Developments in Australian Bank's Funding Costs and Lending Rates

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Abstract. This paper focuses on the funding costs and the lending rates of banks in Australia. As the world emerges from the COVID-19 pandemic, more and more countries need to change their financial policies to fit the new situation. In this trend, the central bank of Australia, which is the Reserve Bank of Australia, plans to increase its cash rate to stop or reduce the starting rate of inflation. Through analyzing the report from the Reserve Bank of Australia (RBA) and articles from related academic works of literature, this writer found some points to understand, evidence, and analyze. It also analyze the importance of the Australian central bank to change the cash rate. After analysis, the result shows that due to the change in the confidence of customers and the increase of the rate of inflation after the COVID-19 pandemic, the central bank had to increase the cash rate. Through tighter financial policies, the central bank planned to stabilize the economy of Australia. Meanwhile, the pressure of Australian banks grew as the funding cost increased and the requirement for home mortgage loans decreased. For future research on the cash rate, it is advised to evaluate that if the continuous increases in cash rate are overused in the future. This might need at least half a year or even longer time to wait for the impact of the policy and the effect on the market and the banks.

Keywords: Australian Bank; cash rate; funding cost; lending rate; Reserve Bank of Australia.

1. Introduction

The position of finance has become much more important than before due to the recent development and promotion of global economic growth. The bank is one of the most vital parts of the whole financial system. It plays a significant role as nearly everything related to the financial system. The tiny change in funding cost and lending rates always impacts a bank's revenue and cost. This paper focuses on the banking industry in Australia. It will discuss the major problems banks have recently faced and provide unique recommendations.

Finance researches the money and capital transfer process from investors to the project they want to invest in. Suppose depositors and investors have extra money and the motivation to earn more income. In that case, they might earn the interest or the profit by investing in some project such as funds, stocks, insurances, options, futures, trusts, real estate, etc. Although it has a strong relationship with the economy, they differ as finance focuses on currency, capital and custom. In history, finance does not have a very long history as an independent subject. It divided from the subject of economics since the middle 20th century. The performance of a country's economy can be directly reflected in its financial situation as the relationship between the economy and finance is close. In general, it obviously displays that if most of the stock price of the major companies in a stock exchange goes down, the economic performance can be recognized as worse and terrible in a country. From a global view, since the Global Financial Crisis (GFC) happened in 2008, countries worldwide have adopted loose financial policies to reduce the impact of the GFC on their economies. Until the period after the large spread of the COVID-19 virus, considered uncontrollable inflation, global central banks started tightening their financial policies.

The bank is a kind of financial institution that makes loans by collecting deposits from the public. In general, most commercial banks profit from the gap between the deposit interest rate and the loan interest rate. This is the major income of a bank. Banks also attach businesses such as foreign exchange trading, trade of derivative instruments, portfolio investment, bank card business, financial management business, etc. The bank always plays a very significant role in a country. It helps the government to make the national economy and finances stable and healthy. Because of this, most of the regulators highly regulated banks. It also reduces the possibility of a bank to go broken as it is easy to cause social disorder.

Like the above text, banks profit from the gap between the deposit interest rate and the loan interest rate. They earn the revenue from the interest that lends money to customers, and the cost is the interest that pays back to depositors. Thus, it shows clearly that any small adjustments to these two rates will lead to large impacts on the revenue and the cost of a bank. First of all, for the funding cost of a bank. It depends on the interest rate at which banks borrow money from depositors [1]. When the interest rate is low, banks might fell hard to gather money from depositors. Because for the depositors, the rate of return is too low to invest. Secondly, the lending rate is the cost of borrowers who want to borrow money from banks. It also impacts the short-term interest rate, such as the rate on car loans, credit cards, and home loans. If the rate is low, potential consumers will come and borrow the money. To some extent, it stimulates the development of the economy. Finally, in most western countries, the central bank often sets a fixed or a range of the target basic interest rate. For example, in the USA, it is called the Federal Funds Rate. In Australia, it is called the Cash Rate. If the target interest rate is low, banks will get better revenue while it provides long-term or short-term loans to borrowers. However, while the rate is high, the cost will transfer to borrowers. They have to accept a higher loan interest rate to get a loan.

2. Australian Banking Industry

In general, the banking industry in Australia is stable and growing healthy. According to the RBA, three major types of intermediaries exist in the Australian financial industry [2]. The first one is authorized deposit-taking institutions (ADIs). Including banks, building societies and credit unions. All of them are regulated by the Australian Prudential Regulation Authority (APRA), which has been the prudential regulator for the financial services industry in Australia since it was established in 1998. The second is the non-ADI financial intermediaries, which include money market corporations, finance companies and securitization vehicles. The major regulator is the Australian Securities and Investments Commission (ASIC), which is an independent commission that regulates companies and financial services. It also enforces the law to protect the rights of consumers, investors and creditors in Australia. The last type is funds managers and insurers. Life insurance companies, superannuation, and trust management companies are typically included in it.

Banks play a significant role in ADIs. Commonwealth Bank, Australia & New Zealand Banking Group, National Australia Bank and Westpac are the four most significant banks in Australia. The total asset equals about 80% of the whole Australian banks' assets, which is about 960 billion AUD [2]. In the global range, these four banks are huge, and all of them are in the range of the top 80 largest banks. They all have strong profitability, as their average pre-tax return on equity has been 21 % during the past ten years. In these recent years, similar to most countries that own sound financial systems, the Australian banking industry is not stable, and the performance is wild fluctuations. Due to the spread of COVID-19 since early 2020, the Reserve Bank of Australia (RBA), the central bank of Australia, constantly changed its financial policy to make the domestic economy sound and healthy. The most typically financial tool is the cash rate, the interest rate that financial institutions lend to each other. It also benefits Australian banks and companies walking on the new road to fit the new global situation after the pandemic.

3. Change of Cash Rate Target

Compared with China, the RBA does not take part in the decision of deposit interest rate and the loan interest rate in each commercial bank directly. Australian central banks use the financial tool, the cash rate, to adjust the national economy. The cash rate is the rate of interest that loan money between Australian financing institutions, which is the interest rate on an unsecured overnight loan between banks. It is also the rate of risk-free benchmark interest rate in Australia. Cash rate plays an important role in the Australian financial market. Cash rate also has the ability to vary the cost of borrowing and the interest on savings. Which means it has the power to change the lending rates and the deposit rates. In Australia, RBA is responsible for formulating and implementing the monetary policy [3]. The major goal of the monetary policy is to maintain the stability of the currency and full employment. Basically, these goals have been achieved within the period that the consumer price inflation has been 2% to 3% since the early 1990s. In order to achieve the target cash rate, RBA does the open market operation. The central bank adjusts the cash rate by selling or buying back national bonds or any other securities issued by governments at all levels. RBA influences the cash rate and the liquidity provided to the financial system by controlling the funding supply by trading.

According to RBA, Figure 1 clearly shows that the target of the cash rate went down during the past 20 years [4]. Obviously, there are two large and rapid changes in the figure. First of all, the cash rate was 7.25 percent before 6 August 2008. Then it dropped to 3 percent on 8 April 2009 due to the global financial crisis. Secondly, the other sharply increasing just happened during the past half a year. The cash rate has been just 0.1 percent since 4 November 2020. However, due to the necessary high rate of inflation problems in the domestic, RBA growth the cash rate up to 2.6 percent on 5 October 2022. This level is just less than the date of 8 May 2013. The cash rate was 2.75 percent in that age.

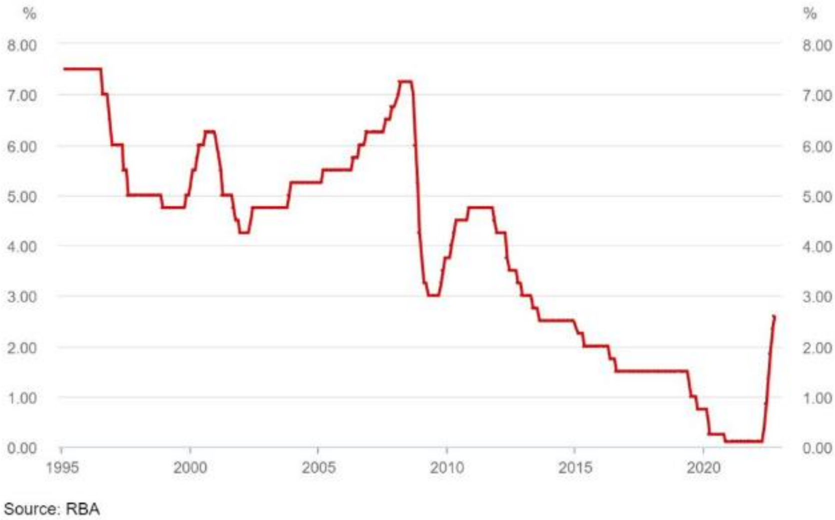

Fig 1. Cash rate target [4]

Such a fast and quick increasing speed display the determination to control excessive inflation. According to RBA, Figure 2 clearly shows the inflation rate during the past 70 years in Australia [3]. Exclude the very high inflation rate period from the 1970s to 1990s, in which the top inflation rate was over 17 percent in 1975. Most of the time inflation rate was around 1 percent to 2.5 percent. Since the 1970s, the inflation rate has decreased slowly from 17.7 percent to 2.6 percent in 1991. At the same time, the target cash rate decreased from 17.5 percent to 8.5 percent in late 1991. Although the gap is still very large, their trend is the same, and both were reduced to a low level. The inflation rate was stable during the 1990s and the early 2000s until the global financial crisis appeared in 2008. The global financial crisis hates the Australian economy deeply. The inflation rate spent only half a year and increased rapidly from 1.8 percent in September 2007 to 4.3 percent in March 2008. It reached 5 percent in September 2008, the highest point since 1991 and until 2022. In order to stop severe inflation, RBA increased the cash rate target to 7.25 percent, the highest rate since the early 1990s. From the result, the activity was effective and efficient. The inflation rate declined sharply to 1.2 percent in September 2009. After the global financial crisis, the target cash rate and the inflation rate dropped slowly. Although the inflation rate fluctuates wildly, overall, they trend downward. The central bank pursued a policy of ultra-low target cash rate, which target cash rate was only 1.5 percent from 2016 to the middle of 2019, and it even decreased to 0.75 in the last month of 2019.

Fig 2. Inflation over the long run [3]

Since the COVID-19 pandemic appeared in early 2020, the inflation rate went down to negative 0.3 percent at first and then increased sharply to over 3 percent at the end of 2020. At the same time, the cash rate target went down from 0.75 percent to 0.1 percent. Such an abnormal low cash rate shows the determination of the central bank to stabilize the Australian economy during the pandemic. Australian banks had also adopted the new challenges from the adjustments of the economic and financial policies. These challenges have affected the funding cost and the lending rates of banks. In the whole of 2021, the inflation rate was around 3 percent. The cash rate target maintained the 0.1 percent goal. RBA selected conservative economic and financial policies due to the uncertain impact of COVID-19, such as the random city lockdown, the traveling limitations, and several necessary healthy policies to stop the spread of the virus. Finally, the inflation rate growth fasts since September 2021. It increased from 3 percent to 6.1 percent in June 2022. Meanwhile, the cash rate target increased rapidly as it just spent half a year from 0.1 percent to 2.6 percent. During the research period, RBA in order to reduce the rate of inflation to raise the cash rate target on 4 October 2022 [5]. It is not hard to find that the reaction speed of RBA is not timely. RBA just remembered to increase the cash rate target in May 2022, which is over six months since the quick increase in the inflation rate. Meanwhile, customers faced more tricky financial pressure as the Australian big four increased their standard variable home loan rate [6].

Until now, unfortunately, such a high-speed increase in the cash rate target still not stop the fast growth of the inflation rate. Thus, it is still very likely that the RBA will keep raising the cash rate target until the inflation rate declines, but the increase will be smaller than before as the RBA wants to avoid the overexerted tight policies [7]. And this will continue to raise the prospect of higher funding costs and lower income from lending to Australian banks. This increases the operational risks of banks.

4. Impact of Cash Rate Target

Table 1 is the income statement of the Commonwealth Bank of Australia (CBA). This income statement shows the income and expenses of CBA until 30 June 2022. The statement shows clearly that the adequate interest revenue went down from 30 billion AUD at the end of the financial year 2020 to 24 billion in 2022. Such a vast decrease has a strong relationship with the low cash rate target of the central bank. The cash rate target was only 1.5 percent to 0.1 percent during that period. Meanwhile, the low requirement for loans during the COVID-19 pandemic also impacted revenue.

The interest expense also went down from 11.5 billion to 4.8 billion. It is a considerable decrease. This decrease has a vital connection to the low cash rate target. However, the net profit increased from 9.6 billion to 10.8 billion. The researcher believes that the net profit increased due to the decreased speed of interest expense being faster than the interest income. Therefore, the change in the cash rate target influenced Australian banks during the COVID-19 pandemic.

Table 1. Income Statement of CBA ($Billion) [8]

	2022	2021	2020
Effective interest income	23.987	24.804	30.053
Interest expense	4.820	5.819	11.552
Net profit attributable to equity holders of the Bank	10.771	10.181	9.592

Compared with the neighboring country New Zealand. New Zealand started to increase the interest rate about seven months earlier than Australia [9]. However, the situation in New Zealand shows that just a minimal number of customers transfer their savings from low-interest accounts to high-interest accounts after increasing the cash rate target at once. It points out that this change should be changed at a low speed if the central bank changes the cash rate target before the inflation rate increases. This fact reduces the pressure on the funding cost of the bank because customers need more time to react to the higher interest-rate revenue. Meanwhile, the number of loan applications decreased due to the requirement reduction. It is a bad signal to banks as there is weak demand growth. Moreover, during the COVID-19 pandemic, the wake of global economic growth also reduces the motivation that companies want to expand their business. Companies are focusing on supply chain issues and the lack of labor force. The banks should adopt to the higher funding cost and the lack of demand for mortgages. Although the head banks might have enough powerful assets to face the possible challenges, their profit cannot avoid the decline as the interest rate differential of lending rate and the deposit rate unavoidably become smaller and smaller.

Thus, to some extent, the action of the Australian central bank was a little bit slow to maintain the stable performance of the domestic economy. According to Gerard Perignon, the growth speed of deposits has been faster than the loan since COVID-19 in Australia [9]. However, with the increase in the cash rate, more and more citizens will try to transfer their money from low-interest rate saving accounts to the high-interest rate fixed term deposits. This must increase the funding cost of banks. Additionally, most Australian banks are trying to increase their lending criteria to face the potential higher funding costs [10]. It is easy to understand why banks increase the requirements for applicators. Banks reduced bad debts by raising lending standards. To some extent, this method can relieve the cash flow and capital pressure of banks. However, it does not benefit to the sluggish demand in the loan market. It even reject those customers that can help banks to digest idle funds. From this perspective, falling loan demand and higher cash rates leave Australian banks with a significant risk of lower profits.

5. Discussion

In general, the development of funding costs and lending rates in Australian Banks is stable and fits the global financial environment. However, there are still some disadvantages appeared in the Australian banking industry. As a bank, there are three significant risks. Credit risk, market risk, and liquidity risk. First, during the COVID-19 pandemic, customers can reject returning their loans to banks, leading to credit risk. A lot of new traveling limitations and new healthy protection policies impacts the tourism and food industry. These customers might face a tight cash flow and lack enough money to repay the loan. Secondly, the considerable changes in the exchange rate during the COVID-19 pandemic also impact the financial asset value. Thirdly, due to the difference in the cash rate target, depositors might change their savings plans immediately. It might increase the funding cost of the banks. The banks have to prepare more cash to face the potential risks. This might reduce the risk of the bank run due to a mismatch between the date of the deposit and the loan.

Therefore, the researcher recommends that Australian banks need pay more attenuations to risk management. The banks need to improve their resist-risk ability during the pandemic. They need to prepare more assets to face the potential sudden changes in the cash rate target. Meanwhile, the Australian central banks need to improve their leadership ability. It needs to study other countries with a similar economic structure to Australia. It should not be too optimistic about the new changes, and it should react faster to the recent economic challenge, whether it comes from the global financial market or the domestic economic risks.

6. Conclusion

In conclusion, the developments of the funding costs and the lending rate in Australian banks is stable and fitting the change of internal and external environment. Most banks can adapt to this development. In Australia, funding costs and lending rates of the banks have a strong relationship with the cash rate target, which set by the central bank. Funding costs and income for Australian banks have also changed in recent years through aggressive adjustments to the cash rate from the central bank. Such a change in the cash rate would not have prepared banks well in advance to face sudden risks. Banks have to reduce the potential losses in the face of this sudden change in risk.

On the one hand, although the Reserve Bank of Australia intended to decrease the consume inflation rate and increased the cash rate, the funding cost of Australian banks increased at the same time. In some sense, an increase in the funding costs of banks could not be benefit for the development of the national economy. Because Australia's banks play an important role in every sector of the country. It not only has the strong relationship with the financial system but also has the indirect connection with every major and important industry. On the other hand, the change in the cash rate target influences the revenue and cost of the banks in Australia. Although the net profit of the bank increased due to the lower funding cost during the COVID-19 pandemic, the net profit should highly possibly go down as the cash rate target has increased since the middle of 2022. This leads to higher funding costs. However, the requirement for the loan should be lower as companies are focusing on the supply chain but not expanding their business. Thus, the lower requirement and the higher funding cost will reduce the net profits of banks. Australian banks will face new challenges and risks in operating.

There are still some limitation of the research of this paper. There is still some limitation of the research of this paper. First, this paper focuses on the typical and significant financial institutions in Australia. The study in this paper cannot be representative of Australia as a whole. It ignores several potential special and unique situations in small banks. The data analyzed in this paper comes from the Australian central bank and typical Australian large bank. Secondly, although the COVID-19 pandemic looks to be ending, it is still not sure if there will be a new and necessary wave of the pandemic in the future. At last, during the study, only Commonwealth Bank of Australia issues the 2022 annual report. Australia & New Zealand banking and other big four banks have not issued their annual report. Due to the lack of information, this paper only analyzes the impact of Commonwealth Bank of Australia. Meanwhile, suppose the Australian economic and financial policies are changed and impact the funding cost and lending rate of banks. In that case, thus, these vital points are the limitation of the study in this paper.

For future studies, the research will focus on the significant financial institutions and small and untypical banks in Australia. The expansion of the research range is beneficial to research the funding costs and lending rates deeply. Moreover, as time goes on, future research can pay attention to the impact of funding costs and lending rates during the COVID-19 pandemic. This will help the researcher come to a conclusion closer to the objective fact after understanding, evidence, and analyzing the financial situation.

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