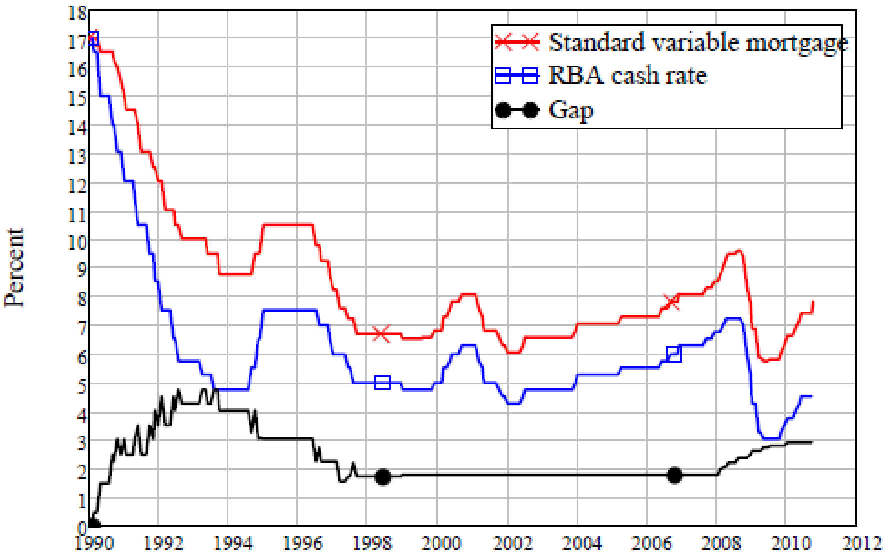
Chapter 5

Home loan interest rates

Introduction

5.1 There is a widespread belief that banks' lending rates should follow (and only follow) movements in the RBA's policy rate, the 'cash rate'. This belief is especially strong for home loans where it has been reinforced by the banks generally behaving in this way for a number of years (Chart 5.1[1]). (The view is also held for small business rates[2] although this attracts less attention.)

Chart 5.1: RBA cash rate and bank's variable home loan rate



Source: Associate Professor Steven Keen, *Submission 63*, p 3.

5.2 Some customers hold this view very strongly:

> As for the arrogance of banks that increase mortgage rates over and above the RBA... this is beyond belief.[3]

1 Similar charts appear in *Submissions 7, 8, 59* and *88.*

2 A survey of Queensland business found that 90 per cent did not believe increases in interest rates above the change in the official interest rate were justified; Chamber of Commerce and Industry Queensland, *Submission 43*, pp 8 and 16. Small business finance is discussed further in the following chapter.

3 Mr Michael O'Connor, *Submission 125*, p 2.

5.3 The increase in home loan rates beyond the Reserve Bank's latest 25 basis point increase in its 'cash rate' on Melbourne Cup Day 2010 attracted particular ire. A recent opinion poll showed that 79 per cent of respondents would support 'government regulation to limit bank interest charges to the level set by the RBA'.[4]

5.4 This belief of customers has developed as a result of the banks' actions over recent years:

> On one hand banks keep saying that there funding costs are disjointed from RBA cash rate as most of their funding is done through purchased funds in international and domestic market…banks however, invariably change their home lending rates as RBA cash rate changes.[5]

5.5 This pattern is, however, the result of an unusual amount of stability in financial conditions over that period rather than being an innate feature of banking operations. As the Reserve Bank Governor explained:

> …market funding costs do not move in this environment one-for-one with the cash rate. In fact, the period of time in which they did was historically rather unusual. It lasted 10 or 12 years. But if you went back prior to that period the association of mortgage rates with the cash rate was actually much looser.[6]

5.6 Some bank CEOs accepted that the banks had created this misperception by sheltering behind the RBA decisions when they raised interest rates on home loans:

> The banks have made a problem for themselves here by continually moving in line with the Reserve Bank… The reality is that that is not the driver of our funding but we have, for many, many years, created that perception in the public's mind, so we have got to face the fact that this is something we have created through our own poor communication on the issue...I certainly do not blame the public at the moment for being upset about moves they see as not in line with the RBA.[7]
>
> The fact that the banks have moved their interest rates in line with the RBA adjustments has led to the understanding of the public that there must be a connection, and that is quite understandable. So I think we have created that problem for ourselves...[8]

5.7 One bank CEO blamed the non-bank mortgage lenders:

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4 Cited in Finance Sector Union, *Submission 80*, p 7.

5 Professor Milind Sathye, *Responses to questions on notice*, p 3.

6 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 15.

7 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 51.

8 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 133.

> …the perception of a nexus between the RBA cash rate and housing loan rates needs to be broken…The perception came about as a result of non-bank lenders entering the home loan market. These lenders used the securitisation market to fund their loans and the securitisation market provided these funds based on…bank bill rates…[which] reflect the market expectation of the cash rate…Banks, erroneously in my view, elected to compete with these originators on price and were therefore led down the path of also changing pricing as official rates changed.[9]

5.8 The belief that home loan interest rates should be related to the RBA's cash rate led one submitter to suggest banks be required to justify any greater increases:

> A National Interest Rate Accord built on an annual National Interest Rate Case is the answer. If banks want to raise mortgage interest rates above and beyond the RBA's, they should be forced to justify one-off moves to an independent authority…Private health insurers, which just like the banks enjoy enormous protection and support from government policy, have to justify premium rises, although that process has been watered down far too much.[10]

Banks' cost of funds

5.9 The banks indeed argue that less than half of their costs of funds vary with the cash rate.[11] Large proportions of bank lending are funded by overseas borrowing. Almost a tenth of deposits pay no or low interest.[12] A significant proportion of funds is longer-term and so only very gradually adjusts to movements in short-term interest rates (Charts 5.2 and 5.3).

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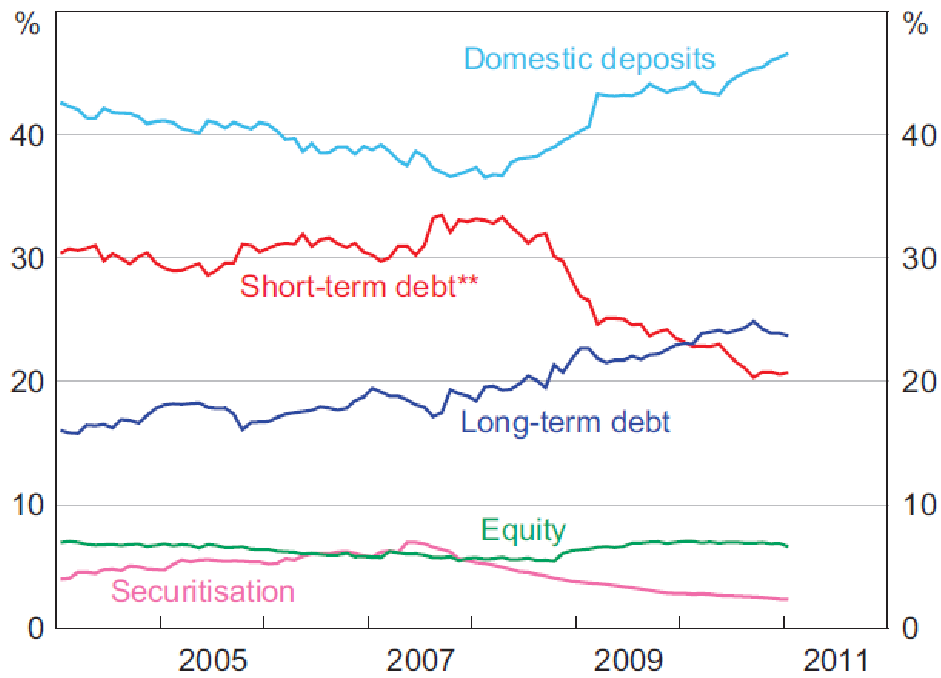
9 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Responses to questions on notice*, no 7, 20 January 2011, p 1. He adds 'the irony in all this is that the non-bank lenders…no longer exist because they didn't manage their liquidity through borrowing across a range of short and long term maturities'.

10 Mr Alan Stokes, *Submission 48*, p 1.

11 For example, Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 46.

12 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 5.

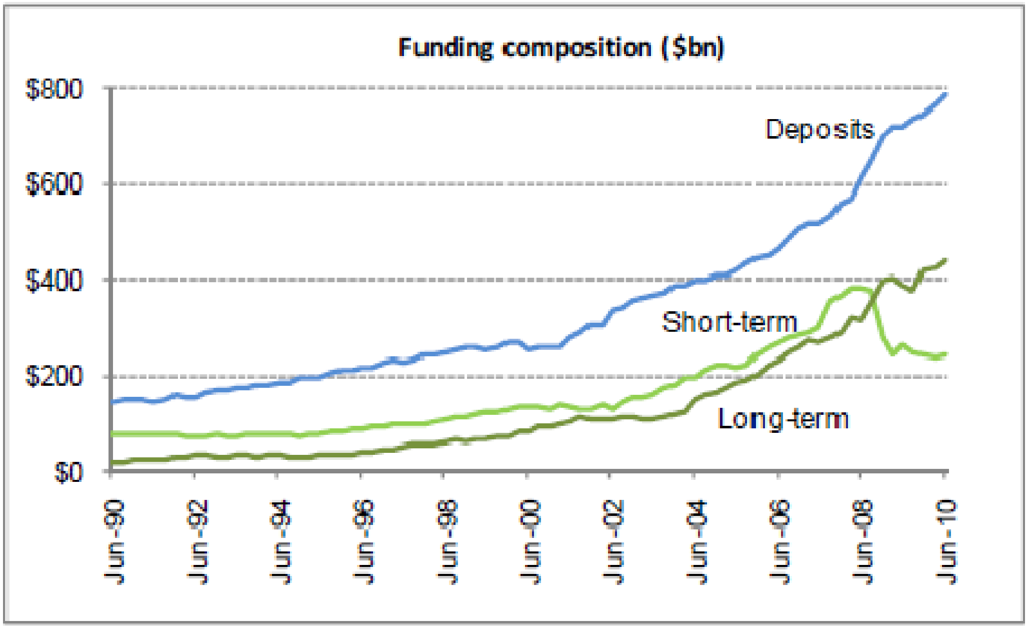
Chart 5.2: Composition of Australian banks' funding (% of funding)



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Source: Reserve Bank of Australia, *Financial Stability Review*, February 2011, p. 46. (Update of chart included in Heritage Building Society, *Submission 113*, p 2)

Chart 5.3: Composition of bank funding



Source: ABS Financial Accounts

Source: Australian Bankers' Association, *Submission 76*, p 82.

5.10 An academic witness stated at the hearing:

> There is no reason the banks should follow the Reserve Bank cash rate…[13]

5.11 In his submission he elaborated:

> The [Reserve] Bank Board sets only one interest rate—the cash rate. This is the interbank rate, the rate at which deposits in the banks' Exchange Settlement Accounts are traded. These deposits are usually of the order of $1bn, a tiny percentage of total bank liabilities. The suggestion of the critics is that if the RBA reduces the cash rate, the banks have somehow received a benefit which they are selfishly refusing to pass on to their customers. In fact, they have received no benefit at all. Of course, RBA cash rate decisions affect longer-term interest rates, but these are determined by market interest rate expectations…And it is these longer-term market rates which determine banks' cost of funds and, therefore, the rates they can charge customers.[14]

5.12 Since the GFC the banks have made increasing use of longer-term funding (Charts 5.2 and 5.3) which, given yield curves generally slope up, is usually more expensive.[15] In part this is a response to pressure from supervisors and ratings agencies:

> The announcement of new global standards for liquidity by the Basel Committee in December…has contributed to this. Banking institutions will need to have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. Increasing the share of funding from longer-term debt can reduce the size of the liquidity portfolio that needs to be held under that scenario.[16]

> These developments partly reflect a reassessment of risk in the post-GFC environment. They are also in anticipation of regulatory change in the post GFC environment, including new international standards on bank liquidity to be fully implemented by 2015.[17]

> …we have put in place far more longer-term funding. This has been done to protect the AA rating, which is so important for the banks, and also at the behest of APRA…[18]

5.13 But it also reflects changes in the banks' own thinking:

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13 Professor Tom Valentine, *Committee Hansard*, 25 January 2011, p 61.

14 Professor Tom Valentine, *Submission 14*, p 1.

15 Australian Bankers' Association, *Submission 76*, pp 3 and 11.

16 Reserve Bank of Australia, *Statement on Monetary Policy*, February 2011, p 46.

17 Then Treasury Secretary Dr Ken Henry (2011, p 17).

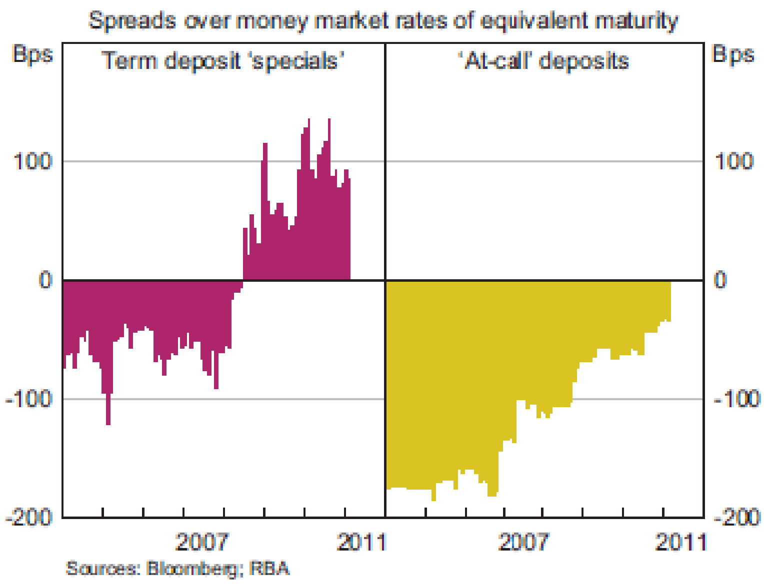
18 Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 118.

… our overall stance that we need to be more conservative, having learnt lessons from the GFC.[19]

5.14 The increased use of longer-term funding raised the average cost of funding. The banks have drawn attention in particular to the increased cost of term deposits, relative to the cash rate.[20] Chart 5.4 shows the large increase in 2009, which now appears to have stabilised:

> A consequence of the banks' efforts to change their funding patterns has been stronger competition in the deposit market in recent years. Deposit rates remain at or around historically high spreads to money market rates, although the intensity of competition for term deposits may have abated somewhat in the second half of 2010 as banks' funding pressures have eased; it might now be that much of the adjustment from lower-rate to higher rate deposit accounts has run its course.[21]

Chart 5.4: Major banks' deposit rates



Source: Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 28.

5.15 There has also been discussion about the impact of interest rates overseas. As offshore borrowings are hedged, however, the cost is not that different to that of domestic borrowing:

> The Group (along with the other Australian banks) hedges the foreign exchange risk from offshore borrowing in order to deliver AUD funding to

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19 Mr David Craig, Chief Financial Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 47.

20 Australian Bankers' Association, *Submission 76*, p 86.

21 Reserve Bank of Australia, *Financial Stability Review*, March 2011, p 28.

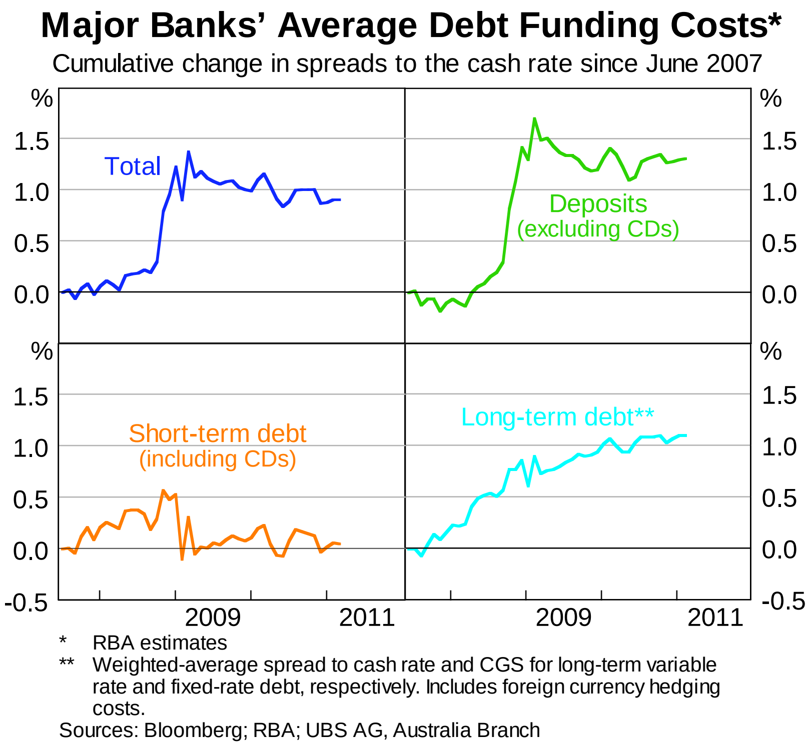
its customer base. Implementing the hedge removes the risk that large swings in the AUD exchange rate can lead to potential significant losses on offshore borrowing.[22]

Funds borrowed by Australian banks in offshore markets are either borrowed in Australian dollars or hedged into Australian dollar exposures using derivatives. In particular, the ABS's 2009 Foreign Currency Exposure release, undertaken on behalf of the RBA, showed that Australian banks hedged almost all of their foreign currency liabilities. The few unhedged liabilities were potentially fully hedged 'naturally' as they were more than offset by the banks' unhedged foreign currency debt assets and foreign equity investments…Hedging converts the interest rate on offshore debt back to an Australian dollar interest rate, which, if it were a floating rate, would be influenced not only by the cash rate but also by changes in the cost of hedging.[23]

The larger part of offshore borrowing is denominated in foreign currency with the foreign currency risk being hedged.[24]

5.16 The increase in the cost of various types of funding relative to the cash rate is shown in Chart 5.5.

Chart 5.5



Source: Reserve Bank of Australia, update of chart in *Submission 41*, p. 14.

22 Commonwealth Bank of Australia, *Submission 88*, p 5.

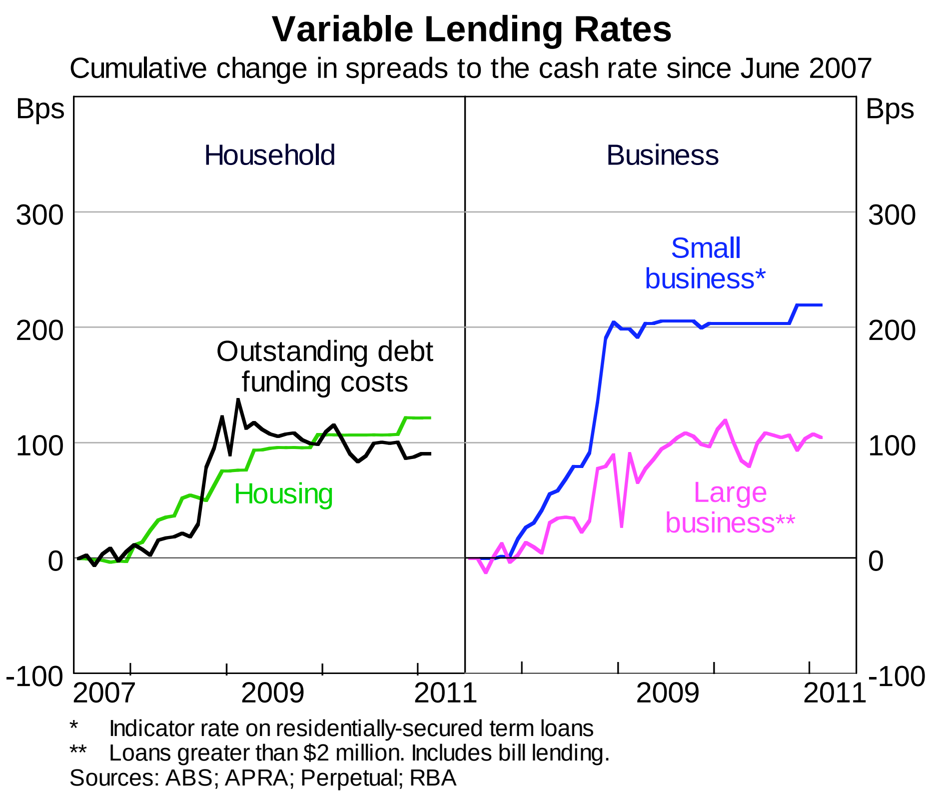
23 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 6.

24 APRA, *Responses to questions on notice*, no 10, 31 January 2011, p 3.

5.17 For the major banks, the increase in the cost of funds was around 100 basis points. One smaller bank estimated its comparable increase was 130-140 basis points.[25]

5.18 Chart 5.6 shows that after the GFC housing loan interest rates rose by less than the Reserve Bank's estimate of banks' cost of funds. By contrast business loan interest rates have been increased by more than the cost of funds. This suggests banks have become risk-averse and the relative safety of housing lending has become more attractive to them.

Chart 5.6



Source: Reserve Bank of Australia, update of chart in *Submission 41*, p. 15.

5.19 The major banks challenged the Reserve Bank's calculations, arguing that while 'spot rates have largely stabilised' the banks have to rollover longer-term funding at rates still well above pre-GFC levels:

> …the average cost of our funding book is rising because we are replacing cheap funding with more expensive funding—certainly, absolutely, very

25 Mr Mike Hirst, Managing Director, Bendigo and Adelaide Bank, *Committee Hansard*, 15 December 2010, p 87.

> pleasingly, funding that is below the peaks but still substantially above the pre-crisis levels.[26]
>
> In our own situation the average cost of funds continues to rise…and that is because…we are still replacing funds that we brought on board before the global financial crisis with funds that are now much more expensive.[27]

5.20 This does not explain any discrepancy with the Reserve Bank's calculations, however, as the RBA is well aware of the banks' need to roll over funds:

> …their funding costs on the offshore part of it, the long-term part, where you borrow at five years—so every year one-fifth of that funding is replaced; the cost of what you borrowed five years ago is 'down here'; the cost of what you are borrowing to replace it with is 'up here'.[28] So, as each month goes by, a little bit of the old stuff rolls off and the new stuff rolls on. How big a quantum that is is a matter of estimation—an empirical estimation, of course—but my guess is that one of the things that is in their mind is that this is happening each month and, as each month goes by, there is that small squeeze on their margins.[29]

5.21 As shown in Chart 5.5, the increase in the average cost of longer-term funding is more than offset by a reduced cost (relative to the cash rate) of short-term borrowing and deposits.

5.22 The Reserve Bank's charts refer to an average of the banks, so may not capture the experience of every individual bank, which may be the cause of the dispute.[30] There are differences in the cost of funds between banks:

> There is some variation in the cost of funding across the major banks. First, there are differences in funding composition across these banks. Second, there are some differences across the banks in the rates paid on particular funding sources; these differences can reflect factors such as timing of bond issuance, or how strongly a bank is competing for a particular type of deposit. The major banks' financial results show that for the 2010 financial year, the average interest rates on the interest-bearing liabilities of these

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26 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 61. Similar comments were made by Mr Ralph Norris, Chief Executive Officer, Commonwealth Bank of Australia, *Committee Hansard*, 15 December 2010, p 47; and Mr Michael Smith, Chief Executive Officer, ANZ Banking Group, *Committee Hansard*, 15 December 2010, p 120.

27 Ms Gail Kelly, Chief Executive Officer, Westpac, *Committee Hansard*, 21 January 2011, p 72.

28 The reader will have to imagine the accompanying hand gestures.

29 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 15.

30 For example, the Commonwealth Bank say they have a more conservative funding mix than the industry average; *Responses to questions on notice*, no 8, 28 January 2011, p 1.

> banks' Australian operations was between about 4 and 4.7 per cent, a range of about 70 basis points.[31]

5.23 Credit Union Australia, the largest competitor from the mutual sector, reported a different recent experience and expectation for funding costs:

> …we are seeing funding costs at the moment largely flat over the last eight to 12 months or that kind of period. So perhaps we have been at the peak.[32]

Loan rates and the cost of funds

5.24 Professor Sathye suggests that in a competitive market banks' loan pricing would reflect their average cost of funds.[33] Asked about this, the Reserve Bank told the Committee:

> How banks reprice outstanding loans is likely to be a significant determinant of whether the bank sets its loan rates on a marginal cost or average cost basis. In Australia, an increase in the indicator rate increases rates for both new and existing variable-rate borrowers. On that basis, we would expect that rates would be set with average funding costs mainly in mind. In contrast, loans that did not reprice as interest rates move could be expected to be set with a view to the marginal cost of funding. Moreover, since the onset of the global financial crisis, banks have become more concerned about how they fund an increase in their balance sheets, thereby putting more emphasis on using a marginal funding cost benchmark to assess a loan proposal.[34]

5.25 The most recent increases to home loan interest rates by the major banks in excess of the Reserve Bank's adjustment to the cash rate, on Melbourne Cup Day 2010, continues to cause controversy. Treasury remains critical:

> Senator WILLIAMS—Mr Murphy, you were just saying that you recognise that the cost of funds for the banks has increased. Is that correct?
>
> Mr Murphy—Yes.
>
> Senator WILLIAMS—Does that justify their position to raise their interest rates outside the Reserve Bank cash rate movement?
>
> Mr Murphy—No, I do not think it does. The cost of funds has risen significantly from, say, pre GFC. It went up dramatically during the GFC

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31 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 6.

32 Mr Chris Whitehead, Chief Executive Officer, Credit Union Australia, *Committee Hansard*, 25 January 2011, p 87.

33 Professor Milind Sathye, *Responses to questions on notice*, no 4, 14 January 2011.

34 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 5. The RBA's response is endorsed by APRA; *Responses to questions on notice*, no 10, 31 January 2011, p 3.

> and it has dropped back down. One of the issues is: what is the time frame in terms of when costs of funding should be looked at? [35]
>
> He [the Treasurer] has taken the view that it is unjustified. As I said, there is a range of factors, and I see it easy to come to that conclusion.[36]

5.26 But importantly the banks increasing their loan rates by more than the Reserve Bank's adjustment to its cash rate does ***not*** mean that borrowers are paying higher rates on their loans (in any other than a very short-term sense). The average loan rate is essentially where the Reserve Bank believes it should be in order to meet its medium-term inflation target. If the banks expand their margin over the cash rate, then the Reserve Bank will set a lower cash rate than they would otherwise have set.

5.27 The Governor of the Reserve Bank explained:

> But since the middle of 2007 there clearly has been an increase in their [the banks'] overall costs of funds relative to the cash rate. That has been reflected in the widening of the margins. It has also been reflected in the cash rate being roughly, I would say, about 100 points lower than it would have been, to take account of that margin change and roughly—not exactly in any given month but roughly speaking—offset it so that the loan rates in place in the economy are, roughly speaking, about where we think they ought to be for the macroeconomic management needs that we have. We cannot finetune this on a month-to-month basis; we could not claim to do that. But over time, in the broad sweep, the big amounts, roughly speaking, have been offset by different behaviour by us on the cash rate compared to what we would have done otherwise.[37]

5.28 The banks' actions may influence the home loan rate relative to other lending rates. The Reserve Bank does not regard the home loan rate as the *only* interest rate that influences economic activity and hence inflation. Higher interest rates on loans for business will lead them to scale back or defer their investment decisions. Higher interest rates on deposits encourage households to save more and so spend less. Higher interest rates on personal loans will also discourage some consumer spending. Higher interest rates also have a wealth effect as they reduce asset prices by more heavily discounting future cash flows. Higher interest rates tend to be associated with a higher exchange rate, weakening activity in exporting and import-competing industries.

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35 Mr Jim Murphy, Executive Director, Markets Group, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 39.

36 Mr Jim Murphy, Department of the Treasury, *Committee Hansard*, 13 December 2010, p 45.

37 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Proof Committee Hansard*, 13 December 2010, p 13.

5.29 Conceptually the Reserve Bank can be thought as being concerned with a weighted average interest rate charged by banks and other ADIs; with the weights reflecting the importance of the interest rate in influencing activity.[38]

5.30 Australian households have high levels of housing debt (compared to the past, and increasingly compared to international peers), predominantly at variable interest rates. This implies that the importance of the link between movements in the Reserve Bank's policy rate and the interest rate on home loans is more important now in Australia than in the past or in most other countries. The much greater media attention given to home loan interest rates amplifies their importance in influencing consumer sentiment.

5.31 The housing variable loan rate is therefore the most influential rate on economic activity in Australia and so the dominant influence on it will be the Reserve Bank's view on how monetary policy needs to be set to achieve the medium-term inflation target.

5.32 Treasury warn of the unintended consequences of regulating interest rates on housing loans or other bank loans:

> …calls for the Government to regulate lending rates on particular bank products are quite peculiar. The only certain outcome of any such regulation would be credit rationing, with some households and businesses finding it impossible to access credit on reasonable terms. Typically, such interventions have unsavourary distributional consequences…[39]

The repricing of risk

5.33 Since the GFC, banks have become more attuned to the differences in risk of different types of loans. As the Governor of the Reserve Bank explained:

> …risk has been repriced since early in 2007…Prior to then it was widely held, I think, that risk was underpriced—that it is to say, investors demanded relatively little compensation for risk in the returns that they required on investment. That meant the financial institutions of all types could get ample funding easily and cheaply… But investors changed their behaviour in 2007-08. The compensation that they require for taking risk now is higher.[40]

5.34 As a major bank CEO put it:

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38 Grenville (1995) and Lowe (1995) describe the monetary transmission mechanism in more detail.

39 Henry (2011, p 24).

40 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2.

Yes, I think we all recognise that risk was mispriced, and that is one of the reasons we had a GFC.[41]

5.35 One implication of this underpricing of risk was that securitisation was unusually competitive for a period of time:

> Business models that took particular advantage of low-cost wholesale funding or securitisation were able to provide a very competitive edge to certain markets, particularly—though not only—markets for mortgage lending…wholesale funding and securitisation are [now] more expensive. In the case of securitisation, in addition costs have risen, in part because certain investors completely exited that market and are very unlikely to return.[42]

(Securitisation is discussed in more detail in Chapter 13.)

5.36 The Governor pointed out that the global reduction in the demand for risk made wholesale markets a less attractive funding source of banks:

> …the strong reliance that many of our institutions, including the major banks, had on wholesale funding—a lot of it from offshore—came to be seen as something of a vulnerability. They felt that themselves. They were under pressure also—from rating agencies and from supervisors and this is everywhere in the world, not just here—to have a higher share of the assets funded by deposits, many of which are thought to be more stable.[43]

5.37 The repricing of risk may also explain why banks have increased interest rates on small business loans by more than on housing loans, as illustrated by Chart 5.6 and Chart 6.3.

Measuring home loan interest rates

5.38 There are complications in measuring the average home loan interest rate.

'Discounts' on home loan rates

5.39 While attention focuses on the banks' advertised or posted indicator rates for home loans, there has been an increasing tendency for banks to offer some customers 'discounts' from these rates (Chart 5.7). As the Reserve Bank explains:

> …it has become commonplace for banks to offer borrowers discounts on indicator rates. Indeed, banks have been advertising these discounts for a

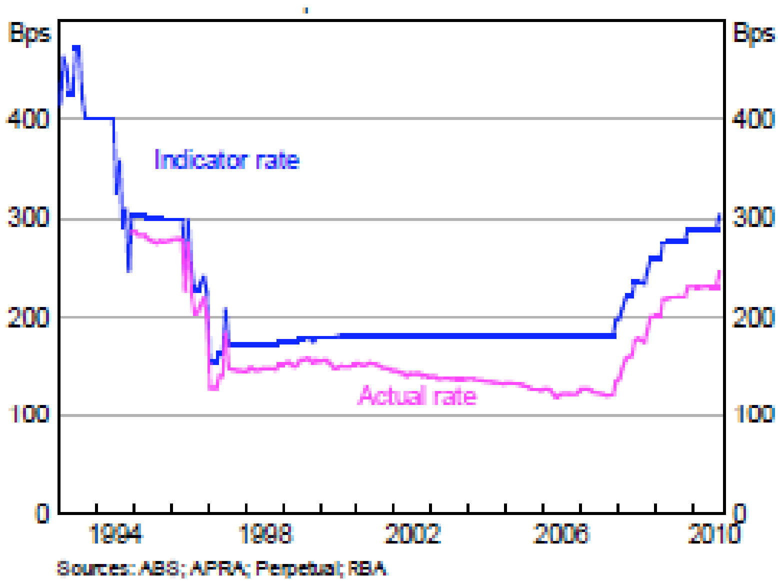
41 Mr Cameron Clyne, Chief Executive Officer, National Australia Bank, *Committee Hansard*, 13 December 2010, p 53.

42 Mr Glenn Stevens, Governor, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 2.

43 Mr Glenn Stevens, Reserve Bank of Australia, *Committee Hansard*, 13 December 2010, p 10.

number of years, resulting in almost all borrowers obtaining a discount of some size. These discounts have increased over time and, on average, are currently around 60 to 70 basis points.[44] It has become more common over recent years for borrowers, particularly those taking out bigger loans, to negotiate larger discounts than those that are advertised.[45]

Chart 5.7: Variable housing lending rates (relative to cash rate)



Source: Reserve Bank of Australia, *Submission 41*, p 15.

5.40 Choice reported that some customers were able to get a better deal just by asking for it:

> …we did some research on this and we found that, with home loans and also with transaction accounts, when people asked their bank for a better deal they did get one. Some people even claimed to get a one per cent reduction in their home loan—not many, but a few claimed that they got that.[46]

5.41 The Reserve Bank commented:

> The discounts were used by the banks to compete for new business while minimising the foregone interest of lower effective interest rates on their existing housing loan portfolios.[47]
>
> Lenders finance a wide spectrum of credit risks so it is appropriate that borrowers with varying risk characteristics are charged different rates. The

44 They range up to around 90 basis points.

45 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 3.

46 Mr Christopher Zinn, Director, Communications, Choice, *Committee Hansard*, 14 December 2010, p 34.

47 Reserve Bank of Australia, *Submission 41*, p 15.

size and prevalence of discounts will also reflect the profitability of the customer's current and potential relationship with the lender, as well as credit conditions at the time of origination.[48]

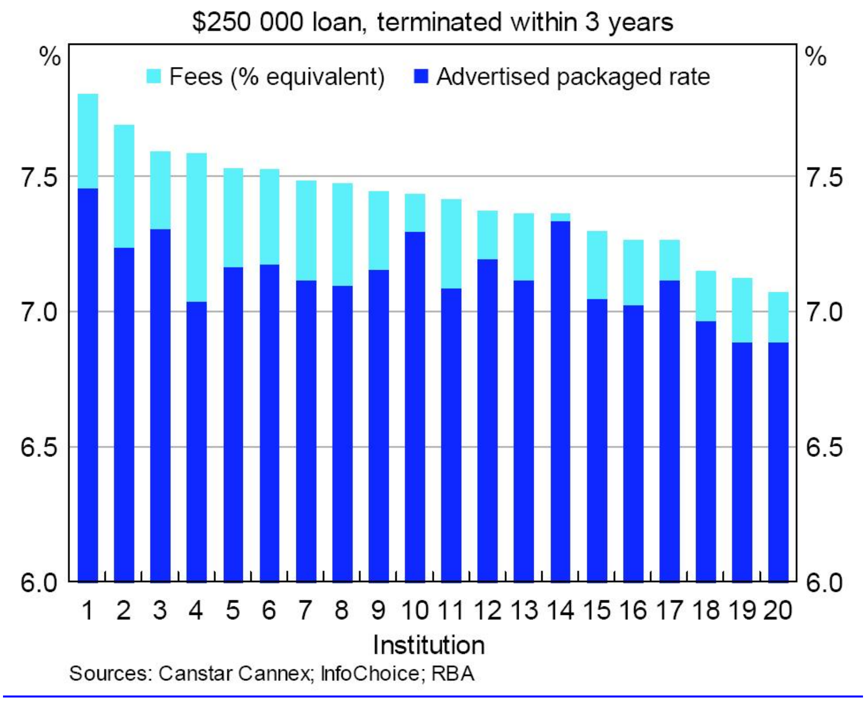
5.42 The variation between posted indicator rates and actual rates charged has the disadvantage of clouding price comparisons. It is not enough to compare the readily available information on indicator rates. It is also necessary to assess which lenders may be willing to make larger reductions in the negotiation process. Arguably this advantages borrowers who go through a broker rather than shop around for a loan themselves.

Effective variable mortgage rates

5.43 The interest rate is, of course, not the only relevant cost of a mortgage. Establishment, service and exit fees also need to be taken into account. The Reserve Bank estimates that 'on a $250 000 mortgage held for up to three years, for instance, these fees are estimated to add, on average, about 30 basis points a year'.

5.44 Chart 5.8 compares rates charged by various lenders including these fees.

Chart 5.8: Effective variable mortgage rates



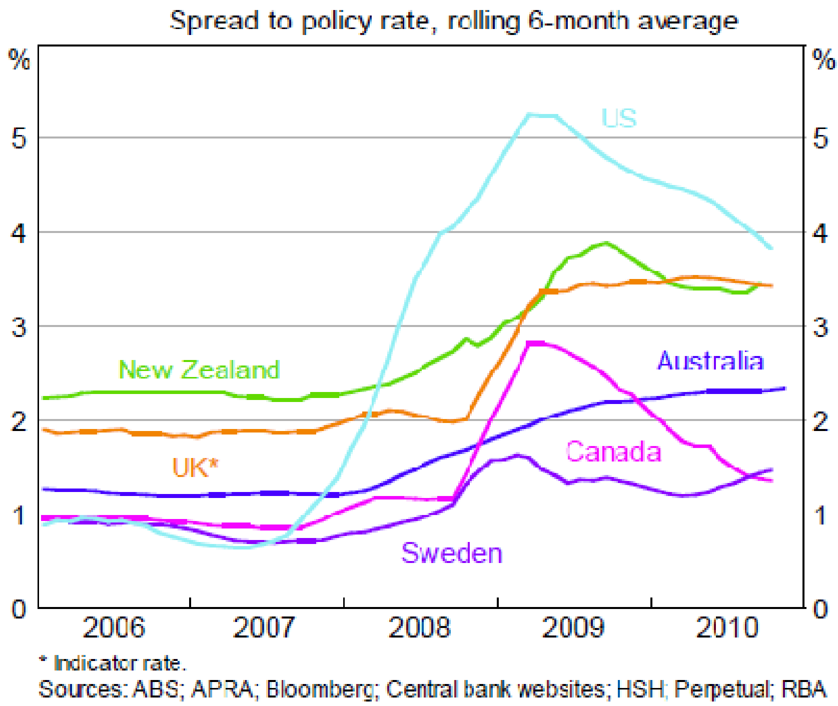
Source: Reserve Bank of Australia, *Submission 41*, p 16.

48 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 3.

International comparison

5.45 While there are always difficulties in obtaining exactly comparable data, the best measures available suggest that the margin of home loan interest rates over central bank policy rates in Australia is around the middle of the range of that in comparable countries (Chart 5.9)

Chart 5.9: Interest margins on variable rate mortgages



Source: Reserve Bank of Australia, *Submission 41*, p 16.

5.46 The ABA present data showing the gap between the central bank policy rate and the interest rate charged on five-year fixed interest home loans is between 2 and 3 per cent in Australia, Canada, New Zealand and the United Kingdom.[49]

Tying home loan interest rates to the Reserve Bank's policy rate

5.47 Professor Sathye has suggested that the interest rate on home loans should be a fixed margin over the Reserve Bank's official cash rate.[50] A problem with this idea is that in extreme market conditions, such as occurred during the global financial crisis,

49 Australian Bankers' Association, *Submission 76*, p 31.

50 Professor Milind Sathye, *Submission 1 to Banking Amendment (Delivering Essential Financial Services for the Community) Bill 2010*, (hereafter *'basic banking inquiry')*, p 7.

a bank's cost of funds may go well above the cash rate (Chart 5.5) and potentially they could be making a loss on the loans.

5.48 Professor Sathye's suggestion has some similarities with that proposed in the Banking Amendment (Keeping Banks Accountable) Bill 2009, which would have required that that if a bank moves interest rates contrary to movements in official interest rates, the treasurer could remove its access to government guarantees of its deposits. The Committee recommended that the Senate not pass that bill, as:

> …it is concerned that the bill may discourage banks from competing in reducing interest rates, could lead to higher bank fees and/or reduced lending to homebuyers, could raise doubts about the deposit guarantees and so reduce confidence in the safety of bank deposits and could be perceived as politicising the setting of bank interest rates.[51]

Variable versus fixed interest rate loans

5.49 Australia is unusual in having most of its home loans with interest rates variable at the bank's discretion.[52] Indeed, some submitters argued that banks should not be allowed to vary interest rates on home loans.[53]

5.50 More common are either fixed rates or adjustable rates tied to some market indicator interest rate.[54]

5.51 The Reserve Bank commented:

> The Australian housing loan market is characterised by relatively limited use of fixed-rate loans by international standards. Historically, more than three-quarters of housing loans have been written with a variable interest rate, and most of the remaining share have rates that are fixed for less than five years. While Australian households will, as a result of this behaviour, generally bear more interest rate risk on their mortgage debt compared to households in other countries, this is partly offset by providing households with greater flexibility. In particular, when interest rates fall to low levels, many households tend to take the opportunity to make additional principal repayments. In contrast to variable-rate loans, fixed rate loans almost always have restrictions on prepayments. The greater prevalence of variable-rate loans in Australia is, in part, likely to be influenced by the fact that these loans provide borrowers with greater flexibility in making prepayments, with Australian borrowers valuing this feature, given that owner-occupier interest payments are not tax deductible as they are in a number of other countries. Also, the greater prevalence of variable rate

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51 Senate Economics Legislation Committee, *Banking Amendment (Keeping Banks Accountable) Bill 2009*, November 2009, p. 17.

52 Professor Kevin Davis, *Proof Committee Hansard*, 25 January 2011, p 57.

53 Mr Peter Higgins, *Submission 17*, p 1.

54 Professor Kevin Davis, *Submission 8*, p 2. Some data are provided in APRA, *Responses to questions on notice*, no 6, 31 January 2011, p 5.

loans increases the effectiveness of monetary policy, as the bulk of households is affected quickly by changes in interest rates. This means that, other things equal, the Reserve Bank needs to move the cash rate less than might otherwise be the case.[55]

Were lenders to offer such products, they are likely to carry a slightly higher interest rate as compensation to the lender for taking on the risk that funding costs might rise more quickly than the cash rate (that is, the lender is providing the borrower with an option) .[56]

5.52 Reserve Bank economist Luci Ellis elaborates:

Mortgage interest deductibility affects the capacity to service debt and the incentives to repay principal. This in turn affects incentives to take mortgages with fixed versus variable interest rates. When interest payments are not deductible, mortgage borrowers are effectively paying their mortgage out of post-tax income. This implies that the post-tax return to paying down the mortgage will generally exceed the post-tax return on investing in financial assets, providing an incentive to pay down the mortgage rapidly if possible. Such an incentive encourages the use of variable-rate mortgages, which are less likely to involve prepayment penalties.[57]

5.53 The reason for this prevalence of variable rate mortgages may just be inertia dating back to the days of controlled interest rates:

…it goes back to the dim, dark ages of history when interest rates were controlled by government, and therefore to borrow you never had to bother about what interest rates were. You knew it would be at the ceiling set by the government. We removed that ceiling on housing loan interest rates but we did not ask whether the current institutional structure of loan contracts appropriate for the new environment.[58]

5.54 As a result of the use of variable rate mortgages in the Australian market, the risk of interest rate variability is borne by households rather than banks. It could well be argued that banks are better placed than households to bear this risk:

…an interest rate which is variable at the lender's discretion…is also undesirable from a risk-sharing perspective in terms of who is better able to bear the risk of changes in banks' funding costs and in terms of the availability of information.[59]

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55 Reserve Bank of Australia, *Submission 41*, p 17.

56 Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, p 2.

57 Ellis (2006) cited in Reserve Bank of Australia, *Responses to questions on notice*, no 6, 18 January 2011, pp 4-5.

58 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, pp 68-69.

59 Professor Kevin Davis, *Committee Hansard*, 25 January 2011, p 58.

'Fixed interest gap' or 'tracker' mortgages

5.55 A bill currently before Parliament requires banks to offer a 'fixed interest gap' (sometimes know as a 'tracker') mortgage product. This is a mortgage where the interest rate charged is adjusted to maintain a fixed percentage (set at the time of the loan) above the lender's cost of funds. Banks would be required to get the approval of APRA for the formula they use to calculate their costs of funds.

5.56 Senator Bob Brown explains the motivation:

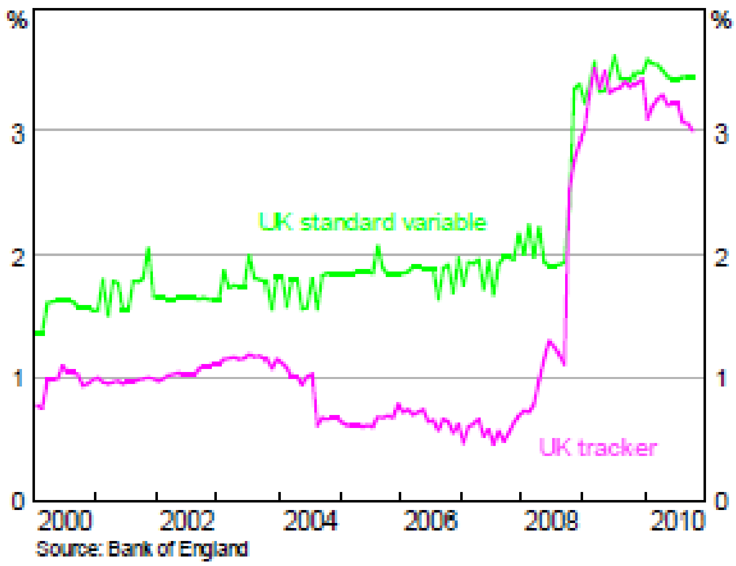
> These mortgages will protect customers from interest rate fluctuations that are not genuinely caused by changes to the bank's cost of funds…these mortgages will offer customers greater transparency and reassurance by behaving as customers expect variable rate mortgages to behave.[60]

5.57 The bill would not preclude banks also continuing to offer their current variable rate loans where they retain discretion to vary the rate charged.

5.58 Such 'tracker' products are offered in the United Kingdom. The Reserve Bank commented:

> While 'tracker' or benchmarked products can provide informational benefits for borrowers and potentially provide lenders with a smoother margin on their mortgage book, these products are not without limitations. In the United Kingdom, for example, the spread between new tracker rates and the policy rate has increased sharply, rising by more than the UK standard variable rate.[61]

Chart 5.10: UK variable housing lending rates (relative to cash rate equivalent)



Source: Reserve Bank of Australia, *Submission 41*, p 17.

60 Senator Bob Brown, *Senate Hansard*, 15 June 2010, p. 30.

61 Reserve Bank of Australia, *Submission 41*, p 17.

5.59 Some submitters want to go further than this bill. Professor Kevin Davis wants to:

> Prohibit loan contracts which give lenders absolute discretion to change the interest rate on existing loans.[62]

5.60 The Australian Bankers' Association reject the idea:

> …demand for such a product is unknown, yet banks and other ADIs would be subjected to additional costs in developing, launching and administering the product that would add cost to all lending. We note that there are a number of recent examples of policy driven products that have not proven to be commercial viable, or have not attracted consumer interest, or have subsequently been cancelled. If a commercially viable market existed in Australia for such a mortgage, we consider that one or more of the 111 institutions marketing home loans would have provided this product.[63]

5.61 The ABA is apparently unaware that there is (at least) one ADI offering such a product. Queensland Teachers Credit Union offer a 'tracker' mortgage loan where the applicable rate only moves in line with changes in the Reserve Bank's cash rate. They comment on it:

> This product creates certainty and surety for consumers and, at the same time, provides transparency. Not only does it provide demonstrable benefits for consumers, it conforms to the social and political objectives of the Government.[64]

5.62 They note that their ability to make the tracker loans is constrained by problems in the securitisation market:

> …due to current securitisation requirements in relation to the ability to reprice mortgage loans, this type of loan does not conform and is therefore ineligible for securitisation,…[65]

5.63 The ANZ Bank is currently considering how a tracker product might work in practice.[66]

5.64 Asked about any prudential concerns, APRA responded:

> In APRA's view, there is a substantial implicit interest rate risk in such a product, when ADI funding costs increase more than the reference rate. The problem was notable, among other examples, with United Kingdom 'tracker' loans during the global financial crisis. If home loan rates were to be tied to the cash rate or other rates not controlled by the lending

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62 Professor Kevin Davis, *Submission 8*, p 5.

63 Australian Bankers' Association, *Submission 76*, p 45.

64 Queensland Teachers Credit Union, *Submission 122*, p 4.

65 Queensland Teachers Credit Union, *Submission 122*, p 4.

66 ANZ Bank, *Responses to questions on notice*, *no 11*, 31 January 2011, p 2.

> institution, the ADI may be required to hold additional capital against the extra risks.[67]

Committee view

5.65 The Committee concludes that the Reserve Bank's policy rate is only one influence on banks' cost of funds. It is therefore not reasonable to expect that banks' variable interest rates on housing loans should always and only move in parallel with changes in the Reserve Bank's policy rate. It welcomes the initiative by some lenders to provide 'tracker loans' with such an explicit linkage for those borrowers who desire this certainty.

5.66 The Committee does not support regulatory controls on home loan interest rates, or interest rates in general, but instead suggests in following chapters measures that will increase competitive pressures.

67 APRA, *Responses to questions on notice, no 6*, 31 January 2011, p 2.