

The mechanics behind mortgage rates

Ever wonder how they set mortgage rates? What makes them go up and down and who decides? If you're a Canadian with a mortgage – or thinking about a mortgage – these are important questions. Understanding the mechanics behind mortgage rates can help you get a grasp on the financial commitment you're making.

Let's call this Mortgage Rate Mechanics 101. Firstly, mortgage rates in Canada are going to hinge on whatever is happening with the Bank of Canada: our nation's central bank. This isn't a bricks-and-mortar commercial bank, and it doesn't offer banking services to the public. The Bank of Canada is the federal organization that has responsibility for Canada's monetary policy, our actual money, and our financial system.

So what does that have to do with mortgage rates? Well, The Bank of Canada sets what is called the "overnight rate", which is the rate that banks charge each other to cover their short-term daily transactions. If the rate goes up, it means that the central bank believes that the economy is growing more quickly than it should. In other words, a small increase in rates can help to slow inflation. The best growth is moderate, low-inflation growth. Things start moving too quickly – wages and prices start climbing rapidly – and the Bank of Canada will nudge the rate higher to slow things down.

It's easy to see how it works the other way. The economy will weaken if people stop shopping – so a little nudge down on interest rates will encourage us to keep the economy ticking along: buying homes, cars, and other big-ticket items that keep the factories, stores, suppliers and truckers in business. If rates get too low – a little too much stimulus – then inflation becomes a risk. It's a careful balance, and correctly forecasting the economic mood is the Bank of Canada's most difficult and important task.

So the Bank of Canada sets the overnight rate, but it is the chartered banks where you do business that set the prime lending rate: the rate they offer their best customers. They must, of course, base their decisions on the overnight rate because that's the rate that influences their own borrowing. So if the central bank changes the overnight rate, it's sending a clear signal that it's time for the banks to change prime lending rates.

As you may know, variable mortgage rates and other floating rate loans – like lines of credit – will move up and down with the prime lending rate. Lenders will offer variable-rate mortgages at the prime lending rate plus a certain percentage. When will your variable-rate mortgage change? There are eight times a year to watch: late January, early March, mid-April, late May, mid-July, early September, mid-October and early December. Why then? Because those are the times when the Bank of Canada makes rate announcements. The exact dates are set at least a year in advance. It's possible for the banks to change a rate between these dates if they choose, but it's not very common.

Fixed-rate mortgages are a little different. Banks use Government of Canada bonds to raise money for fixed-rate mortgages. In the bond market, interest rates can fluctuate more often – since they're subject to the changing moods of traders and bond investors like insurance companies and mutual funds, which try to figure out how fast the economy will grow and where inflation is headed. As a result, watch the bond market for clues on where mortgage rates will go next.

There; you've just graduated Mortgage Rate Mechanics 101.

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