How can mortgage rates be going up when prime is coming down?

And how do you choose whether to go short or long term on your mortgage when it comes up for renewal?

By Alberta Cefis and Roberta Hague, authors of "The Truth About Mortgages", a guide to help Canadians become better borrowers.

Now just imagine the family dinner conversation where your brother or sister declares utter confusion at how the prime rate could drop on the same day that rates went up for fixed mortgages. This just doesn't make sense… or does it? Let's clarify how fixed-rate and variable-rate mortgages are priced and you'll see the difference.

Variable rates are tied to your bank's prime rate, which is based directly on the Bank of Canada rate. The Bank of Canada is our central bank, operating at arm's length from the federal government. The central bank uses its rate as a tool to achieve the goals of "Low and stable inflation, a safe and secure currency, financial stability, and the efficient management of government funds and public debt." Our central bank sets the trend for short-term interest rates and has a direct impact on short-term rates for mortgages and lines of credit, as well as rates paid on deposits and investment certificates.

Fixed-term rates, such as long-term mortgage rates, by contrast, are based on the bond market. Generally, a bond is a debt with a promise to repay the principal of that debt, along with interest. Bonds are issued by governments and large businesses. We've all heard of Canada Savings Bonds, right? And they are just one type of bond. The "yield" of the bond is the annual rate of return, expressed as a percentage. Bond yields can be volatile and fluctuate in response to various political and economic factors, such as inflation and unemployment figures, and developments in the stock markets. They are increasingly affected by global forces. Long-term mortgage rates (3 years and longer) are based on bond yields, but are less volatile because financial institutions absorb the daily market fluctuations in order to create a more stable rate environment for their customers. Generally speaking, higher bond yields increase funding costs for banks, which in turn leads to increased long-term fixed rates. Conversely, lower bond yields lower banks' funding costs and lead to lower long-term mortgage rates.

So, short-term rates move with the Bank of Canada's needs, while longer-term rates are tied to the bond market. The Bank of Canada can influence long-term rates, but it has no direct control over them. This difference in how rates are set is the reason we sometimes see short-term and long-term rates moving in unison, while at other times they diverge.

If it seems difficult to choose between a fixed and variable or long and short mortgage, you don't necessarily have to choose. Perhaps the easiest and best solution is to break your mortgage into pieces and diversify your borrowing across short and long terms. This is mortgage "laddering," a concept Canadians know and use to stagger their GIC maturities for diversification, but which surprisingly few of us use for our mortgages. Diversification is an important principal that applies as much for borrowing as it does for investing. By blending different types of mortgages and staggering maturities, you can diversify your interest rate risk, and perhaps minimize your interest costs.

With files from Scotiabank and NC

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