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How Old Deal With GSEs Could Affect Fed Rate Hike Efforts

In order to end what it considered excessive borrowing by Fannie Mae and Freddie Mac (the GSEs) and the Federal Home Loan Banks the Federal Reserve, in 2006, **cut off their access** to its interest free daily loans known as daylight overdrafts. Since the GSEs need sufficient cash on hand each morning to cover that days payments on loans and securities they now prefer to make overnight loans in the fed funds market where they are repaid at the start of the day.

According to Reuters' Richard Leong, the Fed's nine-year old decision may **hamper its attempt to drain money** from the banking system if, as expected, if moves to increase interest rates on Wednesday.

Here is how Leong explains the situation.

The Federal Reserve plans to use its **reverse repurchase program (RRP)** to siphon cash from major short-term lenders such as money market mutual funds and mortgage finance agencies. The GSEs and the FHLBs are authorized users of the RRP but in the second quarter the Fed averaged 10.5 billion each day to the GSEs compared with $90.1 billion for money market funds.

The RRPs don't provide access to funds until late afternoon and with the GSE's, having lost access to the overdrafts, it is this wrinkle in timing that Leong says is a key factor why GSEs have not fully embraced the RRP and have moved more firmly into lending in the federal funds market since the housing crisis. "This means the Fed has a **tough task** to direct some of over $200 billion in cash and cash equivalents the GSEs have to the RRPs, since the program does not seem to appeal to this key group of lenders," he says.

"It's important to understand the difference between the Fed Funds TARGET rate and the effective rate," note Mortgage News Daily's Matthew Graham. "All the Fed can technically do when it comes to hiking rates is to announce the new target. From there, they use policy tools so manipulate the short-term funding markets such that the overnight rate moves up to the target range. Now, more than any time in recent memory, market participants are wondering if the Fed's tools will provide sufficient incentive for financial institutions to move higher."

If the Fed is unsuccessful in that task it could mean the large amounts of cash the GSEs put into the fed funds market could stymie attempts to raise those

National Average Mortgage Rates

	Rate	Change	Points
Mortgage News Daily			
30 Yr. Fixed	6.43%	+0.02	0.00
15 Yr. Fixed	5.95%	0.00	0.00
30 Yr. FHA	5.82%	+0.02	0.00
30 Yr. Jumbo	6.62%	0.00	0.00
5/1 ARM	6.28%	-0.01	0.00
Freddie Mac			
30 Yr. Fixed	6.35%	-0.51	0.00
15 Yr. Fixed	5.51%	-0.65	0.00
Mortgage Bankers Assoc.			
30 Yr. Fixed	6.44%	-0.06	0.54
15 Yr. Fixed	5.88%	-0.16	0.68
30 Yr. FHA	6.36%	-0.06	0.85
30 Yr. Jumbo	6.75%	+0.07	0.39
5/1 ARM	5.98%	-0.27	0.65

Rates as of: 8/30

Recent Housing Data

		Value	Change
Mortgage Apps	Aug 28	226.9	+0.49%
Building Permits	Mar	1.46M	-3.95%
Housing Starts	Mar	1.32M	-13.15%
New Home Sales	Mar	693K	+4.68%
Pending Home Sales	Feb	75.6	+1.75%
Existing Home Sales	Feb	3.97M	-0.75%

interest rates. The question is whether higher RRP rates could lure the GSEs into that system.

		Value	Change
Builder Confidence	Mar	51	+6.25%

The FHLBs could be **even a bigger problem**. Those banks finance member banks and credit unions that make mortgages and are the single biggest lender in the fed funds market, accounting for as much as 90 percent of daily trading volume. An FHLB vice president however told Leong the bank "intended to work cooperatively and constructively alongside the Federal Reserve to serve our respective purposes."

At end of the third-quarter, the Federal Home Loan Bank System lent $31 billion in fed funds. Fannie and Freddie had $26 billion and $53 billion in both fed funds and repurchase agreements, respectively. Of the three Fannie Mae is the largest user of the RRP.