So for us we accepted interest rates given from on high. We could think of interest rates being set something like:

\[ r + f + P + d + s \]

- \( r \): Real interest rate required by investors who purchase mortgages.
- \( f \): Inflation rate.
- \( P \): Prepayment risk premium.
- \( d \): Default risk premium.
- \( s \): Servicing cost.

In finance, the real rate is generally seen as fairly constant over time. For high-quality borrowers, the default, prepayment & servicing costs are fairly constant. The inflation rate, however, has varied markedly over time. So its primarily the inflation rate that drives change in mortgage rates.
Rates were high because inflation was high. One way to deal with inflation is to charge a high interest rate.

The problem with this approach is that people cannot afford the payments. Over time their income should increase, so they can afford to increase payments over time.

One approach is to use a CAPM. Problems with CAPM include that the lenders is still unsure of the long term rate to charge.

A better solution, especially when the rate of inflation is uncertain is a Price Level Adjusted Mortgage (PLAM). On a PLAM, a real interest rate is charged, but the principle balance is adjusted periodically to reflect inflation. The payment is adjusted. 