JUNE 2008

the Mortgage Press

Keeping The Mortgage Professional Informed

Understanding the Fed

By Gibran Nicholas

With all the headlines screaming "Credit crisis!" and "Mortgage meltdown!," what is the Federal Reserve doing about the situation? Are they doing enough? Should they be doing more?

Well, the Fed is doing something; we just need to understand exactly what they are doing. In doing so, it is helpful to understand the four major interest rates that are affected by the Fed:

Discount rate

The discount rate is the interest rate that banks pay when they borrow money directly from the Fed. The rate has been largely symbolic in the past because banks prefer to get short-term financing by:

- Borrowing money from other financial institutions using the federal funds rate (as illustrated below). In most cases, this rate is also better than the discount rate offered by the Fed;
- Borrowing money using the Fed's new Term Auction Facility, which allows banks to bid anonymously on what interest rate they want to pay when they want to borrow money from the Fed; or
- Borrowing money using the Fed's new Term Securities Lending Facility—where the Fed lends money directly to non-depository financial institutions like brokerage firms and investment banks, allowing them to use non-Fannie Mae and Freddie Mac mortgage bonds and other less liquid securities as collateral.

Fed funds rate

This is the interest rate that banks pay when they borrow money from each other here in the U.S. This rate is also determined by the Fed because banks in the U.S. are part of the Federal Reserve System. You see, the Fed's primary role is to maintain "monetary stability" by keeping a close eye on the flow of money throughout the economy. One way they do this is by regulating the interest rates that banks charge each other for short-term funds.

LIBOR rate

The London Interbank Offered Rate (LIBOR) is the interest rate that banks pay when they borrow money from other banks anywhere in the world (primarily in the international wholesale money market based in London). There are various types of LIBOR rates, including the one-week LIBOR, one-month LIBOR, six-month LIBOR and one-year LIBOR; these are the rates banks would pay if they want to borrow funds for one week, one month, six months, etc. Although the LIBOR rates are determined by the financial markets at any given time, they are very closely related to the Fed in that the LIBOR most often changes when the market anticipates that the Fed will change their rate. The LIBOR is the base rate that is used on most adjustable-rate mortgages (ARMs) in the U.S. and large corporate/commercial loans. The reason a LIBOR is used most often for U.S. ARMs is because it is really the most accurate measure of a bank's cost of borrowing funds, since most banks do business internationally these days.

Prime rate

The Fed's funds rate plus three; this is the base rate that is used for most consumer loans, such as credit cards and home equity lines of credit, as well as most small business loans. Like the LIBOR, the prime rate is also related to the Fed's funds rate.

As the Fed lowers its funds rate, the business- and consumer-based interest rates of LIBOR and prime will also go decrease as illustrated above. The Fed would be reluctant to continue lowering rates if they feel that businesses and consumers would start borrowing and spending so much money that inflation will go up significantly.

It would be reckless of them to artificially encourage too much borrowing and spending, as this would only artificially drive up asset prices and cause money to lose its purchasing power. This phenomenon is known as "inflation."

How does the Fed impact mortgage rates?

Home equity lines of credit (HELOCs), based on prime rates or short-term ARMs based on LIBOR, are directly affected by the Fed, as illustrated above. However, fixed-rate loans and intermediate term ARMs with a fixed period of three, five, seven or 10 years are not directly related to the Fed. Instead, these rates are tied to the mortgage-backed securities that trade on the bond market. These rates will be affected by financial market conditions and the economic reports that mortgage bond investors utilize when evaluating their investment decisions.

What has the Fed done to help solve the financial market turmoil?

In response to the current credit crisis, the Fed has:

- Lowered the discount rate to 2.25 percent from 6.25 percent;
- Lowered its funds rate to two percent from 5.25 percent;
- Created a temporary Term Auction Facility that is successfully injecting approximately $100 billion per month in short-term financing into the banking system; and
- Created a temporary Term Securities Lending Facility and effectively opened its doors to non-depository financial institutions to borrow money directly from the Fed while allowing less-liquid assets to be used as collateral for these loans.

The role of Fed is likely to expand even further in the weeks and months to come. It is now more important than ever to educate yourself on the financial mechanics of our industry. Only then can you adequately decipher market conditions, differentiate yourself from the competition, and help your clients and referral partners make informed financial decisions in today's volatile market.

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