

Prospectus

The Commercial Mortgage Dilemma: Banking's Next Credit Challenge

- Is It A Crisis?
 - 2010 Risk Scores For The 447 Largest Banks
 - 18-Year Delinquency & Net Chargeoff History
 - Market Size, & How Risk Is Spread
 - Commercial Foreclosures By Type Of Building
 - Commercial Foreclosures By State & Metro Area
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SUMMARY OF THE STUDY

As 2009 came to a close, a new banking dilemma had emerged.

Some analysts, economists, and lots of financial news headlines proclaimed that the home loan credit crisis of 2009 would be followed by another in 2010. **Massive defaults on commercial mortgages would be the next mess to cripple the banking industry.**

Was this true – or an exaggerated account by the grumbling "bears?"

If there is a commercial mortgage crisis, which companies will be most at risk? Where will the problem be at its worst? What kinds of commercial properties will go down?

SMR has marshaled all of its data resources to investigate these questions and find balanced answers.

We tapped more than 140,000 regulatory financial reports filed by all of the nation's bank holding companies, independent banks, and thrifts over the last 18 years. Results show the pattern after prior recessions, and the pattern now emerging, in non-performing commercial mortgages and multi-family loans.

We also devised a risk scoring system and applied it to the 447 largest U.S. banks, forecasting their risk exposures for 2010.

And, we utilized our in-house property database to look at completed foreclosure rates on commercial properties – looking at 27 categories of buildings by type, as well as statistics by U.S. state and metro area.

So, what's the general finding? A true crisis? Much ado about nothing? The answer is in between.

Some institutions are clearly going to have a severe problem involving commercial mortgage defaults in 2010. But they won't include the biggest of the banks. And some evidence is beginning to show that if there is a crisis, it may be short-lived.

This Prospectus explains the content of the study.

If your firm has no exposure to commercial mortgages – and no interest in terms of investment – then this 130-page study may be research "overkill."

But if your firm is involved, you'll find this study to be the only one of its kind – presenting all of the salient facts and analyzing them as well.

An Order Form is enclosed or available on our web site. Thanks.

HIGHLIGHTS

The Case For Crisis

Observers who say that commercial mortgage defaults will become a real crisis in 2010 have serious reasons.

Looking at multi-family apartments, we found, the vacancy rate is now the highest it's been since at least 1965. Extremely high vacancy rates also are impacting retail and office building space.

As 2009 was coming to an end, you could see the dilemma in bank statistics. **The percentage of commercial mortgage loans 90 days or more delinquent was rising by a full percentage point per quarter through the first nine months of 2009 – with no clear end in sight.**

And of course, this new dilemma hits a banking industry already weakened by dramatically high credit losses on home loans and credit cards. **Smaller banks that escaped most of that pain may not escape this time.**

Looking at all bank holding companies with less than \$1 billion of assets, fully 32.5% of their combined assets are tied up in commercial mortgages, multi-family loans, and commercial construction and land loans.

How big is the problem? Total U.S. commercial mortgage debt recently was \$3.46 trillion – three times larger than some news reports have cited.

The Case For Calm

Despite the gloom, there are other reasons to believe that the banking industry will be able to handle a new commercial mortgage credit mess.

While the rate of high delinquency on these loans is up, **the rate of early-stage delinquency appears to have peaked in Q1 2009.** If sustained, the improvement since then – combined with the U.S. economic recovery – could make the commercial mortgage dilemma a short-lived problem.

Meanwhile, only a handful of the largest banks will have a problem. Of the four U.S. "mega-banks" (banks with over \$1 trillion of assets each), two appear to be completely "walled off" from exposure to commercial mortgages. A third is just marginally exposed.

Non-performing commercial mortgages, although high, are still lower than in the recession of 1991 – a period we did survive.

And, a surprisingly large portion of the \$3.46 trillion market is comprised of loans for which banks and thrifts have no credit risk exposure.

HIGHLIGHTS (continued)

Learning From The Past

SMR has been collecting delinquency and default data on the commercial mortgages of each U.S. bank and thrift for 18 years.

We utilized all that data in Section III of this study to show a long history of commercial mortgage credit cycles.

Tables and charts illustrate how bad the cycle has been in the past, and how long recovery has taken.

Ranking Banks By Risk

Since this appears to be a crisis for some banks – but not for all of them – it became paramount for us to identify risk levels by company.

We did so with a simple, effective risk-ranking system. We looked at all recent, highly delinquent commercial mortgages as a percent of the total assets of each U.S. bank holding company. We multiplied the result by 100, expressing 2010 credit risk levels in basis points.

Results rank-ordered risk by company. Looking at the 477 largest banks in the USA, some had commercial mortgage risk scores of zero – literally no risk whatsoever. **The worst had a score of 1,210, meaning potential losses equal to about 10 times what a bank typically earns in a good year.**

We name names in this study. Section IV ranks all banks with at least \$1 billion of assets by their commercial mortgage risk scores.

Risk By Property Type & Place

Shifting to our national property records database, SMR computed commercial property foreclosure rates in 2009 by type of property and by place. The last two sections of this study show the results.

Are restaurants still the riskiest bets for commercial mortgage loans? Nope. Are there still any "safe" categories of property by type? Yes.

How about geography? Have commercial mortgage foreclosures been concentrated in the same places as home loan trouble? The answer is: Sometimes, but not always.

We show commercial property foreclosure rates for 27 types of property, as well as rates by state and in more than 400 metro areas.

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Other SMR Products & Services

Think you've got it tough? Try selling fat brown books of market research to banks still alive but cutting costs! It's a good thing we have other lines of business – but you may not know about them.

Consulting Services

SMR has long been a lead research firm for the **American Bankers Association** on bankruptcy and related subjects. We've served other trade groups as well.

Much of the consulting we do is based on unique, deep, in-house data: some 20 years worth of bank, thrift, and credit union loan and financial statistics, bankruptcy filing rates, HMDA loan and income data, HUD and FHA data, property and lien records spanning the nation, and much more.

Before you spend huge sums on the McKinsey's of the world, why not give us a call? We know the subjects. We often work cheaper.

Predictive Modeling

SMR currently creates four scores each month forecasting which home owners will both want and qualify to get mortgage refinances and home equity loans. The use is in direct marketing.

Another SMR score is the most accurate available, we believe, in estimating incomes of specific households. And another uniquely estimates total liquid assets of households.

We are a full-fledged modeling shop, designing customized predictive models as well for our clients.

Want to learn more? Call SMR President Stu Feldstein or Director Jon Varone at 908-852-7677.

Knowing The Landscape

If you manage a line of financial business, you've surely had that moment when you say to yourself: I really need to find this out about the industry. Does the information exist out there? Who's got it?

Sometimes, an Internet web search just doesn't have the answers.

If so, give us a call. SMR personnel have spent 25 years gathering up every detail available from public sources on financial subjects. If we know where you can get what you need, we'll let you know; no charge.