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Understanding the Real Estate Market and its Connection to the Capital Market

Would you be surprised to know that a simple 1% increase in residential mortgage rates has the ability to price thousands of Canadians out of the housing market? Why? Because the real estate financing rate directly affects the amount Canadians pay on their mortgage each month. When the rate is up, the payments on a new mortgage are up as well. Even a simple 1% increase can make a mortgage financially out of reach for many people.

The mortgage market is an entity in itself; however, it is also intimately related to the capital market. The capital market is the overall market for funding of all kinds all over Canada. The capital market functions on a simple principle: on any given day there are people who have extra money to lend, known as investors, and others who have a desire to borrow that extra money, known as borrowers.

The capital market is defined as the market which facilitates the transfer of money from those who have extra to those who need to borrow it. The biggest factor in determining the supply and demand for money is the interest rate which governs the process. The prevailing interest rate provides a quantitative measurement for the reward of investing and the cost of borrowing. The interest rate is the balance point between the amount of money borrowed and the amount of money lent.

In times past, banks made mortgage loans from the deposit money from their customers. However, banks today no longer have enough of a deposit base to be able to lend from. Banks themselves now borrow money from the capital market to fund their mortgages. The interest rate at which they lend at is determined by their borrowing cost, the borrower's credit rating, and the rate of inflation over the term of the loan. If you have a bad credit rating, or desire a long loan term, then you will pay a higher interest rate to borrow money.

Generally, mortgages today are backed by federal government bonds. A bond is a promise by the Canadian Government to pay the interest and principle stated at a given date. By definition of government, the bond is secure because the government can always raise taxes to pay-off the bond if it had to. There is no more secure lender than a federal government.

If you are trying to speculate which direction mortgage rates are headed, by watching the bond rate you can make an educated guess. This can allow you to get the best possible mortgage rate.