, the current economic downturn is the worst since the mid-1980s.<sup>6</sup> During the worst of the current recession, from mid-2008 until the

end of 2009, employment plunged 3.7 percent in the Texas economy, which makes up the major part of the Eleventh District. During the 1985-87 recession, employment fell 3 percent.

The Texas Business-Cycle Index fell almost 4 percent in 2009, compared with a 2.7 percent decline in 1986. According to the Mortgage Bankers Association, the delinquency rate—the percentage of mortgages 90 days or more past due—climbed to almost 4 percent in Texas at the end of 2009. It rose to a high of 2.74 percent at the end of 1987.

One explanation for today's healthier banking industry is the changing nature of the regional economy. In the 1980s, the Eleventh District was a much less diversified economy. For example, oil and gas production accounted for almost 20 percent of Texas output. By the early 2000s, that share had declined to only 6 percent. The move away from a heavy reliance on the fortunes of the oil and gas industry gave rise to a more varied regional economy and offered the local banking industry more opportunities for diversification, potentially contributing to lower risk profiles.<sup>7</sup>

### A Closing Caveat

Even though the Eleventh District economy has been showing signs of improvement, it should be emphasized that banking-sector difficulties may not be behind us. One area of concern is commercial real estate exposure.

These loans account for almost one-fourth of district banks' assets—far exceeding the national average of 13 percent and at the upper end of exposures across Federal Reserve districts. During the 1980s, Eleventh District banks' peak exposure to commercial real estate was 16 percent in mid-1986.

Difficulties in the commercial real estate sector in the aftermath of the oil bust contributed appreciably to the deterioration of the Eleventh District banking industry in the 1980s. For example, the office vacancy rate in Dallas hit a high of slightly over 28 percent in 1988; in Houston, it peaked at over 30 percent in 1987.

If the commercial real estate sector weakens further, the performance of Eleventh District banks can be expected to decline—both in absolute terms and relative to banks nationwide. The article titled "Cloud Over Commercial Real Estate Is Slowly Lifting in Texas," on page 10 in this issue of *Southwest Economy*, investigates the current state and likely prospects for the commercial real estate sector.

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### Notes

<sup>1</sup> The Eleventh Federal Reserve District consists of all of Texas, the northern portion of Louisiana and the southern portion of New Mexico. Data for the Eleventh District banking industry have been adjusted for structural changes involving recent relocations of banks into the district.

<sup>2</sup> Consistent data for the banking industry are generally available beginning in 1984. In this article, records are relative to that date.

<sup>3</sup> There are other components to the guidance as well. See SR Letter 07-1, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, Jan. 4, 2007, [www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm](http://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm).

<sup>4</sup> "Senior Loan Officer Opinion Survey on Bank Lending Practices," Board of Governors of the Federal Reserve System, April 2010, [www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm](http://www.federalreserve.gov/boarddocs/SnLoanSurvey/201005/default.htm).

<sup>5</sup> See "Texas Economy Shakes Off Rough Ride in 2009," by Laila Assanie and Pia Orrenius, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter, 2010.

<sup>6</sup> See note 5.

<sup>7</sup> See "The Effect of High Oil Prices on Today's Texas Economy," by Stephen P.A. Brown and Mine K. Yücel, Federal Reserve Bank of Dallas *Southwest Economy*, no. 5, 2004. Regulatory changes in the banking industry could also have played a role. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allowed banks to set up branches across state lines, which was generally forbidden in the 1980s. These changes provided banks, especially larger organizations, with even more opportunities for diversification and concomitant declines in risk.

## Tapping Technology for Immigration Enforcement

Immigration consultant Lisa Roney, former director of Research and Evaluation in the U.S. Citizenship and Immigration Services' Office of Policy and Strategy, discusses the government's E-Verify program.

### Q. What is E-Verify?

**A.** E-Verify is a free, federally operated electronic program that lets U.S. employers determine whether newly hired employees are legally authorized to work in this country. It's run jointly by the U.S. Citizenship and Immigration Services (USCIS) and the Social Security Administration (SSA). The employer enters information from a new worker's I-9 Employment Eligibility Verification Form and quickly finds out whether it matches information in federal databases.

Form I-9 has been required of all employers since 1987. Under the I-9 process, newly hired workers attest to being U.S. citizens or noncitizens with authorization to work in this country. Employers must review specified documentation showing proof of the worker's identity and either U.S. citizenship or authorization to work in the U.S. Repeated analyses found that the I-9 system alone was vulnerable to fraudulent documents and therefore not sufficiently effective at reducing unauthorized employment. E-Verify was designed to change that.

### Q. What happens when E-Verify cannot confirm work authorization?

**A.** When the program turns up a mismatch with federal information, the employer is to notify the worker and ask whether he or she wants to contest the mismatch with SSA or USCIS. Most data mismatches for employment-authorized workers relate to issues such as changes of name or citizenship status that haven't been reported to SSA or USCIS, but they can also result from errors or illegible writing on the Form I-9 and employer input errors.

If a worker decides to contest the initial E-Verify finding, the employer is required to provide instructions on how to proceed. This includes how to go in person to the SSA or to call USCIS to resolve the discrepancy. The



worker then has eight business days to take the required action to correct the record.

### Q. And if the worker can't or won't do this?

**A.** If the worker with a mismatch with SSA or USCIS data doesn't contest an initial finding of not being work-authorized—most often because they lack proper work authorization—the employer is supposed to terminate employment. However, instructions about when this must occur aren't specific, and employer practices vary from firing workers on the spot to allowing them to finish a particular job or period of employment to allowing them to continue working in violation of the law.

Immigration authorities aren't contacted because federal enforcement priorities preclude picking up individual workers from thousands of employer locations. The worker loses his or her job, and to the extent that other employers in a given geographic area or industry are participating in E-Verify, the unauthorized worker lacks other employment opportunities.

### Q. How well is the program working?

**A.** E-Verify began as a voluntary pilot program established by the Illegal Immigration Reform and Immigrant Responsibility Act of 1996. The program has been consistently improved over time to be more accurate and more responsive to employer needs, and it has grown from a few hundred employers to the current enrollment of more than 200,000. In fiscal year 2009, more than 8.7 million queries were run through E-Verify, the equivalent of about 18 percent of new hires.

During third quarter 2008, almost 97 percent of all verifications were completed electronically without further effort by the employee or the employer. Another 0.3 percent of cases were verified as work authorized after the employee contacted SSA or USCIS to resolve the cause for a data mismatch. The remaining 3 percent involved cases in which the worker wasn't authorized for U.S. employment or the employer or employee didn't take the steps necessary to resolve discrepancies.

### Q. Are all employers required to use E-Verify?

**A.** Not at present. E-Verify remains voluntary for most employers, and less than 4 percent of them now participate. In September 2009, the program became mandatory for most federal government contractors, who must verify all new employees and any existing workers who are directly working on federal contracts. They also have the option of verifying their entire workforce.

In addition, at least some employers in 13 states are now required to use E-Verify, and more than half the states are currently considering legislation relating to the use of E-Verify. To date, Arizona and Mississippi are the only states mandating that all employers within the state use E-Verify, although Mississippi is phasing in participation through July 1, 2011, based on employer size. Beginning July 1, 2010, Utah will require all state agencies and contractors as well as all private employers with 15 or more employees to register with and use E-Verify.

Most, if not all, immigration reform legislation introduced over the past several



*“Improving E-Verify’s ability to detect the use of fraudulent documents will require difficult choices regarding the documentation that’s acceptable in the employment verification process.”*



years has included provisions requiring the use of E-Verify or a similar program that would electronically verify the employment authorization status of new hires. Some legislation would also require employers to verify the status of existing workforces, which is generally prohibited for currently participating employers other than federal contractors, who may elect to do so.

**Q. Would making it mandatory to use E-Verify solve the problems with unauthorized workers?**

**A.** Obviously, the program is effective only to the extent employers participate. If all were required to participate in E-Verify, we would expect the number of unauthorized workers to be reduced substantially. However, we have seen a longstanding pattern where unauthorized workers and those who assist them adapt to initiatives designed to keep them out of the U.S. workplace. Therefore, mandatory E-Verify as currently designed will not be a panacea.

A recent evaluation by Westat, a research organization, looked at how effective E-Verify was at detecting unauthorized workers and removing them from the workplace. Westat estimated that the program was detecting approximately half of all unauthorized workers, with a plausible range from about one-third to two-thirds.

The remaining unauthorized workers were able to escape detection by E-Verify through use of documentation with information that matched federal data, either because they had borrowed or stolen valid documents or because they were using counterfeit documents with good information about work-authorized persons. In addition, there may be employment possibilities in the informal sector, where workers are paid off the books, or through self-employment.

It’s also worth noting that E-Verify, even if not a complete deterrent, is more effective than the Form I-9 process alone. Furthermore, E-Verify is an important part of an overall federal strategy designed to reduce illegal immigration. The collective impact of the programs—including Border Patrol operations and Immigration and Customs Enforcement worksite investigations—is greater than any of the programs alone.

**Q. Does using E-Verify result in discrimination against foreigners in general and certain minorities in particular, such as Hispanics?**

**A.** Westat evaluation results indicate that most employers report that their participation in E-Verify makes them no more or less likely to hire foreign-born workers. When employers do report a difference due to E-Verify, it’s almost always in the direction of making them more willing to take on immigrants.

While data aren’t available by minority group, Westat evaluation findings show that based on their Form I-9 citizenship attestation, noncitizen workers are considerably more likely than U.S. citizens to have mismatches in their data during the E-Verify check. In part, this is because noncitizens go through both SSA and USCIS checks, whereas citizens are in most cases verified through only SSA.

For the second quarter 2008, for example, 0.3 percent of persons attesting to U.S. citizenship had mismatches, compared with 2.1 percent among those saying they were work-authorized noncitizens.

Within the noncitizen group, 5.3 percent of workers claiming they had temporary employment authorization had mismatches, well above the 1 percent of lawful permanent residents, usually green card holders, with mismatches. A series of USCIS database and system enhancements reduced these percentages considerably from the previous evaluation and are expected to reduce the discrepancy in mismatch rates between citizen and noncitizen workers further in the future.

**Q. Can E-Verify be made more effective?**

**A.** Improving E-Verify’s ability to detect the use of fraudulent documents will require difficult choices regarding the documentation that’s acceptable in the employment verification process and the possible use of biometric identifiers in E-Verify. These choices, of course, have both fiscal and civil liberties costs that will have to be considered.

The issues surrounding a national ID card in particular are huge, and moving in that direction would alter our basic tenets and way of life. Even if it were desirable, it would be extremely difficult to implement politically. Every immigration bill that has addressed verification has specifically prohibited creation of a national ID card.

The development of an identity card with readable biometrics is also difficult, not only in making such a highly counterfeit-proof card and issuing it to millions of lawful workers, but also in ensuring that all employers can easily read it.

**Q. Do you think the government will extend the use of E-Verify in the near future?**

**A.** There are big ifs here. I think that inclusion of a mandatory electronic employment verification program is almost a certainty in any serious immigration reform legislation that will be considered in the near future. The question, of course, is whether major immigration reform legislation will be enacted.

In recent years, it has taken several attempts to get legislation through both houses of Congress, and the U.S. population seems even more divided than ever on the direction and desirability of immigration reform.

# Cloud Over Commercial Real Estate Is Slowly Lifting in Texas

By D'Ann Petersen

The year 2009 was a terrible one for Texas commercial real estate. With the U.S. and Texas economies mired in recession and credit markets still reeling from the global financial freeze-up, every segment of the state's commercial property sector suffered. Demand withered for space in offices, warehouses and retail centers, pushing up vacancy rates and lowering rental rates. Private nonresidential construction dropped sharply, reaching near-record lows.

Texas' commercial real estate (CRE) sector has been through booms and busts before—most notably, leading up to and following the state's deep recession in the mid- to late 1980s.<sup>1</sup> What differed in the current down cycle was a global financial crisis that temporarily brought lending to a halt.

Problems began on the residential side but soon spread to CRE financing. Commercial-mortgage-backed securities (CMBS) lending dried up in Texas and the U.S. as it became clear that repackaging suspect loans didn't lower risk. Banks also became wary of adding CRE loans to their books, especially in Texas, where the share of these assets exceeded the national average. By 2009, no one wanted to touch CRE.

Commercial real estate impacts the region's economy through several channels. For example, construction activity contributes to state output and employment growth, and CRE lending is important to the state's banking sector.

While the recession appears to be over, commercial activity is a trailing indicator and, given still-tight credit conditions, remains a potential drag on economic recovery.

Significant declines in property values and rents have raised concerns about impending defaults and foreclosures as loans come due, posing risks to the banking sector and the economy as a whole. Indeed, the share of nonperforming CRE loans at Texas banks is rising.

In a positive sign, the lower rents and

prices are beginning to stir demand for space as well as investor interest. In addition, sectors of the economy that drive real estate demand have turned the corner, suggesting the bottom is near.

## Construction Hits a Wall

Texas private commercial construction surged during the state's expansion, picking up steam as the economy shook off the jobless recovery that followed the 2001 tech bust. Growing demand for Texas-produced goods boosted construction of industrial space, and more office space was built as service-sector firms expanded. Construction of retail space was also strong. By 2006, the inflation-adjusted value of CRE construction had almost reached the high of the previous economic boom.

Just as the construction cycle was gaining steam in Texas, the global financial collapse put an abrupt halt to activity.

Construction faltered in 2007 and plunged in 2008 and 2009 (*Chart 1*). Currently, private CRE construction levels are near lows last seen after the Texas oil and real estate bust of the mid- to late 1980s.

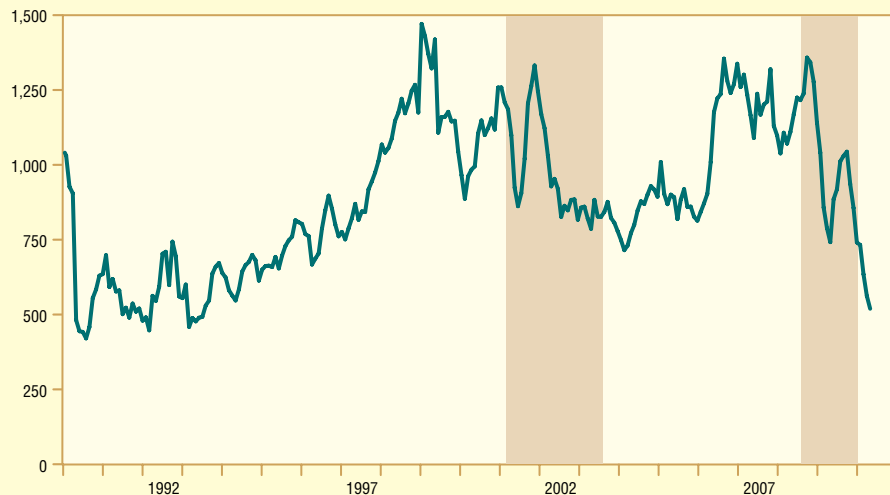
The Dallas Beige Book, the Dallas Fed's anecdotal survey of economic conditions, regularly includes comments from executives at construction and building-related product companies. In late 2008 and early 2009, contacts said private construction activity came to a virtual standstill as credit dried up. Since then, reports on building activity have remained grim.

With construction of warehouses, office and bank buildings, and stores and restaurants in the doldrums, public construction accounted for a larger share of the pie. The little nonresidential construction that occurred in 2009 was partly the result of the federal government's economic stimulus programs.

Chart 1

## Texas Private Nonresidential Construction Plunges

Millions of dollars\*

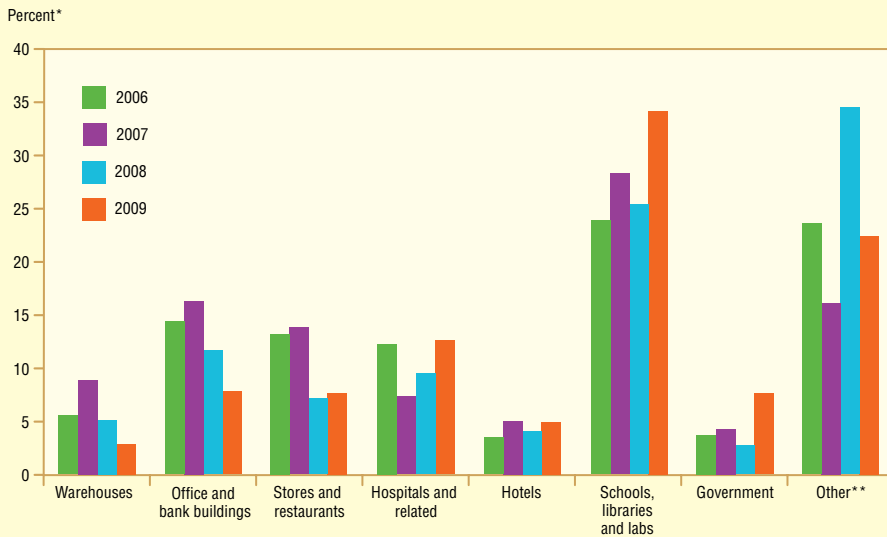


\*Real dollars; five-month moving average.

NOTES: Shaded areas represent Texas recessions as defined by the Texas Business-Cycle Index. Private nonresidential construction is nonresidential contract values minus government buildings and schools.

SOURCES: F.W. Dodge; calculations and adjustments by the Federal Reserve Bank of Dallas.

**Chart 2**  
**Public Projects Account for Most Construction Activity in 2009**



\*Real dollars

\*\*Includes churches, dormitories, parking garages and recreational facilities.

SOURCES: F.W. Dodge; calculations and adjustments by the Federal Reserve Bank of Dallas.

Compared with previous years, public projects like schools and government buildings made up a larger chunk of Texas building activity in 2009 (*Chart 2*). Hospital construction was boosted by strong population growth and a thriving health care sector. While hotel construction is largely private, building activity picked up in 2009 with the start of the Dallas Convention Center hotel, mostly funded by public dollars.

### Leasing Markets Suffer

The recession and the financial fallout took a toll on rental markets in Texas. As demand for space dropped off, vacancy rates climbed in the major property markets—retail, industrial and office.

**Retail.** Demand for retail space was strong from 2002 through 2004, thanks to the state's housing boom and retail sales growth. Even with new retail construction at high levels, vacancy rates edged downward in Texas metros. Texas' housing and retail boom lasted longer than the nation's. However, consumer confidence began to wane in 2006 as the U.S. housing problems spread to the state, and demand for retail space began to slow.

Already weakened by the housing drop-off, retail markets took another hit from the national recession in 2008. Store and restaurant closings—including Circuit City and some Starbucks locations, as well as Texas' own Bombay Company—were

commonplace. In real estate circles, demand is usually measured by net absorption, or the net change in square feet for competitively leased space, including new construction. The widespread business closings and slack demand for retail space led to weak absorption from mid-2008 to early 2009, pushing up vacancy rates in Texas' major metros (*Chart 3A*).<sup>2</sup>

Overall, Texas had positive absorption of 873,000 square feet in 2009, an improvement over 2008 but still well below the 3.2 million in 2004. Conditions worsened in first quarter 2010, and the Texas population-adjusted retail vacancy rate edged up. In a spot of good news, recent industry reports suggest grocers, discount clothiers, wholesale clubs and electronics stores are expanding in Texas markets.<sup>3</sup>

**Industrial.** Before the recession, rising exports and imports and strong growth in industrial production played large roles in Texas' expansion, leading to robust demand for warehouse and industrial space.

However, the state's industrial real estate market deteriorated sharply as global demand for goods dropped off and Texas exports and production fell precipitously. The Port of Houston, for example, reported value declines of 15.9 percent for exports and 39.6 percent for imports during 2009.

Throughout the recession, Dallas Fed contacts reported almost no industrial leasing activity. Not surprisingly, the major

metros had six consecutive quarters of negative net absorption totaling just over 26 million square feet as of first quarter 2010—more than half of which occurred in Dallas–Fort Worth, which houses the state's largest share of industrial space (*Chart 3B*).

Texas' population-adjusted industrial vacancy rate increased from 8.5 percent in third quarter 2007 to 13.5 percent in first quarter 2010, exceeding the highs of past recessions.

More recently, the Dallas Beige Book notes that some deals are being made after landlords took a realistic look at market conditions and drastically reduced rents. Contacts report a pickup in leasing transactions and firms scouting sites for distribution hubs. Still, the large amount of available space suggests it will be a slow recovery, and construction probably won't resume soon.

**Office.** Texas office markets weakened during the recession as firms in finance, energy, real estate and other sectors put leasing and expansion decisions on hold amid credit uncertainty, cost cutting and downsizing.

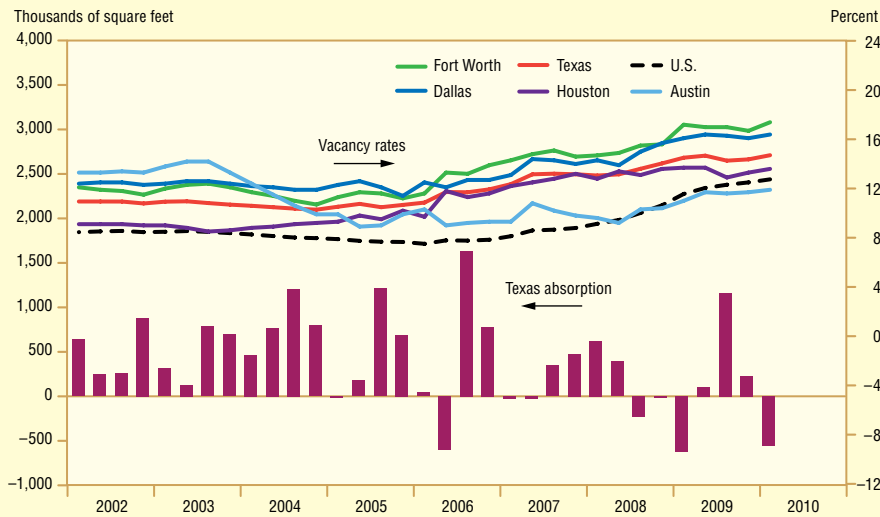
As a result, the Texas population-adjusted office vacancy rate began to rise in 2008 and stood at 18.2 percent as of first quarter 2010 (*Chart 3C*). Despite the increase, the rate remains below the levels seen in the previous two Texas recessions. However, absorption was negative in the first quarter of this year, suggesting vacancy rates may continue to edge up.

Dallas and Austin have the highest metro vacancy rates, although several downtown lease deals led Austin to a marked improvement in the first quarter. Because of the popularity of Austin's downtown location, several developers plan to build commercial properties with an office component once credit restrictions ease, according to C.B. Richard Ellis (CBRE).<sup>4</sup> Houston's vacancy rate is below the national average, but it may move up as construction wraps up on several large projects started before the recession took hold.

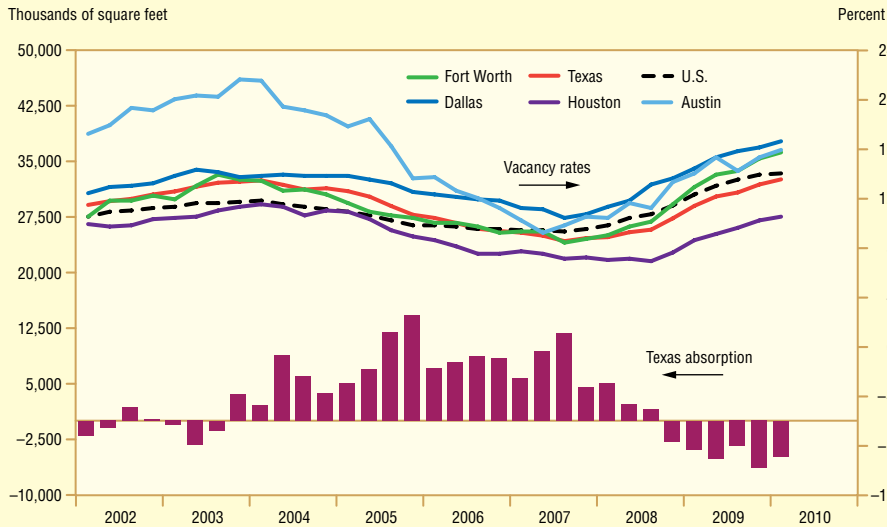
Dallas Fed business contacts report building owners are aggressively reducing office rental rates and making concessions. For instance, first quarter office rents are down \$1.87 per square foot in Austin and \$1.48 per square foot in Dallas from the highs reached in 2008, according to CBRE. The lower rental rates are encouraging some recent leasing activity, according to the Dallas Beige Book.

**Chart 3**  
**Commercial Real Estate Vacancy Rates Edge Up in Texas**

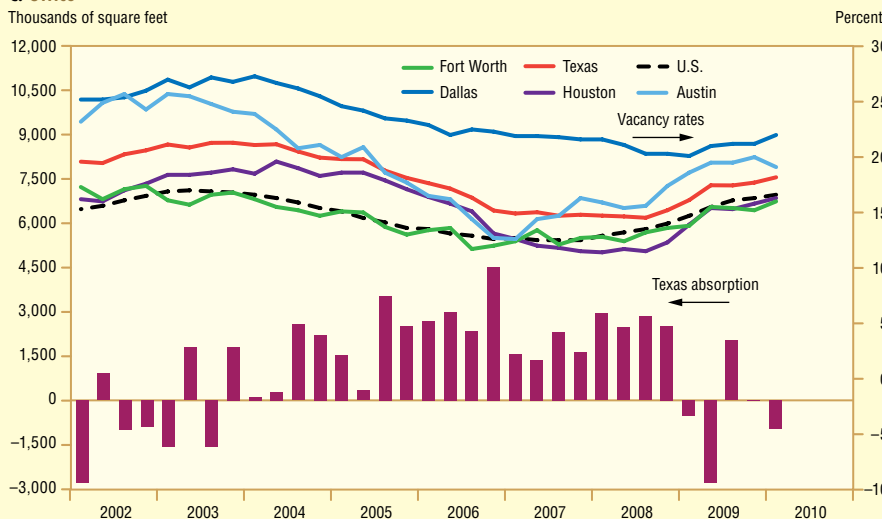
**A. Retail**



**B. Industrial**



**C. Office**



NOTES: The Texas vacancy rate is population-adjusted by the Dallas Fed. Texas absorption is the sum of the major Texas metros.  
 SOURCES: CB Richard Ellis Econometric Advisors; calculations and adjustments by the Federal Reserve Bank of Dallas.

**Prospects for recovery.** A rebound in the retail, industrial and office leasing markets depends on broad economic improvement. Recent data give reason for optimism.

Renewed growth in Texas and U.S. retail sales bodes well for the retail property sector (*Chart 4*). Moreover, Texas exports have recovered from record lows, following improving trends in U.S. industrial production—an encouraging sign for the Texas industrial market. Finally, data point to a brewing recovery in Texas employment in service industries that typically drive office demand—notably, professional and business services and finance.

**Signs of Life**

The analysis of conditions in Texas' retail, industrial and office property markets finds a common theme—a sharp decline during the recession that gives way in the most recent reports to a few glimmers of hope. A similar scenario emerges from data and reports on investment property sales.

**Credit crisis halts investment.** In the years leading up to the credit crunch, financial innovations that repackaged risk—most notably, securitized lending—surged not only in the residential mortgage market but also in CRE and other investments. This led to large increases in the share of mortgages held by investors. CMBS issuers that held commercial and multifamily mortgages spiked from about 4 percent in 1990 to just over 25 percent by 2009 (*Chart 5*).

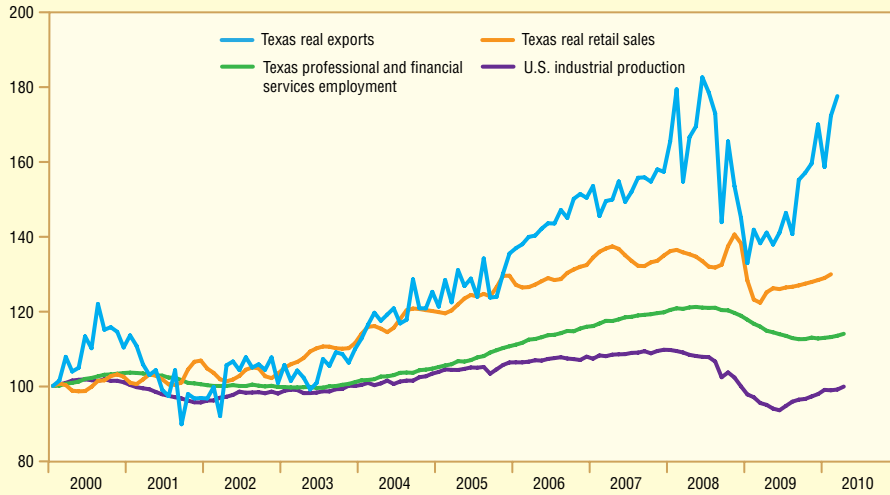
Commercial banks still hold the largest amount of CRE debt, with their share rising to 45 percent over the past two decades. Life insurance companies, savings institutions and other investors saw their shares decline. Researchers suggest that CMBS issuers' rising share made the overall commercial market more vulnerable to financial market disturbances.<sup>5</sup>

Texas' commercial investment market was jolted when financial markets panicked in 2007. CMBS lending was virtually shut down, and banks halted most CRE lending, too, putting stringent standards on new loans. The Dallas Beige Book noted that virtually no loans were being made for large commercial deals as banks tried to reduce their exposure to CRE.

**Sales low but starting to stir.** When credit dried up in 2008, Texas commercial property sales plummeted. Early 2009 was even worse, with Texas transactions falling to almost zero. Later in the year, business picked up, but the full-year sales volume

## Chart 4 Drivers of Rental Demand Show Improvement

Index, January 2000 = 100



NOTE: Retail sales are estimated and based on quarterly data; exports and retail sales are in real dollars.

SOURCES: WISERTrade; Census Bureau; Bureau of Labor Statistics; Texas Workforce Commission; Federal Reserve Board; calculations and adjustments by the Federal Reserve Bank of Dallas.

of office, industrial, retail and apartment properties totaled just \$3.8 billion, down 68 percent from 2008 (Chart 6).<sup>6</sup>

Sales activity for all property types was hampered not only by a lack of available credit but by sellers unwilling to sell at very low prices. Nationally, commercial property prices plunged 44 percent from their peak in late 2007 before bottoming out in October 2009, according to Moody's/REAL commercial

property price index. Texas price statistics are difficult to obtain, but anecdotal reports and rough figures reflect the U.S. trend.

More recently, competition for good deals has spurred some property sales. Data from Real Capital Analytics show first-quarter property sales volumes inched up from year-ago levels in the U.S. and Texas. The largest transaction nationally in February was Anadarko's \$215 million purchase

of its headquarters in The Woodlands, near Houston. Anecdotal reports from Dallas Fed contacts concur that investor interest is growing, with scattered instances of bidding wars bumping up sales prices.

**Financial hurdles lie ahead.** Texas has its fair share of the nation's growing volume of distressed assets—defaults, foreclosures or bankruptcies. While rising distress may mean bargains for investors, it's a concern for the banking industry.

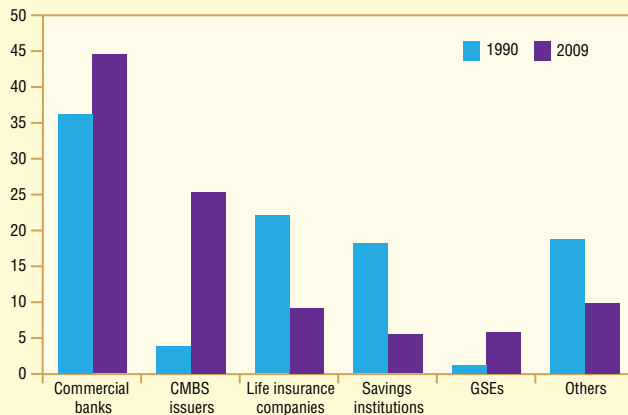
The large number of CRE loans maturing over the next several years is another worry for banks, given today's tighter lending standards and lower property values. This can leave borrowers who are current on their payments with a refinancing gap that may be hard to fund with new loans. This is why banks have preferred to extend maturing loans in hopes that conditions will improve.

Most Texas CRE loans are concentrated at smaller regional and community banks, which depend on CRE lending as a major source of business. Texas banks have almost double the commercial real estate exposure as the national average, although the Texas share has come down considerably from almost 30 percent in third quarter 2008 to 26 percent as of first quarter 2010. The good news is that Texas' share of nonperforming—or troubled—CRE loans has remained well below the national average throughout the downturn.

(Continued on back page)

## Chart 5 Composition of Commercial Mortgage Holders Shifts

Percent

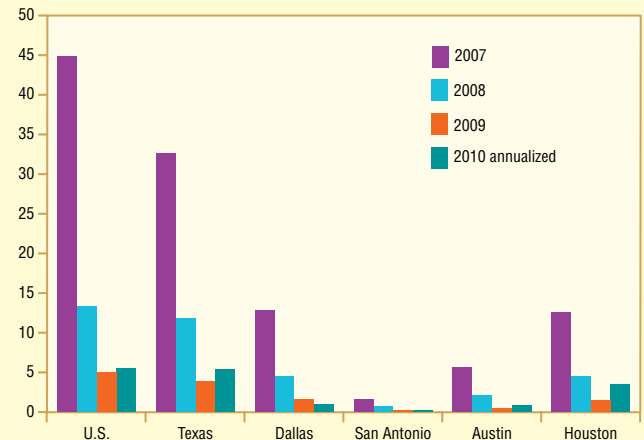


NOTE: CMBS stands for commercial-mortgage-backed securities, and GSEs are government-sponsored enterprises.

SOURCES: Flow of funds data; Federal Reserve Board; Compendium of Statistics; Commercial Mortgage Securities Association.

## Chart 6 Commercial Real Estate Sales Volumes Inch Up

Billions of real dollars (U.S. in tens of billions)



SOURCES: Real Capital Analytics; calculations and adjustments by the Federal Reserve Bank of Dallas.

## Maquiladora Employment New Data Confirm Pickup in Juárez Factory Jobs

For decades, Mexico's maquiladoras have been a major growth engine in the Rio Grande region, and monthly reports on the industry's employment, wages and production were key barometers for the border region's economy.

These valuable indicators were lost in December 2006, when Mexico's Instituto Nacional de Estadística y Geografía (INEGI) ceased publishing maquiladora data. New rules on export-oriented industries merged the maquiladora industry and a program for homegrown exporters into the Maquiladora Manufacturing Industry and Export Services, or IMMEX.<sup>1</sup>

In January, INEGI began releasing IMMEX data going back to July 2007 and including monthly employment, establishments and wages for 17 states and 33 municipalities.<sup>2</sup> In addition to providing a portrait of export-related manufacturing in Mexico, the new data allow us to resurrect an important economic indicator for the El Paso–Juárez region.

Mexico had more than 1.6 million IMMEX jobs as of December 2009, with Juárez, Tijuana and Reynosa representing 23 percent of the total (Table 1). Given that IMMEX combines maquiladoras with other exporters, interior cities such as Apodaca and the Distrito Federal now rank in the top five in terms of number of jobs.

In December 2006, maquiladoras accounted for 22.4 percent of manufacturing jobs

in Mexico; IMMEX firms currently make up 33 percent.

While maquiladora data were unavailable for three years, an alternative barometer of the El Paso–Juárez region's economic conditions was needed. We developed a model to estimate Juárez's monthly maquiladora employment. It uses three indicators:<sup>3</sup>

- U.S. industrial production: Once U.S. industrial production picks up, orders are sent to Mexican plants within one or two months.
- Real peso–dollar exchange rate: Maquiladora plants have peso-denominated costs and dollar-denominated revenues—so changes in the exchange rate are crucial.
- Manufacturing employment: Since Juárez is the major manufacturing city in Chihuahua, changes in state manufacturing employment can be used as a proxy for changes in factory jobs at the city level.<sup>4</sup>

Our model reasonably tracks historical turning points in Juárez's maquiladora employment—for example, the onset of the downturn in October 2000 and the beginning of the recovery in November 2001. Regarding the recent business cycle, our model indicates the employment peak was in October 2007 and the trough was July 2009 (Chart 1).

The model matches closely the turning points in the recently released IMMEX Juárez

employment data. According to our model, Juárez maquiladoras have been expanding their payrolls since August 2009 and employment levels are now above year-ago levels.

This model will continue to be a timely indicator of El Paso–Juárez area manufacturing activity, given its track record and Mexico's two-month lag in reporting IMMEX data.

—Roberto Coronado and Jesus Cañas

### Notes

<sup>1</sup> See "Mexico Regulatory Change Redefines Maquiladora," by Jesus Cañas and Robert W. Gilmer, Federal Reserve Bank of Dallas *Crossroads*, Issue 1, 2007, [www.dallased.org/research/crossroads/2007/cross0701b.html](http://www.dallased.org/research/crossroads/2007/cross0701b.html). IMMEX stands for Industria manufacturera, maquiladora y de servicios de exportación.

<sup>2</sup> For data series, see <http://dgcnesyp.inegi.org.mx/cgi-win/bdieintsi.exe/NIVJ200035#ARBOL>.

<sup>3</sup> For more details on the methodology, see "Short-Run Maquiladora Employment Dynamics in Tijuana," by Roberto A. Coronado, Thomas M. Fullerton Jr. and Don P. Clark, *Annals of Regional Science*, vol. 38, no. 4, 2004, pp. 751–63; and "Maquiladora Employment Dynamics in Nuevo Laredo," by Jesus Cañas, Thomas M. Fullerton Jr. and William Doyle Smith, *Growth and Change*, vol. 38, no. 1, 2007, pp. 23–38.

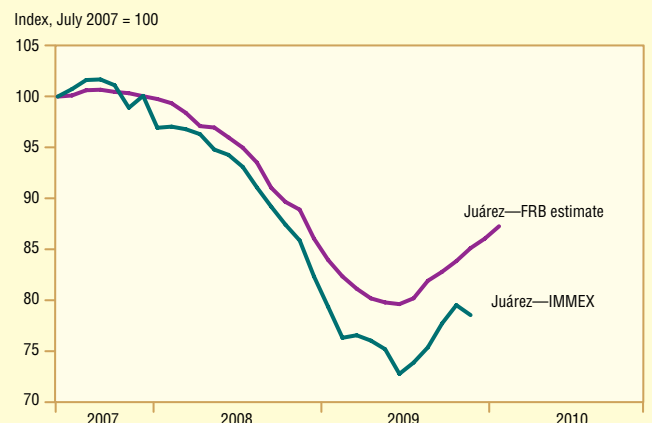
<sup>4</sup> Formal-sector manufacturing employment for Juárez is no longer available through the Instituto Mexicano del Seguro Social. Therefore, we have to rely on the state-level data.

**Table 1**  
**Top Cities for Mexico's Export-Related Jobs**  
Maquiladora Manufacturing Industry and Export Services Employment  
(January–December 2009 average)

Rank	City	Employment	Share (percent)
1	Juárez, Chihuahua	164,613	10.2
2	Tijuana, Baja California	137,580	8.5
3	Reynosa, Tamaulipas	72,372	4.5
4	Apodaca, Nuevo León	55,969	3.5
5	Distrito Federal	52,812	3.3
6	Mexicali, Baja California	45,145	2.8
7	Matamoros, Tamaulipas	39,953	2.5
8	Chihuahua, Chihuahua	37,800	2.3
9	Aguascalientes, Aguascalientes	35,408	2.2
10	San Luis Potosí, San Luis Potosí	32,461	2.0

SOURCE: Instituto Nacional de Estadística y Geografía.

**Chart 1**  
**Model Tracks Turning Point in Maquiladora Employment**



SOURCES: Instituto Nacional de Estadística y Geografía; Federal Reserve Board; Banco de México; Instituto Mexicano del Seguro Social; authors' calculations.

**QUOTABLE:** “Regional conditions have firmed up this year, and recent data suggest a recovery is taking hold in the Eleventh District. Despite the improvement, several risks to the budding recovery remain.”

—Laila Assanie, Associate Economist

## NATURAL GAS: Glitches Point to Inflated Output Data

Natural gas production and consumption data have been drifting apart. The difference grew from 6 percent of natural gas consumption in December 2009 to 10 percent a year later.

Production should equal consumption plus increases or decreases in storage, but sampling and estimation errors typically result in slight discrepancies. Seeing these gaps rise, the Energy Information Administration (EIA) implemented a new methodology with the release of February’s production data that should ensure greater accuracy. Estimates for the prior 12 months were revised as well.

The changes revealed lower production for some states—namely Texas and Louisiana—plus the Gulf of Mexico. While natural gas production was lower than initially thought, the

downward revisions were smaller than expected—as evidenced by a drop in the price of natural gas coinciding with the data release.

The estimation errors were traced to an outdated sampling methodology. The EIA had used data from big producers to estimate smaller companies’ production. Estimates based on long-run data became less accurate as many smaller producers started using newer drilling technology to tap shale gas.

The EIA will now update the list of companies surveyed monthly and base estimates of nonsampled companies’ production on data that are six to 18 months old rather than the two to seven years used previously.

—*Jackson Thies*

## TEXAS AGRICULTURE: Drought’s End Brings Optimism

The outlook for Texas agriculture is brighter for 2010—welcome news after severe drought and a weakened global economy caused distress in 2009.

The El Niño weather pattern brought a wet autumn and winter to Texas, ending one of the worst droughts the state has ever suffered. Prices for livestock and commodities have firmed with economic recovery, and the Department of Agriculture is forecasting a 12 percent increase in U.S. net farm income over last year.

The outlook for the Texas cattle industry—largest among the states—improved in recent months as ample rainfall boosted pasture growth and market prices strengthened.

Livestock producers were hit hard in 2009. Prices fell as global demand retreated and drought conditions caused ranchers to cull herds and implement costly supplemental feeding. Texas cattle and calf inventory at the start of 2010 was the lowest in 20 years.

Rain restored soil moisture in time for the spring planting season, and Texas farmers anticipate a strong 2010 crop. Wet conditions delayed corn planting in some parts of the state, but overall crop progress is good. Cotton prices are expected to increase this year after a relatively low global harvest, which bodes well for Texas, the nation’s top cotton producer.

—*Emily Kerr*

## FORTUNE 500: Texas Ties California for National Lead

More of the nation’s largest companies call the Lone Star state home.

According to the 2010 Fortune 500, released in April, Texas hosts the headquarters of 57 of the nation’s 500 largest companies, ranked by gross revenues. These include three of the top 10: Irving-based Exxon Mobil (second behind Wal-Mart), Houston’s ConocoPhillips (sixth) and Dallas-based AT&T (seventh).

Texas tied California as the national leader in Fortune 500 firms, ahead of New York (56) and Illinois (31). Houston is home to 24 of these companies, more than any other U.S. city outside New York. Twelve are headquartered in

Dallas, and an additional 12 are based in the greater Dallas-Fort Worth area.

Texas secured its place as a Fortune 500 leader through its position as focal point of the domestic energy industry, its relatively strong economic growth over the past decade, and its relatively low tax rates and living costs.

In 2000, Texas was home to 43 Fortune 500 corporations and trailed New York and California by substantial margins. Houston had 18 companies and Dallas eight. Both cities have grown in importance as Fortune 500 hubs, with Dallas rising over the past decade from seventh to third in the nation.

—*Mike Nicholson*

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## Cloud Over Commercial Real Estate Is Slowly Lifting in Texas

*(Continued from page 13)*

### What the Future Holds

The outlook for CRE may not yet be optimistic, but it is less gloomy. With the national and Texas economies turning a corner and demand in the rental and investment markets stirring, a bottom may be within sight.

It will take time for the Texas CRE sector as a whole to heal, and it will likely be quite a while before private commercial construction activity picks up. Asset devaluations and weakness in rental markets remain challenges for CRE loans on banks' books. CRE lending will likely remain subdued while banks address these concerns.

Demand for new space will depend on sustained employment growth and business expansion, and the Texas economy remains fragile, having just entered recovery. Nevertheless, the state's business activity does appear to be moving in the right direction.

*Petersen is a business economist in the Research Department at the Federal Reserve Bank of Dallas.*

### Notes

<sup>1</sup> See "Office Real Estate Cycles in Texas: Some History," by D'Ann Petersen, Federal Reserve Bank of Dallas *Southwest Economy*, March/April 2005, [www.dallased.org/research/swe/2005/swe0502a.pdf](http://www.dallased.org/research/swe/2005/swe0502a.pdf).

<sup>2</sup> Data for all metro property markets provided by CBRE Econometric Advisors.

<sup>3</sup> Grubb and Ellis 2010 Forecast Reports.

<sup>4</sup> From first-quarter Austin office MarketView research report, CB Richard Ellis.

<sup>5</sup> See "Is Commercial Real Estate Reliving the 1980s and Early 1990s?" by C. Alan Garner, Federal Reserve Bank of Kansas City *Economic Review*, Third Quarter 2008.

<sup>6</sup> Apartments are included as commercial real estate properties in sales data because they are income-generating. For the same reason, apartment properties are included in banking statistics for commercial real estate.