Economist Insights

Interesting divergence

Households in the UK may be forgiven for wondering when they are going to benefit fully from the Bank of England's interest rate cuts. In 2006, the BOE rate was 4.5% and the variable mortgage rate was 5.5%. Now, with the BOE rate at just 0.5%, the variable mortgage rate has only fallen to around 3%. With all the ill-feeling about the role of banks in the financial crisis, is this just another example of exploitation by banks?

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Unless they were lucky enough to be on a base-rate tracker mortgage, most households in the UK may be forgiven for wondering when they are finally going to benefit fully from the Bank of England's (BOE) interest rate cuts. Back in 2006, during the height of the housing boom, the BOE rate was 4.5% and the variable mortgage rate was just a percentage point higher at 5.5%. Now, with the BOE rate at just 0.5%, the variable mortgage rate is about 3%. With all the ill-feeling about the role of banks in the financial crisis, is this just another example of exploitation by banks?

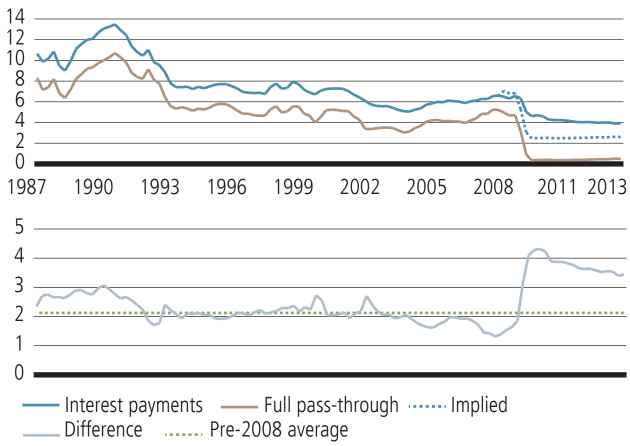
The rates charged on credit cards, bank loans and other forms of borrowing in the UK have also remained high relative to the BOE base rate. Now, we would always expect the actual borrowing rate of households to be higher than the BOE base rate, for three reasons. Firstly, there are risks that a borrower will not be able to repay, so the lender must be compensated for the risk. Secondly, there will be a term premium because households tend to borrow for longer periods, especially mortgages, and this gives more time for risks to build up. Thirdly, the banks have to make some (reasonable) profit or they would not bother lending the money in the first place.

Before the crisis, the actual interest rate faced by UK households moved pretty much in step with the interest rate that they would have paid if there was full pass-through from the BOE base rate (chart 1). Up to 2008, the difference between the two (justified by the three reasons given above) averaged at just over 2%. In the years before the crisis it actually fell – probably due to increased proportion of mortgages which were viewed as less risky. Following the crisis, however, the spread between actual and 'full pass-through' rates shot up to over 4%. In other words, the apparent margin that banks were making on their loans almost doubled. It has since fallen, but remains elevated.

If the spread had remained the same, the implied rate for households to service their debt should be about 2.6%, not 3.9%. This is a lot of money – it is equivalent to the banks taking an extra 2-3% of household disposable income every year since the crisis began. If people were angry at banks before, it would seem that they have good reason to be angry now. Or so it would appear.

Chart 1: Short-changed

Household interest rate (interest payments as a % of liabilities), actual and assuming full pass-through



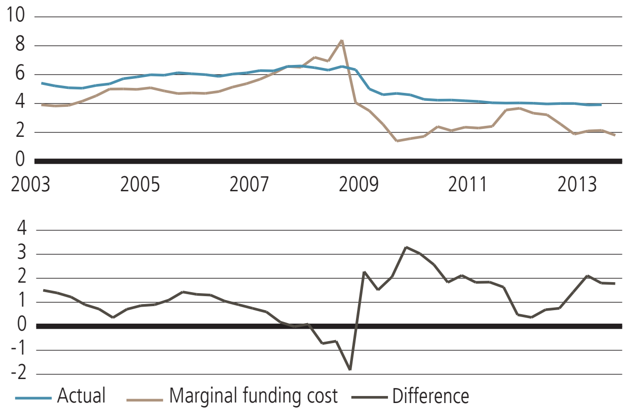
Source: ONS, UBS Global Asset Management

The banks will only be making lots of money at the expense of households if their own costs have not changed. While banks can borrow from the BOE, they can only do so by posting good quality collateral, severely limiting the amount they can borrow. Most bank financing actually comes not from the BOE but from the market. When banks borrow from the market this is usually unsecured, i.e. the borrowing is not backed by any collateral. Therefore, as markets have become more worried about the viability of banks, they have become less willing to lend to banks. When banks find it expensive to borrow, they will need to pass these costs on to borrowers if the banks are to remain profitable.

The BOE itself estimates banks' marginal funding costs by considering the LIBOR rate and the cost that a potential lender to a bank would face if they were to insure themselves against a default (known as a credit default swap, or CDS). A comparison of this marginal funding cost with the interest rate that households actually pay may give a better indication of how much profit banks are potentially making. Sure enough, such a comparison does suggest that at times since the crisis the margin that banks are earning is huge, but at other times it looks like banks were lending at a loss (chart 2).

Chart 2: Marginal

Actual interest rate paid by households and the marginal funding costs of banks



Source: ONS, Bloomberg, UBS Global Asset Management
Note: Marginal funding rate for banks is the 3-month LIBOR plus the simple average of the 5y CDS for major UK banks

Overall, it is hard to escape the impression that banks are earning increased margins, albeit not as consistently large as a simple comparison with movements in the BOE rate would suggest. Banks may argue that they are facing additional costs from regulation and balance sheet repair. During the crisis many UK banks' balance sheets were severely hit, causing a drop in the capital that banks hold as a buffer against future losses. One way to restore this level of capital is through lending less at a higher interest rate. But banks would be hard pressed to claim that these factors explain all of the increase in margins. The banks may also argue that they need to charge a higher risk premium because the state of the economy calls into doubt people's ability to repay.

The more conspiratorially minded might well wonder if this is all part of a plan. Another way to repair the damaged balance sheets of UK banks is to inject public money into the banks, which was done on a big scale but leaves the risk with the banks. The UK government would like to divest its shares in the banks, but that will be easier if balance sheets improve. A simple mechanism for achieving that is to allow them to earn greater margins and greater profits on their lending, and then use those funds to recapitalise. This is slow, but it will work eventually.

If the banks' borrowing rates cannot be justified by higher costs or risks, then this is not much fun for households who are paying higher borrowing rates. Households could try complaining to the government, but even if they can prove that the banks are making extra profits, the government may not want to change the situation because the government is the biggest shareholder in the banks.