

## Box E: Banks' Interest Spreads

The Bank monitors movements in banks' interest rate spreads – i.e. the difference between the average interest rate *received* and the average interest rate *paid* – from a variety of information supplied by banks. The most comprehensive data are from banks' published financial statements, though these are at a very aggregated level and available only half-yearly, with a lag. The Bank also collects, on a quarterly basis, data on the average interest rate received on business loans, together with ongoing data on indicator lending rates. These provide more timely, though less comprehensive, information.

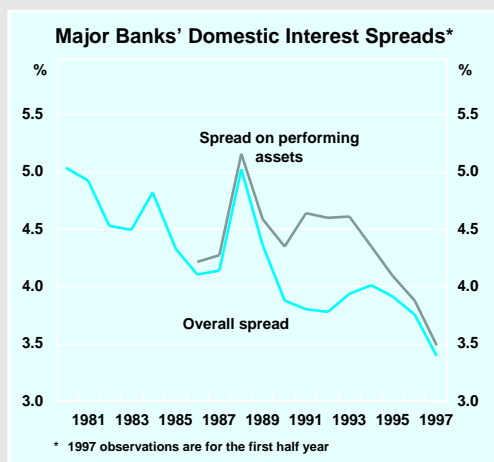
Graph E1 plots data on the average spread of the four major banks for the period up to the first half of 1997, the latest period for which annual report data are available. The overall spread has declined significantly during the period since deregulation, from 5.0 per cent in 1980 to about 3.4 per cent. Since the mid 1980s, the graph also plots the spread on performing assets. The gap between this and the overall spread reflects the impact of non-performing loans. This was most significant in the early 1990s, when the spread on performing loans rose a little while the overall spread declined. As bad loans ran off over 1993 and 1994, the overall spread recovered, and banks responded by reducing

the spread on performing loans. With that period of adjustment over, a clear downward trend in both measures of the spread has resumed since 1994.

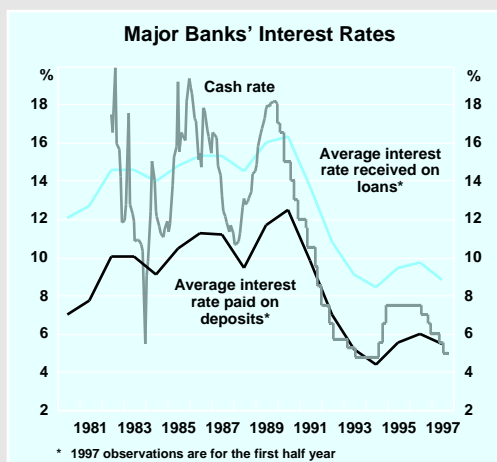
An indication of what factors have been driving the change in the spread can be gained by comparing its two components – the average interest rate *received* and the average interest rate *paid* – to the cash rate. Over the period since mid 1996, as monetary policy has been eased, the average interest rate *received* by banks has fallen broadly in line with the cash rate. As discussed below, however, this average masks a divergent pattern among different loan products. The average interest rate *paid*, in contrast, has fallen by considerably less than the cash rate – hence the reduction in overall spreads.

As can be seen in Graph E2, over a long run of years, the relationship between average rates of interest paid and received, on the one hand, and the cash rate, on the other, is only a loose one. In particular, the cycle in the average interest rates on loans and deposits is less pronounced than that in the cash rate. The cash rate only provides an indication of the rates paid by banks for wholesale deposits. It can be thought of as a measure of banks' *marginal* cost of funds. The greater stability in banks' *average* interest rates reflects two main factors: in addition

Graph E1



Graph E2



to funds raised in wholesale markets, banks also offer retail deposits where interest rates do not vary much; and they also have a sizeable proportion of deposits and loans at fixed rates on which interest rates change only on roll-over, rather than when the cash rate changes.

### Margins on Loans

As noted, not all interest rates on loans have fallen in line with the cash rate: some have fallen by more and some by less. This is illustrated in Tables E1 and E2, which show the net change since the June quarter 1996, the period during which monetary policy has been eased, in a variety of indicator lending rates and, where available, the change in the average overall interest rates paid.

#### *Variable-rate loans*

Table E1 shows movements in interest rates on various types of variable-rate loans. The points to note from the table are as follows:

- The *standard variable housing rate* loan has fallen by 3.8 percentage points over the period, which is 1.3 percentage points more than the fall in the cash rate, implying a sharp contraction in margins; this is also evident, though to a lesser extent, for *basic* housing loans. This reflects the increase in competition in the housing loan market, spurred on by the growth of mortgage managers. Against this, rates on *honeymoon* loans have fallen by less than the cash rate, as banks have pulled back from these types of loans.
- The indicator rates on small business *overdrafts* and *term* loans have fallen broadly in line with the cash rate, consistent with these margins remaining steady. However, as the interest rate on term loans is lower than for overdrafts, there has been some shift out of overdrafts into term loans. Banks have also introduced new products such as overdrafts and term loans secured by equity in residential property. The rate on *residential-secured overdrafts* has fallen

by over 2 percentage points more than the cash rate, as banks have come to recognise more explicitly the quality of security supporting business loans. As a result of the growing popularity of these new products, average interest received across all variable-rate small business loans has fallen by about 3 percentage points since mid 1996. This is larger than the fall in the cash rate, though this trend has only become apparent in the latest preliminary figures for the September quarter 1997.

- In the case of large business loans, the indicator rate for *overdrafts* has fallen by slightly less than the cash rate while the indicator rate for term loans has fallen by a little more. Overall, the preliminary figures for the September quarter 1997 suggest that the overall interest rate on loans to large businesses has fallen by slightly more than the cash rate since mid 1996.

#### *Bills*

Interest rates on bill lines have moved in line with the cash rate, as they are priced directly off yields in the money market.

#### *Fixed-rate loans*

Interest rates on fixed-rate loans are priced off capital market interest rates of relevant maturities, rather than the cash rate. Table E2 shows movements for 3-year fixed-rate loans and the movement in their funding cost, proxied by the 3-year rate in swap markets. For small and large business loans, the change in the average interest rate received on all existing fixed-rate loans outstanding is also shown.

*Indicator* rates have fallen broadly in line with the swap rate since mid 1996. However, the average interest rate received on all *existing* business fixed-rate loans has fallen by less than the swap rate. The smaller fall in the overall interest rate received than in the indicator rates for new loans reflects the fact that the latter have not yet worked their way through the stock of existing loans. Of

Table E1: Variable-rate Loans

Movement between June quarter 1996 and September quarter 1997 Percentage points	
Housing	
Standard variable	-3.8
Basic	-2.8
Honeymoon	-2.0
Small business	
Indicator rates	
– Overdrafts	-2.5
– Residential-secured overdraft	-4.7
– Term loans	-2.6
Average overall rate <sup>(a)</sup>	-3.1 <sup>(b)</sup>
Large business	
Indicator rates	
– Overdrafts	-2.3
– Term loans	-2.6
Average overall rate <sup>(a)</sup>	-2.7 <sup>(b)</sup>
Cash rate	-2.5

(a) Includes customer risk margin

(b) Figures for the average overall rate are based on the four major banks, using preliminary data for the September quarter 1997

course, on the deposit side, banks would be experiencing a corresponding phenomenon – i.e. the average cost at which existing fixed-rate loans are being funded has not yet fully reflected the recent falls in interest rates. As noted earlier, during periods of falling interest rates, these adjustment lags work to hold up both the average interest rate received and the average interest rate paid; during periods of rising interest rates, they work in the opposite direction.

#### End Piece

In summary, banks' interest margins have narrowed over the past 18 months or so as monetary policy has been eased. Their overall deposit costs have not fallen in line with the cash rate, due importantly to the limited scope to further reduce retail deposit interest rates. At the same time, competition has nonetheless forced loan rates lower. This

Table E2: Fixed-rate Loans

Movement between June quarter 1996 and September quarter 1997 Percentage points	
Housing	
New loans	-2.5
Small business	
Indicator rate on new loans	-2.9
Average rate on all existing loans	-1.2 <sup>(a)</sup>
Large business	
Indicator rate on new loans	-3.0
Average rate on all existing loans	-1.2 <sup>(a)</sup>
Three-year swap rate <sup>(b)</sup>	-2.9

(a) Figures for the average overall rate are based on the four major banks, using preliminary data for the September quarter 1997; they include customer risk margin

(b) 3-year swap rate is used as indicative funding rate

competition was first evident in the housing loan market, particularly from mid 1996 reflecting the expansion of mortgage managers into this market. It has now started to flow through into small business loan rates, as reduced housing margins have forced banks to look to increase market share in other areas. This process has resulted in banks introducing a range of new small business products offering discounted interest rates and better reflecting the type of security being offered. Until recently, the effects of this competition in small business finance were not evident in banks' aggregate figures on interest received, suggesting that the switch to lower priced products was only gradual. But the latest numbers from the major banks, which remain preliminary, are starting to show a more significant impact.

This competition should continue, though it is unlikely that margins on small business loans will fall to the same level as those on housing, due both to the higher risk on small business lending and to the greater difficulty new lenders are likely to face in contesting this market. ✎