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Economic commentaries

The composition of Norwegian banks' funding and the effect of risk premiums on bank lending rates

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**The views expressed in this article are the views of the author and do not necessarily reflect the views of Norges Bank*

The composition of Norwegian banks’ funding and the effect of risk premiums on bank lending rates

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Banks' funding can be divided into customer deposits, wholesale funding and equity. Chart 1 shows Norwegian banks' (including mortgage companies) assets and liabilities at the end of the third quarter of 2011. Most deposits are not time deposits. Deposit rates are normally raised or lowered in step with lending rates.

Deposits from financial institutions and securities debt are often referred to as wholesale funding. The largest banks rely heavily on foreign markets for both long- and short-term wholesale funding. Long-term wholesale funding comprises covered bonds and senior bonds. While covered bonds fund a substantial portion of bank residential mortgage lending, senior bonds are used to fund corporate lending and residential mortgages that have not been transferred to mortgage companies. Senior bonds are the instruments most vulnerable to market turbulence, with regard to both price and availability.

Covered bonds and senior bonds may have fixed or floating interest rates. For fixed-rate loans, mortgage companies and banks will enter into interest rate swap contracts to exchange fixed-rate for floating-rate loans. Ordinarily, the floating rate is the Norwegian Interbank Offered Rate (NIBOR). The reason for this is that fixed-rate funding is used to fund floating-rate loans. The interest rate on a bond can thus be divided in two: the money market rate and a fixed risk premium. The risk premium banks must pay is determined by both general market conditions and the market’s assessment of a particular bank as a borrower. Recently, increased market turbulence internationally has pushed up premiums, also for Norwegian banks. Unsecured senior bonds have shown the strongest increase. The increase has been less pronounced for Norwegian covered bonds, owing to the high quality of the cover pool.

When banks rely on funding in foreign currency, they need to swap the foreign currency for Norwegian kroner, for which they will often have to pay a premium. This premium is on top of the risk premium, but is normally considerably lower than the risk premium. The premium will depend on the relative demand and supply of the currencies being swapped.

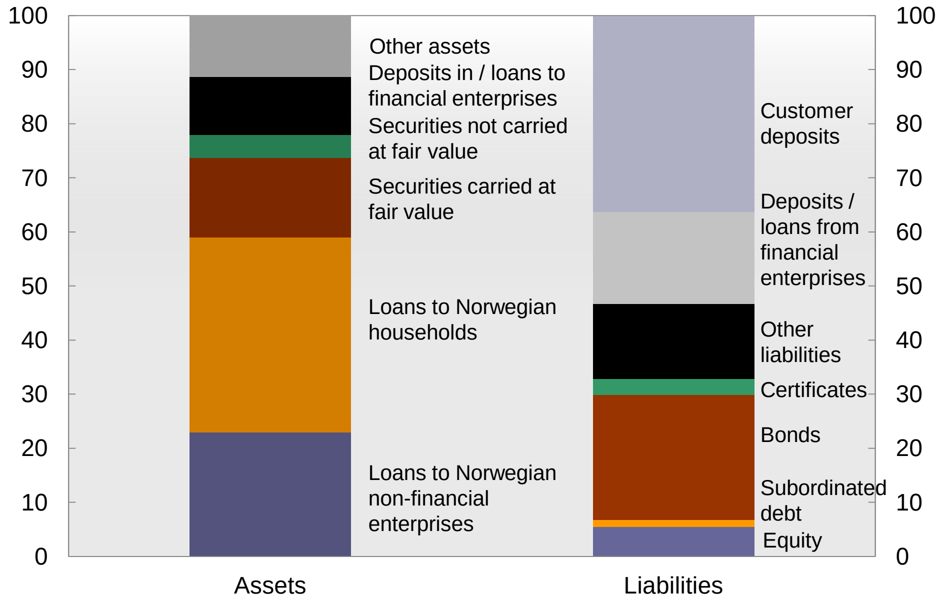
Banks also swap long-term fixed-rate foreign currency funding to floating-rate krone funding. This means that banks’ borrowing costs for short- and long-term funding both in foreign currency and in Norwegian kroner is affected by changes in the NIBOR. The spread between the NIBOR and the expected key policy rate, ie the money market premium, widens during market turbulence. The money market premium has risen in recent months, increasing banks' borrowing costs even though the key policy rate has remained unchanged.

Assets primarily comprise loans and securities (see Chart 1). A large proportion of assets yield a return that is linked to a money market rate.

Estimates based on data for Norwegian banks from 2001 – 2010 indicate that banks have not fully passed on higher costs of market funding to lending rates.[1] The estimates showed that in the course of a quarter approximately 80 per cent of the increase in the NIBOR was passed on to borrowers. Higher risk premiums affected corporate loans, but had less impact on lending rates in the retail market. The likely reason is greater competition among banks for residential mortgages than for corporate loans.

As shown in Chart 2, banks' lending rates for new residential mortgages have shown little change since 2009, even though the rate mortgage companies must pay on five-year covered bonds has risen. The rise in yield on covered bonds in this period is due to both higher money market rates and higher risk premiums. Chart 3 shows development in rates on senior bonds. Risk premiums are now substantially higher than before the financial crisis. Over time, banks will have to pass on higher borrowing costs by raising lending rates in order to maintain margins on lending.

Chart 1 Bank[1)] assets and liabilities. Per cent. 2011 Q3



1) All banks and mortgage companies in Norway (except Norwegian banks' foreign subsidiaries and branches abroad) Source: Norges Bank

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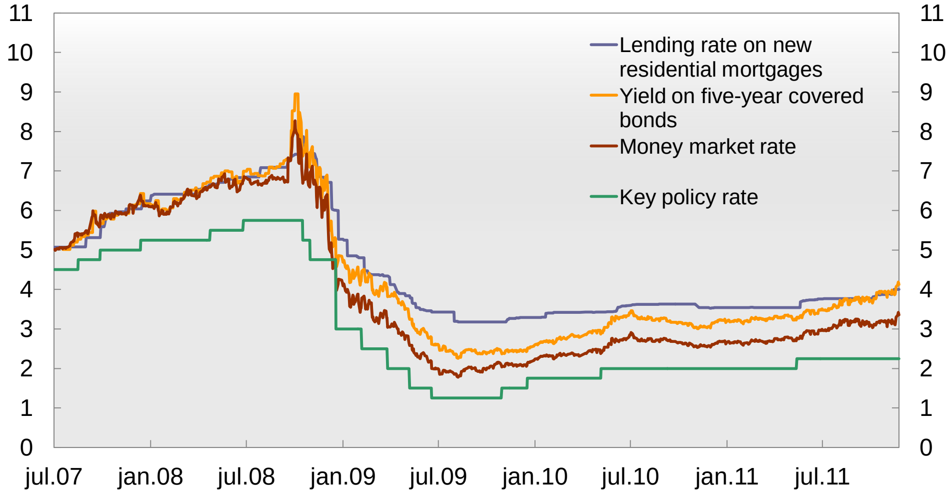
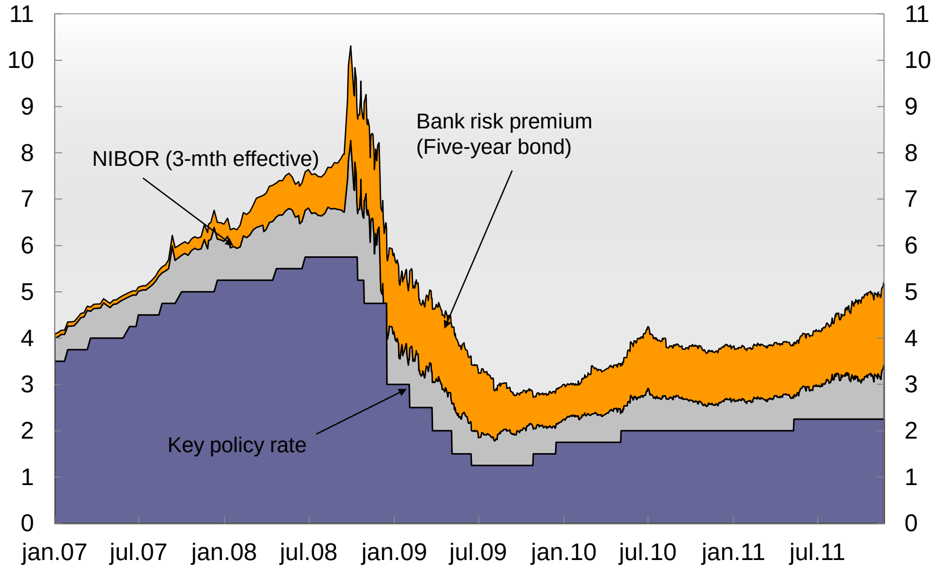
[1] See "How do banks' funding costs affect interest margins?" Working Paper, Norges Bank, 2011/09.

Chart 2 Key policy rate, money market rate[1)], yield on covered bonds and weighted average bank lending rate on new residential mortgages[2)]. Per cent.
1 July 2007 – 23 November 2011



1) Three-month NIBOR (effective)
2) Interest rates from the 20 largest banks, weighted by market share. for new variable-rate residential mortgages of NOK 1 million, within 60 per cent of the purchase price.
Sources: Norsk familieøkonomi AS, Statistics Norway, DNB Markets and Norges Bank

Chart 3 Bank funding cost
Percentage points. 3 January 2007 – 23 November 2011



Sources: DNB Markets and Norges Bank