Cass Business School
CITY UNIVERSITY LONDON

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Credit and store card rates appear unrelated to Bank of England policy rate changes

New research from Cass Business School, London, shows banks may pass on rate changes for some of their products but not others and also differ in the degree to which they respond a policy rate change. Changes in store card and credit card rates, meanwhile, behave haphazardly and appear to be unrelated to changes in the policy rate.

The Bank of England cuts the official interest rate to increase lending and decrease saving. For this to happen banks must pass on the official rate changes to their customers so as to stimulate consumer spending.

The Cass (pre-credit crunch") research* found that some banks and building societies match the policy rate quickly for certain products but others are slower to change deposit or loan rates. Banks and building societies are quickest at passing on rate cuts to savers and rate increases to mortgage borrowers. For half of sampled deposit rates and a quarter of loan rates, large changes in the official rate triggered faster rate responses than small changes.

The ESRC financed research led by Cass Professors Shelagh Heffernan and Ana-Maria Fuertes, measured the degree to which financial institutions, such as banks and building societies, adjust their rates on current accounts, savings accounts, unsecured personal loans, credit cards and department store cards following changes in the official rate over a 12 year period. It also compared the differences in response rates across financial institutions and products. The empirical analysis was based on an extensive dataset of 113 financial institutions, representing a substantial part of the UK banking market.

The speed of the adjustment to savings, current account and mortgage rates was found to be proportional to the size of the change in the official rate. However, the proportionality factor depends on whether the policy rate change narrows or widens the gap between a bank's overall target rate of interest on a product and the actual average rate that different customers receive - or have to pay. Larger gaps provoke disproportionately stronger retail rate responses than smaller ones for many deposit and some loan products.

Professor Heffernan said: "This research shows that for certain retail products, some financial institutions are quick to pass on rate changes if it benefits the institution, but less so if it is the customer who gains. The effectiveness of the monetary policy is impaired if policy rate changes are not passed on."

**How Do UK Banks React To Changing Central Bank Rates?* Professor Ana-Maria Fuertes, Professor Shelagh Heffernan and Dr. Elena Kalotychou, Cass Business School London, May 2008.

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Notes to editors:

Research Methodology
This paper investigates the presence of nonlinearity in the dynamics of British retail rates over the period 1993:1-2005:6. The focus is on their responsiveness to official rate changes. The dataset consists of 662 disaggregated, bank-specific monthly rates for several types of savings and current accounts, unsecured personal loans, mortgages, credit cards and store cards. The 113 financial institutions sampled range from the top five banks to the smallest building society.

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