# BANK LENDING RATE CONSIDERATIONS AND LINKAGES TO THE CASH INTEREST RATE

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Public information

# FACTORS CONSIDERED WHEN REVIEWING HOME LOAN RATES

ANZ considers a range of factors when setting the headline interest rates for home loans, including:

- **Domestic depositors:** Borrowings are in part sourced from domestic deposits and ANZ is committed to providing competitive returns for customers' savings.
- **Cost of funding:** Together with domestic deposits, borrowings that fund home loans are sourced from wholesale borrowing and the equity capital required to be held against those assets. How these sources change in price and availability is also a key consideration.
- **Competitive position:** ANZ is determined to remain competitive by attracting customers, winning business and managing our costs.
- **Impact of economic conditions on customers:** An important factor for Headline Interest Rate change is the impact of current economic conditions on ANZ customers and the financial impact on them of any rate change.
- **Regulatory requirements:** Australian banks work within a strong prudential and regulatory environment that requires ANZ to hold capital reserves and levels of liquidity to operate safely and securely for its customers.
- **Business performance:** ANZ balances the interests of all stakeholders, including our shareholders, who take the risk and expect a fair return on their capital.

All of these factors are taken into account in deciding headline interest rates. There is no specific weighting determining individual factors.

This document discusses how Australian banks typically fund their loans, which is a key consideration in determining any changes to interest rates for lending – as outlined above.

# BANK LENDING RATES AND THE RBA CASH INTEREST RATE

While banks respond to changes in the cash interest rate, those changes don't necessarily mirror the RBA change, including timing. The RBA cash interest rate is not the *only factor* impacting bank funding costs. *Overall* cost of funding (one of the considerations above) is a key determinant when banks make rate decisions.

## The cash interest rate and banks' cost of funds

The cash interest rate is the rate at which banks pay one another for overnight loans of cash. Even though it's a market rate, the RBA sets the target cash interest rate because it controls the overall supply of funds in this market. The RBA can provide, or withhold, as much cash as it likes to the banking system to shift the cash interest rate up or down via supply and demand.

The RBA does this to influence other interest rates charged by banks and other lenders.  When the RBA lowers the cash interest rate, it wants all lenders to lower their loan rates too, so credit is cheaper in the economy. When credit is cheaper, people typically borrow more money and economic activity is stimulated.

The linkage between the RBA cash interest rate and the interest rates banks charge on their loans to customers is not direct or completely correlated. The primary factor influencing a banks cost of funds is the overall price the bank has to pay to get all the money it needs to fund lending. This price is a bank's "cost of funds". The RBA cash interest rate, while important, is only one component of a bank's cost of funds.

Banks don't fund their loans by borrowing each night at the RBA cash interest rate. In fact, a negligible portion of their balance sheet is funded this way. Instead, banks fund their loans with different types of borrowings, generally for periods much longer than overnight, sourced from Australia and offshore.

Foreign funds are converted to Australian dollar (AUD) liabilities and interest rates are not directly referenced to the RBA cash rate.

## Domestic Deposits

The banks themselves, in competition with one another, determine the interest rates they pay to depositors for leaving their money with the bank. A bank that wants to attract more deposits or keep those deposits it already has must offer high enough interest rates to attract more deposits and/or discourage depositors from taking their money elsewhere.

Many domestic customer deposit rates are at or close to 0% - in particular those deposits that offer a large range of payment types and features to support a transactional-type account. As such, the rates banks pay on these deposits do not decrease in line with RBA cash rate decreases – in effect the relative cost of this funding increases.

## Wholesale borrowing

Apart from deposits, banks also borrow from wholesale investors, typically large fund managers, corporations and other investors. They do this by selling securities (bonds and other financial instruments) to wholesale investors on specialised financial markets in Australia and overseas.  This is also called issuing "bank debt".  Banks also use the proceeds of these security sales to fund loans.

Debt provided to banks for longer periods of time is more expensive. Short-term debt is due within 12 months, long-term debt comes due in periods beyond 12 months. The use of short term debt now however, is a relatively modest proportion of a bank's overall funding. Bank regulation also requires banks to hold a higher proportion of wholesale debt as long-term debt to meet minimum regulatory requirements.

Interest rates on wholesale borrowings are determined in securities markets, the RBA does not set them. These markets have many buyers and sellers, not just banks. Their trading determines the interest rates borrowers pay to the lenders. These market-based rates shift continually – hence so does a bank's 'cost of funds'.

## Average cost of funds

While the level of the RBA cash interest rate can and does influence the interest rates banks pay on deposits and wholesale borrowings, the effect is indirect and takes time to work through the system.

Overall, a bank's average cost of funds depends on how much it has of each type of borrowing and the rates paid on each type. How a change in the RBA cash interest rate impacts the average cost of funds depends on how much each type of borrowing is affected by the cash rate and how much of each type is used by the bank.

## Business Performance and net interest income

Lowering loan rates by more than a fall in the average cost of funds can lower a bank's net interest income (NII). NII is the difference between the income received on assets (such as loans) and the interest paid on funding. NII is one source of bank revenue, along with fees. Absent other changes, lowering NII impacts overall Business Performance, generally lowering bank profits.

Lowering bank profits can affect bank shareholders, as they may receive lower returns on their investment. Shareholders may hold shares in banks directly or through their superannuation funds.  So when banks think about changes in business performance from interest rate reductions, they also consider the impact upon their shareholders.

In addition, lower bank profitability may have consequences for prudential soundness, which is the concern of the Australian Prudential Regulation Authority (APRA), the bank supervisor. The position of bank prudential supervisors like APRA globally is that banks should be profitable enough to both support the economy and maintain a strong balance sheet to protect depositors and other funding providers.

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