

Developments in Banks' Funding Costs and Lending Rates

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Photo: Busakorn Pongparnit – Getty Images

Abstract

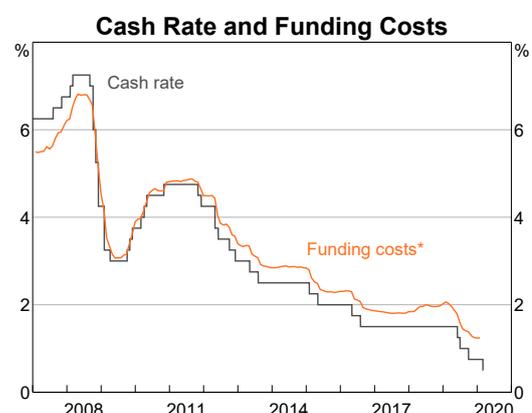
Banks' funding costs declined over 2019, driven by reductions in the cash rate. Lenders passed most of the decrease in funding costs through to interest rates on mortgages and business loans. Funding costs and lending rates are at historical lows.

Funding costs and lending rates declined with the cash rate in 2019

The cash rate is a key determinant of the overall cost of banks' funding (Graph 1). This is because the level of the cash rate is an anchor for other interest rates in the Australian financial system. The pass-through from the cash rate to funding costs and lending rates is an important channel of monetary policy (Brassil, Cheshire and Muscatello 2018). The transmission of the cumulative 75 basis points of reductions in the cash rate in 2019 to Australian financial conditions – including to lower funding costs for banks – has been in line with historical experience (Kent 2019). Most of the decrease in funding costs was passed through to the interest rates offered by lenders for mortgages and business loans. This article updates previous Reserve Bank research, focusing on developments in the major

banks' funding costs and lending rates over 2019 (Black and Titkov 2019).^[1]

Graph 1



* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks
Sources: ABS; AFMA; APRA; ASX; Bloomberg; major bank liaison; major banks' websites; RBA; Refinitiv; Securitisation System; Tullett Prebon; US Federal Reserve; Yieldbroker

Consistent with the low level of the cash rate, banks' funding costs are at historically low levels. The decrease in funding costs over 2019 largely reflected the effects of reductions in the cash rate on wholesale debt costs and (retail and wholesale) deposit rates (Graph 2). The decline in these costs continues to flow through to banks' overall cost of funding, as term funding is replaced at lower interest rates. As discussed in more detail below, much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to bank bill swap (BBSW) rates. BBSW rates declined by more than the cash rate over 2019, as the tighter conditions in money markets from 2018 eased. On the other hand, the average interest rate paid on at-call deposits declined by a little less than the cash rate over 2019. This was primarily because, as is typical, the interest rates on many transaction accounts (which are usually close to zero) did not change following the cash rate reductions. The larger decline in wholesale funding costs broadly offset the smaller decline in some deposit rates. Overall, the major banks' funding costs are estimated to have decreased by a little more than the cash rate over 2019.

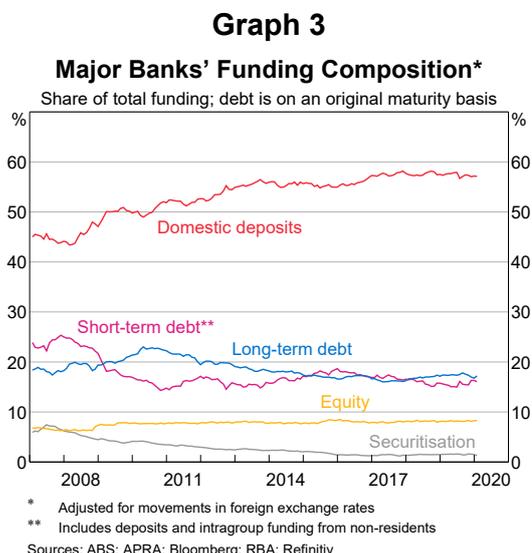
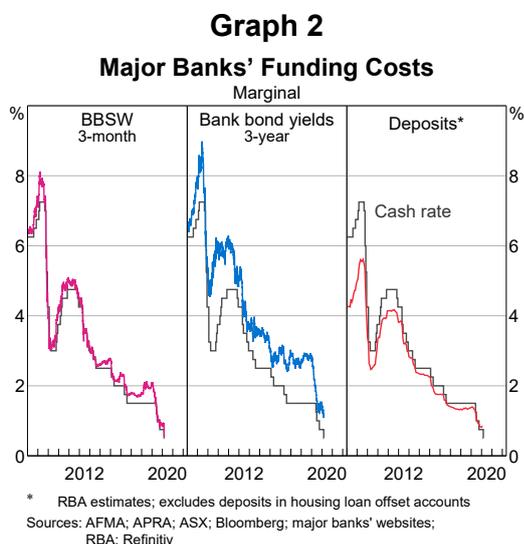
A large share of the decrease in funding costs flowed through to major banks' lending rates. The average rate paid on outstanding variable-rate housing loans decreased by almost 70 basis points following the 75 basis point decline in the cash rate in 2019, amid strong competition for new borrowers. Following the 25 basis point reduction in

the cash rate in March 2020, the major banks have lowered their standard variable rates (SVRs) on housing loans by 25 basis points. Fixed rates for new mortgages declined by around 100 basis points in 2019, consistent with a similar decline in swap rates, which are often used as a benchmark for pricing fixed-rate loans. Interest rates on loans to businesses also decreased, particularly the interest rates paid by large businesses, which tend to move with BBSW rates. Like banks' funding costs, the interest rates at which households and businesses can borrow are at historically low levels, reflecting the low level of the cash rate.

Deposits continue to be the largest source of bank funding

Banks obtain funding from retail deposits, wholesale deposits, wholesale debt and equity. Excluding equity, around two-thirds of the major banks' funding is from deposits. Short- and long-term wholesale debt (including securitisation) make up the remaining third of non-equity funding, in roughly equal shares. The composition of the major banks' funding in terms of these broad categories was little changed over 2019 (Graph 3).^[2]

A little under half of the major banks' deposits are sourced from households; the rest are from businesses, financial institutions (with a large share from superannuation funds) and the government (Graph 4, left panel). Deposits from households are typically smaller than those from other sources and



therefore face 'retail' rates of interest. Although some small- and medium-sized businesses may also face retail deposit rates, larger non-household depositors have access to wholesale debt markets, and the rates in these markets are used by banks as a benchmark for pricing some non-household deposits. For the purpose of this article, all non-household deposits are categorised as 'wholesale' deposits.

There has been some switching by both retail and wholesale depositors from term deposits to at-call deposits over the past year (Graph 4, right panel). This shift was supported by narrower spreads between term and at-call rates, as the interest rates offered for new term deposits fell by more than the rates on at-call accounts in 2019 (discussed further below).

Banks' demand for new long-term debt funding has been low

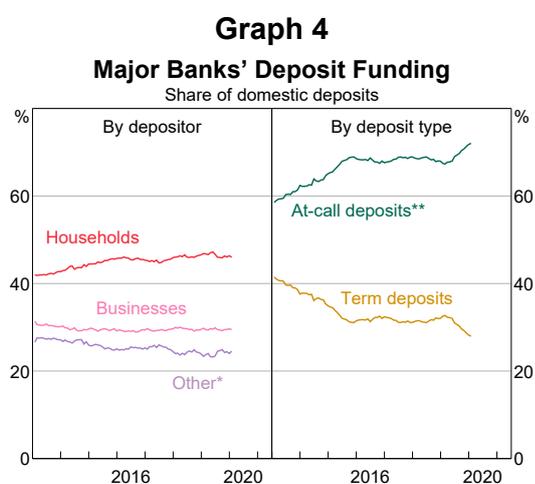
The total share of funding sourced by the major banks from wholesale debt markets was little changed over 2019, though there was a slight shift from long- to short-term debt within this. The value of long-term debt issued in 2019 was more than offset by the value of securities that matured, such that issuance was negative in net terms over the year. This has in part reflected lower demand from the major banks for new long-term debt funding in 2019 than in recent years because modest growth

in their balance sheets reduced the need for additional term funding.

The composition of the major banks' new long-term debt funding was also different from prior years (Graph 5). Bond issuance was at its lowest level since 2011; by contrast, issuance of Tier 2 hybrid securities picked up significantly in the second half of 2019. This followed an announcement by the Australian Prudential Regulation Authority (APRA) in July 2019 that the major banks would be required to increase their total loss-absorbing capital by the beginning of 2024. Hybrid securities have both equity- and debt-like features, and can be used to fulfil a part of banks' regulatory capital requirements.

The share of funding from equity has been stable

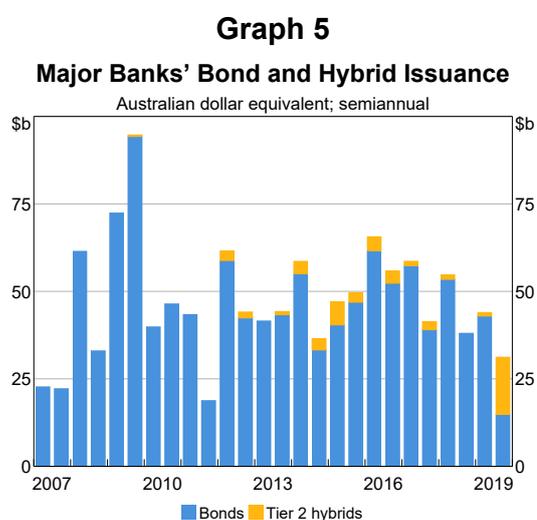
In addition to deposits and wholesale debt, banks obtain a portion of their funding from equity. The major banks' share of funding from equity has been stable over recent years, though they have increased their stock of equity funding by around \$50 billion since mid 2015. This increase was largely in response to changes in prudential regulations that increased the amount of capital that banks are required to hold. The major banks have all met APRA's 'unquestionably strong' capital benchmarks, which were put in place ahead of new prudential standards that are expected to take effect at the start of 2022.



* Includes deposits from financial institutions and the government

** Includes deposits in housing loan offset accounts and non-interest-bearing deposits

Sources: APRA; Bloomberg; RBA; Refinitiv



Sources: Bloomberg; KangaNews; Private Placement Monitor; RBA

Banks' funding costs declined to historic lows

As discussed above, the major banks' (non-equity) funding costs are estimated to have declined to historically low levels in 2019 (Graphs 1 and 2). This decline largely reflected the effects of reductions in the cash rate in 2019. Overall, the transmission of the cash rate reductions to banks' funding costs has been in line with historical experience (Graph 6).

The cost of wholesale funding decreased by more than the cash rate

Much of the major banks' wholesale funding costs are ultimately linked to BBSW rates, which declined by more than the cash rate over 2019 (Graph 7, left panel). For wholesale debt costs, these links can be direct (such as where debt is issued at a spread to BBSW rates) or indirect (as a result of the major banks' interest rate hedging practices, where BBSW rates are used as reference rates). The rates paid on wholesale term deposits also tend to be benchmarked against BBSW rates, though the interest rates on some at-call accounts (particularly, transaction accounts) for wholesale depositors are less sensitive to BBSW rates.^[3]

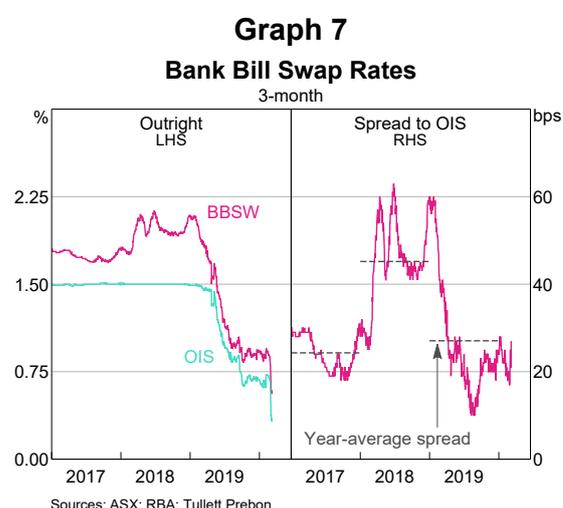
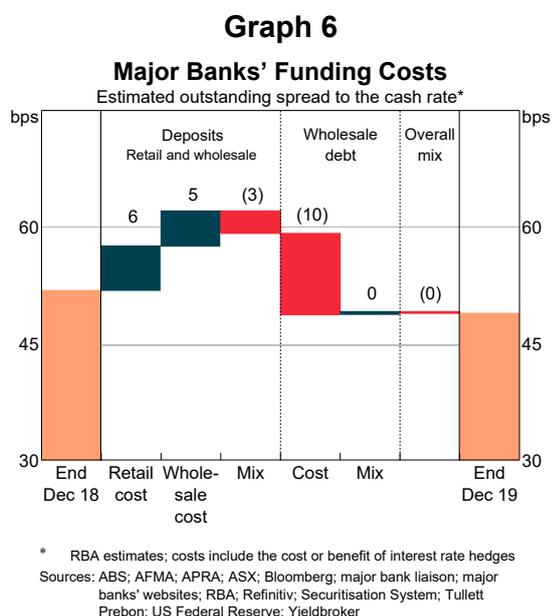
BBSW rates are heavily influenced by (actual and expected) cash rate reductions. In 2019, BBSW rates declined by more than the cash rate, even when accounting for expectations of a further reduction in the cash rate. This was because the spreads

required by investors to hold short-term bank debt narrowed, following elevated money market spreads throughout most of 2018 (Graph 7, right panel). The narrower BBSW spreads reflected reduced tightness in domestic and foreign money markets.^[4] Overall, the 3-month BBSW rate declined by more than 100 basis points over 2019 (compared with a decline of around 80 basis points in the 3-month overnight indexed swap rate).

The major banks' wholesale debt costs are estimated to have declined alongside the decline in BBSW rates (Graph 8). In addition, the cost of sourcing new long-term debt fell by a bit more than the decline in BBSW rates, owing to a larger decline in long-term reference rates; this fall in the marginal cost of long-term debt is continuing to flow through to the outstanding cost, as maturing term funding is being replaced at lower interest rates. As a result, the major banks' overall cost of wholesale funding is estimated to have fallen by more than the cash rate over 2019. Changes in the mix of wholesale debt funding had little overall effect on funding costs: the slight shift from long- to short-term debt supported the decline in the overall cost of wholesale funding, but this was offset by the major banks' increased issuance of (more expensive) Tier 2 hybrid securities.

Deposit rates are at historic lows

Following the cumulative 75 basis points of reductions in the cash rate in 2019, banks decreased the interest rates paid on most types of deposits. The average decrease was smaller for the rates paid



on at-call deposits than for the rates offered on new term deposits, some of which fell by more than the cash rate over 2019. These declines are continuing to flow through to the cost of outstanding deposits, as maturing term deposits are replaced at lower interest rates. Overall, the major banks' deposit costs are estimated to have declined by a bit less than the cash rate over 2019, though the decline was supported by changes in the mix of deposit funding to (less expensive) at-call deposits from term deposits, as well as the major banks' hedging practices.

Over 2019, the major banks lowered their rates on various deposit accounts (Graph 9), including on:

1. interest-bearing at-call accounts for retail depositors, such as online and bonus saver accounts, by an average of 65–80 basis points
2. new retail term deposits by around 100 basis points
3. new wholesale term deposits by more than 100 basis points, reflecting the fall in BBSW rates over the year.

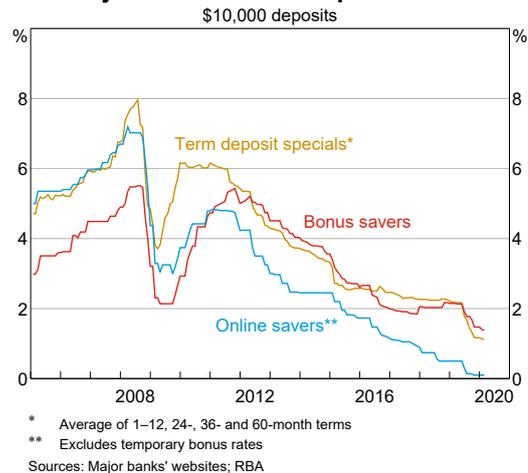
However, as is typical, the interest rates on many transaction accounts (which are usually close to zero) did not change following reductions in the cash rate, for both retail and wholesale depositors. Following the reductions in the cash rate last year, the major banks were estimated to be paying no or low interest (between zero and 25 basis points) on a little over one-quarter of their deposit funding (Graph 10). This compares with around 10 per cent

of deposits paying no or low interest before the reductions in the cash rate. However, the major banks enter into hedges for at least their non-interest-bearing deposits, such that the hedged costs of their non-interest-bearing deposits decreased in line with BBSW rates in 2019. Over time, as these hedges expire (and are replaced at lower interest rates), banks' deposit funding costs will increase a little.

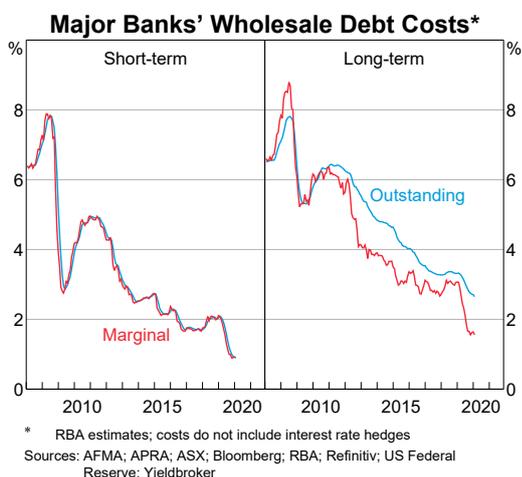
Housing and business lending rates are also at historic lows

Most of the cumulative 75 basis points of cash rate reductions in 2019 has flowed through to mortgage rates paid by households. Interest rates on outstanding variable-rate housing loans have declined by almost 70 basis points (Graph 11).

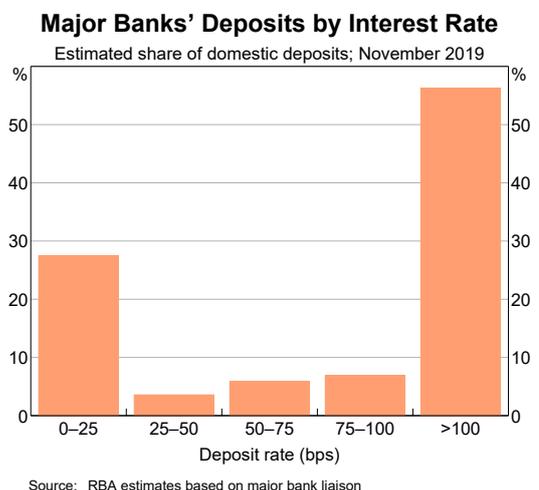
Graph 9
Major Banks' Retail Deposit Rates



Graph 8



Graph 10



Following the reductions in the cash rate in 2019, lenders lowered their SVRs on housing loans by an average of 60 basis points, which automatically flowed through to all variable-rate loans. The average rate paid on outstanding variable-rate loans declined by more than this, reflecting strong competition for new high-quality borrowers as well as households switching away from interest-only loans (which generally have higher interest rates). Following the 25 basis point reduction in the cash rate in March 2020, the major banks have lowered their SVRs on housing loans by 25 basis points.

Rates for fixed-rate housing loans have also declined. Over the past year, the major banks reduced their advertised 3-year fixed lending rates by around 100 basis points for owner-occupiers. This decline was consistent with a similar decline in interest rate swap rates, which are often used as a benchmark for pricing fixed-rate loans (given that they reflect expectations about the future path of the cash rate).

Interest rates on loans to large businesses – which tend to move with BBSW rates – are estimated to have declined over recent months and are at very low levels (Graph 12). Lending rates for medium and, to a lesser extent, small businesses have also decreased over recent months.^[5]

Banks' lending spread widened a little over 2019

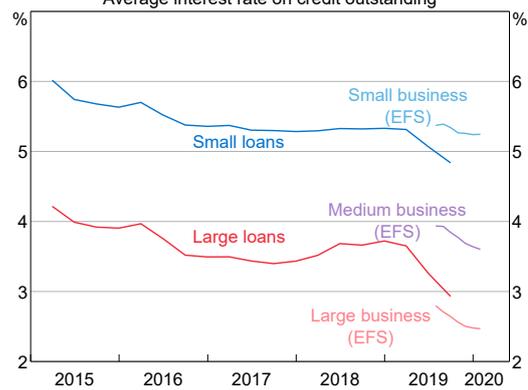
A bank's implied spread on its outstanding lending is the difference between its average lending rate

and average cost of debt and deposit funding.^[6] We estimate that the implied lending spread for the major banks widened a little over 2019 (Graph 13). Although the major banks passed on most of the cash rate reductions in 2019 to lending rates, the implied lending spread widened because their funding costs declined by slightly more than the cash rate reductions. This largely reflected the narrowing in BBSW spreads in the first quarter of 2019. Following the 25 basis point reduction in the cash rate in March 2020, the major banks have lowered their SVRs on housing loans by 25 basis points. ↘

Graph 12

Business Lending Rates

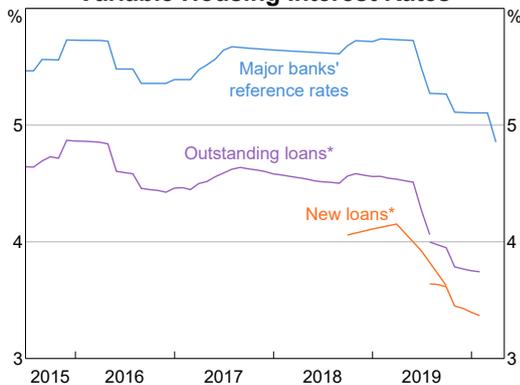
Average interest rate on credit outstanding



Sources: APRA; RBA

Graph 11

Variable Housing Interest Rates

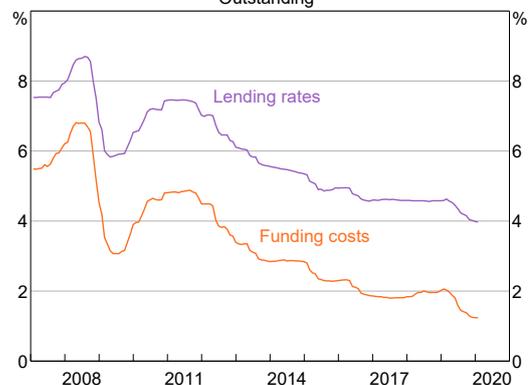


* Series break in July 2019; thereafter, data based on EFS collection
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Graph 13

Funding Costs and Lending Rates

Outstanding*



* RBA estimates for the major banks
Sources: ABS; AFMA; APRA; ASX; Bloomberg; CANSTAR; major bank liaison; major banks' websites; RBA; Refinitiv; Securitisation System; Tullett Prebon; US Federal Reserve; Yieldbroker

Footnotes

- [*] The authors are from Domestic Markets Department.
- [1] RBA estimates of banks' funding costs are now informed by interest rate data collected in the new Economic and Financial Statistics (EFS) collection. Incorporating these new data into our methodology has revised our estimates of funding costs up marginally in recent years. For more information on the EFS collection, see Bank, Durrani and Hatzvi (2019) and RBA (2020).
- [2] RBA estimates of banks' funding composition were revised last year when improved balance sheet data became available with the EFS collection. The major banks' share of funding from deposits was revised a bit lower. For more information, see RBA (2019), 'Domestic Financial Conditions', *Statement on Monetary Policy*, November pp 43–54.
- [3] For more information on the influence of BBSW rates on the major banks' funding costs, see Black and Titkov (2019).
- [4] For a further discussion see RBA (2019), 'Domestic Financial Conditions', *Statement on Monetary Policy*, February, pp 43–56.
- [5] The EFS collection provides more disaggregated data on the lending rates paid by businesses; these data are broken down by small, medium and large businesses, instead of small and large business loans. For more information, see RBA (2020).
- [6] This measure differs from some commonly reported measures of bank profitability as it excludes the effects of non-loan interest-earning assets, such as cash and liquid assets.

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