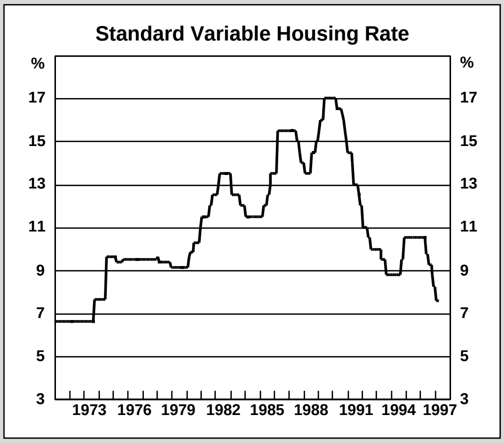
Box 5: Competition in Housing Financing

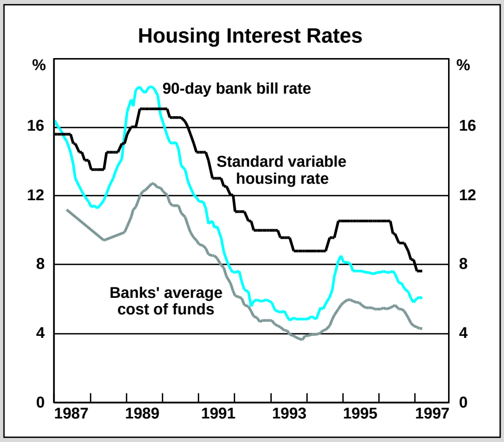
Competition in the provision of housing finance has increased over the past year, with banks announcing two rounds of cuts in housing interest rates (in June 1996 and February 1997) independent of any easings in monetary policy. The combination of these reductions and banks' responses to the three easings of monetary policy in the second half of 1996 has seen interest rates on variable-rate mortgages fall by about 3 percentage points in the past year. The standard variable rate is now at 7.55 per cent, its lowest level since late 1973 (Graph 1).

Graph 1



While financial deregulation a decade ago opened up the way for greater competition in the provision of finance, the full impact was not felt until recent years, particularly for households. One reason for this was that inflation remained high in the 1980s. The resulting high level of interest rates in the wholesale money market, the main source of funds for lenders such as mortgage managers, made it difficult for potential new lenders to compete with banks, who had access to low-cost retail funding. This situation enabled banks to sustain wide margins on housing lending, largely uncontested by other institutions. The return to low inflation and the fall in money market interest rates opened up the way for new institutions to enter the market, since there was then sufficient margin between money market interest rates and the rates charged by banks on housing loans for these new lenders to undercut banks (Graph 2). The development of markets for securitised assets facilitated the funding activities of mortgage managers.

Graph 2



Mortgage managers were slow to start but by the end of the first half of the 1990s, they were gaining substantial market share from other lenders. By mid 1996, their share of new lending had risen to around 10 per cent (Graph 3). Correspondingly, banks' market share fell by 10 percentage points from over 90 per cent of new loans in early 1994 to over 80 per cent in mid 1996.

Banks initially responded to the competition from mortgage managers by product innovation aimed at new borrowers, rather than cutting their main standard variable interest rates. This latter course would have been more costly to banks as it would have passed on lower rates to existing as well as new customers. New facilities included 'honeymoon' loans, a wider range of fixed-rate loans and the introduction of 'basic' loans at substantial discounts to the

Graph 3

standard variable-rate home loan, with similar conditions to those offered by mortgage managers. Signs of more general competition on housing rates emerged in late 1994, when banks responded to the rise of 2$^{3}/_{4}$ percentage points in cash rates by raising housing rates by only 1$^{3}/_{4}$ percentage points. Banks accommodated this smaller rise mainly by limiting the rise in interest rates on deposits.

Competition spread more openly to the market for existing borrowers in mid 1996 when banks cut the interest rate on standard variable-rate loans independently of any effect on funding costs from a change in monetary policy. Several banks also introduced incentives to refinance existing loans – for example, waiving fees and loan establishment costs – with the aim of attracting borrowers from their competitors. A similar episode occurred in February of this year. In total, the standard variable rate was lowered by 1$^{1}/_{2}$ percentage points over and above the falls that accompanied the three monetary policy easings.

The result of this competition, which originated from the entry of new non-bank lenders into the market, is that banks have reduced their standard mortgage rates to match those of the new entrants. Some banks are offering 'no-frills' or basic loans at rates lower than those offered by key mortgage managers. In the process, banks' margins on housing loans, which had been high by international standards, have come down significantly in the past year (Graph 4). They are now more in line with those in comparable overseas countries. ✠

Graph 4