Box B

Developments in Bank Funding Costs*

After a period in which spreads had been relatively steady, a pick-up in uncertainty in global financial markets and general investor risk aversion in recent months has seen renewed upward pressure on spreads in wholesale debt markets globally. Reflecting this, spreads on the major banks' bonds were around 25–50 basis points higher than the recent low in April, although they remain well below the peak levels in late 2008 and early 2009 (see Graph 62). There has also been some increase in costs associated with hedging the foreign exchange risk on new foreign-currency denominated bonds.

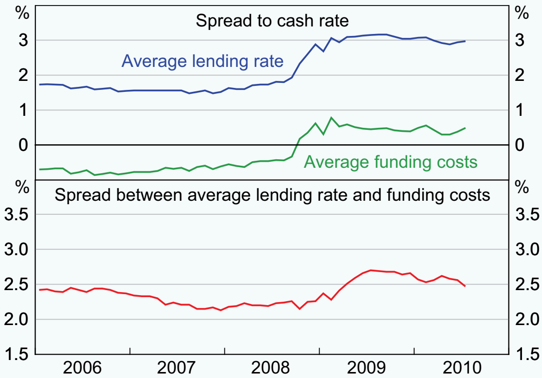
Nevertheless, these recent increases in bond spreads are estimated to have had only a small effect on the major banks' overall funding costs to date. While long-term wholesale debt funding accounts for around one-quarter of the major banks' debt funding liabilities, due to the long life of this type of funding only a small share has actually been issued in the past few months. The major banks have issued $15 billion in bonds (domestically and offshore) in the three months to end July compared with around $425 billion of outstanding long-term debt capital market liabilities (see Graph 61).

In contrast to bond market spreads, the cost of deposits relative to the cash rate has been little changed since the beginning of the year. Given deposits (excluding CDs) account for about one-half of the major banks' overall debt funding liabilities, the cost of this funding source is particularly important in driving movements in overall funding costs. While banks continue to offer attractive rates on deposits (particularly term deposits) in an effort to attract this source of funding, the intensity of competition in the deposit market seems to have eased somewhat over the past few months. In particular, the average spread of new term deposit rates relative to wholesale market interest rates has fallen by around 30–40 basis points from its peak in February.

Banks source the remainder of their funding largely from the wholesale short-term money markets. While spreads in these markets rose during the turbulence in May and June, they have since fallen back and remain around the average seen over the past year.

* This is an update of previous Reserve Bank research on banks' funding costs published as Brown A, M Davies, D Fabbro and T Hanrick (2010), 'Recent Developments in Banks' Funding Costs and Lending Rates', RBA *Bulletin,* March, pp 34–44.

Graph B1
Major Banks' Interest Spreads



Source: RBA

Taking into account the various costs for new debt and deposit raisings in recent months, as well as the average cost of outstanding funding, banks' overall funding costs, relative to the cash rate, are estimated to have risen slightly since the beginning of the year (Graph B1). Looking ahead, if bond spreads and hedging costs were to remain around their current levels, then as maturing bonds and hedges are rolled over, the average spread on banks' outstanding bonds is estimated to increase by around 20–25 basis points by the end of 2011. Together with spreads on deposit and short-term wholesale funding staying around current levels, this would imply a rise in banks' overall funding costs of around 5 basis points over the next 18 months or so.

These pressures on funding costs, however, are partially offset by banks continuing to reprice their business loans as facilities are rolled over. Average risk margins have been gradually increasing over the past couple of years. Overall, taking into account movements in average lending rates relative to the movements in the funding costs, the major banks' interest spread has declined from its peak in the middle of 2009 but remains higher than prior to the onset of the global financial turmoil.[1]

1 The interest spread estimated here differs from the net interest margin published by the major banks. Their published margins include interest received on total financial assets (loans, liquid assets and other debt securities), while the calculations used here focus on interest earned on loans.