

Why banks aren't paying higher interest rates

So far in 2010, Canadians have opened 20 per cent more chequing and savings accounts than last year at this time.

That amounts to about \$100 billion in new deposits and Canada's major banks have been fighting for a share of it with incentives, including cash rewards for customers opening new accounts.

While consumers can get cash and travel points to open a new account, there is one conspicuous weapon missing in the banks' marketing arsenal when it comes to attracting new customers.

And that is the lure of higher interest rates, something you won't find the banks offering on those new savings accounts and products – or old ones for that matter.

On July 20 when the Bank of Canada raised its overnight rate by 0.25 per cent to 0.75 per cent, the increase was immediately passed on to consumers with lines of credit, mortgages and other products that were priced directly off of the prime rate.

Which raises an obvious question: why doesn't a jump in the bank rate, which can signal a sudden increase in the rate of interest charged on a line of credit, trigger a corresponding interest-rate increase on products such as savings accounts and GICs?

It's certainly an answer many investors with money sitting in the bank would like to know.

After all, with the banks paying between 1 per cent and 2 per cent on many savings products it would take years to generate any kind of return. In fact, if your bank is paying you 1 per cent annually on your savings account it would take 72 years to double your money – at 2 per cent it would take 36 years to double up.

Even worse, with inflation factored in, consumers are actually losing money on bank deposits.

It isn't likely to get any better, especially with consumers clamouring for the security of savings accounts and GICs. Indeed, according to some economists, in the current environment the banks are under even less pressure today to increase interest rates on savings accounts and GICs than they have been historically.

Mike McCracken, an economist and head of Ottawa-based Infrometrica, says as the Bank of Canada raises rates, it allows the major banks to turn around and say, "look at us we're wonderful guys" withdrawing stimulus just like Bank of Canada governor Mark Carney wanted.

They then turn around and increase interest rates on a wide range of lending products – but not on savings or GICs. And notes McCracken, it's not unusual for the banks to crank up interest rates on many of these products by 0.50 per cent after a 0.25 per cent Bank of Canada increase.

The fact there is a lot of surplus money in the banking system is also helping the banks keep rates low on savings products. "Right now the demand for loans is very low," says Doug Peters, former chief economist at TD Bank.

"Businesses are not expanding or investing, so banks don't need to raise interest rates on those deposits."

There are forces at work in the wider market that are also conspiring to keep interest rates on savings and GICs low – even if Carney continues to raise rates.

That's because investors who were pummeled in the financial crisis don't want to be beat up again. And when the European debt crisis erupted this spring, they dumped equities and fled to the safety of bank deposits and T-bills.

With so many people seeking shelter in bank deposits and other conservative investments, at one point this spring the government was even able to reduce the yield it paid on products like T-bills, a staple holding in money-market mutual funds.

The fact Europe and the U.S. have so far refused to raise interest rates, doesn't help Canadian fixed income investors. Their reluctance to raise rates, gives the Bank of Canada the option to move slowly. And by extension, it takes the pressure off the major banks to raise the interest it pays to consumers.

On top of that, there is little sign of inflation, a factor that could force Carney to raise rates at a quicker pace if it moves higher. So savers may have to wait a long time before they see a return to 5 per cent interest rates.

"Eventually interest rates on savings accounts will go up," says McCracken, "but it won't be anytime soon."

So, on the one side of the bank ledger they can pass along interest rate increases with impunity, while keeping the interest rates that they have to pay on savings and GICs at historic lows. And as the spread, between what they have to pay out and what they take in widens after each successive interest rate increase, the more money the banks will make.

"It speaks to the power of the Canadian banks," says Arthur Donner, a Toronto-based economic consultant. "They won't raise rates until they absolutely have to."

Still, the Bank of Canada is uniquely positioned to use "moral suasion" to convince the big banks to raise rates on savings products. But it may not be in the best interest of the Bank of Canada to do so at this time.

Donner's reasoning: with the European debt crisis and the threat of a further economic slowdown still on the horizon, Carney may not be opposed to a wider spread between what the banks pay out in interest and what they bring in. This would allow the banks to build up their capital reserves just in case the economy stalls again.

Still, Donner has little doubt that at some time in the future if the Bank of Canada keeps raising rates, the

major banks will be forced to pay consumer more for their money. "In the end," says Donner, "if Carney keeps raising rates it will balance out." Consumers can hardly wait.