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The credit crunch: How did it happen and where do we go from here?

First in a special six-part series on coping with the financial crisis

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By Tim Grant

A chain reaction of adverse events this year in the financial markets has put the squeeze on lenders and made it harder for businesses and consumers to get loans.

The residential foreclosure crisis that swept the nation and dominated the headlines in 2007 has ultimately caused what is known as a credit crunch.

In a credit crunch, lenders stop lending and start hoarding cash because they are afraid of rising bankruptcies and mortgage defaults. It leads them to charge higher interest rates or reject all but the safest loans.

For an economy that has been fueled by easy access to borrowed money, tighten credit could spell trouble for companies that need loans to pursue their business plans and for consumers who want to buy big-ticket items.

"The credit crisis is all about the consumer and the consumer's ability to purchase things as they have in the past," said Paul Brahim, executive vice president of BPU Investment Management, Downtown.

"The big issue today is if the consumer contracts and stops spending money or depositing money, the economy slows to a halt," Mr. Brahim said.

Normally, banks fear that individuals and business borrowers won't be able to repay them on time.

Now, banks are even afraid to loan to each other because no single bank knows what the other's exposure to the credit crunch really is.

The Federal Reserve recently has taken steps to help make it easier for banks to borrow from the government when they can't borrow from other banks. Earlier this month, the Fed cut the interest rate it charges banks on overnight loans to 4.75 percent and extended its loan terms to 30 days to encourage banks to lend more freely at a time when fear has seized up credit markets.

Most recently, the Federal Reserve made \$40 billion in loans available that banks can borrow anonymously so that no bank would have to be embarrassed by admitting they need the money, and potentially cause a crisis in confidence for any single bank.

"I want people to stop thinking about the credit crunch as an issue exclusively tied to mortgages and subprime, because it's not," said Lynnette Khalfani, a financial consultant and author of "Zero Debt" and Zero Debt For College Grads."

"It's about the nature of how consumers apply for, accept and use credit offered by a variety of financial institutions as well as how the institutions are drastically changing their credit policies."

As for how it all started, most economists would point their fingers at the sub prime mortgage market.

Not long ago, it was easy to obtain any type of loan, including home loans because bankers who originated the loans knew they wouldn't be the ones who actually held them. They immediately sold the loans on the secondary market, took their profits and pushed the liability on whoever purchased the loan on the secondary market.

There was no real risk to the banks that wrote the loans so there was little incentive to closely scrutinize a borrower's ability to repay it.

Homebuyers with risky credit ratings were able to get mortgages with adjustable interest rates offering low monthly payments to start with. But as rates crept higher, borrowers began to default at an alarming pace. Inflated home prices fell dramatically and lenders were forced to foreclose on mortgages that exceeded the value of the property.

These mortgages are at the heart of the credit crunch that has shaken financial institutions, rattled builders and burned investors who bought mortgage backed bonds on the secondary market which turned out to be worth far less than they thought.

"As the secondary market dried up, banks realized they would have to hold these loans themselves and they've slowed down the process of writing loans," said Peter Anastasian, managing director of CJM Fiscal Management in Melville, N.Y.

"A lot of people can no longer get loans with no income verification or no money down," Mr. Anastasian said. "It all comes down to exposure for these banks. When they don't have exposure they don't care. But when they do they look with a fine tooth comb at individuals and their ability to repay."

Tim Rawlinson, vice president of consumer lending at Fox Chase Bank in Blue Bell, said even people with good credit may have to come up with more cash for a car or house down payment. And they'll have to jump through more hoops to prove their income.

"It will depend on the type of borrower you lend to," Mr. Rawlinson said. "For people with relatively good credit, (the credit crunch) won't have much impact. But they may have to provide additional documentation that they may not have been required to provide previously."

Some examples of additional documentation, he said, would be extra pay stubs. Lenders also might place more reliance on verification of income by employers.

"If you have people who were on the margin before (the credit crunch) they'll have a more difficult time getting loans and they may have to pay a higher rate," Mr. Rawlinson said. "Obviously we can't predict where interest rates will go and that will be a determining factor. If rates keep decreasing more borrowers will qualify for loans."

Many people who previously would have been able to borrow from banks months ago find themselves in a situation where they are being turned down. Some of those people are turning to social lending networks like Lending Club.

Renaud Laplanche, CEO of Lending Club based in Sunnyvale, Calif., said lenders in the online community are regular people who don't operate under the same restrictions banks do and are not affected by the credit crunch.

He said loan volume has been increasing 100 percent each month since the company opened in May. This month, about \$4 million in loans were made through the Web site. The three-year unsecured loans are \$5,000 to \$7,000 at interest rates of between 10 percent and 12 percent.

"It's a good rate for the borrowers and an attractive rate for the lenders," Mr. Laplanche said, adding that the default rate is less than 10 percent. "I think the credit crunch is a contributing factor (in the increased volume.) There are other factors, but the credit crunch is a main factor."

One way to help financial institutions make better lending decisions with people who have a long rental history, but no mortgage history on a credit report is to track their payment record as renters.

RentBureau, based in Atlanta, collects rental payment histories and incorporates them into its proprietary National Rental Data Exchange.

"The housing expense for a renter or homeowner is their largest expense, and as a renter you had nothing to show," said Eric Hartz, CEO. "This helps renters in the credit crunch. Banks are looking at every possible piece of data they can on a borrower now."

The lingering impact of the credit crunch on the economy in 2008 could lead to a recession if it does not improve because the entire financial system hinges on credit and debt.

Consumers lend banks money through deposits and banks take that money and lend it to others for mortgages, unsecured consumer loans, car loans and credit cards. The interest charged to consumers on these loans is higher than what is paid on the deposits and this difference creates the bank's profits.

"Our banking system, for better or worse, is all about confidence," Mr. Brahim said. "It's not about real assets. There's no little slot at the bank with all your money in it. They've lent it out."