Banks, not customers, should manage interest rate risk

Greg Medcraft, the Chairman of ASIC, has argued that bank mortgage interest rate setting needs to be reviewed. He is right. There is a fundamental problem with the current situation. That problem is the discretion given in standard loan contracts for banks to vary the interest rate to whatever and whenever they choose. This unfettered discretion is relatively uncommon internationally, and warrants change.

Banks take advantage of this discretion when their changes to loan rates differ from RBA cash rate changes. They then get criticised, and object to the criticism on the grounds that their funding costs don't necessarily track the cash rate. That is true, but we shouldn't shed any tears. They can avoid the criticism by changing the way in which loan rates are set, and taking on responsibility for managing risk rather than passing it on to customers.

Banks need to be able to vary interest rates to manage the risk which arises from their core business of making long term loans financed by shorter term deposits. If the cost of funding changes, loan rates need to change to reduce the impact on profits and returns to shareholders. That is important for banking sector stability.

But shareholders should bear some part of interest rate risk. Linking loan rates to some market indicator rate means that existing borrowers would bear the risk of general movements in interest rates. Shareholders would bear the risk (gains or losses) if the bank's funding cost moved differently. That could result from either the bank's funding and risk management decisions or changes in market perceptions of the bank's safety. They are the risks that shareholders (and bank management) rather than existing loan customers should bear.

The current loan interest rate arrangements make the banks' task of risk management much simpler (albeit politically costly) for them than would otherwise be the case. Not only can they adjust loan interest rates in response to changes in the general level of interest rates, but also in response to changes in funding costs specific to themselves.

Bankers are supposed to be risk management experts (and paid accordingly). So it is natural to expect that they would be able to manage risks arising from different types of loan contracts, rather than passing those risks onto loan customers. One possibility would be to offer variable rate (tracker) loans with interest rates which reset at specified intervals at some fixed margin over an agreed market indicator rate (such as the bank bill rate).

A bank could, and should, offer loans where the interest rate changes at specified intervals in line with the corresponding market indicator rate.

The effect would be that banks would adjust their funding structures and risk management practices to deal with those loan characteristics. Arguably they would be less inclined towards very short term financing because of less scope to pass on changes in those rates to borrowers. Existing borrowers would not be penalised as a result of poor bank management causing its funding costs to increase relative to others (since the margin over the market rate borrowers pay is fixed), but the bank would need to charge new borrowers a higher margin – and thus, deservedly, lose market share.

Borrowers would have transparent information on how their interest rates were set and the interest rate risks they face (assuming, in the case of adjustable rates that there was no manipulation of the indicator rate!).

But linking all loan rates to the cash rate would not be a good risk management strategy, since bank funding costs reflect market rates over a range of maturities. A sensible bank would offer borrowers a choice of loans with rates that reset at different frequencies (1, 3, 6 months etc) in line with movements in the corresponding market indicator rate
Requiring contractual integrity in loan interest rate setting arrangements would go part of the way towards more transparent cost and risk sharing between bank customers and shareholders, and reduce complaints about bank decisions. One would have thought that bank CEO's might like that!

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(Disclosure: Like most Australians I am an owner of bank shares).