

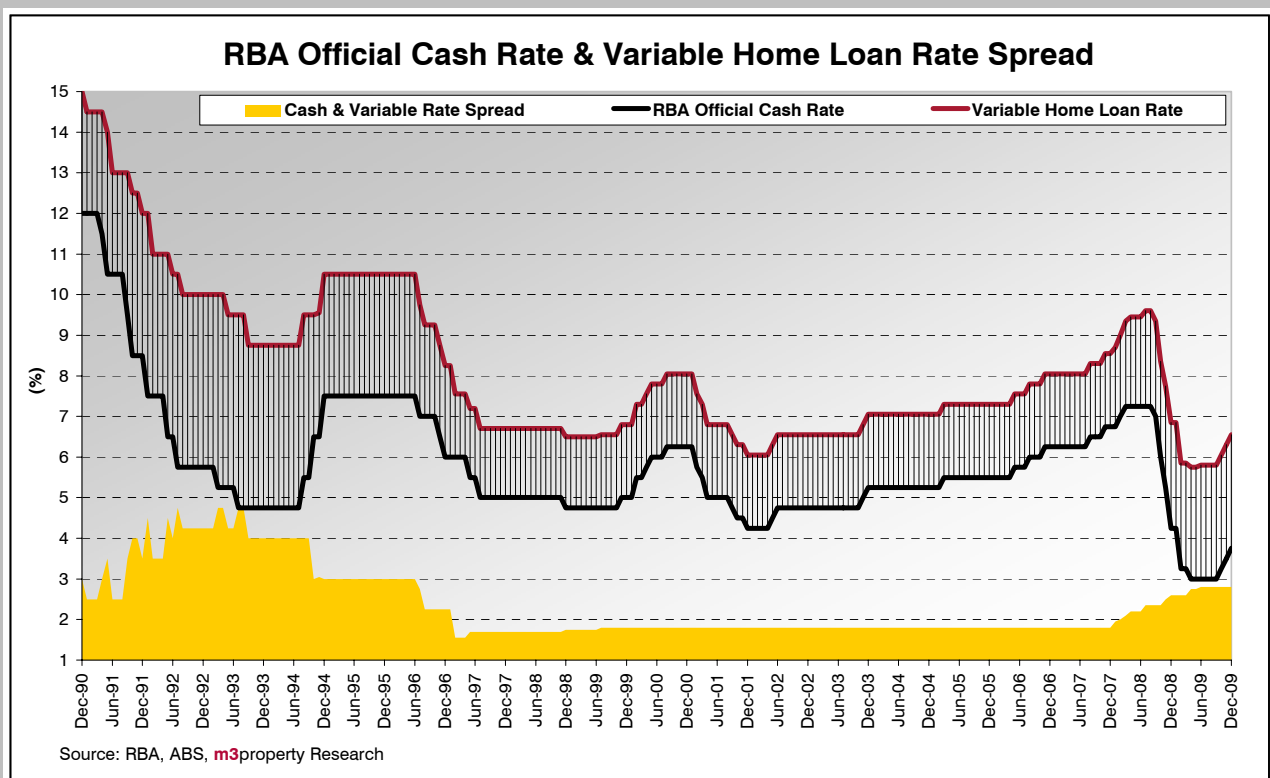
Interest Rate Spreads – Relationship between the Official Cash Rate & Variable Home Loan Rates

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Recently there has been much discussion about the relationship between the official cash rate and variable home loan rates. This has become topical because recent increases to variable rates have been higher than the change in the RBA's official cash rate, leading to a wider interest rate spread between both.

This is best demonstrated in the following chart which shows the 20-year relationship between the Official Cash Rate and Variable Home Loan Rate.



From the chart the following observations can be made:

- The yellow area highlights the difference between both rates over time;
- During the early 1990's the difference, or spread, was up to 4% for about 3 years;
- This coincided with the last major recessionary period and reflected the tightness in credit markets and lack of competition as several lenders had been sidelined or disappeared due to the downturn conditions;
- During the mid 1990's the economy started to improve and competition re emerged. In particular the RMBS (Residential Mortgage Backed Security) market started to grow with pioneers such as Aussie Home Loans changing the way mortgages were distributed and funded in Australia;

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- This caused margin pressure on the major lenders and the spread narrowed to 1.75%, where it remained for a period of 10 years;
- Towards the end of 2007 the first impacts of the Sub-prime lending crisis, which triggered the Global Financial Crisis began to be felt. This initially led to a reduction in demand for RMBS product and spreads started to ease;
- As the Global Financial Crisis unfolded during 2008 and 2009, the market for RMBS virtually disappeared and a number of players in the home lending industry left the market;
- This has enabled the major lenders to increase their margin or spread on housing loans up to about 2.75%, which is about where it was before the recession in the early 1990's; and
- If you deduct the cost of the Government wholesale funding guarantee of 70bp for AA-rated banks and more for lesser rated banks, the actual margin or spread is still low.

Where to from here for rates and lending markets?

- The Government is providing some support for RMBS issuers and more competition should result from this however, the cost of issuing RMBS is still high;
- The domestic economy is now in recovery and the residential market has been resilient in 2009. This may entice previously sidelined lenders to re-enter the market;
- Wholesale funding is still constrained and more expensive than previously, therefore limiting the capacity of lenders to shave their margins;
- Proposed increases to the amount of liquid assets banks have to hold on balance sheet may lead to higher interest margins and reduced lending capacity;
- New mortgage business has become very concentrated amongst the four major banks in Australia. At some point, some lenders may reach capacity causing them to be less price sensitive; and
- Continued low spreads or margins on home lending would indicate that commercial loan margins are not going to reduce anytime soon.

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