

What's Prime Rate and Who Sets It?

Financial institutions often advertise their "Prime Rate" or often their "Better Than Prime Rates". Have you ever wondered what "prime" really means and who decides what the prime rate should be?

Prime rate is influenced by The Bank of Canada. Basically, it sets a target overnight rate (an average rate it would like to see in the marketplace) and most other, if not all, Canadian financial institutions follow its lead.

How It Works:

Prime's history begins at night when many major financial institutions borrow and lend money amongst themselves to settle their transactions during the day. If one financial institution needs money it will borrow from another institution who has funds leftover at the end of the day. This is called "the overnight market" and the interest charged on loans is the "overnight rate".

The Bank of Canada uses a system to ensure trading stays within an "operating band". "The band, which is one-half of a percentage point wide, always has the Target for the Overnight Rate at its centre," according to the Bank of Canada. "For example, if the operating band is 4.25 to 4.75 per cent, the Target for the Overnight Rate would be 4.50 per cent."

"Since financial institutions know the Bank of Canada will always lend money at the rate at the top of the band, and pay interest on deposits at the bottom, there is no reason for them to trade funds at rates outside the band."

Therefore when the Bank of Canada changes the Target for the Overnight Rate, it usually leads to changes in the prime rate at all financial institutions, which affects loans and indirectly mortgage rates, and the interest paid to consumers on bank accounts, GICs, and other savings.

"When comparing Canada's official interest rates with those of other countries, the Target for the Overnight Rate is the best rate to use," according to the Bank of Canada. "It is directly comparable with the U.S. Federal Reserve's target for the federal funds rate, the Bank of England's two-week "repo rate," and the minimum bid rate for refinancing operations (the repo rate) at the European Central Bank."

What does this mean to you?

By influencing the prime rate, The Bank of Canada affects the Canadian economy. For instance, a change in the target overnight rate can lead to a change in the exchange rate of the Canadian dollar.

By influencing the interest rates The Bank of Canada hopes to protect the value of Canadian money and avoid inflationary "boom-and-bust" cycles that lead to recessions and unemployment.

For example, when interest rates are low, people are encouraged to spend more, save less and borrow more, which boosts the economy. But if the economy grows too fast, it can lead to inflation. The Bank of Canada may then decide to raise interest rates to slow down borrowing and spending, putting a brake on inflation.

The Bank of Canada estimates there are lags from 18 months to 24 months between monetary policy changes and the effects on inflation and the economy.

When influencing prime rate the Bank of Canada looks toward the future and anticipates monetary conditions needed today to help keep the economy on track for growth and job creation in the future.

Prime rate is traditionally the lender's lowest interest rate and is expressed as a percentage per year. If the prime rate is eight per cent; prime plus two would be an interest rate of 10 per cent (eight plus two).

If you read the Wall Street Journal you may have noticed the "WSJ Prime Rate". WSJ stands for Wall Street Journal, of course. The journal surveys large financial institutions and publishes the consensus prime rate. It's the most widely quoted measure of the prime rate.

Now you know what prime really means and next time you visit your financial institution and are given prime rate, you know you are getting the interest rate financial institutions charge their most favoured customers.