# Developments in Banks' Funding Costs and Lending Rates

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Photo: Busakorn Pongparnit – Getty Images

## Abstract

Banks' funding costs declined to historical lows over 2020, reflecting the monetary policy measures announced by the Reserve Bank. In aggregate, lending rates have fallen in line with banks' borrowing costs, such that the major banks' average interest spreads were little changed over the year.

## The Reserve Bank's policy measures led to lower funding costs and lending rates in 2020

In 2020, the Reserve Bank reduced the cash rate target to historically low levels and implemented other measures to lower the cost of funding for banks and support the supply of credit to households and businesses (Graph 1; Kent 2020a; Lowe 2020a; Lowe 2020b). The flow-through from the reductions in the cash rate and from other policy tools to interest rates was a key channel of monetary policy transmission. Consistent with this, banks' debt funding costs and lending rates declined substantially over the year. This article updates previous Reserve Bank analysis, focusing on developments in the major banks' funding costs and lending rates over 2020 (Black, Titkov and Wang 2020).

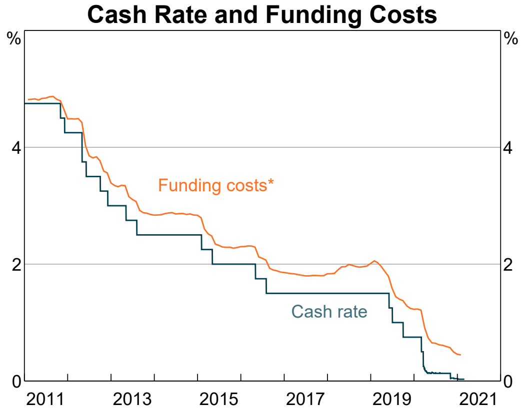
The cash rate declined by about 70 basis points over 2020 and banks' funding costs declined by a similar amount. Wholesale debt costs and retail and wholesale deposit rates all declined to historical lows as a result of the Reserve Bank's policy measures (Graph 2). Bank Bill Swap (BBSW) rates fell substantially over the year, reflecting the reductions in the cash rate target and the high levels of liquidity provided by the Reserve Bank to the banking system since March (Kent 2020b). BBSW rates are important benchmark rates in the Australian financial system, and much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to these rates (Alim and Connolly 2018).

The Reserve Bank's Term Funding Facility (TFF) also reduced banks' funding costs through the provision of low-cost funding to support lending and by reducing banks' need to issue more expensive long-term wholesale debt. Banks also significantly reduced retail deposit rates over the year, initially in response to the March policy easing but also due to strong growth in the supply of funding, including deposits, over 2020. The decline in these costs continues to flow through to banks' overall cost of funding, as fixed-rate deposit and other term funding matures and is replaced by funding at lower interest rates.

Overall, aggregate lending rates are estimated to have declined by a similar extent to the major banks' funding costs over 2020. A large share of the decline in funding costs over 2020 flowed through to the housing interest rates paid by borrowers, though the extent of the reductions differed across variable- and fixed-rate loans. Interest rates on existing variable-rate housing loans declined by around 50 basis points over the year, while those offered on new fixed-rate housing loans fell by around 90 basis points over the same period. Interest rates on outstanding business loans declined by a little more than the decline in banks' overall debt funding costs over 2020.

**Graph 1**

**Cash Rate and Funding Costs**



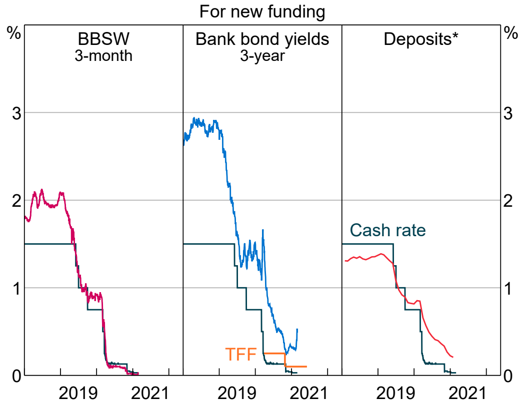

* RBA estimates of overall outstanding hedged debt and deposit costs for the major banks

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

**Graph 2**

**Major Banks' Funding Costs**

For new funding




* RBA estimates; excludes deposits in housing loan offset accounts

Sources: AFMA; APRA; ASX; Bloomberg; major banks' websites; RBA; Refinitiv

## Funding from deposits increased …

Banks obtain funding from retail deposits, wholesale deposits, wholesale debt (including securitisation) and equity. The share of bank funding from deposits increased substantially over 2020 (Graph 3). Excluding equity, around two-thirds of the major banks' funding now comes from deposits.[1] In contrast, the share of bank funding drawn from wholesale debt markets declined over the year. Short- and long-term debt (including securitisation) now account for a little under one-third of the major banks' non-equity funding, in roughly equal shares. Banks can also obtain funding from the Reserve Bank's TFF, which was announced in March 2020 as part of a monetary policy package to reduce funding costs across the economy and to support lending (Alston *et al* 2020). Over 2020, the major banks took up almost all of their initial allowances, amounting to a little over half of the low-cost funding available to these banks under the TFF. TFF funding currently accounts for around 2 per cent of the major banks' non-equity funding.[2]

Deposit growth is typically driven by new lending by the banking sector. Lending creates deposits as the funds made available to a borrower find their way into a deposit somewhere in the banking system, either as a deposit in the borrower's account, or in another account when the borrower uses those funds to make a purchase (RBA 2020). While the provision of new credit to the economy added to deposits over the year, it was not the only driver of the increase in deposits.

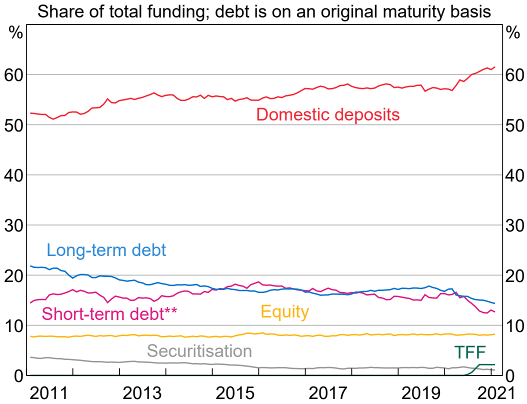
Over 2020, growth in total deposits also reflected government bond purchases by the Reserve Bank and by the banking sector, and a decline in banks' outstanding short-term and long-term debt. Both of these channels can add to the stock of deposits by converting the original asset (government or bank debt) held by private (non-bank) investors into deposits.[3] For instance, the major banks' holdings of Australian Government Securities (AGS) and semi-government securities issued by the central borrowing authorities of the states and territories (semis) increased over 2020 (Graph 4). Some of these bonds would have been purchased from non-bank investors, with the proceeds then credited to a deposit account.

New deposits mostly flowed into at-call accounts held by households and businesses, which tend to pay relatively low rates of interest (Graph 5). In addition, there was some switching by depositors

**Graph 3**

**Major Banks' Funding Composition***

Share of total funding; debt is on an original maturity basis



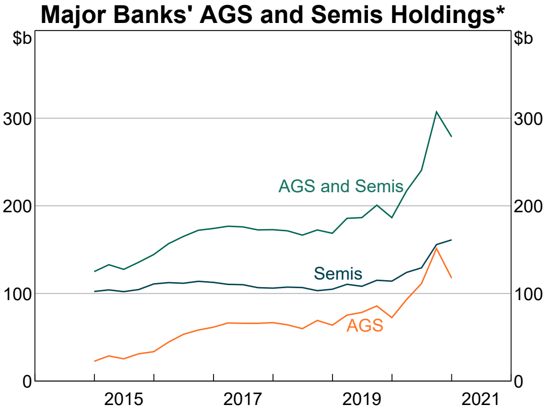

* Adjusted for movements in foreign exchange rates

** Includes deposits and intragroup funding from non-residents

Sources: ABS; APRA; Bloomberg; RBA; Refinitiv

**Graph 4**

**Major Banks' AGS and Semis Holdings***




* This data is compiled on a consolidated balance sheet basis

Sources: APRA; RBA

from term deposits to at-call deposits over the past year, supported by the decline in the spread between interest rates on term and at-call deposits. Both of these changes have contributed to lowering the average interest rates paid by the major banks on deposit funding (discussed further below).

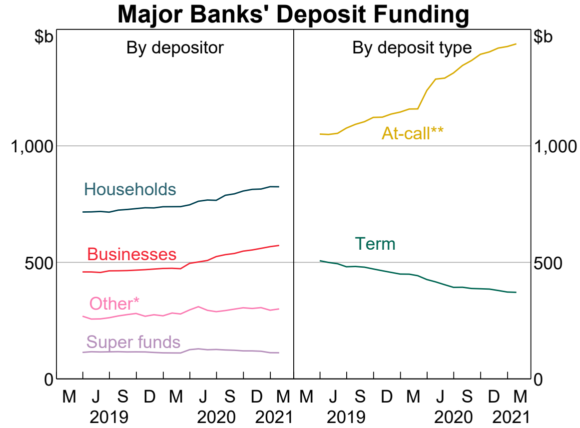
## … while the use of wholesale debt funding declined

The share of funding sourced by the major banks from both short- and long-term wholesale debt markets declined substantially over 2020. Bank bonds account for the bulk of banks' long-term wholesale debt funding (banks can also obtain loans in wholesale funding markets). The stock of these bonds declined over 2020, largely reflecting maturities of bonds issued in offshore markets (Graph 6). This is because the major banks can access low-cost term funding from the TFF – $63 billion of which had been drawn by these banks by the end of December – and because of an increase in deposit funding. Also, loan asset growth was low compared with earlier years, so banks have needed less funding than otherwise.

While new bond issuance has been low by historical standards, banks continued to source new long-term debt funding from Tier 2 hybrid securities (Graph 7). Hybrid securities have both equity- and debt-like features, and can be used to fulfil a part of banks' regulatory capital requirements (RBA 2012).

**Graph 5**

**Major Banks' Deposit Funding**




* Includes deposits from governments and financial institutions that are not superannuation funds

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

Sources: APRA; RBA

This issuance increased the major banks' total loss-absorbing capital ahead of a higher regulatory minimum capital requirement that will take effect at the beginning of 2024 (APRA 2019).

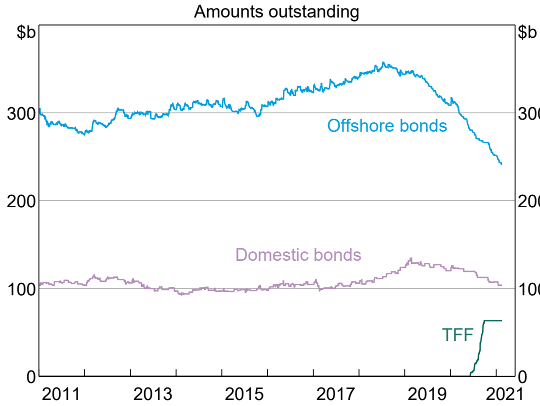
## Banks' share of equity funding was little changed

The amount of banks' equity funding (or 'equity capital') rose over 2020 in line with an expansion in banks' balance sheets, leaving the equity share of funding broadly stable. Banks increased their equity capital to absorb potential losses arising from the COVID-19 pandemic by retaining a greater share of their earnings, in line with APRA's guidance to ensure that banks maintained the capacity to lend and support the economy until the outlook was clearer (APRA 2020a). National Australia Bank raised around $4 billion in equity capital in the June quarter through new share issuance. All of the major banks also raised equity capital through ongoing dividend reinvestment plans, in line with the guidance from APRA. In addition, APRA accommodated banks drawing down on capital stocks to support lending by relaxing the expectation that banks maintain capital at or above 'unquestionably strong' levels (APRA 2020b). Despite this change, the major banks all maintained capital ratios above this benchmark level over the year.

**Graph 6**

**Major Banks' Wholesale Funding**

Amounts outstanding

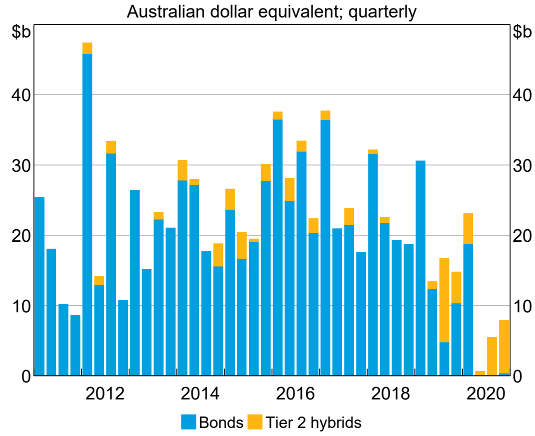



Sources: Bloomberg; Private Placement Monitor; RBA

**Graph 7**

**Major Banks' Bond and Hybrid Issuance**

Australian dollar equivalent; quarterly




Sources: Bloomberg; KangaNews; Private Placement Monitor; RBA

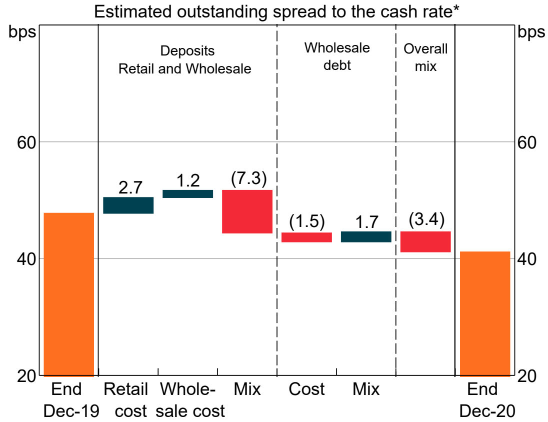
## Banks' funding costs declined to historic lows

As discussed above, the major banks' (non-equity) funding costs are estimated to have declined to historically low levels in 2020 (Graphs 1 and 2). Historically, the cash rate has been a key determinant of the overall cost of banks' funding, as it is an anchor for other interest rates in the Australian financial system. Over 2020, the major banks' overall debt funding costs are estimated to have declined by a similar amount to the cash rate (Graph 8). As well as the effect of the reduction in the cash rate, funding costs declined in response to the Reserve Bank's other policy measures.

**Graph 8**

**Major Banks' Funding Costs**

Estimated outstanding spread to the cash rate*




* RBA estimates; overall costs include the benefit/cost of interest rate hedges

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

## The cost of wholesale funding declined

Banks' wholesale funding costs declined substantially over the year, primarily reflecting the decline in BBSW rates. Much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which declined by around 85–100 basis points over 2020. Much of the decline in BBSW rates occurred following the introduction of the March policy packages, as BBSW rates are heavily influenced by (actual and expected) reductions in the cash rate (Domestic Markets Department 2019; Graph 9). The supply of liquidity provided by the Reserve Bank to the banking system since March further contributed to lowering BBSW rates over the year.

Access to the TFF helped to reduce banks' wholesale funding costs, since it is cheaper than alternative forms of wholesale term funding (Graph 10). The interest rate paid by banks on funding from the TFF is lower than the cost of existing market-based funding for the same term. The major banks therefore allowed relatively more expensive wholesale debt funding to mature and replaced this with cheaper funding from the TFF, which lowered banks' outstanding funding costs. The availability of the TFF since March last year has also added to downward pressure on marginal wholesale funding costs, as access to low-cost funds from the TFF, along with inflows of deposits and reduced lending growth, has reduced the need for banks to raise funds in wholesale debt markets. Consistent with this, bond yields and BBSW rates have declined to historically low levels.

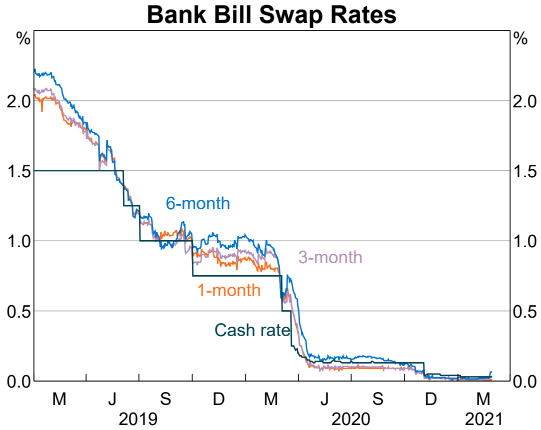
## Household deposit rates declined to historic lows

The major banks significantly reduced deposit rates over 2020, reflecting the substantial easing of monetary policy, access to low-cost funding from the Reserve Bank's TFF and continued inflows of deposit funding throughout the year. Interest rates for new term deposits from households declined by around 95 basis points, while rates for new at-call deposits declined by around 40 basis points over the same period (Graph 11). Much of the decline in deposit rates occurred immediately following the Reserve Bank's March policy announcements, though these rates have continued to drift lower since then. Banks reduced the rates paid on relatively costly term deposits by more than the rates on at-call deposits over the year, and the spread between term and at-call deposits narrowed as a result. This further supported the decline in banks' deposit costs; savers switched from term deposits to at-call deposits as the lower spread reduced the implicit cost to savers of having ready access to their savings. At-call deposits pay low interest and so are less expensive for banks.

The reductions in deposit rates over 2020 are expected to continue to flow through to banks' overall funding costs over 2021 as changes in new term deposit rates take time to flow through to the stock of banks' deposits. These deposits earn fixed rates of interest over a set term, such that reductions in new rates have a more gradual impact as existing, higher-cost term deposits mature. Most

**Graph 9**

**Bank Bill Swap Rates**

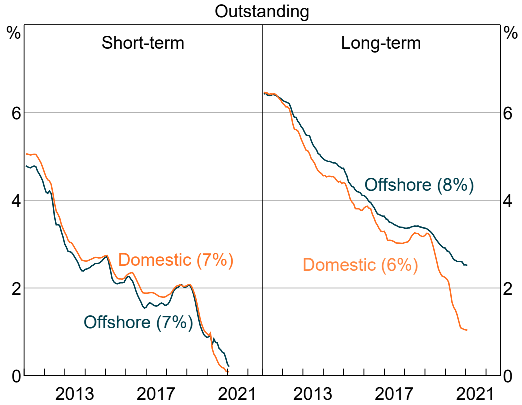



Sources: ASX; RBA

**Graph 10**

**Major Banks' Wholesale Debt Costs***

Outstanding




* Numbers in brackets are share of total debt funding on an original maturity basis

Sources: APRA; Bloomberg; RBA

outstanding term deposits have a term to maturity of less than one year. In contrast to term deposits, lower variable at-call rates tend to feed directly into the cost of outstanding deposits as changes in at-call rates affect both new and existing deposits.

However, as is typical, the interest rates on many transaction accounts (which are usually close to zero) did not change following the easing of monetary policy over 2020. In addition, the decline in deposit rates and the growth in at-call deposits over the year meant that the share of bank deposits paying low interest rates (between zero and 25 basis points) rose. For the major banks, the share of debt funding from low-rate deposits was around one-quarter in late 2020, compared to around 15 per cent in late 2019 (Graph 12). Banks appear unlikely to reduce rates on some of these deposits further, as they are reluctant to reduce household deposit rates below zero. Despite the larger share of low-rate deposits, the bulk of the major banks' deposits were still paying rates greater than 25 basis points last year.

## Banks' lending spread was little changed over 2020

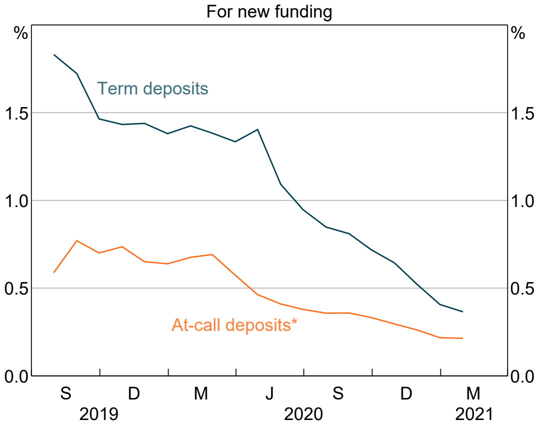
A bank's implied spread on its outstanding lending is the difference between its average lending rate and average cost of debt and deposit funding. We estimate that the implied lending spread for the major banks was little changed over 2020 (Graph 13). While the average lending rate declined by roughly the same amount as funding costs, the extent of reductions in interest rates varied across housing and business loans (discussed below).

The implied lending spread differs from some other reported measures of bank profitability, such as net interest margins. For example, the implied lending spread excludes the effects of non-loan interest-earning assets, such as cash and other high-quality liquid assets. The major banks' interest earnings on the stock of non-loan assets declined over 2020 as the yields earned on these assets declined. The stock of non-loan assets also increased over 2020, which reduced average interest earnings on these assets. In part, this reflects an increase in the major banks' holdings of AGS and semis (discussed above). The monetary policy response to the COVID-19 pandemic also resulted in an increase in (low-yielding) balances held by the major banks in

**Graph 11**

**Major Banks' Household Deposit Rates**

For new funding



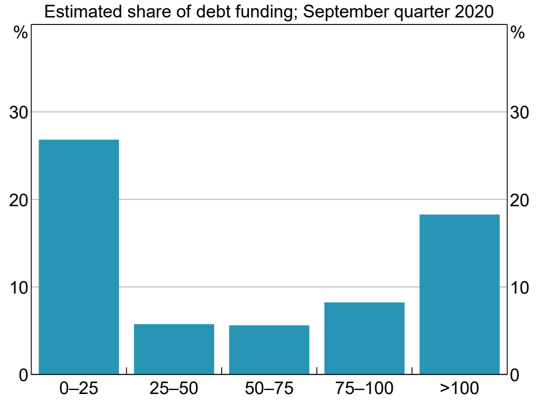

* Excludes deposits in housing loan offset accounts; includes non-interest bearing deposits

Sources: APRA; RBA

**Graph 12**

**Major Banks' Deposits by Interest Rate***

Estimated share of debt funding; September quarter 2020

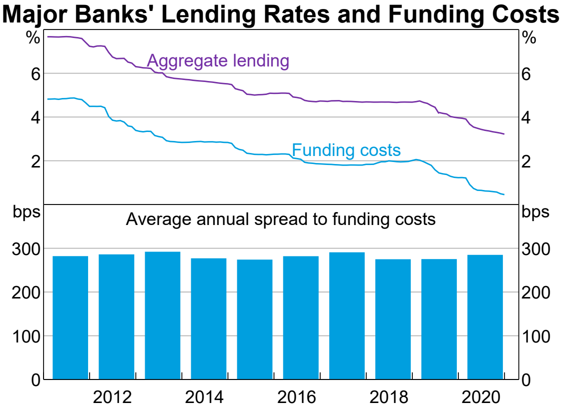



* Includes deposits in housing loan offset accounts

Sources: APRA; Bloomberg; Major bank liaison; RBA; Refinitiv

**Graph 13**

**Major Banks' Lending Rates and Funding Costs**




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

Exchange Settlement Accounts with the Reserve Bank.

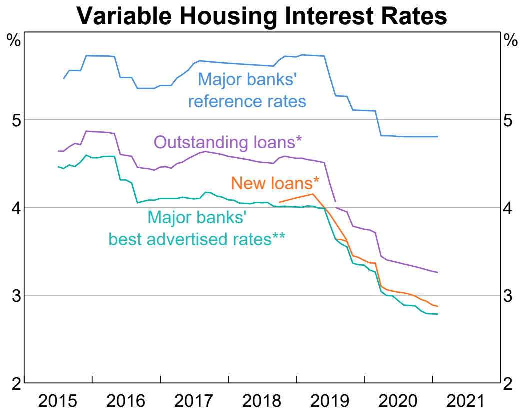
## Housing and business lending interest rates have declined to historic lows

A large share of the decline in banks' overall debt funding costs over 2020 flowed through to the housing interest rates paid by borrowers, though the extent of the reductions was mixed across variable- and fixed-rate loans. Interest rates on outstanding variable-rate housing loans declined by around 50 basis points (Graph 14). Lenders lowered their standard variable rates (SVRs) on housing loans by close to 30 basis points, on average, in the months following the Reserve Bank's initial package of policy measures announced in March last year. Reductions in SVRs automatically flow through to all variable-rate loans. The decline in outstanding variable rates also reflects ongoing competition for high-quality borrowers, with lenders offering particularly low interest rates to new and refinancing borrowers.

Over the past year, rates for new fixed-rate loans also declined by around 90 basis points – slightly more than the estimated decline in banks' overall debt funding costs (Graph 15). This decline was broadly consistent with a 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 monetary policy. Fixed-rate loans have become more popular, as these interest rates have generally declined to be below the interest rates available on variable-rate loans. The stock of fixed-rate housing loans rose from 20 per cent to around 25 per cent of housing credit outstanding over the past year.

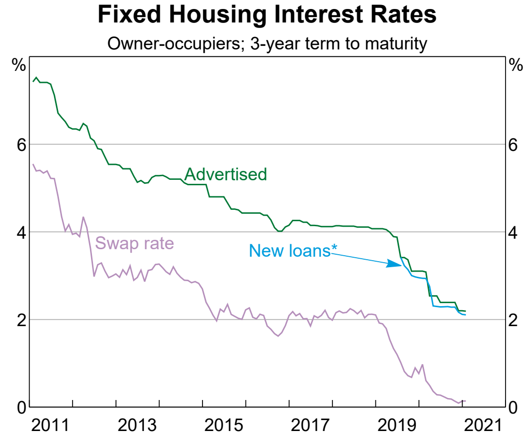
Interest rates on outstanding business loans also declined by more than the decline in banks' overall debt funding costs over 2020 (Graph 16). Interest rates on variable-rate loans to large businesses declined by 85 basis points over 2020, while interest rates on variable-rate loans to small and medium-sized businesses declined by around 80 basis points over the same period. The major banks substantially lowered the interest rates for loans offered under the Australian Government's Small and Medium Enterprises (SME) loan guarantee scheme (Bank and Lewis 2021).

### Graph 14



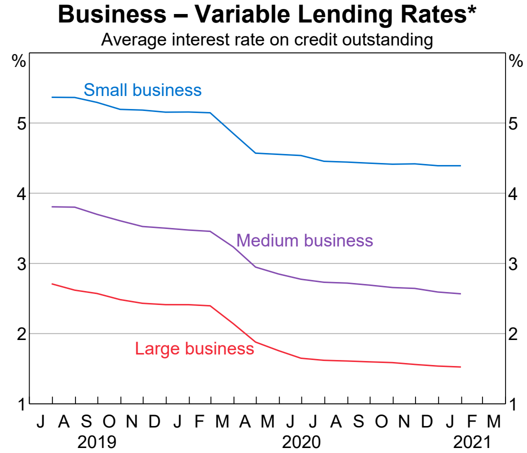

* Series break in July 2019; thereafter, data based on EFS collection
** Including low-cost brands
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

### Graph 15




* Data based on the EFS collection
Sources: APRA; Banks' websites; CANSTAR; RBA; Refinitiv

### Graph 16




* Data cover financial institutions with $2 billion or more in business credit
Sources: APRA; RBA

## Conclusion

The monetary policy measures announced by the Reserve Bank in 2020 worked to lower funding costs across the economy and support the provision of credit. As a result, the cash rate and BBSW rates, which are important reference rates for banks' overall debt funding costs, declined significantly. Banks' lending rates and funding costs declined alongside these other interest rates, such that average interest spreads were little changed. ✠

## Footnotes

[*] The authors are from Domestic Markets Department.

[1] All measures in this article (unless otherwise noted) use banks' 'domestic books' as the basis of measurement, rather than their global balance sheet (APRA 2017).

[2] Banks can access the remainder of their TFF allowances until the end of June 2021.

[3] For more information on deposit creation, see RBA (2020)

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