RESERVE BANK
OF NEW ZEALAND

New Zealand bank funding costs and margins

6 July 2009

Summary

- A large part of the OCR cuts have been passed on to household and business borrowing rates, reflecting the soundness of New Zealand banks.
- However, about 100-150 basis points of the OCR cuts have been offset by higher marginal funding costs for deposit and wholesale funding.
- The spreads between marginal funding costs and floating mortgage rates have widened in recent months to historically high levels. Spreads on fixed-rate mortgages have also increased, but from historically low levels and are now more in line with historical norms.
- There is useful information in the Westpac analysis of bank funding costs, but we take issue with the use of average funding costs as an appropriate basis for marginal pricing decisions. The interest rate on a bank's latest loan will more likely reflect current marginal funding costs than historical average costs.
- We are continuing to talk to the banks to gather information about their funding and pricing.
- Our next public review will be of these matters will be in the Bank's November 2009 *Financial Stability Report*.

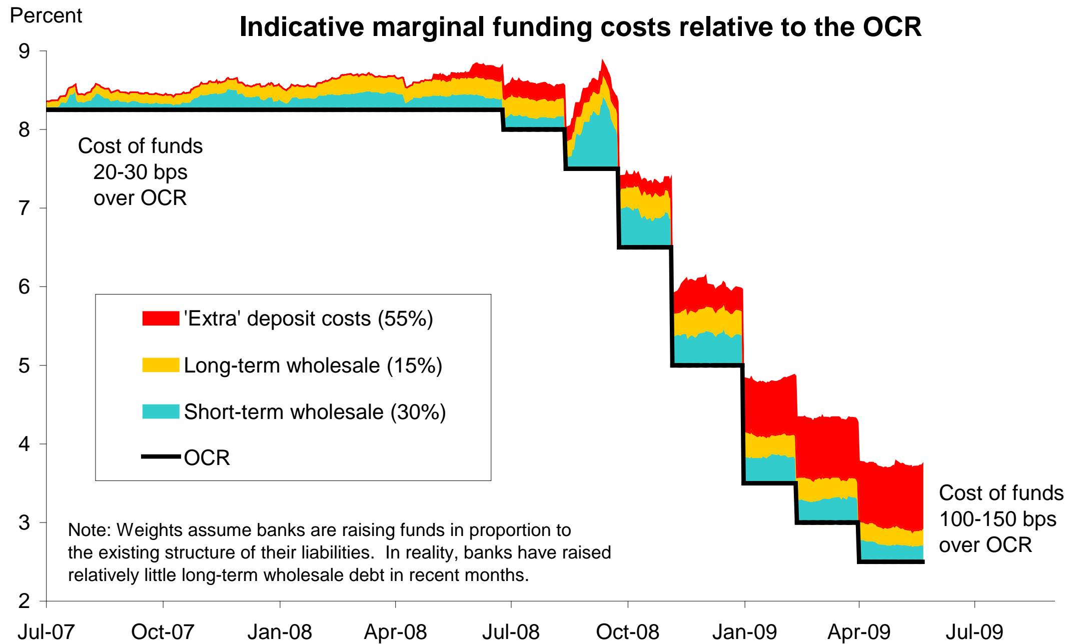
Marginal funding costs relative to the OCR

When making pricing decisions on new loans and credit facilities or on existing floating rate loans, banks focus principally on the cost of raising funds at the margin rather than the average cost of funds measured across their existing stock of funding.

Funding costs have increased across some important sources of funding, relative to their usual benchmarks. While OCR cuts have lowered those benchmarks, increased spreads[1] have reduced the impact of the OCR cuts on overall marginal funding costs.

Marginal funding costs have increased to around 100-150 basis points over the OCR from around 20-30 basis points over the OCR prior to the onset of the global financial crisis (see chart below). That means upwards of about 100-150 basis points of the 575 basis point reductions in the OCR have been offset by increased funding spreads.

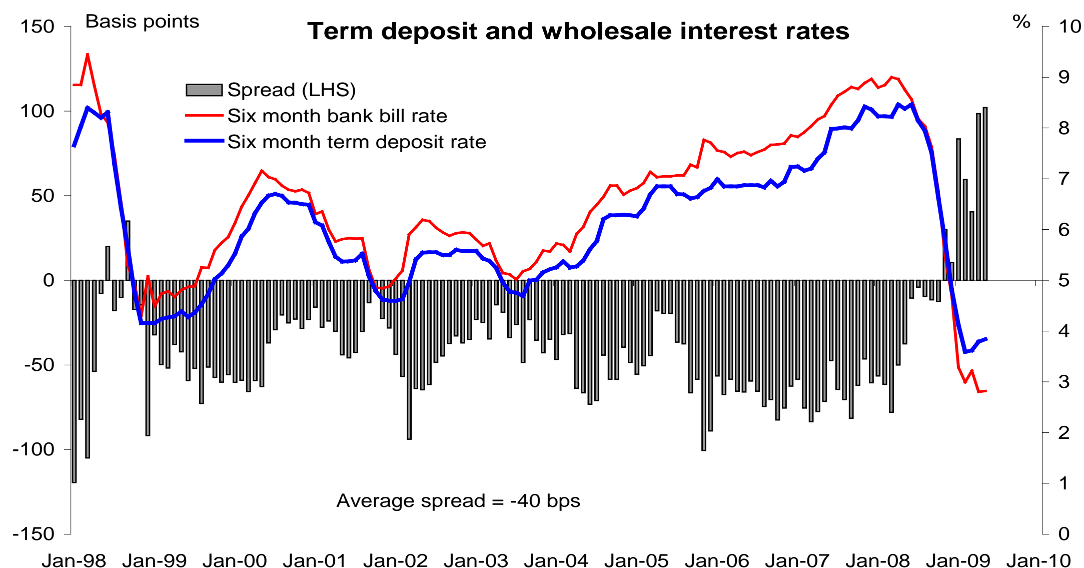
[1] Spread here refers to the difference between the benchmark – e.g. swap rates – and the actual funding rate.



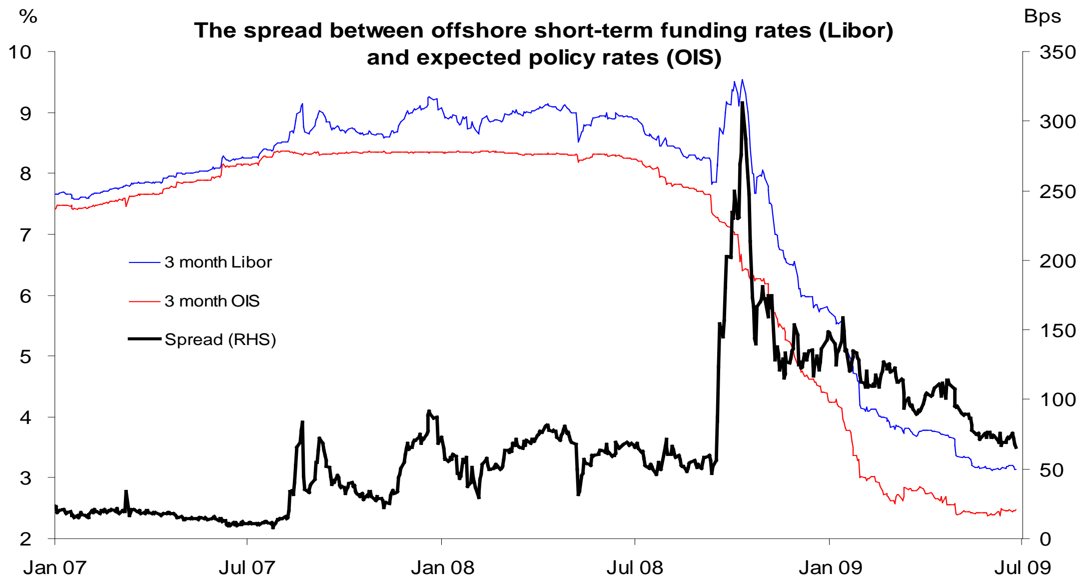
This is an 'indicative' measure. It uses fixed weights for the various funding sources in line with the composition of existing funding. The mix of marginal funding actually being raised by banks at any particular time will vary from this.

There are three major funding channels:

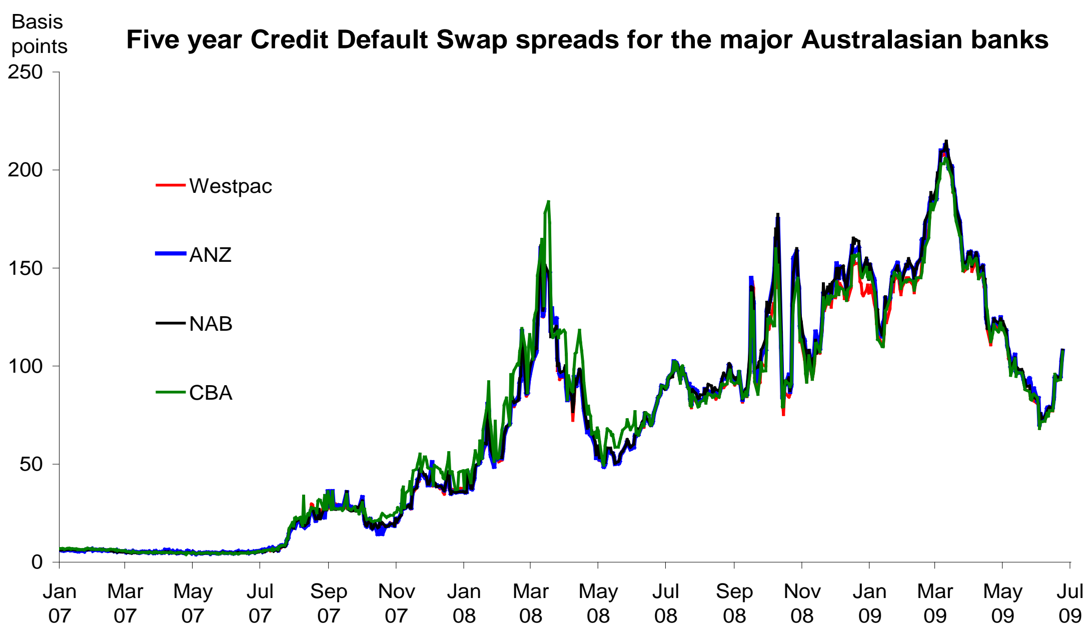
Deposit rates. The cost of deposits has increased. There has been increased competition for deposit funds in recent months, as banks attempt to ensure they maintain, or even grow, this source of funding. Banks are also competing with a raft of recent corporate bond issues targeting retail investors. As shown in the chart below, six-month deposit rates were generally priced at around 40 basis points <u>below</u> six-month bank bill rates prior to 2008, but have recently risen to more than 100 basis points <u>over</u> bank bills.



Short-term wholesale funding. These costs have risen reflecting the increased spreads between offshore short-term funding rates and expected policy rates. As shown by the chart below, these spreads have risen substantially during the crisis – peaking in late 2008 following the collapse of Lehman Brothers. These spreads have subsequently narrowed as central banks have provided increased liquidity and risk appetite has improved, but they remain above pre-crisis levels.



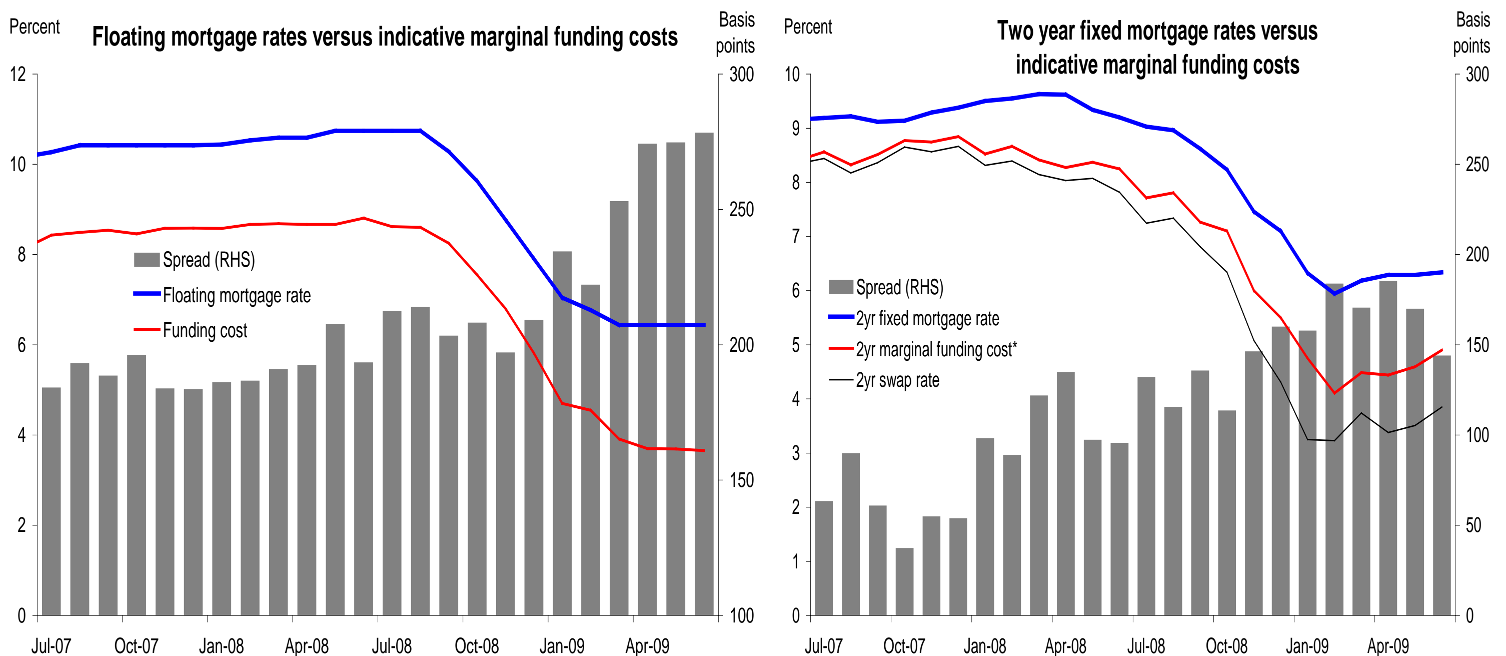
Long-term wholesale funding. These costs have eased from the highs seen in late 2008 – albeit to levels that are still significantly above those prevailing prior to the crisis. Long-term wholesale funding costs are proxied (given the limited amount of recent bond issuance by New Zealand banks) by movements in Australian bank bond spreads, with a margin added to reflect the higher cost for NZ bank issuers. Although not a source of funding in their own right, the movements in Credit Default Spreads for the major Australian banks shown in the chart below provide an indication of the extent to which the funding spreads have increased.



Marginal funding cost compared to mortgage rates

The charts below contrast the overall movement in our indicator of marginal funding costs relative to the mortgage rates being offered to new borrowers and borrowers refinancing existing debt. Over the past several months the floating mortgage rate has lagged the fall in the marginal funding cost indicator, with the spread between the two widening. However, it is difficult to draw conclusions about this spread going forward – particularly given uncertainties around the exact composition of marginal funding costs at any particular time.

The spreads between marginal funding costs and fixed-mortgage rates have also risen. However, unlike the spreads between marginal funding costs and floating mortgage rates – which have risen to historically high levels – this represents a return to more normal historical levels. The spreads on fixed-mortgage rates had fallen to very low levels during the last upswing in the housing market and had remained low until late 2007.



* This is calculated by adding the relevant increased funding spreads to the two-year swap rate.

The Westpac analysis of bank funding costs

"*Funding it tough: a detailed look at bank funding costs*" released by Westpac on 23 June provides some useful perspectives. However, we take issue with the use of average funding costs as a basis for justifying marginal pricing decisions. There is undoubtedly some smoothing of pricing on new loans relative to the short-term movements in marginal funding costs. Notably, banks did not raise rates in response to the implicit increase in marginal funding costs associated with the sharp widening in wholesale funding spreads during late 2008 – although the banks actually raised little, if any, wholesale funding during that period. However, the cost of funding existing loans is not the appropriate reference point for pricing new loans, particularly when the underlying wholesale interest rates are falling rapidly due to cuts in the OCR.

New prudential liquidity policy

The Reserve Bank has recently announced the release of its prudential liquidity policy for banks. The policy sets various balance sheet requirements and disclosure obligations for banks around their internal liquidity management. The purpose of the policy is to ensure that banks maintain strong liquidity positions, making them more resilient to both short term and long lasting funding shocks.

The shift the banks have made themselves over the past six months or so to more stable 'core' funding sources has increased their marginal cost of funds, particularly through higher deposit margins. The new liquidity policy is consistent with this trend and will reinforce it over the long term. Some banks are already meeting the required core funding ratio and the others will have a two-year transition period. Accordingly, we do not expect the new liquidity policy to have a significant further impact on the banks' cost of funds. The policy is only likely to really bite in a cyclical upturn, when the banks might be tempted to revert to inappropriately heavy reliance on the short-term offshore markets to fund a rapid credit expansion.

Conclusion

In contrast to many other countries during the global financial crisis, a large part of the OCR cuts have been passed on to household and business borrowing rates, reflecting the soundness of New Zealand banks. Marginal funding costs for banks have increased relative to the OCR, reflecting increased spreads for deposit and wholesale funding. We estimate that these increased spreads have offset 100-150 basis points of the reductions in the OCR.

The factors influencing the banks' pricing decisions are complex and involve a range of trade-offs. On the one hand, banks must ensure that they earn an adequate rate of return on lending to reflect the underlying credit risks. On the other hand, if margins on loans are expanded unduly, this is likely to carry costs for the macro-economy and can hinder the efforts of monetary policy to stimulate economic activity. On balance, we believe the pricing of the banks' fixed-rate lending products is reasonable given the underlying cost of funds and taking into account the margins typically earned on these products over time. However, the pricing of floating-rate mortgages appears unusually high over recent months and we believe there is some scope for further reductions in these rates without compromising the viability of this lending.

The Reserve Bank is continuing to talk to the banks in order to clarify recent trends in their funding costs and margins. We will review these matters further in the Bank's November 2009 *Financial Stability Report*.

Appendix: Interest rate movements over 2008/09

	Peak level	Recent low	Current	**Net change from peak (basis points)**
OCR	8.25	2.50	2.50	**-575**
90 day bank bill rate	9.1	2.7 (Jun 09)	2.8	**-630**
2 year swap rate	8.8	3.2 (Mar 09)	3.8	**-500**
Six month term deposit	8.5	3.6 (Feb 09)	3.8	**-470**
Floating mortgage	10.74	6.44	6.44	**-430**
Six month fixed	9.93	5.50	5.50	**-440**
1 year fixed	9.90	5.75	5.75	**-420**
2 year fixed	9.63	6.19 (Mar 09)	6.30	**-330**
5 year fixed	9.50	6.56 (Feb 09)	8.00	**-150**
Effective* mortgage rate	8.83	7.63	7.63	**-120**
Business (SME) base lending rate	12.29	9.82	9.82	**-250**
Effective* non-residential rate	9.52	5.94	5.94	**-360**
Credit Card	20.3	18.4	18.4	**-190**

* Average rate currently being paid on outstanding debt