How Multi-Decade Highs Are Changing The Way Mortgage Rates Are Quoted

At this point "high rates" are old news. We were already close to hitting the highest levels in more than 20 years last week, so it wasn't a huge surprise to achieve that dubious distinction this Thursday. Some sources see the record-breaking rate at 7.09% for a 30yr fixed while others are over 7.5%. Both are accurate and we'll explain why.

To understand why, we first need to remember that a mortgage rate quote is not as simple as the rate itself. The rate that almost everyone refers to (officially the "note rate") is only part of the equation. While the note rate dictates the amount of interest paid with each mortgage payment, it doesn't account for all the interest the average borrower pays.

For instance, several of the closing costs seen on almost every mortgage are considered "prepaid finance charges." Essentially, that's just interest paid upfront.

But what if the mortgage in question has "lender paid closing costs." Or what if a builder offers a closing cost credit? You've heard that there's no such thing as a free lunch and the same is true here. Whether it's coming out of your pocket, or from the lender, the same amount of money will be paid to the same parties.

So what's the difference then? Wouldn't it always be better to get those upfront costs paid by someone else? The catch here is that the money that a lender can pay toward your closing costs is determined by your interest rate. The higher your rate, the more of your upfront costs a lender could pay. This is the first key reason that a rate of 7.09% could be the same as a rate of 7.5% if one of them includes upfront costs and the other one doesn't.

The following chart shows 30yr fixed rate indices from various sources. All three agree that this week's rates broke the long term ceiling despite all being at slightly different outright levels.

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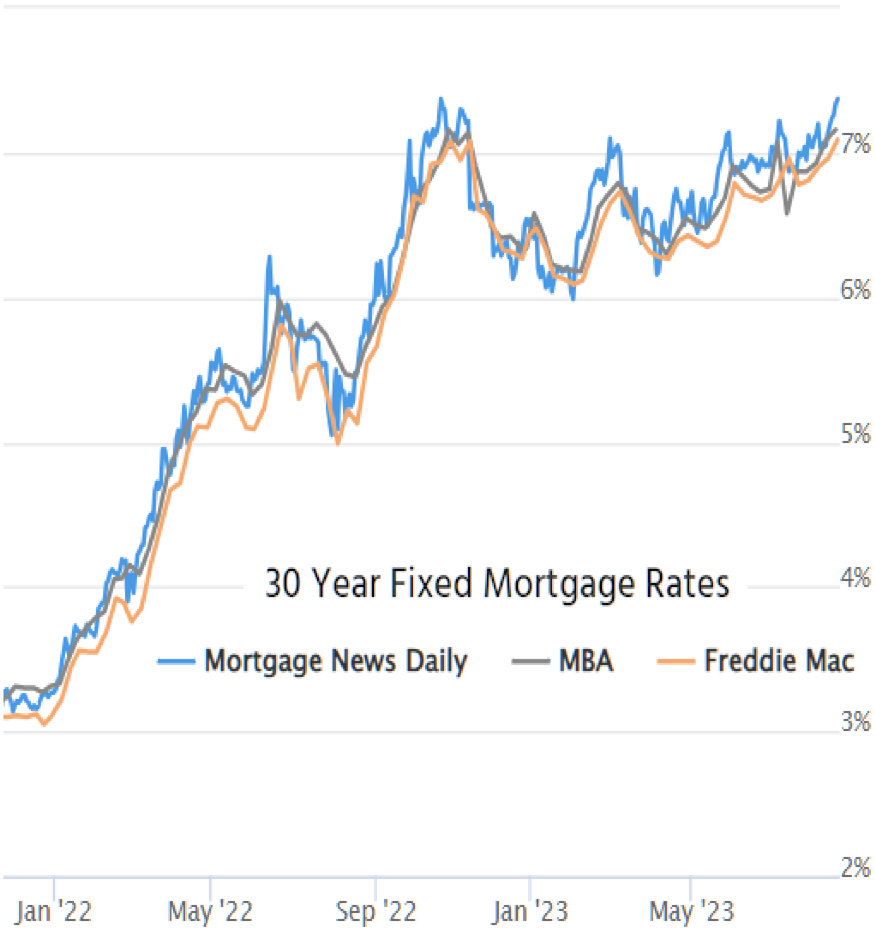

That brings us to the topic of how higher rates are changing mortgage quotes. In a stable rate environment, there is a fairly linear trade-off between higher rates and a lender's ability to pay more of your upfront costs. The current environment isn't exactly stable. In fact, over the past few years, there have been times when a higher note rate would actually **DECREASE** the amount of upfront costs a lender could pay.

WARNING: The following is fairly technical, but it will explain why a higher mortgage rate could be worth less to a mortgage lender.

Whether a mortgage lender sells your loan or not, the loan still has a value that it could be sold for. In general, a higher interest rate makes a loan worth more because more interest will be collected over time. Because of this, a hypothetical $400k loan at 7.5% could be worth about $5000 more than the same loan at 7.0%.

As outlined above, that means a lender could pay $5000 of your upfront costs at 7.5%, or they could offer you a rate of 7.0% if you pay your own $5000 in upfront costs. Some individual lenders have restrictions as to what they're able to do with these options, but this is the general phenomenon that exists in the secondary mortgage market where mortgage rates are determined.

One key assumption behind a 7.5% rate being more valuable is that the mortgage has to last long enough for the extra interest to be collected. Otherwise, the lender (or whoever buys the loan from the lender) is coughing up money they won't recoup. An extreme but simple example would be the same scenario above where a lender pays $5000 for a 7.5% mortgage, but then rates magically fall to 6.5% two weeks later and you refinance. The lender no longer collects the extra interest and they are out their $5k.

While it was a bit of a bigger issue when rates were initially surging toward long-term highs, it's still the case that lenders are afraid to pay much of a premium for higher mortgage rates because they are afraid that any decent recovery will lead to premature refinancing.

There are already more upfront costs on the average mortgage than there have been in years. Many of these are unavoidable as they are imposed by Fannie and Freddie for certain loan characteristics (credit score, equity, occupancy). That means that certain loans with a certain amount of upfront costs will simply leave your lender unable to offer you a higher rate with lower closing costs.

What's the bottom line?

Whereas lenders have almost always been able to quote you a higher rate in order to keep your closing costs lower, there are certain scenarios where there is simply no market for rates that high. In those cases, the only option is for you to pay much higher closing costs than you may have been expecting. In certain purchase scenarios, realtors and builders can take part in defraying those upfront costs, but the point is that it won't be the mortgage lender until the secondary market for mortgages gets back to a more stable trend.

What will it take for a return to normalcy? That will be an ongoing conversation, to be sure. We addressed big picture structural issues with rates last week. (Here's a link to the commentary). Next week, we will discuss the outlook for the rest of the year, and beyond.