

# 4. Domestic Financial Markets

Volatility in Australian financial markets picked up recently, consistent with developments in international markets. Money market rates imply that the cash rate is expected to remain unchanged over the year ahead. Government bond yields have declined in line with global developments, with borrowing costs for state governments around historic lows. Spreads on corporate bonds remain around their lowest levels since 2007, although there has been relatively little bond issuance as gearing continues to decline, particularly in the resources sector. Interest rates on the stock of housing and business loans have continued to edge down further, as new loans are priced at lower rates than existing loans. Growth in housing lending has continued to rise, driven by lending to investors. Australian equity prices underperformed those in other developed markets, with commodity price falls weighing on the resources sector.

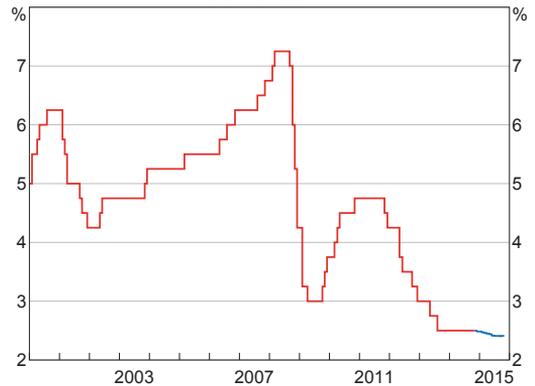
## Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 2.50 per cent since August 2013. Interest rates on short-term money market instruments imply that the cash rate is expected to remain unchanged over the coming year (Graph 4.1).

Rates on bank bills and certificates of deposits (CDs) have increased slightly since the previous *Statement*. Spreads between bank bills and overnight indexed swaps (OIS) have edged higher (Graph 4.2).

Yields on long-term Commonwealth Government securities (CGS) have declined since the previous *Statement*. Offshore developments have been the

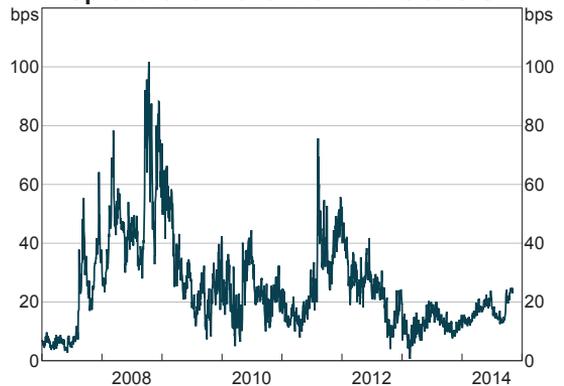
**Graph 4.1  
Cash Rate\***



\* Data from November 2014 onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

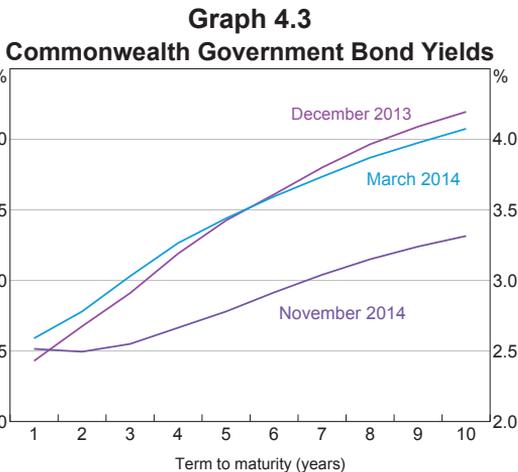
**Graph 4.2  
Spread of 3-month Bank Bills to OIS**



Sources: AFMA; Tullet Prebon (Australia) Pty Ltd

main factor contributing to the decline in yields, with appetites for risk deteriorating owing to renewed concerns about the outlook for economic growth in some of the major economies. The spread between

10-year CGS and US Treasuries has been little changed. The Australian yield curve has flattened considerably in recent months (Graph 4.3). Since mid March, the spread between 3-year and 10-year CGS yields has declined by around 50 basis points.

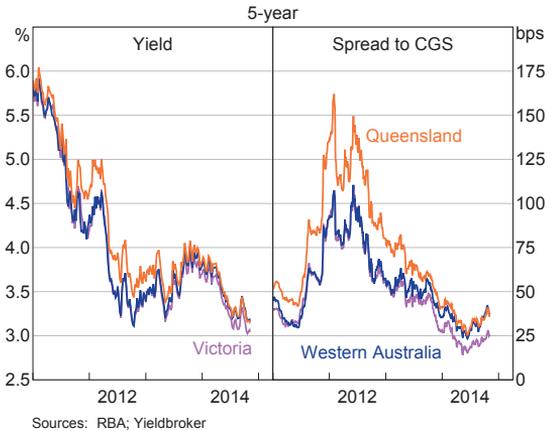


The primary market for long-term CGS remains strong, with bond tenders conducted by the Australian Office of Financial Management (AOFM) clearing at yields below those quoted in the secondary market. In October, the AOFM issued \$7 billion of a new April 2037 nominal bond at a yield of 3.94 per cent. This was equal to the largest initial government bond issue on record and had the longest term-to-maturity of any CGS issued since 1996. A little less than half of the new bond line was purchased by non-residents.

Spreads between debt issued by the state borrowing authorities ('semis') and CGS have increased modestly since the previous *Statement*, but in outright terms yields on semis are around their lowest levels on record (Graph 4.4).

Net issuance of semis has totalled over \$3 billion since the previous *Statement*. New issuance has continued to feature floating-rate notes (FRN); increased issuance of FRNs has been driven by demand from Australian banks, which have a preference for floating rate liabilities and are

**Graph 4.4**  
**State Government Debt**



increasing their holdings of high quality liquid assets ahead of the implementation of the Australian Prudential Regulation Authority's (APRA's) Basel III liquidity reforms on 1 January 2015.

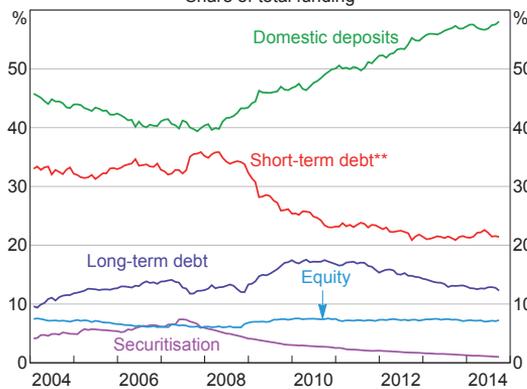
Domestic bond issuance by non-resident entities ('Kangaroo' issuance) has totalled around \$10 billion since the previous *Statement*, with around two-thirds raised by banks. Secondary market spreads of Kangaroo bonds have widened, although they remain close to the low levels seen in late 2007.

Since the previous *Statement*, the cost of hedging Australian dollar issuance into some major currencies has decreased, as the cross-currency basis swap spreads of the yen and the euro against the Australian dollar have widened. Conversely, the cost of hedging foreign currency yen or euro issuance into Australian dollars has increased. Australian dollar cross-currency basis swap spreads against the US dollar have been relatively unchanged.

## Financial Intermediaries

The aggregate share of deposits in banks' funding has edged higher over recent months as banks continue to fund new lending from deposits and only replace maturing wholesale debt (Graph 4.5). Major banks' average funding costs have generally declined since the previous *Statement*.

**Graph 4.5**  
**Funding Composition of Banks in Australia\***  
Share of total funding



\* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

\*\* Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

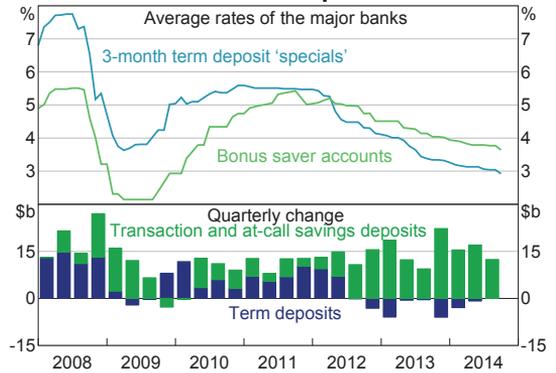
Banks have reduced their term and at-call deposit rates over the past few months, suggesting that competition for deposits has eased (Graph 4.6). Depositors have continued to move away from term deposits as the interest rates on these products continue to be less attractive in comparison to bonus saver accounts.

Conditions in long-term wholesale debt markets continue to be favourable, with the cost of issuance having fallen since the beginning of the year. At the same time, some wholesale debt issued previously at higher spreads has matured, further reducing the average cost of outstanding debt. To date this has only had a modest effect on overall average funding costs as the share of long-term wholesale debt has been broadly stable for some time at around 12 per cent of banks' total funding.

Australian banks have issued around \$27 billion in senior unsecured and covered bonds since the previous *Statement*. Around 60 per cent of these bonds were issued in the offshore market, primarily in US dollars (Graph 4.7). The stock of outstanding bonds has increased.

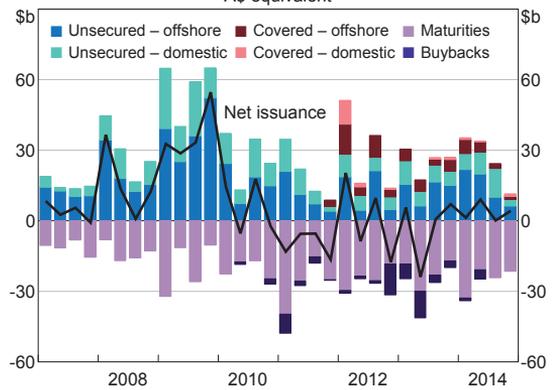
Spreads on the major banks' unsecured bonds, relative to CGS, have increased slightly since the previous *Statement*, but remain around their lowest levels since late 2007 (Graph 4.8).

**Graph 4.6**  
**Household Deposits**



Sources: APRA; Canstar; RBA

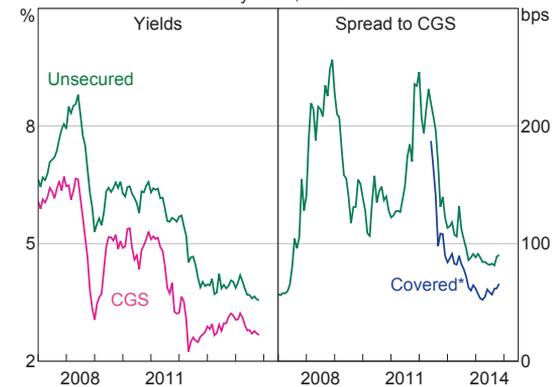
**Graph 4.7**  
**Banks' Bond Issuance and Maturities\***  
A\$ equivalent



\* Last quarter gross issuance and net issuance are quarter to date

Source: RBA

**Graph 4.8**  
**Major Banks' Bonds**  
3-5 year A\$ debt

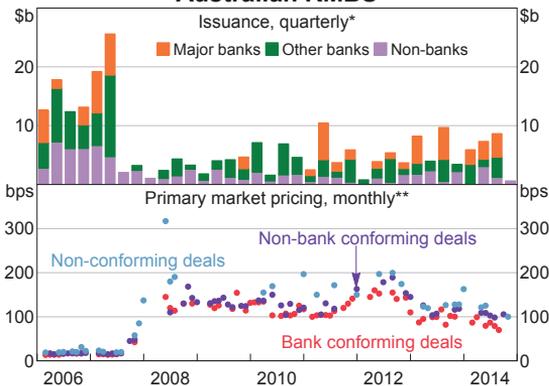


\* Covered bond pricing interpolated to a target tenor of 4 years using bonds with a residual maturity between 2 and 10 years

Source: Bloomberg; RBA; UBS AG, Australia Branch

Australian securitised issuance has totalled around \$8 billion since the previous *Statement* (Graph 4.9). Around 85 per cent of this issuance has been in the form of residential mortgage-backed securities (RMBS). Most RMBS were originated by banks including a \$4 billion RMBS by a major bank, which was the largest RMBS issue since 2007. Mortgage originators raised around \$1½ billion, including a \$400 million ‘non-conforming’ RMBS. These mortgages typically involve borrowers with a history of credit impairment, higher loan-to-valuation ratios or reduced documentation. A \$950 million security backed by assets such as motor vehicles and equipment finance for small businesses was also issued. Primary market issuance spreads for banks and mortgage originators on senior RMBS tranches have generally declined since the previous *Statement* and remain at their lowest levels since late 2007.

**Graph 4.9**  
**Australian RMBS**



\* Latest observation is quarter-to-date  
 \*\* Face-value weighted monthly average of the primary market spread to bank bill rate  
 Source: RBA

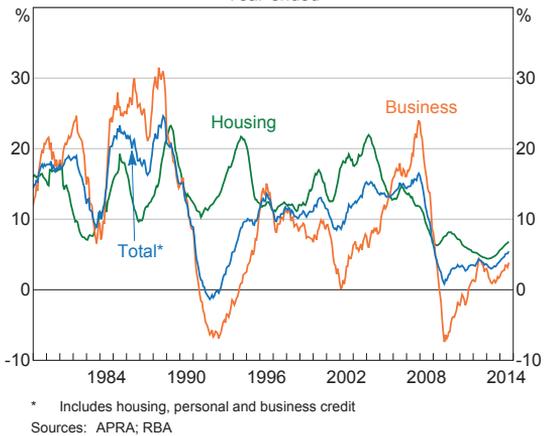
Issuance of hybrid securities by banks and other financial institutions has increased, with six entities raising around \$5½ billion of Basel III compliant securities since the middle of the year. Most of the bank-issued hybrids were in the form of Additional Tier 1 capital instruments. S&P revised its global credit rating methodology for bank-issued hybrids to reflect its assessment of the higher risk of conversion into equity of Basel III Tier 1 hybrids. As a result, ratings of a number of hybrids were downgraded by

an additional one notch, including 21 hybrids issued by Australian banks.

## Financial Aggregates

Total credit grew by around 5½ per cent over the year to September (Graph 4.10). Growth in credit remains below growth in broad money, which increased by around 8 per cent over the year (Table 4.1).

**Graph 4.10**  
**Credit Growth by Sector**  
Year-ended



\* Includes housing, personal and business credit  
 Sources: APRA; RBA

## Household Financing

Housing credit growth has picked up to an annualised pace of around 7 per cent this year. Credit extended to owner-occupiers has been steady at around 5½ per cent while the pace of investor credit growth has increased to around 10 per cent. The rate of new housing loan approvals suggests that growth of lending to owner-occupiers will remain around its current pace, but the pick-up in investor loan approvals in the past three months should contribute to faster growth in that segment in coming months (Graph 4.11). Lower interest rates have made owner-occupiers more inclined to refinance their loans or pay down mortgages at a faster rate; consistent with this, mortgage prepayments remain at a high level.

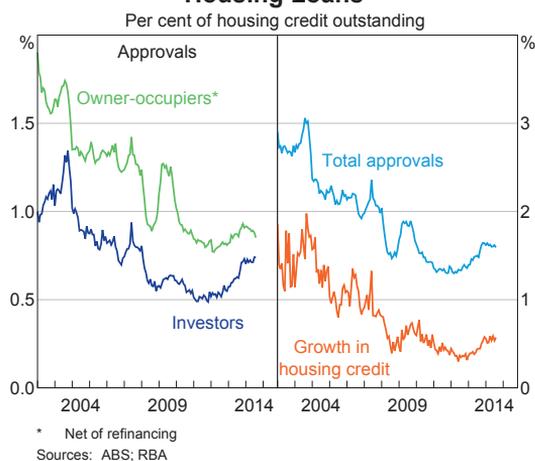
Personal credit grew at an annualised rate of 2.6 per cent over the quarter. The modest pick-up was driven largely by increases in fixed term loans and credit card balances outstanding.

**Table 4.1: Financial Aggregates**  
Percentage change<sup>(a)</sup>

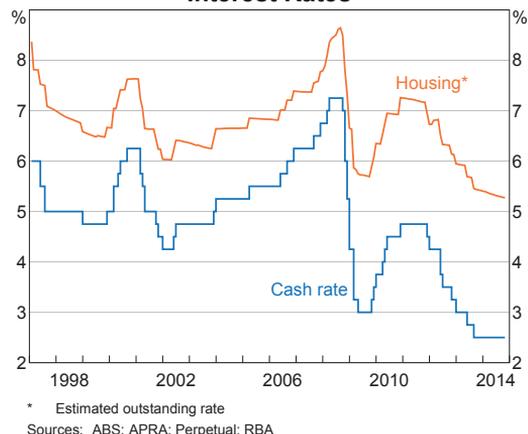
	Three-months ended		Year-ended
	June 2014	September 2014	September 2014
Total credit	1.6	1.3	5.4
– Housing	1.7	1.7	6.8
– Owner-occupier	1.3	1.3	5.5
– Investor	2.5	2.5	9.5
– Personal	0.4	0.6	1.0
– Business	1.6	0.7	3.8
Broad money	2.0	2.1	7.9

(a) Growth rates are break adjusted and seasonally adjusted  
Sources: APRA; RBA

**Graph 4.11**  
**Housing Loans**



**Graph 4.12**  
**Interest Rates**



The average interest rate on outstanding housing loans has continued to decline as new loans are being written at lower rates than expiring loans and borrowers have refinanced at lower rates (Graph 4.12). The average interest rate on housing loans is now around 20 basis points below its level following the cash rate reduction in August 2013. Lenders' standard variable rates have remained largely unchanged over this period, although lenders have increased the interest rate discounts on new loans significantly (Table 4.2).

## Business Financing

Growth in business external funding slowed in the September quarter after picking up in the June quarter (Graph 4.13). The pace of equity raisings and business credit eased in the quarter, while non-intermediated debt declined.

Australian non-financial corporate bond issuance totalled around \$4½ billion since the previous *Statement*, remaining low compared to previous years. Resource companies have been largely absent from the bond market over the past year. The majority of issuance was placed offshore, as is typical for Australian corporate bonds, with almost all offshore issuance denominated in euros.

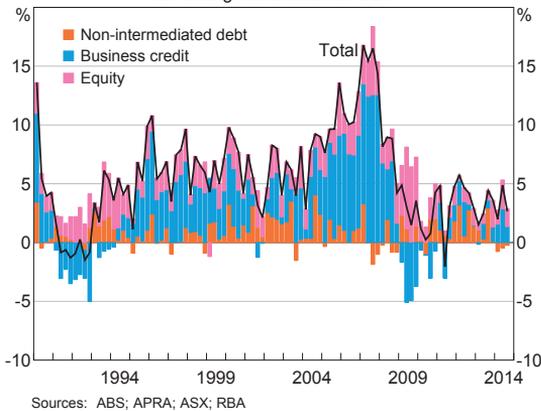
**Table 4.2: Intermediaries' Fixed and Variable Lending Rates**

	Level at 5 November 2014 Basis points	Change since end August 2013 Basis points
<b>Housing loans</b>		
– Standard variable rate <sup>(a)</sup>	5.93	0
– Package variable rate <sup>(b)</sup>	5.08	–2
– Fixed rate <sup>(c)</sup>	5.08	–3
– Average outstanding rate	5.27	–19
<b>Personal loans</b>		
– Variable rate <sup>(d)</sup>	11.66	–9
<b>Small business (variable rates)</b>		
– Term loans <sup>(e)</sup>	7.10	0
– Overdraft <sup>(e)</sup>	7.97	0
Average outstanding rate	6.63	–17
<b>Large business</b>		
Average outstanding rate (variable rate and bill funding)	4.50	–30

(a) Average of the major banks' standard variable rates  
 (b) Average of the major banks' discounted package rates on new, \$250 000 full-doc loans  
 (c) Average of the major banks' 3 year fixed rates  
 (d) Weighted average of variable rate products  
 (e) Residentially secured  
 Sources: ABS; APRA; Canstar; RBA

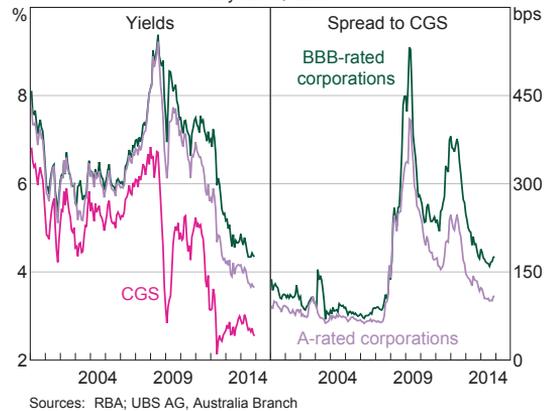
**Graph 4.13**

**Business External Funding**  
Net change as a share of GDP



**Graph 4.14**

**Australian Corporates' Bond Pricing**  
3-year A\$ debt



Secondary market spreads over CGS for 3-year Australian dollar BBB-rated corporate bonds have widened by around 15 basis points since the previous *Statement*, while spreads for A-rated corporate bonds have increased by around 6 basis points (Graph 4.14). Nevertheless, spreads remain around their lowest levels since late 2007.

Hybrid bond issuance by non-financial entities has totalled around \$1½ billion since the previous *Statement*.

Non-bank financial corporate bond issuance has totalled around \$2½ billion since the previous *Statement*, which was supported by issuance

from Scentre Group (a company formed from the restructure of Westfield).

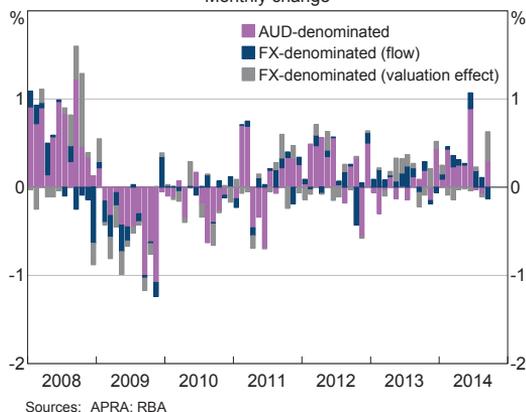
Business credit growth slowed over the September quarter, partly driven by two large loan repayments, but has edged up further in year-ended terms. Following its bond issuance in July, Scentre Group repaid part of the bridging finance drawn down in June for the restructure of Westfield. There was also a large loan repayment by an Australian Government non-financial corporation in August. The repayments were reflected in slower growth in Australian-dollar-denominated business credit over the quarter (Graph 4.15); foreign-currency-denominated business credit continued to grow strongly owing in part to the depreciation of the Australian dollar. Lending to private non-financial corporations has generally grown at a faster pace than lending to unincorporated (typically smaller) businesses over recent months. Commercial loan approvals remain at a high level and are expected to contribute to growth in business credit in coming months.

Activity in the syndicated loan market increased strongly in the September quarter, although much of this related to approvals for the restructure of Westfield, which was included in the July data. Notably, approvals for acquisitions increased to their highest level since 2007, with the increase covering a range of industries. Some of these approvals had very long terms, boosting the average loan maturity at origination to about 4½ years, compared to about four years in the June quarter.

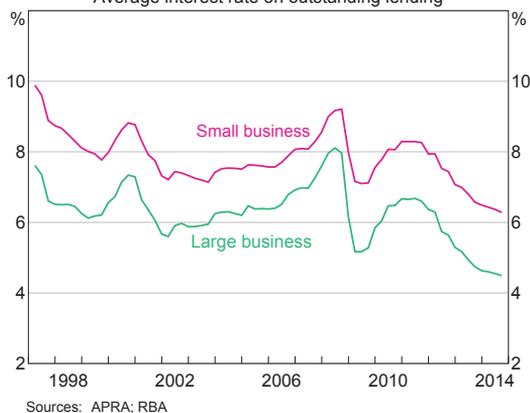
The cost of intermediated business borrowing for both small and large businesses continued to edge down over recent months, with much of the decline driven by the maturation and replacement of fixed rate loans at lower interest rates. Average rates on outstanding business loans are likely to fall further in the short term as existing loans continue to be refinanced at lower rates (Graph 4.16).

Equity raisings by non-financial corporations (including real estate companies) slowed in the September quarter to \$6 billion, mainly driven by

**Graph 4.15**  
**Business Credit**  
Monthly change



**Graph 4.16**  
**Australian Business Lending Rates**  
Average interest rate on outstanding lending

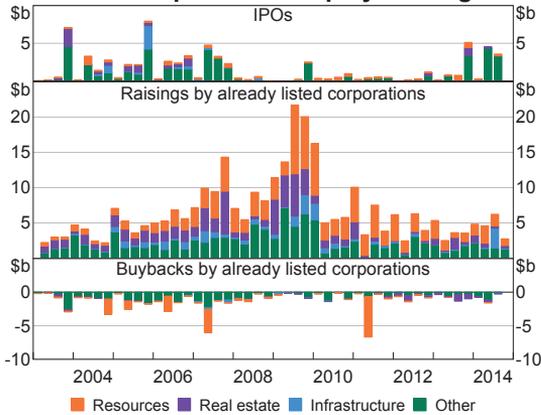


lower equity raisings by already listed companies (Graph 4.17). Initial public offerings (IPOs) remain high relative to 2013, at around \$3½ billion. The Government has announced further details of the sale of shares in Medibank Private, which will be completed by the end of November.

Mergers and acquisitions (M&A) activity has been subdued since the previous *Statement*, with around \$8 billion in deals announced by listed companies. M&A activity was concentrated in the consumer discretionary sector, with \$2½ billion of transactions conducted in the September quarter.

**Graph 4.17**

**Listed Corporations' Equity Raisings\***



\* Excludes financial corporations other than real estate; excludes privatisations and hybrid conversions  
Sources: ASX; RBA

**Graph 4.18**

**Share Price Indices**

End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

**Graph 4.19**

**Australian Share Prices Indices**

End December 2006 = 100



Sources: Bloomberg; RBA

**Equity Markets**

Australian equity prices have risen slightly since the previous *Statement*, generally underperforming other major equity markets which have risen over this period (Graph 4.18). Australian equity prices have been particularly affected by lower commodity prices owing to the resources sector's relatively large share of the domestic market. Similar to other international markets, the volatility of Australian equities has increased since the previous *Statement*.

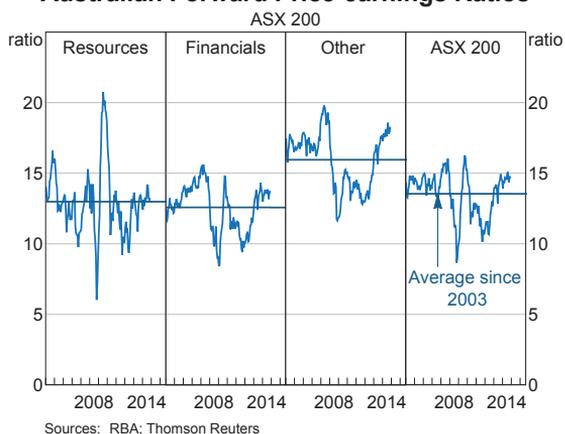
Equity prices in the resources sector have fallen by 12 per cent since the previous *Statement* (Graph 4.19). The share prices of the major miners have broadly tracked iron ore price movements while energy sector share prices have fallen 6½ per cent alongside lower oil prices. In contrast, financial sector equity prices have risen since the previous *Statement*. Share prices in other sectors increased by 3 per cent, with defensive sectors generally outperforming the broader market. Healthcare sector equity prices have increased substantially since the previous *Statement*, supported by higher earnings and international product approvals.

Valuations of Australian equities, as measured by forward price-earnings (PE) ratios, have fallen slightly since the previous *Statement*, but remain close to their decade averages for all broad sectors (Graph 4.20). Valuations declined the most in the resources sector as the fall in equity prices has outpaced the decline in analysts' consensus earnings estimates.

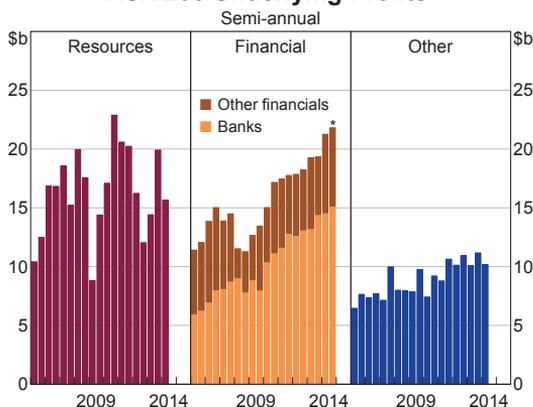
ASX 200 companies reported their June half 2014 results in July and August. Aggregate underlying profits, which exclude the effect of non-recurring items, increased by 10 per cent compared with the same period last year (Graph 4.21).

Resource sector profits were 10 per cent higher than the same period in 2013 driven by significant increases in production volumes and lower costs. However, profits fell by 20 per cent compared to the previous half as lower commodity prices, particularly for iron ore, weighed on earnings.

**Graph 4.20**  
Australian Forward Price-earnings Ratios



**Graph 4.21**  
ASX 200 Underlying Profits



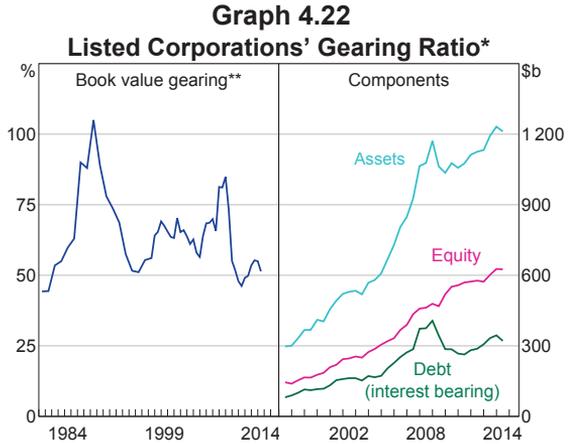
\* Figures for financials for the December 2014 half are based on reported results during the half and consensus expectations for companies that have not yet reported.

Sources: Bloomberg; Morningstar; RBA

Underlying profits in the financial sector rose by 13 per cent in the June half of 2014 compared to the same period in the previous year supported by substantial increases in the profits of insurers and diversified financials. Banks generally reported increases in full year underlying profit. These increases were partly driven by higher net interest income, which resulted from growth in interest earning assets. Declines in bad and doubtful debt charges owing to improved asset quality also contributed to profit growth. For the major banks, net interest margins have been broadly stable, with strong competition in lending markets offset by lower funding costs and improved wholesale market conditions. Banks generally increased their dividend payments compared with the same period in the previous financial year.

Underlying earnings outside the resources and financial sectors increased by 2 per cent from the same period last year. Earnings in the industrial sector, which includes a number of mining service-related companies, declined as resources firms continued to reduce their capital expenditure. Consumer sectors also reported lower profits weighed by weaker sales growth.

Debt of listed corporates declined by 7 per cent, while equity was unchanged (Graph 4.22). As a result, the book value gearing ratio declined to 51 per cent to remain well below its historical average. Gearing in the resources sector declined as the major diversified miners continued to reduce outstanding debt. Further declines in resources sector gearing are expected to be more moderate, as companies approach their target net debt levels and increase shareholder distributions. Gearing also declined across the non-resources sectors. ↗



\* The gross gearing ratio is defined as the ratio of the book value of gross debt to the book value of equity; excludes foreign-domiciled companies

\*\* Data from 1997 includes real estate companies

Sources: Morningstar; RBA; Statex