

Chapter 2

Banks' adjustment of home loan interest rates

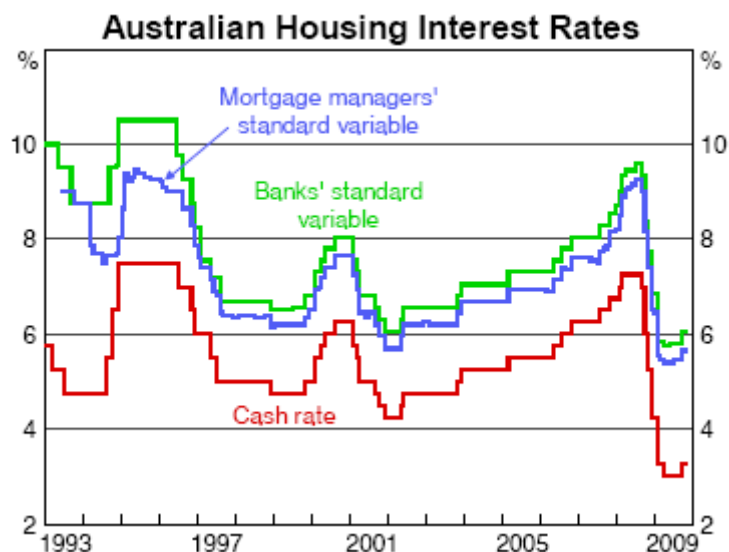
The official rate and banks' cost of funding

2.1 In recent years, banks have tended to move the interest rate charged on their variable home loans closely in line with movements in the Reserve Bank's official target overnight 'cash' rate (see Chart 2.1, the thick line in Chart 2.2 and the left hand half of Chart 2.3). This has led to an expectation developing that this is the 'usual' or 'fair' way of setting home loan interest rates.

2.2 However, the Reserve Bank recently observed:

...while the cash rate still has a large influence on banks' funding costs, changes in risk premia in markets over the past two years have weakened this relationship. In turn, this has also weakened the close relationship that has been experienced in the previous decade between the cash rate and banks' interest rates on loans.¹

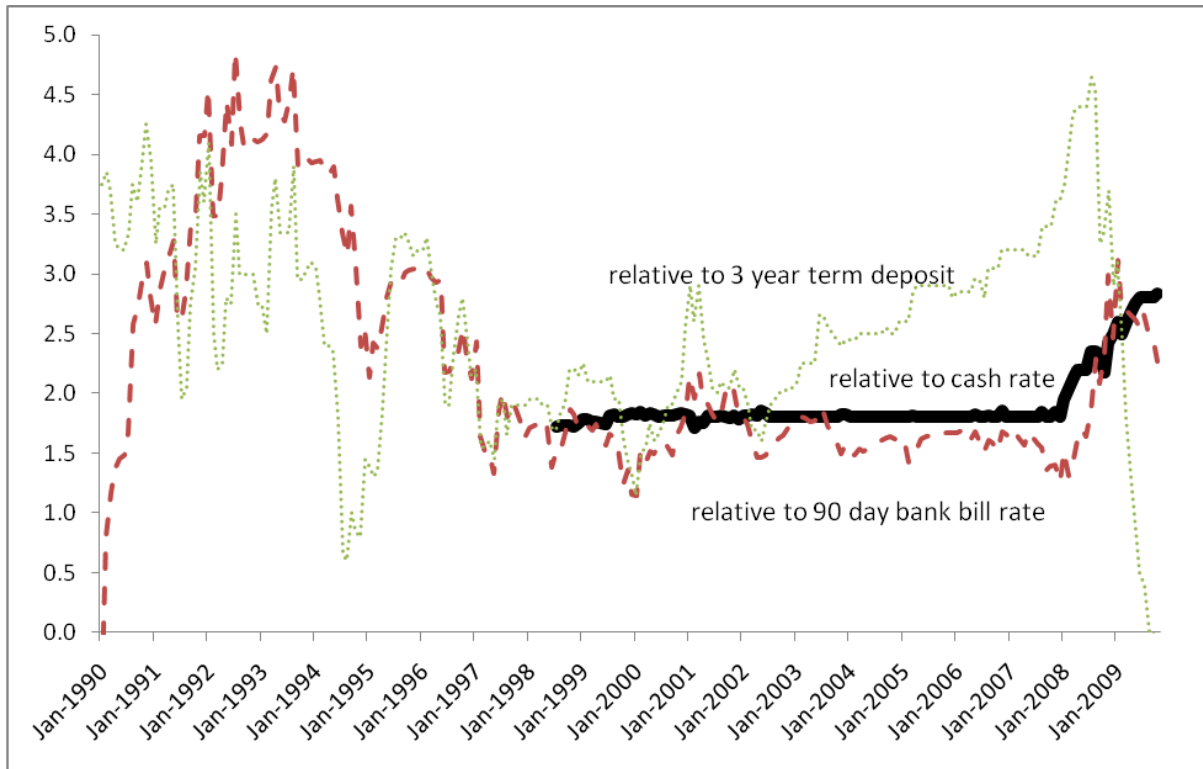
Chart 2.1



Source: Reserve Bank of Australia, www.rba.gov.au

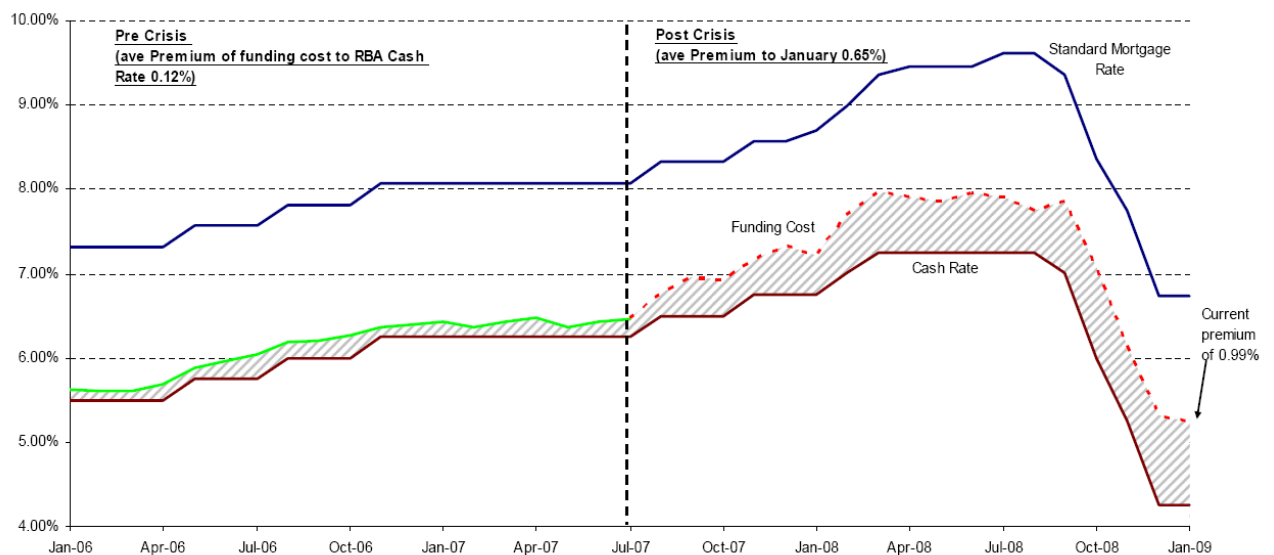
1 Reserve Bank of Australia, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009, p 1.

Chart 2.2: Difference between home loan variable interest rate and other rates



Source: Secretariat, based on data from Reserve Bank of Australia, www.rba.gov.au

Chart 2.3: NAB's standard variable mortgage rate, funding costs and cash rate



Source: National Australia Bank, *Submission 5*, attachment 2.

2.3 The recent breakdown in the relationship between the variable home loan interest rate and the cash rate is shown in Charts 2.2 and 2.3.

2.4 Rather than the norm, the close relationship between the cash rate and lending rates had been an *unusual* feature of the 2000s:

The relationship between the cash rate and the rate on standard housing loans was particularly close from 1999 to 2007, though in the longer sweep of history this period looks unusual.²

The presumption that their lending rates would and should move only in line with the cash rate, which had arisen in an earlier period when all these rates were much more closely related, has not been a realistic one in the recent environment.³

2.5 Chart 2.2 shows that while the home loan interest rate is currently higher than usual when compared to the cash rate, it is around its long-term average when compared to the 90 day bank bill rate and is currently very low compared to term deposit rates.

2.6 A number of lenders made the point that the interest rate paid on a significant proportion of funds raised by lenders does not move with the official cash rate and so it is not reasonable to expect lending rates to move in line with the official cash rate:

The fact is that roughly half of the money that banks borrow to lend to people here in Australia is sourced from outside depositors. It is sourced from the wholesale markets both here in Australia and overseas; it is sourced both long term and short term. That means, as I said before, that the cash rate has little if any effect on the costs that banks have to pay to source their money to lend to people.⁴

There are really three factors that we take into account when determining the mortgage rate. They are the actual cost of our funds, the risk that we perceive in the environment we are lending into and also, obviously, we are looking at remaining competitive with other providers of credit. The main factor within that would be the cost of funds, and that in itself is broken down into three areas. About half of our funding, like most major banks in Australia, comes from depositors; about half of the remaining 50 per cent comes from short-term wholesale funding; and the final 25 per cent comes from long-term wholesale funding.⁵

2 Reserve Bank of Australia, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009, p 9.

3 Mr Glenn Stevens, Governor, Reserve Bank of Australia, Address to Smart Capital 2008: The Euromoney Australian Financial Markets Innovation Congress, Sydney - 27 March 2008, cited by Australian Bankers' Association, *Submission 3*, p 1.

4 Mr David Bell, Chief Executive Officer, Australian Bankers' Association, *Committee Hansard*, 5 October 2009, p 9.

5 Mr Munchenberg, National Australia Bank, *Committee Hansard*, 5 October 2009, p 17. NAB elaborated on the factors driving their cost of funds in their Supplementary *Submission 5*.

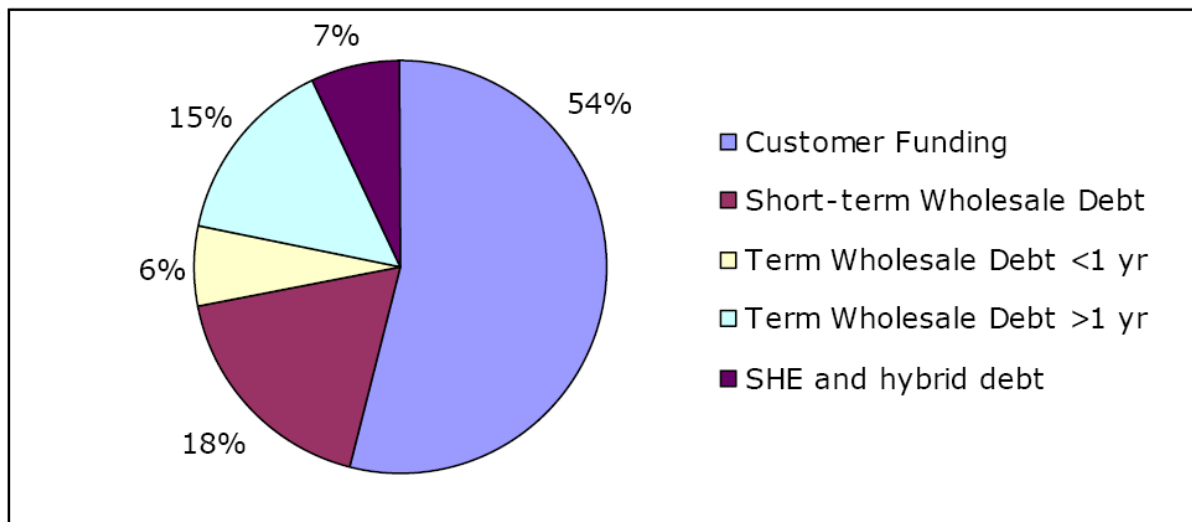
Mortgage rates are determined by the cost of funds to institutions – that is, the cost of raising funds through either retail deposits or wholesale funds. The cost of these funds has no direct link to the RBA cash rate.⁶

The current Bill attempts to bring back a system of setting rates that were inefficient and do not reflect how funds are raised and costed today... The big four do not rely on the RBA cash rate; the international market governs the costs of funds.⁷

2.7 As an example, the ANZ comments that over half their funding comes from customer deposits (Chart 2.4), and that the cost of these has not dropped commensurately with the official cash rate:

...the cost of deposits has fallen more slowly than the cash rate over the past year. This reflects the current strong competition between financial institutions for deposits. Since early September 2008, rates on savings deposits have fallen by an average of 380 basis points, less than the 425 basis point decrease in the official cash rate.⁸

Chart 2.4: Composition of ANZ's funding (March 2009)



Source: ANZ Bank, *Submission 4*, p 4.

2.8 The Reserve Bank have compiled data showing only around a quarter of banks' funding is priced directly off the official cash rate (Table 2.1).

6 Abacus, *Submission 6*, p 1.

7 Michael Peters, *Submission 7*, p 2.

8 ANZ Bank, *Submission 4*, p 5.

Table 2.1: Major banks' funding mix (as at April 2009)

Funding source	Per cent of funding liabilities	Pricing benchmark	Additional costs
Domestic deposits	53		
Transaction	9	Rates do not change	..
Savings	26	Cash rate	..
Term	18	Bank bills	..
Capital markets	47		
Short-term domestic	13	Bank bills	..
Short-term foreign	7	Bank bills	Hedging
Long-term domestic	5	Bank bills/swap rate	Spread
Long-term foreign	19	Bank bills/swap rate	Spread + hedging
RMBS	2	Bank bills	Spread + hedging

Source: Reserve Bank of Australia, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009, p 3.

2.9 NAB added about the use of foreign funding:

Structurally, it is true that Australians are borrowing more than they save. Hence, the National Bank is reasonably typical in only being able to obtain half the money we wish to loan from the depositors in the bank.⁹

2.10 Looking at the recent period, the Reserve Bank observe:

It is estimated that the major banks have reduced their variable housing lending rate by an average of 385 basis points since September 2008. This is less than the reduction in the cash rate of 425 basis points, but more than the reduction in their average funding costs of 330 basis points.¹⁰

Competition and bank margins

2.11 Calls for a degree of re-regulation of bank loan interest rates have been fuelled by concerns that there is reduced competitive pressure on banks. For example, former ACCC head Allan Fels has commented:

We are now back to where we were in the 1970s and I fear a similar prolonged period of limited competition...¹¹

2.12 Bank margins narrowed as competition (most notably from non-bank home lenders such as Aussie, RAMS and Wizard) increased over the past decade (Charts 2.1 and 2.5).¹² More recently, the global financial crisis has seen a drying up of the

9 Mr Salamito, National Australia Bank, *Committee Hansard*, 5 October 2009, p 19.

10 Reserve Bank of Australia, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009, p 9.

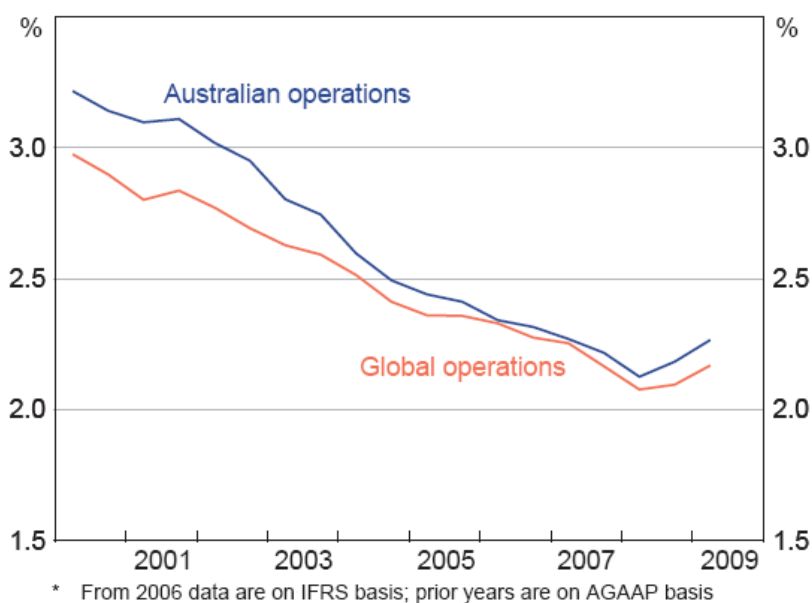
11 Quoted in *The Australian*, 1 August 2009.

12 A similar chart in ANZ Bank, *Submission 4*, p 3, shows the downward trend in the margin started in the mid-1990s.

securitisation markets used by the competitors to banks and a reduction in the competitive pressure exerted by these non-bank lenders. There has also been some consolidation within the banking industry.¹³ The combined effect has been that the four major banks have gone from accounting for around 60 per cent of new home loans in 2007 to approaching 90 per cent now.

2.13 There has been an expansion in bank margins recently (Chart 2.5).¹⁴ However, as noted above it has been in their loans to business rather than households that the expansion in margins has occurred.

Chart 2.5: Major banks' net interest margin



Source: Reserve Bank of Australia, 'The impact of the capital market turbulence on banks' funding costs', *Reserve Bank Bulletin*, June 2009, p 11.

Accountability and transparency

2.14 National Australia Bank's submission emphasises their efforts to explain the relationship between their cost of funds and lending rates:

With each adjustment in our variable mortgage interest rate NAB has publicised and made widely available detailed information on our over-all funding costs and how these have impacted our decisions on rates.¹⁵

2.15 At the hearing they reiterated their support for transparency:

13 Westpac took over St George Bank and the Commonwealth Bank took over BankWest. The impact of bank mergers is discussed in the Senate Economics References Committee's *Report on Bank Mergers* (September 2009).

14 A similar chart is included in ANZ Bank, *Submission 4*, p 3.

15 National Australia Bank, *Submission 5*, p 3.

NAB supports the need for greater transparency around the commercial setting of interest rates. We believe that NAB customers and the wider community should hear directly from us about the factors that influence their home loan repayments...We also believe that better public information and understanding of the full range of factors affecting commercial interest rates is in the interests of all stakeholders: customers, the media, government and the banks themselves.¹⁶

2.16 They explained the measures they were taking:

Since August last year, National Australia Bank has provided detailed information on funding costs to our customers, the media and other stakeholders. This means that each time the NAB has adjusted its variable mortgage rate we have made available details of how our overall funding costs have impacted our decision.¹⁷

2.17 Critics of the banks may always be sceptical of information provided by them. This has led to calls for independent authorities to publish information as well:

Senator PRATT—... who has the most substantive body of knowledge that compares what is going on with both official interest rates and what banks are actually doing?

Prof. Sathye—I would say that APRA and the Reserve Bank of Australia are the best organisations to do that kind of research and get that kind of information...I would like that kind of information [on interest rate margins] to be generated by these agencies and put forward to people.¹⁸

We would also like to suggest that the RBA itself continue to play a role in increasing information and education on the factors affecting interest rates, as it did with its analysis published in its June bulletin on the costs of funds...We believe that more of this type of information from the RBA would make a significant and positive contribution to public transparency and understanding of the factors affecting interest rates.¹⁹

16 Mr Steven Munchenberg, National Australia Bank, *Proof Committee Hansard*, 5 October 2009, p 14.

17 Mr Steven Munchenberg, National Australia Bank, *Proof Committee Hansard*, 5 October 2009, p 14.

18 Professor Milind Sathye, *Proof Committee Hansard*, 5 October 2009, p 4.

19 Mr Steven Munchenberg, National Australia Bank, *Proof Committee Hansard*, 5 October 2009, p 14.

Committee view

2.18 The committee regards it as helpful for the public debate for banks to explain the relationship between the official cash rate, their own cost of funds and the rates they charge on loans, especially for variable rate housing loans. It commends those banks which do so.

2.19 It would further enable informed opinions to be made around this issue if the relevant authorities made more data available.

Recommendation 1

2.20 The committee recommends that the Reserve Bank and the Australian Prudential Regulation Authority regularly publish estimates of the costs of funds for the banking sector as a whole and bank interest margins.