FinStart

What determines the interest rate you'll pay on your mortgage?

Interest rate you'll have to pay reflects 4 things:

A. Your timing.

B. How much risk, the lender thinks, there is that you will not be able / willing to make mortgage payments as scheduled.

C. The terms of your loan.

D. Competition from other lenders for your business.

A. Your timing

Interest rates change over time, depending on the health of the economy and inflation (and a few other things, which are usually covered when you take a course in Economics).

- Interest rates were much higher before the 2008-09 financial crisis. They are very low now and may stay low for a long time, but they may also rise if the economy recovers (and / or if inflation increases). Banks will change interest rates they charge on loans (and pay on savings accounts) accordingly.

B. How risky you are to the lender

1. Your credit history and credit score
   It affects not only whether you'll be able to get a mortgage loan at all, but also how much you'll pay for it (the interest rate).

2. Amount of your down payment
   If you make a small down payment (less than 20% of the purchase price), you'll have to buy mortgage insurance (which insures the lender in case you don't make your payments as scheduled). With a small down payment, your loan is riskier and some lenders may charge you a higher interest rate.

C. Terms of the mortgage loan

1. Type of interest
   Variable interest mortgages are cheaper than fixed rate mortgages at the time you take out the loan. But if interest rates increase during the term of your mortgage, your variable rate will increase, and may even rise above the fixed rate you had been offered at the beginning. A variable rate will decrease if interest rates fall, while the fixed rate will stay the same.

2. Length of term
   Generally, interest rate on a shorter-term mortgage (say, 3 years) will be lower than on a longer-term mortgage (say, 5 years). But you will renew your 3-year mortgage sooner than the 5-year mortgage - if interest rates rise, you may end up paying a higher rate than on the last 2 years of the 5-year loan.

3. Amount you borrow
   Lenders may charge more for both very large and very small mortgages. A very large mortgage (on a larger / more expensive home) can be riskier to the lender. A very small mortgage requires pretty much the same amount of work of the lender but in absolute dollars they get paid less, so to make up for it they may charge a higher interest.

4. Type of home
   Lenders may charge different interest rates for condominiums than for single-family homes and mobile (manufactured) homes. The rate may also be different when you buy a vacation home or second residence. The rate may also be different if you are buying an investment property (that you'll rent out) rather than a home where you will live.

D. Competition: Mortgage rates differ based on where you live

Lenders compete with one another for your business. The more lenders are there in your area, the more competition there is and the lower the mortgage rates will be (the price of the mortgage).

- There are more lenders in large cities, which tend to have hot real estate markets.

- Lenders in bigger markets tend to be bigger businesses – they have more customers who buy more expensive houses and take out bigger mortgage loans. The bigger the lender's business, the more efficient it is– and the lender can pass on some of these cost savings to customers in the form of lower interest.

- Big markets also attract more mortgage brokers, many of whom operate online only. Brokers are paid commission by lenders. Some use a portion of the commission to subsidize mortgage rates for their customers.

Mortgage markets are not transparent. Lenders advertise indicative rates – those are for information only rather than the rates informed customers will end up paying. To learn how much you'll actually pay in interest, you need to negotiate with each individual lender. You have more negotiating power in a market where there are many lenders competing for your business. That also helps keep interest costs lower in large markets.