Community Banking Monitor
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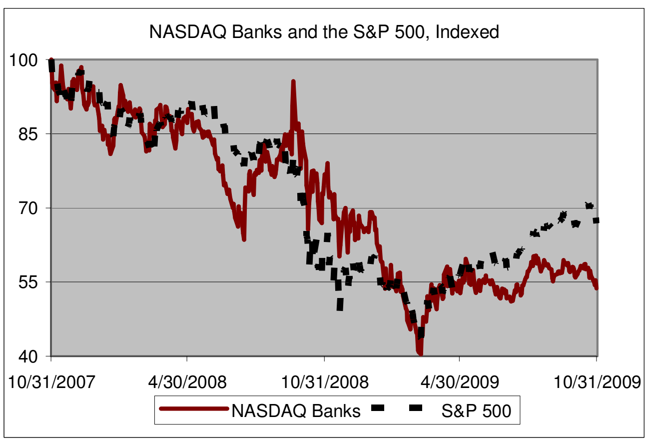
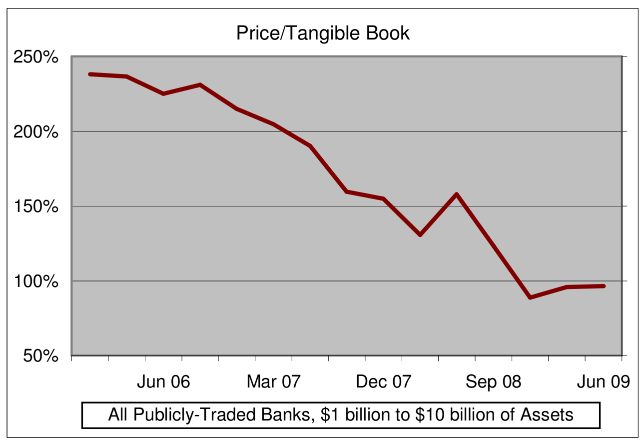
OAK RIDGE FINANCIAL
The Oak Ridge Financial Services Group, Inc.

The Eye of the Hurricane?

Perhaps we are indeed past the worst of it. Housing seems to be showing signs of a modest upturn – the Case-Shiller index of home prices apparently bottomed in the April-May period and has increased slightly since then, new and existing home sales have recently been trending modestly positive, housing starts have provided some moderate surprises on the positive side, and mortgage delinquencies and home repossessions have recently been trending in the right direction. In part due to these favorable trends, bank stocks have performed quite well in the past several months, with the community bank-dominated NASDAQ Bank Index climbing 49% from its March low to its early-August high (although it has been drifting off since then). During that period, the broad S&P 500 Index recovered by 62%. Of course, it also needs to be pointed out that the NASDAQ Bank Index is still down 53% versus its early 2007 peak, and our focus group of smaller and mid-sized banks is trading at only 96% of tangible book value. So while the banks have climbed up off the mat, they are certainly still bloodied.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

So, can we relax and breathe easily? Unfortunately, probably not; we fear that we are likely to see a continuing stream of bad credit quality news extending well through this year and most of 2010 as well. The damage shouldn't be as much of a surprise, and may not even be quite as harsh as the first part, but we suspect there is another period of fairly severe credit losses ahead – the second half of the hurricane, if you will. In our opinion, there are at least two more "pigs in the python" that need to be processed before the all-clear signal can be sounded. And even though neither of these two pigs my actually reside in the loan portfolios of most community banks, they have the ability to infect healthy banks.

Pig #1 -- Phase II of the residential mortgage cycle. While the sub-prime aspect of the mortgage/home price cycle is probably in its later stages, there are significant ripple effects that seem alarming. For one thing, some of the stability in this area is due to mortgage relief programs, which tend to be short-term fixes with renewed delinquencies likely to follow. More importantly, the collapse of this segment of credit has clearly led to a weaker economy, which affects all forms of credit quality; the foreclosure of low-quality mortgages has resulted in a heavy inflow of repossessed and "short sale" homes into the market, depressing the value of virtually all of the

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single-family housing stock and substantially eroding the net worths of most consumers as a result.

These factors leave us in a poor position to handle a probable new jump in the supply of houses as aggressive (irrational is a better word) mortgages written to nominally good credits in the recent past – option ARM loans and interest-only ARM loans, for example – reach their "come to reality" rate adjustments, moving a whole new crop of borrowers into a position of not being able to cover their mortgage payments. As they adjust during the next several quarters, mortgage credit is not likely to be available at generous terms to allow for refinancing, and we seem fated to be pushed into another wave of foreclosures. This will not only make it difficult to work off any portfolio of repossessed homes without suffering significant write-downs, it will tend to maintain the stress on consumer balance sheets and therefore consumer spending, the primary driver in our economy.

Pig #2 -- Commercial real estate loans. Most community banks have relatively modest exposure to residential loans in their portfolios, so that the pressure on their credit quality has been largely indirect (the impact on economic activity). That cannot be said for commercial real estate lending, a category of credit that has been the focus of a lot of the balance sheet growth for many community banks during this decade, much more so that for the biggest banks. In our view, investors' perception of an outsized exposure to commercial real estate is a major reason why the recovery in the NASDAQ Bank Index has lagged so far behind that of the S&P Bank Index.

The risks in this category are both direct and indirect. The direct impact comes in the form of commercial real estate loans made by the banks to support ventures with shaky economic prospects; we have all seen the half-empty shopping malls, primarily financed by community banks. The equivalent in half-empty (or moving that way) office buildings are not so visible, but represent another major category of loans where the underlying economics of many properties have deteriorated severely.

Compounding this risk is another ripple effect. In the middle part of this decade, the rapid growth of the securitization of commercial real estate mortgages (the CMBS market) generated a very large amount of funds to be invested in commercial real estate, with the predictable effect of driving up loan-to-value relationships at the same time that loan yields were competed downward. These loans were typically granted on an intermediate-term basis (3-5 years), with the idea that the loan would be rolled over (and maybe even increased due to appreciation) at the end of that term. But occupancy has been weak, commercial real estate values have declined, and the securitization market is all but dead.

In other words, the loans are not renewable at anything like their original terms, and there will be no good solution at hand when the loans come due. We expect to see substantial write-downs over the next few years, along with the bankruptcy of some commercial property owners, as this effective unavailability of credit combines with the upward pressure on vacancy rates and downward pressure on lease rates resulting from the weak economy. All of this suggests a significant increase in the supply of commercial real estate space as lenders and developers attempt to escape their plight, with the increased supply representing a feedback loop that will generate and maintain a new source of credit issues for some time.

No one knows exactly how these two factors will play out, but they tell us that we are quite a ways away from being out of the woods in terms of credit losses. On the other hand, on something of a positive note, we suspect that the category of pure commercial (C&I) loans, which would presumably be pressured by the ongoing weakness in our economy, will probably prove to be relatively manageable.

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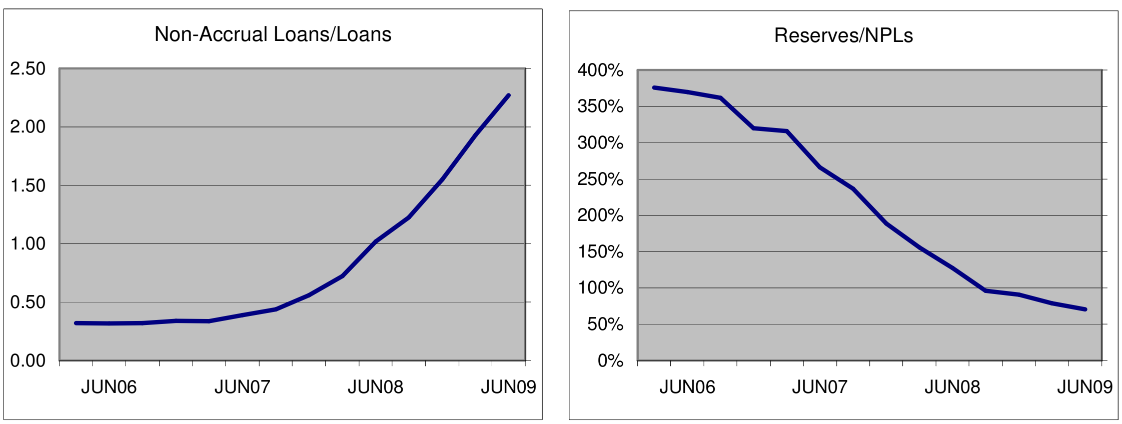
We believe that lending excesses were far less prevalent here than in residential and commercial real estate lending, in large part because it takes more time, work and skill to generate C&I loans. But real estate lending, which in our view can be (and has been) grown quite quickly and carelessly, is likely to present a major challenge to many bank managements for another couple of years.

Conclusion: Darwinian Banking, Chapter II. This does not represent a complete disaster scenario – those banks which are reasonably on top of their credit problems, which have adequate loss reserves, and which have strong capital ratios (and therefore, probably have pretty good relationships with their regulators) should be in position to gain significant competitive advantage over those banks which will need to use all of their abilities to just stay alive. In that sense, it seems to us that the bank industry is in a Darwinian banking environment like that of the early 1990s, in which the strong succeed while the weak tend to go away while they are waiting to be saved by a vigorous economic rebound (that seems unlikely to occur). Contributing to these forces, now as in the early 1990s, is the nearly undeniable conclusion that regulators continue to play catch-up by requiring relatively severe asset write-downs at the same time as they are requiring substantial boosts to both loss reserves and capital, actions that should have come earlier but are now pro-cyclical. So we are once again facing sharp increases in problem assets at the same time as we're seeing erosion in the balance sheet strength needed to deal with those problems:

All Banks $2 billion to $10 Billion of Assets



Source: Highline Financial

Once again, the industry is likely to be restructured; we expect to come out of this storm with a new crop of clear winners, and a longer list of casualties. For those positioned to take advantage of the turmoil, it should be a period of exceptional opportunity, perhaps the best in a generation. To take advantage of these opportunities will require that a bank has rigorously dealt with current and potential asset quality issues as well as having built very substantial, even historically high reserves against those assets. In addition, there should be substantial rewards for healthy capital ratios, strong management teams, and relatively healthy regulatory relationships. While boosting reserves and/or adding equity would clearly have a negative impact on near-term earnings, balance sheet ratios are now the key, not profit margins. And to paraphrase the Duchess of Windsor, who reportedly said that a woman can never be too rich or too thin, we might say that banks currently can't have too-high loss reserves or too much capital.

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