BANK OF CANADA
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B A C K G R O U N D E R S

Lending Rates

How they are set

Banks and other financial institutions are independent business entities that set their own lending rates. However, the level of interest rates that commercial banks charge their clients is influenced by several factors, some of which are not determined by the banks themselves.

A key factor is the Bank of Canada's policy interest rate, the target for the overnight rate. This is the rate that the Bank of Canada expects financial institutions to use when borrowing or lending one-day funds among themselves. Thus, changes in the Bank's policy rate influence other interest rates in the economy, including the prime rate and mortgage rates that banks and other financial institutions charge customers.

The policy rate is not the only factor affecting lending rates, however. There are other important elements that influence such rates—factors that reflect the relative balance between the supply of and demand for loanable funds in the economy. One such element is the cost to the banks of raising long-term funds in financial markets that they can then lend to households and businesses.

Financial institutions also build a risk premium into their lending rates, as protection from uncertainty. As well, they factor in certain administrative costs and, like any other commercial business, a profit margin.

Short-term and longer-term interest rates

The term of a loan has an important influence on the interest rate charged. Short-term interest rates usually apply to money lent for a period of one year or less. Long-term interest rates can be either higher or lower than short-term rates, depending on the term of the loan and the prospects for economic growth and inflation.

In general, long-term interest rates reflect the expected level of short-term rates plus a risk premium to compensate for uncertainty. This premium tends to increase with the term of the loan because the uncertainty increases as one goes further into the future.

Nominal and real interest rates

The distinction between nominal and real interest rates is important in economic terms.

Nominal rates consist of two components: a portion that represents expected inflation (known as the inflation premium) and a portion that represents the real rate of return. The expected real rate of interest is the difference between the nominal rate of interest and the expected rate of inflation. For example, with a nominal interest rate of 6 per cent and an expected inflation rate of 2 per cent, the real rate of interest is 4 per cent.

Real interest rates reflect the real return to a lender and the real cost to a borrower and are thus more relevant than nominal rates for economic decisions.

October 2011

This text, and other backgrounders on topics related to the Bank of Canada's work, can be found at: bankofcanada.ca—search for "backgrounders."

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