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Credit: The problem or the solution to the financial crisis?

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I awakened this morning to news that Iceland is the most over leveraged country in the world, and on the verge of bankruptcy. A small country of 300,000, its few major banks are becoming nationalized for protection, victims of the worldwide credit crunch taking place.

I pondered whether an over-built and over-valued housing product in places like Los Angeles, Las Vegas, and Miami could possibly have lead to the bursting of a housing bubble and, ultimately, to a financial crisis in Iceland, or the rest of the world for that matter.

Most pundits say that our economic problems started with an unsustainable rise in residential real estate valuation. They attribute this primarily to deregulation of credit under the Clinton administration, which grew to abusive levels during the Bush administration, combined with lowered interest rates by the Fed., leading ultimately to increases in the purchasing and valuing of residential real estate. Do the math; if interest rates were 6% to 8% at the beginning of the period, and dropped to variable rates of 3% and 4%, then the borrowing power of individuals effectively doubled. For a family earning $50,000 a year which may have been able to purchase a house for $250,000, the lowering of rates gradually moved up borrowing power to purchase a house of $500,000 to $600,000.

As appraisers know well, valuation is based upon the last best sale, and as the purchase prices went up, so did the valuations, and so did the belief in these values. Using easy credit from home equity loans, people also purchased automobiles, vacations, electronic equipment, whatever, with the newly inflated value of their homes, which seemed to be "all good".

Add to this some the brightest and most creative minds on Wall St., creating new financial vehicles by which traditional loans could be pooled, dissected by risk level, securitized, and sold to a world market of stockholders. Top it off with a social policy that argued for home ownership for all in America, as the fulfillment of the American dream and you ended up with a prescription for a "bubble" that was unsustainable. (From January 2000 to its peak in January 2007 the Case-Schiller home price index for the composite 20 U.S. metropolitan areas increased at an unsustainable annualized rate of nearly 11%, only to drop at an annualized rate of over 12% through July 2008.).

Who knows what started the downward trend from the top of the parabolic bubble curve: loan defaults from unqualified sub-prime borrowers, revaluations, equity line problems, increasing credit card debt, it doesn't matter. The fact is that confidence in the bubble faltered, credit tightened, and the lenders decided they wanted to be paid back. The payments could not be made without the ever inflating sales of homes as in the past. Traditional banks and investment banks learned they were under capitalized compared to the amount of unsustainable debt now in the marketplace. You all know the recent news of the resultant failures.

Now the "toxicity" (a soon-to-be over-used word) has moved into commercial real estate. With credit almost impossible to obtain, and ten-year old loans created by Wall St. coming due, who will be there to refinance? Wall St., as we knew it, does not exist. My lending and mortgage brokerage friends tell me that the some small traditional banks, some insurance companies, and large commercial banks are still there. The lending rules however, have changed with requirements for significantly more equity, higher rate spreads based on risk, lower valuations, and personal recourse. Clearly this is having a downward impact on commercial purchases and development, and ultimately on values.

I end with one point and one question. The proposed solutions thus far to this credit crisis are to re-inflate the economy with new money, take over or underwrite bad debts, redo mortgages so they are once more affordable for people who couldn't afford them, and further lower interest rates. In other words, and clearly this is an over simplification, the solution to a credit crisis, brought on by too easy credit, is to provide more ample and easier credit. Isn't this a little ironic? Clearly there needs to be credit available, and the pendulum has swung too far in the tightening direction. Banks need to start lending to other banks, as well as to businesses. But ultimately will it create the same problem and simply postpone the pain?

Daniel Calano is managing partner and principal at Prospectus, Inc., Cambridge, Mass.