Funding Costs, Fees and Mortgages

Since the onset of the Global Financial Crisis (GFC) it would have been obvious to Blind Freddie that bank loan interest rates would need to increase more than the cash rate, if bank profitability was to be maintained. And that was probably obvious to bank executives as well.

But whether the many new housing loan customers acquired by the banks under variable rate mortgages over the past two years were informed about that is another matter. Whether they should have been is an important disclosure (if not ethical) issue – although it could qualify as "price signaling" with which the ACCC apparently has some concerns.

The reason that loan rate increases beyond the cash rate could be predicted results from two factors. First, variable rate lending where banks can increase interest rates on existing loans at their discretion, facilitates a form of average historical cost pricing.

An increase in the marginal cost of new or replacement funding (as old borrowings mature) only increases the average cost of funding of a bank's balance sheet gradually over time. Thus if interest rates on all loans can be increased in line with the average cost of funding, bank profitability will be insulated.

The second relevant factor is that competition encourages such average cost pricing. Rather than increasing the initial cost of new loans to completely reflect their marginal cost of funding, and risk losing market share of new lending, it is much simpler to average the increased cost of funds over the existing loan portfolio. As long as existing borrowers cannot easily exit (and where would they go?) the bank remains more competitive in the new lending market.

But the downside of this approach is, obviously, that if the increased marginal cost of funds is long lasting, new borrowers will find that their loan rate subsequently increases in line with the average cost of bank funding. Unless Australian bankers believed that the GFC was likely to be a very short run disruption to funding markets, this scenario would have been apparent to them.

Not only are home borrowers unlikely to be able to anticipate the future implications of such market disruptions, it is more appropriate that those risks are borne by bank shareholders, and managed by the bank executives who are paid to do just that.

The solution to this undesirable situation where new borrowers face risks of future higher loan rates which are not apparent to them, is to replace variable-at-the-lender's-discretion loan contracts with adjustable rate mortgage contracts. In these contracts the loan rate is set for a specified period as a fixed margin above some observable market indicator rate, and adjusts automatically at regular intervals as that indicator rate changes.

In such loans, renegotiation of loan terms after the initial specified period may see the borrower wishing to depart from their current lender for greener pastures of better

terms on offer elsewhere. This raises the controversial issue of “exit fees”, particularly deferred establishment fees which can make such switching less attractive.

Banning such exit fees, as some suggest, is one option, but at least one bank CEO has indicated that it may lead to re-introduction of up-front establishment fees. So what! If the borrower is cash-constrained, it is a simple matter for the bank to add the establishment fee to the initial loan principal on which subsequent repayments are based.

This is, in effect, what happens implicitly with deferred establishment fees except that: the contract is specified differently (involving a slightly higher interest rate and ex post repayment of the residual fee if the borrower exits); the lender partially “hides” the establishment fees and the borrower is arguably less able to ascertain the likely cost involved. Banks must be able to recoup loan establishment costs specific to a particular loan, but it should be done in a transparent and understandable manner.

Hence, two reform measures are warranted. First abandon variable-at-the-lender’s-discretion mortgage loans for adjustable rate mortgages. Second, abolish deferred establishment fees and require any such fees not paid up-front to be added to the initial loan principal. A more transparent and fairer loan market would result.

Kevin Davis
Research Director, Australian Centre for Financial Studies
Professor of Finance, University of Melbourne