

# BANK'S LONG-TERM RATE POLICY EXPOSED!

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Last week my business report on News 1130 spoke about the fact that I am very surprised at the current price of the long-term fixed rate mortgages and why no one is complaining about them. Just before the January 22nd announcement by the Bank of Canada that they were going to lower the overnight lending rate by a quarter point, there was a small announcement from one of the banks that hinted that they might not lower the prime lending rate accordingly. This caused a virtual outcry across the country. 'How dare the banks not pass on the 'Obvious' savings?' Why those money-hungry, greedy you know whats.....

Well it wasn't long before the banks fell into damage control position and began saying all the right things - "We were simply misunderstood - we had no real intention of doing that." The problem is, all of the major Canadian banks outside of TD have taken huge losses in the Sub-Prime fiasco and they are looking at even greater losses in 2008. The idea of taking the extra quarter point and bankrolling it to cover future losses was not only discussed - it was seriously considered. And if they thought they could get away with it - they would have.

But the truth is the banks have been able to get away with something else - they have been building up a war chest to buffer future losses for months now by overpricing their long-term fixed rates and since the average Canadian does not follow how banks set their

long-term fixed rates and the media is not putting a spotlight on it, they have been getting away with it.

Previous to the August Sub-Prime crisis, Chartered banks liked to keep the spread (margin) between the 5 yr bond rate and the 5 yr fixed rate (fully discounted) between .9 and 1.3%. If the gap rose more than 1.3%, too many other players would be attracted to the market causing them to lower rates. Well since August, the gap between the two has grown to as much as 2.5%. That means technically, the 5 year rate at chartered banks today could be as much as 1.2% higher than it is. Now the lenders will say "Ya but the cost of borrowing money has changed since the August crisis." Ok, I'll give you that - but that should only factor in a quarter to a half point at most. What about the other three quarters of a point? There is simply no other explanation than the fact that they need to stockpile money today for more anticipated losses in the US market over the next year. And to think - we were all upset because they wanted to take the measly quarter point off of Prime - yet no one is saying a word about the three quarter point spread they are taking on the long-term rates.

But alas, the end looks to be coming soon to the added pricing the banks are charging. Remember I said that if the spread got above 1.3%, it would attract more players to the market? Well the chartered banks weren't worried about other players because everyone else got beat up in the global credit crunch as well. But I think they got a little too

greedy and underestimated that the Canadian Sub-Prime lenders were not hurt as bad as their US counterparts, and once they saw the gap between the bond rate and the 5 yr fixed get to 2.5%, it became attractive enough for them to enter the market. So as of the end of January, two of the Canadian Sub-Prime lenders jumped into the discount game and started offering 5 yr rates lower than most of the chartered banks. At one point Xceed mortgages had the best 5 yr rate in the country.

I'm not really sure if you follow what I've been trying to tell you - but any time a Canadian Sub-Prime lender offers a 5 year mortgage rate cheaper than a chartered bank's 5 year rate - it should be headline news! Think about it - if the spread is attractive enough for a Sub-Prime lender to jump in, that means the banks have been raking it in for months and not passing the savings on to you - giving up on the quarter point in Prime when everyone complained was not too painful - trust me - they have made up for it. The only reason the media isn't all over this story is because it's a little harder to follow and takes a little more time to explain.

The good news is that now that the Sub-Prime lenders are trying to play in this discounted fixed rate sandbox, the chartered banks will have no choice but to make a move and lower rates before they get exposed on a larger scale. In the meantime, this all supports my argument from last month's letter - the best mortgage to take for the next 6 months will be a front end loaded Variable. Take the heavier discount up front and then sit back and wait till the long-term rates fall a bit and then lock it in.

Feel free to call us if you have any questions until then,  
Happy Investing.

Peter

