Developments in Banks' Funding Costs and Lending Rates

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This article updates previous Reserve Bank research on the ways in which developments in the composition and pricing of banks' debt funding have affected their overall cost of funds and influenced lending rates. Major banks' outstanding funding costs and lending rates declined in 2016, following two reductions in the cash rate. However, lending rates and funding costs did not decline by as much as the cash rate. This was largely due to an increase in the cost of deposit funding, which reflected competition between financial institutions for deposits.

Introduction

The rates that banks set on their loans to households and businesses are determined in part by the cost of banks' funding. Banks also take into account risk premia, such as that for credit risk associated with loans, and the liquidity risk involved in funding long-term assets with short-term liabilities. Banks' growth strategies, competition and the desired return to equity holders also affect their lending rates.

An important influence on the cost of banks' funding is the level of the cash rate, which acts as an anchor for the broader interest rate structure of the domestic financial system. However, the cash rate is not the only determinant of lending rates. Changes in the level of compensation demanded by investors to hold bank debt, competitive pressures and non-price factors (such as funding composition) can influence banks' funding costs significantly. There is usually some lag before the full effect of changes in these factors flows through to funding costs and lending rates. This reflects the time it takes for banks' liabilities to be repriced, particularly those with longer terms to maturity.

The Reserve Bank Board takes developments in funding costs and lending rates into account when determining the appropriate setting of the cash rate (Lowe 2012). The Board aims to ensure that the interest rates faced by households and businesses are consistent with the desired stance of monetary policy. The following analysis updates previous Reserve Bank research and focuses on developments in banks' funding costs and lending rates over 2016 (Wilkins, Gardner and Chapman 2016).

Over the past year, funding costs have declined in absolute terms, but have risen relative to the cash rate. Deposit pricing has been a major driver of recent changes in funding costs, reflecting increased competition for certain deposits. Banks have also been active in issuing long-term wholesale debt, with net issuance well above levels in previous years, although this has had a relatively small effect on banks' funding costs as the cost of new issuance has declined over 2016.

Composition of Funding

Banks operating in Australia have diverse funding bases, including deposits, short-term and long-term wholesale debt as well as equity (Graph 1).

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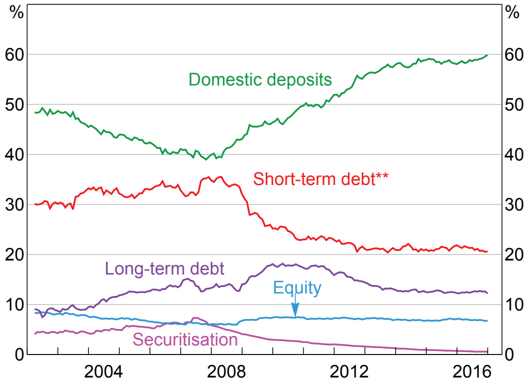
Graph 1
Funding Composition of Banks in Australia*
Share of total funding



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Deposits from households and businesses comprise about 60 per cent of Australian banks' funding liabilities. Banks have increased the share of deposit funding since the financial crisis as deposits are considered to be a more stable form of funding than short-term debt, thereby reducing the liquidity risks that banks face. Much of the increase in deposit funding over the past year has been sourced from households, either directly or through superannuation funds.

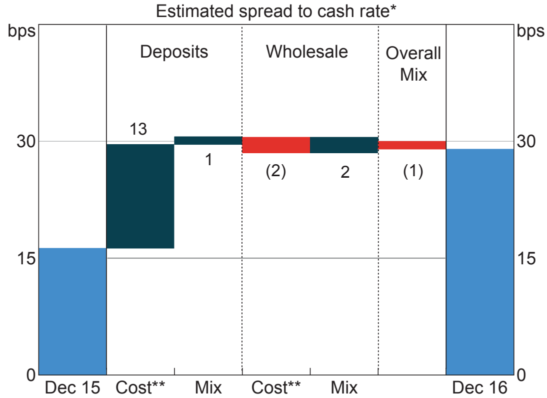
The share of equity funding has remained relatively stable during 2016. Similarly, the share of funding sourced from long-term wholesale debt has remained steady over the past year. Long-term wholesale debt, such as bank bonds, is also considered a relatively stable source of funding; bank bonds typically have a maturity of around three to five years at issuance and this longer term to maturity reduces the frequency with which banks need to refinance their debt.

In contrast, the share of funding sourced from short-term wholesale debt has declined to around 20 per cent of banks' funding. Short-term wholesale debt, such as bank bills, repurchase agreements or unsecured interbank loans, typically has a residual maturity of less than six months and is therefore considered to be a less stable source of funding.

Cost of Debt Funding

In aggregate, debt funding costs (hereafter 'funding costs') for the major banks are estimated to have fallen by around 35 basis points over 2016, partly reflecting a reduction in the cash rate of 25 basis points in May and again in August. The spread between the major banks' funding costs and the cash rate is estimated to have risen by around 13 basis points over the past year (from around 15 basis points to just under 30 basis points, as shown in the blue columns of Graph 2). The widening in this spread largely reflects a rise in the cost of some deposits relative to the cash rate. Compositional changes within the mix of different deposits and wholesale funding sources also added a little to banks' funding costs, while wholesale funding costs declined by more than the cash rate during the year. The increase in the spread between banks' funding costs and the cash rate occurred in mid 2016; funding costs have been little changed since then.

Graph 2
Major Banks' Debt Funding Costs
Estimated spread to cash rate*



* RBA estimates; numbers represent contributions to the overall change in the spread and may not add to the total due to rounding; bracketed numbers represent negative contributions

** Includes the cost or benefit of interest rate hedges

Sources: APRA; Bloomberg; RBA; UBS AG, Australia Branch

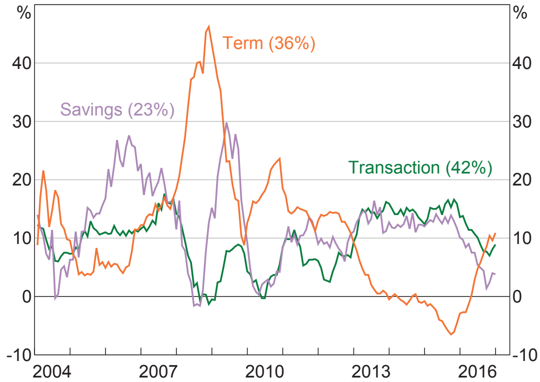
Deposits

Over 2016, the advertised interest rates on at-call savings accounts, such as online and bonus savings accounts, were lowered by less than the total reduction in the cash rate. At the same time, interest rates on term deposits were relatively steady. This followed a period of several years during which average term deposit rates were lower than interest rates on 'bonus saver' deposits (Graph 3).

Consistent with the movements in the relative rates on different deposits, there has been a corresponding change in the composition of deposits, with term deposits growing more strongly than transaction and savings deposits over the past year (Graph 4). The change in the mix of deposit funding increased banks' total funding costs slightly as term deposit interest rates have been higher than other deposit products.

The increased competition for longer-dated deposits, particularly deposits from households and small businesses, reflects the fact that these products are classified as more stable sources of funding under the proposed Net Stable Funding Ratio (NSFR), which comes into effect in 2018 (APRA 2016). The NSFR requires banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. Accordingly, banks have begun to prepare their balance sheets for the implementation of the NSFR by offering higher interest rates on term deposits with longer maturities (Graph 5). However, to date the increased cost of these products has had only a very small effect on total funding costs as term deposits with maturities beyond one year only account for around 2 per cent of total funding. Moreover, household and small business

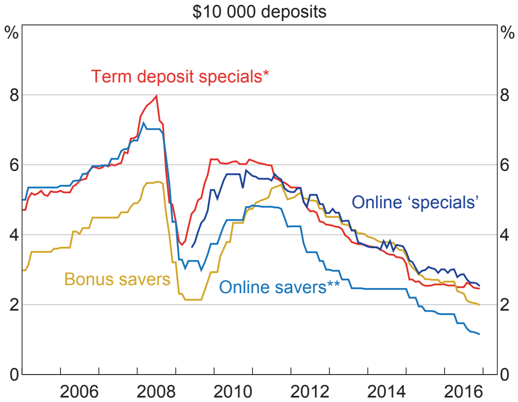
Graph 4
Deposits by Product Type*
Year-ended growth



* Break-adjusted; not seasonally adjusted; excludes foreign currency, intragroup deposits and certificates of deposit; values in brackets represent share of AUD deposits

Sources: APRA; RBA

Graph 3
Major Banks' Deposit Rates
$10 000 deposits

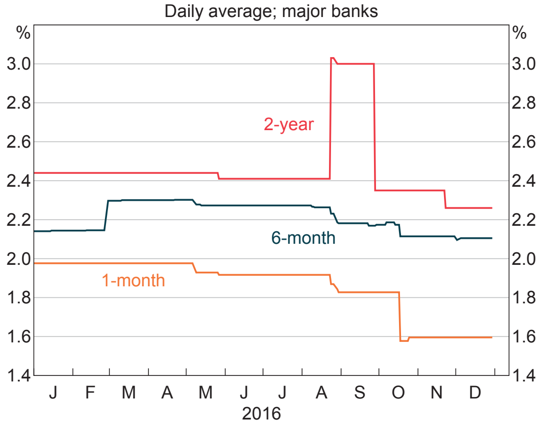


* Average of 1–12, 24-, 36-, and 60-month terms

** Excludes temporary bonus rates

Sources: Canstar; RBA

Graph 5
Advertised Term Deposit Rates
Daily average; major banks



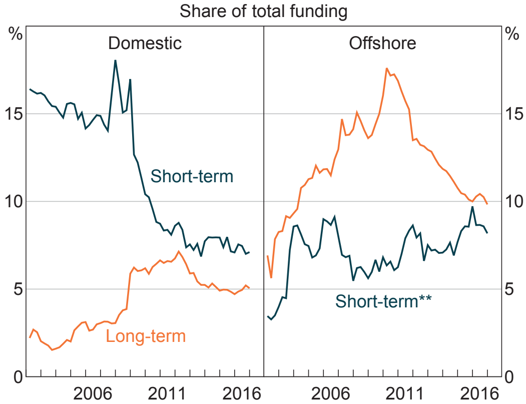
Sources: Canstar; RBA

customers make up a very small proportion of term deposits with maturities of more than one year.

Wholesale Funding

Changes in the cost and composition of wholesale funding had little effect on the major banks' cost of funding relative to the cash rate over the past year. While there was a slight shift in domestic wholesale funding from short-term debt to long-term debt, and an overall lengthening in the term of banks' issuance, this had only a small effect on funding costs (Graph 6).[1]

Graph 6
Major Banks' Wholesale Funding*
Share of total funding

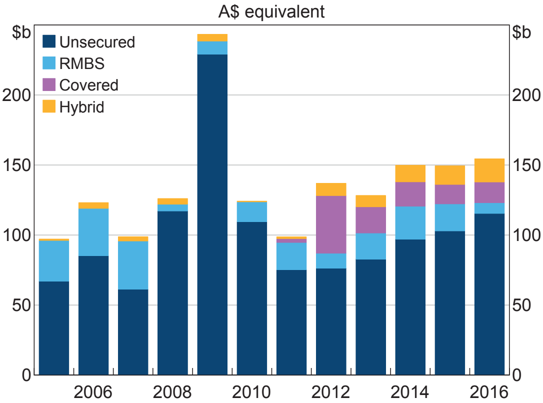


* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA

The volume of issuance by banks of senior unsecured bonds, covered bonds and hybrid instruments increased in 2016 compared with the previous year, although banks issued fewer residential mortgage-backed securities (RMBS) (Graph 7). Primary market spreads for RMBS have narrowed in recent months, but remain above the levels seen in late 2015.

1 Short-term offshore wholesale funding is defined as non-resident deposits and non-resident debt securities issued overseas with a residual maturity of less than 12 months (and includes Australian dollar-denominated and foreign currency-denominated securities), as reported to APRA. Residual maturity is useful for assessing banks' funding task for the period ahead, but overstates the issuance of new short-term debt and understates long-term issuance.

Graph 7
Australian Banks' Wholesale Issuance
A$ equivalent



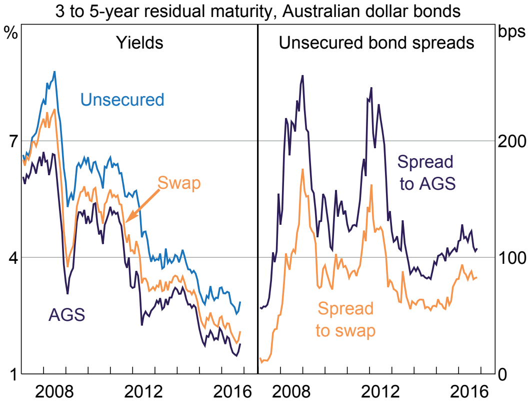
Source: RBA

A decline in wholesale funding rates over 2016 and the refinancing of maturing bonds at lower interest rates have contributed to a reduction in the major banks' outstanding wholesale funding costs. Yields on major banks' senior unsecured debt largely moved in line with sovereign and swap rates in 2016 and, on average, yields were lower than in the previous year (Graph 8).

Conditions for issuance in wholesale funding markets have been favourable for much of 2016; however, wholesale debt funding rates have increased since September, which has raised the cost of issuing new wholesale debt. The cost of new wholesale debt issuance is now fairly close to the cost of outstanding issuance (Graph 9).

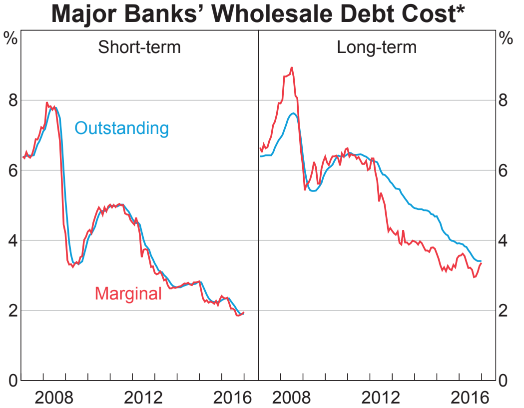
Over recent years, issuance of hybrid securities – securities with both debt and equity properties – has steadily increased owing to the implementation of Basel III capital reforms in Australia. Hybrids have the ability to absorb losses in a situation of stress or default (that is, if certain triggers are breached) and rank higher in a bank's capital structure than common equity, but below senior debt and deposits. While the cost of hybrid funding outstanding has fallen over the year, it remains costly relative to other wholesale funding sources and accounts for a relatively small share of total funding.

Graph 8
Major Banks' Bond Pricing
3 to 5-year residual maturity, Australian dollar bonds



Sources: Bloomberg; UBS AG, Australia Branch

Graph 9
Major Banks' Wholesale Debt Cost*

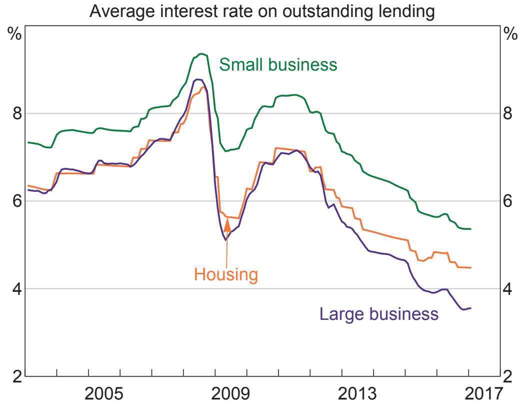


* RBA estimates; rates do not include interest rate hedges
Sources: Bloomberg; RBA

Lending Rates

Interest rates for housing loans generally declined during 2016, but by less than the cash rate, with the average outstanding interest rate on mortgages falling by around 35 basis points (Graph 10). The difference between pricing of owner-occupier and investor housing loans declined a little over the year. Interest rates for business loans also declined by less than the cash rate; lending rates for large businesses fell by around 40 basis points over the year, while small business lending rates declined by around 30 basis points.

Graph 10
Major Banks' Lending Rates*
Average interest rate on outstanding lending



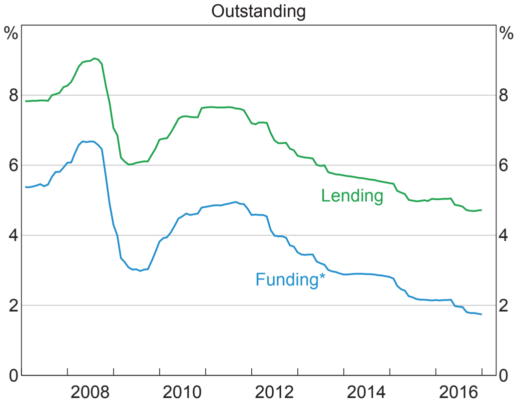
* RBA estimate
Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australia Branch

Towards the end of 2016, banks adjusted their advertised housing lending rates for particular types of loans. These included investor loans, interest-only loans and fixed-rate loans. During the first half of 2016, major banks increased interest rate discounts offered on their standard variable rates; although interest rate discounts were reduced towards the end of 2016 they remained higher than they were a year earlier. Some lenders have indicated that they have implemented these changes in response to higher funding costs and to meet regulatory requirements, including the Australian Prudential Regulation Authority's (APRA) guidance for a maximum growth rate on investor housing credit of 10 per cent. The interest rates on outstanding small and large business borrowing are estimated to have been little changed over the past few months.

Banks' Implied Spread

The major banksí implied spread, which is the difference between average lending rates and average debt funding costs, is estimated to have remained largely unchanged over 2016, as debt funding costs declined by around the same amount as lending rates (Graph 11).

Graph 11
Major Banks' Lending and Funding Rates
Outstanding



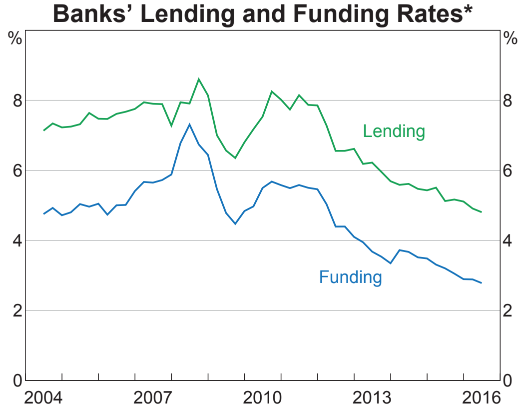
* Assumes interest rate swaps and replicating portfolio hedges
Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australia Branch

The implied spread on major banks' housing lending has been relatively stable during 2016, owing to lending rates moving broadly in line with funding costs. Housing lending accounts for around two-thirds of all lending; changes in housing lending rates can have a significant impact on the overall implied spread. Over the past two years, outstanding housing lending rates have fallen by less than debt funding costs. This smaller decline in housing lending rates was partly in order to offset some of the increase in overall funding costs attributable to increases in equity funding, particularly in 2015; equity tends to be a more expensive source of funding than debt.

The implied spread on major banks' business lending has been stable over the past year. This is because business lending rates have moved broadly in line with funding costs. Over recent years, there has been strong competition between banks for large business lending, particularly from foreign banks, with the average interest rate on business loans written by foreign banks significantly lower than the business lending rate charged by Australian banks.

Average debt funding costs and lending rates for other Australian banks are estimated to have declined by about the same amount over 2016, and by a similar amount to that of the major banks (Graph 12). Other Australian banks have a greater relative share of housing lending and a smaller share of large business lending. They also tend to source a greater share of their funding from deposits. Differences in the asset and liability mix across other Australian banks, and relative to the major banks, can result in differences in lending and funding rates, although this was not a significant factor in 2016. ✠

Graph 12
Other Australian Banks' Lending and Funding Rates*



* Weighted average lending and funding costs; licensed ADI basis
Sources: APRA; RBA

References

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