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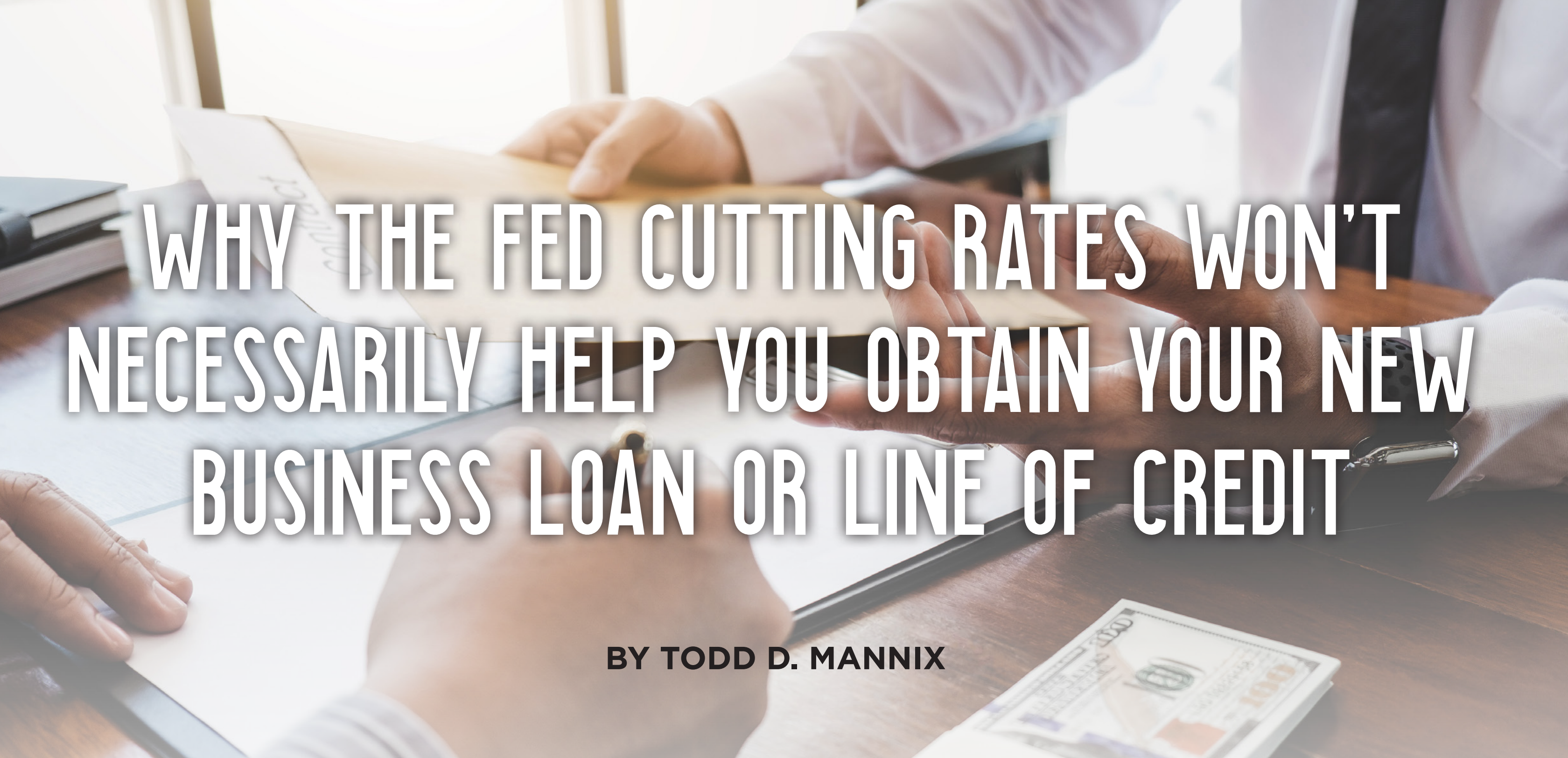

WHY THE FED CUTTING RATES WON'T NECESSARILY HELP YOU OBTAIN YOUR NEW BUSINESS LOAN OR LINE OF CREDIT

BY TODD D. MANNIX

By the time this article is published, it is anticipated the Federal Reserve (the Fed) will have decided to reduce the federal funds rate at least one time. In the past when rates were reduced, it meant an opportunity for businesses because a lower interest rate meant more opportunity for borrowing. That may not be the case today, especially for small businesses who depend on access to bank money for growth or remodeling to increase profits. This is because it is increasingly difficult to get approval to access these funds.

The Federal Funds Rate

The federal funds rate is the interest rate that depository institutions, or banks, use to lend money to one another. The funds come from excess balances the bank owns that are held at the Federal Reserve and are used to meet Reserve requirements (Investopedia.com). Since the fed funds rate is the rate at which banks can lend to each other, a single decision by the Fed to move rates up or down does not necessarily translate into a change in publicly available loan rates such as business loans or mortgage rates. A continuing trend of rate changes, however, will create more possibility for such changes to impact the money's availability in the economy.

The Federal Rate as an Economic Lever

Prior to the financial crisis in 2008, the Federal Reserve utilized the fed funds rate as a way to stimulate a sluggish economy or to slow down an overheating economy. The Fed looks at many economic indicators to identify movements in our economy and tweaks the fed funds rate to allow banks access to funds at a cheaper rate or conversely at a more expensive rate, depending upon what is needed at the time. For example, if The Federal Reserve perceived the economy as growing too fast, they may increase rates to make "the cost of money" more expensive to banks who in turn lend money to consumers. If it costs more for the banks to access funds, they will generally extend higher rates to their consumers (businesses and individuals), thus slowing expansion and investment. Conversely, if the Federal Reserve perceives the economy as slowing down too much, they will decrease the fed funds rate in an effort to stimulate the economy. In this instance, the banks are able to access money cheaper allowing them in turn to extend money to consumers at a lower rate. Money essentially becomes "cheaper" and allows businesses and individuals to invest or expand because the interest cost they end up paying will be less. Think about mortgage rates. When rates are low, more people can afford to purchase a home because their monthly payments for the same house would be less.

When the financial crisis hit in 2008, the impacts were so devastating and far reaching, the fed funds rate dropped to essentially zero and stayed there until December of 2015. The Federal Reserve had to use other means to stimulate the economy during these times because the traditional lever of lowering the fed funds rate was not possible. It was already at zero.

Since that time, The Federal Reserve has been working to slowly raise rates in order to get their lever back. The economy (now more than ever a global economy with many importing and exporting and raw good codependencies across boundaries) has been the largest hindrance to getting the fed funds rate back to a comfortable position. Other countries have not fared as well in their recoveries since the crisis and with the dependencies, economies are tied together more than ever. Once our economy is in a stronger position, the Federal Reserve can once again use Fed Fund rates in an attempt effectively to manage the pace of the economy. It is far from an exact science.

Since the onset of the financial crisis, the recovery has been slow and sluggish especially in the first five to seven years. While growth has been better since then, there has been a lot of pressure on The Federal Reserve to reduce rates because the global economy is experiencing slowing that will impact the US economy as well. With the pressure to reduce rates in the environment of a slowing world economy, one would think that rate cuts would mean more opportunity for people and businesses with greater access to “cheaper” money.

Today’s Banking Environment

Even if The Federal Reserve drops rates twice this year, it may not translate into more people having access to money. Even though the banks are able to access cheaper funds, this is not necessarily immediately passed along to the consumer. For example, we began to see this (and rightfully so) after the financial crisis when it became very difficult for people to get mortgages. Banks were burned so badly by the extent of bad loans, that they went from very relaxed regulations for loan approval to very stringent loan approval. So even though rates were very low after the financial crisis, people could not access money to stimulate the economy as they would have in traditional markets because of stringent guidelines for loan approval. Even when The Fed pumped money into the economy in the years following the financial crisis, banks were not lending it as freely as they had before. Some of it was lawmakers trying to make sure large bank greed did not have the opportunity to topple our economy again, and some of it was banks needing to monitor their profits and reputations.

Prior to the collapse, seemingly all people needed to get a mortgage was a pulse. Lenders were offering no money down, interest only loans with very little income verification protocols. This means that someone could buy a home with no skin in the game and never pay down the principal so long as they could keep up with the interest on the amount borrowed. As someone who manages finances conservatively, I would never recommend such a loan for the average individual.

During these times, however, the US housing market continued to increase upwards of 20% per year in some areas. The lenders were essentially pitching the fact that the consumer would have equity through appreciation, and for a time that worked. But for anyone who knows how markets work, they know this is not a sustainable pattern. Once the market plummeted, the equity many of these people had in their homes, not only disappeared, but went negative and people owed more on their homes than the home was worth. This is why traditional loans require a 20% minimum down payment. A 20% down payment not only assures equity remains in the home during a downturn, but also hedges against loans that turn negative and are defaulted on during such a downturn.

Since the crisis it has become increasingly difficult to obtain a mortgage because of more stringent underwriter requirements. Banks originated based on relationships and a customers’ entire business. It was good for a business owner to know their local banker as the banker understood the person’s place in the community and could vouch for them. Documents were collected in a verification process, but the Banker could ultimately play the relationship card and move the process along if a piece of documentation was not readily available or easily explained. Since the crisis, regulations have, in essence taken the “relationship” or loan officer assessment out of the equation thus making it more difficult for Americans to access money. A borrower must meet a long and specific checklist of requirements and there is very little (if any) wiggle room.

Other Pressures Facing Banks Reducing Access

This trend of making it more difficult to access money from banks is not only true for individuals, but for businesses (small and large) due to several other factors. Regulations and bank policies surrounding anti-fraud, anti-money laundering, and anti-terrorism have continually increased since 9/11. As more information becomes available as to how terrorist networks had and have been using markets to increase financial positions to fund terrorist activities, legislators and banks have increased measures to identify and prevent such activity.

Another major change that all the bank chairs highlighted in a congressional hearing in April of this year is cyber security. Each bank chair/president in the hearing stated clearly that cyber security was the largest threat to not only their individual bank, but our entire banking system.

While billions of dollars are being spent by the banks to prevent all of these threats form a systematic, procedural, and technology standpoint, some simple checks and balances are being put in place at the consumer level that may not necessarily make funds less available if you are doing things above board, but will increase the level of scrutiny and documentation required in order to access money. Banks are required to know who their customers are in a more thorough and intimate way than just a federal tax id number. For example, banks have to check their customers against The Office of Foreign Assets Control (OFAC) database controlled by The Department of the Treasury. In addition, banks often require ownership information including; names, addresses, percentage of ownership, two years worth of tax returns, documents used to create a business entity such as the articles of organization or corporation, and potentially more.

In summary, the days of assuming that rising and falling rates relate to less or more access to funds in our businesses and economy are not as directly translatable as they were in the past. There is a lot more to the story and business owners should be prepared to jump over many hurdles in order to benefit from more favorable rates in an effort to increase their business opportunities while rates are low. **FBA**

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