

# Understanding the Role of the Fed in Today's Credit Crisis

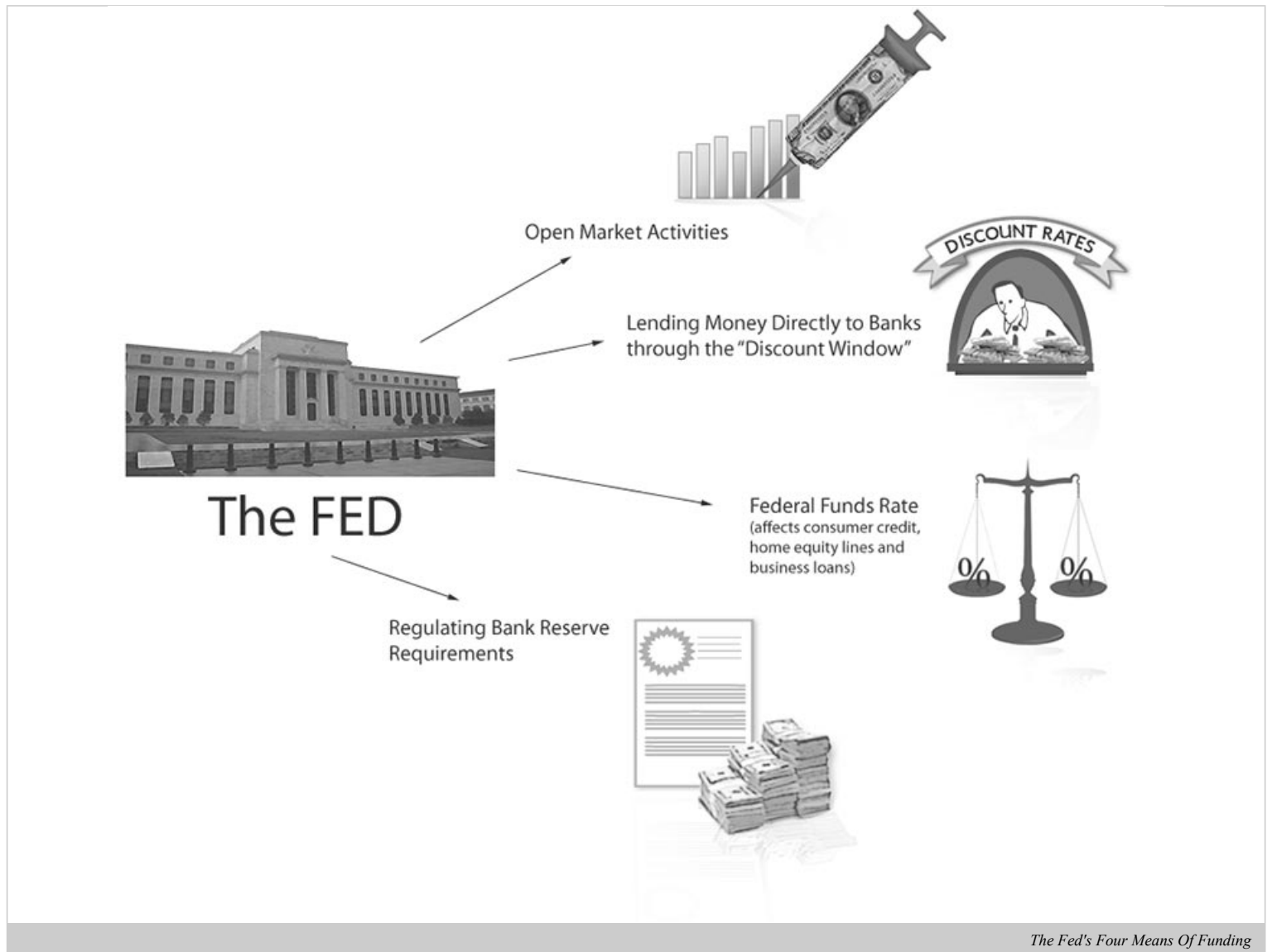


With all the headlines screaming **Credit Crisis!** and **Mortgage Meltdown!**, it can be disheartening to think that the apparently smart people serving on the Federal Reserve Board think that the answer to all of this would be to lower a "largely symbolic" interest rate called the "discount rate." After all, any reasonable person would think that if there really is a credit crisis, the Fed should do away with "symbolic" gestures and start **DOING** something for goodness sake!

Right?

Well... the Fed **IS** doing something; we just need understand **WHAT** they are doing.

In order to understand the current credit crisis, please reference the article entitled, [Saga of the US Mortgage Industry](#). Assuming you have read that article, you know that we are currently facing a "run on the mortgage banks" by the Wall Street investors and warehouse lenders who provide funding for US mortgage loans. Well, the Fed has looked at this situation and basically said, "Hmmm, we better provide these financial institutions with a new source of short term funding so that they can continue to operate even during this liquidity crunch."



The Fed can provide funding in four ways:

- Open market activities – this would be where the Fed injects cash into the banking system by purchasing the Treasury securities held by various banks and financial institutions. This allows the financial institutions to use this cash to meet their liquidity needs.
- Lending money directly to the banks that are part of the Federal Reserve System through what is called the "discount window"
- Regulating the interest rates that banks charge each other
- Regulating the amount of reserves that banks are required to maintain in order to operate

The Fed has done quite a bit of open market activity in recent weeks, and that hasn't quite fixed the credit crisis problem. So, on Friday, August 17, the Fed lowered the "Discount Rate" from 6.25% to 5.75%. This is the interest rate that banks pay when they borrow money directly from the Fed. Sounds simple enough! However, why are people saying that this is largely a "symbolic" move? Also, what affect will this really have on the current "credit crisis"?

In order to answer these questions, it is helpful to understand the four major interest rates that are affected by the Fed: **Discount Rate** (currently 5.75%)- the interest rate that banks pay when they borrow money directly from the Fed. The reason this is largely symbolic is because hardly any banks take the Fed up on their offer these days!

You see, banks prefer to get short term financing by:

- Issuing "commercial paper" – these are short term IOUs of typically one to sixty days that are sold on the open market to Wall Street investors. Interest rates on these short term loans are often better than the discount rate offered by the Fed
- Borrowing money from other financial institutions using the Fed Funds Rate as illustrated below. In most cases, this rate is also better than the discount rate offered by the Fed

**Fed Funds Rate** (currently 5.25%) - the interest rate that banks pay when they borrow money from each other here in the US. This rate is also determined by the Fed because banks in the US are part of the Federal Reserve System. You see, the Fed's main 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** (1 month LIBOR is currently 5.6%) – 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 1 week LIBOR, 1 month LIBOR, 6 month LIBOR, and 1 year LIBOR; these are the rates banks would pay if they want to borrow funds for 1 week, 1 month, 6 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 LIBOR most often changes when the market anticipates that the Fed will change their Fed Funds Rate. LIBOR is the base rate that is used on most adjustable rate mortgages (ARMs) in the US and large corporate / commercial loans. The reason LIBOR is used most often for US adjustable rate mortgages is because LIBOR is really the most accurate measure of a bank's cost of borrowing funds since most banks do business internationally these days.

**Prime Rate** (currently 8.25%) – the Fed Funds Rate + 3; 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 tied to the Fed Funds Rate.

So there you have it!

In response to the current credit crisis, the Fed has done some open market activities and they have lowered the discount rate. However, more action is probably needed.

In the coming days and weeks, the Fed is probably likely to:

- Continue lowering the discount rate as necessary to make it more attractive for banks to take advantage of that window of opportunity (no pun intended)
- Lower the Fed Funds Rate as long as inflation remains under control. You see, if the Fed lowers the Fed Funds Rate, the business and consumer-based interest rates of LIBOR and Prime will also go down as illustrated above. The Fed would be reluctant to do this if they feel that businesses and consumers would start borrowing and spending so much money that inflation will go up significantly.

Remember, the Fed's main goal is to "maintain monetary stability" by keeping a close eye on the flow of funds in the US economy. 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". The good news, however, is that in some of their most recent statements, the Fed has said that inflation is basically under control. They have seemed to indicate that they are starting to get more concerned about other threats to monetary stability – such as the current credit crisis facing the economy. In fact, according to the latest reading, the Fed's favorite measure of inflation was only running at an annual rate of 1.9% compared to over 2% in recent months. This is below the implied inflation "danger zone" and seems to indicate that the Fed may be more likely to lower the Fed Funds Rate moving forward.

With all this in mind, it is more important than ever to work with a Certified Mortgage Planning Specialist™ who can decipher market conditions and help you make informed decisions in today's volatile market. Whether you have or are considering an ARM or a fixed rate loan; whether you are buying, selling or refinancing a home; whether you are dealing with a primary, vacation or investment property; now is not the time to be dealing with an amateur or one who is not qualified to give you expert guidance.

CMPS® professionals are committed, qualified and equipped to help you navigate today's turbulent mortgage marketplace. Don't delay in implementing the mortgage and real estate equity planning strategies that will make a positive impact in your life and the lives of your loved ones!



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