



How Are Mortgage Interest Rates Determined?

If you have ever bought a home or considered buying a home, you know how important interest rates are in getting yourself a good mortgage deal. Have you ever wondered though how those mortgage rates are determined? Why it is that all the lenders you talked with gave you roughly the same interest rate estimate (all other things being equal)? Mortgage interest rates are a complicated thing, but they are largely based on overall market indicators. Becoming familiar with the general trends of rates can help you track the direction of rates and give you a better idea of what to expect.

Do you remember that old phrase “supply and demand” from your economics class? Here’s a case where something from school actually applies to real life! The general idea is when demand goes up, so do prices. When demand for a product decreases, so does the price. When there is a great demand for new mortgage loans, lenders have the upper hand and can charge higher interest rates to loan money. When demand falls, borrowers have a little more leverage in the rate they get.

As stated though, this is the general idea. You might be thinking ‘there must be more to mortgage rates because during the recent housing slump, mortgage demand dropped off significantly, but interest rates stayed fairly constant.’ And you are right. Demand is only one of the factors influencing interest rates. Another major factor is the perceived condition of the economy. This has a lot to do with the Federal Reserve and inflation rates.

When the economy is doing really well, prices for goods and services tend to go up even though their value hasn’t changed. This is inflation. When inflation rates start rising too much, the Federal Reserve will raise their federal funds rate, the amount of money Federal Reserve banks charge each other for overnight transfers. This is a short-term rate but it usually has a large impact on mortgage rates. The point of raising interest rates is to make borrowing seem less attractive and thereby decrease demand and pull the inflation down. The Fed gets together and decides on its rate every six weeks or so. They monitor the condition of the economy and raise or lower rates based on what they perceive is going on with inflation.

There is yet another part to the interest rate equation. Mortgage rates are also heavily influenced by the stock markets and especially the secondary markets. Here the principle is when the economy is doing well, interest rates go up. When it is doing poorly, rates go down. Mortgage interest rates can be affected weekly by the various economic reports that come out.

And then too, there is the supply-and-demand issue for individual mortgage lenders. If an individual company is struggling to close enough loans, it might offer slightly lower interest rates than competitors in order to attract more business.

Unfortunately there is no exact science when it comes to predicting how mortgage rates will move. Knowing the influencing factors though can help you get a sense of what will happen. Keeping an eye on these market indicators will give you that extra insight helpful in finding the best mortgage interest rate.