Box 6 How closely do interest rates on bank loans to households follow the repurchase rate?

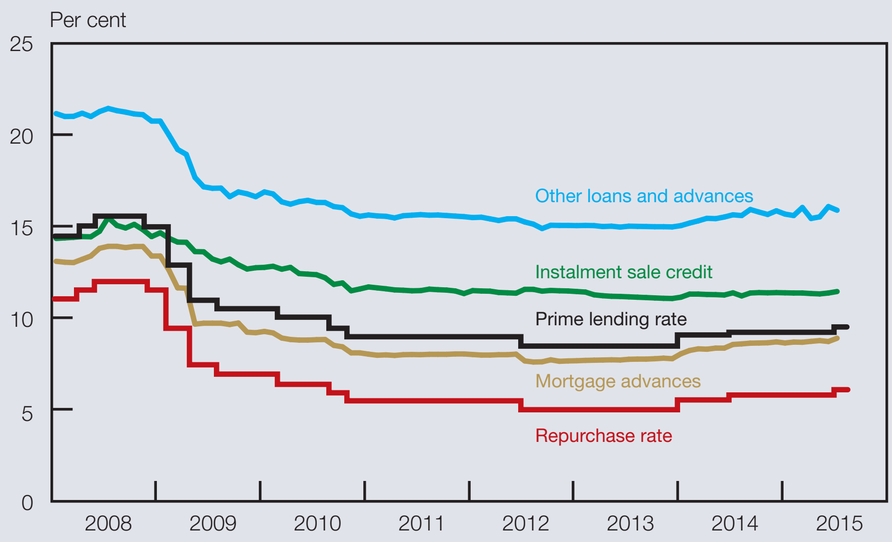
Monetary policy has been accommodative in the post-crisis era, with the policy rate declining from 12 per cent per annum in 2008 to a low of 5 per cent in July 2012 where it remained up to early 2014; even allowing for the subsequent increases, its most recent level of 6 per cent is half its 2008 peak level. Interest rates generally followed the movements in the policy rate, but the spread of lending rates above the repurchase rate widened in recent years, reflecting a tightening of credit standards and a repricing of risk. During the period, households also shifted towards the types of bank loans that carry a higher interest rate risk premium. This box reviews how the interest rates faced by household borrowers have evolved since 2008.

The adjustment of lending margins

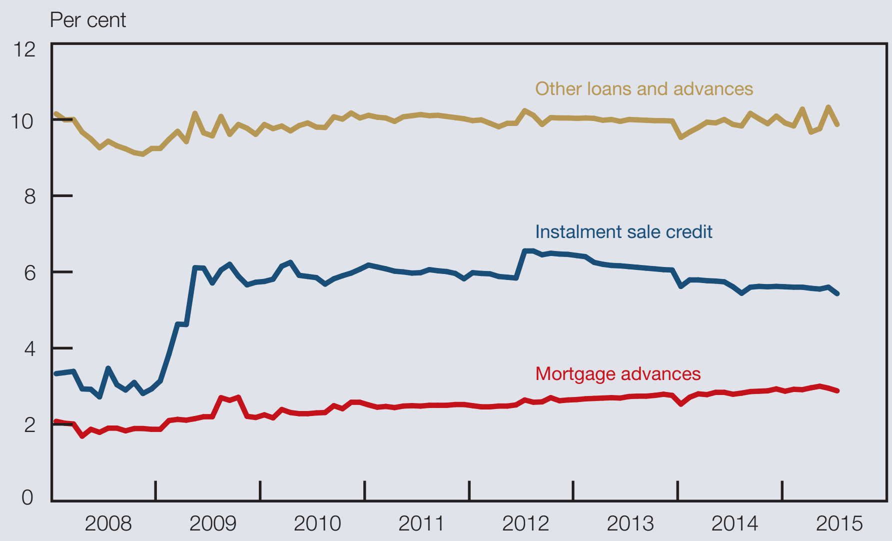
Having experienced substantial increases in impaired loans and write-offs, banks reviewed their risk premiums on loans in the period following the 2009 recession as their risk appetite waned and lending standards were tightened in the challenging macroeconomic environment. At the same time, challenges were also posed by increased regulatory scrutiny and rising operating costs as the South African banking sector started gearing up for the further implementation of the Basel III supervisory requirements.

As can be seen in the accompanying graph, key interest rate spreads widened significantly over the past seven years. However, the exact contribution to this widening of regulatory changes, on the one hand, and macroeconomic conditions, on the other, cannot be quantified.

The repurchase rate and selected bank lending rates



Margins of selected bank lending rates to repurchase rate



After a period of relatively relaxed credit standards alongside rising property prices, with the end of the property boom banks started tightening their standards and even though the monetary policy stance became progressively more accommodative, the interest rate spread on mortgage advances widened. In turn, the tighter credit standards contributed to the slow growth in mortgage advances in recent years.

Instalment sale finance refers to the financing of movable assets and is generally dominated by vehicle finance, which constitutes around 85 per cent of instalment sale credit. The spread between the interest rate on instalment sale credit and the repurchase rate recorded a significant upward adjustment in 2009. A surge in overdues and repossessions triggered the pronounced repricing of risk by banks on this type of credit. The margin has generally been maintained in subsequent years although the spread narrowed somewhat from 2013 alongside buoyant vehicle sales.

The category of 'other loans and advances' includes general loans, credit card advances and overdrafts. While this covers a variety of products, the interest rates on these loans are generally charged at a much higher rate than those on the asset-backed categories of mortgage advances and vehicle financing. The risk premium included in these interest rates already increased in 2007, and has been broadly maintained in recent years.

Changes in the composition of household credit

Mortgage advances have traditionally been the dominant category of credit taken up by households. However, in the wake of the 2009 recession the composition of credit underwent a gradual change. The uptake of mortgage loans slowed markedly as the fixed property market ran out of steam, while growth in other categories of credit, such as instalment sale credit and general loans, gathered pace. The progressive change in the uptake of credit is especially evident when the composition is expressed as a percentage of total loans and advances to households, as shown in the accompanying table.

Composition of household loans in selected years

Per cent

As at December	2008	2010	2012	2014	2015*
Mortgage advances..........................	69,6	68,6	61,3	58,7	58,7
Instalment sale and leasing finance ...	14,9	14,5	15,9	17,4	17,1
Overdrafts	2,7	2,3	2,3	2,6	2,5
Credit card advances	5,5	4,9	6,0	6,7	7,0
General loans	7,3	9,6	14,5	14,6	14,7
Total..	100,0	100,0	100,0	100,0	100,0

* June

Mortgage advances declined from around 70 per cent of outstanding bank credit to households in December 2008 to less than 60 per cent in June 2015. Other categories of credit, such as general loans, picked up strongly from 2009 as unsecured lending gained momentum, but levelled out from 2012. Instalment sale finance and credit card advances also increased in recent years.

Calculating a weighted average household lending rate

By using the composition of loans and advances to the household sector and applying the applicable interest rate[1] to each category of credit, it is possible to derive a weighted average interest rate for the household sector. The rate may be compared to the repurchase rate to indicate how the combined effect of the change in preference for credit and the change in the risk spreads charged by banks affected the interest rate burden of households.

Weighted average rate

As at December	Repurchase rate	Weighted average rate	Margin to repurchase rate
2008..	11,5	14,91	3,41
2009..	7,0	11,12	4,12
2010..	5,5	10,21	4,71
2011..	5,5	10,47	4,97
2012..	5,0	10,47	5,47
2013..	5,0	10,45	5,45
2014..	5,75	11,23	5,48
2015*	5,75	11,27	5,52

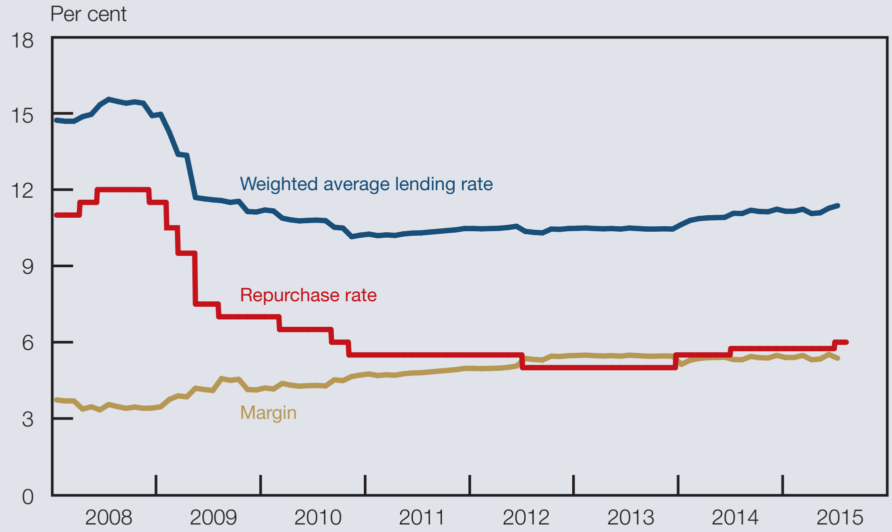
* June

There was some narrowing of the spread between the average repayment rate for households and the repurchase rate in 2008, indicating the easier credit conditions that prevailed during the period, but the margin started to widen early in 2009. While households have benefited from the easier monetary policy stance since 2008, the pass-through of the benefit has weakened in subsequent years, especially since 2010 when growth in unsecured lending started to accelerate. Banks progressively tightened the risk premium on interest rates for most categories of credit in the period following the 2009 recession, but households also increased their exposure to the more expensive categories of credit. Exposure

1 The weighted average interest rate as reported by banks, inclusive of both new and existing loans, for each category of credit

to instalment sale credit and general loans has increased since 2009, while growth in mortgage loans decelerated. The rising margin is therefore a combination of tighter credit standards and a change in households' exposure towards loans that carry a higher risk premium reflected in the interest rate. However, the margin stabilised from late 2012 when growth in unsecured lending started to decelerate.

Weighted average lending rate to households and margin to repurchase rate



Conclusion

Monetary policy has been accommodative since 2008, with the policy rate declining to levels last recorded more than 30 years ago. This provided households with substantial relief in terms of their repayment burden on bank credit. However, when calculating a weighted average repayment rate for the household sector and comparing it to the repurchase rate, it is evident that the spread has widened since 2009. Part of the reason is the generally tighter credit standards adopted by banks in a challenging macroeconomic environment while also gearing up towards the requirements of Basel III. However, households also recorded a shift in exposure towards loans that carry a higher interest rate risk premium. Accordingly, the average interest rate faced by households on their borrowing from banks has not moved parallel to the policy interest rate set by the Bank, but has effectively become somewhat more restrictive – by as much as 2 percentage points over the past seven years. This probably contributed to the weak growth in the household sector's credit uptake in recent years.