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How Do Federal Interest Rates Affect Your Mortgage?

Have you ever wondered why mortgage interest rates go up and down? What effects do these rate swings have on your mortgage? What's the cause of the fluctuations and who controls the rates? You may be surprised to find that mortgage rates are most directly influenced by the country's inflation watchdog, the Federal Reserve.

The Federal Reserve, often nicknamed "the Fed," is in charge of the national banking system. The Fed's board members include presidents of the various Federal Reserve banks around the country. They meet together in Washington D.C. about every month to set interest rates, make financial policy, and examine the nation's economic outlook. They are particularly responsible for keeping inflation rates under control.

All other banks and lenders borrow money from Federal Reserve banks and Federal Reserve banks even have to borrow from each other at times to cover loans. The rate that Federal Reserve banks charge each other for overnight transfers is known as the federal funds rate. This rate affects how much each bank will charge other lending institutions, which in turn affects how much lenders will charge their borrowers. The Fed evaluates this federal funds rate roughly every six weeks and votes on whether to raise, lower, or hold the rate steady. If inflation is on the rise, the Fed will raise rates to curb spending and borrowing. If the economy is doing poorly however, the Fed will usually lower rates to encourage more economic activity.

During the past few months, the Federal reserve has held rates steady, as it has found inflation to be mostly in check. Depending on your type of mortgage loan, how will it be affected if the Fed decides further inflation checks are in order and they raise interest rates?

If you have a fixed rate mortgage, you are in lucky in some senses. You don't have to pay any attentions to federal rates. Your loan interest rate was locked in at the beginning and will not change with the fluctuations of the Fed's rate. You may wish your rate were affected by the national rate however if the Fed dramatically drops interest rates.

If you have an adjustable rate mortgage, your rate will seem some changes tied to Fed decisions. Your initial interest rate will be low, but future interest rates will periodically rise or fall based on a calculated formula that incorporates the federal interest rates.

The good news is that no matter what type of loan you have, you can always opt to refinance your current loan if the Fed drops rates really low. Just make sure to assess whether the lower rate in a refinance will be enough to compensate for the attached closing costs.