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How Do Lenders Calculate Your Interest Rate?

If you have ever shopped for a mortgage home loan, you know that interest rates change daily on loans, sometimes even more often. Interest rates are a very important part of your mortgage, as they determine how much extra you will pay for your loan. When you apply for a 30-year $200,000 loan at 6 percent, you will end up repaying the $200,000 plus an extra $231,676 in interest charges. At 6 percent you will pay more in interest than you will in principal! If you live in a pricier area where the average home price is around $400,000 for example, a 30-year, 6 percent loan will cost you $463,352.00 in interest fees. That makes the total loan value $863,352! Pretty mind boggling! You can see why even a small difference in your mortgage interest rate can make a huge impact on your overall loan total.

Realizing this, it is helpful to know how a lender calculates your interest rate. First loan officers receive rate sheet from their parent company. Mortgage brokers are the middlemen for many companies so they get rate sheet from their various wholesale lenders. These rate sheets provide the cost of each interest rate offered for a particular loan category. The cost is equal to the number of points the borrower must pay for a certain interest rate. One point is equal to one percent of the loan value. The lower the interest rate offered, the more the borrower must pay in points. This is because the lender will make less money on the loan over the long run. So, he charges more upfront to cover that loss.

The rate sheets also provide the interest rate/cost range that the wholesale lender will allow the loan officer to offer. For example, a rate sheet might include a range of rates from 6.250 percent to 7.500 percent. With the 6.250 percent rate loan, the cost of the loan is 2.000 points, but with the 7.500 percent rate loan, the loan officer and his branch would actually get a rebate from the wholesaler of 2.375 points. Loan officers therefore must strike a balance between their desire to make as much money on the loan as possible and the necessity of offering competitive rates. Loan officers are generally paid on commission which makes the cost of the loan very important to them.

When you call in to get a quote on a home loan, you are not shown the rate sheets provided to the loan officer. Instead the loan officer determines how much he wants to make and quotes you a rate that corresponds to that amount of earnings. For example, say a loan officer want to make one point on any loan he offers you. So if his rate sheet says that a 6.75 percent, 30-year loan will cost him 0.0 points, he will add on his one point and tell you that he can offer you a 6.75 percent rate with one required point. Or if you tell him you do not want to pay points, he will look at his rate sheet and see that at 7.0 percent, his wholesaler will rebate him one point. So then he will offer you a 7.0 percent loan with no points. With each loan officer you will have a range of interest rate options; you will just have to choose how many points you are willing to pay.

Of course the interest rate and point scheme quoted to you does not include the loan officer fees, so make sure you ask about those as well!