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Factors That Determine Mortgage Rates in Canada

For many years now, mortgage rates have remained at historically low levels in Canada, and most analysts expect them to increase progressively over the course of 2011 and 2012. Given the significant impact that mortgage rates have on the cost of homeownership and the housing market in general, this article focuses on the key factors that explain mortgage rate fluctuations in Canada.

First, it is important to note that the factors that determine variable mortgage rates are different than those that determine fixed mortgage rates.

Variable Mortgage Rates

Variable mortgage rates are essentially determined by commercial banks' prime rates[1], which are mainly influenced by the Bank of Canada's key interest rate. Thus, an increase in the key interest rate almost automatically leads to an equivalent increase in variable mortgage rates. The Bank of Canada raises its key interest rate when it wants to fight inflation[2].

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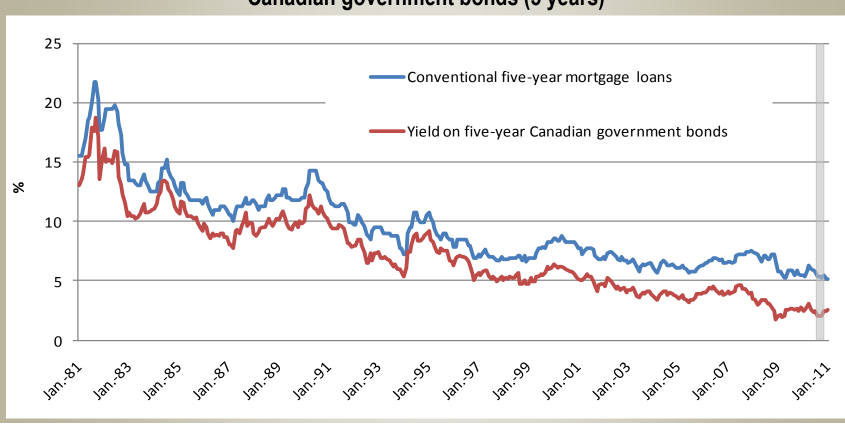
Fixed Mortgage Rates

Fixed rate mortgage loans are primarily influenced by the yield on Canadian government bonds (bond yields) of corresponding maturity. Chart 1 shows the relationship between five-year mortgage rates[3] and the yield on five-year Canadian government bonds. Notice that the correlation between the two is almost perfect. This is because bond rates represent the benchmark for financial institutions' cost of funds[4]. The difference between the two rates (mortgage rates and bond yields) represents the yield that financial institutions require to lend the funds out on the mortgage market[5].

Chart 1

Fixed mortgage rates (5 years) and yield on Canadian government bonds (5 years)



Source: Statistics Canada

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[1] The expression "prime rate" refers to the annual interest rate announced by the banks to be the reference rate for commercial loans in Canadian dollars.
[2] The inflation target range established by the Bank of Canada is between 1 and 3 per cent.
[3] Average five-year mortgage rate offered by Canada's main banks.
[4] The cost of capital for financial institutions is dictated by bond yields because they reflect what the market considers to be the cost of funds for the lowest level of risk for a given period.
[5] The difference between the two rates is in reality smaller because the effective mortgage rates granted by financial institutions are lower than the rates initially posted.

In order to understand mortgage interest rate fluctuations, we need to understand the factors that influence Canadian government bond yields.

Factors Influencing Bond Yields

There are many factors that influence bond yields. Bonds issued by the Canadian government are among the most liquid and least risky assets, since they are guaranteed by the Canadian government. A significant volume of bonds are traded daily in the market. The supply and demand game in the bond market determines their price, which, in turn, determines their yield[6]. This yield can be seen as the minimum rate of return required by investors before investing their capital for a determined period. It is influenced by many factors, notably inflationary expectations, exchange rate risk[7], and the return on other financial assets.

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Here is an example, taken from current events, that helps us to understand the recent movement in bond yields. In the spring of 2010, international investors fled from volatile stock markets, as well as from government bonds issued by certain troubled European countries caught in the midst of a sovereign debt crisis. Thus, many investors flocked to the safety of the Canadian government-bond market, which was considered less risky due to Canada's economic and financial situation. The increase in demand for Canadian government bonds pushed their price up, which necessarily lowered their yield. The shaded area on Chart 1 shows the decrease in yield on five-year Canadian government bonds that took place during this period. We can see that five-year mortgage rates followed the same trend, decreasing from 6.25 per cent in April to 5.39 per cent in August 2010.

In conclusion, mortgage rates in Canada are determined by many factors that are directly related to domestic economic activity and decisions made by Canadian financial authorities. They are also influenced by foreign economic conditions and investors' perception of Canada's financial and economic health.

[6] The yield and price of a bond are inversely related. Suppose you buy a five-year bond, at original issue, for $1000 and suppose the bond pays 4% per year (you receive $40 during five years). The yield of this bond is then 4 per cent ($40/$1000). Suppose now that the price of the bond drops to $950. The yield, for the person buying at $950, jumps to 4.21 per cent ($40/$950).

[7] Risk of financial loss resulting from exchange rate movements.

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