$10-15 oil price makes Texas banks unsalvageable

by David Goldman

OPEC ministers' failure to agree upon a price-support plan for oil was the final blow to southwestern commercial banks and savings and loan associations, already the subject of speculation during the past several weeks. BancTexas has been unable to find a merger partner after months of searching, and will fail without one; Texas Sen. Philip Gramm (R) (as in Gramm-Rudman) has proposed to soften the state's tough restrictions on interstate banking, in order to permit one of the major New York banks to acquire it on the Maryland S&L model. First City National Bank of Houston has also been the subject of rumors about impending failure.

As the following analysis shows, the entire group of major Texas banks, with one exception, have no hope of survival if current oil-market conditions prevail—and less because of energy loans than because of the real-estate lending spun off from the state's energy economy.

According to the Federal Deposit Insurance Corporation's March 24 statement, 563 U.S. banks have lent a collective $60 billion to more than 600 independent energy producers who stand to be ruined by the collapse in oil prices. This $60 billion amounts to 25% of the aggregate capital of these banks. However, $57 billion of these loans were held by large regional banks with assets of more than $1 billion each. The regional banks which hold the overwhelming majority of energy exposure are concentrated in Arkansas, Louisiana, New Mexico, Oklahoma, and Texas. Of these, the most concentrated group of energy lenders are the major Texas banks.

As noted above, federal bank examiners are now treating Texas as a potential disaster area, and the imminent failure of several major banks, including First City National Bank and BancTexas of Houston, has been the subject of widespread speculation.

Attention has centered one-sidedly upon these banks' extensive energy loans, as well as their loans to oil-dependent developing nations, especially Mexico and Venezuela. In fact, these loans take second and third place, respectively, to these banks' problem real-estate loans. In a market where *current* vacancy rates for prime commercial real estate are in the range of 40% *before* the effects of the oil price collapse are fully registered, the real-estate bombshell could take down virtually all of the major Texas banks, producing a situation much worse than that of the 1930s.

These conclusions are obvious from the following analysis of Texas banks' balance sheets: The banks have, in fact,

TABLE 1

Energy and real estate loans as a percentage of banks' total loans at year-end 1985

Bank	% energy	% real estate
Allied Bank	8.6	36.4
BancTexas	7.9	32.4
First City Banc.	18.9	31.4
Cullen/Frost	6.9	37.2
InterFirst	15.9	36.8
MCorp	11.2	34.3
National Banc.	3.4	38.6
RepublicBank	12.8	32.7
Texas American	9.6	44.0
Texas Commerce	17.6	31.2
Victoria Bank	5.7	38.2
Texas average	10.8	35.7

(Source: Paine Webber Mitchell Hutchins)

charged off a substantial portion of their problem energy loans since oil prices began to weaken in 1983, but have charged off a negligible proportion of their real-estate loans. The second, heavier, shoe, has yet to drop.

Real estate worse than energy

As **Table 1** indicates, real-estate loans have roughly three-and-a-half times the weight of energy loans in Texas banks' portfolios.

In fact, Texas banks have followed the usual procedure for reducing exposure to the energy sector. They reduced their total energy loans from $13.766 billion in 1982 to $12.075 billion in 1985. However, they drastically increased their exposure in the real-estate sector, which, as reported below, is in disastrous condition. Most real-estate ventures involve a limited cash flow ultimately related to oil income, leveraged with a great deal of outside financing. Oil is the small wheel that turns the big wheel of real-estate speculation. It appears that the response of Texas commercial interests to the downturn in oil-drilling during 1982 was to shift heavily into real estate, particularly under the encouragement of the 1981 tax code.

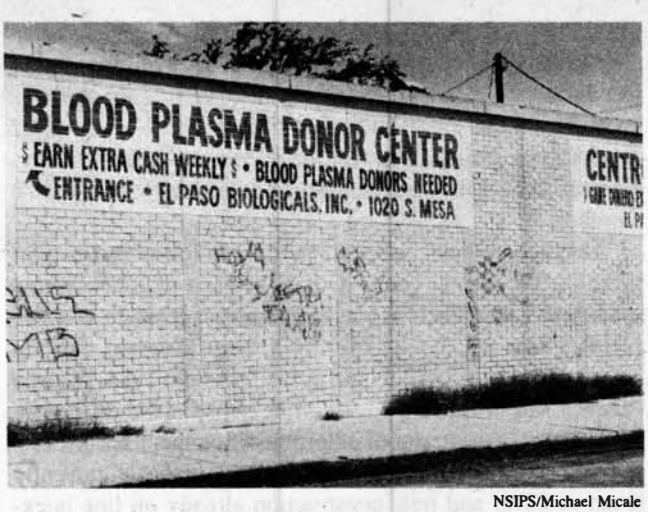
Tax reform: the worst yet to come

As *EIR* reported previously, tax reform will pour gasoline onto the fire. Sen. Robert Packwood's (R-Oreg.) current version of tax reform restores certain benefits to energy, agriculture, and some heavy industries, but proposes an even tougher approach to the elimination of tax benefits in the case of real estate.

The various versions of tax reform in circulation eliminate the features of the 1981 code which sucked money into commercial real-estate development: The total amount of available depreciation is less; rather than 19-year declining-balance (accelerated) depreciation, the various administration and Ways and Means Committee proposals prescribe 30-year straight-line depreciation. A study by the "big eight" accounting firm Price Waterhouse estimates that the value of depreciation benefits will fall by 40% under the Treasury option, the Ways and Means Committee option, and the final version passed by the House, for real estate held for 30 years. Although no such analysis has been conducted upon the current Packwood proposals, the impact will, if anything, be greater.

Also, appreciation of property held for investment purposes would not be taxed at the 20% capital gains rate, but at the 35% ordinary rate, under the tax reform proposals.

Price, Waterhouse concludes that the rate of return on 80%-leveraged real estate would fall by 40%. That is the most typical case for the major commercial office market, in Texas, as well as in Denver and other oil-producing areas. After the second oil shock in 1979, southwestern oil interests dove headlong into the real-estate market, sheltering their enormous oil income through the beneficial provisions of the 1981 tax bill. Between 1981 and 1983, the projects coming on line now in Houston, Dallas, Phoenix, and Denver were submitted to accounts, in the midst of an unprecedented oil boom.



NSIPS/Michael Micale

With the collapse of the real estate boom in Texas, unemployment is rising among construction workers especially. At the rate things are going, selling blood will be the only way for some to earn a living.

The oil boom ended in 1983. The number of rotary rigs in operation in the United States fell from 4,467 in the first week of 1983 to 2,874 by the middle of the year. By the first week of 1984, rigs in operation were down to 2,710, and down slightly, again, to 2,576 in the first week of 1985. The present rig count is under 1,600 and falling sharply. However, the office-building boom continued under its own momentum, since most of the projects begun in the boom days were scheduled for completion in 1985-1986. The construction boom shut down flat in the middle of 1985, leaving the major southwestern cities with 40-story ghost towns in their urban centers.

Even before tax reform hits the fan, the present bad-loan rate on commercial and multi-family residential real estate is in the 15-20% range: a striking conclusion. It is less striking in consideration of a national vacancy rate for office space estimated at 16%. In reality, the vacancy rate is much higher than the usual estimates.

According to the fall/winter 1985 survey of the real-estate market published by the Office Network:

- The national vacancy rate is leveling off at 16.3%, after climbing continuously since 1980. The rate was 16.4% at the beginning of the year.
- Current construction of 177.1 million square feet exceeds that of the 1981 boom and defies the double-digit vacancy rate.
- The national average rental rate has hit a new high of $22.32 per square foot. Quoted rental rates, including on space not yet completed, are expected to continue escalating as space under construction is completed and added to the existing market.

- Absorption reached a new high of 75.9 million square feet during the past 12 months.
- Available space, including uncommitted space under construction, has reached the 365.9 million square-foot level, an amount 4.8 times the absorption figure for the past 12 months.

These remarkable numbers permit the following insight: If the vacancy rate is calculated on the basis of uncommitted space under construction plus existing vacant space, *the true vacancy rate is 27.4%*. Even if it were assumed that the absorption rate of 1985 would prevail through 1986, the true vacancy rate would be 23.9%. We can split the difference and say that one-quarter of all prime office space is currently vacant. In Houston and Dallas, vacant space is currently listed at 28%, and new construction already on line is expected to bring this level up to 40% in the course of 1986.

Most significant in this regard is that resale prices have not yet softened, and rents have continued to rise, from a national average of about $19 per square foot in 1981, to an estimated $22 per square foot at the end of 1985. The biggest year for major sales of real estate in U.S. history was 1985, with 23 sales in excess of $500 million. Even Goldman, Sachs took the opportunity to sell off their headquarters building while the going was good.

The conclusion we may draw from this singular behavior of the real-estate market—a combination of astronomical loan-delinquency and vacancy rates, with still-rising rents and prices—is that *bankers and developers have engaged in a massive fraud to preserve the nominal values of commercial properties, and avoid writing down the values of loans on their books*.

The holes in Texas banks' balance sheets

Although the Texas banks have acted prudently in writing off energy loans, they have hardly begun to write off their real-estate loans. We calculate a 20% loan-delinquency rate on commercial real-estate loans nationally on the basis of hard data reported by the Federal Home Loan Bank Board; numerous interviews in the banking and real-estate industry confirm that this figure is, if anything, an underestimate. We calculate a minimum 30% loan-delinquency figure for Texas, based on the higher (40%) Texas vacancy rate for commercial properties. Assuming that the overall Texas rate for real-estate loan delinquencies, including residential properties, is half of the commercial rate, or 15%, writing off bad real-estate loans would cost the banks 5.25% of their total assets, and virtually their entire shareholders' capital—without taking into account energy or Third World loans.

The Texas banks' charge-offs of real-estate and energy loans amounted to 40% of total loan charge-offs in the case of energy, and 10.2% of total loan charge-offs in the case of real estate, at year-end 1985 (Source: Paine Webber Mitchell Hutchins).

As conditions stood in the Texas real-estate market at the beginning of 1986, i.e., before the crash in oil prices, the true rate of loan charge-offs dictated by market conditions should have been several times larger than the reported rate. That conclusion is obvious: If real-estate loans are three-and-a-half times as important to the banks as energy loans, and delinquency rates, all things considered, are comparable, the loan charge-off rate should be similar. In other words, total loan charge-offs for Texas banks will, according to normal banking practice, be in the range of four times the current rate.

TABLE 2
Reduction in Texas banks' book value

Bank	Aftertax per share additional provision	Adjusted book value	Change in book value
Allied Banc.	$5.60	$10.34	−35.2
BancTexas	n.a.	n.a.	n.m
Cullen/Frost	9.88	12.90	−43.4
First City	11.35	13.24	−46.1
InterFirst	8.77	8.83	−49.8
MCorp	13.64	12.50	−52.2
National Banc.	6.33	11.96	−34.6
RepublicBank	17.41	22.80	−43.3
Texas American	16.63	18.17	−47.8
Texas Commerce	14.68	21.25	−40.9
Victoria Bank	2.87	16.89	−14.5

(Source: Paine Webber Mitchell Hutchins)

At this point, all but one of the major Texas banks would be unsalvageable, even under the most generous criteria the bank regulators might devise. Paine Webber conducted a hypothetical exercise, published Feb. 26, 1986, concerning the changes in Texas banks' book value under various assumptions. Assuming

1) $15 per barrel oil;

2) a 10% charge-off of general commercial and industrial loans and real-estate loans;

3) a 5% charge-off of consumer loans; and

4) a 25% charge-off of Mexican and Venezuelan loans and aggregate energy net chargeoffs,

Paine, Webber projected those reductions in Texas banks' book value, from the current reported level, that are shown in **Table 2.**

By the above criteria, any bank whose book value would decline by 40% or more under the Paine, Webber, scenario, would have negative book value under a more realistic set of assumptions concerning the oil price, as well as the Texas real-estate market. Among the major Texas banks, it appears that the Victoria Bank is the only one whose problems remain under the danger line.