How will the latest lowering of the key interest rate affect mortgage rates in Canada?

Last January 21, the Bank of Canada unexpectedly lowered the overnight rate, commonly known as the *key interest rate* [1] from 1% to 0.75%. This intervention by the Bank, the first since September 2010, was due to the dramatic decline in oil prices in recent months and its expected negative effect on economic growth and inflation in Canada in the coming months[2]. Consequently, the low cost of borrowing in Canada is expected to continue for several quarters and interest rates, including mortgage rates, could even decline slightly in the coming months if the Bank again decides to lower the key interest rate on March 4. One thing is certain; the scenario of an imminent increase in mortgage rates in 2015 expected by the majority of experts has now become very unlikely.

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Financial institutions slow to respond

The Bank of Canada key interest rate more directly affects the preferential rates (usually called «prime rates») of commercial banks[3] widely used to determine the evolution of variable mortgage rates. Accordingly, a cut of the key interest rate usually leads to a corresponding, almost automatic, lowering of prime rates which in turn, results in a lowering of variable mortgage rates. However, this was not the case following the cut in the key interest rate last January 21. Financial institutions were slow to respond and reduced their prime rate by only 0.15 percentage points, instead of 0.25 percentage points as the Bank had done with its key interest rate[4]. As a result, variable mortgage rates from several financial institutions have also decreased, but only very slightly[5].

Over the past 10 years, a similar spread between cuts in the prime and key interest rates has happened only once before, in December 2008. You may recall that the subprime crisis in the United States broke out in late 2008 and early 2009: financial markets were highly volatile and the risk to the lenders was perceived as higher. It is possible that banks and other financial institutions assess that the probability of default is currently slightly higher which would explain the increasing spread between the key interest and average prime rates[6].

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1 The overnight rate or key interest rate is the rate at which major Canadian financial institutions lend money for a one-day period. For more information on the Bank of Canada key interest rate, click here.

2 The Bank of Canada changes its key interest rate in order to keep inflation low, stable and predictable. Source: Bank of Canada.

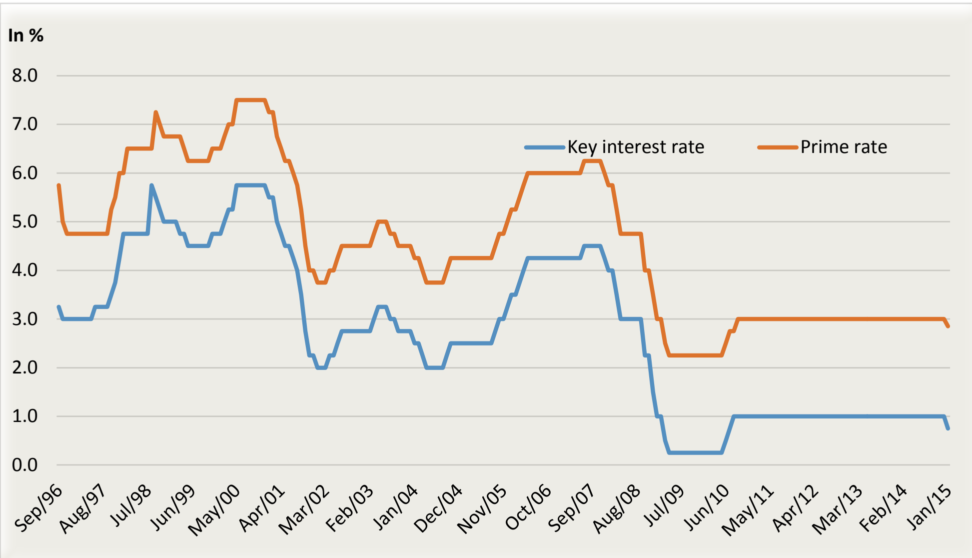
3 The prime rate is the annual interest rate announced by banks and used as a benchmark to determine their various interest rates.

4 The prime rate is currently 2.85%, down from 3% prior to January 21, 2015.

5 According to data from RateHub, the lowest five-year variable rate on February 9, 2015 was 2.05%, down from 2.10%.

6 The difference between the Bank of Canada key interest rate and the average prime rate of commercial banks is currently 2.1 percentage points, the highest level since September 1996.

CHART 1 - WIDENING GAP BETWEEN THE KEY INTEREST RATE AND THE PRIME RATE



Sources: Bank of Canada and Statistics Canada

And the effect on fixed mortgage rates?

In regards to fixed mortgage rates, the effect of a decrease on the key interest rate is less direct and more shifted. A lowering in the Bank of Canada key interest rate affects fixed mortgage rates primarily through lower bond yields. By making Canadian government bonds more attractive to investors, the lowering of the key interest rate favours rising bond prices and therefore, lower bond yields[7]. Since bond rates are used by financial institutions as the benchmark for the cost of funds, lower bond yields generally result in lower fixed mortgage rates of corresponding maturity. However, this decline does not necessarily correspond (see Chart 2)[8]. Between December 2014 and January 2015, the rate on five-year Canadian government bonds decreased from 1.34% to 0.69%[9] while the average mortgage rate in Canada for a five-year term fell from 3.98% to 3.96%.

Note however that bond yields were already showing a downward trend well before the surprise cut of the key interest rate last January: under the effect of lower inflationary expectations (linked to the fall in oil prices), bond yields had, in fact, begun to decline at the end of summer 2014.

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[7] There is an inverse relationship between bond prices and yields. Suppose you buy a five-year bond at original issue for $1,000 that pays 4% per year. You will therefore receive $40 per year for five years. Now, suppose that the price increases to $1,050. The yield or interest rate for the one who buys the bond at $1,050 is reduced to 3.81% ($40/$1,050).

[8] For more information on the factors that affect mortgage rates, click here.

[9] Source: Statistics Canada.

CHART 2 - AVERAGE MORTGAGE RATE FOR A 5-YEAR TERM IS HIGHLY CORRELATED WITH THE RETURN ON GOVERNMENT BONDS WITH THE SAME MATURITY

Sources : CMHC and Statistics Canada.

Banks grant more and more discounts to their best customers

The mortgage rates of the major chartered banks in Canada are already at an historic low and financial institutions appear less willing to reduce their posted mortgage rates more. However, we have observed a trend in recent years for financial institutions to offer larger discounts on posted rates to some of their clients. By granting various discounts based on the borrower's credit history and negotiating skills instead of lowering the publicly posted rates, lenders can increase their profit margin. Between 2010 and 2014, according to data from the Canadian association of accredited mortgage professionals (CAAMP), Canadians negotiated mortgage rate discounts ranging from 1.42 percentage points to 1.85 percentage points. Therefore, the cut in the key interest rate was accompanied by a slight decrease of the average five-year fixed mortgage rate, although the posted average fixed mortgage rate has remained unchanged.

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Conclusion

Canadian mortgage rates are expected to remain very close to the current low, at least for the rest of 2015, and will stimulate the Quebec real estate market this year. The effects of expansionary policies currently implemented by the Bank of Canada, however, may be more noticeable as regards negotiated mortgage rates than those posted by financial institutions. Borrowers who want to invest the time in shopping for a mortgage rate (or use the services of a mortgage broker) and those with a good credit report will probably be entitled to lower rates[10].

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If you have any questions or comments about the content of this article, please contact us by email at: stats@fciq.ca.

[10] For details on discounting, refer to pages 4 and 5 of this document published by the Bank of Canada.

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