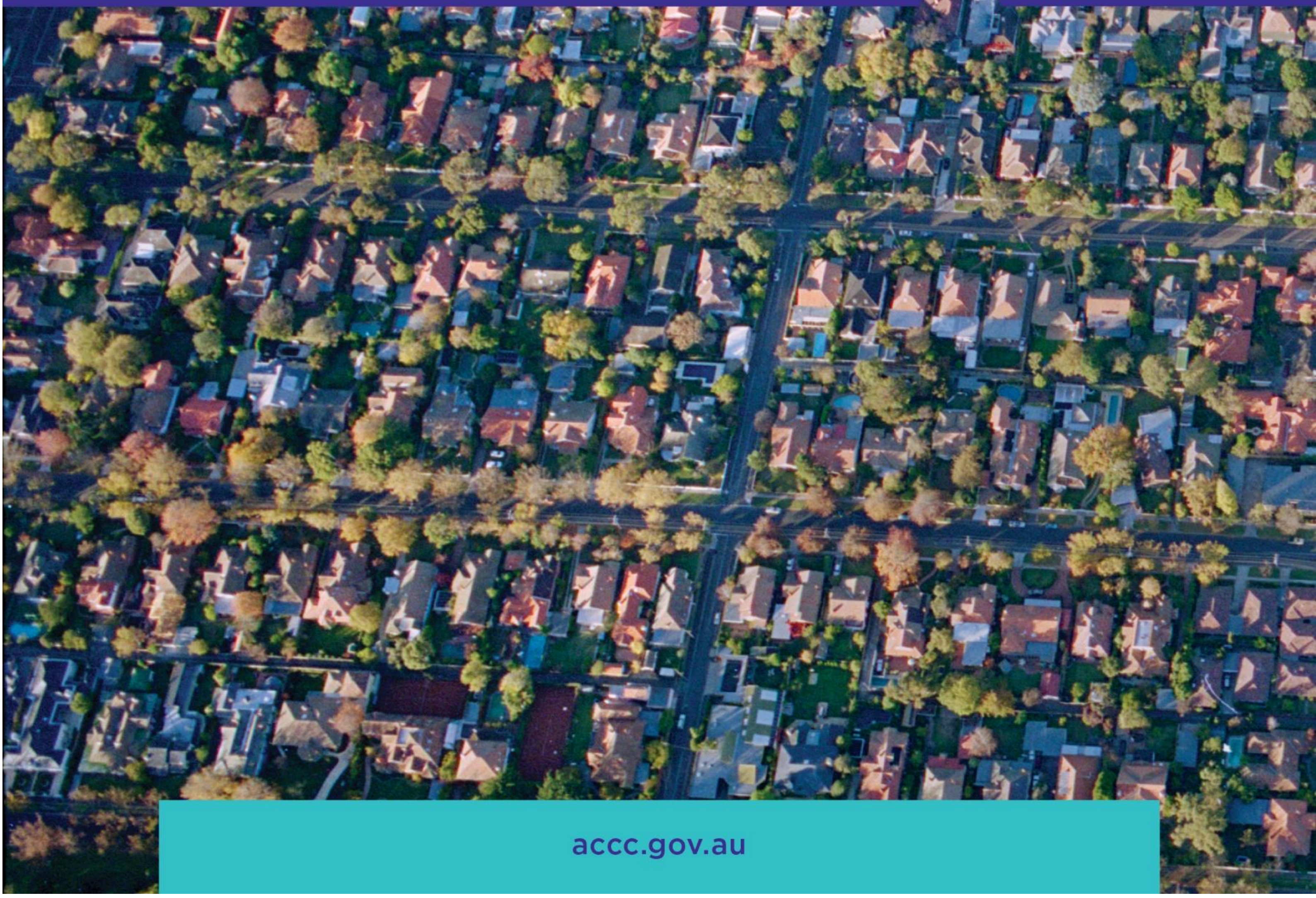
AUSTRALIAN COMPETITION
& CONSUMER COMMISSION

Home loan price inquiry

Interim report

March 2020



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Abbreviations and glossary

ACCC	Australian Competition and Consumer Commission
ADI	Authorised deposit-taking institution
ANZ	Australia and New Zealand Banking Group Limited
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
Basic home loan	Home loan products offered without the add-on features available under a standard home loan (defined below)
Basis points or bps	A unit of measure for interest rates. 1 basis point equals 0.01 per cent
Big four banks	ANZ, CBA, NAB and Westpac
Cash rate	The interest rate that banks pay to borrow funds from each other in the money market on an overnight basis. The cash rate is calculated as the weighted average interest rate on overnight unsecured loans between banks settled in the Reserve Bank Information and Transfer System
CBA	Commonwealth Bank of Australia
Cost of funds or funding costs	The total cost for a bank to fund its lending activities from a pool of sources that may include, but is not limited to: deposits, short−term wholesale debt, long-term wholesale debt and equity
Discount	A reduction off the headline variable rate. The interest rate paid by the home loan customer is usually expressed as the headline variable rate (less any discounts granted by the lender). There are two main types of discounts. The first type of discount is those publicly advertised by lenders. The second type of discount is those offered at the lender's discretion on a case-by-case basis to individual customers
Fixed rate home loan	A home loan where the interest rate is set and does not vary over a time period agreed with the customer and set out in the loan contract (the fixed rate period)
Funds transfer price or FTP	The interest rate charged by a bank's treasury unit for 'lending' money to the business unit(s) responsible for providing loans (such as home loans). The funds

	transfer price should reflect the bank's cost of funds along with adjustments to cover other costs including: • the cost of managing the mismatch of funding long-term loans with short-term deposits (for example, the cost of liquidity requirements) • the cost of hedging to manage the risk of borrowing at fixed rates (and sometimes in foreign currencies) and lending at variable rates (and in Australian dollars)
Headline variable rate	The reference rate on which the variable interest rate paid by both new and existing variable rate home loan customers is based
Home loan or residential mortgage product	A loan secured by a mortgage over one or more residential premises
Interest-only benchmark	A regulatory benchmark implemented by APRA in March 2017 to limit new interest−only lending to 30 per cent of new residential mortgage lending
Investor loan	A home loan used to purchase or construct a residence as an investment
Lag period	The time between the announcement date of a headline variable rate change and the date the headline variable rate change came into effect
Loan to value ratio	The amount of a home loan expressed as a percentage of the value of the property being used as security for the home loan
Levy Banks	The five ADIs subject to the Major Bank Levy (ANZ, CBA, NAB, Westpac and Macquarie Bank Limited). These banks were the focus of the Residential mortgage price inquiry
NAB	National Australia Bank Limited
Owner-occupier loan	A home loan used to purchase or construct a residence for the home loan customer to live in
Package	An arrangement under which a customer is eligible for discounts and/or other benefits on a specified range of a lender's products such as transaction accounts, credit cards and home loans. To be eligible for a package a customer may need to maintain specific products with the lender and, in some cases, pay an annual fee
Price monitoring period	1 January 2019 to 31 October 2019

Price reduction	Any reduction (customer-initiated or bank−initiated) in the interest rate or recurring fees granted to an individual customer after a home loan has been established, other than via a reduction in headline variable rates, and excludes any reductions arising from the customer switching product or repayment type
RBA	Reserve Bank of Australia
Standard home loan	Home loan products supplied with a range of add on features. In general these home loan products can, but need not, be taken as part of a package
Variable rate home loan	A home loan that has an interest rate that can fluctuate over the period of the loan. The interest rate can be changed at any time at the lender’s discretion by altering the relevant headline variable rate
Westpac or WBC	Westpac Banking Corporation

Overview

This interim report focuses on findings about the pricing of the big four banks' home loans during the period 1 January 2019 to 31 October 2019 (the price monitoring period). We examined a range of documents and data on the prices paid by customers for their home loans, including collecting significant information from the big four banks. Many of our findings reinforced or built on findings from our previous Residential mortgage price inquiry (those findings are summarised in box 1 below).

Our final report, to be provided to the Treasurer by 30 September 2020, will examine impediments to home loan customers switching between lenders.

Interest rates paid by home loan customers

There are two components that determine the interest rate a home loan customer pays: the headline interest rate and discounts off that headline interest rate. Reductions in headline variable interest rates following cuts to the cash rate and increasing discounts drove a reduction in the average interest rates paid on variable rate home loans over the price monitoring period. However, a lack of price transparency and the tendency for lower interest rates to apply on new loans compared to existing loans will have tempered the benefit to some consumers from falling interest rates.

A lack of price transparency makes it difficult for consumers to compare home loans

There has been little difference in the headline variable rates of the big four banks. In any event, headline variable rates have not been an accurate indicator of what most home loan customers of these banks actually pay, or what most consumers should expect to pay. This is because the overwhelming majority (close to 90 per cent) of the big four banks' home loan customers receive discounts off the headline variable rate. For many customers, these include both advertised discounts and discretionary discounts. For example, as at 31 October 2019, the gap between the headline variable rate and the average interest rate paid on standard owner-occupier loans with principal and interest repayments across the big four banks ranged from 123 to 131 basis points.

This gap between headline variable rates and the average interest rates paid by customers increased for each of the big four banks between 30 September 2018 and 31 October 2019. This widening of the gap was due, in part, to a large increase in the number of big four bank customers that received a discount of 150 basis points or more off the headline variable rate. As at 31 October 2019, around 13 per cent of the big four banks' customers received a discount of 150 basis points or more off the headline variable rate, while around 11 per cent received no discount off the headline variable rate.

Discounts lead to big differences in what customers pay for their home loans. If a customer with no discount was able to obtain the average discount of 128 basis points (the average discount for owner-occupier loans with principal and interest repayments with the big four banks), for example by asking their bank for a lower rate, refinancing to another home loan or switching lenders, this could result in interest savings of nearly $5 000 in the first year alone for an average sized new loan of $386 000.[1]

[1] The average size new variable rate owner-occupier loan with principal and interest repayments across the big four banks was $386 000 as at 31 October 2019. The average loan size data supplied by CBA was reported as at 23 October 2019. For the remaining big four banks, the data was reported as at 31 October 2019.

The discount received by many home loan customers includes both advertised discounts and discretionary discounts. Discretionary discounts are offered on a case-by-case basis to individual customers, usually after the lender has assessed their application.

The lack of transparency in discretionary discounts makes it unnecessarily difficult and more costly for consumers to discover the best price offers.[2] However, consumers will soon have access to the Consumer Data Right which will improve their ability to compare and switch between home loan products and lenders.

We also note that one of the big four banks offered higher advertised discounts in the second half of 2019, in order to improve the transparency of discounts and reduce its reliance on discretionary discounts. In the ACCC's view, this is a positive development for transparency.

Loyalty can cost existing customers

The big four banks' focus on attracting new home loan customers with increasingly large discounts over time has created a difference between the average interest rates paid for new loans compared to existing loans. As at 30 September 2019, customers with new owner−occupier loans with principal and interest repayments were paying, on average, 26 basis points less than customers with existing loans.

In most cases, the average difference is even more significant for customers with older loans. For example, as at 30 September 2019, the big four banks' customers whose existing owner-occupier loans with principal and interest repayments were greater than five years old were, on average, paying 40 basis points above what the big four banks' customers with new loans were paying. If one of those customers with an existing loan of around $200 000 (the approximate average size for those loans greater than five years old) had refinanced to obtain a new loan rate at one of the big four banks at that time, they could have saved around $850 in interest the first year.[3]

The difference between average interest rates paid by customers with new loans and customers with existing loans persists, in part, because price reductions for customers with existing loans are not always as large as discounts on new loans. This demonstrates the importance of home loan customers shopping around and asking about available discounts.

Guidance for consumers

We encourage consumers to shop around when looking for a home loan and to negotiate with lenders. Even a small reduction in interest rates can potentially save a consumer thousands of dollars over the life of their loan.[4] While not all lenders offer discounts, and not all consumers will be eligible for a discount, consumers willing to ask for a better rate can often obtain an additional discount to that advertised by lenders; these additional discounts are known as discretionary discounts.

Customers with existing home loans should review their loan on a regular basis, and ask their lender for a better deal. Some customers with an existing loan may need to switch to another home loan product with their lender, or switch to another lender, to get the best deal available to them.

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[2] See also: Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 7.

[3] As at 30 September 2019, the average loan size among the big four banks' customers with existing variable rate owner−occupier loans making principal and interest repayments and whose loan was greater than five years old was $210 304.

[4] See also: Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 11.

Factors in the big four banks' decisions on headline variable rates

We obtained internal decision making documents and data from the big four banks on how they set their headline variable rates. In particular, we focused on their responses to the cash rate cuts in June, July and October 2019.

The banks balanced a range of factors when making headline rate decisions, but a key consideration was maintaining their profitability

The big four banks balanced a range of factors when making their headline variable rate decisions following the cash rate reductions in 2019. The relative weight given to each factor varied by bank and month but, in most instances, a key consideration for the banks was maintaining their profitability against internal benchmarks. It was in this context that the banks balanced the interests of different stakeholders, including, for example, home loan customers and deposit customers.

Given the low interest rate environment in which the banks operated during the price monitoring period, they anticipated profit reductions because of their limited ability to reduce deposit rates in the event of reductions in the cash rate. The banks preferred not to reduce deposit rates that were approaching zero per cent for a range of reasons, including for example that low rates would negatively impact the return to depositors.

At the time of making headline variable rate decisions for home loans, three of the banks primarily characterised these anticipated profit reductions as occurring in their deposit portfolios. All of the banks aimed to at least partly recover their anticipated profit reductions through their headline rate decisions.

Community expectations and competitive positioning were also considered

The big four banks considered community expectations and the public's reaction when making their headline variable rate decisions. This resulted in some of the banks reducing their headline variable rates by more than they otherwise might have.

The banks were also aware of their competitive position, particularly among their big four peers, when making their headline rate decisions. However, we did not see evidence of the banks aiming to match the headline variable rates of lenders other than their big four peers. These lenders appeared to be growing at the big four banks' expense. We did observe that the big four banks increased discounts for new loans. This may have been driven, at least in part, by competition from other lenders.

The cost of funds was heavily influenced by, but did not move in lockstep with, the cash rate

We found that the big four banks' cost of funds measures were heavily influenced by changes in the cash rate. The cash rate acts as a benchmark for many interest rates in financial markets, particularly shorter term rates such as bank bill swap rates. While it would be expected that the banks' cost of funds would move closely with the cash rate (as around two-thirds of the big four banks' debt and deposit funding is linked to bank bill swap rates), there are a number of reasons why the banks' cost of funds did not move in lockstep with the changes in the cash rate.

Cuts to headline variable rates were smaller than the reduction in funding costs over 2018 and 2019

Based on our review of the banks' internal documents, changes in the cost of funds were considered by each bank when making their headline rate decisions following the cash rate reductions in 2019. One bank's headline rate decisions were influenced by these considerations. The influence of these considerations on the remaining banks' decisions was less clear.

Based on our analysis of data supplied by the big four banks, the banks experienced increases in their costs of funds from January 2018 to early 2019. This was followed by larger ongoing decreases in the cost of funds from early 2019. We found that the banks' changes to headline variable rates were not fully aligned with changes in their cost of funds.

For each of the big four banks, the overall decrease in the headline variable rates on owner-occupier home loans with principal and interest repayments was less than the decrease in their cost of funds over the course of 2018 and 2019. This was also the case for investor home loans with interest-only repayments for three of the big four banks.

The big four banks only cut headline variable rates after cuts to the cash rate

The banks approached headline variable rate cuts differently to headline variable rate increases. In particular:

- we observed that the big four banks only cut their headline variable rates following the cash rate reductions in June, July and October 2019. This was despite a sustained decrease in their cost of funds over much of 2019
- in comparison, in mid-2018 to early 2019, each of the big four banks increased headline variable rates when there was no change in the cash rate.

The banks took time to implement headline variable rate changes

While each of the big four banks announced their rate changes on the day of or the day following the Reserve Bank of Australia's (RBA) cash rate announcements in June, July and October 2019, changes to the big four banks' headline variable rates came into effect 9 to 21 days after they announced a rate change, depending on the bank. As well as allowing the banks sufficient time to implement the required business and operational changes that followed a change in the headline variable rate, the time between the announcement date and the effective date of the rate changes was also estimated by each bank to result in additional revenue, compared to if the rate changes were effective immediately (that is, on the day the rate change was announced).[5]

Only one of the big four banks took into account the additional revenue, amongst other considerations, when deciding on the date that headline variable rate changes would be implemented.

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[5] Headline variable rate reductions lead to additional home loan revenue during the time between the announcement date and the effective date of the rate changes (the lag period), compared to if the changes were implemented immediately. This increase in revenue may be partly offset by higher costs (in the form of interest paid by the bank to deposit holders) during the lag period, assuming the headline variable rate and deposit rate changes have the same effective date. Conversely, headline variable rate increases lead to a decrease in home loan revenue in the lag period, compared to if the headline variable rate changes were implemented immediately, partly offset by lower interest costs paid to deposit holders, assuming the headline variable rate and deposit rate changes have the same effective date.

Introduction

On 14 October 2019, the Treasurer directed the Australian Competition and Consumer Commission (ACCC) to conduct an inquiry into home loan pricing (the inquiry). A copy of the direction is at Appendix A.

The inquiry will focus on two issues:

- prices charged for home loans since 1 January 2019, in particular:
  - the difference between advertised interest rates and interest rates paid by home loan customers
  - the difference between interest rates paid by customers with new loans and customers with existing loans
  - home loan suppliers' pricing decisions following changes in the RBA's target for the cash rate, including why suppliers reduced their headline variable rates by as much as they did and how suppliers' cost of funds affected these decisions
- impediments to consumers switching to alternative home loan suppliers.

This interim report focuses on the first issue. It considers prices charged for home loans during the price monitoring period (1 January 2019 to 31 October 2019). Given this price monitoring period, and the date of reporting, this report does not consider the two cuts to the cash rate in March 2020.

The final report will consider the second issue, impediments to switching. The ACCC is to provide the final report to the Treasurer by 30 September 2020.

The focus of the interim report

Although there are many suppliers of home loans, this interim report is focused on the prices and pricing decisions of the big four banks, as they account for close to 80 per cent (by value) of home loans held by authorised deposit-taking institutions (ADIs) (see table 1).[6]

The big four banks are:

- Australia and New Zealand Banking Group Limited (ANZ)
- Commonwealth Bank of Australia (CBA)
- National Australia Bank Limited (NAB)
- Westpac Banking Corporation (Westpac).[7]

[6] The ACCC was directed to have particular regard to the activities of those suppliers with the largest shares of outstanding home loans by market value, see *Competition and Consumer (Price Inquiry—Home Loans) Direction 2019*, s. 7(a).

The big four banks' share of home loans outstanding was around 82 per cent as at 31 December 2009 and has trended down since 2010 to be around 78 per cent as at 31 December 2019.

See: Australian Prudential Regulation Authority, *Quarterly authorised deposit-taking institution property exposures statistics September 2019*, issued 12 December 2019; Australian Prudential Regulation Authority, *Monthly authorised deposit-taking institution statistics December 2019*, issued 31 January 2020.

[7] CBA, NAB and Westpac sell home loans through their main brands (for example, CBA, NAB and Westpac) and through other brands (for example, Bankwest, UBank or St George). Unless otherwise indicated, the ACCC's analysis is focused on the big four banks' main brands.

Table 1 Home loan portfolios of the big four banks and other ADIs, December 2019

	Home loan portfolio (outstanding balances) *$ billion*	Share of outstanding home loans* *%*
CBA**	445	26
Westpac**	408	23
NAB**	261	15
ANZ	247	14
Other ADIs with total assets over $200 million***	382	22

* Share (by value) of home loans outstanding with ADIs. ADIs have historically accounted for approximately 95-96 per cent of all outstanding home loans, while non-ADIs (or non-bank lenders) are estimated to account for less than 5 per cent of outstanding home loans (by value).

** This data includes the big four banks' main brands and other brands.

*** In December 2019, there were 75 'Other ADIs with total assets over $200 million' that reported home loans on their domestic books. Other ADIs include Australian-owned ADIs which account for around 17 per cent of outstanding home loans (by value) and foreign subsidiary banks which account for around 5 per cent.

Sources: Australian Prudential Regulation Authority, *Quarterly authorised deposit-taking institution property exposures statistics September 2019*, 12 December 2019.

Australian Prudential Regulation Authority, *Monthly authorised deposit-taking institution statistics December 2019*, 31 January 2020.

Reserve Bank of Australia, 'Box D: Non-bank Lending for Property', *Financial Stability Review*, April 2019, pp. 56–59.

We have also focused on the big four banks because these banks, along with Macquarie Bank Limited, were the focus of the ACCC's work in the Residential mortgage price inquiry, and because this inquiry builds on that work. The Residential mortgage price inquiry considered the prices charged or proposed to be charged for residential mortgage products[8] by the banks that were subject to the Major Bank Levy (the Levy Banks) during the period 1 July 2017 to 30 June 2018. The key findings of Residential mortgage price inquiry are set out in box 1.

Box 1 Key findings from the Residential mortgage price inquiry

Opaque pricing: The headline interest rates advertised by the Levy Banks (ANZ, CBA, Macquarie Bank Limited, NAB and Westpac) are a poor indicator of the interest rate actually paid by borrowers, as Levy Banks offer reduced and unadvertised interest rates. This practice is known as 'discounting'. The inquiry found that:

- product comparison for borrowers was unnecessarily difficult which affects their willingness to shop around and stifles price competition
- the majority of borrowers were paying interest rates below the relevant headline interest rates
- a borrower's willingness to negotiate with their lender was an important factor in the pricing of their residential mortgage
- the Levy Banks with the lowest headline interest rates were not always the banks with the lowest average rates paid by borrowers

[8] 'Residential mortgage product' and 'home loan' are both references to a loan secured by a mortgage over one or more residential premises.

- the average interest rates paid for basic or ‘no frills’ residential mortgages were often higher than for standard mortgage products.

Existing borrowers pay more: New borrowers were paying significantly lower interest rates than existing borrowers who did not actively shop around for a better deal. This occurred as a result of discounting practices, which disproportionately affect borrowers who remain loyal to their current bank.

Oligopoly behaviour: There were signs of oligopoly behaviour and a lack of vigorous price competition among the big four banks. When setting variable interest rates, the big four banks were often accommodative and focused on each other, giving little regard to smaller lenders. Comparatively, other banks employed a more diverse approach to pricing.

Public perception: The Levy Banks’ sensitivity to public perception factored into their pricing decisions. For example, interest rate increases may be deferred until a ‘trigger event’ such as a cash rate change, or a Levy Bank might make rate announcements soon after one of the big four banks to manage reputational damage. Media attention also impacted banks’ public messaging on rate changes. Media releases announcing interest rate changes did not always include all factors considered by the banks when choosing to change their rate.

Regulatory requirements: The Australian Prudential Regulation Authority’s (APRA) interest-only benchmark, which had the objective of contributing to financial system stability, lessened price competition for interest-only lending and provided an opportunity for banks to increase interest-only rates, at a significant cost to borrowers. The inquiry also found that some other (non-Levy) banks faced exacerbated challenges due to other regulatory requirements.

The price of a home loan is made up of the interest rate and any fees (see Appendix B). This interim report focuses on interest rates, rather than interest rates and fees, because, as at 1 November 2019, there have been no significant changes to the big four banks’ fees for home loans reported in the Residential mortgage price inquiry.[9]

This interim report primarily focuses on two categories of variable rate home loans:

- owner-occupier loans contracted with principal and interest repayments
- investor loans contracted with interest-only repayments.

We have focused on owner-occupier loans with principal and interest repayments as this represented the largest home loan category (by value outstanding) for the big four banks as at 31 December 2019. It also represented the largest category (by value) of home loans funded by the big four banks over the 2019 calendar year. Owner-occupier loans with principal and interest repayments accounted for around 58 per cent of total home loans outstanding as at 31 December 2019[10] and around 61 per cent of new home loans funded by the big four banks over 2019.[11]

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9 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 39.

10 Data supplied by APRA, collected in form *Residential Mortgage Lending (ARF_223_0)*. This data is based on the value of total home loans outstanding at the big four banks, and excludes secured revolving credit, such as reverse mortgages. Over the quarters ending 31 March 2019, 30 June 2019, 30 September 2019, and 31 December 2019, owner-occupier loans with principal and interest repayments accounted for 55 to 58 per cent of the value of total home loans outstanding, depending on the quarter. Owner-occupier loans with interest-only repayments accounted for 6 to 9 per cent, investor loans with principal and interest repayments accounted for 21 to 22 per cent, and investor loans with interest-only repayments accounted for 13 to 16 per cent.

11 Data supplied by APRA, collected in form *Residential Mortgage Lending (ARF_223_0)*. This data is based on the value of new home loans funded over the quarter by the big four banks, and excludes secured revolving credit, such as reverse mortgages. Over the quarters ending 31 March 2019, 30 June 2019, 30 September 2019, and 31 December 2019, owner occupier loans with principal and interest repayments accounted for 59 to 63 per cent of new home loans funded over the quarter, depending on the quarter. Owner-occupier loans with interest-only repayments accounted for around 8 per cent, investor loans with principal and interest repayments accounted for around 19 per cent, and investor loans with interest−only repayments accounted for 11 to 14 per cent.

Investor loans with interest-only repayments accounted for 13 per cent of home loans outstanding with the big four banks as at 31 December 2019 and 12 per cent of new home loans funded over 2019.[12] Including this loan category in our analysis allowed us to examine and make findings in relation to the two main home loan categories (owner occupier and investor) and the two repayment types (principal and interest, and interest-only) offered by the big four banks.

This interim report focuses on variable rate home loans as these are significantly more common than fixed rate home loans. For example, from January 2019 to September 2019, fixed rate home loans accounted for, on average, 15 per cent of new owner-occupier home loans (by value).[13]

Details of the types of home loans and their features are set out in Appendix C.[14]

Conduct of the inquiry

The ACCC used its compulsory information-gathering powers to obtain documents and data from the big four banks on the pricing of their home loans. In addition, the ACCC supplemented its analysis of the documents and data from the big four banks with data, including data in relation to other suppliers, from the RBA and APRA.

Documents provided to the inquiry

The information contained in this report is largely derived from information and documents provided by the big four banks in response to compulsory notices issued under section 95ZK of the *Competition and Consumer Act 2010*. In those notices, we sought, amongst other things, documents considered by decision makers and information relating to the rationale behind the banks' June, July and October 2019 headline variable rate changes. In some instances, the information and documents provided did not give us a complete picture of why particular decisions were made. For example, some banks produced very few documents relating to their pricing decisions in response to particular cash rate reductions. These banks advised the ACCC that their decisions in response to the cash rate reductions were primarily discussed verbally.

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[12] Data supplied by APRA, collected in form *Residential Mortgage Lending (ARF_223_0)*. Refer to footnote 10 and 11 for further information on this data.

[13] Calculated on a simple average basis.

Australian Bureau of Statistics, *5601.0—Lending to households and businesses, Australia, September 2019*, November 2019 (see table 15. Lending to households for owner occupier dwellings, by loan type, number and value of commitments, original).

[14] The *Residential mortgage price inquiry interim report* describes the components of home loans prices and the various different types of residential mortgages (or home loans) offered by lenders. For convenience we have largely reproduced this information in Appendices B and C.

1. Trends in home loan pricing

Key findings

- Over the four years to October 2019, the largest decreases in average interest rates paid across all lenders occurred in months when the cash rate was reduced. Conversely, the largest increases in average interest rates paid over this period occurred when there was no change to the cash rate.
- The differences between the big four banks' headline variable rates decreased over the price monitoring period. Consistent with our findings in the Residential mortgage price inquiry, we observed little difference in headline variable rates across the big four banks.
- Over the price monitoring period, the big four banks' headline variable rate changes came into effect 9 to 21 days after they were announced, depending on the bank. While the lag period allowed the banks sufficient time to implement required business and operational changes, each bank also estimated it would result in additional revenue, compared to if the rate change was implemented on the day of the announcement. One bank took into account this additional revenue, among other considerations, when deciding on the date that headline rate changes would come into effect.

In this chapter, we report on:

- changes in the average variable interest rates paid by home loan customers across all lenders[15]
- the range of interest rates paid across different types of lenders
- the size and timing of headline variable rate changes by the big four banks over the price monitoring period.

On average, interest rates paid by home loan customers have been falling

There are two components that determine the interest rate a home loan customer pays: the headline interest rate and any discounts off the headline interest rate (see Appendix B). Most variable rate home loan customers pay an interest rate that is materially below the headline variable rate due to discounts.[16]

In this section, we report on average variable interest rates paid by home loan customers across all lenders over the four years to October 2019, which includes the price monitoring period (see figure 1.1). This allows us to discuss longer term trends in average interest rates.[17]

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[15] All lenders include the big four banks, other ADIs and non-ADI lenders.

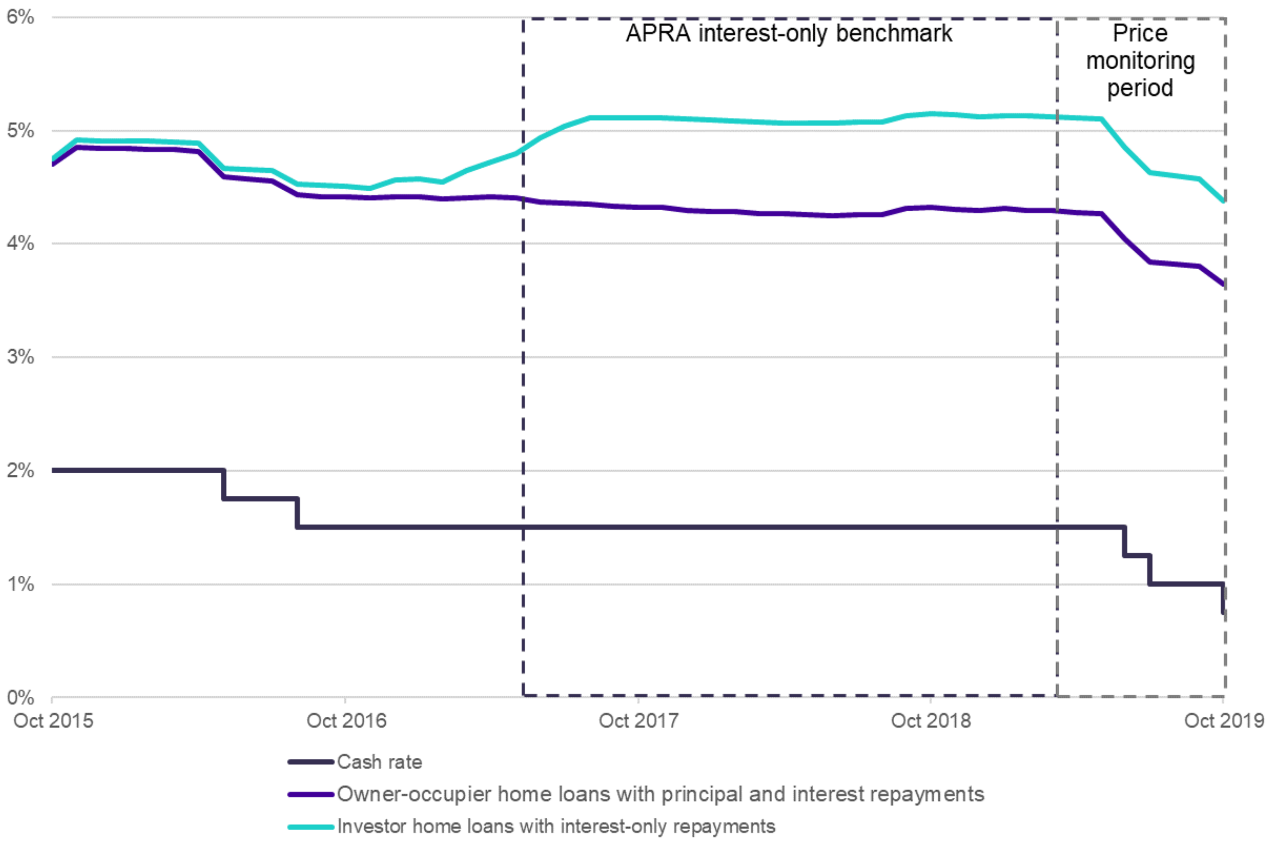
[16] In the Residential mortgage price inquiry we found that around 87 per cent of home loan customers with the Levy Banks received a discount off the headline variable rate and the Levy Banks accounted for over 80 per cent of home loans outstanding with banks as at 31 July 2018.

See: Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* pp. 4, 23.

See also: Reserve Bank of Australia, 'Box C: Do Borrowers with Older Mortgages Pay Higher Interest Rates?' *Statement on Monetary Policy,* February 2020, p. 56.

[17] Data on the average interest rates paid by home loan customers across all lenders has been sourced from the RBA's Securitisation Dataset. The RBA's Securitisation Dataset has been collected by the RBA since mid-2015, and enables us to report on longer term trends in average interest rates to the end of the price monitoring period. The average interest rate, is the weighted average interest rate over the month based on the balance of securitised loans that are eligible as collateral in the RBA's domestic market operations.

Figure 1.1 Average variable interest rates paid across all lenders, by home loan type, and the cash rate, October 2015 to October 2019



Note: Weighted average interest rate based on the balance of securitised loans that are eligible as collateral in the RBA's domestic market operations.

The Securitisation Dataset contains data on 1.7 million individual home loans with a value around $400 billion, or just under one-quarter of the total value of home loans in Australia. The RBA considers the Securitisation Dataset is reasonably representative of average interest rates in the home loan market, however there are several factors that can influence the types of home loans that are securitised and the representativeness of the dataset including the way credit ratings agencies assign ratings, the type of lender, investor preferences, and the RBA's repo-eligibility framework.

Source: Reserve Bank of Australia, *Securitisation Dataset*.

For more information on the RBA's Securitisation Dataset see: Reserve Bank of Australia, 'The Reserve Bank's Securitisation Dataset', *Bulletin—December 2018*, December 2018.

In October 2019, the average variable interest rate paid across all lenders was:

- 3.65 per cent for owner-occupier loans with principal and interest repayments. This represents a 66 basis point decrease from the average interest rate paid on these loans in January 2019
- 4.38 per cent for investor loans with interest-only repayments. This represents a 75 basis point decrease since January 2019.

The average variable interest rate paid on owner-occupier loans with principal and interest repayments was 105 basis points lower in October 2019 compared to October 2015. The decrease in the average variable interest rate paid for investor loans with interest-only repayments has been less significant, falling by only 37 basis points since October 2015. Further, from May 2017 to May 2019, the average variable rate paid on investor loans with interest-only repayments was considerably higher than in October 2015 (the average variable rate paid on investor loans with interest-only repayments was 4.70 per cent in October 2015).

The largest decreases in average variable interest rates paid by customers across all lenders, over the four years to October 2019, for owner-occupier loans with principal and interest repayments and investor loans with interest-only repayments all occurred in months when the cash rate was reduced.[18] Conversely, the largest increases in average variable interest rates paid by customers occurred where there was no change to the cash rate. For example, the average interest rate paid by investors with interest-only loans rose sharply from early 2017 until September 2017. This increase followed the announcement of APRA's interest-only benchmark in March 2017.[19] In the Residential mortgage price inquiry, we found the interest-only benchmark lessened price competition for interest-only loans by providing an opportunity for the big four banks (and other lenders) to synchronise their increases to interest rates on these loans for both new and existing customers, even though the interest-only benchmark only applied to new interest-only lending.[20] APRA removed the interest-only benchmark on 1 January 2019.[21]

The distribution of interest rates paid varies across different types of lenders

The average variable interest rate data in figure 1.1, which is aggregated across all lenders, masks the range of interest rates paid across different types of lenders (see figure 1.2 and figure 1.3).

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[18] Over the four years to October 2019, the cash rate was lowered by 25 basis points on five occasions. These cash rate reductions occurred in May 2016, August 2016, June 2019, July 2019 and October 2019. The cash rate was unchanged in all other months from October 2015 to October 2019.
See: Reserve Bank of Australia, *Cash Rate,* https://www.rba.gov.au/statistics/cash-rate/, viewed 25 February 2020.

[19] The interest-only benchmark required ADIs to limit the flow of new interest-only lending to 30 per cent of new residential mortgage lending and would be measured over the course of each quarterly period. The benchmark became effective from the quarter ending September 2017. APRA stated that it would consider imposing additional requirements on ADIs if their proportion of new interest-only lending exceeded the interest-only benchmark.

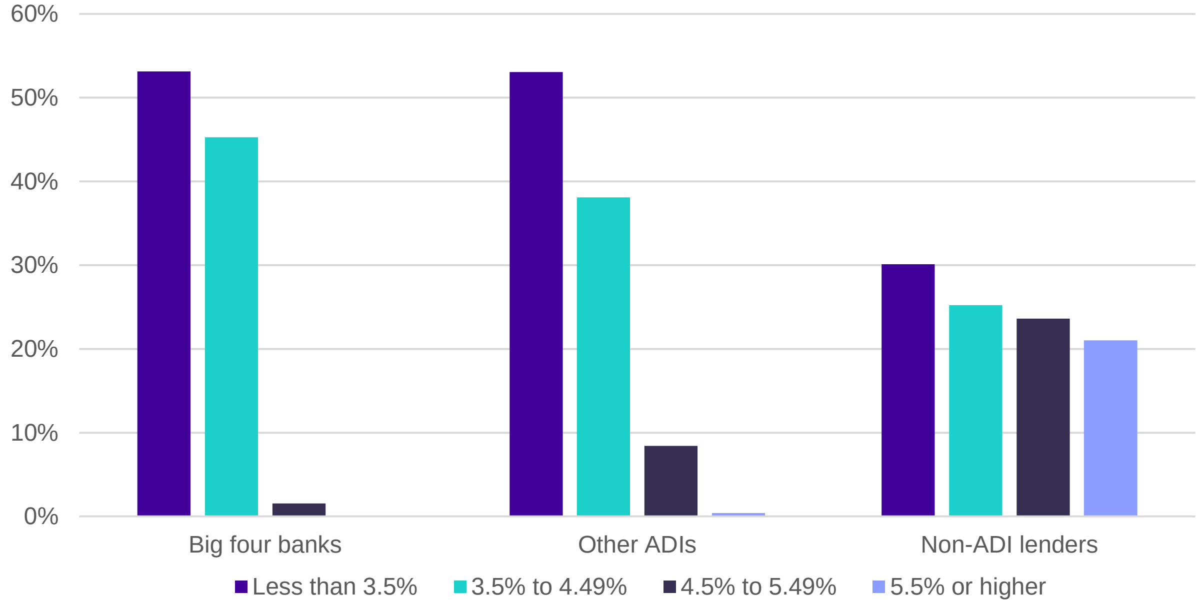
See: Australian Prudential Regulation Authority, *APRA announces further measures to reinforce sound residential mortgage lending practices*, 31 March 2017, https://www.apra.gov.au/news-and-publications/apra-announces-further-measures-to-reinforce-sound-residential-mortgage, viewed 25 February 2020.

[20] Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* pp. 42–54.

[21] APRA removed the interest-only loan benchmark on 1 January 2019 for ADIs that were no longer subject to the investor loan benchmark. For ADIs that continued to be subject to the investor loan benchmark, the interest-only benchmark will be removed concurrently, with the removal of the investor loan benchmark.

See: Australian Prudential Regulation Authority, *APRA to remove interest-only benchmark for residential mortgage lending,* 19 December 2018, https://www.apra.gov.au/news-and-publications/apra-to-remove-interest-only-benchmark-for-residential-mortgage-lending, viewed 25 February 2020.

Figure 1.2 Distribution of average variable interest rates paid on owner-occupier loans with principal and interest repayments, by type of lender, October 2019



Note: Weighted average interest rate based on the balance of securitised loans that are eligible as collateral in the RBA's domestic market operations.

Source: Reserve Bank of Australia, Securitisation Dataset. The Securitisation Dataset may not be fully representative of the home loan interest rates in the portfolio of each type of lender. This is because the type of loans that are securitised may be influenced by (among other things) the way credit ratings agencies assign ratings, the type of lender, investor preferences, and the RBA's repo-eligibility framework.

In October 2019, around 98 per cent of owner-occupier loans with principal and interest repayments with the big four banks (by outstanding balance) were charged an interest rate below 4.50 per cent. The range of interest rates charged by other ADIs was broadly similar to the big four banks, with around 91 per cent of balances charged an interest rate below 4.50 per cent.

The range of interest rates paid on owner-occupier loans with principal and interest repayments with non-ADI lenders was larger than for ADIs. In terms of distribution, more than 40 per cent of balances with non-ADI lenders were charged an interest rate of 4.50 per cent or higher in October 2019. This compares to less than 3 per cent of balances at the big four banks and around 9 per cent for other ADIs. This is likely to reflect the different types of lenders and customers in the non-ADI segment. Some non-ADI lenders specialise in providing home loans to higher risk customers, such as those with impaired credit histories; high loan to value ratios; or customers that require 'alternative' or low-documentation loans. These higher risk home loan customers generally attract higher interest rates.[22]

Some non-ADI lenders also offer highly competitive interest rates for a small proportion of high quality customers. The presence of these higher quality loans makes it easier for non-ADI lenders to sell their residential mortgage backed securities and fund their mortgage book.[23]

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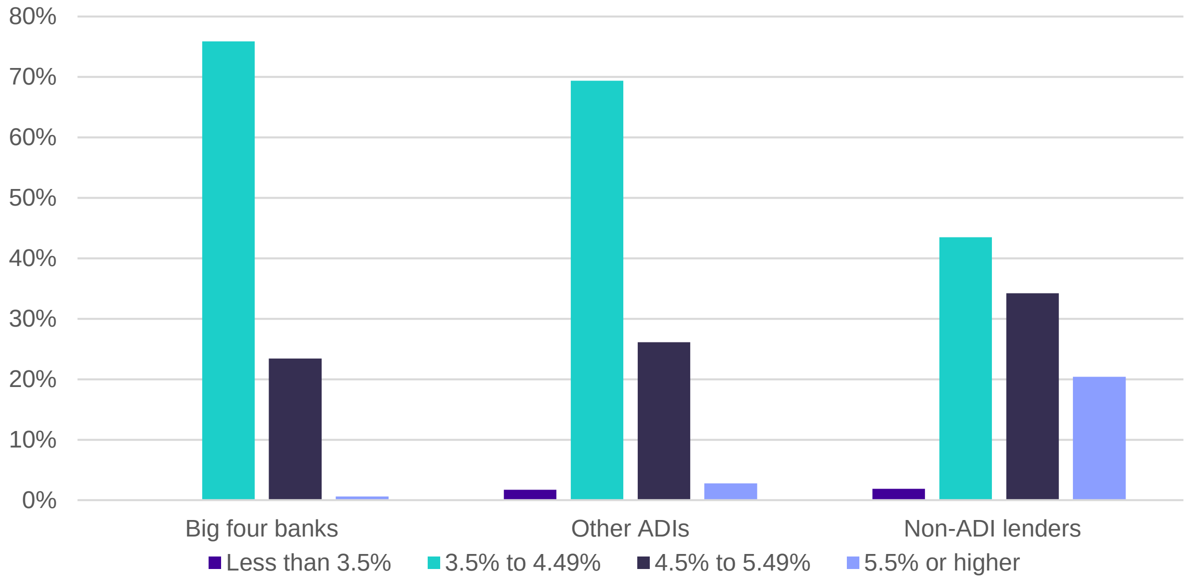
[22] M. Bergmann and M. Tran, Reserve Bank of Australia, 'The Distribution of Mortgage Interest Rates', *Bulletin—March 2018,* March 2018.

[23] Reserve Bank of Australia, 'Box D: Non-bank Lending for Property', *Financial Stability Review,* April 2019, p. 57.

Figure 1.3 Distribution of average variable interest rates paid on investor loans with interest-only repayments, by type of lender, October 2019



Note: Weighted average interest rate based on the balance of securitised loans that are eligible as collateral in the RBA's domestic market operations.

Source: Reserve Bank of Australia, Securitisation Dataset. The Securitisation Dataset may not be fully representative of the home loan interest rates in the portfolio of each type of lender. This is because the type of loans that are securitised may be influenced by (among other things) the way credit ratings agencies assign ratings, the type of lender, investor preferences, and the RBA's repo-eligibility framework.

In October 2019, for each type of lender, less than 2 per cent of investor loans with interest-only repayments (by outstanding balance) were charged an interest rate below 3.50 per cent (figure 1.3). Non-ADI lenders had the largest proportion of balances with an interest rate below 3.50 per cent.

Around 99 per cent of investor loans with interest-only repayments (by outstanding balance) with the big four banks were charged an interest rate between 3.50 and 5.49 per cent in October 2019. The range of interest rates charged by other ADIs for investor loans with interest-only repayments was similar to the big four banks, with around 96 per cent charged an interest rate between 3.50 and 5.49 per cent. Similar to our findings for owner-occupier loans with principal and interest repayments, the range of interest rates paid on investor loans with interest-only repayments for non-ADI lenders was larger, with a greater proportion of balances charged an interest rate of 5.50 per cent or higher. This is likely to reflect the different types of lenders and home loan customers in the non-ADI sector.

Headline variable rates decreased at the big four banks, following cash rate reductions

Over the price monitoring period, the RBA reduced the cash rate from 1.50 per cent to 0.75 per cent. This occurred through three 25 basis point reductions, which the RBA announced on 4 June 2019, 2 July 2019 and 1 October 2019.[24] Following each announcement, the big four banks reduced their headline variable rates (see table 1.1).

24 Each cash rate reduction came into effect the day following the announcement.
Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board,* 4 June 2019.
Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board,* 2 July 2019.
Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board,* 1 October 2019.
Reserve Bank of Australia, *Cash Rate,* https://www.rba.gov.au/statistics/cash-rate/, viewed 25 February 2020.

There was little difference in the headline variable rates of the big four banks following their rate changes

At the start of the price monitoring period (1 January 2019), the big four banks' headline variable rates for owner-occupier loans with principal and interest repayments ranged from 5.24 to 5.38 per cent, a difference of 14 basis points. For investor loans with interest-only repayments, headline variable rates at the big four banks ranged from 6.25 to 6.44 per cent, a difference of 19 basis points (see table 1.1).

The main reason for the difference in headline variable rates across the banks as at 1 January 2019, was that in the second half of 2018, ANZ, CBA and Westpac increased their headline variable rates, publicly attributing this increase to a sustained rise in funding costs.[25] However, NAB did not increase its headline variable rates until 31 January 2019. When NAB increased its headline variable rates, it attributed the increase to *'[achieving] the right balance between rewarding customer loyalty, shareholder outcomes, and responding to sustained increases in funding costs*' (see box 5.4 for further details about NAB's decision to 'hold' its headline variable rates in late 2018).[26] Following NAB's headline variable rate increase in January, the difference in headline variable rates between the big four banks was two basis points for owner-occupier loans with principal and interest repayments; and five basis points for investor loans with interest-only repayments.

At the end of the price monitoring period, following the three cash rate reductions, the headline variable rates for owner-occupier loans with principal and interest repayments ranged from 4.77 to 4.83 per cent, a difference of 6 basis points. For investor loans with interest-only repayments, headline variable rates ranged from 5.64 to 5.74 per cent, a difference of 10 basis points (see table 1.1).

These observations of little difference between headline variable rates across the big four banks, are consistent with the pricing behaviour that we observed in the Residential mortgage price inquiry, where changes in headline variable rates led to a reduction in the already small difference between headline variable rates across the banks.[27]

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[25] Australia and New Zealand Banking Group Limited, *ANZ increases variable home loan rates,* 6 September 2018, https://media.anz.com/posts/2018/09/anz-increases-variable-home-loan-rates, viewed 25 February 2020.

Commonwealth Bank of Australia, *Commonwealth Bank announces interest rate change,* 6 September 2018, https://www.commbank.com.au/guidance/newsroom/interest-rate-change-201809.html, viewed 25 February 2020.

Westpac Banking Corporation, *Westpac increases variable home loan rates,* 29 August 2018, https://www.westpac.com.au/about-westpac/media/media-releases/2018/29-august/, viewed 25 February 2020.

[26] National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 26 February 2020.

[27] Following headline variable rate changes by each of the big four banks in mid-2017, the headline variable rates for owner−occupier loans with principal and interest repayments ranged from 5.20 to 5.24 per cent, a difference of four basis points. For investor loans with interest-only repayments, the headline variable rates of the big four banks ranged from 6.24 to 6.30 per cent, a difference of 6 basis points.

See Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* pp. 19–20.

Table 1.1 Changes to the big four banks' headline variable rates, over the price monitoring period

	ANZ	CBA	NAB	Westpac
January 2019				
Owner-occupier loans with principal and interest repayments	5.36%	5.37%	5.36% (+12bps)	5.38%
Investor loans with interest-only repayments	6.42%	6.39%	6.41% (+16bps)	6.44%
June 2019				
Owner-occupier loans with principal and interest repayments	5.18% (-18bps)	5.12% (-25bps)	5.11% (-25bps)	5.18% (-20bps)
Investor loans with interest-only repayments	6.24% (-18bps)	6.14% (-25bps)	6.16% (-25bps)	6.09% (-35bps)
July 2019				
Owner-occupier loans with principal and interest repayments	4.93% (-25bps)	4.93% (-19bps)	4.92% (-19bps)	4.98% (-20bps)
Investor loans with interest-only repayments	5.99% (-25bps)	5.89% (-25bps)	5.97% (-19bps)	5.79% (-30bps)
October 2019				
Owner-occupier loans with principal and interest repayments	4.79% (-14bps)	4.80% (-13bps)	4.77% (-15bps)	4.83% (-15bps)
Investor loans with interest-only repayments	5.74% (-25bps)	5.64% (-25bps)	5.67% (-30bps)	5.64% (-15bps)

Note: The headline variable rate figures for January 2019 for ANZ, CBA and Westpac are the headline variable rates that applied at 1 January 2019. All other headline variable rate figures are the rates that applied at the date a headline variable rate change came into effect (see table 1.2 for the date of headline variable rate changes). The size of the change is shown below each headline variable rate figure.

The headline variable rates are the rates reported in the banks' media releases (see below) and in some cases relate to a single product. These headline variable rates may differ to those reported in figure 4.1 and figure 4.2. This is because, where a bank reported data for more than one product and some of those products had different headline variable rates, the headline variable rates reported in figures 4.1 and 4.2 are averages.

Source: Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates*, 4 June 2019, https://media.anz.com/content/dam/mediacentre/pdfs/mediareleases/2019/June/190604%20-%20ANZ%20decreases%20variable%20home%20loan%20rates.pdf, viewed 26 February 2020; *ANZ decreases variable home loan rates*, 2 July 2019, https://media.anz.com/posts/2019/07/anz-decreases-variable-home-loan-rates, viewed 26 February 2020; *Rate decision—2 October 2019*, 2 October 2019, https://www.anz.com.au/personal/home-loans/your-loan/rate-changes/, viewed 26 February 2020.

Commonwealth Bank of Australia, *Commonwealth Bank home loan interest rate change*, 4 June 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-home-loan-interest-rate-change-201906.html, viewed 14 January 2020; *Commonwealth Bank cuts home loan interest rates*, 2 July 2019, https://www.commbank.com.au/guidance/newsroom/cba-rba-interest-rates-201907.html, viewed 26 February 2020;

Rates announcement, 1 October 2019, https://www.commbank.com.au/news/rate-announcement.html, viewed 26 February 2020.

National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 14 January 2020; *NAB cuts home loan variable interest rates*, 4 June 2019, https://news.nab.com.au/news_room_posts/nab-cuts-home-loan-variable-interest-rates/, viewed 26 February 2020; *NAB announces changes to home loan interest rates*, 2 July 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-2/, viewed 26 February 2020; *NAB announces changes to home loan interest rates*, 1 October 2019 https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-3/, viewed 26 February 2020.

Westpac Banking Corporation*, Westpac reduces interest rates for its home loan customers*, 4 June 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/4-june/, viewed 26 February 2020; *Westpac cuts variable home loan interest rates*, 2 July 2010, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-july/, viewed 26 February 2020; *Westpac decreases variable home loan rates*, 2 October 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-october/, viewed 26 February 2020.

The big four banks received additional revenue from the lag period

While each big four bank announced their rate changes on the day of or the day following the RBA's cash rate decision, changes to the big four banks' headline variable rates came into effect 9 to 21 days after the banks announced their rate changes (see table 1.2). We refer to the time between a bank's announcement date and the date the bank's rate change came into effect as the lag period.

Each bank had a consistent lag period following each of the three headline variable rate changes in June, July and October 2019; with CBA consistently having a significantly longer lag period than the other big four banks. The banks informed the ACCC that their respective lag periods allowed sufficient time to implement the required business and operational changes that follow a change in the headline variable rate.

Table 1.2 Timing of headline variable rate changes, following cash rate reductions

	ANZ	CBA	NAB	Westpac
June 2019				
Announcement date	4 June	4 June	4 June	4 June
Date the change came into effect	14 June	25 June	14 June	18 June
Days between announcement date and date the change came into effect	10	21	10	14
July 2019				
Announcement date	2 July	2 July	2 July	2 July
Date the change came into effect	12 July	23 July	12 July	16 July
Days between announcement date and date the change came into effect	10	21	10	14
October 2019				
Announcement date	2 October	1 October	1 October	2 October
Date the change came into effect	11 October	22 October	11 October	16 October
Days between announcement date and date the change came into effect	9	21	10	14

Source: Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates*, 4 June 2019, https://media.anz.com/content/dam/mediacentre/pdfs/mediareleases/2019/June/190604%20-%20ANZ%20decreases%20variable%20home%20loan%20rates.pdf, viewed 26 February 2020; *ANZ decreases variable home loan rates*, 2 July 2019, https://media.anz.com/posts/2019/07/anz-decreases-variable-home-loan-rates, viewed 26 February 2020; *Rate decision—2 October 2019,* 2 October 2019, https://www.anz.com.au/personal/home-loans/your-loan/rate-changes/, viewed 26 February 2020.

Commonwealth Bank of Australia, *Commonwealth Bank home loan interest rate change*, 4 June 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-home-loan-interest-rate-change-201906.html, viewed 14 January 2020; *Commonwealth Bank cuts home loan interest rates*, 2 July 2019, https://www.commbank.com.au/guidance/newsroom/cba-rba-interest-rates-201907.html, viewed 26 February 2020; *Rates announcement*, 1 October 2019, https://www.commbank.com.au/news/rate-announcement.html, viewed 26 February 2020.

National Australia Bank Limited, *NAB cuts home loan variable interest rates*, 4 June 2019, https://news.nab.com.au/news_room_posts/nab-cuts-home-loan-variable-interest-rates/, viewed 26 February 2020; *NAB announces changes to home loan interest rates*, 2 July 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-2/, viewed 26 February 2020; *NAB announces changes to home loan interest rates*, 1 October 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-3/, viewed 26 February 2020.

Westpac Banking Corporation, *Westpac reduces interest rates for its home loan customers*, 4 June 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/4-june/, viewed 26 February 2020; *Westpac cuts variable home loan interest rates*, 2 July 2010, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-july/, viewed 26 February 2020; *Westpac decreases variable home loan rates*, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-october/, viewed 26 February 2020.

The lag period for the headline variable rate reductions in June, July and October 2019 was estimated by each bank to result in additional revenue, compared to a situation where the rate changes were implemented immediately (that is, on the day the rate change was announced by the bank). We note that the big four banks had different lag periods for their headline variable rate increases in the second half of 2018 and in early 2019 for NAB. The lag period for these headline variable rate increases were: ANZ 21 days, CBA 28 days, NAB seven days, and Westpac 20 days.[28]

Box 1.1 Impact of the lag period on home loan revenue

Headline variable rate reductions lead to additional home loan revenue during the lag period, compared to if the changes were implemented immediately. This is because customers continue to pay a higher interest rate on their home loans during the lag period, compared to the lower interest rate customers pay after the headline variable rate is reduced. This increase in revenue may be partly offset by higher costs in the form of interest paid by the bank to deposit holders during the lag period, assuming the headline variable rate and deposit rate changes come into effect on the same day.

Conversely, headline variable rate increases lead to a decrease in home loan revenue during the lag period, compared to if the headline variable rate changes were implemented immediately, possibly offset by lower interest costs paid to deposit holders.

Three of the big four banks informed the ACCC that the additional revenue from the lag period was not a consideration when they decided on the date that a headline variable rate change would take effect. These banks reported that they had used the same timeline for their respective headline variable rate changes since June 2019.The other big four bank, CBA, took into account business and operational requirements, consistency with previous lag periods and the additional revenue from the lag period when deciding on the date that headline variable rate changes would be implemented.

The additional home loan revenue to CBA from the lag period, compared to if the change was implemented on the day of the announcement, was estimated to be $37 million for each interest rate cut. This additional revenue, which appears to be relatively insignificant in the context of the bank's overall home loan revenue, was one factor that contributed to the length of CBA's lag period (which was longer than the lag period for the other big four banks).

[28] See: Australia and New Zealand Banking Group Limited, *ANZ increases variable home loan rates*, 6 September 2018, https://media.anz.com/posts/2018/09/anz-increases-variable-home-loan-rates, viewed 26 February 2020.

Commonwealth Bank of Australia, *Commonwealth Bank announces interest rate change*, 6 September 2018, https://www.commbank.com.au/guidance/newsroom/interest-rate-change-201809.html, viewed 26 February 2020.

National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 26 February 2020.

Westpac Banking Corporation, *Westpac increases variable home loan rates*, 29 August 2018, https://www.westpac.com.au/about-westpac/media/media-releases/2018/29-august/, viewed 26 February 2020.

2. Key influences on headline rate decisions

Key findings

- The big four banks balanced a range of factors when making their headline variable rate decisions following the cash rate reductions in June, July and October 2019. The relative weight given to each factor varied by bank and month but, in most instances, a key consideration for the banks was maintaining their profitability against internal benchmarks.
- The banks cited in their media releases that they balanced the interests of different stakeholders, such as home loan customers and deposit customers, in making their decisions. We found that it was in the context of their desire to maintain profitability that the banks balanced the interests of these stakeholders.
- The banks anticipated profit reductions in a low interest rate environment because they preferred not to reduce deposit rates further as they approached zero per cent. This was due to a range of reasons, including that low rates would negatively affect the return to depositors.
- At the time of making headline variable rate decisions, three of the banks primarily characterised these anticipated profit reductions as occurring in their deposit portfolios. All of the banks aimed to at least partly recover their anticipated profit reductions through their headline rate decisions for home loans.
- Each of the big four banks considered their cost of funds in their decision making and one bank's headline rate decisions were influenced by those considerations. The influence of cost of funds on the remaining banks' headline rate decisions was less clear based on our review of their internal documents.
- The banks also considered community expectations and the public's reaction in their decision making. This resulted in some banks reducing their headline variable rates by more than they otherwise might have. The desire to maintain their reputation also impacted the timing of at least one bank's announcements of changes to headline rates.
- The banks were aware of their competitive position, particularly among their big four peers. However, we did not see evidence of the banks aiming to match the headline variable rates of lenders other than their big four peers, who appeared to be growing at their expense.

The RBA cut the cash rate by 25 basis points in each of June, July and October 2019. In the context of a low interest rate environment, the big four banks responded to these cash rate changes by reducing their headline variable rates by varying degrees and with varying 'lag periods' following the RBA announcements of the cash rate cuts (see tables 1.1 and 1.2).

This chapter contains our findings on the key factors that influenced the big four banks' headline variable rate decisions. In particular, this chapter discusses the impact of:

- profitability considerations
- changes in the cost of funds for home loans
- community expectations about bank decisions following a cash rate cut and public reactions to the big four banks' decisions
- the banks' competitive positioning, particularly amongst their big four peers
- factors influencing the banks to reduce investor interest-only headline rates by more than headline rates for other loan types.

Our findings in this chapter are based on our analysis of contemporaneous internal documents from the big four banks, consisting of their own observations at the time that they made their headline rate decisions.

Maintaining profitability was a key consideration

While each of the big four banks considered a range of factors when making their headline rate decisions, we conclude based on our analysis of their internal documents that maintaining financial performance (such as revenue or profitability)[29] was a key factor for them in making those decisions.[30] We consider that this was a major reason the banks sometimes reduced headline variable rates by less than 25 basis points in response to the three 25 basis point cuts in the cash rate in June, July and October 2019.

Given the low interest rate environment prevailing during the price monitoring period, the big four banks anticipated profit reductions because of their limited ability to reduce deposit rates in the event of reductions in the cash rate. The banks considered they could not cut deposit rates that were already at or near zero per cent for several reasons. One factor considered in their internal documents was the level of return provided to depositors, including, for example, pensioners and retirees.

Each of the banks stated in most of their media releases for the headline rate decisions that they balanced the interests of different stakeholders in making those decisions.[31] These stakeholders included, for example, home loan customers, deposit customers and shareholders. We found that the banks balanced the interests of home loan customers and deposit customers within a framework of wishing to maintain profitability. In particular, the banks reduced headline variable rates for home loans by a smaller amount than the cash rate cuts because, among other reasons, they considered this to be an effective way to recover or mitigate anticipated profit reductions arising from their limited ability to reprice deposits.

In addition to headline rate reductions that were less than the cash rate cuts, two banks considered other strategies to recover profits in the low interest rate environment, such as increasing reliance on fee-based revenue and reducing costs.

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29 While the banks' own internal documents referred to a range of financial performance metrics, for simplicity, we have generally referred to 'profitability' in this section as a representative metric for financial performance (given that profit is affected by changes in those other metrics, all else equal).

30 The focus of the big four banks on maintaining profitability is similar to what we observed in the Residential mortgage price inquiry. See Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, p. 26.

31 Source:

Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates,* 4 June 2019, https://media.anz.com/posts/2019/06/anz-decreases-variable-home-loan-rates, viewed 17 January 2020.

Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates,* 2 October 2019, https://media.anz.com/posts/2019/10/anz-decreases-variable-interest-rates, viewed 17 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank cuts home loan interest rates*, 2 July 2019, https://www.commbank.com.au/guidance/newsroom/cba-rba-interest-rates-201907.html?ei=card-view, viewed 17 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank reduces home loan interest rates*, 1 October 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-reduces-home-loan-interest-rates-201910.html?ei=card-view, viewed 17 January 2020.

National Australia Bank Limited, *NAB announces changes to home loan interest rates*, 2 July 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-2/, viewed 17 January 2020.

National Australia Bank Limited, *NAB announces changes to home loan interest rates*, 1 October 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-3/, viewed 17 January 2020.

Westpac Banking Corporation, *Westpac reduces interest rates for its home loan customers*, 4 June 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/4-june/, viewed 17 January 2020.

Westpac Banking Corporation, *Westpac cuts variable home loan interest rates*, 2 July 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-july/, viewed 17 January 2020.

The banks anticipated profit reductions in a low interest rate environment

As the RBA reduced the cash rate in 2019, the big four banks anticipated they would experience profit reductions because of their limited ability to reduce deposit rates in the low interest rate environment.[32] In particular, they considered that these factors would affect revenues and costs in their retail business units, which in turn would affect profits in these units (see box 2.2 below). Their estimates of profit reductions were at times made on the basis of both existing and future predicted cash rate cuts. For example, one bank estimated in June 2019 that if three cash rate cuts occurred in 2019 (including two further predicted cuts), the decline in revenue in its deposit portfolio would exceed $300 million in its 2020 financial year.

The banks considered they were constrained in their ability to reduce deposit rates because some deposit products were already priced close to or at zero per cent, or were approaching a 'floor rate'.[33] The banks preferred not to reduce these deposit rates further for reasons that varied from bank to bank and that were not always clear. Some reasons included:

- consideration of the interests of depositors. Some banks were explicitly concerned that low rates could negatively affect deposit customers such as pensioners and retirees
- wishing to maintain product differentiation between savings products, which generally pay interest, and transaction products, which generally do not
- wanting to provide a certain level of return on deposit products to attract or retain deposit customers.

Documents from three of the banks indicated that, with each consecutive cash rate reduction, an increasing portion of their deposit balances had an interest rate at or approaching zero per cent, leading to a more acute constraint on deposit repricing and a larger financial impact (see box 2.1).

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32 Other profitability concerns that may have impacted some banks' headline rate decisions include increased amounts of discounting to customers with new loans (as characterised by those banks; see chapter 5 for a discussion on increased levels of discounting), though it is unclear if or how this affected their headline rate decisions based on the available evidence, and margin compression from customers switching to lower margin products.

33 The floor rate is a minimum interest rate below which the bank preferred not to further reduce rates for a given deposit product.

Box 2.1 A larger proportion of three banks' deposit balances fell closer to zero per cent with each cash rate cut

In April 2019, in anticipation of two cash rate reductions, one bank estimated that '[*a] drop in cash rates will have a negative financial impact on the Group if cuts are fully passed on to all variable [rate] products as there is a large number of deposit balances that cannot be repriced any lower (ie already zero or close to zero)*'. The bank estimated that, *'assuming a 25bps customer deposit rate floor (on variable savings accounts*)', for the first cash rate reduction there will be *'[n]on-repriceable deposit balances across [banking division] [of] $XXbn [confidential]'*. For a second cash rate reduction of 25 basis points, the bank estimated that this balance would increase by approximately four times.

In June 2019, in anticipation of a cash rate reduction, another bank estimated in a pricing strategy document for decision makers that a 25 basis point reduction in the cash rate would result in *'$5.8b [in savings accounts that] can no longer be repriced down [as they would be at the floor rate]...'* Following the cash rate reductions in June and July 2019, the same bank reported in September 2019 that *'[t]he impact of the 3rd RBA cut is more severe than the 2nd cut as the volume [of deposit products] on the floor has now increased to $XXb [confidential] (up from $Xb [confidential] with the 2nd cut)…*'

Finally, a third bank noted that following the October 2019 cash rate reduction, of the relevant division's deposit balance, around one third had an interest rate below 0.10 per cent, and close to half had an interest rate below 0.25 per cent. This is consistent with the bank's narrative that *'[a] large proportion of deposit rates (ie at call deposits) are now at or close to zero so passing on cash rate reductions to lower deposit rates is increasingly difficult—without moving to negative interest rates or reducing returns to investors to unacceptable levels'*.

The banks characterised these profit reductions differently

All of the big four banks were concerned about profitability given their limited ability to reduce deposit rates in the low interest rate environment. However, there were differences in the way the banks characterised this profitability issue.

The internal documents of three banks indicated that at the time of making headline rate decisions, decision makers primarily characterised the issue as one of reduced profit in their deposit portfolios. The decision makers of the fourth bank primarily characterised the issue as one of reduced profit in its home loan portfolio. See box 2.2 for a high level and simplified explanation of how this could occur.

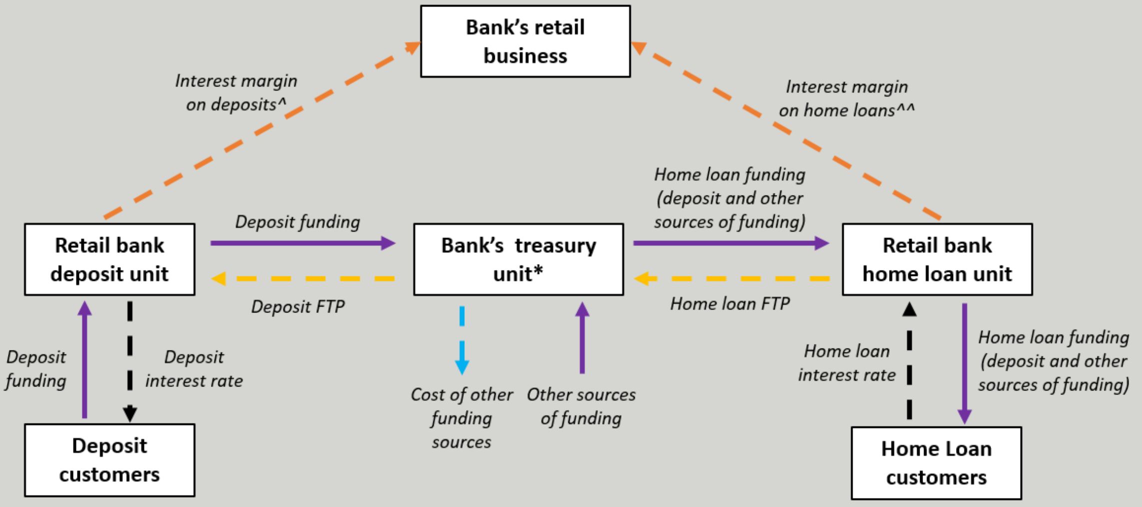
Box 2.2 How banks can characterise profit reductions in a low interest rate environment

The retail business of a bank consists of different product portfolios, including the deposit portfolio and the home loan portfolio. These portfolios may be run as separate units and considered independently in decision making, even though they can be part of the same division within the bank. There are a number of possible reasons for this, including that it may enable the bank to better understand the drivers of revenue and costs across the bank and to allocate resources more efficiently.

However, the performance of both portfolios is affected by the interest rate paid to depositors. This is because the interest rate paid on deposits is one component of a bank's cost of funds, and this can impact the funds transfer price (FTP) for home loans (see chapter 3). As a result, a bank may consider the impact of changes to deposit interest rates on these portfolios together.

Diagram 2.1 below shows a simple stylised example of how the performance of both portfolios can be affected by deposit interest rates, all else equal.

Diagram 2.1 How deposit rates can influence bank performance



represents the movement and direction of funds

represents the payment for accessing other funding sources by the treasury unit, such as wholesale domestic and international debt

represents the payment and direction of interest rates between a bank and its customers

represents the payment and direction of FTPs between business units and the treasury unit

* A bank's treasury unit acts as a central risk management hub for the different business lines within the bank (such as the retail and commercial banking arms) that extend loans and accept deposits. The treasury unit centralises funding, liquidity and interest rate risk through the funds transfer pricing process. The funds transfer pricing process determines an interest rate (the FTP) that is charged by the treasury unit for 'lending' money to the business unit responsible for providing loans (such as home loans) and a rate the treasury unit pays to different units for providing funding (such as deposits) to the bank. A different FTP is usually provided for different products.

^ The interest margin on deposits is based on the difference between the deposit FTP received from the treasury unit by the deposit unit less the interest rate paid to deposit customers.

^^ The interest margin on home loans is based on the difference between the interest rate received from customers less the home loan FTP paid to the treasury unit by the home loan unit.

Source: Fabrizio Cadamagnani, Rashmi Harimohan and Kumar Tangri, *'A bank within a bank: how a commercial bank's treasury function affects the interest rates set for loans and deposits'*, Bank of England, June 2015, pp. 153–154.

Profit impacts from the deposit repricing constraint in a low interest rate environment

Impact in the deposit portfolio

Although the exact mechanisms may vary by bank, in simplified terms, a bank's deposit unit generates an interest margin from paying depositors a lower interest rate than the FTP it receives from the bank's treasury unit for the deposit funding it generates for the bank. The FTP that the bank's treasury unit pays to the deposit unit can be impacted by a cash rate cut because this FTP is linked to movements in wholesale market interest rates, including the cash rate. If the bank cannot reduce the amount it pays to its depositors by an equivalent amount, which may occur when deposit rates are at or close to zero per cent, the interest margin for the bank's deposit portfolio will fall.

Impact in the home loan portfolio

More broadly, deposits are a significant source of funding for a bank's home loan portfolio (see box 3.1). Therefore, the inability to reduce deposit rates flows through to the cost of funds for home loans. One bank explained how a limited ability to reprice deposits can affect its cost of funds and therefore the profitability of its home loan portfolio in the following terms:

> *…[Bank name] has a limited ability to adjust the interest rate on domestic deposits (and for deposits with a zero interest rate, further reduction would require negative interest rates, which at this point is deemed commercially unfeasible). Because*

> *deposits comprise approximately XX% [confidential] of [bank name]'s funding… a significant portion of [bank name]'s funding comes at a cost that is not lessened by an amount equal to a decrease in the OCR [cash rate], after a change in the OCR.*
>
> *Given the context above in relation to the cost of domestic deposits, in a low interest rate environment, if [bank name] decides to decrease its Headline Interest Rate for Home Loans by the same amount as a Relevant OCR decrease, it does so knowing the decision will decrease its Home Loan portfolio profitability (ie, decrease [bank name's] NIM [net interest margin]).*

Banks generally evaluate the financial performance of each portfolio and the overall retail business. Depending on the bank, headline rate decision makers may consider the performance of the retail business as a whole or may focus on the performance of the home loan portfolio specifically. This and other factors can influence how these decision makers primarily characterise any reduction in profits. For example, if a decision maker considers the performance of the retail business (that is, both the deposit and home loan portfolios) and anticipates reduced profit in the deposit portfolio to be comparatively larger than reduced profit in the home loan portfolio following a given event, the decision maker may characterise the impact of that event as primarily occurring in the deposit portfolio.

The banks used headline rate repricing to make up for their anticipated profit reductions

Regardless of any differences in how the banks characterised their profit reductions, they were all ultimately concerned about the same issue of profitability. Each bank used headline rate repricing as a mechanism to improve revenue outcomes, with the aim of improving profitability in its retail business.

Each of the three banks which primarily characterised the effects on profit as occurring in their deposit portfolios considered they could at least partially recover a portion of these anticipated profit reductions through headline rate decisions in their home loan portfolios. This was a key reason that each of these banks reduced headline variable rates by less than 25 basis points in at least two of the three months (June, July and October 2019):

- One bank noted in its July and October 2019 decision making documents that it was possible *'[t]o recover the revenue impact [in the deposits portfolio] through the home loans portfolio'*, however it would *'require a large reprice of the [home loans] portfolio relative to movements in the RBA cash rate'*.
- An internal strategy document considered by the same bank in September 2019 outlined options to reduce headline rates and deposit rates by amounts of 25 basis points or less, subject to a 'floor rate' for deposits, and estimated the resulting revenue effects from each combination of options. The document noted:

  > *Each 1bps [in headline variable rates] is worth ~$XXm [confidential] annualised meaning to offset the $XXXm [confidential] impact in deposits from an October rate cut would require 6bps repricing in home lending.*

  The bank ultimately decided to 'hold back' more than 6 basis points of the cash rate reduction in October 2019 for all loans except investor interest-only loans.
- An internal memorandum dated September 2019 from another bank noted the impact of its constrained ability to reduce deposit rates on its deposit portfolio margins and given this, suggested that the bank could maintain its consumer bank net interest margin (NIM) through repricing its home loan portfolio. The document noted:

  > *Given the diminishing ability to reprice the deposit base with each additional RBA rate cut, this will require the mortgage portfolio to generate additional margin to support overall [retail division] NIM outcomes. [Bank unit] is forecasting two 25bps*

> *rate cuts in FY20. Given the impact to deposits, for each of the 25bps reductions in the cash rate, mortgages would be required to withhold X-Xbps [confidential] to maintain [retail division] NIM, this is factored into [the] FY20 portfolio margin target of X% [confidential]...*

For the remaining bank that characterised the effects on profit as occurring in its home loan portfolio via the cost of funds (and in particular deposit funding costs), this concern was a key reason why it reduced some headline rates by less than 25 basis points in two of the months. For example, an internal document considered for the bank's decision in one of those months stated:

> *[Bank name's] response in adjusting variable rate Home Loan indices in the context of an RBA Overnight Cash Rate reduction will need to consider that average Deposit funding costs will reduce by less than any RBA reduction due to the impact of zero rate/low rate deposits (which cannot be fully repriced).*

It is unclear from the available evidence to what extent the big four banks successfully mitigated their anticipated profit reductions by reducing headline variable rates by amounts less than 25 basis points. However, three of the banks forecasted a positive mitigating effect on revenue or profit from implementing this strategy. The fourth bank noted in an internal document that reducing headline rates by less than 25 basis points in July 2019 had actually improved profit in its home loan portfolio in August 2019 and among other factors, outweighed the negative performance in its deposit portfolio to uplift revenue in the overall retail division.

Other strategies in response to the low interest rate environment

Two banks considered their broader strategy to maintain profitability in the low interest rate environment in July 2019 and October 2019, respectively. Both banks considered dealing with this issue by limiting reductions in their headline variable rates, increasing fee-based revenue and reducing their costs.

One bank noted that it needed to *'optimise pricing on assets and deposits to protect NIM'* and to *'[a]ccelerate growth in commercial lending'.* It also debated whether to actively shift to more fixed rate loans. The other bank considered *'push[ing] for a lower multiple of system growth, which protects margins, and results in a [sic] better revenue (and capital) outcomes'*. Both banks acknowledged risks and challenges of their potential strategies.

The banks internally debated the extent to which they could reduce the floor rate for deposits as the cash rate was expected to continue to decline, with one bank considering in late October 2019 the prospect of negative deposit rates if the cash rate or deposit margins became negative in the future. However, both banks considered that near-zero or negative rates were risky or undesirable, or should not be their starting position for addressing their profitability concerns.

Other than headline rate and deposit repricing decisions, it is unclear from the available evidence if and to what extent these banks adopted the other strategies described above. As at 1 November 2019, we observe that they had not increased fees for home loans from what was reported for June 2018 in the Residential mortgage price inquiry.[34]

The banks considered changes in cost of funds to various degrees in their decision making documents

We observe that each bank considered changes in its overall cost of funds, or individual components of its cost of funds, at the time it made its headline rate decisions. However, the

[34] Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* p. 39.

extent to which these changes were expressly discussed or linked to headline rate decisions in the banks' internal documents varied.

As outlined above, one bank considered the impact of the cash rate cuts on its deposit funding costs and this was a key influence on some of its headline rate decisions. It noted that other changes in its cost of funds were not as significant in its headline rate decisions. However, the bank also noted that declining wholesale funding costs in 2019 contributed positively to revenue results in its home loan portfolio and a broader product division.

Of the remaining three banks:

- Two banks did not expressly outline if and how the trends in cost of funds identified in their internal documents actually influenced their headline rate decisions. For example, in a document dated April 2019 regarding its potential response to future expected cash rate cuts, one of these banks noted that while some components of its cost of funds had been more favourable in 2019, this could reverse due to volatility and would likely be offset by anticipated profit reductions in its deposit portfolio. Later documents considered at the time of its headline rate decisions did not provide any further clarity on the ultimate influence of favourable changes in its cost of funds on those decisions.
- The third bank observed in decision making documents for its June and July 2019 headline rate decisions that its revenue had been affected by elevated funding costs sustained from an earlier period. However, it is unclear from the available evidence to what extent this factor impacted those decisions. By September 2019, the bank's internal analysis showed that the elevated funding costs had declined and it did not feature as a prominent decision making factor for its October 2019 headline rate decision.

We discuss the ACCC's analysis of the banks' cost of funds data in further detail in chapter 3.

Community expectations and public reactions continued to constrain headline rate decisions

While profitability concerns influenced the big four banks to reduce headline variable rates by less than they otherwise could have, we observe that community expectations and public reactions were a countervailing consideration for their decision making. We found that these factors constrained decisions on headline variable rates for at least two banks—that is, this sometimes resulted in those banks reducing their headline variable rates by more than they otherwise might have (consistent with our findings in the Residential mortgage price inquiry[35]).

The big four banks were aware of expectations to 'pass on' the full cash rate cuts

At least three of the big four banks' internal documents explicitly considered community and Government expectations that they reduce their headline variable rates by the same amount as reductions to the cash rate or 'pass on' the full cash rate cuts. Given media coverage and the RBA Governor's comments following the June 2019 cash rate cut that it *'should be fully passed through to variable mortgage rates'*[36], we consider that all of the big four banks were aware of these expectations.

At least three of the banks were also aware that there could be adverse consequences to their reputation if they did not 'pass on' reductions in the cash rate in line with expectations:

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[35] Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report,* pp. 30–31.

[36] Phillip Lowe, 'Today's Reduction in the Cash Rate', Reserve Bank of Australia Board Dinner, 4 June 2019, https://www.rba.gov.au/speeches/2019/sp-gov-2019-06-04.html, viewed 15 January 2020.

- At least two banks were concerned about attracting heightened political scrutiny, with one bank noting that *'[t]he June rate announcement received unprecedented attention from the Treasurer'*.
- At least two banks noted customer satisfaction and potential conduct consequences. One bank considered that not 'passing on' the full cash rate cut would be risky for its net promoter score[37] and cause *'negative reputational impacts given [the] prominence of the Royal Commission and continued reports of "unfair" and "inappropriate" home loans being provided'*.

The desire to maintain reputation constrained some headline rate decisions

The desire to maintain reputation appears to have, at least partially, affected the headline rate decisions of at least two banks. Consistent with the other factors discussed in this chapter, the weight placed on reputation considerations varied over time and between banks. For example, in June 2019, despite facing revenue pressures, NAB decided to reduce its headline variable rates by the same amount as the cash rate cut. Part of the rationale for this was that it *'reflect[ed] our commitment to supporting our existing customers'*. This was consistent with a longer-term trust renewal plan that included holding its headline variable rates flat for four months from September 2018, despite rate increases from its competitors.[38] However, NAB's position changed in July 2019 when revenue impacts arising from the low interest rate environment appeared to outweigh these considerations.

At least one other bank also faced profitability pressure in June 2019 and also considered the possible reputational damage of its decision. However, in contrast to NAB, it did not decrease its headline variable rates by the same amount as the cash rate cut. It appears that its business performance considerations, including profitability concerns, outweighed other factors in this particular decision.

Public reactions to past headline rate decisions influenced future ones

Each bank monitored community reactions to its headline rate decisions, and at least three banks took this into consideration (whether negative, positive or neutral) when making their next headline rate decision.

ANZ received significant criticism from the Government and the media for its headline rate decision in June 2019.[39] This was a contributing factor to its decision in July 2019 to 'pass on' the full cash rate cut. Another contributing factor was ANZ's slowing growth in home loan application volumes (discussed in box 2.4 below). ANZ identified to the ACCC that its July 2019 decision was part of a broader effort to *'improve market sentiment and increase Home Loan volume'*.

Some banks also considered the public's reaction to their competitors' previous headline rate decisions when making their own current headline rate decisions, although the extent to which this factor impacted their decisions is less clear. For example, two of the big four banks were aware of the reputational impact experienced by the other two banks following

[37] A net promotor score is a method of gauging customer loyalty and the willingness of customers to recommend a company's products and/or services.

[38] National Australia Bank Limited, *NAB standard variable rate for home loans on hold*, 9 September 2018, https://news.nab.com.au/news_room_posts/nab-standard-variable-rate-for-home-loans-on-hold/, viewed 13 January 2020.

National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 13 January 2020.

[39] See for example, J Frost, 'ANZ in damage control over deposit hit', *Australian Financial Review*, 5 June 2019, https://www.afr.com/companies/financial-services/anz-in-damage-control-over-deposit-hit-20190605-p51utb, viewed 17 January 2020.

their earlier headline variable rate decisions. They noted that these decisions generated *'a lot of media attention and community backlash'* and *'significant media and political scrutiny'*.

The banks timed their headline rate announcements with their reputations in mind

At least three of the banks were aware of the potential reputational impacts of the timing of their announcements for their headline rate decisions relative to the announcements of their competitors. This is consistent with our findings in the Residential mortgage price inquiry, where we noted that the big four banks often utilised a 'fast follower' approach when making announcements.[40]

In our view, the timing of announcements was often used to leverage anticipated positive publicity when the banks met community expectations, and to alleviate anticipated negative publicity when they did not.

Generally, the big four banks made their announcements on the day of the RBA decision[41] and, with the exception of ANZ, announced their decisions in the same order (as between themselves) each time, being CBA followed by NAB and then Westpac.[42] ANZ was the first

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40 Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report,* pp. 31–32.

41 During the price monitoring period, NAB also announced an increase to its headline variable rates in January 2019, which followed similar headline variable rate increases by the other big four banks in the second half of 2018.

The only cash rate announcement during the price monitoring period when a big four bank did not announce a headline variable rate reduction on the same day occurred in October 2019. Westpac and ANZ announced their headline variable rate decisions on the day following the cash rate announcement.

42 Sources for June 2019:

J Eyers, 'ANZ takes a hard lesson in interest rate game theory', *Australian Financial Review,* 7 June 2019, https://www.afr.com/companies/financial-services/anz-takes-a-hard-lesson-in-interest-rate-game-theory-20190607-p51vgz, viewed 10 January 2020.

Australia and New Zealand Banking Group Limited, Twitter, 4 June 2019, https://twitter.com/ANZ_Newsroom/status/1135772714197590016, viewed 10 January 2019.

Commonwealth Bank of Australia, Twitter, 4 June 2019, https://twitter.com/CommBank/status/1135788731225427969, viewed 10 January 2020.

National Australia Bank Limited, Twitter, 4 June 2019, https://twitter.com/NAB/status/1135795484142870528, viewed 10 January 2020.

Westpac Group Media Relations, Twitter, 4 June 2019, https://twitter.com/WestpacMedia/status/1135837097456103425, viewed 10 January 2020.

Sources for July 2019:

J Frost, 'How the big four responded to the RBA cut', *Australian Financial Review*, 2 July 2019, https://www.afr.com/companies/financial-services/big-four-rate-game-plan-takes-shape-20190702-p523ed, viewed 10 January 2020.

Australia and New Zealand Banking Group Limited, Twitter, 2 July 2019, https://twitter.com/ANZ_Newsroom/status/1145936623869153280, viewed 10 January 2019

Commonwealth Bank of Australia, Twitter, 2 July 2019, https://twitter.com/CommBank/status/1145962022254731264, viewed 10 January 2020.

National Australia Bank Limited, Twitter, 2 July 2019, https://twitter.com/NAB/status/1145971065899741185, viewed 10 January 2020.

Westpac Banking Corporation, Twitter, 2 July 2019, https://twitter.com/Westpac/status/1145974742622429184, viewed 10 January 2020.

Sources for October 2019:

A Vickovich, 'Westpac and ANZ break silence with partial rate cut', *Australian Financial Review*, 2 October 2019, https://www.afr.com/companies/financial-services/competing-interests-paralyse-westpac-and-anz-on-rates-20191002-p52wsf, viewed 10 January 2020.

Australia and New Zealand Banking Group Limited, Twitter, 2 October 2019, https://twitter.com/ANZ_Newsroom/status/1179260290426458113, viewed 10 January 2019.

Commonwealth Bank of Australia, Twitter, 1 October 2019, https://twitter.com/CommBank/status/1178950743266430977, viewed 10 January 2020.

National Australia Bank Limited, Twitter, 1 October 2019, https://twitter.com/NAB/status/1178958252094050305, viewed 10 January 2020.

Westpac Banking Corporation, Twitter, 2 October 2019, https://twitter.com/Westpac/status/1179257251871244288, viewed 10 January 2020.

of the big four banks to announce in June and July 2019 but the last in October 2019. This change was influenced by reputational considerations (see box 2.3).

Box 2.3 Timing of ANZ's announcements on headline variable rate decisions

In June 2019, ANZ reduced its headline variable rates by less than the cash rate reduction. It faced criticism for doing so, especially because it was the first to announce its decision.[43]

In between its June and July 2019 decisions, ANZ developed draft guidance on how to manage the reputational impacts of its headline rate decisions. Among other things, it recommended that *'[i]f we are not matching the official rate move, we should consider waiting to side step first mover political/reputation disadvantage; acknowledging there may be other reasons to act first'.*

In line with this strategy, ANZ announced its headline variable rate changes:

- first out of the big four banks in July 2019 when it reduced its headline rates by the same amount as the cash rate cut.[44] Since ANZ was 'passing on' the cash rate cut in full, we consider that making its announcement first carried little (if any) reputational risk, and may also have been seen as addressing some of the reputational harm it experienced in June 2019
- last out of the big four banks in October 2019 when it reduced some of its headline rates by less than the cash rate cut.[45]

At least two other banks also considered how the timing of their announcements relative to competitors could impact their reputation. One of these banks noted that if it reduced its headline variable rates by the same amount as a cash rate reduction and announced its decision:

- first out of the big four banks, it could take a *'leadership position in [the] market'*, but risked the *'[p]otential for peers to move differently'*
- immediately after the other big four banks, it would (among other things) *'[l]ikely [be] seen as a "follower" by [the] public/media'*.

The same bank considered that if it reduced headline variable rates by less than a cash rate cut and waited *'to be the last major to announce after the RBA'*, this would (among other considerations) present the *'[b]est opportunity to optimise competitive position [and] revenue impact without announcing first'.*

In addition, one bank noted that it should be aware of when the Government may publicly respond to cash rate cuts, possibly *'encourag[ing] downward SVR [standard variable rate]*

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43 See, for example, J Eyers, 'ANZ takes a hard lesson in interest rate game theory', Australian Financial Review, 7 June 2019, https://www.afr.com/companies/financial-services/anz-takes-a-hard-lesson-in-interest-rate-game-theory-20190607-p51vgz, viewed 10 January 2020.

44 J Frost, 'How the big four responded to the RBA cut', *Australian Financial Review*, 2 July 2019, https://www.afr.com/companies/financial-services/big-four-rate-game-plan-takes-shape-20190702-p523ed, viewed 10 January 2020.

45 A Vickovich, 'Westpac and ANZ break silence with partial rate cut', *Australian Financial Review*, 2 October 2019, https://www.afr.com/companies/financial-services/competing-interests-paralyse-westpac-and-anz-on-rates-20191002-p52wsf, viewed 10 January 2020.

Australia and New Zealand Banking Group Limited, Twitter, 2 October 2019, https://twitter.com/ANZ_Newsroom/status/1179260290426458113, viewed 10 January 2019.

Commonwealth Bank of Australia, Twitter, 1 October 2019, https://twitter.com/CommBank/status/1178950743266430977, viewed 10 January 2020.

National Australia Bank Limited, Twitter, 1 October 2019, https://twitter.com/NAB/status/1178958252094050305, viewed 10 January 2020.

Westpac Banking Corporation, Twitter, 2 October 2019, https://twitter.com/Westpac/status/1179257251871244288, viewed 10 January 2020.

movement which matches official [cash] rate moves', when considering the timing of its announcements. Given that the bank expected any reduction to the cash rate to prompt an almost immediate political response, it suggested discussing its decision with the Government before making any public announcement. The bank also considered that the timing of its announcements should avoid *'colli[ding]'* with the timing of the Government's public response.

The banks were aware of their competitive position among big four peers when making their headline rate decisions

Each of the big four banks considered its competitive position when making headline rate decisions. We observed each big four bank making comparisons to competitors, particularly its big four peers, on factors including growth in its home loan portfolio, headline rates and headline rate decisions. These considerations influenced the headline variable rate decisions of at least two banks.

In July 2019, ANZ was the only big four bank to reduce all headline variable rates by 25 basis points. In doing so, ANZ was particularly motivated by concerns about slow growth in its home loan portfolio and consequently its market share (see box 2.4).

Box 2.4 ANZ's June and July 2019 headline rate decisions

ANZ had been concerned about its relatively slow growth leading up to June 2019. ANZ's documents show that lending volume was shrinking in absolute terms. It was also growing slower than system growth and was the slowest growing among the big four banks and other lenders[46] that it compared itself against. Its decision not to cut its headline rates by 25 basis points in June 2019, when two other big four banks and some other lenders did, appears to have further worsened its position. One consequence of its June 2019 headline rate decision was that ANZ received more calls from existing customers seeking larger discounts and significantly more customer complaints. ANZ may have reasoned that customers switching away from it would shrink the size of its home loan portfolio and further impact its market share.

In an attempt to retain customers, ANZ changed its discounting policy sometime in June 2019. ANZ temporarily increased the level of discounting it offered to customers with existing loans who asked for a price review. This allowed these customers access to the same interest rates offered to customers with new loans.

Concerns about its home loan portfolio growth appear to have led ANZ to be more concerned about supporting its growth than other issues, such as short-term profitability[47], in making its July 2019 headline rate decision. In a document used for communications to internal staff regarding ANZ's 'offer so good' campaign (discussed below), a senior group executive noted that:

> ***Tomorrow the RBA will announce their July rate decision.*** *And while we don't know what the RBA will do, I can tell you that if there was to be a rate change announced by the RBA, ANZ will make an informed decision to help support our momentum.* [original emphasis]

It appears that this led to ANZ's July 2019 decision to cut its headline rates by 25 basis points. At the same time, ANZ also launched the 'offer so good' campaign, which offered new customers frequent flyer points and both new and existing customers a chance to win

[46] 'Other lenders' refers to lenders other than the big four banks.

[47] When headline rates are lowered (all else equal), immediately following this lowering, revenue from the existing portfolio decreases. Lower headline rates, however, may attract more customers, leading to an increase in the size of the portfolio and subsequently greater revenue over time.

cash prizes in the form of a reduction in the balance of their ANZ home loan. This campaign in combination with ANZ's headline rate decision was intended to address volume decline.

After its July 2019 decision, ANZ reversed its earlier discounting decision because its competitive position had improved, the discounting policy change was causing ANZ to lose revenue, and the *'elevated volume of calls […] had settled'.*

However, the collective headline rate decisions of the big four banks in June and July 2019 may have influenced another bank's decision in October 2019 to reduce its headline variable rates (with the exception of its investor interest-only rate) by less than 25 basis points. Internal documents from this bank suggest that the previous headline rate decisions of its big four peers contributed to it feeling that it could cut rates by less than 25 basis points without negatively impacting its competitive position. For example:

- The bank's October 2019 pricing strategy documents prominently reported on the decision of the other big four banks and observed that *'[f]ollowing the June and July 2019 RBA rate cuts, all competitors ([except] Athena) responded with reductions less than the RBA'*.
- In recommending to decision makers to reduce headline rates, except investor interest-only rates, by less than the cash rate cut, the bank noted that *'[o]ur competitive position is maintained, given moves from our key competitors for this change and changes in June and July'*.

At least two banks also specifically considered their competitive position for investor interest-only loans when deciding how to respond to the October 2019 cash rate cut. For example, a bank executive who was monitoring the announcements of other big four bank headline rate decisions advised the bank's CEO that the bank was considering reducing its headline variable rates for investor interest-only loans by a greater amount because *'we have fallen behind here'*.

Other lenders are making inroads into the big four banks' market share

The big four banks considered that other lenders were gaining market share. In particular, at least three of the banks observed that other lenders were growing their mortgage portfolios significantly faster than the big four banks and were consequently taking market share from them. For example, one bank reported data in June 2019 that, when analysed by the ACCC, showed that non-bank lenders were collectively experiencing system growth at least three times faster than that of the big four banks (accounting for the relative size of their respective mortgage books).

We did not observe these trends to a significant degree during the Residential mortgage price inquiry. Despite this apparent change in dynamic, based on the available evidence, we did not observe the big four banks aiming to match the headline variable rates offered by other lenders when considering their headline rate decisions. For example, despite noting that its system growth was negative and that there were '*sharp rates*' available at some second tier banks, one bank stated that it *'[w]on't be matching 2nd tiers on rates'*, and reminded its staff to *'have proposition led discussions when competing with 2nd tiers (branches, support, cashback(?))'*. However, as discussed in chapter 5, the big four banks increased discounts for new loans. This may have been driven, at least in part, by competition from other lenders.

The banks reduced headline variable rates for investor interest-only loans by more than other loan types for various reasons

The big four banks seemingly approached reducing headline variable rates for investor interest-only loans differently to other loan and repayment types. Each bank reduced these rates by more than other headline rates, sometimes in the same month (see table 1.1). For example, in October 2019, three banks reduced their investor interest-only headline rates by more than headline rates for their other loan types. The headline rates for their other loan types were reduced by a consistent amount within each bank.[48]

The documents provided to us contained limited information on the rationale behind why this loan type was treated differently. However, in addition to the considerations outlined in the sections above, the information available to us indicates that the banks' decisions on this loan type were also influenced by factors including:

- Investor interest-only headline rates were notably higher than headline rates for other loan types as at June 2019.[49] They remained higher in July and October 2019 after the banks' headline rate cuts. As one of the big four banks noted, investor interest-only loans have *'been disproportionately impacted by historical back book reprices'.* One likely reason for this is how the banks responded to APRA's interest-only benchmark[50], which resulted in significant increases to headline rates for interest-only loans (see the Residential mortgage price inquiry).[51] We note that investor interest-only loans (as distinct from other loan and repayment types) were also subject to APRA's investor benchmark.[52]
- At least three banks were concerned about the impact on their margins of customers switching from higher margin interest-only loans to lower margin principal and interest loans. As further discussed in box 5.3, the big four banks reported that a number of their interest-only customers had refinanced to principal and interest loans during the price

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48 Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates,* 2 October 2019, https://media.anz.com/posts/2019/10/anz-decreases-variable-interest-rates, viewed 17 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank reduces home loan interest rates*, 1 October 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-reduces-home-loan-interest-rates-201910.html?ei=card-view, viewed 17 January 2020.

National Australia Bank Limited, *NAB announces changes to home loan interest rates*, 1 October 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-3/, viewed 17 January 2020.

49 Australia and New Zealand Banking Group Limited, *ANZ decreases variable home loan rates,* 4 June 2019, https://media.anz.com/posts/2019/06/anz-decreases-variable-home-loan-rates, viewed 17 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank home loan interest rate change,* 4 June 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-home-loan-interest-rate-change-201906.html?ei=list-view, viewed 17 January 2020.

National Australia Bank Limited, *NAB cuts home loan variable interest rates*, 4 June 2019, https://news.nab.com.au/news_room_posts/nab-cuts-home-loan-variable-interest-rates/, viewed 17 January 2020.

Westpac Banking Corporation, *Westpac reduces interest rates for its home loan customers*, 4 June 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/4-june/, viewed 17 January 2020.

50 Australian Prudential Regulation Authority, *Letter to all ADIs: Further measures to reinforce sound residential mortgage lending practices*, March 2017.

51 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* pp. 42–54.

52 Since January 2019, both the investor and interest-only benchmarks have no longer been in place for ADIs meeting certain conditions set by APRA.

Sources:

Australian Prudential Regulation Authority, *Letter to all ADIs: Reinforcing sound residential mortgage lending practices*, December 2014.

Australian Prudential Regulation Authority, *APRA announces plans to remove investor lending benchmark and embed better practices*, 26 April 2018, https://www.apra.gov.au/news-and-publications/apra-announces-plans-to-remove-investor-lending-benchmark-and-embed-better, viewed 25 February 2020.

Australian Prudential Regulation Authority, *APRA to remove interest-only benchmark for residential mortgage lending*, 19 December 2018, https://www.apra.gov.au/news-and-publications/apra-to-remove-interest-only-benchmark-for-residential-mortgage-lending, viewed 25 February 2020.

monitoring period. A large differential between headline variable rates of different loan and repayment types may be one cause of this switching, leading to at least two banks wanting to reduce the differential.[53] One bank noted that its headline rate decisions for different product types were partly aimed at reducing *'switching to lower margin products (i.e. IO [interest-only] to PI [principal and interest])*', to help reduce *'margin compression'*.

[53] Customers may have switched from interest-only loans to principal and interest loans for a number of reasons. These include (among other reasons) the interest rate differential between principal and interest and interest-only loans and the expiry of the interest-only period.

See also: Reserve Bank of Australia, 'Box C: The Expiry of Interest-only Loan Terms', *Statement on Monetary Policy*, May 2018, pp. 45–48.

3. Cost of funds

Key findings

- The big four banks' cost of funds are heavily influenced by the cash rate, but do not move in lockstep with it.
- While cost of funds was a consideration for the banks when making headline variable rate decisions, changes to headline variable rates were not fully aligned with changes in each of the banks' cost of funds from January 2018 to October 2019.
- From January 2018 to early 2019, the big four banks' cost of funds increased. Over this period the banks initially held back from increasing headline variable rates, absorbing the increase in funding cost. However, as these increases appeared to become more permanent, each of the banks eventually increased their headline variable rates.
- The big four banks' cost of funds began decreasing in early 2019 and continued to decrease over the remainder of the year to October 2019. Despite this ongoing decrease in the cost of funds, the banks only decreased headline variable rates following a reduction in the cash rate.
- For each of the big four banks, the overall decrease in the headline variable rates on owner-occupier home loans with principal and interest repayments was less than the decrease in their cost of funds over the course of 2018 and 2019. This was also the case for investor home loans with interest-only repayments for three of the big four banks.

The Treasurer's Direction asked the ACCC to examine supplier pricing decisions following changes in the cash rate, including *'the extent to which any resulting price changes were due to changes in suppliers' access to, and costs of, finance'*.

Our analysis in chapter 2 found that each of the big four banks considered its cost of funds at the time it made headline variable rate decisions. However, the extent to which this influenced final decisions on headline variable rate changes varied between each bank.

In this section, we use cost of funds data provided by the big four banks in response to our notices to examine the changes to their costs of funds over 2018 and 2019 and we compare this to changes in the cash rate and the banks' headline variable rates.[54] We have examined this longer period (compared to the price monitoring period) because this gives a more complete picture of changes in funding cost and how they may have informed changes to headline variable rates.

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[54] Depending on the bank, the cost of funds data provided to decision makers in determining headline variable rates over the period from 1 January 2018 to 30 October 2019 included information on:

- the total cost of funds for the bank, or for the home loan portfolio
- the funds transfer price for the variable rate home loan portfolio.

The data provided to the ACCC is one of many measures that can be used to examine a bank's cost of funds. We consider that the data presented in this section was reflective of the overall funding environment in 2018 and 2019.

The influence of the cost of funds on home loan interest rates

Banks use funds raised from depositors, wholesale investors and shareholders to make loans, including home loans (see box 3.1). In simple terms, banks earn profits by setting the interest rate on loans at a level that generates sufficient interest income to cover:

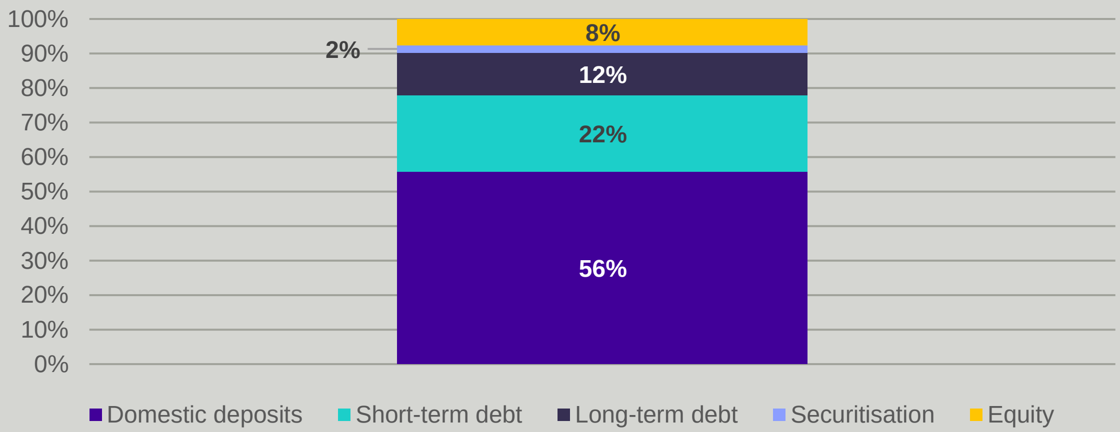
- the interest they pay to depositors and wholesale investors
- the costs from managing the risks associated with raising funds from depositors and in wholesale funding markets (these costs are further discussed in Appendix D)
- operating costs, such as staff wages
- a return to shareholders.

Box 3.1 How banks fund their lending and the role of funds transfer prices

A bank's choice of how it funds its lending operations is a critical business decision. The largest expense for a bank is typically the interest paid on its deposits and wholesale funding. This is the case for the big four banks who collectively paid over $50 billion in interest to depositors and wholesale investors for their respective 2018–19 financial years. Their next largest expense, staff costs, was less than half of their interest expense (or about $20 billion combined) for their 2018–19 financial years.[55]

Each of the big four banks rely on different models and assumptions to measure their funding costs. At a simplified level, bank lending is typically funded through three main sources: deposits, wholesale debt, and equity.[56] The RBA's estimate of the big four banks' funding composition is provided below.

Figure 3.1: RBA estimate of the big four banks' funding composition* as at 31 October 2019



* Short-term debt securities are those that are issued with less than 12 months to maturity. Long-term debt refers to any debt issued that has a maturity greater than 12 months.

Source: RBA data provided to the ACCC.

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[55] The interest and staff expenses referred to relate to the consolidated group for each bank and have been drawn from:

- Australia and New Zealand Banking Group Limited, *2019 Annual Report*, 2019, pp. 111–114.
- Commonwealth Bank of Australia, *2019 Annual Report*, 2019, pp. 130–139.
- National Australia Bank Limited, *Annual Financial Report 2019*, 2019, pp. 86–88.
- Westpac Banking Corporation, *2019 Annual Report*, 2019, pp. 159–162.

[56] Susan Black and Dmitry Titkov, Reserve Bank of Australia, *Developments in Banks' Funding Costs and Lending Rates, Bulletin—March 2019*, March 2019, p. 3.

The RBA also attributes a much smaller additional proportion to securitisation, however as box 3.1 indicates this is only around 2 per cent of their funding.

A bank's funding composition can vary over an extended period of time, although it will tend to remain relatively stable from year to year.[57] Changes may occur due to a range of factors such as the prevailing price of relevant securities, both in Australia and internationally, prudential regulation, changes in credit ratings, demand for deposits, the need for the bank to protect against maturity mismatches, and demand for new loans.

As shown in figure 3.1, a bank's funds come from a range of sources, both within the bank and externally. It is the responsibility of the bank's internal treasury unit to provide funding to the bank's business units. It does this by pooling the deposits from its deposit-taking businesses and acquiring wholesale funds by issuing financial instruments in debt markets.[58]

Treasury units within each bank are also responsible for setting internal prices for this pooled funding, and managing the allocation of the funds to various business units, such as its retail bank or its institutional bank. To do this, a treasury unit typically takes the pooled funds, and then 'lends' these to the loan-writing businesses. In doing so, it charges an internal interest rate on these funds. It also provides an internal rebate to its deposit-taking businesses, in exchange for their deposit funding. The nominal interest rates rebated to the deposit-taking business and the interest rate charged to the loan-writing business are known as funds transfer prices.[59]

Funds transfer prices account for the cost of the bank acquiring funding, as well as managing risks including liquidity, interest rate and currency risks.[60] Appendix D discusses these risk management costs further. In setting funds transfer prices, the treasury unit can also give effect to particular management decisions, by adjusting the funds transfer price for a particular business line or product.[61]

To ensure the cost of acquiring funds is accurately reflected in their funds transfer prices, banks will tend to rely on easily observable, transparent, external market proxies that can be updated regularly. The marginal cost of unsecured wholesale funding has often been a particularly useful benchmark.[62]

With a funds transfer price established for a product by the treasury unit, the relevant business line will then decide the rate at which it chooses to extend loans or take deposits. A business line's new loan will be priced with a spread above its funds transfer price to reflect matters such as expected losses on the loan, regulatory capital requirements, other costs and a rate of return. A deposit will be priced at a spread below its funds transfer price to reflect the costs of raising the deposit, the cost of holding liquid assets to meet withdrawal requests from depositors, and a rate of return.[63] As bank treasuries often rely on an external proxy for fund transfer pricing[64], if business lines wish to maintain a spread, they will be required to adjust the pricing of their own loan and deposit products when such proxies reprice.

How cash rate changes can impact a bank's cost of funds

A change to the cash rate will have an impact on most of an Australian bank's funding sources. However, as these banks rely on a range of funding sources, it is only one of several factors affecting their cost of funds. The cost of funds can move for reasons other

57 Black and Titkov, p. 4.

58 Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report,* p. 48.
See also: Fabrizio Cadamagnani, Rashmi Harimohan and Kumar Tangri, *A bank within a bank: how a commercial bank's treasury function affects the interest rates set for loans and deposits*, Bank of England, June 2015, pp. 153–164.

59 Cadamagnani, Harimohan and Tangri, p. 154.

60 Cadamagnani, Harimohan and Tangri, p. 153.

61 Cadamagnani, Harimohan and Tangri, p. 156.

62 Cadamagnani, Harimohan and Tangri, p. 156.

63 Cadamagnani, Harimohan and Tangri, p. 155.

64 Cadamagnani, Harimohan and Tangri, pp. 155–156.

than cash rate changes, as explained below. Due to this, changes to a bank's funding costs tend not to move in lockstep with changes in the cash rate.

In simple terms, the cash rate acts as a benchmark for interest rates in Australian financial markets.[65] This means that a change to the cash rate will have an impact on capital market interest rates in Australia, this includes money market rates, such as bank bill swap rates (BBSW)[66], and bond yields.[67] The RBA estimated in early 2019 that the cost of around two−thirds of the big four banks' debt and deposit funding (see box 3.1) was linked to BBSW either directly or through interest rate hedging practices.[68]

Cash rate expectations will tend to encourage the prices of financial instruments to adjust ahead of a cash rate decision. When the target cash rate is changed by the RBA, short-term wholesale markets will respond immediately. However, these rates may not always move by the same amount as a cash rate change, as these markets evaluate how a change may influence future monetary policy.[69] Other factors that influence short-term money market rates include investor demand for short-term financial instruments and developments in international money markets.[70]

Following a cash rate change, the pricing of new longer-term instruments such as bonds and existing instruments that have had their fixed interest rates swapped for floating rate exposures using derivatives[71] will depend upon a number of factors. These include the current short-term interest rate and market expectations about future interest rates, as well as financial conditions and competitive tensions.[72] Notwithstanding, sustained short-term interest rate decreases will typically place downward pressure on other interest rates.[73]

Some Australian banks also source funds from international capital markets. These markets enable banks to diversify their funding sources, access deeper and more liquid markets and borrow for longer terms than they often can domestically.[74] In October 2019, around 20 per cent of the big four banks' funding was sourced from international wholesale markets.[75] Instruments issued by Australian banks in foreign debt markets are less likely to be impacted by a change in the cash rate. This is because offshore debt instruments tend to be issued in foreign currencies and are more likely to be influenced by factors in the denominated currency or the relevant debt market, unless the bank converts these foreign

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65 Tim Atkin and Gianni La Cava, *The Transmission of Monetary Policy: How Does It Work?, Bulletin—September Quarter 2017,* RBA, September 2017, pp 1–8.

66 The BBSW rate is the primary interest rate benchmark which measures the cost for highly rated banks in Australia to issue short-term securities for each monthly tenor between one month and six months.

Australian Securities Exchange, *Benchmark Administration*, https://www.asx.com.au/services/benchmark.htm, viewed 25 February 2020.

Reserve Bank of Australia, *Market Operations Resources—Interest Rate Benchmark Reform in Australia*, https://www.rba.gov.au/mkt-operations/resources/interest-rate-benchmark-reform.html, viewed 25 February 2020.

67 Reserve Bank of Australia, *About Monetary Policy,* https://www.rba.gov.au/monetary-policy/about.html, viewed 14 January 2019.

68 Black and Titkov, pp. 2–3.

69 E George, M King, D Clementi, A Budd, W Buiter, C Goodhart, D Julius, I Plenderleith and J Vickers, Bank of England, 'The Transmission Mechanism of Monetary Policy'*, Quarterly Bulletin 1999 Q2,* June 1999, p. 162.

See also: Christopher Viney and Peter Phillips, *Financial Institutions, Instruments and Markets,* McGraw-Hill Education (Australia), 2015, pp. 404–405.

70 Reserve Bank of Australia, *Statement on Monetary Policy—August 2018*, 2018, p. 40.

71 Black and Titkov, p. 8.

72 Viney and Phillips, p. 437.

Atkin and La Cava, pp 1–8.

See also: E George, M King, D Clementi, A Budd, W Buiter, C Goodhart, D Julius, I Plenderleith and J Vickers

73 Viney and Phillips, p. 405.

74 Bellrose and Norman, *The Nature of Australian Banks' Offshore Funding, Bulletin—December Quarter 2019,* RBA, December 2019, p. 1.

75 RBA data provided to the ACCC.

liabilities into Australian Dollars (see Appendix D for a discussion of hedging and the associated cost).[76]

As explained in box 3.1, the cash rate will generally influence the interest rate paid on deposit products. This is because a bank's deposit pricing will generally be set relative to the funds transfer price set by the bank's treasury unit. The funds transfer price, in turn, relies on external factors (such as unsecured wholesale funding costs) which are influenced to varying degrees by the cash rate. That said, as noted in chapter 2, the current low-interest rate environment is creating challenges for the big four banks, as some deposit rates are at or very close to zero per cent, and the banks consider that these deposit rates cannot be repriced any lower.

Trends in the cash rate and the big four banks' cost of funds

Our analysis of the big four banks' cost of funds data, showed that each bank's cost of funds exhibited a similar trend over the period; with an initial increase that lasted from the beginning of 2018 until early 2019, followed by a sustained decrease to October 2019 (see figure 3.2).[77]

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76 As noted in Appendix D, Australian banks can transform their foreign denominated liabilities into Australian dollars, which should make their pricing more sensitive to cash rate changes. However, the extent of the impact will depend on the other factors discussed above.

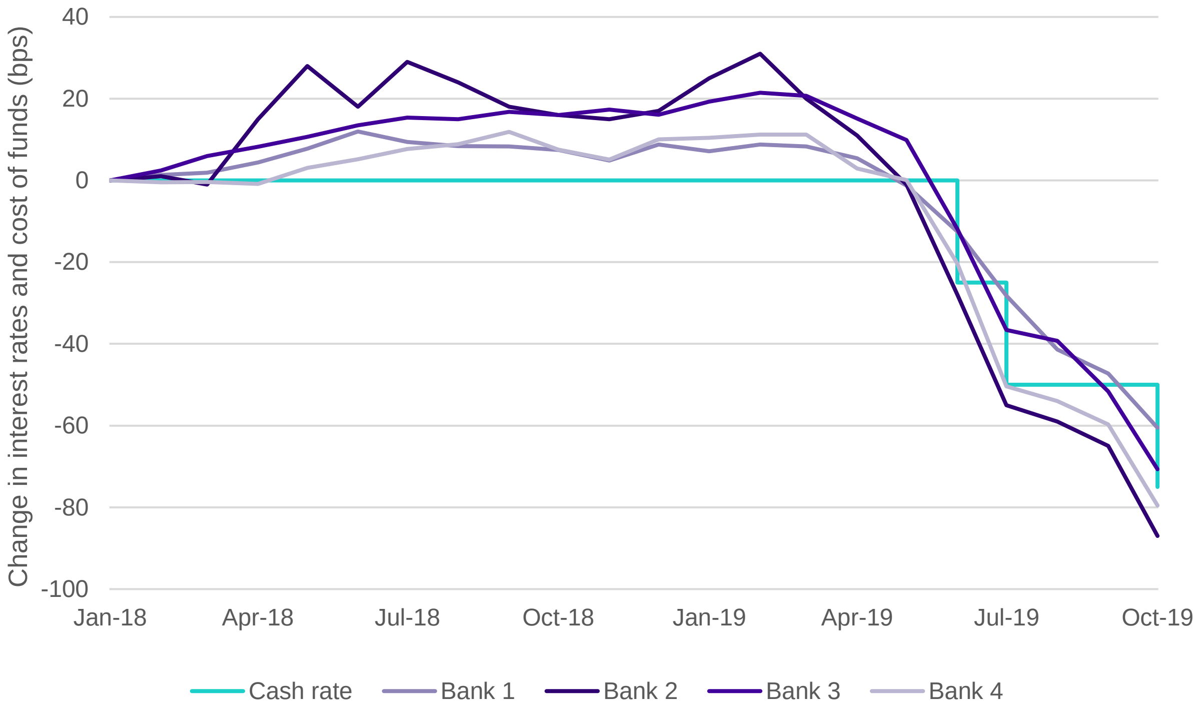
Viney and Phillips, pp. 683–684,

Atkin and La Cava, pp 1–8.

77 Each of the big four banks exhibited similar movements in their cost of funds from the beginning of 2018 to October 2019, despite some marked differences in the approaches and assumptions employed by each bank in estimating their cost of funds. The similarity (between the trend in their respective cost of funds) is not, however, unexpected given the big four banks are sourcing funds from the same deposit and wholesale funding markets, and have the same credit ratings.

Figure 3.2 Changes in the cash rate and the big four banks' cost of funds

Movements in the cash rate and the banks' cost of funds relative to their level as at January 2018



Note: The lines Bank 1, Bank 2, Bank 3 and Bank 4 represent the changes in the cost of funds for each bank.

There are many measures that can be used to examine a bank's cost of funds. The cost of funds data presented in the figure is one of the cost of funds measures provided to decision makers when determining headline rate decisions. Depending on the bank, the cost of funds measure is either the total cost of funds for the bank, the total cost of funds for the home loan portfolio or the funds transfer price for the variable rate home loan portfolio.

Source: ACCC calculations using cost of funds data provided by the big four banks.

The initial increase in the big four banks' funding costs during 2018 coincided with an increase in short-term wholesale funding costs firstly in the United States and subsequently Australia.[78] This increase in wholesale funding was acknowledged by each of the big four banks as a factor that impacted their funding costs in 2018. The sustained decrease in funding costs that commenced in early 2019 was driven firstly by a decrease in short-term wholesale funding costs, which largely unwound funding cost increases from 2018,[79] and secondly by reductions in the cash rate in June, July and October 2019, which the big four banks acknowledged had an impact on their funding costs.

The big four banks' cost of funds and headline variable rates

As described in chapter 2, headline variable rate decisions of the big four banks were influenced by numerous factors and considerations. The increase in wholesale funding was publicly stated by the banks as a primary reason for increasing headline variable rates

78 Reserve Bank of Australia, *Statement on Monetary Policy—February 2018,* 2018, pp. 43–51.
Reserve Bank of Australia, *Statement on Monetary Policy—May 2018,* 2018, pp. 35–44.
Reserve Bank of Australia, *Statement on Monetary Policy—August 2018,* 2018, pp. 39–50.
Reserve Bank of Australia, *Statement on Monetary Policy—November 2018,* 2018, pp. 41–54.
Reserve Bank of Australia, *Statement on Monetary Policy—February 2019,* 2019, pp. 43–56.

79 Reserve Bank of Australia, *Statement on Monetary Policy—May 2019,* 2019, pp. 45–56.
Reserve Bank of Australia, *Statement on Monetary Policy—August 2019,* 2019, pp. 41–50.

between mid-2018 and early 2019[80], and references were made to the challenges caused by interest rates on deposit products being close to or at zero, when headline variable rates were being cut in mid-to-late 2019.[81]

Consistent with this, over the period between January 2018 to October 2019, the big four banks' decision makers were provided with, or considered, cost of funds data alongside other information when making headline variable rate decisions.

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80 Australia and New Zealand Banking Group Limited, *ANZ increases variable home loan rates*, 6 September 2018, *https://media.anz.com/posts/2018/09/anz-increases-variable-home-loan-rates*, viewed 8 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank announces interest rate change*, 6 September 2018, https://www.commbank.com.au/guidance/newsroom/interest-rate-change-201809.html, viewed 8 January 2020.

National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 8 January 2020.

Westpac Banking Corporation, *Westpac increases variable home loan rates*, 29 August 2018, https://www.westpac.com.au/about-westpac/media/media-releases/2018/29-august/, viewed 8 January 2020.

81 Australia and New Zealand Banking Group Limited 2019; *ANZ decreases variable home loan rates*, 4 June 2019, https://media.anz.com/posts/2019/06/anz-decreases-variable-home-loan-rates; *ANZ decreases variable home loan rates*, 2 July 2019, https://media.anz.com/posts/2019/07/anz-decreases-variable-home-loan-rates; *ANZ decreases variable home loan rates*, 2 October 2019, https://media.anz.com/posts/2019/10/anz-decreases-variable-interest-rates; viewed 10 January 2020.

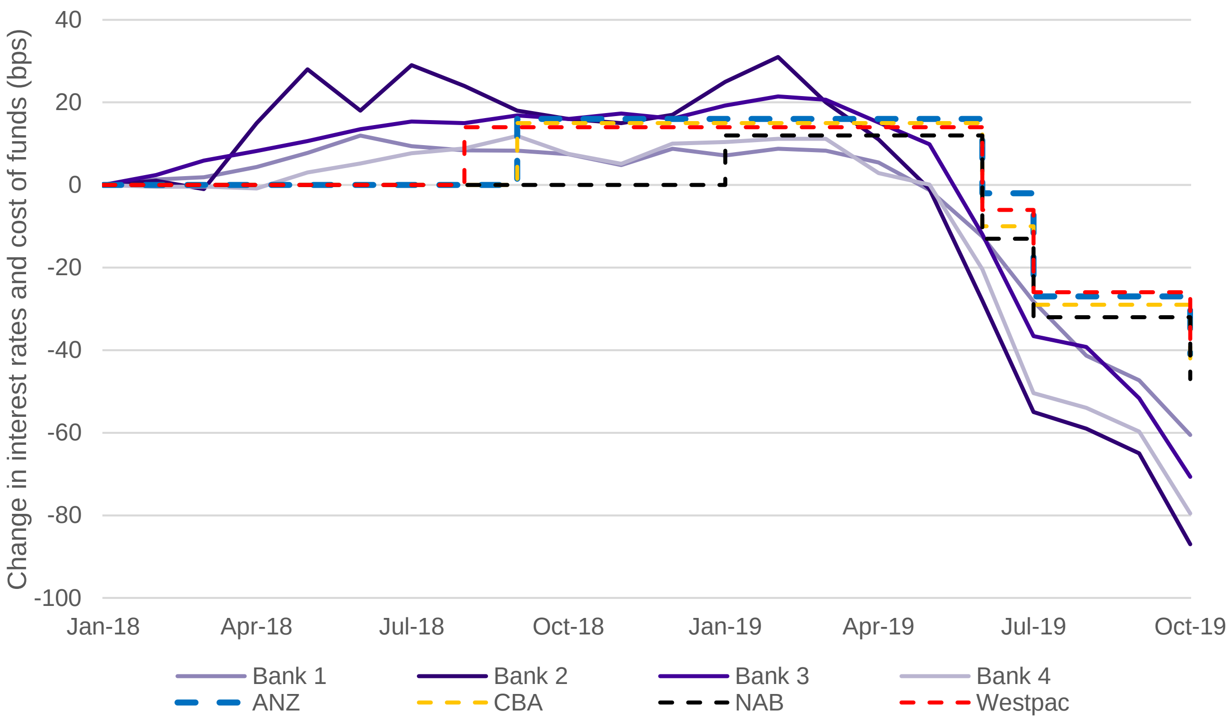
Commonwealth Bank of Australia 2019; *Commonwealth Bank home loan interest rate change*, 4 June 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-home-loan-interest-rate-change-201906.html; *Commonwealth Bank cuts home loan interest rates*, 2 July 2019, https://www.commbank.com.au/guidance/newsroom/cba-rba-interest-rates-201907.html; *Commonwealth Bank reduces home loan interest rates*, 1 October 2019, https://www.commbank.com.au/guidance/newsroom/commonwealth-bank-reduces-home-loan-interest-rates-201910.html; viewed 10 January 2020.

National Australia Bank Limited 2019; *NAB cuts home loan variable interest rates*, 4 June 2019, https://news.nab.com.au/news_room_posts/nab-cuts-home-loan-variable-interest-rates/; *NAB announces changes to home loan interest rates*, 2 July 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-2/; *NAB announces changes to home loan interest rates*, 1 October 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-interest-rates-3/; viewed 10 January 2020.

Westpac Banking Corporation 2019; *Westpac reduces interest rates for its home loan customers*, 4 June 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/4-june/; *Westpac cuts variable home loan interest rates*, 2 July 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-july/; *Westpac decreases variable home loan rates*, 2 October 2019, https://www.westpac.com.au/about-westpac/media/media-releases/2019/2-october/; viewed 10 January 2020.

Figure 3.3 Changes in the big four banks' cost of funds and headline variable rates for owner-occupier home loans with principal and interest repayments

Movements in the banks' cost of funds and headline variable rates relative to their level as at January 2018



Note: The unbroken lines represent the changes in the cost of funds for each bank. The dashed lines represent the changes in the headline variable rates for standard owner-occupier loans with principal and interest repayments for each bank.

The ordering of Bank 1, Bank 2, Bank 3 and Bank 4 in the legend has been randomised and does not reflect the ordering of the headline variable rate figures.

There are many measures that can be used to examine a bank's cost of funds. The cost of funds data presented in the figure is one of the cost of funds measures provided to decision makers when determining headline rate decisions. Depending on the bank, the cost of funds measure is either the total cost of funds for the bank, the total cost of funds for the home loan portfolio or the funds transfer price for the variable rate home loan portfolio.

Source: ACCC calculations using cost of funds and headline variable rate data provided by the big four banks.

Increasing funding costs and headline variable rates: January 2018 to early 2019

From the beginning of 2018, each of the big four banks experienced a sustained increase in funding costs. Despite their funding costs increasing, the banks initially did not change their headline variable rates. Ultimately, Westpac was the first of the big four banks to announce an increase to its headline variable rates in August 2018, followed by ANZ and CBA in September 2018.[82] NAB chose not to increase its headline variable rates at the same time as the other big four banks, despite an increase in its cost of funds from January to August 2018 (see figure 3.3). NAB explained this decision as follows:

> *We are listening and acting differently. We need to rebuild the trust of our customers, and by holding our NAB Standard Variable Rate longer, we help our customers for longer.*[83]

However, in January 2019, NAB announced that it would increase its headline variable rates by 12–16 basis points, depending on the home loan type, due to *'sustained increases in funding costs'.*[84]

Overall, the big four banks absorbed funding cost increases as wholesale funding costs increased from January 2018 until early 2019. However, when faced with sustained increased funding costs, they ultimately increased their headline variable rates (see figure 3.3). We consider the timing of individual banks' decisions to change headline variable rates reflects, in part, the differences in their individual willingness to absorb cost of funds increases during 2018.

Decreases in the cash rate, funding costs and headline variable rates: early 2019 to October 2019

As discussed earlier, the cash rate affects the banks' cost of funds because it acts as a benchmark interest rate in the domestic economy that influences what banks pay for various sources of funds. This relationship is a key reason why the banks' cost of funds follow a similar path to changes in the cash rate (see figure 3.2). It also explains why customers regularly ask whether a reduction in the cash rate has been 'passed through' in full in the form of home loan interest rates that they pay.

Importantly, as noted above, it should not be assumed that changes in the cash rate will translate into 'one-to-one' changes in each banks cost of funds (or headline variable rates). This is because the main factors that impact a bank's funding costs—that is, the BBSW and deposit rates—can move for reasons other than changes to the cash rate.

The RBA has noted that it is often asked about the effect of the cash rate on home loan interest rates.[85] On 4 June 2019, shortly after the RBA Board announced its 25 basis point reduction in the cash rate, the Governor of the RBA (Dr Lowe) discussed that he would typically respond to the question of whether banks should fully 'pass through' a cash rate

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82 Westpac Banking Corporation, *Westpac increases variable home loan rates*, 29 August 2018, https://www.westpac.com.au/about-westpac/media/media-releases/2018/29-august/, viewed 8 January 2020.

Australia and New Zealand Banking Group Limited, *ANZ increases variable home loan rates*, 6 September 2018, https://media.anz.com/posts/2018/09/anz-increases-variable-home-loan-rates, viewed 8 January 2020.

Commonwealth Bank of Australia, *Commonwealth Bank announces interest rate change*, 6 September 2018, https://www.commbank.com.au/guidance/newsroom/interest-rate-change-201809.html, viewed 8 January 2020.

83 National Australia Bank Limited, *NAB Standard Variable Rate for home loans on hold*, NAB, 9 September 2018, https://news.nab.com.au/news_room_posts/nab-standard-variable-rate-for-home-loans-on-hold/, viewed 10 January 2020.

84 National Australia Bank Limited, *NAB announces changes to home loan variable interest rates*, NAB, 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates, viewed 8 January 2020.

85 Philip Lowe, *'Today's reduction in the cash rate'*, speech, RBA, 4 June 2019, p. 4.

change by saying *'it all depends'.* This recognises that a range of factors can influence how home loans are priced.[86] However, regarding the cash rate reduction in June 2019, Dr Lowe chose to be more emphatic, declaring:

> *… Yes, this reduction in the cash rate should be fully passed through to variable mortgage rates. This answer is based on recent reductions in bank funding costs.*[87]

Dr Lowe's statement is supported both by the RBA's data on the big four banks' funding costs[88], and the cost of funds data that the big four banks provided to the ACCC. The RBA's own estimates of the banks' funding costs show that at the time of Dr Lowe's speech, bank funding costs had fallen to below the levels of early 2018.

Similarly, the banks' data shows that by the end of May 2019, ahead of the RBA's reduction to the cash rate in June and Dr Lowe's speech, the increases in funding costs experienced by the big four banks from January 2018 to February 2019 had reversed for three of the big four banks. Following the reduction in the cash rate, all of the big four banks' funding costs decreased further.

Despite increasing their headline variable rates in response to rising funding costs in 2018 (when there had been no change in the cash rate), as the big four banks' cost of funds consistently declined in 2019, they only decreased their headline variable rates in response to cash rate reductions in June, July and October 2019 (see figure 3.3).

Overall, for the entire period between January 2018 and October 2019, even allowing for the increases in funding costs between January 2018 and January 2019, and acknowledging that the cost of funds measures are only estimates, it appears that headline variable rates, for both owner-occupier home loans with principal and interest repayments and investor loans with interest-only repayments, have decreased by less than the banks' respective cost of funds.[89]

Cost of funds and average interest rates paid in 2019

The above analysis concentrates on headline variable rates, but as noted in chapter 1, the actual interest rates paid by home loan customers are based on the headline variable rate less discount(s). As a result, we have also examined whether the big four banks 'passed on' the decrease in funding costs to their customers through higher discounts (which would result in lower average interest rates).

The data available to the ACCC indicates this has not been the case. The average interest rate paid on a variable rate owner-occupier home loan with principal and interest repayments fell by around 55 to 68 basis points, depending on the bank, between January 2019 and October 2019. This compared to decreases in the banks' cost of funds between 68 to 112 basis points over the same period, depending on the bank.

The 74 to 89 basis point reduction in the average interest rates paid on variable rate investor loans with interest-only repayments between January 2019 and October 2019 suggests the big four banks 'passed through' more of the decrease in funding costs to these customers. However, other than for CBA's investor loans with interest-only repayments, this was still less than the decrease in their respective funding costs.

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86 Lowe, p. 4.

87 Lowe, p. 4.

The RBA also approximates the banks' cost of debt funding based on estimates of deposits costs, wholesale funding costs, and securitisation costs.

88 RBA data provided to the ACCC estimates that funding costs peaked in January 2019.

89 The only exception to this was CBA, which reduced its headline variable rate for its investor loans with interest-only repayments by slightly more than the decline in its cost of funds over the period.

4. Headline variable rates differ significantly from the interest rates most customers actually pay

Key findings

- Headline variable rates are not an accurate indicator of what most consumers should expect to pay at the big four banks. This is because the overwhelming majority (close to 90 per cent) of the big four banks' customers receive discounts off the headline variable rate. For many customers, these include both advertised discounts and discretionary discounts.
- The gap between headline variable rates and the average interest rates paid by customers increased for each of the big four banks between 30 September 2018 and 31 October 2019. This widening of the gap was due, in part, to a considerable increase in the number of big four bank customers that received a large discount (150 basis points or more) off the headline variable rate.

In this chapter, we report on:

- the increase in the gap between headline variable rates and the average interest rates paid by home loan customers of the big four banks
- the lowest advertised interest rates offered on packaged loans at the big four banks, compared to the average interest rate paid by customers with packaged loans
- the volume and value of discounts off headline variable rates provided by the big four banks.

This chapter focuses on the time period of 30 September 2018 to 31 October 2019. Using this time period allows us to continue our analysis from the Residential mortgage price inquiry, where we reported the gap between headline variable rates and average interest rates paid at the end of each quarter from 30 June 2017 to 30 June 2018.[90]

The gap between headline variable rates and average interest rates paid has increased across the big four banks

From 30 September 2018 to 31 October 2019, the gap between headline variable rates and the average interest rates paid by customers increased at each of the big four banks. This increase in the gap was due to higher levels of discounting over the period and continued the trend of an increasing gap we observed from June 2017 to June 2018 in the Residential mortgage price inquiry.

Owner-occupier loans with principal and interest repayments

As at 31 October 2019, the average interest rate paid on owner-occupier loans with principal and interest repayments was 123 to 131 basis points below the relevant headline variable rate, depending on the bank (figure 4.1).

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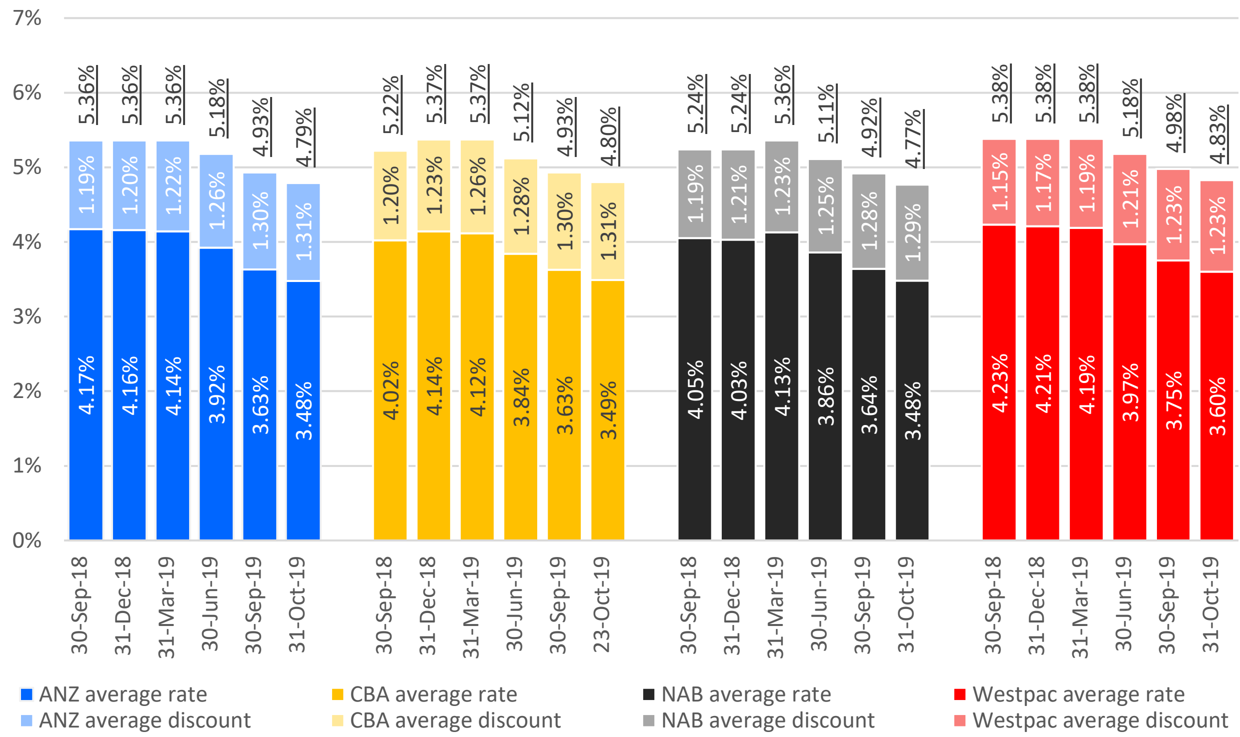
[90] Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, pp. 24–29.

Figure 4.1 Average interest rates paid on standard owner-occupier loans with principal and interest repayments (compared to headline variable rates): 30 September 2018 to 31 October 2019



Note: The average interest rates paid are based on the variable interest rates paid by both new and existing customers on standard home loans under the bank's main brand. The interest rate paid by customers typically depends on a number of factors, including the customer's characteristics and the lender's policies at the time the home loan was sought. The average discounts reported include advertised and discretionary discounts. Individual products may also have different fees which have not been taken into account here. Those fees will affect any comparison of the overall cost of these products to customers.

Underlined figures above the bars are the headline variable rates for standard owner-occupier loans with principal and interest repayments under the bank's main brand.

Some banks reported data for more than one product and some of those products have different headline variable rates. For that reason, the headline variable rates in this figure are averages. A headline variable rate for a single product was reported in table 1.1 and that is why the headline variable rates in this figure may differ slightly from those in table 1.1.

For CBA, October 2019 data on the average interest rate paid and the headline variable rate is reported as at 23 October 2019. For the other big four banks this data is reported as at 31 October 2019.

Source: ACCC analysis of home loan data supplied by the big four banks.

The gap between the headline variable rate and average interest rate paid increased by 8 to 12 basis points from 30 September 2018 to 31 October 2019, depending on the bank. This increase in the gap is consistent with our findings of higher levels of discounting over this period (see below).

The gap between the headline variable rate and the average interest rate paid on owner−occupier loans with principal and interest repayments is larger than the gap of 110 to 116 basis points we observed for the big four banks as at 30 June 2018 in the Residential mortgage price inquiry final report.[91] The gap has grown significantly compared to the gap of

[91] Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, pp. 25–26.

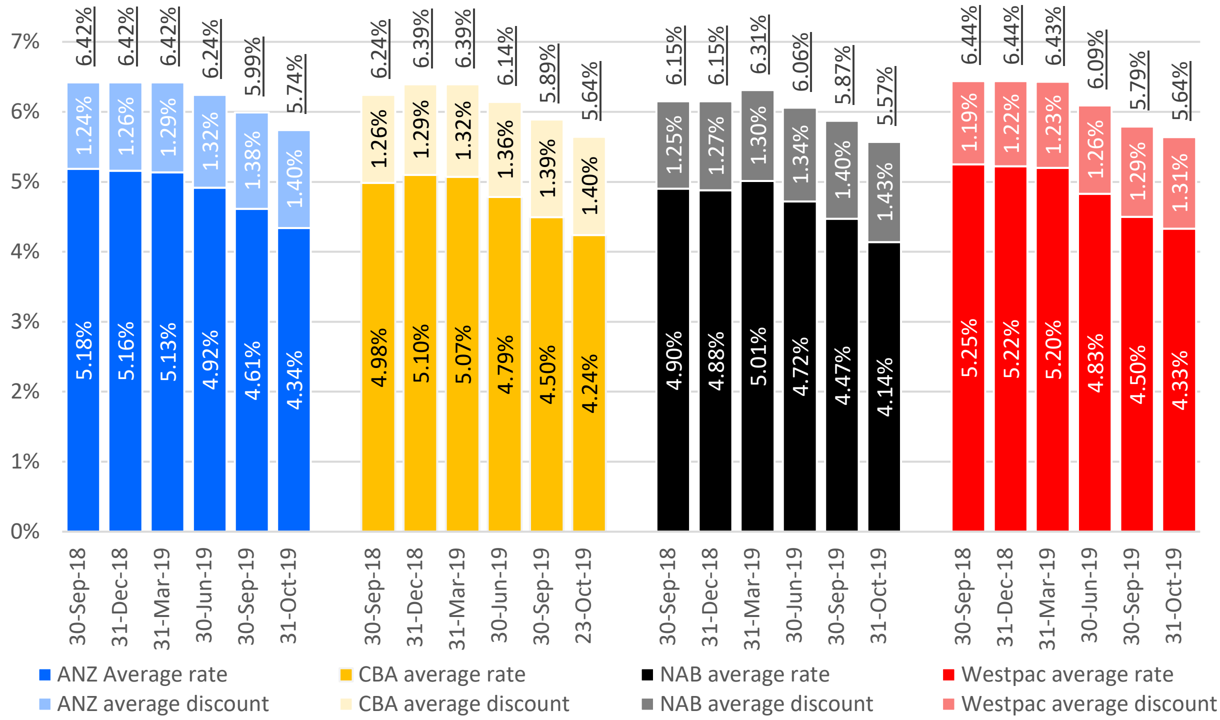
79 to 89 basis points we observed as at 30 June 2015 in the Residential mortgage price inquiry interim report.[92]

Investor loans with interest-only repayments

For each of the big four banks, the average discount on investor loans with interest-only repayments (figure 4.2) was larger than the average discount for owner-occupier loans with principal and interest repayments over the period 30 September 2018 to 31 October 2019.

The average variable rate paid on investor loans with interest-only repayments as at 31 October 2019 was 131 to 143 basis points below the relevant headline variable rate, depending on the bank.

Figure 4.2 Average interest rates paid on standard investor loans with interest-only repayments (compared to headline variable rates): 30 September 2018 to 31 October 2019



Note: The average interest rates paid are based on the variable interest rates paid by both new and existing customers on standard home loans under the bank's main brand. The interest rate paid by customers typically depends on a number of factors, including the customer's characteristics and the lender's policies at the time the home loan was sought. The average discounts reported include advertised and discretionary discounts. Individual products may also have different fees which have not been taken into account here. Those fees will affect any comparison of the overall cost of these products to customers.

Underlined figures above the bars are the headline variable rates for standard investor loans with interest-only repayments under the bank's main brand.

Some banks reported data for more than one product and some of those products have different headline variable rates. For that reason, the headline variable rates in this figure are averages. A headline variable rate for a single product was reported in table 1.1 and that is why the headline variable rates in this figure may differ slightly from those in table 1.1.

For CBA, October 2019 data on the average interest rate paid and the headline rate is reported as at 23 October 2019. For the other big four banks this data is reported as at 31 October 2019.

Source: ACCC analysis of home loan data supplied by the big four banks.

[92] Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report,* pp. 19–21.

The gap between the headline variable rate and average interest rate paid increased by 12 to 18 basis points from 30 September 2018 to 31 October 2019, depending on the bank. As discussed above, the increase in the gap is consistent with our findings of increased levels of discounting over this period.

The gap between the headline variable rate and the average interest rate paid on investor loans with interest-only repayments is larger than the gap of 115 to 123 basis points we observed in the Residential mortgage price inquiry final report for the big four banks as at 30 June 2018.[93]

Most customers with a packaged loan paid an interest rate below the lowest advertised rate

In this section, we report on the lowest advertised discounted rates offered on packaged standard home loans at the big four banks and compare these to the average interest rate actually paid by customers with these loans.

A packaged home loan is an arrangement under which a customer is eligible for discounts and/or other benefits on a specified range of the lender's products, such as transaction accounts, credit cards and home loans. To be eligible for a package, a customer may need to hold certain products with the lender and, in some cases, pay an annual fee. Packaged loans accounted for the large majority (over 90 per cent by balance) of standard owner−occupier loans with principal and interest repayments at the big four banks in 2019.[94]

As discussed in Appendix B, there are two types of discounts available to customers. These are advertised discounts and discretionary discounts. Advertised discounts are generally published on a lender's website and are relatively easy for a consumer to discover. In October 2019, the largest advertised discounts offered on packaged owner-occupier loans with principal and interest repayments from the big four banks ranged from 70 to 129 basis points.[95] In contrast, discretionary discounts are offered at the lender's discretion on a case−by−case basis to individual customers. They are usually offered after the lender has assessed a customer's application. There is little to no transparency on discretionary discounts available to consumers before they apply for a home loan.

At three of the big four banks, the average interest rate paid on packaged owner-occupier loans with principal and interest repayments was significantly below the lowest advertised package discounted rate on offer in October 2019 (table 4.1). The difference between the average interest rate paid under a package and the lowest advertised discounted rate for these banks ranged from 39 to 63 basis points. This discounting behaviour by ANZ, CBA and NAB, where the average interest rate paid on packaged products is materially below the lowest advertised discounted rate, is consistent with the pricing behaviour we observed for packaged home loans by these banks in the Residential mortgage price inquiry.[96] In contrast, the average interest rate paid by Westpac customers on packaged owner-occupier loans with principal and interest repayments was close to Westpac's lowest advertised discounted rate offered under a packaged home loan. This was due to Westpac offering higher advertised discounts in the second half of 2019, in order to improve the transparency of discounts and reduce its reliance on discretionary discounts.

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93 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 29.

94 ACCC analysis of data supplied by the big four banks. Three of the big four banks provided data to the ACCC that showed 92 to 98 per cent of standard owner-occupier loans with principal and interest repayments outstanding (by balance) had been sold as part of a package as at 31 October 2019. One bank provided data on packaged loans, and did not provide data on unpackaged loans. This bank reported to the ACCC that packaged standard loans had accounted for more than 95 per cent of loans originated over 30 September 2018 to 31 October 2019.

95 The largest advertised discounts as at 23 October 2019, available for owner-occupier loans with principal and interest repayments sold as part of a package were: ANZ 90 basis points, CBA 70 basis points, NAB 90 basis points, Westpac 129 basis points. ACCC analysis of home loan data supplied by the big four banks.

96 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, pp. 30–31.

Table 4.1 Variable interest rates on packaged standard owner-occupier loans with principal and interest repayments, October 2019

	ANZ %	CBA %	NAB %	Westpac %
Headline variable rate**	4.79	4.80	4.77	4.83
Lowest advertised discounted rate under a package*	3.89	4.10	3.87	3.54
Average variable rate paid on packaged loans**	3.45	3.47	3.48	3.58
Difference between the lowest advertised discounted rate and average variable rate paid on packaged loans	0.44	0.63	0.39	-0.04

* The lowest advertised discounted rate has been calculated based on the relevant headline variable rate less the maximum package discount offered under the bank's main brand as at 23 October 2019. The lowest advertised discounted rate as at 23 October 2019 may not reflect the level of advertised discounts available at the time individual customers took out their home loan. The interest rate paid by customers typically depends on a number of factors, including the customer's characteristics and the lender's policies at the time the home loan was sought. Individual products may have different fees which have not been taken into account here. Those fees will affect any comparison of the overall cost of these products to customers.

** For CBA, October 2019 data on the average interest rate paid on packaged loans and the headline variable rate is reported as at 23 October 2019. For the other big four banks the average interest rate paid on packaged loans and the headline variable rate is reported as at 31 October 2019.

The average interest rate paid on packaged products is based on the variable rates paid by both new and existing customers for packaged standard variable rate home loans under the bank's main brand.

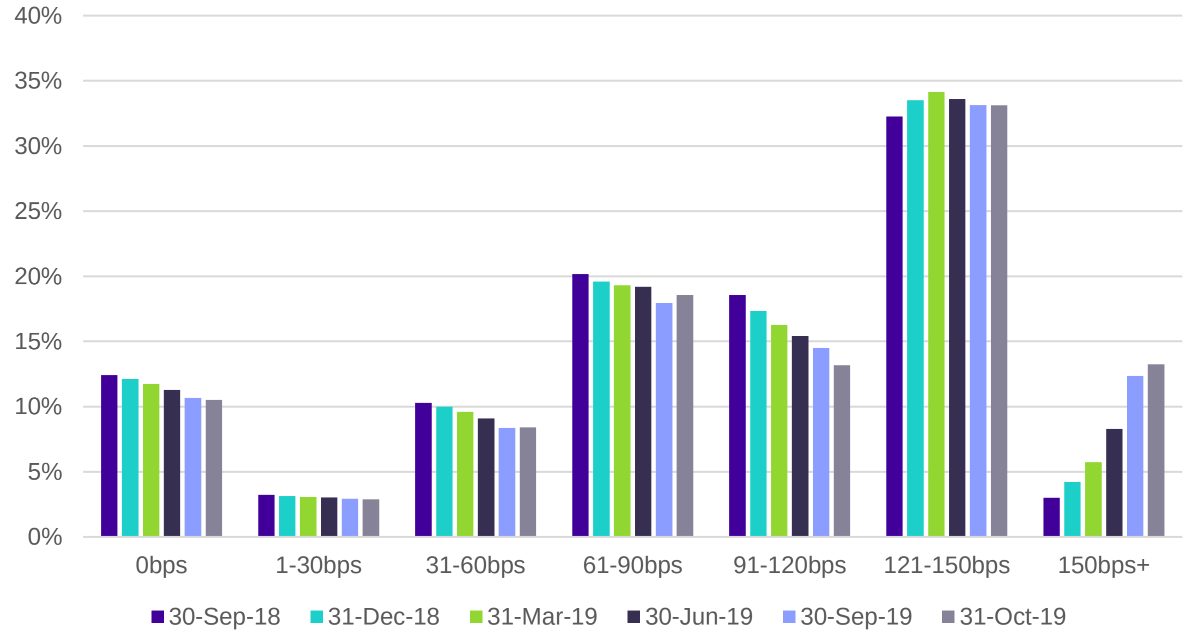
Source: ACCC analysis of home loan data supplied by the big four banks.

The overwhelming majority of customers at the big four banks receive discounts off the headline variable rate

In this section, we report on discounts off headline variable rates provided by the big four banks for standard and basic home loans. This includes discounts offered on home loans sold as part of a package and those not sold as part of a package, and captures both advertised and discretionary discounts.

As at 31 October 2019, 89 per cent of variable rate home loans (by number) with the big four banks received a discount (advertised and/or discretionary) off the bank's relevant headline variable rate. Further, 59 per cent (by number) were charged at least 90 basis points less than the relevant headline variable rate (figure 4.3).

Figure 4.3 The big four banks' home loan portfolios (main brands) by size of discount: 30 September 2018 to 31 October 2019



Note: The discount on a home loan has been calculated as the difference between the relevant headline variable rate for that product and the actual interest rate paid on that product. As a result, the discounts reported include both advertised and discretionary discounts. Eligibility for a discount typically depends on a number of factors, including the customer's characteristics and the lender's policies at the time the home loan was sought. The discounting data includes discounts offered on both standard home loans and basic home loans and discounts on home loans that are sold as part of a package and that are not sold as part of a package. This discounting data covers all variable rate loans and repayment types.

For October 2019, the discounting data supplied by CBA was reported as at 23 October 2019. For the remaining big four banks, the data was reported as at 31 October 2019.

Source: ACCC analysis of data supplied by the big four banks.

This high level of discounting is consistent with the discounting behaviour observed in the Residential mortgage price inquiry, where we found around 87 per cent of variable rate home loans (by number) received a discount off the Levy Bank's relevant headline variable rate; and 53 per cent were charged at least 90 basis points less than the relevant headline variable rate.[97]

Between 30 September 2018 and 31 October 2019, there was a significant increase in the number of big four bank customers who were receiving a discount of 150 basis points or more off the headline variable rate. The share of customers who were receiving this discount increased from 3 per cent to 13 per cent during this period. The largest increases occurred in the quarters ending 30 June and 30 September 2019, which followed the RBA's 25 basis point reductions in the cash rate in June and July 2019. In contrast, in the Residential mortgage price inquiry, we found that less than 3 per cent of customers were receiving a discount of 150 basis points or more for each of the quarters between 30 June 2017 and 30 June 2018.[98]

The value of discounts that home loan customers receive vary significantly. The average discount off the headline variable rate for owner-occupier loans with principal and interest

97 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 23.

98 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 23.

repayments with the big four banks was 128 basis points as at 31 October 2019.[99] If a customer receiving no discount was able to obtain an average size discount of 128 basis points, for example by refinancing to another lender, this would result in interest savings of close to $5000 in the first year alone for the average size new owner-occupier loan with principal and interest repayments.[100] If a customer with an average size discount of 128 basis points was able to obtain a discount of 150 basis points, this could result in interest savings of over $850 in the first year for an average sized new loan.

[99] ACCC analysis of data supplied by the big four banks. The discounting data supplied by CBA was reported as at 23 October 2019. For the remaining big four banks, the data was reported as at 31 October 2019.

[100] ACCC analysis of data supplied by the big four banks. The average size new variable rate owner-occupier loan with principal and interest repayments across the big four banks was $386 000 as at 31 October 2019. The average loan size data supplied by CBA was reported as at 23 October 2019. For the remaining big four banks, the data was reported as at 31 October 2019.

5. Customers with new loans continue, on average, to pay lower interest rates than customers with existing loans

Key findings

- The difference between average interest rates paid on new loans and average interest rates paid on existing loans has persisted since 30 September 2018, but did not significantly increase in the 12 months to 30 September 2019.
- The difference arises because of the banks' focus on offering increasingly large discounts on new loans.
- The difference between average interest rates paid by customers with new loans and customers with existing loans persists, in part, because price reductions for customers with existing loans are not always as large as discounts on new loans. This demonstrates the importance of customers with existing loans reviewing their home loan products on a regular basis.

In this chapter, we:

- report the difference in the average interest rates paid on new loans and existing loans at the big four banks[101]
- consider how the difference in average interest rates paid on new loans and existing loans has remained stable between September 2018 and September 2019, despite the big four banks increasing discounts for customers with new loans[102]
- identify pricing strategies of the big four banks that maintain the difference in average interest rates paid by customers with new loans and customers with existing loans
- consider whether the big four banks have sought to create or maintain a particular difference between prices paid for new loans and existing loans.

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101 Throughout this report, the term 'new loan' generally refers to a home loan that has recently been established. Some lenders refer to these loans as the 'front book'. 'Existing loans' are those home loans that have been established for a longer period of time. Some lenders refer to these loans as the 'back book'.

Where we make findings based on analysis undertaken by the ACCC using data supplied by the big four banks, these definitions are more specific: new loans are those established less than 12 months prior to a given date. For example, new loans as at 30 September 2019 were loans established between 1 October 2018 and 30 September 2019. Existing loans are those established 12 months or more prior to a given date.

Where we cite quotes or describe strategies of the big four banks that relate to new and existing loans, these typically reflect how the banks define these terms internally. While the banks' specific definitions may differ slightly from those that the ACCC has adopted for the purpose of our quantitative analysis, and may also vary within the bank depending on the context, the ACCC considers that the definitions of new and existing loans used throughout this report are broadly consistent.

102 This chapter focuses on the time period from 30 September 2018 to 30 September 2019. This is because some of the data featured represents aggregate values for a given quarter (see figure 5.1), rather than a snapshot at a point in time (see table 5.1). We have opted to align the reporting dates so as to contain our analysis to a single period, noting that data for the quarter ending 31 December 2019 was not available for the purposes of the interim report.

The difference in interest rates paid on new loans and existing loans

The big four banks' practice of offering larger discounts to customers with new home loans, compared to the discounts offered to existing customers when they previously established their home loan, has resulted in a difference in the average interest rates paid on new loans and existing loans.[103] A simplified example of how the difference arises is set out in box 5.1.

Box 5.1 Example of how the difference in interest rates paid on new loans and existing loans arises

In 2018, Customer A accepted a variable rate home loan offer from Bank A that included a 0.50 per cent (50 basis point) discount. Bank A's headline variable rate was 5.50 per cent, so Customer A paid 5.00 per cent interest.

In 2019, Customer B accepted a variable rate home loan offer from Bank A that included a 1.00 per cent (100 basis point) discount. Bank A's headline variable rate was still 5.50 per cent, so Customer B paid 4.50 per cent interest, while Customer A continued to pay 5.00 per cent interest.

In 2020, Bank A reduced its headline variable rate to 5.00 per cent. Customer A now pays 4.50 per cent interest and Customer B pays 4.00 per cent. Assuming Customer A and Customer B keep their loans with Bank A, and that both customers' discounts were fixed for the life of the loan[104], Customer A will continue to pay a higher interest rate than Customer B, unless Bank A reduces the price on Customer A's loan.

Calculation of the difference

In the Residential mortgage price inquiry, we observed that the average interest rates paid by customers with new loans at the big four banks were less than those paid by customers with existing loans from at least June 2015 to June 2018.[105]

This difference between the average interest rates paid by customers with new loans and customers with existing loans has persisted. Between 30 September 2018 and 30 September 2019, the difference increased slightly, by 1 basis point, on owner-occupier loans with principal and interest repayments (see table 5.1. The difference for investor loans with interest only repayments is considered in box 5.3).

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103 See also:

Reserve Bank of Australia, 'Box C: Do Borrowers with Older Mortgages Pay Higher Interest Rates?', *Statement on Monetary Policy,* February 2020, pp. 55–57 (*'[T]he rise in the average differential between SVRs and interest rates charged on outstanding variable-rate loans reflects the increased discounting on more recently originated loans. The discounts borrowers receive on loans are usually fixed over the life of the loan, although they can be renegotiated'*.)

Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, p. 21.

Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 32.

104 Discounts are generally fixed for the life of the loan. Some lenders offer loans with introductory discounts for a fixed initial period, although these are relatively less common.

See also:

Reserve Bank of Australia, 'Box C: Do Borrowers with Older Mortgages Pay Higher Interest Rates?' *Statement on Monetary Policy*, February 2020, pp. 55–57 (*'The discounts borrowers receive on loans are usually fixed over the life of the loan, although they can be renegotiated'*.).

105 This observation applied to standard home loans with a variable rate.

Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, pp. 21–22.

Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report*, p. 32.

Table 5.1 Average interest rates paid by big four banks' customers with new and existing owner-occupier loans with principal and interest repayments: 30 September 2018 and 30 September 2019

30 September 2018			30 September 2019		
Existing	**New**	**Difference**	**Existing**	**New**	**Difference**
4.18%	3.93%	0.25%	3.71%	3.45%	0.26%

Note: Average interest rates paid by customers with new and existing standard home loans with a variable rate. New loans are those established less than 12 months prior to a given date. Existing loans are those established 12 months or more prior to a given date.

The interest rate paid by customers typically depends on a number of factors, including the customer's characteristics and the lender's policies at the time the home loan was sought. Individual products may have different fees which have not been taken into account here. Those fees will affect any comparison of the overall cost of these products to customers.

The average was calculated on a value-weighted basis. The value of the home loans used in the calculation was the total outstanding amount owed on the home loan as at the relevant date, excluding redraw facilities and payments in advance.

Source: ACCC analysis of data supplied by the big four banks.

The big four banks were aware their customers with existing loans paid relatively higher interest rates

During the price monitoring period, each of the big four banks were aware that their customers with existing loans generally paid higher interest rates than their customers with new loans. Routine pricing documents considered by decision makers showed either that, across their variable rate home loan portfolios, discounts were larger for new loans; or that customers with new loans, on average, were paying lower interest rates than customers with existing loans.

The big four banks have their own estimates of the difference

Each of the big four banks have publicly commented on the size of the difference between the rates paid by their customers with new loans and their customers with existing loans.[106] Although the 26 basis points difference between the average interest rate on new and existing loans observed by the ACCC (see table 5.1) is similar to the differences estimated by the big four banks, there are some methodological differences which mean they are not a like-for-like comparison. Details of these methodological differences and further details of the banks' estimates of the difference between interest rates paid by customers with new loans and customers with existing loans are set out in Appendix E.

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[106] ANZ stated that the difference was *'[L]ess than 30 basis points',* CBA stated that the difference was *'substantially'* less than 30 basis points, NAB stated that the difference was *'[A]bout 26 basis points'* and WBC reported that the difference was 28 basis points.

Evidence to Standing Committee on Economics, Australia's four major banks and other financial institutions: four major banks, The House of Representatives, 15 November 2019, https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/toc_pdf/Standing%20Committee%20on%20Economics_2019_11_15_7355_Official.pdf;fileType=application%2Fpdf#search=%22committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/0000%22): p. 9 (NAB); p. 38 (ANZ).

C Yeates, 'CBA chief Matt Comyn defends different loans rates for customers', The Sydney Morning Herald, 16 October 2019, https://www.smh.com.au/business/banking-and-finance/cba-chief-matt-comyn-defends-different-loan-rates-for-customers-20191016-p531bd.html, viewed 10 January 2020.

Evidence to Standing Committee on Economics, Review of the four major banks, Response to The House of Representatives questions November 2019, Westpac Banking Corporation, https://www.aph.gov.au/-/media/02_Parliamentary_Business/24_Committees/243_Reps_Committees/Economics/46p/Banks_and_Financial_Institutions/1_Bank_Review_-_First_Report/Westpac_QoNs/WBC15QON.pdf?la=en&hash=0DE5712BCCF1B7D5C3FF617C2EEFA5C96C9D6830.

Average interest rates paid are falling, but are still higher on existing loans than on new loans

The big four banks increased average discounts on new loans in the 12 months to 30 September 2019 (table 5.2).[107] At the same time that average discounts on new loans increased, the difference in average interest rates paid on new loans and existing loans remained stable. This means that average discounts on existing loans also increased during this period.

Table 5.2 Average discount granted on new owner-occupier loans with principal and interest repayments (basis points): 30 September 2018 and 30 September 2019

	30 September 2018	30 September 2019	Difference
ANZ	135	152	17
CBA	139	150	11
NAB	132	145	13
Westpac	135	146	11

Note: The average discount equals the difference between the average interest rates paid by customers with new standard home loans with a variable rate, and the average headline variable rate of those home loans. As a result, the discounts reported include both advertised and discretionary discounts. New loans are those established less than 12 months prior to a given date. The averages were calculated on a value-weighted basis.

Source: ACCC analysis of data supplied by the big four banks.

We consider there are three main reasons why the average discount on existing loans would increase:

- some customers with existing loans, who previously paid a relatively high interest rate, discharging their existing home loans, including by refinancing to a new loan or new lender
- some customers with existing loans obtaining a price reduction on their current loan that saw their interest rate become the same as or closer to interest rates applying to new loans
- some customers who previously obtained a 'new loan' rate (either as a buyer of a new property or after refinancing) becoming a customer with an existing loan at a later time.

107 Not all home loan customers will be eligible for a discount or willing to agree to the terms on which a lender offers a discount.

Box 5.2 How the average interest rate paid on existing loans could decrease over time: refinancing and price reductions

By refinancing to a new loan or lender, customers with an existing loan become customers with a new loan, and may benefit from the larger discounts that may not otherwise be available on an existing loan. If those customers who switch to a new loan or lender were previously paying relatively high interest rates (compared to interest rates on other existing loans), the average interest rate paid by customers with existing loans would reduce as a result.

When those customers have had their newly refinanced loan for more than a year and become customers with an existing loan again, the lower rate they obtained upon refinancing further reduces the average interest rate paid by customers with existing loans.

Customers with existing loans may also be able to obtain a price reduction on their current loan. If a significant number of customers with existing loans successfully negotiate a reduced price on their current loan, the average interest rate paid by customers with existing loans will decrease. Evidence obtained by the ACCC from the big four banks indicates this is a growing trend (see figure 5.1 below).

The banks considered that increasingly large discounts were necessary to attract new home loan customers

The big four banks cited '*increased competition*' or similar as a reason why they needed to increase discounts on new variable rate loans during the price monitoring period (see table 5.2). As set out in chapter 2, each big four bank recognised that other non-big four lenders were gaining market share. The big four banks variously attributed other lenders' increased market share to '*aggressive', 'attractive'* or competitive pricing strategies, as well as other factors such as faster approval times. While, based on the available evidence, we did not observe the big four banks aiming to match the headline variable rates offered by other lenders when considering their headline rate decisions (see chapter 2), the banks' increased discounts on new loans may have been driven, at least in part, by competition from other lenders.

We expect that the banks would prefer to increase discounts, rather than reduce headline variable rates, because increasing discounts, in particular discretionary discounts, allows the banks to compete for new loans without needing to extend the reduction in price to (and therefore lower margins/profit earned from) all other existing home loan customers. The effectiveness of such a strategy relies on inertia from a large proportion of a bank's customers. This is because the banks' margins/profits will be negatively impacted if a sufficiently large number of customers with existing loans demand increased discounts similar to those available on new loans, or switch to another lender to benefit from the larger discounts that may not otherwise be available on existing loans.[108]

[108] See also: Reserve Bank of Australia, 'Box C: Do Borrowers with Older Mortgages Pay Higher Interest Rates?', *Statement on Monetary Policy,* February 2020, pp. 55–57.

Philip Lowe, *The Link Between the Cash Rate and Market Interest Rates,* May 1995, pp. 27–28.

Box 5.3 Interest-only customers refinancing to principal and interest loans

The difference in average rates paid on the big four banks' new and existing investor loans with interest-only repayments remained stable at around 34 basis points in the 12 months to 30 September 2019. Similar to the change in the difference for owner-occupier loans with principal and interest repayments (table 5.1), it increased by only 1 basis point. The difference remained stable despite the big four banks increasing discounts for new investor loans with interest-only repayments during the period.[109]

It appears that the difference remained stable, in part, due to existing investor customers with interest-only repayments refinancing to other loan types. As explained in box 5.2, this would have the effect of decreasing the average interest rate paid on existing loans if those customers who refinanced away were previously paying a relatively high interest rate.[110] Data obtained by the ACCC shows a significant reduction in both the number of investor loans with interest-only repayments and the highest interest rate paid on those loans at the big four banks between 30 September 2018 and 30 September 2019.[111]

The big four banks reported a decrease in the size of their interest-only portfolios. Many of these interest-only customers refinanced to principal and interest loans, which generally had lower interest rates than interest-only loans, either proactively or when their interest-only term expired.

Customers with existing loans are increasingly getting price reductions

To mitigate the risk of their customers refinancing to a different lender, the big four banks sometimes reduce the price of their customers' existing home loans, typically by increasing the discount they receive off the headline variable rate. The big four banks primarily do this in response to a customer's request to reduce the price on their home loan (customer−initiated price reductions). Some of the banks also proactively reduce the price applying to certain customers' loans (bank-initiated price reductions).

In the Residential mortgage price inquiry we found that, over the 12 months to 30 June 2018, an increasing number of price reductions were granted to customers of the Levy Banks with variable rate home loans.[112] We observe a continuation of this trend for the big four banks over the 12 months to 30 September 2019 (see figure 5.1).

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109 Average discounts reflect the average headline variable rates for the big four banks' customers with standard investor loans with interest-only repayments between 30 September 2018 and 30 September 2019 less the average interest rates paid by the big four banks' customers with new standard investor loans with interest-only repayments between 30 September 2018 and 30 September 2019.

New loans are those established less than 12 months prior to a given date. The average was calculated on a value−weighted basis. The value of the home loans used in the calculation was the total outstanding amount owed on the home loan as at the relevant date, excluding redraw facilities and payments in advance.

Source: ACCC analysis of data supplied by the big four banks.

110 This is consistent with the RBA's observation in February 2020 that *'[one of the reasons] for the drift lower in outstanding variable rates is that households are continuing to switch from interest-only loans to principal-and-interest loans (which tend to have lower interest rates)'*.

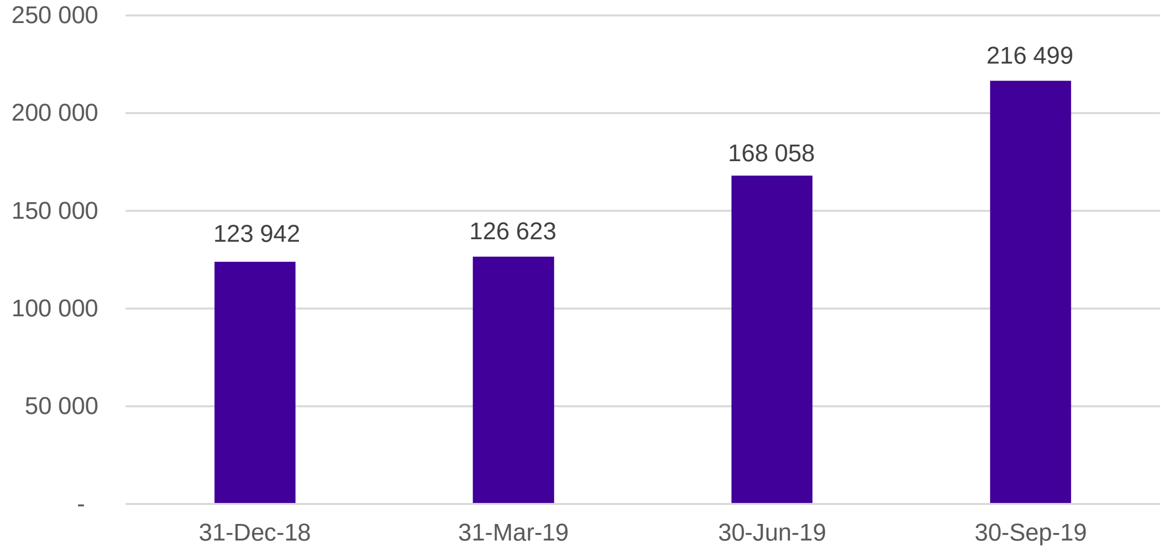
See Reserve Bank of Australia, '3. Domestic Financial Conditions', *Statement on Monetary Policy,* February 2020, pp. 43–54.

111 Highest interest rates paid by the big four banks' customers with standard investor loans with interest-only repayments between 30 September 2018 and 30 September 2019 and the total number of those loans between 30 September 2018 and 30 September 2019.

Source: ACCC analysis of data supplied by the big four banks.

112 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* pp. 35–36.

Figure 5.1 Number of price reductions granted per quarter to the big four banks' customers with variable rate home loans, quarters ending 31 December 2018 to 30 September 2019



Note: A price reduction is any reduction (customer-initiated or bank-initiated) in the interest rate or recurring fees granted to an individual customer after a home loan has been established, other than via a reduction in headline variable rates, and excludes any reductions arising from the customer switching product or repayment type. The price reductions reported relate to all variable rate (standard and basic) home loans under the bank's main brand, and, for one bank, includes loans issued with an introductory discount applicable for either two or four years. The data reported represents an aggregation of the data supplied by the big four banks.

Data for the quarter ending 30 September 2018 has been excluded due to a disproportionately large number of price reductions applied to home loans held by customers affected by drought.

Figure 5.1 includes both customer-initiated and bank-initiated price reductions and shows there was a significant increase in the number of price reductions granted to the big four banks' customers with existing variable rate home loans, particularly in the quarters ending 30 June 2019 and 30 September 2019.[113]

Between them, the big four banks variously identified a number of reasons why an increasing number of price reductions were requested by customers with existing loans during 2019, including:

- cash rate cuts, specifically those occurring in June and July 2019, acted as a *'trigger'* for customers to review the price of their home loan. One big four bank speculated in May 2019 that price reductions for customers with existing loans *'will likely pick up should the RBA cut rates – i.e. it puts interest rates front of customer minds'*
- customers with existing loans observing lower rates, compared to their rates, offered by other lenders and an increase in marketing campaigns aimed at encouraging existing customers to refinance. One bank noted that *'[m]any customers contact their current provider to see if they can match or better these offers'*
- customers with existing loans' awareness of increased discounts on new loans, leading to *'more customers seeking pricing reviews'*
- media coverage and regulatory reviews, including the ACCC's work on the Residential mortgage price inquiry, that encouraged customers to consider switching and *'led to increased public awareness that requesting a provider to review a customer's rates […]*

113 The ACCC is unable to assess whether the October 2019 cash rate reduction had a material effect on the number of price reductions granted to the big four banks' customers for the purpose of this report. This is due to data availability at the time of data collection and when analysis for this report was undertaken.

is an option consumers have available to them [and] may be less arduous than the customer realised'.

Discounts on existing loans following price reductions are not always as large as discounts on new loans

The big four banks estimate that a typical price reduction granted to those customers with existing variable rate loans that obtained a price reduction in 2019 was between 25 basis points and *'over 30 basis points'* on top of their existing discount. For a customer of one of the big four banks with an existing average size owner-occupier loan of around $275 000, making principal and interest repayments as at 30 September 2019, this could generate savings of around $700 or more in the first year.[114]

While a price reduction of this magnitude could generate significant savings for an individual home loan customer, for many customers, even larger discounts would be available if they refinanced. This is because discounts available to customers with existing loans may not be as large as those available on new loans. For example, we found evidence that some of the big four banks' discount offers to customers who sought a price reduction were not as large as the discounts offered on new loans and some of the big four banks' advertised discount offers were only available on new loans. As one big four bank put it in June 2018, *'switching banks is a pain – we shouldn't need to beat a competitor on price to retain a customer if they are happy with our service'*.

In the Residential mortgage price inquiry we observed that there were many existing home loan customers who remained with a lender that did not offer them the best deal and these lenders earned higher profits as a result.[115] We consider this is still true for the big four banks' customers with existing loans, especially those who have not refinanced in recent years and are paying a significant margin above what customers with new loans are paying on average. For example, the big four banks' customers whose existing owner-occupier loans with principal and interest repayments were greater than five years old were, on average, paying 40 basis points above what the big four banks' customers with new loans were paying as at 30 September 2019.[116] If one of those customers with an existing loan of around $200 000 (the approximate average size for those loans greater than five years old) had refinanced to obtain a new loan rate at one of the big four banks at that time, they could have generated interest savings of around $850 in the first year.[117] Customers with larger loans than the average value of around $200 000 stand to save significantly more.[118]

Given the monetary and non-monetary costs associated with switching lenders, some home loan customers may prefer to remain with their existing lender and get a smaller price reduction compared to what they could get if they refinanced.

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114 ACCC analysis of data supplied by the big four banks. As at 30 September 2019, the average loan size among the big four banks' existing customers with variable rate owner-occupier loans making principal and interest repayments was $275 059.

115 Australian Competition and Consumer Commission, *Residential mortgage price inquiry final report,* p. 8.

116 This data represents the difference in average interest rates paid by the big four banks' customers with a new standard owner-occupier loan with principal and interest repayments as compared to their customers who have had their standard owner-occupier loan with principal and interest repayments for more than five years as at 30 September 2019. The average was calculated on a value-weighted basis. The value of the home loans used in the calculation was the total outstanding amount owed on the home loan as at the relevant date, excluding redraw facilities and payments in advance.

Source: ACCC analysis of data supplied by the big four banks.

117 ACCC analysis of data supplied by the big four banks. As at 30 September 2019, the average loan size among the big four banks' customers with existing variable rate owner-occupier loans making principal and interest repayments and whose loan was greater than five years old was $210 304.

118 ACCC analysis of data supplied by the big four banks. As at 30 September 2019, the average loan size among the big four banks' customers with existing variable rate owner-occupier loans making principal and interest repayments and whose loan was greater than five years old was $210 304. For those customers whose loan was $500 000, they could have saved around $2000 in the first year.

The difference between prices on new and existing loans is an outcome of the big four banks' discounting practices over time

Each of the big four banks has stated that the difference in prices paid by customers with new loans and customers with existing loans is a function of different market conditions, and other factors, at different times.[119] Relevant factors identified by the banks variously included:

- their perception of changing competitive dynamics over time
- variation in loan sizes and customers' level of risk over time[120]
- the bank's motivation to manage or grow its balance sheet, sometimes for specific loan types, at a particular point in time.

In and of itself, maintaining the difference does not appear to be a consideration in the big four banks' pricing decisions, with one big four bank explicitly stating that it *'does not seek to maintain any particular 'gap' between the discounts for New Loans and Existing Loans'*.

Three of the big four banks considered narrowing or eliminating the difference during the price monitoring period, including by reducing discounts for new loans, increasing discounts for customers with existing loans, or both. Some of these strategies could have negatively affected their revenue or competitive position, at least in the short term.

Two banks, NAB and ANZ, implemented pricing changes during the price monitoring period which, had they been sustained, would have had the effect of narrowing the difference (see box 5.4).

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[119] Evidence to Standing Committee on Economics, Australia's four major banks and other financial institutions: four major banks, The House of Representatives, 8 November 2019, https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/86eef00b-f8cd-4c13-b8c3-3cef597b3142/toc_pdf/Standing%20Committee%20on%20Economics_2019_11_08_7339_Official.pdf;fileType=application%2Fpdf, p. 9, Mr Brian Hartzer (WBC), *'[Interest rates at a point in time] reflect the particular demand and supply dynamics that exist at that point in time'*; p. 36, Mr Matt Comyn (CBA), *'We don't seek to distinguish between new or existing, but we recognise that the prevailing offers that are available in any market at a point in time can occasionally differ'.*

Evidence to Standing Committee on Economics, Australia's four major banks and other financial institutions: four major banks, The House of Representatives, 15 November 2019, https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/toc_pdf/Standing%20Committee%20on%20Economics_2019_11_15_7355_Official.pdf;fileType=application%2Fpdf#search=%22committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/0000%22, p. 9, Mr Phillip Chronican (NAB), *'Discounts [are] set with reference to the riskiness of the loan, the size of the loan and also the combination of business that the customer brings in' and 'We compete at a point in time to get a customer and we quote a discounted rate to get it to be competitive'*; p.38, Mr Shayne Elliott (ANZ*), '[Home loans are priced] on the day based on the environment they're in, the cost of funds on the day, the risk environment on that day and the competitive environment on that day'.*

[120] This accords with our observations in Residential mortgage price inquiry: larger loans tend to receive higher discounts due to greater customer bargaining power and the existence of fixed costs associated with writing a home loan, regardless of size; and reductions in high risk lending lead to competition, and hence higher discounts, for 'high quality' home loan customers.

See Australian Competition and Consumer Commission*, Residential mortgage price inquiry final report,* p. 34.

Box 5.4 Pricing changes implemented by the banks which could have had the effect of narrowing the difference in prices paid for new loans and existing loans

Increasing prices for new customers

In September and October 2018, ANZ, CBA and Westpac increased headline variable rates, citing increased funding costs.[121] NAB's decision not to increase headline variable rates at this time was said to be part of a strategy to rebuild the trust of customers and reward existing customers for loyalty.[122] In November 2018, consistent with its intention '*to close the gap between front and back-book discount'*, NAB decreased the advertised discount for new loans whilst leaving rates paid by customers with existing loans unchanged.[123]

However, by the end of January 2019, NAB had increased its headline variable rates, publicly citing a need to balance customer loyalty with *'shareholder outcomes' and 'sustained increases in funding costs'*. NAB also decided to *'leave [front book] rates largely steady […] to compete in the market'*, observing internally that the other big four banks had already *'lowered front-book pricing to [pre-October 2018] levels'*. NAB expressed the view that increasing new loan prices (in line with existing loan price changes) would price it *'out of market'*.

Since the 'new loan' rate was now measured against a higher headline variable rate following the reprice, the size of the average discount off the headline variable rate for new loans increased.

Decreasing prices for existing customers

As discussed in chapter 2, in June 2019, ANZ temporarily removed the discount differential between customers with new loans and customers with existing loans who sought a price reduction during that period. As a result, customers with existing loans who contacted ANZ seeking a price reduction were eligible for the same discounts as equivalent customers with new loans. Prior to this, customers with new loans would typically receive a discount 4 to 5 basis points higher than the discount for a customer with an existing loan seeking a price reduction.

The primary reasons for this decision were to allow ANZ to efficiently deal with the large volume of price reduction requests it received following the June 2019 headline rate cut, as well as address its declining market share. It had the practical effect of temporarily eliminating the difference between discounts on new loans and existing loans for those customers with an existing loan who sought a price reduction.

In mid-July 2019, ANZ reintroduced discount differentials so that customers with new loans generally obtained, on average, a discount 4 to 5 basis points higher than the

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121 Australia and New Zealand Banking Group Limited, *ANZ increases variable home loan rates*, 6 September 2018, https://media.anz.com/posts/2018/09/anz-increases-variable-home-loan-rates, viewed 25 February 2020.

Commonwealth Bank of Australia, *Commonwealth Bank announces interest rate change*, 6 September 2018, https://www.commbank.com.au/guidance/newsroom/interest-rate-change-201809.html?ei=card-view, viewed 25 February 2020.

Westpac Banking Corporation, *Westpac increases variable home loan rates*, 29 August 2018, https://www.westpac.com.au/about-westpac/media/media-releases/2018/29-august/, viewed 25 February 2020.

122 National Australia Bank Limited, *NAB standard variable rate for home loans on hold,* 9 September 2018, https://news.nab.com.au/news_room_posts/nab-standard-variable-rate-for-home-loans-on-hold/, viewed 13 January 2020.

National Australia Bank Limited, *NAB announces change to home loan variable interest rates,* 24 January 2019, https://news.nab.com.au/news_room_posts/nab-announces-changes-to-home-loan-variable-interest-rates/, viewed 13 January 2020.

J Eyers and S Turner, 'NAB to hold mortgage rates in an attempt to 'build trust'', *Australian Financial Review*, 10 September 2018, https://www.afr.com/companies/financial-services/nab-to-hold-mortgage-rates-in-an-attempt-to-build-trust-20180910-h155iw, viewed 13 January 2020.

D Hughes, 'NAB cuts discounts on standard variable rates for new borrowers', *Australian Financial Review*, 5 November 2018, https://www.afr.com/companies/financial-services/nab-cuts-discounts-on-standard-variable-rates-for-new-borrowers-20181105-h17i31, viewed 13 January 2020.

123 See also D Hughes, 'NAB cuts discounts on standard variable rates for new borrowers', *Australian Financial Review*, 5 November 2018, https://www.afr.com/companies/financial-services/nab-cuts-discounts-on-standard-variable-rates-for-new-borrowers-20181105-h17i31, viewed 13 January 2020.

discount available to customers with existing loans seeking a price reduction. Negative revenue impacts from the *'significant volume'* of loans receiving the higher discount as a price reduction was cited as one of the reasons for reintroducing the differential, along with the decline in the volume of calls and an improvement in ANZ's competitive position. ANZ stated that the ultimate decision to reintroduce the differential balanced the bank's competitive positioning with *'business performance'*.

New tools designed to help home loan customers compare prices, negotiate with lenders and switch

The Residential mortgage price inquiry observed that many customers with an existing home loan could benefit from:

- asking their current lender for a better interest rate and lower fees on their current home loan; that is, seeking a price reduction
- switching their home loan to a cheaper product with their current lender
- switching lenders.[124]

We consider this remains the case, and customers should review their home loan products on a regular basis. The potential benefit to home loan customers could be significant, with one bank noting that for variable rate owner-occupier customers who have not obtained a price reduction on their home loan for a *'couple of years'*, the difference between their discount and the new loan discount could *'conceivably be at the high 30's [basis points] differential'.*

Consumer Data Right

The Consumer Data Right, which will apply first in the banking sector, will soon provide individuals and businesses the ability to access their own banking data or securely share that data with accredited third parties. It will also require banks to provide access to product data in machine readable form. This will improve consumers' ability to compare and switch between home loan products and suppliers.[125]

In relation to data for serviceability assessments[126], consumers will be able to direct the big four banks to share their credit and debit card, deposit account and transactional account data with accredited data recipients from 1 July 2020.[127] Consumers' home loan data will be able to be shared from 1 November 2020.

Consumers can find out more about the Consumer Data Right by visiting https://www.accc.gov.au/focus-areas/consumer-data-right-cdr-0.

Interest rate transparency tool

The Australian Securities and Investments Commission's (ASIC) Moneysmart Mortgage calculator will shortly be enhanced to include information on average interest rates for new loans across borrower and repayment types. The enhanced calculator will use weighted

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124 Australian Competition and Consumer Commission*, Residential mortgage price inquiry final report,* p. 11.

125 Australian Competition and Consumer Commission*, Consumer data right (CDR),* https://www.accc.gov.au/focus-areas/consumer-data-right-cdr-0, viewed 30 January 2020.

126 Serviceability assessment refers to *'the calculation of whether a borrower can afford the repayments on a loan, after other expenses and income are taken into account'*.

Heidi Richards (Australian Prudential Regulation Authority), *'A prudential approach to mortgage lending'*, 18 March 2016.

127 Accredited data recipients are third parties that have been accredited by the Data Recipient Accreditor (currently the ACCC). The criteria for accreditation is outlined in the Consumer Date Right rules. These providers may include (but are not limited to) authorised deposit-taking institutions, non-bank lenders and financial technology organisations.

average interest rate data,[128] collected from all ADIs (including banks, building societies and credit unions).[129] The calculator will provide consumers with a benchmark against which they can compare offers from lenders or their current interest rate.

This enhancement follows the Productivity Commission's recommendation that ASIC develop an online calculator that reports median interest rates for loans issued according to different combinations of loan and borrower characteristics. The enhancement was developed by the Council of Financial Regulators (APRA, ASIC, the RBA and the Australian Treasury), with the ACCC.[130] The beta version of the calculator will be available on the Moneysmart website https://moneysmart.gov.au/home-loans/mortgage-calculator.

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128 The weights correspond to the value of credit outstanding or funded in the month for a given type of finance.

See Reserve Bank of Australia, 'Box D: Enhancing the Transparency of Interest Rates', *Statement on Monetary Policy*, February 2020, p. 61.

129 The data also includes data from APRA registered financial corporations.

See Australian Prudential Regulation Authority, *Modernised economic and financial statistics*, July 2019, https://www.apra.gov.au/modernised-economic-and-financial-statistics, viewed 13 March 2020.

These lenders represent roughly 95 per cent of credit outstanding, where credit outstanding includes all mortgages, personal and business loans.

See Reserve Bank of Australia, 'Box D: Enhancing the Transparency of Interest Rates', *Statement on Monetary Policy*, February 2020, p. 59.

130 The Council of Financial Regulators is the coordinating body for Australia's main financial regulatory agencies, which aims to contribute to the efficiency and effectiveness of financial regulation and promote financial stability. The CFR's members include APRA, ASIC, the RBA and the Australian Treasury.

Appendix A: Competition and Consumer (Price Inquiry — Home Loans) Direction 2019

Competition and Consumer (Price Inquiry—Home Loans) Direction 2019

I, Josh Frydenberg, Treasurer, give the following direction to the Australian Competition and Consumer Commission.

Dated 14/10/ 2019

Josh Frydenberg
Treasurer

Contents

Part 1—Preliminary

1 Name

This instrument is the *Competition and Consumer (Price Inquiry—Home Loans) Direction 2019*.

2 Commencement

(1) Each provision of this instrument specified in column 1 of the table commences, or is taken to have commenced, in accordance with column 2 of the table. Any other statement in column 2 has effect according to its terms.

Commencement information		
Column 1	**Column 2**	**Column 3**
Provisions	**Commencement**	**Date/Details**
1. The whole of this instrument	The day after this instrument is registered.	

Note: This table relates only to the provisions of this instrument as originally made. It will not be amended to deal with any later amendments of this instrument.

(2) Any information in column 3 of the table is not part of this instrument. Information may be inserted in this column, or information in it may be edited, in any published version of this instrument.

3 Authority

This instrument is made under the *Competition and Consumer Act 2010*.

4 Definitions

Note: Expressions have the same meaning in this instrument as in the *Competition and Consumer Act 2010* as in force from time to time—see paragraph 13(1)(b) of the *Legislation Act 2003*.

In this instrument:

Australian credit licensee has the meaning given by the *National Consumer Credit Protection Act 2009*.

authorised deposit-taking institution has the meaning given by the *Banking Act 1959*.

exempt supply has the meaning given by subsection 95A(1) of the Act.

goods has the meaning given by subsection 95A(1) of the Act.

home loan means a loan secured by a mortgage over one or more residential premises.

inquiry has the meaning given by subsection 95A(1) of the Act.

price has the meaning given by subsection 95A(1) of the Act.

residential premises has the same meaning as in the *A New Tax System (Goods and Services Tax) Act 1999.*

services has the meaning given by subsection 95A(1) of the Act.

State or Territory authority has the meaning given by subsection 95A(1) of the Act.

supply has the meaning given by subsection 95A(1) of the Act.

the Act means the *Competition and Consumer Act 2010*.

Part 2—Price inquiry into the supply of home loans

5 Commission to hold an inquiry

(1) Under subsection 95H(1) of the Act, the Commission is required to hold an inquiry into the market for the supply of home loans. The inquiry is *not* to extend to any of the following:

(a) the supply of a good or service by a State or Territory authority;

(b) the supply of a good or service that is an exempt supply;

(c) the conduct of the Australian Prudential Regulation Authority or the Australian Securities and Investments Commission;

(d) the conduct of a mortgage broker.

Note: The matters referred to in paragraphs (c) and (d) fall within scope of other inquiries.

(2) For the purposes of subsection 95J(1), the inquiry is to be held in relation to goods and services of the following descriptions:

(a) home loans supplied by authorised deposit-taking institutions;

(b) home loans supplied by Australian credit licensees;

(c) home loans supplied by a person who would be covered by paragraph (a) or (b) apart from an exemption in force under the *Banking Act 1959* or the *National Consumer Credit Protection Act 2009*.

(3) Under subsection 95J(2), the inquiry is *not* to be held in relation to the supply of goods and services by a particular person or persons.

6 Directions on matters to be taken into consideration in the inquiry

Under subsection 95J(6) of the Act, the Commission is directed to take into consideration all of the following matters in holding the inquiry:

(a) the prices charged, since 1 January 2019, by suppliers covered by subsection 5(2) for providing home loans, including:

(i) differences between the prices advertised and the prices actually charged or paid, with particular regard to interest rates published by suppliers and the interest rates paid by customers; and

(ii) differences between the prices charged to, or paid by, existing customers as compared to new customers; and

(iii) supplier pricing decisions following changes in the Reserve Bank of Australia's target for the cash rate (which is the overnight money market interest rate), including:

(A) the extent to which any resulting price changes were due to changes in suppliers' access to, and costs of, finance; and

(B) the timing of suppliers' announcements of price changes and their implementation of those changes; and

(b) the extent and existence of supplier practices and strategies that create an impediment to existing home loan customers refinancing to an alternative supplier (commonly referred to as 'switching'), including impediments resulting from product features and the effect of product bundling; and

(c) other impediments to existing home loan customers refinancing to an alternative supplier, with particular regard to:
   (i) consumer behaviour, including consumer decision-making, biases and choices; and
   (ii) the availability to the public of information about prices actually being charged, or paid, for home loans.

7 Directions as to holding of the inquiry

Under subsection 95J(6) of the Act, the Commission is directed to do the following in holding the inquiry:

(a) have particular regard to the activities of those with the largest shares of outstanding home loans by market value; and

(b) give to the Treasurer an interim report on the inquiry by 30 March 2020.

8 Period for completing the inquiry

For the purposes of subsection 95K(1) of the Act, the inquiry is to be completed, and a report on the matter of inquiry given to the Treasurer, by no later than 30 September 2020.

EXPLANATORY STATEMENT

Issued by authority of the Treasurer

Competition and Consumer Act 2010

Competition and Consumer (Price Inquiry–Home Loans) Direction 2019

Section 95H of the *Competition and Consumer Act 2010* (the Act) provides that the Minister may require the Australian Competition and Consumer Commission (ACCC) to hold an inquiry into a specified matter or matters.

The *Competition and Consumer (Price Inquiry–Home Loans) Direction 2019* (the Direction) is made under subsection 95H(1) and provides a direction to the Chairperson of the ACCC requiring the ACCC to hold a price inquiry into the market for the supply of home loans.

The inquiry will support the Government's commitment to promoting competition and good consumer outcomes in the home loan market, including by bringing more transparency to the pricing practices of the banks. As such, the Treasurer is requesting the ACCC hold a price inquiry into the market for the supply of home loans.

Part 1 of the Direction provides the machinery provisions of the instrument, including the definitions.

Part 2 of the Direction provides the terms of reference for the inquiry and guidance on the matters to be taken into consideration. The ACCC must have particular regard to the activities of those with the largest shares of outstanding home loans by market value.

The ACCC must give the Treasurer an interim report on the inquiry by 30 March 2020 and provide a report to the Treasurer by no later than 30 September 2020.

In accordance with section 17 of the *Legislation Act 2003*, the ACCC has been consulted on the terms of this Direction.

The Direction is a legislative instrument for the purposes of the *Legislation Act 2003*. However, the instrument is not disallowable and does not sunset (see *Legislation (Exemptions and Other Matters) Regulation 2015*).

The Direction commences the day after the instrument is registered.

A statement of Compatibility with Human Rights is at Attachment A.

ATTACHMENT A

Statement of Compatibility with Human Rights

Prepared in accordance with Part 3 of the Human Rights (Parliamentary Scrutiny) Act 2011

Competition and Consumer (Price Inquiry–Home Loans) Direction 2019

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*.

Overview of the Legislative Instrument

Section 95H of the *Competition and Consumer Act 2010* (the Act) provides that the Minister may require the Australian Competition and Consumer Commission (ACCC) to hold an inquiry into a specified matter or matters.

The *Competition and Consumer (Price Inquiry–Home Loans) Direction 2019* (the Direction) is a direction to the Chairperson of the ACCC to hold a price inquiry into the market for the supply of home loans.

The Direction sets out the terms of reference for the inquiry.

Human rights implications

This Legislative Instrument does not engage any of the applicable rights or freedoms.

Conclusion

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.

Appendix B: Components of home loan prices

The price of a home loan is comprised of the interest rates and fees paid by home loan customers to lenders.[131] There are two components to the interest rates home loan customers pay: the headline interest rate and any discounts off the headline interest rate granted by the lender.

Headline interest rates

Headline variable rates are the reference or indicator rates on which variable interest rates paid by new and existing home loan customers are based. Lenders also maintain separate headline interest rates for fixed rate home loans on which offers to new fixed rate customers are based. Generally, the headline interest rate (variable or fixed) is the maximum rate a new customer will be offered on a home loan.

Lenders generally maintain a number of headline variable rates for various products and combinations of borrower and repayment types. For example, it is common for lenders to have a different headline variable rate applying to home loans for:

- owner-occupiers contracted with principal and interest repayments
- owner-occupiers contracted with interest-only repayments
- investors contracted with principal and interest repayments
- investors contracted with interest-only repayments.

Lenders are referring to changes to the headline interest rates when they announce a change in their interest rates.

Discounts

The interest rate a home loan customer actually pays is the headline interest rate (fixed or variable) less any discounts granted by their lender. The discount agreed between a customer and lender applies for the life of the home loan unless otherwise specified in the loan contract (for example, lenders sometimes provide short-term discounts that run between one to two years as part of a promotional campaign). As a result, the variable interest rates actually paid by home loan customers change by the same amount as any change in their lender's headline variable rate (see box B.1).

Box B.1 Example of how discounts work

A home loan customer accepts an offer for a variable rate home loan that includes a 0.50 per cent (50 basis point) discount. If their lender's headline variable rate is 3.50 per cent, the customer will pay 3.00 per cent interest.

If the lender reduces its headline variable rate to 2.50 per cent, the customer will pay 2.00 per cent interest. If the lender increases its interest rate to 4.50 per cent, the customer will pay 4.00 per cent interest.

131 See Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, pp. 15–16.

There are two main types of discounts: advertised and discretionary.

- Advertised discounts are often offered as part of a home loan package that includes, for example, a home loan, transaction account or offset account, and a credit card. The customer often has to pay an annual fee for the package and, in turn, receives reduced (or waived) fees on the products included in the package as well as a discount on the interest rate applying to their home loan.
- Discretionary discounts are offered at the lender's discretion on a case-by-case basis to individual home loan customers. Discretionary discounts are less easily discovered by consumers compared to advertised discounts, as the decision criteria for discretionary discounts vary across lenders. Further, consumers may be required to lodge a loan application to confirm the discretionary discount that would be available to them, and/or may be required to supply evidence of another lender's offer if they want a lender to match or better that offer.[132]

Not all home loan customers will be eligible for a discount or willing to agree to the terms on which a lender offers a discount.

Fees

The fees customers typically pay on home loans include the establishment or setup fees at the beginning of a loan and service or administration fees during the life of a loan. Customers may also pay an ongoing fee as part of a packaged home loan.

[132] Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, p. 6.

Appendix C: The different types of home loans

Home loan products are characterised by a combination of the loan's purpose or borrower type (owner-occupier or investor), the type of interest rate (variable or fixed) and the repayment arrangements (principal and interest or interest-only).

The loan's purpose: owner-occupier or investor

Lenders offer home loans to suit two main purposes:

- for home loan customers to purchase or construct a residence for the customer to live in (known as an owner-occupier loan)
- for home loan customers to purchase or construct a residence as an investment (known as an investor loan).

The type of interest rate

The interest rate applying to a home loan can be variable or fixed. Under a variable rate home loan, the lender can change the interest rate at its discretion by altering the relevant headline variable rate (discussed in Appendix B). Under the National Credit Code[133], a lender must advise the customer of a change in their interest rate no later than the day on which the change takes effect.

By contrast, under a fixed rate home loan, the interest rate does not change during a set period (for example, two or three years). After the fixed rate period expires, the home loan customer usually has the choice between 'locking in' another fixed rate period based on the then prevailing fixed interest rates or reverting to a variable rate home loan.

Many lenders also give their customers the option of splitting their total borrowing requirement across fixed and variable rate home loan products. Where this occurs, the customer will usually have two or more loan accounts created—one for each home loan product they choose.

The loan repayment arrangements

Lenders often provide their customers with a choice between making principal and interest repayments or interest-only repayments.

A principal and interest home loan requires the customer to make regular repayments of the amount borrowed (the principal), and pay interest on the principal. These loans are paid off over an agreed period of time, for example, 25 or 30 years.[134]

An interest-only home loan allows the customer to pay the lender only the interest payable on the amount borrowed for a set period of time (for example, five years). During this period, the principal of the loan will not reduce.[135] Interest only loans are popular among investors. This is, at least in part, because interest paid on an investor loan may be tax deductable.

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133 *National Consumer Credit Protection Act 2009* (Cth), Schedule 1.

134 Moneysmart, 'Choosing a home loan', https://www.moneysmart.gov.au/borrowing-and-credit/home-loans/choosing-a-home-loan, viewed 2 March 2020.

135 Moneysmart, 'Choosing a home loan', https://www.moneysmart.gov.au/borrowing-and-credit/home-loans/choosing-a-home-loan, viewed 2 March 2020.

Appendix D: The risks and associated costs banks face in providing loans

Banks face numerous costs in sourcing and lending funds in addition to their costs of funds. In many cases, these additional costs arise because of the risks inherent in the business of borrowing and lending money.[136] Some of these risks, and the costs of managing them, are set out below.

Credit risk

Credit risk is perhaps the best-known risk banks need to manage. It involves the potential for losses from home loan customers being unable to repay their loans and the sale of collateral pledged for the loan not fully covering the losses. Banks need to set aside funds to protect against potential losses if they are to remain solvent.

Maturity mismatch between loans and funding sources

Banks generally take a forward-looking approach to their funding decisions. A long term view of funding costs is critical for home lending, as loans can have terms of up to 30 years (although their 'behavioural maturity', which is the term in which loans are actually repaid, is often much shorter). In contrast, funding terms are significantly shorter. For example, as at March 2017, the majority of banks' funding had maturities below three years.[137] As a result, a bank may need to renew its sources of funding multiple times over the life of a home loan. This maturity mismatch creates potential risk that funding sources will not be renewed or will only be renewed at an increased cost. There are costs to managing these risks, including the term premium a bank will need to pay if it issues longer-term debt.

Liquidity risks

The term mismatch between long-term loans and short-term funding liabilities also means banks must hold sufficient liquid assets to meet the withdrawal demands of depositors and repayment demands of bondholders. Liquid assets, such as Australian Government Bonds, generally earn a much lower return than the other assets (including loans) in which a bank could invest. This creates an opportunity cost for the banks that their treasury units reflect by including a liquidity premium within their funds transfer prices. This is to ensure a bank's interest rates on deposits and loans account for the cost of liquidity. The liquidity premium means that not every dollar raised from depositors and bondholders can be lent out by a bank.

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[136] Australian Competition and Consumer Commission, *Residential mortgage price inquiry interim report*, pp. 50–51.

[137] Tim Atkin and Belinda Cheung, 'How have Australian banks responded to tighter capital and liquidity requirements?', June 2017, p.43.

Hedging costs

There can be mismatches in the currency in which funding is raised and loans are made. For example, a bank may issue bonds that pay a variable rate of interest based on the London Interbank Offered Rate and are denominated in United States Dollars but use the proceeds for home loans in Australian dollars. This creates a number of risks for the bank, such as exchange rate risk from a loss if the Australian dollar depreciates against the United States Dollars and thereby increases the cost of servicing the US denominated bonds, and the risk of changes in London Interbank Offered Rate contrary to interest rate trends in Australia where the money was lent. Banks commonly use derivative contracts, such as swaps, to hedge these risks. The costs associated with those derivative contracts are part of the cost of raising funds. The portion of the funds transfer price intended to allow for these costs is sometimes referred to as the 'hedging premium'.

Appendix E: The banks' estimates of the difference between interest rates paid on new and existing loans

Table E.1 The big four banks' estimates of the difference between interest rates paid by customers with new loans and customers with existing loans

Bank	Publicly stated difference	Actual difference estimated by the Bank	Product type	Borrower and repayment type	Date the difference was calculated
ANZ	*'[L]ess than 30 basis points'*	29 basis points	All standard home loans with a variable rate under the bank's main brand	All borrower types (owner occupier and investor) and repayment types (principal and interest and interest-only)	30 September 2019
CBA	*'[S]ubstantially'* less than 30 basis points	21 basis points	All standard home loans with a variable rate under the bank's main brand	All borrower types (owner occupier and investor) and repayment types (principal and interest and interest-only)	24 September 2019
NAB	*'[A]bout 26 basis points'*	26 basis points	Packaged home loans with a variable rate under the bank's main brand	Owner-occupier loans across all repayment types (principal and interest and interest-only)	30 September 2019
Westpac	28 basis points	28 basis points	All standard home loans with a variable rate under the bank's main brand	Owner-occupier loans with principal and interest repayments	30 September 2019

Note: Throughout this report, the term 'new loans' generally refers to home loans that have recently been established. 'Existing loans' are those loans that have been established for a longer period of time.

Sources: Information provided by the big four banks.

Evidence to Standing Committee on Economics, Australia's four major banks and other financial institutions: four major banks, 15 November 2019, https://parlinfo.aph.gov.au/parlInfo/download/committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/toc_pdf/Standing%20Committee%20on%20Economics_2019_11_15_7355_Official.pdf;fileType=application%2Fpdf#search=%22committees/commrep/1dd5064e-e2b0-4616-b7a5-665cf9e50617/0000%22. pp. 9 (NAB) and 38 (ANZ).

C Yeates, 'CBA chief Matt Comyn defends different loans rates for customers', The Sydney Morning Herald, 16 October 2019, https://www.smh.com.au/business/banking-and-finance/cba-chief-matt-comyn-defends-different-loan-rates-for-customers-20191016-p531bd.html, viewed 10 January 2020.

Evidence to Standing Committee on Economics, Review of the four major banks, Response to The House of Representatives questions November 2019, Westpac Banking Corporation, https://www.aph.gov.au/-/media/02_Parliamentary_Business/24_Committees/243_Reps_Committees/Economics/46p/Banks_and_Financial_Institutions/1_Bank_Review_-_First_Report/Westpac_QoNs/WBC15QON.pdf?la=en&hash=0DE5712BCCF1B7D5C3FF617C2EEFA5C96C9D6830

Box E.1 Methodological differences in calculating the difference

Although the 26 basis point difference between the average interest rate of new and existing home loans observed by the ACCC for owner-occupier loans with principal and interest repayments (table 5.1) is similar to the differences estimated by the big four banks (table E.1), there are some methodological differences which means they are not a like-for-like comparison. The extent to which these differences have a material impact on the validity of comparisons between the various figures provided by the various banks is not entirely clear.

Definition of customers with new loans

ANZ and CBA defined customers with new loans as, respectively, customers that opened a home loan account, or had their home loan funded in a given month. In calculating its estimate of the difference between interest rates on new loans and existing loans, NAB defined new loans as loans drawn down in a given month. The ACCC and Westpac defined new loans as those established less than 12 months prior to a given date.

Calculation of the difference

The average interest rate for existing loans used by ANZ and CBA was derived from the interest rates of their entire home loan portfolios, which included new loans. Conversely, the average interest rate for existing loans used by the ACCC, NAB and Westpac excluded the interest rates for new loans.

Different borrower, repayment and product types

Whilst the ACCC's and Westpac's calculations included only owner-occupier loans with principal and interest repayments, NAB included both interest-only and principal and interest repayment types in its calculations. ANZ and CBA included all borrower types (owner-occupier and investor) and repayment types (principal and interest and interest-only) in their calculations. Information provided by the banks indicated that the extent of discounting varies between different loan types.

The ACCC, ANZ, CBA and Westpac included all standard home loans, packaged and unpackaged, in its estimates. NAB was the only big four bank that included both basic and standard home loans, and also excluded any unpackaged home loans.

The ACCC and the big four banks only included variable rate home loans in their calculations.