Focus: Banks and Interest Rates

Focus Sheet

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There are several factors influencing a bank's decision to adjust its lending rates including:

- The Bank of Canada's Target for the Overnight Rate
- Conditions in lending markets
- Cost of funds in financial markets

The Bottom Line

Interest rate decisions by individual banks and other financial institutions are business decisions made in a competitive marketplace.

While the Bank of Canada's Target for the Overnight Rate does influence the pricing of credit, it does not set the interest rates that consumers pay on their loans (except for loans tied to their prime rate such as variable-rate mortgages) or receive on their deposits.

For example, between February and August 2022, while the Bank of Canada's Target for the Overnight Rate and the banks' prime rate rose 2.25 percentage points, conventional 5-year mortgage rates only rose 1.35 percentage points over the same period.[1]

How does the Bank of Canada affect bank lending rates?

There is a common misconception that the interest rate on loans paid by bank customers is solely driven by the Bank of Canada's Target for the Overnight Rate. The Bank of Canada's Target for the Overnight Rate is one of several factors that influence bank lending rates.

Lenders continually assess market conditions to determine the interest rates they charge on loans, whether for short-term or long-term loans. An individual bank's decisions on lending rates are also impacted by conditions in lending markets and the cost of funds borrowed by banks in financial markets.

Target for the Overnight Rate:

The interest rate that the Bank of Canada uses to signal the direction of monetary policy. It is the target interest rate that the Bank of Canada wants major financial institutions to use when lending and borrowing one-day funds among themselves.

Prime Rate:

A benchmark rate of interest set by individual banks and other lenders from which the interest rate charged on loans to customers is calculated.

Inflation and Interest Rates:

The most important factor influencing the Bank of Canada's Target for the Overnight Rate is inflation. Inflation is a general rise in the price of goods and services (or, put differently, a fall in the value of the currency used to buy goods and services). As the Bank of Canada aims to target inflation at the 2 per cent midpoint of an inflation-control target range of 1 to 3 per cent, it primarily uses the Target for the Overnight Rate to bring inflation closer to the 2 per cent target and keep it within the target range. Generally, a rise in inflation leads to an increase in the Target for the Overnight Rate while a decrease in inflation leads to a decline in the Target for the Overnight Rate.

Lending rates to and savings rates for consumers and businesses are not necessarily tied 1:1 to changes in the Target for the Overnight Rate and bank prime rates (except