Commercial Finance- The Mortgage Meltdown

Contributed by Gregg Elberg
Saturday, 08 March 2008

Commercial Finance- the Mortgage Meltdown explores the history of the mortgage meltdown of 2008, and the likely consequences to the public. The article looks back at the savings and loan crisis of the late 1980’s for comparisons. The effects on commercial finance, purchase order financing and accounts receivable financing are also discussed.

{mosbotwordcount}

Banks lend money to people and businesses. The money is used for investment purposes and consumer purchases like food, cars and houses. When these investments are productive the money eventually finds its way back to the bank and an overall liquidity of a well functioning economy is created. The money cycles round and round when the economy is functioning effectively.

{bot_wrgoogle}When the market is disrupted financial markets tend to seize up. The liquidity cycle may slow, freeze up to a degree or stop completely. This is true because banks are highly leveraged. A well capitalized bank is only required to have 6% of their assets in core capital. It is estimated that the residential mortgage meltdown will cause credit losses of about $400 billion dollars. This credit loss is about 2% of all U.S. equities. This hurts the bank’s balance sheets because it impacts their 6% core capital. To compensate, banks have to charge more for loans, pay less for deposits and create higher standards for borrowers which leads to less lending.

Why did this happen? Once upon a time after the great depression of the 1930’s a new national banking system was created. Banks were required to join to meet high standards of safety and soundness. The purpose was to prevent future failures of banks and to prevent another disastrous depression. Savings and Loans (which still exist but call themselves Banks today) were created primarily to lend money to people to buy houses. They took their depositor’s money, lent it to people to buy homes and held these loans in their portfolio. If a homeowner failed to pay and there was a loss, the institution took the loss. The system was simple and the institutions were responsible for the building of millions of homes for over 50 years. This changed drastically with the invention of the secondary market, collateralized debt obligations which are also know as collateralized mortgage obligations.

Our government created the Government National Mortgage Association (commonly known as Ginnie Mae) and the Federal National Mortgage Association (commonly known as Fannie Mae) to purchase mortgages from banks to expand the amount of money available in the banking system to purchase homes. Then Wall Street firms created a way to expand the market exponentially by bundling up home loans in clever ways that allowed originators and Wall Street to make big profits. The big stock market firms were securitizers of mortgage-backed securities and resecuritizers who sliced and diced different parts of the groups of home loans to be bought and sold in the stock market based on prices set by the market and market analysts. Home loans, packaged as securities, are bought and sold like stocks and bonds.

In the quest to do more and more business, the standards to get a loan were lowered to a point where, at least in some cases, if a person wanted to buy a house and could assert they could pay for it they received the loan. Borrowers with weak or poor credit histories were able to get loans. There was little risk to the lender because unlike the earlier days when home loans were held in their portfolios, these loans were sold and if the loans defaulted the investors or purchasers of these loans would take the losses i.e. not the bank making the loan. The result today is tumult in our economy from the mortgage meltdown which has disrupted the overall financial system and affects all lending in a negative way.

Who is responsible for this situation? All loan originators, including banks, are responsible for turning a blind eye to loans that were based on poor credit criteria. Under the label of “subprime” loans there were low documentation loans, no documentation loans and very high loan to value loans- many of which are the foreclosures we read about on a daily basis. Wall Street is responsible for pumping this system into a financial disaster that may grow from the current $400 billion dollar estimate to over a trillion dollars. Realtors, mortgage brokers, home buyers and speculators are responsible for their willingness to pay higher and higher prices for homes on the belief that prices would only go higher and higher. This basically fueled the system for the mortgage meltdown.

Are there any similarities to the saving and loan crisis of the 1980’s? Between 1986 and 1995 Savings and Loans (S&L’s) lost about $153 billion. The institutions were regulated by the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation. These entities passed laws that required the S&L’s to make fixed rate loans only for their portfolios. The rates that could be charged for these loans were determined by the marketplace. Imagine an institution with $100 million in loans at 6% to 8%. For years the interest rates on deposits were also regulated by the government. The interest rate spread between the two allowed institutions to make a small profit.

In 1980 the U.S. Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). A committee was established in Congress. Over a period of years the committee deregulated the rates S&L’s could pay on savings. Nothing was changed with respect to what could be charged for home loans. Many institutions started to loose huge amounts of money because they had to pay market rates of 10% to 12% for their savings, yet they were stuck with their old 6% to 8% loans. Some executives in the savings and loan business referred to this committee as the damned idiots in Washington.

Many books have been written about these events. There is documented evidence of substantial wrongdoing by S&L executives who were trying to invest funds to save their institutions, sometimes for personal gains. Some were sophisticated criminals. Congress recognized their mistake in 1982 when the Garn-St.Germain Depositary Institutions Act was passed to allow S&Ls to diversify their activities to increase their profits. It also allowed S&L’s to make variable rate loans. It was too little too late. After bankrupt institutions were liquidated by the government, the surviving S&Ls were assessed billions of dollars by the Federal Deposit Insurance Corporation to replenish the fund that insures the depositors of all U.S. banking institutions.

The mortgage meltdown and the savings and loan crises are similar with regard to the presence of greed and criminal activity. They are very different with respect to the fact that the S&L crises originated from a broken government mandated regulatory system and the mortgage meltdown has been caused primarily by a system that went wild with greed.

This has impacted non-bank lenders such as private commercial finance companies that provide hard money real estate loans, purchase order financing and accounts receivable financing. Most of these firms have raised their prices and their origination standards for safety and soundness of operations.

The bottom line: Bank lending can be replaced by other sources such as commercial finance companies to some degree. Hard money, purchase order financing and accounts receivable financing will help some businesses grow during these difficult times. But for the average borrower, businessman, or business owner these are difficult economic times, caused by the mortgage meltdown, which are here to stay for several years.

www.greggfinancialservices.com

Mr. Elberg is a licensed attorney and licensed real estate broker. Gregg Financial Services is a full service brokerage for commercial finance companies and banks that fund B2B businesses. We work with all industries and can arrange financing transactions throughout the US and Canada, Mexico, Australia, India and several areas of Europe including the UK, Ireland, France, and Poland. Mr. Elberg arranges funding from $25,000 to $50 million per month at competitive pricing, and works to reduce your financing costs as your company grows. For more information about GFS, please call 888 482 9221 or visit our website: http://www.greggfinancialservices.com