THE OMNIVEST MARKET VIEW

Investments

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Why Can't Banks Lend?

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During the past few days we heard Fed Chairman Bernanke say that they would keep interest rates at historical lows for an extended period of time. Our view is that the Fed will not change rates for the balance of this year and perhaps not until the middle of next year. Therefore, we would expect risk assets to regain strength once it is understood just how long the Federal Reserve will maintain its current stance on monetary policy. But, will the ultra low interest rate policy have a positive impact on the economy? We think the impact will be less than desired.

One of the many problems hampering the speed and strength of the economic recovery has been the very restrictive lending guidelines that have arisen since the start of the financial crisis. These restrictions, in our view, have actually been counterproductive, regressive and in many ways have negated the easy money made available by the Federal Reserve.

A case in point; a friend of ours is attempting to refinance his home, lower his mortgage balance and generally improve his personal balance sheet, even though it is not necessary. In 2004, he purchased a $2.3mm home with $1.8mm as a down payment and subsequently added approximately $350,000 in improvements. He financed the difference between the cost and down payment with a 5.35% 10-year interest-only loan (IO).

Since then, interest rates have fallen sufficiently enough that our friend can now (theoretically) refinance from 5.35% 10-year loan to a 15-year 3.87% conforming loan. To be more specific, our friend wants to move from a $500,000 balloon payment IO loan to a $417,000 15-year conforming loan. It not only sounds like a simple transaction but also a practical decision. One other point, he has a $500,000 cash balance at his bank.

The lender is now into its fourth month of financial discovery. Yes, I said fourth month. His substantial assets, excluding the value of his home, now have little bearing on his ability to borrow. I forgot to mention that his house was recently appraised at $2.35mm. Remember, his cost was $2.3mm. So by my math the value of real estate would need to decline by 82% from today's value to begin to impair the first mortgage loan.

Mortgage interest rates have fallen by nearly 200 basis points since he purchased his house. The assessed value of his house is slightly higher than his original cost and he wants to refinance into a smaller mortgage. Unfortunately, the lending institution is not taking into account the assessed value of the house, and his $500,000 balance in the bank is of little help. The only real item that the lender is taking into consideration is the historical records of his income, which is also more than sufficient to cover the ongoing costs of the previous and new mortgage. Clearly this case in point shows how far the pendulum has swung in the opposing direction relative to gaining access to credit. Multiply this situation across thousands of mortgage applicants, and small businesses attempting to get a loan and it becomes abundantly clear that we continue to miss a fundamental driver to economic growth.

In short, banks need to begin to lend again and they need to do it now.

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