Big banks may cut rates without RBA

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Australians are preferring to pay debts than to borrow, making the home loan market tougher for lenders. **Photo: Bloomberg**

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The opening up of the mortgage-backed security market and greater competition from smaller lenders could trigger cuts to home loan interest rates even if the Reserve Bank of Australia keeps the cash rate on hold.

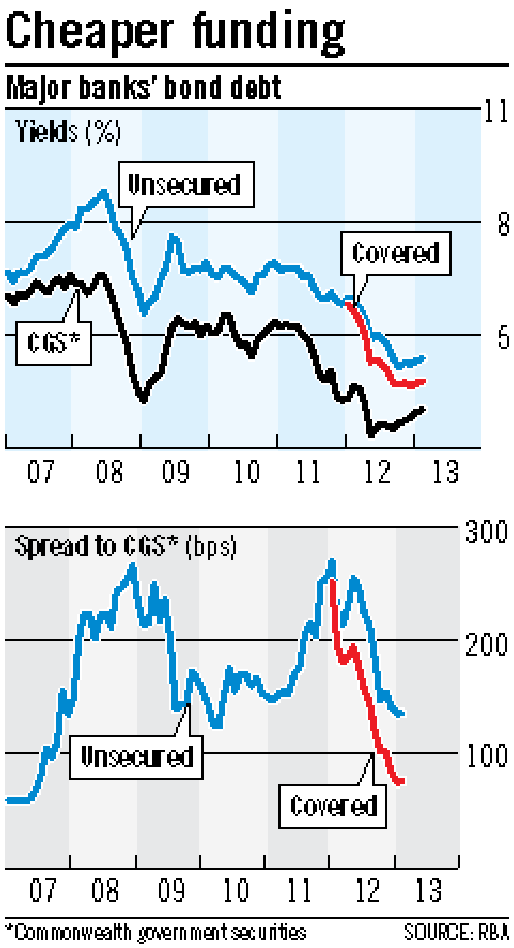
All major banks refused to pass on the RBA’s interest rate cuts in full to home loan customers last year but some analysts believe the falling cost for banks to obtain funds may force them to cut rates to lure a dwindling number of mortgage customers.

“Potentially, we could see out-of-cycle interest rate cuts, but not in the near, near future,” Morningstar bank analyst David Ellis said. “It depends on how offshore, wholesale funding markets perform.

“If they continue to improve and if the pressure on pricing in the customer deposit pricing improves, I would expect to see some type of out-of-cycle interest rate cuts in home loans later in the year.”

While deposit pricing remains elevated, the cost of wholesale funding has declined dramatically in recent months amid an improving outlook for the global economy.

Commonwealth Bank of Australia raised $US2 billion by issuing bonds to investors in the US in January at a cost that was close to 1 percentage point cheaper than a year earlier.



Last week, Bendigo and Adelaide Bank raised $850 million by issuing "residential mortgage-backed securities" to investors at the lowest cost since the global financial crisis.

The big four banks control about 90 per cent of the home loan market but the ability for smaller lenders such as Bendigo to raise money at cheaper rates is lifting hopes they can increase competition.

"It's been a long time since the regional banks could issue at these levels," said John Claudianos, the head of securitisation at Deutsche Bank. "Their relative funding competitiveness in RMBS markets has improved considerably but the major banks still have a slight advantage."

The big banks were put on notice this week that they are set to face stiffer competition in the home loan market after one smaller lender cut its variable mortgage interest rates.

BMC Mortgage, a small non-bank mortgage provider, lowered its standard variable mortgage rates by 0.10 percentage points to 5.9 per cent.

While it is a bit player, the move by BMC to lower variable rates outside of a cut by the RBA could be a taste of things to come as lenders try to turn around weak demand for mortgages.

"This is the first. It is likely that others will follow and cut variable mortgages out of cycle with the RBA because of the conditions they are facing with the tough market for home loans at the moment," said Michelle Hutchison, a spokesperson for financial product comparison service RateCity.

There have been some signs the big banks will become more aggressive, with Westpac last cutting 0.4 percentage points off its two-year fixed rate, taking it to 4.99 per cent.

Housing finance figures this week showed demand for loans slumped by 2.2 per cent in December as consumers choose to pay off debt rather than borrow. The home loan market grew 4.5 per cent in 2012, the slowest annual pace since records began in 1976.

"We believe that borrowing demand will remain cautious," Merrill Lynch analyst Matthew Davison said.

The major banks blamed the higher cost of obtaining funds on wholesale debt markets and through customer deposits, for keeping back some of the RBA's rate cuts last year.

An all-out mortgage price war to attract customers would put pressure on bank's earnings but Mr Ellis said the big four would only cut rates if it did not outweigh the improvement in funding costs and hurt profit margins on loans. He added that while conditions improved for smaller lenders, they were a long way from being a serious challenge to the big four.

"The four major banks have got such a dominant hold of the market than even with improved funding costs, the regional and non-bank lenders are still up against it to really make a dent in the big four banks' market position," he said. "The big banks wouldn't do any out-of-cycle interest rate cuts if it was going to damage their margins."

Aberdeen Asset Management senior investment manager John Manning agreed the big banks remained in the driver's seat despite the improvement in the funding markets for smaller lenders.

“The demand is sporadic for new lending [so] that it’s difficult to see how a new entrant can get meaningful market,” he said. “It is not clear as to what funding benefit a new entrant will enjoy given the cost of funds will consistently be cheaper for a major bank versus their peers.”

Investment manager Robert Camilleri at Realm Investments said the new environment has entrenched the competitive advantage of the major banks.

“The big banks have got free reign on the deposit market, they’re crowding out the asset management sector and they have access to incredibly cheap capital in the hybrid market. It’s a treasurer’s utopia.”

The debate on interest rates and bank funding costs comes as CBA prepares to report its half-year results on Wednesday. Analysts predict CBA will post a cash profit between $3.7 billion and $3.75 billion for the six months to December 31, 2012. The figure would top CBA’s $3.6 billion result for the same period a year earlier and put it on track to break last year’s record annual profit of $7.1 billion as it reaps the rewards of its decision to keep back interest rate cuts from customers. CBA shares closed at a record high $65.52 on Tuesday ahead of the result.

The Australian Financial Review