



How the Fed Funds Rate Affects Your Financing Decisions

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So the Fed's are meeting again, you are in the middle of a loan, and you don't know whether to lock your rate or not. Or maybe you are thinking about buying a home, but not sure if now is the best time based on the changes in the Fed Funds Rate. Sound familiar? Perhaps not, since it is not everyday you need to decide these things. However, as a Real Estate Finance Consultant, my team and I are helping customers make these decisions often and see some common misconceptions and worries about how the Fed Funds Rates affects mortgage rates. This report will share with you some of my insight into what you should and shouldn't worry about in regards to the Fed Funds Rate changes and how you can use this information to your benefit.

What is the Fed Funds Rate?

First of all, we need to define terms. The Fed Funds Rate, also known as the Discount Rate, is the cost of funds for the banks when they borrow money from each other. To be sure, the Fed Funds Rate is not the same as mortgage rates. By decreasing or increasing the Fed Funds Rate, the Federal Reserve is decreasing or increasing the cost of money in the economy.

What does the Fed Funds Rate do?

If the cost of money is decreased, you are able to afford to borrow more money. As the cost of money increases, you are able to afford to borrow less money. This is the contraction and expansion of the money supply. In this case, we are just talking about money in general, not mortgage specific dollars.

How does a change in the Fed Funds Rate affect mortgage rates and my real estate financing?

Although often times misunderstood, mortgage rates are not directly affected by the Fed Funds Rates. What causes mortgage rates to rise or decline is the supply and demand of investors (lenders) and borrowers, the same way any fair market value of a product is determined. In this case, the product just happens to be money for mortgages.

Follow me on this logic. The Fed's lower the Fed Funds Rate; people are able to afford more money and so being the debt driven society we are, people borrow more money into circulation in the economy; people begin to spend this increase of money on consumer goods and services; business start showing higher profits; stocks start rising; investors leave the bond market chasing rising profits in the stock market; this results in less supply of money for mortgages; demand



relative to the lowering supply drive prices (mortgage rates) higher; you can now afford less home or real estate because your cash flow is not converting to as much of a lump sum of cash.

On the flip side, when the Fed's higher the Fed Funds Rate; people are able to afford less money and so being the debt driven society we are, people are not able to put as much money into circulation in the economy; people stop being able to spend as much money on consumer goods and services; business start losing profits; stocks start falling; investors leave the stock market chasing more stable profits in the bond market; this results in higher supply of money for mortgages; demand relative to the increasing supply drive prices (mortgage rates) lower; you can now afford more home or real estate because your cash flow is converting to a higher lump sum of cash.

Does this make sense? So now that you understand the dynamics between the Fed Funds Rate and mortgage rates, you can see why a decline in the Fed Funds Rate equates to an increase in mortgage rates, and an increase in the Fed Funds Rate equate to a decrease in mortgage rates. When the Fed Funds Rate rises you do not need to worry that mortgage rates will rise.

What other things should I consider when financing my real estate in a changing Fed Funds Rate environment?

Keep in mind that if you are borrowing with an Adjustable Rate Mortgage (ARM) you will want to understand not just how the Fed Funds Rate affects overall mortgage rates, but how it will affect your Index. The Fully Indexed Rate (FIR) of an ARM is calculated by adding the going rate of whatever Index the loan is tied to with a Margin that is determined at the time you get the loan. There are too many different Indexes used for ARMs to go into detail on each one in this report, but let's take a look at the Prime Rate for example.

The Prime Rate is the going mortgage rate that banks charge their very best customers. It is the Index used for Home Equity Lines of Credit (HELOC). You can imagine that the banks do not have a very big margin of profit on their Prime Rate mortgages, right? So, if the Fed Funds Rate is increased and the cost of the funds for the bank increases than in order for the banks to maintain a margin of profit on their Prime Rate mortgages they must immediately increase the Prime Rate. You can see now how the previous general changes in mortgages rates may vary for your situation based on what Index your financing is linked to. If you are using a Home Equity Line of Credit tied to the Prime Rate for the majority of your financing needs, you have reason to believe that in our current (year end 2004) Fed Funds Rate environment will cause your interest rates to rise. You may want to consider another type of financing right now.



How do I make the best Real Estate Financing decision?

Your mortgage is one of the biggest decisions of your life and the right mortgage can save you tens of thousands of dollars and make you hundreds of thousands of dollars. While I believe you should always work with a professional, you also want to become educated yourself about the factors that affect your decision. This is what we call *Education for Effective Action*[™]. If you are looking to increase your knowledge of real estate and financing, we'd love to have you join us at one of our education events soon! Visit our website for upcoming events.