

How the Lenders Manage Mortgage Rates and Products

The mortgage market rate leader has to adjust its rates to balance off its demand and supply of money with the market at the national (even international) level. If they didn't adjust, in a falling rate market they'd be paying above market rates for deposits, or losing mortgage business, or both. In a rising rate market, they'd be paying below market rates for deposits, and attracting little or no new business, while at the same time charging below market rates for mortgages and would be short of funds required to fund the rush of new applications.

The bottom line for the banks (triggered by the rate leader) is that whether rates rise or fall, they'll be out of balance with demand for and supply of money, and their profits will shrink unless their rates meet demand in the retail marketplace - primarily in their branches but also from brokers.

There is a major difference between the way mortgage rates are managed in Canada compared with, for example, the United States. In Canada, the vast majority of mortgages are funded by a relatively few major financial institutions directly out of their customers' long-term and short-term deposits. The impact of the bond market is just as significant as in the US, but because mortgages are typically "securitized" - that is, funded over the long haul by market securities rather than by private depositors, mortgage rate changes are virtually immediate and adjust precisely to the market.

The Canadian mortgage market can be good news or bad news for the consumer. The relative size and strength of Canadian financial institutions allows them to ride out minor market fluctuations without constantly changing posted rates. On the other hand, a longer-term rate trend can often be delayed, and the eventual adjustment can be larger than the gradual changes prevailing in the US. This can occasionally result in "rate shock" on the part of Canadian consumers in a rising rate market. This occurred in the Spring of 1994 a few months after a US Federal Reserve Board policy change which eventually drove Canadian mortgage rates up a few times by almost a full percent each time, due to the delayed reaction on the part of the Canadian financial institutions. This panicked many into locking in their mortgages, only to see rates fall again shortly afterwards. On balance, however, Canadian consumers seem unconcerned about these discontinuities, and are for the most part enjoying Canada's single-digit rates, which are below those of the US.

All Canadian banks are involved to some degree in securitization - funding pools of loans "off balance sheet", or selling off consumer "paper". Considering the deregulatory trend in both Canada and the US it is inevitable that our mortgage market will eventually follow the American model. It remains to be seen, however, whether product differences - US banks offering fully open privileges without penalty - will also be eliminated.