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Does the Federal Reserve Control Mortgage Rates?

Every time the Federal Reserve Board meets there is plenty of hype in the media about what the Fed's decision will do to interest rates. What is this all about? How does the Federal Reserve affect mortgage interest rate? And do they actually affect them? The answers to these questions may be helpful as you consider getting a new mortgage.

When someone says 'the Fed raised interest rates again' the group they are actually referring to is the Federal Open Market Committee. This is a group made up of the presidents of several of the Federal Reserve Bank branches. They meet together roughly every six weeks to decide the direction of their federal funds rate. This is the rate the Federal Reserve banks charge each other for an overnight transfer of money. The Fed uses this rate mostly as a means of controlling inflation in the U.S. If prices are rising too quickly, the Fed will raise their rate. If the economy is slumping, the Fed will lower their rate, to put more money in the economy for borrowing and to encourage consumer spending.

So what does all of this have to do with mortgage interest rates? The Federal Reserve does have some influence over mortgage rates. They have more direct power when it comes to short-term interest rates and very indirect sway with long-term rates.

Home equity mortgage interest rates are based on the Prime Rate (a short-term rate) which is directly based on the federal funds rate. The Prime Rate is typically 3% higher than the Fed's rate. For example, the Fed's rate is currently 5.25% so the Prime Rate is about 8.25%. This is the rate that mortgage lenders use as the guide for home equity or second mortgage rates. So if you are in the market for such a loan, obviously the decisions of the Federal Reserve will make a big difference in the type of rate you can expect.

When it comes to long-term rates however, like the 30-year fixed mortgage rate, the Fed has only limited influence. Mortgage rates are based on the government 10-year Treasury bond. This is because long-term mortgages are generally bought up by companies like Freddie Mac and Fannie Mae, and bundled and repackaged as securities to be resold on the secondary markets. The investors and their buying and selling trends with the bonds determine the interest rates for long-term mortgages. If the investors perceive that the Fed is lowering rates because the economy is doing poorly, they may be more conservative in their buying and selling and long-term mortgage rates may also dip slightly. Conversely if the Fed perceives that the economy is doing really well and inflation is rising too quickly they will raise rate. Mortgage rates may also rise, though usually not as dramatically, because the bond traders have the same perceptions.

So while the exact influence of the Federal Reserve on mortgage interest rates is hard to define, it is clear that it does have an impact on rates. Although if you are trying to determine which way mortgage rates are going to go, you would probably do better watching the bond market and monitoring the general economic trends.

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