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## Banks and Mortgages: Love on the Rocks

By Sam Chandan

December 1, 2009 | 4:58 p.m

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The broader market's increasingly conventional wisdom regarding the intersection of the banking sector and commercial real estate has compartmentalized the nation's regional banks as a focal point for increasing commercial mortgage woes. The negative perception stems from the rapid rise in the delinquency and default rates of CMBS and bank-held commercial mortgages and its coincidence with relatively higher commercial mortgage concentrations on the balance sheets of regional banks.



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A report released Monday morning by Real Estate Econometrics substantiates that defaults in bank-held commercial mortgage pools are rising, but also speaks to the marked variation in outcomes across lenders with similar commercial real estate concentrations. The bottom line: While regional banks

exhibit greater commercial real estate exposure, the default and loss experience of individual institutions covers a range that belies an assumption of homogeneity.

### How Banks' Commercial Mortgages Are Performing

The national default rate for commercial real estate mortgages held by depository institutions rose from 2.88 percent in the second quarter of 2009 to 3.40 percent in the third quarter of 2009, according to Real Estate Econometrics' analysis of data published by the Federal Deposit Insurance Corporation (F.D.I.C.). This increase is consistent with Real Estate Econometrics' projections for the commercial mortgage default rate trajectory in

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2009. The national default rate for commercial mortgages held by depository institutions is projected to rise to 4 percent in the fourth quarter of 2009. The default rate is projected to rise to 5.2 percent by year-end 2010, and to peak at 5.3 percent in 2011, before beginning to fall back.

The default rate for multifamily mortgages surpassed that of commercial mortgages in the second quarter of 2008, and has remained marginally higher in the ensuing period. Between the second and third quarters of 2009, the multifamily mortgage default rate increased by 44 basis points, rising from 3.14 percent to 3.58 percent. Like the commercial mortgage default rate, the default rate on multifamily mortgages has more than doubled over the past year, rising by 211 basis points, from 1.47 percent in the third quarter of 2008. At its cyclical low, the multifamily mortgage default rate was just 0.24 percent in the first and second quarters of 2005.

The combined balance of delinquent and defaulted commercial mortgages increased by 14 percent in the quarter, from \$44.1 billion to \$50.3 billion. The balance of delinquent and defaulted multifamily mortgages increased by 9.8 percent in the quarter, from \$9.3 billion to \$10.2 billion.

### **There's More to the Story Than the Headline**

The increase in foreboding headlines about commercial defaults notwithstanding, we find that mortgage performance varies dramatically across banks. The analysis shows that banks with similar concentrations in commercial real estate may exhibit marked differences in delinquency and default rates. In particular, an analysis of loan performance at the 5,015 institutions with the largest exposures to commercial real estate shows no statistically significant relationship between concentration and default rate. In fact, default rates are often higher for institutions in larger asset-size groups, where concentrations are generally lower.

While the largest institutions (those with \$10 billion or more in assets) have significantly lower commercial real estate concentrations, they also exhibit higher default rates at the mean and across the distribution. The median default rate at the largest institutions is 2.7 percent, as compared to 1.4 percent across the broader pool.

Across an array of tests, the report suggests that regional banks' experience with their commercial mortgages should not be pigeonholed. Rather, the absence of a clear default-rate-concentration relationship-coinciding with variation in loan-portfolio performance across institutions with similar concentrations-reinforces that institutional factors, including risk-management capabilities and accountability structures, may be just as determinative of commercial mortgage performance as the apparent ignominy of a regional footprint.

Aggregations of data that fail to recognize these critical dimensions of institutional variation also fail to convey the current and prospective performance heterogeneity of these smaller and midsize institutions.

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