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**Beyond the Rate – Chapter 1**

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 1, looking at the source of mortgage money and what determines prevailing interest rates.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'll be your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

So, where does all the money actually come from? When you get a \$500K mortgage, who actually writes the checks? Most people have no idea. Does it come from a bank? Does it come from the government or some large quasi-governmental agency like Fannie Mae or Freddie Mac? It all seems so confusing and the numbers are so big that they become abstract for most of us. But an understanding of where the cash comes from is the first step to understanding why things are the way they are.

For our purposes here, you can effectively break down the source of money into two broad categories. On the one hand, you have banks that recycle money that's been deposited into personal and corporate accounts. We all have bank accounts; checking accounts, savings accounts. That money all belongs to us and the bank pays us interest on it. But they, in turn, lend that same money out to people who want to borrow it. These banks then charge their borrowers a higher interest rate than they offer to their savers. That's how they make their money. They charge what's called "a spread" between their borrowing interest rates and their deposit interest rates. In fact, banks can even lend out more money than they physically have on deposit, based on ratios federally regulated by certain governmental agencies. But the details of that mechanism are beyond the objectives of this podcast. The point is that banks get money from our deposits and that's what they lend out to their borrowing clients.

The interest rates charged by these banks are heavily influenced by the decisions of the Federal Reserve. Most of us are familiar with Alan Greenspan who has been the chairman of the Fed since 1992. His term just came to an end on January 31 2006 and he is now being replaced by Ben Bernanke. At the time of this recording, the Fed has raised interest rates 13 consecutive times during the past 18 months to gradually tighten a highly accommodating monetary policy that's been in place since 2001.

The Fed manipulates interest rates by buying and selling bonds in the bond markets. During challenging economic times, the Fed buys bonds on the open market, and they pay for these bonds with cash. As the Fed continues buying bonds, it floods the market with cash. All of this excess cash makes money more available for people who want to borrow and interest rates naturally come down as different lenders compete for a limited number of borrowers. Think about it. If there's excess cash out there, the interest rates to borrow that money gets bid down as different lenders compete for the business. Just like the rest of us, borrowers go for the lowest price.

When the economy starts growing again, consumer confidence starts rising and people start spending money again. They buy cars. They buy stainless steel refrigerators. They buy computers. So with this rising demand, companies start charging more for their products. Profits start rising and soon, workers start asking for raises and better benefits. That increases costs for companies and a vicious cycle of inflation begins. Inflation is a complicated phenomenon but suffice to say, it can send the economy into a tailspin. So, to slow down that cycle, the Fed can start selling bonds on the market. Buyers pay for these bonds with cash and the Fed immediately puts that money away, taking the cash OUT of the economy. With less cash available on the open market, borrowers start bidding up interest rates which dampens the feeding frenzy and keeps the economic growth at a sustainable level.

I know this all seems a bit overwhelming but the background information gives you a basis for understanding what's going on out there. The beauty of these podcasts is that you can listen to them more than once. For now, just stay with me on this stuff. I'm gonna keep going. Don't worry about following everything yet. Instead, try to follow the basic progression. This is leading somewhere, trust me.

The interest rate directly affected by the Fed is what's called "the Overnight Rate." This rate is what the banks charge each other. You may or may not be familiar with the Overnight Rate but most of us are familiar with the Prime Rate. This rate is simply the Overnight Rate plus 3. Right now, for example, the Overnight Rate is 4.25% and the Prime Rate is 7.25%. So, the Prime Rate is also DIRECTLY affected by the Fed. Every time the Fed makes a change, the Prime Rate changes at the exact same time.

There are also a number of indexes that are affected by these policy changes made by the Fed. Some of you have heard of the LIBOR index. If you're curious, the acronym LIBOR stands for the London Inter-Bank Offered Rate. You may have also

heard about the MTA index. It stands for the Monthly Treasury Average and there are others like the Cost of Funds Index and so on. All of these indexes are all heavily influenced by the actions of the Fed. So as you can imagine, they have all gone up significantly during the past 18 months. In 2003, the Prime Rate was at 4.00%. Today, it's at 7.25%. In 2003, the LIBOR and MTA indexes were both around 1.00%. Today, they're at 4.9% and 3.7% respectively.

The Prime Rate and all these various indexes govern the interest rates of all VARIABLE rate loan products. For example, a home equity line of credit is a variable rate product and is generally tied to the Prime Rate. There are also a lot of loan products these days that are fixed for the first few years, but that become variable after that. Once they become variable, they are usually tied to one of the indexes like the LIBOR or the MTA. Anyone who has a variable rate product has seen their payments go up significantly over the past year and a half.

We started this discussion by saying there are two primary sources of mortgage money. The first is from bank deposits. The second comes from a wide variety of "investors" who provide money through Wall Street. But don't think these are just a bunch of super wealthy individuals. They're actually Money Managers that are managing OUR OWN money. Most of us have investment accounts like Insurance Funds, Pension Funds and various Retirement Funds. Many of the accounts that contain all these funds end up housing HUGE amounts of cash. You can imagine the Pension Fund for General Motors or some other Fortune 500 company. Think about Insurance Companies like New York Life or State Farm. These companies manage immense sums of money; money they have accumulated from all their contributors – people like you and me.

These huge funds are managed by professional Money Managers. They are always trying to maximize the return they get on this money so they look for good places to invest. For the most part, they end up putting the cash into three main areas. They buy equities; stocks of various companies that trade on the stock exchanges – shares of General Electric or Google or Starbucks Coffee. They also buy corporate and government bonds. That's the second choice. And they buy what's called "mortgage-backed securities". That's the third choice. Well, those are mortgages! They're bundled mortgage loans that are bought and sold on Wall Street every day.

Essentially, these various Money Managers approach the mortgage business and say, "all right, you can lend out our money as long as you follow these guidelines". The guidelines they're referring to are the underwriting guidelines we have to follow when helping someone apply for a loan. The interest you pay becomes the Return On Investment for these Money Managers. So that's where much of the money comes from. Now, within certain limits, many of these loans are insured by Fannie Mae or Freddie Mac as long as they meet THEIR underwriting guidelines. So you can imagine, most investors have guidelines that closely resemble the Fannie Mae or Freddie Mac standard underwriting guidelines. The Fannie Mae and Freddie Mac guidelines are the benchmark for the entire industry.

Today, there's so much money out there, money that has accumulated from Baby Boomers putting money aside for their retirement during the past 25 years, that a lot of investors have widened their guidelines beyond the standard Fannie Mae or Freddie Mac requirements. This is happening through the competitive process. There's a lot of money out there. An economist might say, "there's excess capital" out there. And what happens when there's excess capital. Well, you can bet on two major results. First, you can bet that interest rates will get bid down as various investors compete for the business. Second, you'll start seeing more and more innovative loan programs out there. Again, it's the competitive pressures that breed those results.

You have all seen this in your own lives. You've seen interest rates get bid down lower and lower with the bottom just behind us, back in 2003. Interest rates are now slowly on the rise again and you can bet they'll start rising faster when all the Baby Boomers start retiring in a few years and start drawing money OUT of those huge pools of investment capital. You've also seen a flood of innovative loan programs. First came all the different Adjustable Rate Mortgages, or ARMs. Then came the Interest Only options. Now, they have these Negative Amortization loans. You know the ones. The loans that start with an interest rate of just 1%. Believe me. Interest rates were never that low and they never will be. These loans allow borrower to make payments that are not even enough to pay the interest. So the loan balance actually gets BIGGER each and every month. We'll talk more about these various programs in Chapter 3 but the point here is that you have all seen these phenomena play out right in front of your eyes.

Now, we all see these mortgages coming from some big well known players; companies like Countrywide Mortgage, Wells Fargo, Chase or Bank of America. Yes, these guys are huge players in the mortgage business. But that doesn't mean the money is all theirs. Of course, Wells Fargo and Bank of America have all kinds of regular banking business but their mortgage divisions are in the business of packaging and servicing loans. They package the loans and sell them on Wall Street. In many cases, you may not even know because they continue to "service" the loan themselves. That means they do the customer service, they collect your payments and they pass them on to the investor that holds the actual loan, less an administration fee. Fascinating.

So again, this is all a direct result of excess capital. There's a lot of money out there and they're all competing for your business; your mortgage. So they're all offering different perks to try and get you to pick them. A lower rate. Looser guidelines. Flexible new loan programs. It's all marketing, trying to get you to borrow their money, rather than somebody else's.

Briefly reviewing, there are two sources of mortgage money and both sources come indirectly from you and me. Your bank deposits get recycled and lent back out to the community. Your investment, insurance and retirement funds also get recycled and lent back out. It's all a big circle from our savings to our debts. Obviously, there are some very wealthy people out there who have huge savings and few debts. Others have huge debts and very little savings. But in the aggregate, it's

the entire community that lends money to itself and it's the total amount of savings in the community that determines the interest rates within it. If there's lots of money available, interest rates will be low. If there's a shortage of money, interest rates rise. So the fact that we've enjoyed steadily dropping interest rates in recent years is a sign that the economy is healthy and that there's lots of money available. And the fact that rates are now slowly rising is a sign that the pool of investment capital is slowly shrinking. The soon-to-be retiring Baby Boom generation will definitely shrink that pool of money and we can expect interest rates to continue rising as a result. We'll talk more about that in Chapter 5 of this series.

This Chapter 1 podcast is a pretty broad brush. A lot of the information is conceptual in nature and I didn't give you a lot of specific numbers or detail. But even still, it gives you a fairly good idea what you can expect from the Beyond the Rate series.

If you like what you hear on this podcast, tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I deserve yours, please accept my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at [patrick@beyondtherate.com](mailto:patrick@beyondtherate.com).

See you next time for Chapter 2: the hierarchy of lenders and underwriting requirements. There's an established pecking order in this business, just like any other industry, and we'll break it all down into four primary loan categories and explore the actual underwriting guidelines within each. It's fascinating stuff. Tune in.

Bye for now.