

Developments in Banks' Funding Costs and Lending Rates

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This article updates previous Reserve Bank research on how developments in the composition and pricing of banks' funding have affected their overall cost of funding and the setting of lending rates. The main finding is that the spread between the major banks' outstanding funding costs and the cash rate narrowed a little over 2014. This was due to slightly lower costs of deposits combined with a more favourable mix of deposit funding. The contribution of wholesale funding to the narrowing was marginal as more favourable conditions in long-term debt markets were mostly offset by a rise in the cost of short-term debt. Lending rates declined a little more than funding costs, reflecting competitive pressures.

Introduction

In setting lending rates, banks consider a number of factors. Banks take into account risk premiums, including the credit risk associated with loans, and the liquidity risk involved in funding long-term assets with short-term liabilities. Banks' growth strategies, competitive pressures and the desire to provide a return to equity holders also affect banks' lending rates. In addition to these factors, a key consideration is their cost of funding, which is a function of the composition and price of different liabilities (Fabbro and Hack 2011).

An important element in determining the overall cost of banks' funding is the level of the cash rate, which acts as an anchor for the broader interest rate structure of the domestic financial system. Nevertheless, changes in the level of compensation demanded by investors to hold bank debt, competitive pressures and non-price factors can exert significant influences on banks' funding costs. There is typically some delay before the full effect of changes in these factors flows through to funding costs and lending rates. In part, this reflects the time that it takes for balance sheet liabilities to be repriced, particularly those with longer terms to maturity.

The Reserve Bank Board takes developments in banks' funding costs and lending rates into account when it determines the appropriate setting of the cash rate. The Board aims to ensure that the structure of interest rates faced by households and businesses is consistent with the desired stance of monetary policy.

The analysis presented in this article updates previous Reserve Bank research.¹ The article focuses on developments in banks' funding costs and lending rates over 2014.² It does not cover more recent developments following the reduction in the cash rate in February 2015.

Banks' Cost of Funding

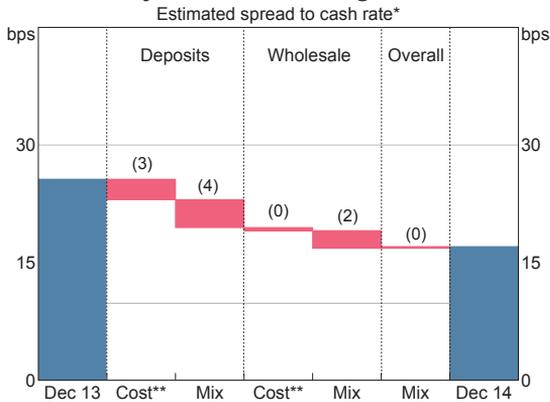
The spread of banks' funding costs to the cash rate is estimated to have narrowed by about 9 basis points in 2014 (Graph 1). With the cash rate unchanged over the past year, the slight narrowing in the spread was entirely due to changes in the absolute cost and mix of funding liabilities. In particular, the narrowing was driven by a lower cost of deposit funding and changes in

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1 For details, see Berkelmans and Duong (2014).

2 The Reserve Bank uses a wide range of information to derive the estimates presented in this article. It supplements the analysis with detailed discussions with financial institutions.

Graph 1
Major Banks' Funding Costs



* RBA estimates; bracketed numbers represent negative contributions to the overall change in the spread and may not add to the total due to rounding

** Includes the cost or benefit of interest rate hedges

Sources: APRA; Bloomberg; RBA; UBS AG, Australia Branch

the composition of deposits. Changes in the costs and composition of wholesale funding (i.e. bonds and bills) contributed only marginally to the fall in funding costs. Nonetheless, funding costs relative to the cash rate remain significantly higher than they were before the global financial crisis in 2008.

Deposit funding

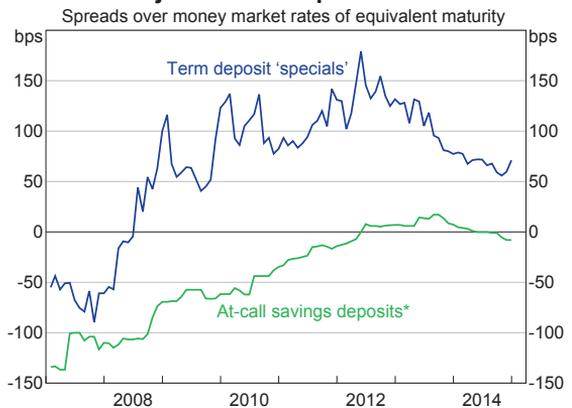
Over 2014, lower deposit costs and changes in the mix of deposits contributed in similar measure to a small narrowing in the overall spread of banks' funding costs to the cash rate. Deposit costs contributed 3 basis points to the narrowing, as competition in the deposit market moderated over the year. This is consistent with the deposit share of banks' funding stabilising through the year and an easing in funding conditions in wholesale markets. Changes in the deposit funding mix also contributed 4 basis points to the overall fall in banks' funding costs, as funding shifted from relatively expensive term deposits to transaction and at-call accounts.

Deposit interest rates

Interest rates offered on some types of deposits declined over the year. The cost of outstanding term deposits is estimated to have fallen by about 40 basis points as deposits issued at higher rates

matured and were replaced by new deposits at lower rates.³ Similarly, the major banks' advertised 'specials' on new term deposits fell by about 40 basis points over the past year. The decline outpaced equivalent market benchmark rates over most of the year, although the spread widened at the end of the year due to a sharp decrease in benchmark rates (Graph 2).

Graph 2
Major Banks' Deposit Rates



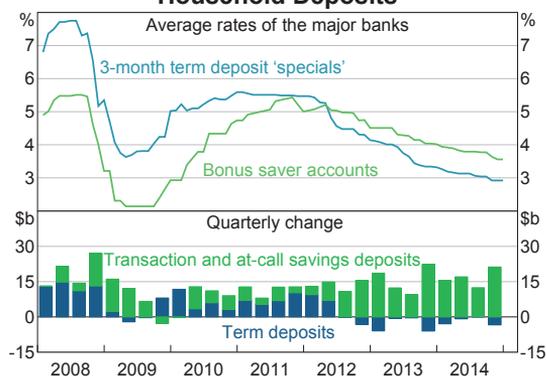
* Spread to cash rate; existing customers only; excludes temporary bonus rates

Sources: Bloomberg; CANSTAR; RBA

The interest rates offered on at-call savings deposits declined by a similar amount to term deposit specials over 2014. However, interest rates on some at-call accounts, such as bonus or reward savings accounts, have been higher than rates on term deposit 'specials' for some years and this continues to be the case (Graph 3). Banks are willing to pay a premium on bonus savings accounts because they are a relatively stable source of funding. This owes to their contractual requirements for minimum monthly deposits or limitations on withdrawals in order to receive a higher interest rate for that month. Moreover, depending on their particular features, these deposits may qualify for a more favourable treatment than other types of deposits under the new liquidity standards recently implemented by the

³ As a result of the introduction of the Liquidity Coverage Ratio, most banks have changed or are changing the conditions of term deposits to make them explicitly unbreakable.

Graph 3
Household Deposits



Sources: APRA; CANSTAR; RBA

Australian Prudential Regulation Authority.⁴ These standards provide a strong incentive for banks to encourage customers to move into deposit products with more stable characteristics.

Interest rates on traditional online savings accounts remained broadly unchanged. These accounts typically offer an interest rate close to the cash rate and are generally repriced in line with movements in the cash rate. To attract new deposit funding without increasing the cost of their existing deposit base, some banks continue to offer an additional bonus of over 100 basis points to new online customers. These bonus rates are generally for a short period of time, such as four months, after which the customer receives the standard online rate.

In an effort to further increase their stable funding base, a few banks also offer notice of withdrawal accounts. These accounts require depositors to provide advance notice (generally a minimum of 31 days) of their intention to withdraw funds from the account. Advertised interest rates for these accounts have been lower than those available for bonus saver accounts and similar to those offered on term deposit 'specials'. Nonetheless, notice of withdrawal accounts only represent a small share of banks' total deposit funding.

As in previous years, many traditional transaction accounts continue to offer zero interest rates. As

they are essentially fixed-rate liabilities, their relative cost depends on the level of the cash rate. Since the cash rate was unchanged over the past year, the contribution of transaction deposits costs to changes in banks' funding costs was negligible (see below for the contribution from changes in the deposit mix).

Banks often attempt to mitigate changes in the cost of transaction deposits relative to the cash rate by using interest rate hedges, which transform these deposit liabilities into a portfolio of variable-rate liabilities. Over the past year, these hedges have contributed a little to the decline in banks' funding costs. Due to the recent sustained low interest rate environment, longer-term fixed rates have fallen, diminishing the benefit to the banks from these hedges. This has resulted in estimates of net payments to banks on new hedging contracts to be lower than net payments on expiring contracts.

Offset deposit accounts, which are linked to a housing loan, continue to grow at a faster rate than other transaction and at-call savings deposits. These accounts are popular with mortgage holders since they reduce the interest calculated on the loan. Their contribution to major banks' funding costs, however, is minor since they only represent a small share of total deposits.

Deposit mix

Since mid 2012, the level of funding from transaction and at-call savings deposits has continued to grow, while the level of term deposits has been little changed (Graph 4). Because the cost of outstanding term deposits is higher than most at-call savings deposits and all transaction deposits, this shift in the mix has lowered the cost of deposit funding. Nonetheless, term deposits are still an important source of deposit funding, representing close to 40 per cent of banks' total deposit liabilities.

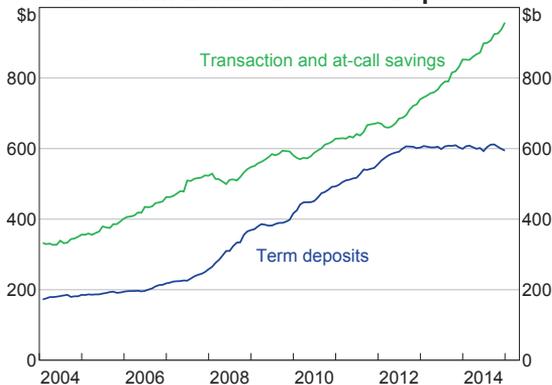
Wholesale funding

Over 2014, the direct contribution of changes in wholesale funding costs to changes in banks' funding

⁴ For details on the new liability standards, see APRA (2014).

Graph 4

Australian Banks' Domestic Deposits*



* Break-adjusted; not seasonally adjusted; excludes foreign currency deposits and certificates of deposit

Sources: APRA; RBA

costs was negligible despite significant changes in wholesale funding interest rates. A decline in the cost of long-term debt was broadly offset by an increase in the cost of short-term debt. Similarly, the composition and level of wholesale funding made a marginal contribution to the fall in banks' funding costs. Interest rate hedges on wholesale funding also had a minimal influence on funding costs. Overall, the mix of wholesale debt in banks' funding was little changed over the past year (Graph 5).

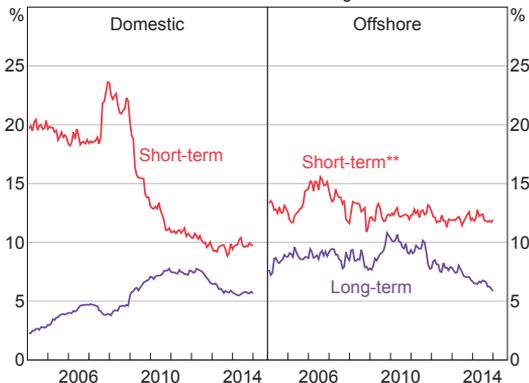
The absolute cost of issuing long-term wholesale debt declined substantially over the past year. The fall in yields for major banks' senior unsecured debt was broadly similar to the decrease in benchmark risk-free rates (Graph 6), with a narrowing in spreads over the first half of 2014 reversed in the second half. While spreads are wider than their levels prior to 2007 they remain much narrower than they were during 2008–12. For lower-rated (single A) issuers, conditions improved over the year more than for higher-rated (double A) issuers, with the difference between the two narrowing.

Consistent with more favourable conditions in long-term wholesale markets over 2014, bank bond issuance was higher than in 2013. This partly reflected greater issuance by lower-rated banks as access to a range of funding markets improved significantly over the year. The average cost of outstanding

Graph 5

Wholesale Funding*

Share of total funding



* Adjusted for movements in foreign exchange rates; wholesale debt is on a residual maturity basis

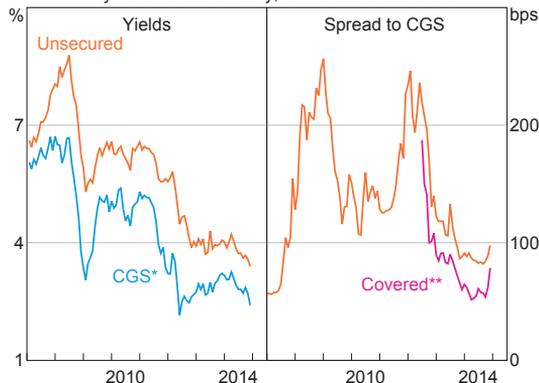
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA

Graph 6

Major Banks' Bonds

3–5 year residual maturity; Australian dollar bonds



* Commonwealth Government securities

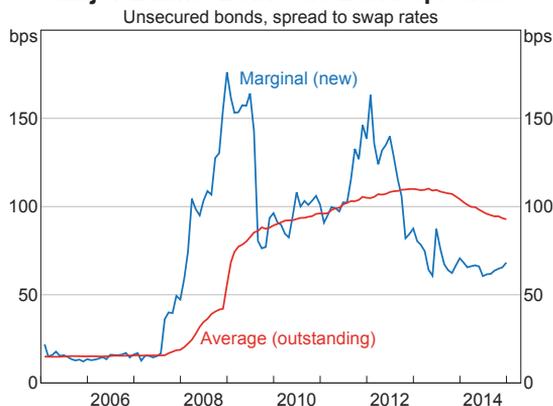
** Covered bond pricing interpolated to a target tenor of 4 years using bonds with a residual maturity between 2 and 10 years

Sources: Bloomberg; RBA; UBS AG, Australia Branch

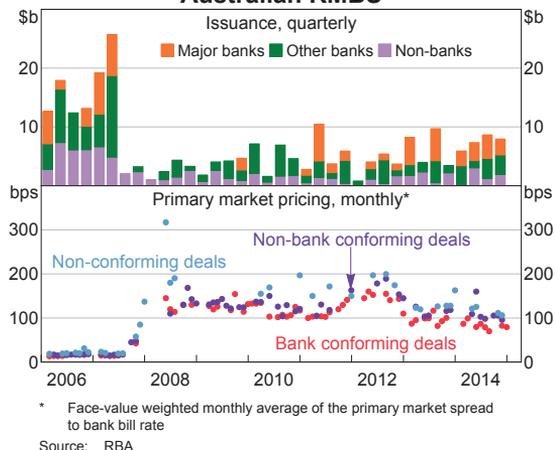
bonds continued to decline over the year, as bonds previously issued at higher rates matured and were replaced with bonds issued at lower rates (Graph 7). If spreads on new issuance remain around current levels, the average spread is likely to continue declining for the next few years.

Banks' issuance of covered bonds over 2014 was modest, and similar to 2013 (Graph 8). Covered bonds generally attract lower interest rates than unsecured bonds due to the additional security

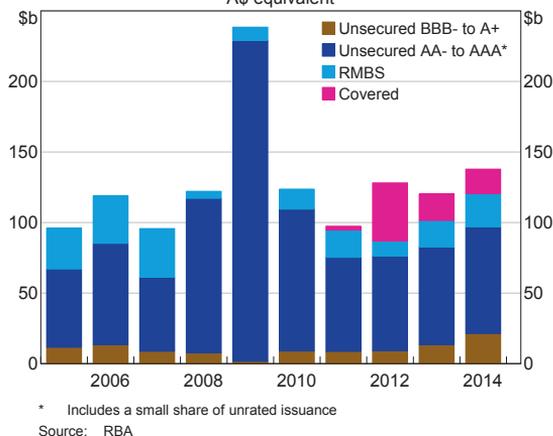
Graph 7
Major Banks' Domestic Bond Spreads



Graph 9
Australian RMBS



Graph 8
Australian Banks' Wholesale Issuance



offered to investors from their dedicated pool of collateral, as well as the expanded investor base to which these securities appeal. While Australian banks' covered bond issuances are capped at 8 per cent of domestic assets, banks continue to maintain some spare capacity to issue covered bonds in the event of heightened stress in global financial markets.⁵

In 2014, activity in the securitisation market – particularly for residential mortgage-backed securities (RMBS) – continued its gradual recovery after declining sharply in 2007 (Graph 9). Both major and non-major banks recorded stronger issuance

over the year. In contrast, issuance by non-banks remained weak. RMBS spreads to the bank bill rate continued to narrow a little, with some bank conforming RMBS deals pricing at the tightest spreads since 2007.⁶

Banks' use of short-term wholesale funding (i.e. with maturity less than a year) was little changed over 2014. The composition of short-term debt remains fairly evenly split between domestic and offshore sources. However, ahead of the introduction of the new prudential liquidity regulations, banks increased the term of their domestic short-term issuance and reduced the issuance of 1-month securities.

Relative to expectations of the cash rate (as implied by the 3-month overnight indexed swap rate) the cost of short-term wholesale debt increased over 2014. The widening in the spread between bank bills and overnight indexed swaps was most pronounced at the longer bank bill maturities. In part, this reflected the new prudential liquidity regulations for banks. Under the new regulations, issuing bills with a maturity shorter than 30 days carries a higher relative cost for banks since they would have to hold an equivalent amount of high-quality liquid assets (Debelle 2014).

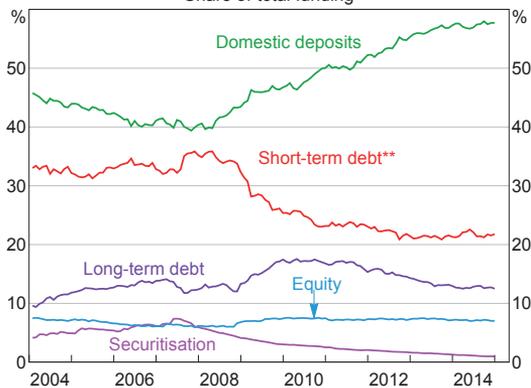
5 For further details on covered bonds, see Aylmer (2013).

6 Conforming mortgage loans are those made to borrowers who meet the normal eligibility requirements of the mainstream lenders.

Funding composition

The trend toward a greater use of deposit funding that has been evident over the past five years moderated in 2014 (Graph 10). A small rise in the share of deposits and short-term debt was largely accommodated by a small fall in the share of long-term debt. These changes in the overall funding composition are estimated to have had a negligible effect on the major banks' funding costs relative to the cash rate.

Graph 10
Funding Composition of Banks in Australia*
 Share of total funding

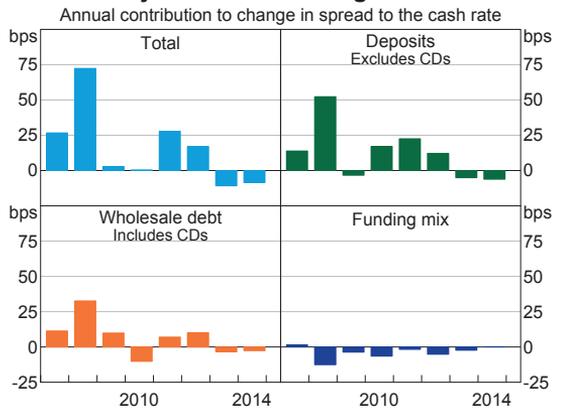


* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis
 ** Includes deposits and intragroup funding from non-residents
 Sources: APRA; RBA; Standard & Poor's

Overall cost of funding

As mentioned previously, there are a number of factors that influence banks' total debt funding costs, including changes in risk sentiment and competition for funding sources. These factors affect both the price of banks' funding liabilities and the composition of their balance sheets. Taking the cost of the individual funding sources noted above and weighting them by their share of total bank funding provides an estimate of banks' overall funding costs. Following this approach, over the past year the major banks' funding costs decreased by an estimated 9 basis points, due to a lower cost of deposits and a more favourable mix of funding *within* both deposits and wholesale debt (Graph 11). The small changes in

Graph 11
Major Banks' Funding Costs*
 Annual contribution to change in spread to the cash rate



* RBA estimates
 Sources: APRA; Bloomberg; RBA; UBS AG, Australia Branch

the mix of funding *between* deposits and wholesale debt made no discernible contribution to the decrease in banks' funding costs.

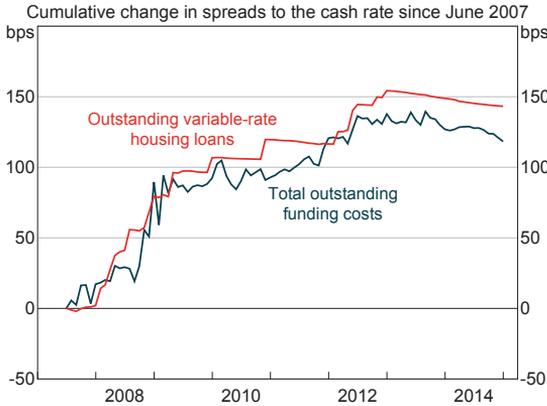
Banks' Lending Rates

In setting lending rates, banks take account of the cost of funding liabilities and the desired return on equity, as well as the margin designed to cover expected losses from making a loan. After the global financial crisis, increases in the cost of some of these factors – predominantly an increase in banks' funding costs – contributed to a widening of the spread between lending rates and the cash rate. Over the past two years, however, lending spreads have narrowed, driven by decreases in funding costs and competitive pressures in lending markets.

During 2014, the estimated average interest rate on outstanding variable-rate housing loans continued to drift lower relative to the cash rate (Graph 12). The overall outstanding rate declined as new or refinanced loans were written at lower rates than existing and maturing loans. This reflected a sizeable reduction in fixed rates over the year and an increase in the level and availability of discounting below advertised rates.

Graph 12

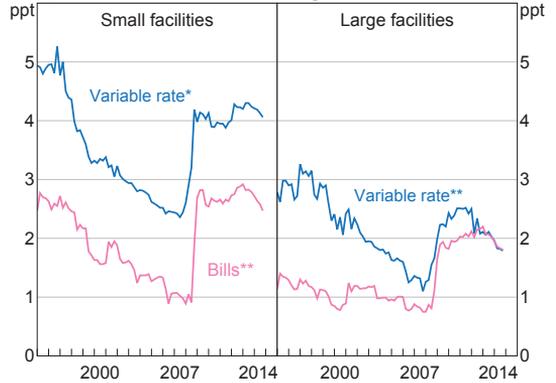
Major Banks' Lending and Funding



Sources: ABS; APRA; Bloomberg; Perpetual; RBA; UBS AG, Australia Branch

Graph 13

Spreads on Outstanding Business Loans



* Spread to the end-quarter cash rate
 ** Spread to the 3-month trailing average of the 90-day bank bill rate
 Sources: APRA; RBA

The interest rates on around two-thirds of business loans are typically set at a margin over the bank bill swap rate rather than the cash rate. While these spreads remain wider, reflecting the reassessment of risk since the global financial crisis, they have generally trended down over the past two years (Graph 13). Much of the narrowing of spreads over 2014 was due to average business lending rates declining by over 20 basis points, with outstanding rates for small business decreasing by more than rates for large businesses.

Over the past few years, banks' funding and lending rates have moved together closely, with declines in funding costs contributing to declines in lending rates. Over 2014, competition in lending markets resulted in the overall outstanding lending rate falling a little more than funding costs, with the spread between the two narrowing by about 10 basis points. ↗

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