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Understanding Interest Rates and How to Take Advantage of Them

By John Rosenfeld

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One of the most common topics I get asked about is interest rates, which has come up even more in the last two years as rates have climbed for two years and then dropped again pretty much all of last year. In fact, calls into our call center generally spike every time there's a rate change, and people want to understand exactly how we set rates and what triggers changes in those rates.

So, today we're going to go inside the vault to shine a light on interest rates, discuss how they move and arm you with some savvy tips that should help you take better advantage of different interest rates situations.

What You Really Need to Know About Interest Rates

People often talk about interest rates as a single thing, when in truth, it's a collection of many different interest rates that all move in slightly different ways. At its core, an interest rate is what one entity is willing to pay another entity to use their money. Banks pay consumers and other banks to use their money and consumers pay banks for the same convenience, and banks basically make money by charging customers a little more to lend money than they pay to hold deposits for someone.

So, let's give you an example.

Mortgage rates today are around 4%, and the highest savings accounts are generally about 2%. Banks basically make money by charging customers a little more to lend than they pay to hold deposits for someone. Hence, if a bank lent out all its money at 4% and paid consumers the 2%, they'd make about 2% for offering the service.

This is actually called the net interest margin for a bank. Now 2% on all that money may sound like a lot for that service, but don't forget all of the other things that banks have to pay for with that money, like the salaries for their employees or keeping the lights on or printing and mailing statements and countless other expenses.

Now Let's Talk About the Fed
So, let's talk about what the Fed has to do with all of this. You've probably heard about the Fed in the media, they're always talking about "Fed holds rates flat" or "Fed cuts rates." And they're generally referring to "the Fed funds rate target." This is actually the rate that banks will pay each other to borrow money.
The Fed, or the Federal Open Market Committee (also called the FOMC), sets a target rate, which can change up or down each night with the supply and demand for funds. The Fed adjusts this rate as a tactic to influence monetary policy. The Fed really has two primary objectives: keep inflation in check and help drive job growth.

The common belief is that by bringing interest rates down more consumers and companies will borrow money, which will increase spending and investment, leading to business growth and ultimately more jobs. But if that's true, why don't they always keep rates low? Well, there's another side on the interest rate coin called inflation.

Keeping Inflation in Check
The Fed generally increases rates to keep inflation in check. Now, the Fed raised the target rate four times in 2018 and three times in 2017 before that. But then just last year, dropped it three times in 2019 to where it is now, about 1.75%. We've effectively lived in a low-rate environment for the past 10 years, where rates have remained below 3%.

Now, this is great news if you need to borrow money or carry any debt but not such great news for your savings account. This is also a long way from the 20% rate that existed back in 1979 or 1980. But back then we had outrageous inflation to deal with. So then I'm asked: When rates move, why don't my deposits seem to move in sync with those rates?

How Do Banks Set Rates?
Some banks move rates up or down long before or long after a fed rate change, and others don't move it at all. Banks set rates based on the competitive landscape and based on the level of demand for a given product that they wish to achieve, which is relatively independent of the Fed funds target. For example, when rates are low, customers love to refinance mortgages or other loans into lower fixed rates, which generates much demand for loans.

To meet that demand, many banks need to bring in more deposits. So they increase rates on savings and CDs to do so. When lending demand falls again, banks have less need for incremental funding, so they lower the deposit rates. Then there are also interesting dynamics around fixed and variable rates. When a bank needs fewer deposits, you'll typically see them lower CD rates first, because that has far less impact on their existing customers and creates far less risk that those customers are going to choose to leave the bank.

However, the interest expense savings that the bank is trying to achieve is not as great when they just reduce the current CD rates. So, if things get tighter, then a bank may actually lower their savings rate, which impacts far more customers and potentially increases the risk that some of those customers will leave them. Some banks even reduce rates on a more selective basis by product while leaving some products alone and changing others to balance interest, expense savings and customer attrition risk.

How Can Reduced Rates Affect Lending?
On the lending side, everyone loves low rates because you can borrow money and pay very little interest for it. Of course, that depends upon what type of borrowing we're talking about.
For example, you can get a mortgage or a home equity loan for under 4% today, which is relatively low. But if you carry a balance on a credit card, you could be paying north of 15% of that balance. The reason these rates differ so much is generally based on risk. Far fewer people will default on a mortgage or even a car, but many people simply walk away from a credit card.
Of course, that'll crush their credit score, but the bank still ends up with a loss, and that higher rate that they charge for credit cards is designed to offset those losses. But that's a whole different vault story.
So, now that you're armed with a better understanding of interest rate dynamics, how can you take advantage of these rate fluctuations?
Well, I've got three tips for you.

3 Tips for Taking Advantage of Rate Fluctuations

Number one: Refinance from high to low. Number two: Know when to lock in a rate. And number three: Know when to stay liquid. Let's expand on these a little.

1. Refinance from high to low
Take out a piece of paper and write down all your debts and the interest rate you're paying on each one. List things like your mortgage, a home equity line of credit, a student loan, an auto loan or credit card debt.
Now let's rank them from high to low. Pick the one with the highest interest rate and let's search the internet to see what the current rate for that same product is. So, if you have a mortgage at 6% and you find online that there's a mortgage available for 4.5%, put a star next to it anytime you find a percentage point or more difference.
Then look down the list to figure out, are there any debts that you're paying a higher interest rate on where you could consolidate it into another product? For example, if you're carrying debt on your credit card at 13 or 14%, but you have a home equity line of credit that you're only paying 4% on, put an extra star next to that credit card debt. Because then you can go back and consolidate these and take that debt into your home equity line of credit and reduce how much interest you're paying for the same money.

2. Know when to lock in a rate
About five years ago, rates were so low that I was able to refinance my 5/1 adjustable-rate mortgage at 4.5% to a fixed-rate loan for 30 years at 2.75%. This was a three-way win.
I did pay down the rate a little to do this, and we can talk about that tactic another time, but locking in a lower rate not only means I'm now paying less every month, but more of every monthly payment is going to the principal of my loan.
Additionally, now with a fixed-rate mortgage, I never have to worry about that rate creeping up on me. Booyah!
Locking in rates can also apply to deposits when longer-term CD rates offer a decent premium over savings or short-term CDs or you think rates are headed south, it may be a great time to put some of your money in a five-year CD. I opened a five-year CD about a year ago at 3.15%. Today, it's hard to find anything above 2.25%. And if rates go any lower, I'm going to feel even smarter about the move I made last year.

3. Know when to stay liquid
This is the flip side of what I was just describing. Here, I'm really [00:09:00] talking about the difference between liquid savings and CDs. Bankers call savings liquid because there's no commitment by the customer to keep the money there and no penalty if they choose to move it.
CDs typically offer a slightly higher rate in return for a customer commitment. They keep the money on deposit for the term of the CD. And if they do move it, they'll typically pay a penalty, unless it's a breakable CD, but that's yet another story for another time.
The difference between long- and short-term rates is shown by something called the yield curve, which you may also hear about in the news.

A flat yield curve means that there really isn't much difference at all between short- and long-term rates. An inverted yield curve means short-term rates are actually higher than longer-term rates, typically indicating trouble ahead for the economy. Under either of these conditions, you're probably better suited keeping your savings liquid.

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