Crunch Time?

Lenders Tighten the Reins on Mortgage Loans

By JUSTIN DION, Esq.

The facts appear overwhelming. The housing market is continuing to cool, interest rates are slowly increasing, and foreclosure rates are reaching record numbers. In fact, the Mortgage Brokers Association recently reported that 5% of all mortgages in the U.S. are in default.

The culmination of these factors appears to have had a catastrophic effect on a number of lenders that are suffering losses, especially in the subprime market.

The Problem — from the Perspective of Residential Mortgages

The calamitous affect on lenders is most clearly evidenced by the recent bankruptcy filing of one of the nation's largest mortgage lenders, American Home Mortgage. In addition, at least five other lenders have stopped funding loans or appear to be experiencing instability, including the biggest mortgage lender in the nation, Countrywide Financial Corp., which recently reported escalating financial problems due to the continuing rise in the default rate.

Especially hard hit have been subprime and mortgage loans in which people seek to borrow more than 80% of the value of their house. These borrowers are facing increasing difficulty as lenders are concerned with continuing real estate value depreciations.

These lending circumstances seem to create a complex situation as mortgage loans become more difficult to obtain, and home sales will likely continue to decrease. As this happens, home values tend to decrease as well, which in turn leads to an increase in default and foreclosure. Lower home values mean some refinances and sales are no longer an option, due to a sudden lack of home equity.

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Following the loss of high-risk lending, the crunch may ease into traditional markets, thus making it more difficult for companies and people with good credit to obtain loans. To gauge the health of the lending market, typically we could look at the financial markets and determine the willingness of investors to make money available. Based on recent market fluctuations, it would appear there are some signs a credit crunch may be upon us, as the market has suffered significant losses in mortgage investments.

As more homeowners lose their homes to foreclosure, lenders will continue to suffer significant losses. In addition, the rising foreclosure rates have caught the attention of both state and federal officials, who have started scrutinizing mortgage lending policies.

In turn, lenders now scrutinize potential borrowers more carefully. Prior to the subprime collapse, a borrower who missed a monthly payment was simply monitored, whereas in the current market, a lender must now set aside earnings in reserve for possible loan losses. The lender's fear of default leads to skepticism and, ultimately, a bank that is less inclined to loan money across the board.

The Problem — from the Perspective of Commercial Lenders

Although the commercial market has not experienced the sudden collapse experienced by the subprime home mortgage industry, both the residential lending market and the commercial lending market are interrelated.

As fear and uncertainty continue to build in the home mortgage market, commercial pessimism will likely continue to build.

This is evidenced by changes on Wall Street, as investors continue to move money away from the volatile lending market and into more secure and consistent investments. Although this affect has not yet fully solidified in the commercial marketplace, borderline commercial loan applications are increasingly subject to higher scrutiny.

Surviving the Storm

As with most finances, mortgage money is cyclical. Most anticipate things will eventually turn around and the crunch will ease. In the meantime, there are steps that can be taken to minimize the impact of the current conditions.

Delay Selling. If it's not essential, consider postponing the sale of your home. Because there is less mortgage money available to buyers, the pool of potential buyers begins shrinking, thus resulting in fewer and lower offers to buy your home.

Delay Buying. As real estate values depreciate, if you are not in need of mortgage financing, it may be a good opportunity to consider purchasing real estate at values that have been reduced. However, if you are in need of financing, the time may not be right to purchase until mortgage markets stabilize. Also, avoid adjustable rate mortgages because indicators show a likelihood of increasing interest rates. The ability to refinance out of an adjustable-rate mortgage is no longer guaranteed.

Loan Reformation. Because many homeowners recently refinanced with adjustable rate mortgages, intending to refinance again, the loss of mortgage money may make another refinance difficult. Some lenders may be open to rewriting some of the terms of your current mortgage in order to make them more favorable and thus allow you to avoid foreclosure.

Second Mortgages. During times of falling equity, avoid using a second mortgage to pay off unsecured debts and to make small home improvements. Not only does this put your house at increased risk of foreclosure due to the increase in your monthly mortgage obligation, but it also may make your house more difficult to sell, because now any selling price must include the payoff for the first and second mortgage.

Smart Planning. Although a commercial credit crunch has not materialized, some believe it may be a forthcoming consequence of residential lending instability. As such, a business contemplating the need for a business loan in the near future may want to adjust its current financial needs with some skepticism regarding the availability of definite funds.

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Although Ben Franklin is quoted as proclaiming, "… he that goes a-borrowing goes a-sorrowing," in reality, borrowing money is a necessity for most homeowners and companies. Smart planning and good timing will help most borrowers survive the ups and downs that accompany the fluid borrowing markets.

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