Bank Funding – An Explanation

Sydney, 2 February, 2012: The Australian Bankers' Association (ABA) has today released the following explanation for how bank funding works and why banks are under funding cost pressures.

Steven Münchenberg, Chief Executive of the ABA said: "There is a lot of concern in the community that banks might move their mortgage and small business interest rates independently of movements in the Reserve Bank of Australia's (RBA) official cash rate."

"We understand that many people will be angry if banks do not pass on the full extent of RBA rate changes. For over ten years banks moved in step with the RBA and that created the reasonable expectation that the RBA cash rate was the only factor determining bank funding costs and the interest rates banks charged. Unfortunately, the global financial crisis has shown that this is not the case."

The RBA still influences short term interest rates, but other factors, such as global uncertainty and strong demand for deposits, also affect what banks have to pay when they raise money. For these reasons, the RBA cash rate is no longer an accurate indicator of bank funding costs.

This does not mean banks can set mortgage and other interest rates at any level they choose. The RBA still influences some bank funding costs and can cut or raise the cash rate to drive responses from banks. If the banks do not follow a change in the cash rate, the RBA can adjust the cash rate again until commercial interest rates are where the RBA wants them.

Competition also prevents a bank from overpricing its mortgages or other forms of lending.

Major banks raise the money they lend to customers from three main sources:

1. Around 60% comes from bank deposits, mainly from Australians;

2. 20% comes from money borrowed for less than 12 months from other banks, pension funds and investors, from Australia and overseas; and

3. 20% comes from money borrowed for a longer period, usually from overseas banks and investors.

"Australia's banks have to raise an important proportion of their funding from overseas. The deep crisis in Europe means the cost of borrowing money in those international markets has risen to levels last seen during the global financial crisis. The RBA does not influence the price of money internationally," Mr Münchenberg said.

"Because overseas prices are so high, there is greater demand for funds from depositors and investors in Australia. This has driven up the price of this money as well. While the RBA has been cutting rates, banks have continued to pay high interest rates to depositors, benefitting Australian savers, but adding to the cost of bank funding."

The ABA also acknowledges that many people question why, given the profitability of Australian banks, they have to pass on these higher costs to borrowers, many of whom are already struggling with higher living costs or lower business revenue.

Mr Münchenberg said: "Banks are conscious that the community is concerned that many people are doing it tough. Banks also do not under-estimate the anger many borrowers will feel if all RBA rate cuts are not passed on. For these reasons, banks have been absorbing the higher costs of bank funding for over six months now and have not passed these costs on to borrowers."

"But banks need to balance the concerns of borrowers on the one hand, with the interests of lenders, including retail depositors and superannuation funds, on the other. This is the only way Australia can have a safe and stable banking system that continues to raise money at the best possible price to lend to people buying houses or running businesses, while also adequately rewarding depositors and other providers of funding."

"In globally uncertain times, Australia's banks need a clear signal to investors around the world that our banking system is solid and healthy. A vital sign of this is the profitability of our banks."

"If investors become concerned with Australia's strength, they will charge more for the money they lend our banks, compounding bank funding cost pressures. In the worst case, banks would not be able to raise enough money to meet demand in the Australian economy, resulting in a credit squeeze."

"We should also remember that, following the last financial crisis, the RBA warned that if Australia's banks had only moved their interest rates in line with the RBA cash rate, our banks would have made losses." [1]

"Solid bank profits, together with the strong financial position of the Australian Government, are two of the best safeguards we have to ensure Australia can continue to attract the money we need at a reasonable price to keep the economy going."

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1 In December 2009, Deputy Governor of the Reserve Bank, Ric Battelino, stated: "We estimate that if banks had not adjusted their lending interest rates to reflect their higher cost of funds over the past couple of years, they would now be incurring losses. That would have threatened their ability to keep raising funds and, in turn, their capacity to lend." Battellino, R (2009). Some comments on bank funding – Remarks to the 22nd Australasian Finance & Banking Conference. 16 December 2009.

http://www.rba.gov.au/speeches/2009/sp-dg-161209.html