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The impact of the global financial crisis on mortgage pricing and credit supply

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ABSTRACT

This paper studies the pricing and sales of home mortgages in Australia, focusing on the global financial crisis (GFC). It shows that the crisis significantly changed banks' pricing behavior and its impact varied across banks, depending on their asset sizes, deposit sources and liquidity profiles. Big banks led in price setting and responded promptly to both upward and downward adjustments of the cash target rate before and during the GFC. Albeit cutting their prices sluggishly after the GFC, they still enjoy greater market power and are expanding faster. Banks with solid deposit support became slower in responding to policy shocks during the GFC and sold more than their counterparts. Interestingly, banks in a better liquidity position tended to be more conservative in pricing during the GFC, i.e. reacting quickly when the cash rate moved up but slowly if it fell, but became more aggressive thereafter.

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1. Introduction

The demise of the US sub-prime residential mortgage market was the catalyst for the global financial crisis (GFC), leading the world economy into a period of turmoil unprecedented since the Great Depression. The GFC forced governments and central banks in developed economies to be increasingly active in reinforcing regulation and tightening their supervision in the lending channels (Moshirian, 2011). Effective policy implementation requires a fast and complete response to policy initiatives by the banking system, which is the primary conduit of monetary policy. Understanding the transmission

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mechanism and its dynamic evolution provides insights into banking regulation and policy implementation. Furthermore it has important implications for financial stability and consumer welfare.

There is a broad consensus that Australia's banking system showed increased resilience compared with most developed countries during the GFC. The strength of Australian Financial Institutions (FIs) can be largely attributed to the less competitive structure of the banking market due to the "four pillars" policy[1] and the lucrative domestic mortgage lending opportunities in the 2000s (Davis, 2011). This paper focuses on the Australian residential mortgage market from 2002 to 2011 and seeks to answer the following questions. Firstly, how do different FIs adjust their mortgage rates in response to monetary policy changes? Secondly, have the pricing strategies of the FIs changed since the onset of the GFC? If so, how has this occurred? Thirdly, what are the main factors determining FIs' pricing behavior and how are these factors related to credit supply before and after the GFC?

To address these questions, we first employ the traditional error correction model to investigate the pass-through of monetary shocks by Australian FIs. Based on regimes determined by the data, we explore how the onset of the GFC altered lenders' pricing decisions. Then, we identify the factors that determine cross-sectional variations in banks' pricing behavior and the sources that prompted banks to change pricing strategies during the GFC. An ordered probit model is applied, which relates the sequences of mortgage rate adjustments to bank balance sheet information. After that, we examine the relationship between a bank's home mortgage sales and funding support at different stages of the GFC. We also include mortgage prices and a proxy for banks' pricing strategy as an explanatory variable to capture the effect of price on the quantity of home mortgage supply. Finally, by comparing the Australian mortgage market with its most comparable international peer – Canada, the study reinforces the importance of solid funding sources and regulatory supervision in maintaining financial stability.

Several important findings emerge from this analysis. Firstly, as demonstrated by empirical results from the error correction model and the probit model, big banks lead the price setting in home loan markets and these banks extended their dominant role during the GFC. They moved much more sluggishly when the Reserve Bank's target rate fell again after the GFC but gained greater market expansion than the smaller banks. Secondly, the effects of mortgage price and pricing strategy on mortgage sales were more profound during the crisis period. Thirdly, we find that a bank with a higher proportion of liquid assets has more conservative pricing policies, as was particularly the case during the GFC. This is consistent with the argument that banks are more risk averse and increase cash accumulation during financial distress. Substantiating this argument, this study shows that higher liquidity is associated with smaller loan supply and slower sales growth during and immediately after the GFC and the effect is strongly significant. Finally, banks with solid deposit funding are found to respond sluggishly to policy shocks during the GFC. Household deposit-to-asset ratios and financial deposits contribute positively to the home loan supply, especially in an unstable economy, suggesting that banks with more solid funding support tend to have a larger credit supply. However, deposits from nonfinancial companies contribute negatively to a bank's mortgage sales.

Significant attention has been drawn to the banking system and the lending market since the GFC triggered widespread financial instability. Relevant to our analysis, Ivashina and Scharfstein (2010) study the amount of credit supply in the US corporate sector during the GFC and find that banks with better access to deposit financing are able to offer more new lending. Puri et al. (2011) analyze individual loan applications and loans granted by German savings banks. They conclude that the GFC induced a contraction in the supply of credit, particularly for smaller and more liquidity constrained banks. Santos (2011) investigates banks' pricing behavior and shows that banks that incurred larger losses in the GFC became riskier and raised their corporate loan rates more than other banks. Unlike these studies, this paper contributes to the literature by jointly examining the pricing and capacity of banks' credit supply.

This paper also contributes to the monetary policy transmission literature, emphasizing FIs' asymmetric responses and heterogeneous behavior. Previous studies show that reactions to monetary shocks appear to be asymmetric, depending on whether the shock is positive or negative, whether

[1] The "four pillars" policy prohibits mergers among any of the major banks which is discussed in the next section.

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