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How, When Fed Move Impacts Consumer Interest Rates

Interest rates just rose, and they could rise more next year

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By CARRIE WELLS The Baltimore Sun - Tribune News Service

The Federal Reserve's move to boost short-term interest rates last week by a quarter of a percentage point might not change much immediately, financial experts say, but next year or the year after could be a different story if rates keep rising.

Federal Reserve Chair Janet L. Yellen and her colleagues indicated that with the U.S. economy stabilizing and unemployment dropping, more rate increases are ahead.

Many observers predict there could be two to four more increases of a quarter of a percent, so the key rate could rise from near zero before last week to one percent by the end of 2016.

"The key thing is that previous announcement, because everybody knew that was coming," said Campbell Harvey, a professor of finance at Duke University's Fuqua School of Business. "The question is, how aggressive are they going to be over the next year?"

The effects of rising interest rates can be mixed.

Mortgages, credit card bills and auto loans could become more expensive, while those with savings in certificates of deposit or invested in government bonds finally might see higher returns after years of barely keeping pace or even lagging behind the modest inflation rate. Many observers say that significant changes in loan rates and returns on CDs and bonds will not come soon.

The Federal Reserve slashed the federal funds rate -- the interest rate at which banks lend to each other or borrow from the Fed itself -- to nearly nothing amid the financial crisis in 2008 as the nation fell into recession. By lowering the cost of borrowing money, the Federal Reserve aims to stimulate lending by the banks and therefore economic growth.

The federal funds rate directly influences short-term interest rates on business loans, adjustable-rate mortgages and other forms of credit. It also influences, but is not directly connected to long-term interest rates on credit such as fixed-rate mortgages.

The first rate increase in seven years signaled the Federal Reserve's renewed confidence in the country's economic recovery. The unemployment rate was 5 percent in November, down from a peak of 10 percent in 2009.

Yet the housing market has not fully recovered, and the Fed said it would tread carefully in future rate increases and hold off if the economy begins to falter.

"This increase is important because it reflects the economy getting better," said Kathleen Murphy, head of the Maryland Bankers Association. "It's a symbolic move by the Federal Reserve to say that the recovery has taken hold."

If interest rates continue to rise, it could eventually lead to higher interest rates on savings accounts. For future retirees, climbing interest rates also would lead to higher annuity payments, which are linked to interest rates that exist when the annuity is purchased, said David John, senior strategic policy adviser at the AARP Public Policy Institute.

But the cost of borrowing also will increase -- an effect likely to be felt more immediately. For those in debt, increased costs could start to appear almost immediately, as credit cards, home-equity loans and other products with variable interest rates swing up.
"It's a double whammy on everyone because you're paying more on your debt but you're not getting a similar interest rate increase ... on your savings," said Mike Couch, executive director of Making Change, a Columbia nonprofit that provides financial advice. "For the consumer, they just need to shop around and try to get the best rate they can."

A one-year certificate of deposit yielded more than 3 percent in 2008, but now the national average is 0.27 percent, according to Bankrate.com.

Duke's Harvey said he doubts that consumers will see higher interest rates on savings accounts anytime soon. Banks are awash in money, he said, and have little incentive to pay for more.

"The banks will do something, but it won't be proportional to their loan hikes," he said.

Harvey also warned that because of the low returns for certificates of deposits and government bonds, many investors have pumped up the price of high-yield junk bonds, creating a bubble that could burst soon.

Mark Hamrick, a senior economic analyst at Bankrate.com, compared the way banks increase interest rates on savings to fluctuations in gas prices.

"When gasoline prices are on the rise, consumers are quick to notice that," he said. "But as prices come down, retailers are a little less aggressive about passing those savings on to their customers."

Adrian Johnson, chief financial officer at MECU of Baltimore, said he believes the Fed wants to raise interest rates at least in part to have tools available in the event of a future recession, as many predict based on historic cycles will occur in the next few years.

But he sounded less confident than Yellen that the conditions for further increases will continue.

"I'm hopeful, but as you look across the country, there is expansion, there is growth that's going on and that's a good thing," he said, "but ... in different areas of the country the expansion doesn't feel the same."

Murphy of the Maryland Bankers Association said the effect of the rate increase might be muted in Baltimore and the rest of the state because of the intense competition between a large number of banks that know customers can compare interest rates with a click of a mouse. There are 112 banks and lending institutions in the state and 45 in the city.

"When there is good credit out there to be had, the banking industry is competing for those loans," she said.

Anirban Basu, an economist and head of the Baltimore consulting firm Sage Policy Group, agreed that competition would tamp down rising interest rates for the region's consumers.

"I know the optics for Baltimore have been very rugged this year, but the regional economy has held up beautifully and I don't expect rising interest rates to create new head winds," he said.

Mazy agreed that rate increases up to a percentage point would not make much difference in consumers' decisions.

"Incremental changes like that are usually not reflected in any mass changes in peoples' decision-making for big-ticket items over the years," said Bill Vowles, general manager of Norris Honda in Dundalk. "But anything more than a point, ...people do hold off then."

Gayle Briscoe, a real estate agent at Coldwell Banker in Catonsville, Maryland, said that when she bought her first house in 1987, mortgage interest rates were around 13 percent.

"The interest rates now are really the best interest rates we've had in 40 years," she said. "When you think about the alternatives to not owning a home -- you don't have any tax benefits whatsoever and no protection -- I don't see how a hike of even a percentage point would make homeownership less attractive."

Baltimore Sun reporter Natalie Sherman contributed to this article.
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