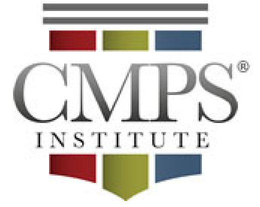
Understanding the Role of the Fed in Today's Credit Crisis



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 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, "Hmmmm, 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." There are currently four options for the Fed's involvement:

Option #1 – Regulate the amount of reserves that banks are required to maintain in order to operate

It would be reckless for the Fed to reduce the amount of reserves banks are required to maintain because that would encourage banks to take more risk in an already risky environment. Therefore, this option is out of the question for the most part.

Option #2 - Lend money directly to the banks that are part of the Federal Reserve System through what is called the "discount window"

As for as the discount window, the Fed has lowered the discount rate through a series of rate cuts to 2.5% from the 6.25% rate that was effective in August, 2007. This is the interest rate that banks pay when they borrow money directly from the Fed. The problem with this, however, is that most banks do not like to borrow from the Fed's discount window because it can be construed as a sign of weakness. How so?

Imagine that you are in an action movie playing the part of the hero who is being mistaken for a criminal.

You are on the run from the police who don't really know that you are on their side in the first place. After a few days on the run, you start getting hungry. You find a grocery store, find some food and proceed to the check-out line. You are faced with two choices:

- Pay cash for the food
- Use a credit card

If you use the credit card, you know that the authorities will be monitoring all the activity on that card. This will tip them off to your location and BAM – you are caught! On the other hand, if you pay cash for the food, you can remain anonymous and continue with whatever it is you are doing to prove your innocence and give the movie a happy ending.

The banking industry is like an action movie, and the banks that need funds are like the heroes of the movie. The banks on the sidelines are like the authorities. If you are a bank that needs funds, and you go directly to the Fed and borrow from their discount window, this would tip off all the other banks that you could be experiencing financial difficulty. This in turn causes them to be more cautious when dealing with you and could potentially result in driving down your stock price because the stock market may interpret this as a sign of financial weakness.

That is why the discount rate is often referred to as symbolic, as most banks don't like to borrow from the Fed's discount window if they can avoid it. If a bank finds other sources of funding outside of the Fed's discount window, they can borrow anonymously and avoid tipping off all the other banks to the fact that they are in need of short term funds.

Option #3 - Open Market Activities where the Fed injects cash into the banking system by purchasing the Treasury securities held by various banks and financial institutions

The Fed uses their "open market activities" to regulate the supply and demand of cash that is available between banks. They do this by buying or selling the Treasury securities held by the banks. Financial institutions can then use this cash injection to meet their liquidity needs. This process directly impacts the Federal Funds Rate, which is the interest rate banks charge each other for short term funds.

You see, the Fed sets a "target" for the Fed Funds Rate and then uses their open market activities to reach that target by altering the supply of cash available to the banks that are part of the US Federal Reserve System. This "wholesale" cost of borrowing money called the Fed Funds Rate trickles down into the various retail interest rates that banks charge the retail customers who borrow money from them. From September 18, 2007 through March 18, 2008, the Fed lowered the Fed Funds rate from 5.25% to 2.25% in response to the credit crisis and economic slowdown.

For more info on how the Fed Funds Rate affects you and your mortgage, please see the article entitled ***The Fed and YOU.***

Option #4 – The Term Auction Facility where the Fed auctions funds to banks that need short term financing

This is the latest tool that the Fed has created to help banks through the current credit crisis. Essentially, this auction process allows banks to bid anonymously on what interest rate they are willing to pay in order to borrow money directly from the Fed. Remember, if banks borrow money directly from the Fed using the discount window, this becomes public knowledge and could be interpreted as a sign of financial weakness. Therefore, on December 12, 2007, the Fed announced the creation of the Term Auction Facility where banks can borrow money directly from the Fed as part of a private bidding process that allows banks to maintain their anonymity. Since then, there have been several successful auctions of $20 billion to $30 billion each, and the Fed has indicated a willingness to continue offering this funding option for banks in the coming months.

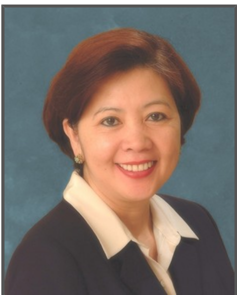
So there you have it!

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

- Lowered the Discount Rate to 2.5% from 6.25%
- Lowered the Fed Funds rate to 2.25% from 5.25%
- Created a temporary “Term Auction Facility” that has successfully injected over $100 billion of short term financing into the banking system since December, 2007

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!



Melba Eva del Rosario, CMPS ®
Bankers Preferred Real Estate Loans
2850 So. El Camino Real
San Mateo, CA 94403
650.227.1018 direct
415-244-5772 alternate
650-240-3890 fax
eva@bankerspref.com

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