

May2005 Newsletter

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How Do Banks Set Interest Rates?

One of our newsletter readers suggested that I write a newsletter article about how banks set interest rates. It is interesting to consider the factors that influence a bank when setting rates because it gives you a good insight on how much margin they have to play with and therefore what sort of deal you might be able to negotiate.

It is a bit of a 'heavy' topic and can get a bit technical. I have tried to 'lighten' it up as much as I can and avoid getting too technical.

There are two primary factors that influence residential interest rates; cost of funds and market competition/growth strategies.

Cost of funds

'Cost of funds' is an industry term and refers to how much it costs lenders to source money which they will then lend to residential borrowers.

Variable rates

Lenders can source money from a number of sources. The main sources of funds include bank deposits (i.e. money customers deposit with a bank) and wholesale mortgage backed securities. Mortgage backed securities are essentially a number of individual mortgages lumped together and sold to the wholesale money market for a particular term and yield. Normally, institutional investors purchase these securities.

The larger lenders generally have a lower cost of funds because they have a larger amount of money in deposits. For example, the Commonwealth Bank of Australia (CBA) had \$71 billion in short-term (on demand) deposits and \$5.4 billion in deposits that do not bear interest (per 2004 financial statements). We all know that banks don't pay very much interest on short-term (on demand) deposits so the whole \$76.4 billion (\$71bn + \$5.4bn) is very cheap money. They also had \$38.5 billion in term deposits. Compared to the amount of home loans CBA has (\$104 billion) they don't have to source too much

money outside of the bank [This is a simplistic explanation of home loan funding. Banks have to comply with capital adequacy requirements which can limit the amount and use of customers funds]

The larger banks treasury departments manage and normally set the banks internal cost of funds. The cost of funds for similar sized banks can be quite different because the treasury department may build a profit margin into its cost of funds.

The smaller lenders generally have to rely upon funding through the wholesale market (i.e. mortgage backed securities). This is a lot more costly compared to sourcing monies from a banks balance sheet (i.e. customer deposits). Therefore, smaller lenders generally cannot compete with the aggressive pricing by the larger lenders.

Over 10 years ago, when Aussie Home Loan started, larger banks were making twice the margin on home loans than they currently are. That's why Aussie was able to source funds in the wholesale market and lend these money to home owners at a lower rate. However, over the past 10 years the big banks have responded by offering better deals. We have negotiated interest rate discounts for some of our clients such that the actual rate they are paying is probably less than what small lenders could buy it for on a wholesale basis.

Most banks variable rate cost of funds do not change very much. The cost generally moves in line with the Reserve Bank of Australia's cash rate.

Fixed rates

Lenders fund fixed rates by lending money through the wholesale money markets for a particular term (say 3 years). They then add their profit margin to this rate and re-lend the money to retail clients. The lenders costs are essentially fixed because they have borrowed the money on a fixed rate and re-sold it at a higher fixed rate for the same term. This is called hedging. This is a very crude explanation (for simplicity purposes). Some larger lenders are able to make decisions about how much they want to 'hedge'. For example, a larger lender may decide to fund fixed rates with some variable rate money from deposits. Larger lenders can then 'play' with their cost of funds more than smaller lenders.

Profit margins for fixed rate loans can vary from time to time (more so than variable rate loans). It just depends on how much they can buy the money for on the wholesale market. Often you will see lenders fixed rates move very closely together. For example, last year a lot of cheap 3 year fixed money was sold on the wholesale markets. Within weeks many banks were offering "special 3 year fixed rates".

Market competition

Forget everything I just told you. Cost of funds may not have any influence on rate setting. Marketing objectives may override cost. For example, sometimes lenders set interest rates lower than their normal levels to "buy" new business. For example, Wizard has a product with a current variable rate of 5.83% which is only 0.33% above the cash rate. There is no way Wizard would make any money on this product. The product is extremely inflexible and has no features (and can only be used in limited circumstances). However, it's a great marketing strategy - attract the customers with a low rate, tell them the low rate loan is no good for them and sell them a more expensive product.

Similarly, St George and Westpac are very aggressive in the lending over \$250,000 segment. They will both offer pretty significant interest rate discounts (0.70% off). Westpac has only recently changed its tune and started to offer better deals when they lost a lot of market share. Now they are trying to "buy" that market share back.

The same thing can happen in the fixed rate market. If a lender starts to offer a very attractive fixed interest rate (maybe because they have purchased some cheap money in the market) it may influence other lenders to match the rate (even if they haven't been able to buy the same cheap money).

Power to the borrowers

The existence of Aussie Home Loans really changed the face of the mortgage market. It encouraged the larger lenders to offer lower rates and has snowballed from there. Now the smaller lenders can't really compete with the bigger lenders because they have a lower cost of funds. In addition, the bigger lenders don't want to lose market share so they are always trying to beat each other by offering 'better' deals. The real winner is the borrower! A simple strategy is, gravitate towards the larger lenders and use competition as your negotiating tool... or get ProSolution to do it on your behalf.

Any questions about this article? [Email us.](#)

Not all property is good property! Get the facts from the experts.

Wakelin Property Advisory are holding a Property Investment Forum on Tuesday (10 May 2005) in Melbourne.

Don't miss this step by step introduction to safe and sensible investment in residential property. Wakelin Property Advisory will take you through real-life case studies that show how its clients have taken control of their financial destiny. The forum includes:

- How to make a start on investing in residential property
- What, where, when and how to buy
- Common mistakes and how to avoid them
- Financing — selecting the right option (**presented by ProSolution**)

- How much to pay – the art of negotiation
- Best-performing suburbs
- The investment potential of units vs houses
- The impact of interest rates and inflation
- Why capital growth is the key to successful property investment
- The importance of reviewing your property portfolio.

Your \$45 forum fee includes a complimentary copy of *Streets Ahead: How to Make Money from Residential Property*, by Monique Wakelin and Richard Wakelin.

To book please [click here.](#)

Or phone Wakelin on **(03) 9859 9595.**

Victorian State Budget Matters affecting property & finance

There were two significant items announced in the Victoria State budget this week.

1. The \$5,000 First Home Bonus will remain in place until 31 December 2005. The bonus will reduce to \$3,000 for contracts entered into between 1 January 2006 to 30 June 2007.
2. Land Tax reforms that will provide more than \$800 million in Land Tax relief over five years. The reforms include reduced Land Tax rates for 2006, including an increase in the threshold from \$175,000 to \$200,000, rebates for some Land Tax payers in 2005, and new exemptions for aged care facilities and rooming houses, retrospective to January 2004.

Recent product changes...

- ANZ will now pay \$200 towards the costs of refinancing if you switch your loan from another lender to ANZ.
- Westpac has decreased the total lending threshold that customers must meet in order to obtain an interest rate discount of 0.70% (therefore 6.62%) from \$500,000 to \$250,000. An annual package fee of \$395 applies. The discount applies for the life of the loan. This is now in line with the discount offered by St George.
- Suncorp Metway will offer an interest rate discount of 0.80% off the standard variable rate (therefore 6.62%) for customers that borrow over \$300,000. A \$600 application fee and \$10 monthly fee applies.

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