

Lending Crisis Will Get Worse

In 2008, the lending crisis will continue to extend far beyond the creative sub-prime mortgages that precipitated the massive problems we're now experiencing. With falling housing prices and rising default rates, lenders are now becoming more afraid to make loans to even qualified borrowers – and are tightening their loan standards, even on "A" paper loans. Loans are getting approved, but in most cases, buyers have to come up with sizable down payments, have high credit scores, and, in most cases, fully document their income.

Take giant investors like Fannie Mae and Freddie Mac, for example, who buy and own trillions of dollars of mortgage loans. Starting March 1, they require an extra 5% down payment in declining markets. That's now all of California, Florida, Nevada, Arizona, and many other metro areas. And if first-time home buyers can't buy until they save up 5% or more down, it impacts the entire housing chain, and so practically no one can sell their home. At the end of the day, it's the first-time homebuyers that drive the real estate market.

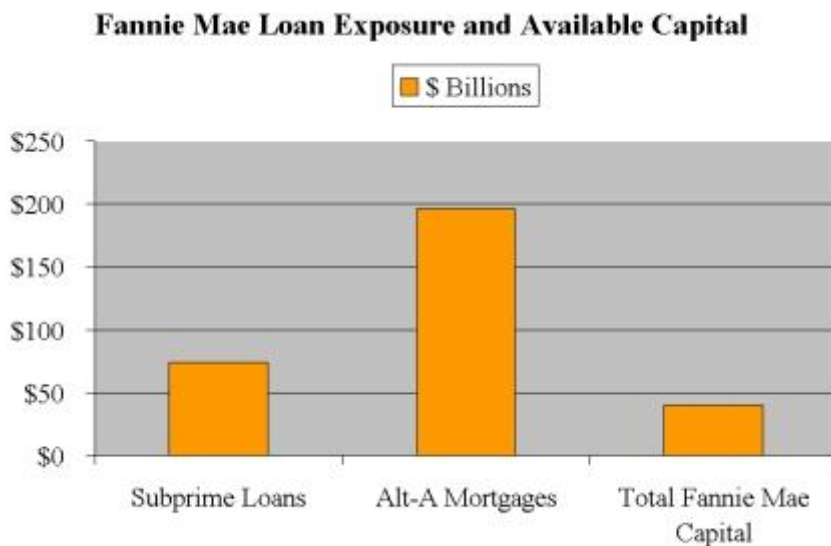
Once considered "prime" borrowers, significantly higher fees are also being charged to those people with FICO credit scores less than 680 and who have less than a 30% down payment – either in the form of higher loan costs or higher interest rates.

While it's true that sub-prime lending died off a year ago, these changes back to "normal" loans are only now starting to have a more and more serious impact on mortgage lending. In addition to the increased down payment requirements, Freddie and Fannie are often requiring a minimum of 6 months worth of "reserve" mortgage payments in the bank. As one mortgage broker said to me, "and who has that!"

The U.S. banking system is heading deeper into a crisis. Data from First American Core Logic estimates that if home prices fall 20 percent, there will be 13.7 million homeowners with negative equity. If prices fall 30 percent, that number would rise to more than 20 million.

Only time will tell how far housing prices will ultimately fall, but its safe to say there are going to be a massive amount of loan losses – maybe a trillion dollars or more by some estimates – and that explains why mortgage lending is tightening up.

To illustrate the amount of bad debt out there, and the huge problem that many if not most owners of mortgages face, take a look at the chart below.



As of September 30, 2007, Fannie Mae had \$40 billion in capital. The company also owned \$196 billion in Alt-A loans and \$74 billion in sub-prime loans (loans with a FICO score under 620). Altogether, Fannie owns \$2.7 trillion worth of mortgages. If a high percentage of the risky loans go bad – and there's no reason to think they won't – Fannie Mae could quickly lose all the capital they have, becoming insolvent, and they would not be able to purchase any more mortgages without capital infusions.