How the U.S. Federal Reserve Lost Control of Mortgage Rates

Despite the United States Federal Reserve Board's diligent attempts to stimulate the economy throughout the year of 2008 by repeatedly reducing the Federal Funds rate, the typically correlating thirty-year average mortgage rate stubbornly remained unchanged through the first quarter of 2009 as if mortgage rates had intentionally ignored Board Chairman Ben Bernanke's seemingly regular rate cut announcements. The unanticipated loss of the Federal Reserve Board's control over mortgage rates hampered its ability to stimulate home sales and stabilize declining housing values that became the impetus of the nation's troubled economic condition. To fully comprehend how mortgage rates managed to slip out of Mr. Bernanke's leash, it is necessary to first grasp the characteristics and interrelationships of the rates and securities vehicles involved. The overnight lending rate that the Federal Treasury charges banks for funds is the interest rate that the Federal Reserve Board continuously lowered until it ultimately rested at a rate of .25% by the first quarter of the year 2009. Once upon a time when this rate was lowered one could reliably wager that the thirty-year average mortgage rate would follow suit. It was logical that if a bank borrowed from the government at a lower rate, it could provide mortgage financing to borrowers at discounted rates. However, the mortgage rate is not quite so directly manipulated by the puppet strings of the Federal Reserve Board. Instead, the thirty-year mortgage rate is predominantly influenced by fluctuations in the ten-year Treasury bond rate. Because most thirty-year mortgages are paid off by borrowers during the first ten years of their loans, conservative securities investors choose between purchasing the relatively safe ten-year Treasury bond and the once slightly more risky mortgage-backed securities that consist of many thirty-year mortgages pooled together. It is this very competition between the price of Treasury bonds and mortgages on the securities markets that most impacts the thirty-year mortgage rate. Although Treasury bonds typically provide a relatively low rate of return, they represent a very low-risk investment because they are backed by the United States Treasury. Mortgage-backed securities have generally produced a somewhat higher yield than treasury bonds, yet were considered to be narrowly riskier investments since they are secured by real estate. Consequently, the spread" between Treasury bond and mortgage-backed security yields has historically been around .75%, with mortgage-backed securities representing the higher end of the spread due to the additional risk attributed to them. When real estate values significantly declined from 2006 to 2008, the risk associated with purchasing and holding mortgage-backed securities became significantly enhanced. To counter this perception of increased risk, sellers of mortgage-backed securities were forced to offer mortgage-backed securities at higher yields so that they would continue to be attractive to investors. By the first quarter of 2009, the spread between Treasury bonds and thirty-year mortgages reached an unprecedented 3.00%. As a result, banks were forced to offer mortgages to borrowers at higher rates to compensate for the higher yields they had to provide to investors on the secondary loan and securities markets. So despite all of the Federal Reserve Board's efforts in reducing overnight lending rates to banks in 2008, thirty-year mortgage rates remained relatively unchanged by early 2009. The Federal Reserve had lost all ability to influence mortgage rates. In turn, this forced the federal government's hand to look to other means of simulating the housing and financial industries, such as purchasing hundreds of billions of dollars worth of mortgage-backed securities from financial institutions itself. This extreme government action has often been labeled a bank bailout" since the government reluctantly purchased toxic assets" that investors were otherwise unwilling to purchase on the open securities market. Whether the government's investment in these securities amounts to a success or a failure still remains to be seen. If housing values once again appreciate before too many more borrowers default on their mortgages, the government may be able to sell these mortgage-backed securities for handsome returns to investors in the future. However, if increased foreclosures continue to flood the housing market with excessive supply, the federal government may eventually learn how great a price it actually paid for its investment. If these potential securities losses, coupled with further anticipated economic stimulus spending, ever amounted to an inability or unwillingness on the part of the federal government to meet its obligations, even Treasury bonds might begin to look like a risky proposition.

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