DOMESTIC MARKETS REVIEW: JANUARY 2010

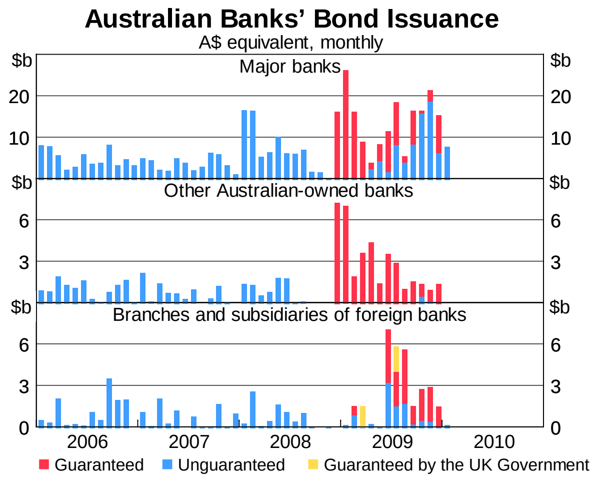
Summary

NON-INTERMEDIATED MARKETS

Credit markets

Financials

Australian banks have issued $8 billion of bonds in January to date, all unguaranteed issues offshore. While the share of bonds that is unguaranteed continues to increase overall – underpinned by the major banks for whom it is generally cheaper than guaranteed funding – there were some large guaranteed issues (totalling $12 billion[1]) by the major banks in December. The major banks have tended to issue guaranteed bonds opportunistically in recent months, particularly in response to reverse enquiries where the cost of raising funds is lower as no marketing or road show expenses are paid.



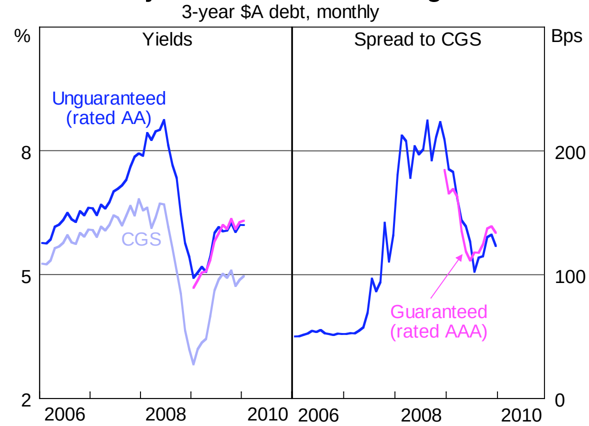
Source: RBA

The largest offshore issue in January was a US$3 billion ($3.3 billion) deal by ANZ which comprised 3-, 5- and 10-year tranches. The hedged spreads on the 3- and 10-year tranches were around 10-15 basis points tighter than previous issues by a major bank. In mid-January, Westpac priced a three-tranche Samurai deal (totalling $1.3 billion), the first Samurai bond issued by a major bank since early 2009. The Westpac Samurai deal was met with strong demand from across 'the full spectrum' of institutional investors in Japan, with over 140 investors participating. The 5-year tranches priced at the tight end of initial guidance, with the spread slightly wider than a *guaranteed* issue of the same tenor by Westpac in February 2009 (the last time the bank issued a Samurai bond). The 7-year fixed rated tranche is the first ever of such duration issued by an Australian bank in Japan and was the result of a reverse enquiry.

Domestically, secondary market spreads on the major banks' 3-year unguaranteed bonds have fallen around 5 basis points since end November , to around 125 basis points over CGS. While these spreads remain well below their peak of 240 basis points in September 2008, they have increased around 30 basis points since September 2009. Including the cost of the guarantee fee, spreads on guaranteed bonds are lower at around 135 basis points over CGS. With CGS yields rising slightly in December and January, yields on the major banks' guaranteed and unguaranteed bonds have risen to around 6.3 per cent for 3-year debt.

Major Banks' Bond Pricing*

3-year $A debt, monthly



* Includes fee for guaranteed issues.
Sources: RBA; UBS AG, Australia Branch

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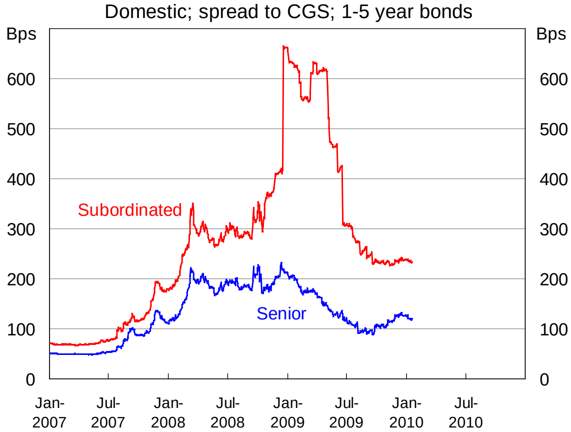
Spreads on the major banks' domestically-issued subordinated bonds are broadly unchanged from end November levels, at around 235 basis points over CGS.

Major Banks' Bond Spreads

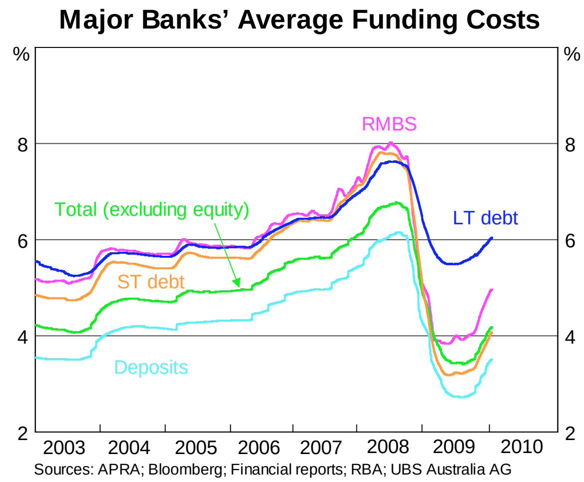
Domestic; spread to CGS; 1-5 year bonds



Source: UBS AG, Australia Branch

No new hybrids were issued in January to date. ANZ raised $2 billion from its new hybrid issue ‘CPS2’ in mid December last year. The issue was upsized from $750 million. Pricing on the hybrid was 310 basis points over BBSW, 30 basis points tighter than CBA’s $2 billion PERLS hybrid issue in mid October. With the pricing of ANZ’s hybrid securities, financials’ hybrid issuance for the December 2009 quarter reached its highest level since the onset of the financial crisis. Non-financial corporates have not issued hybrids since December 2008.

INTERMEDIATED MARKETS

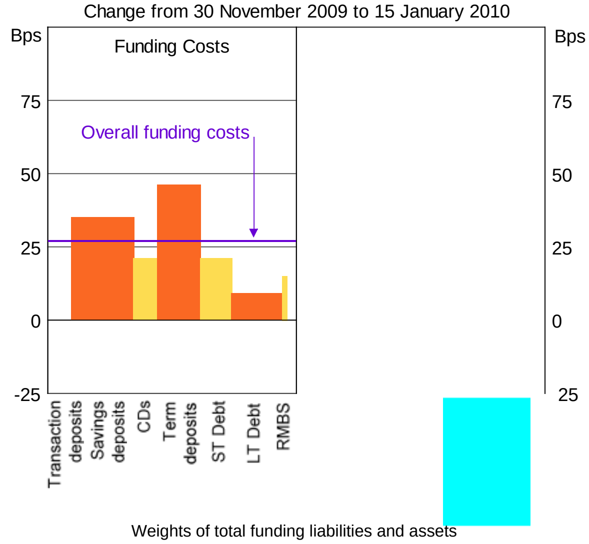


The major banks' average funding cost is estimated to have increased by 35 basis points since end November. This was driven by increases of about 40 basis points in the costs of short-term debt and deposits. The average cost of long-term debt increased by about 21 basis points.

On a marginal basis, it is estimated that the major banks' NIM has declined by 4 basis points since end November, with the cost of new funding rising by 27 basis points and rates on new loans increasing by 24 basis points. Over this period, deposits have driven the increase in funding costs, while household lending rates have risen by more than business lending rates.

Marginal Interest Rates on the Four Major Banks' Assets and Liabilities

Change from 30 November 2009 to 15 January 2010



Weights of total funding liabilities and assets

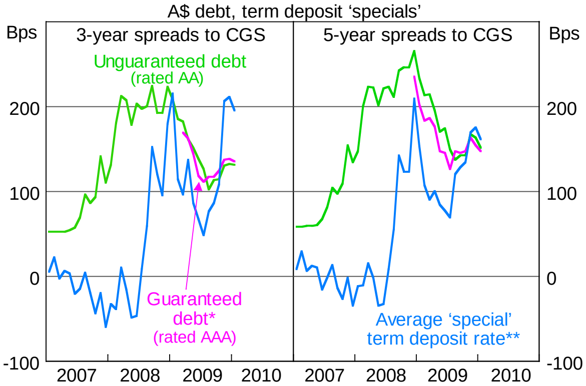
Sources: APRA; Bloomberg; RBA; UBS AG, Australia Branch

As discussed in previous monthly notes, a narrowing in the marginal NIM is normal during the early part of tightening cycles as market rates (which are more important for funding costs) typically rise faster than the cash rate (which is more important for lending rates) during these periods.

The major banks' 3 and 5-year 'special' term deposit rates are currently 25-75 basis points above yields on the banks' bonds of equivalent maturity, compared to around 50-60 basis points below these yields in mid 2009.

Major Banks' Pricing of Term Deposits and Bonds

A$ debt, term deposit 'specials'



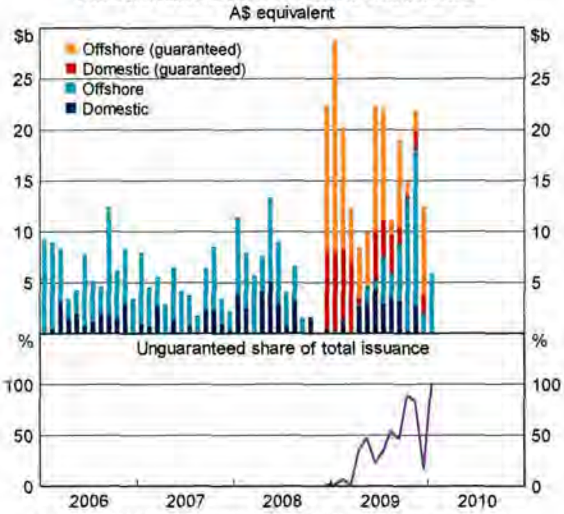
* Includes fee for guaranteed issues
** Prior to September 2008 it is the 24-month spread
Sources:Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

GOVERNMENT GUARANTEE SCHEME: DECEMBER 2009 FEE REPORT

This paper briefly recaps use of the Australian Government Guarantee Scheme. A separate paper for the Council of Financial Regulators also covers international developments.

More timely data show that there has not been any significant guaranteed issuance in January to date (Graph 3). Unguaranteed issuance has been relatively firm though, totalling $7.7 billion. The main issuers were the four majors. This highlights that the increase in offshore guaranteed issuance by Westpac in December reflected opportunistic issuance to lower cost/widen their investor base rather than a problem of access to funding.

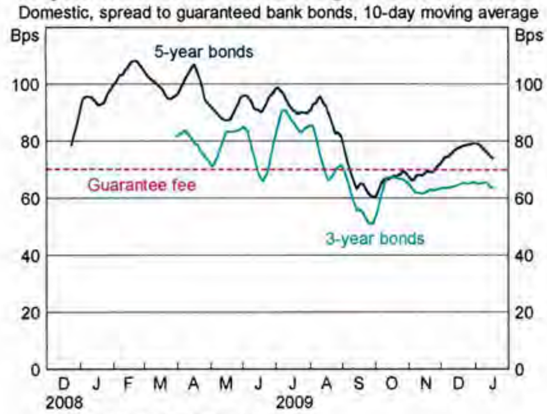
Graph 3
Australian Banks' Bond Issuance*
A$ equivalent



* January 2010 is month to date; excludes 12-15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme.
Source: RBA

Market activity and yield spreads suggest that changes in funding market conditions are yet to fully remove the incentive to issue guaranteed across the banking system. For the AA-rated major banks, in the domestic market it appears to remain cost-effective to issue unguaranteed for 3-year maturities and avoid the 70 basis point guarantee fee, though it is less clear for unguaranteed 5-year maturities and offshore (Graph 4).

Graph 4
Major Australian Banks' Unguaranteed Bonds
Domestic, spread to guaranteed bank bonds, 10-day moving average



Source: UBS AG, Australia Branch

Financial Stability Department
18 January ~~2009~~ 2010

RBA PAPER FOR CFR CONFERENCE CALL ON 20 JANUARY 2010: EXITING FROM THE GUARANTEE SCHEME

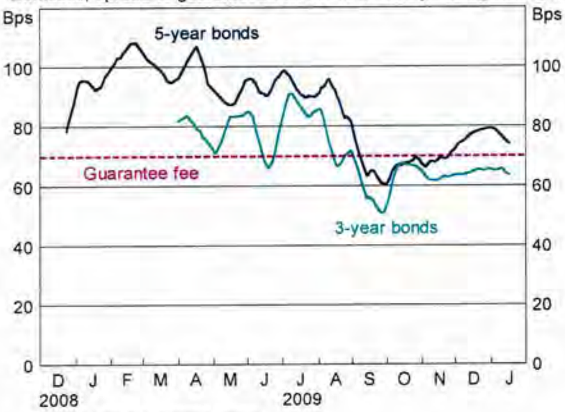
Australia

Market activity and yield spreads suggest that changes in funding market conditions are yet to fully remove the incentive to issue guaranteed across the banking system. For the AA-rated major banks, in the domestic market it appears to remain cost-effective to issue unguaranteed for 3-year maturities and avoid the 70 basis point guarantee fee, though it is less clear for unguaranteed 5 year maturities and offshore (Graph 7).

Graph 7

Major Australian Banks' Unguaranteed Bonds

Domestic, spread to guaranteed bank bonds, 10-day moving average



Source: UBS AG, Australia Branch

DOMESTIC MARKETS REVIEW: FEBRUARY 2010

Summary

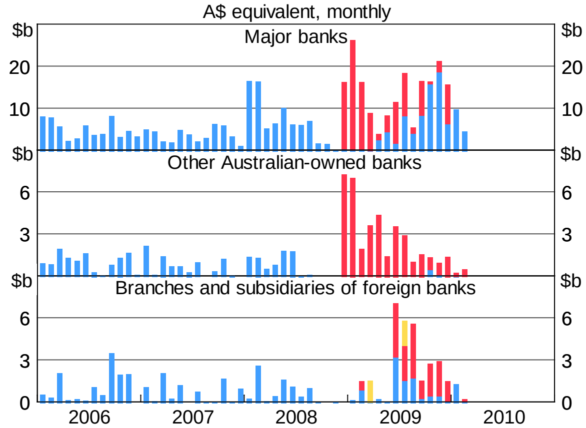
- Domestic secondary market spreads on major banks' guaranteed bonds fell around 10 basis points following the announcement that the Guarantee Scheme would be withdrawn at end March, as investors factored a 'scarcity premium' into the price of these bonds. In contrast, the cost of unguaranteed debt has remained broadly unchanged.

NON-INTERMEDIATED MARKETS

The largest unguaranteed deal in February was a 4-year $1.8 billion domestic issue by ANZ, the first domestic deal by a major bank this year. The issue comprised a $1.2 billion floating rate tranche and a $600 million fixed rate tranche, which priced at 95 basis points over BBSW/swap (equivalent to 146 basis points over CGS). ANZ's unguaranteed deal was met with strong investor demand, with the issue upsized from $500 million and pricing at the lower end of initial guidance.

Australian Banks' Bond Issuance

A$ equivalent, monthly



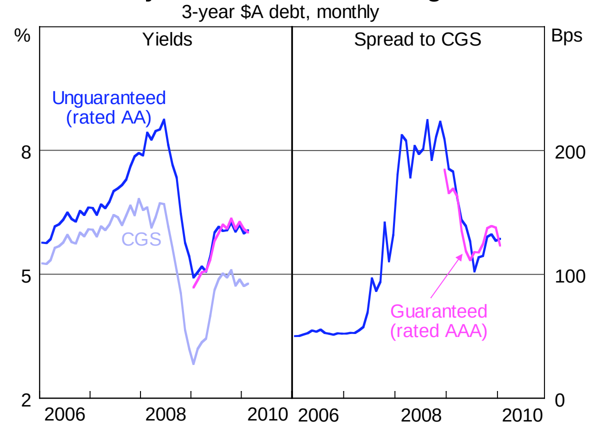
Guaranteed   Unguaranteed   Guaranteed by other governments

Source: RBA

Spreads on major banks' guaranteed bonds trading in the domestic secondary market have fallen around 10 basis points (to 124 basis points, including the cost of the guarantee fee) since the announcement that the Guarantee Scheme would be withdrawn, as investors have factored a 'scarcity premium' into the price of these bonds. In contrast, the cost of unguaranteed debt has remained broadly unchanged at around 130 basis points over CGS for 3-year debt. With CGS yields rising in February, yields on the major banks' guaranteed and unguaranteed bonds have increased to around 6.1 per cent for 3-year debt.

Major Banks' Bond Pricing*

3-year $A debt, monthly



* Includes fee for guaranteed issues.
Sources: RBA; UBS AG, Australia Branch

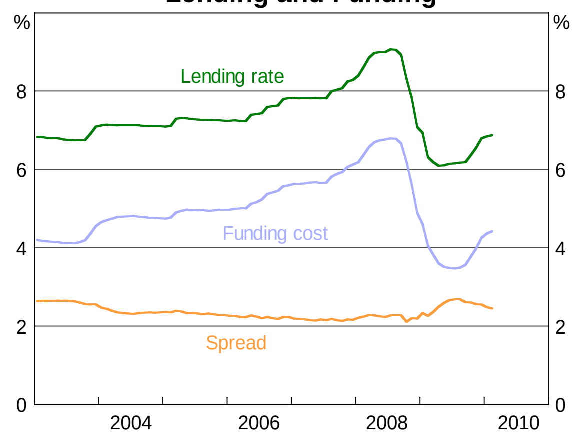
Spreads on the major banks' domestically-issued subordinated bonds have fallen by 5 basis points since end January, to around 235 basis points over CGS.

The largest offshore issue in February was a subordinated 10-year €1 billion ($1.5 billion) deal by NAB, which priced at 133 basis points over swap (equivalent to a hedged spread of 270 basis points over CGS). Also, ANZ issued a 5-year JPY60.3 billion ($755 million) Samurai bond, the second time an Australian entity has accessed the Samurai market this year (after a Westpac issue in January). The ANZ deal priced at 45 basis points over swap (equivalent to 197 basis points over CGS), the same as the pricing on Westpac's 5-year floating rate tranche in January.

INTERMEDIATED MARKETS

increasing by 6 basis points and 3 basis points respectively. The major banks' net interest margin (NIM) on their outstanding interest-earning assets and liabilities declined by about 3 basis points over the month.

Average Rates on Major Banks' Outstanding Lending and Funding



Sources: APRA; Bloomberg; Financial reports; RBA; UBS AG, Australia Branch

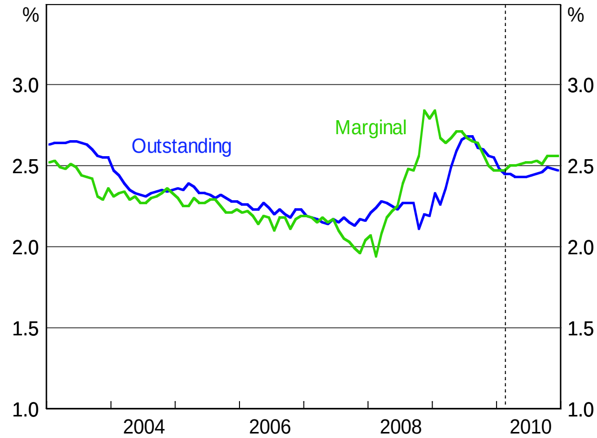
As discussed in previous monthly notes, some narrowing in the marginal NIM is normal during the early part of tightening cycles as market rates (which are more important for funding costs) typically rise faster than the cash rate (which is more important for lending rates) during these periods.

On a marginal basis, the major banks' NIM is estimated to be little changed since end January, with little movement in lending rates or funding costs. However, since mid 2009, the estimated marginal NIM is

Cost of Funding

The major banks' average funding costs and lending rates are estimated to have risen only slightly since end January, 20 basis points lower, with a 96 basis point increase in funding costs outweighing a 76 basis point increase in lending rates.

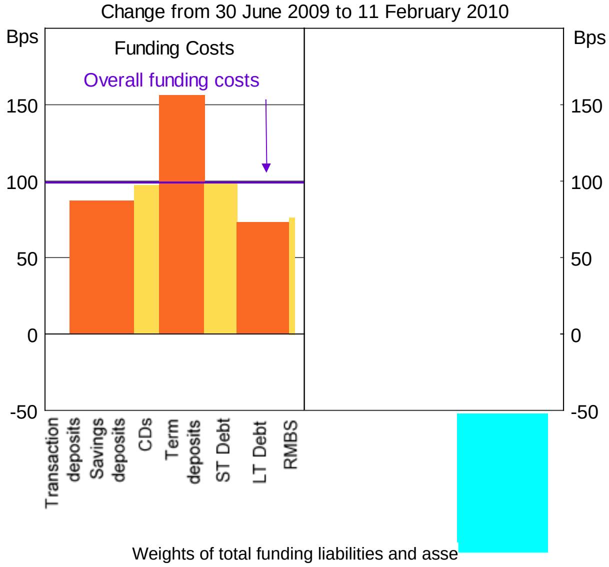
Major Banks' Net Interest Margin



Source: RBA

Marginal Interest Rates on the Major Banks' Assets and Liabilities

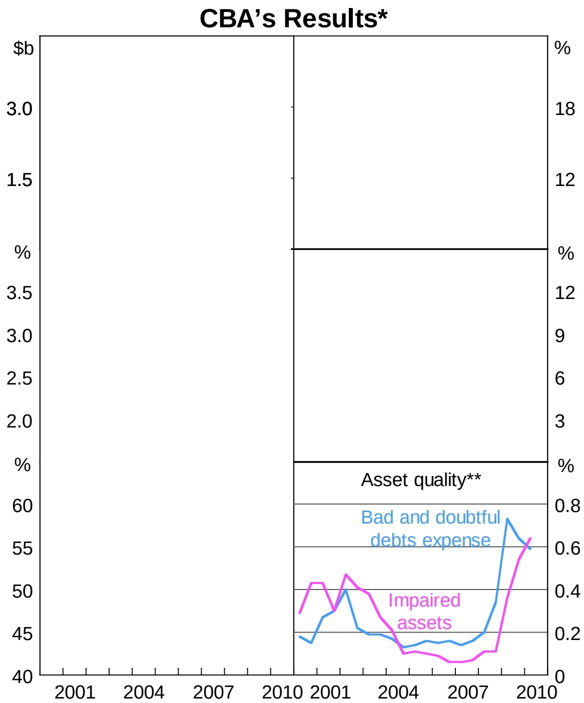
Change from 30 June 2009 to 11 February 2010



Sources: APRA; Bloomberg; RBA; UBS AG, Australia Branch

Banks' profits

CBA recently released its profit result for the half-year ending 31 December 2009.[2]



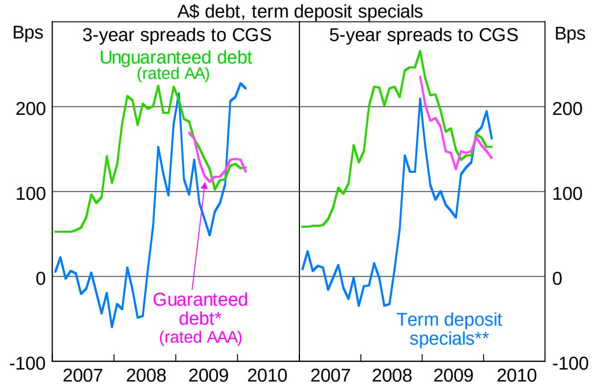
* From 2006, figures are under AIFRS.
** Expressed as a percentage of net loans.

Net impaired assets as a percentage of net loans and advances were 64 basis points as at December 2009, an increase of 28 basis points from December 2008.

The average rate on 'special' term deposits at the major banks is little changed since end-January, at 6.16 per cent. The major banks have continued to offer higher rates on their 3 and 5-year 'special' term deposits relative to rates on bonds of equivalent maturities. These spreads are currently around 95 basis points and 20 basis points, respectively.

Major Banks' Pricing of Term Deposits and Bonds

A$ debt, term deposit specials



* Includes fee for guaranteed issues
** Prior to September 2008 it is the 24-month spread
Sources:Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

Westpac also reportedly notified brokers of changes to lending standards (across all of its brands) that took effect on 20 January. Maximum loan to valuation ratios (LVRs) for new customers have been lowered from 92 per cent to 87 per cent. The maximum LVRs for new low-documentation customers is 80 per cent.

Westpac closes part of RAMS and tightens lending criteria

Domestic Markets Department

16 February 2010

RELEASE NOTE

CBA PROFIT RESULT FOR THE HALF-YEAR TO DECEMBER 2009

Net interest income

Underlying net interest income increased by 33 per cent to $6.0 billion. Average interest-earning assets rose by 25 per cent, primarily due to a 36 per cent increase in housing lending.[2]

The Group net interest margin (NIM) in the December 2009 half was 2.18 per cent, 13 basis points higher than in the previous corresponding period (19 basis points on a pro forma basis). The Australian NIM was 23 basis points higher than in the December 2008 half and 8 basis points higher than in the June 2009 half. On a pro forma basis, the NIM was up 30 basis points since the December 2008 half. However, the overseas NIM declined.

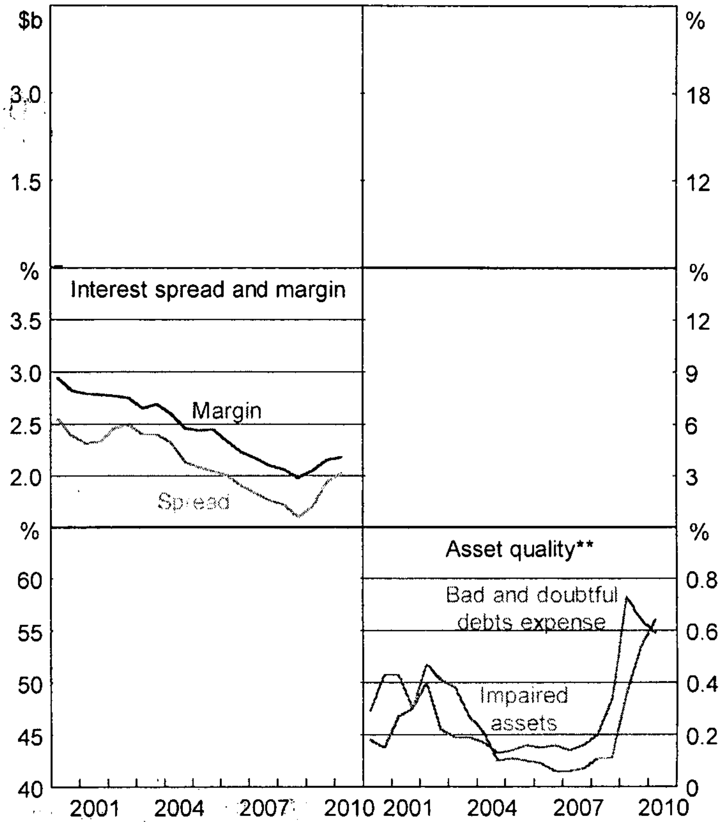
The increase in the NIM was driven by loan repricing and reduced holdings of liquid assets, which was partly offset by the impact of a higher share of lower margin assets (particularly home loans).

CBA Half-Year Profit Results

	Underlying*		Headline	
	$b	Growth**	$b	Growth**
Bad and doubtful debts	1.38	(14)	1.38	(14)

* Excluding significant items
** Year-on-year percentage change

CBA's Results*



* From 2006, figures are under AIFRS.
** Expressed as a percentage of net loans.

Asset quality

The bad and doubtful debts expense (BDDE) in the December 2009 half was $1.4 billion. This was 0.59 per cent of lending assets (annualised), down from 0.73 per cent in December 2008 and 0.64 in June 2009. The lower BDDE largely reflects the underlying improvement in the economic conditions, the absence of new large single name problem loans and a slight decrease in collective provisions. CBA continues to maintain a conservative approach to provisioning, with their total provisions (specific and collective) remaining at around 1.1 per cent of lending assets since the June 2009 half. Net impaired assets as a percentage of net loans and advances were 64 basis points as at December 2009, an increase of 28 basis points from December 2008.

Anna Brown
Institutional Markets Section
Domestic Markets Department / 10 February 2010

BANKS' COMMERCIAL PROPERTY LENDING & ASSET QUALITY – DECEMBER 2009[1]

Asset quality

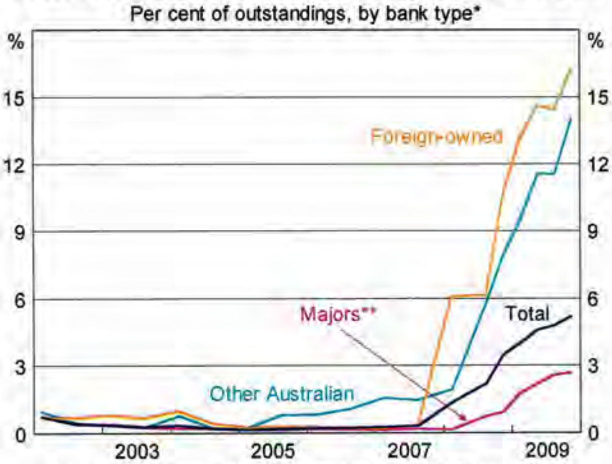
By **bank type**, the rise in impaired assets over the December quarter was driven by the smaller Australian-owned banks (Graph 6).

The *value* of impaired assets at the major banks remained broadly flat over the December quarter and fell at the foreign-owned banks, but impaired asset *ratios* increased for both these groups, due to the relatively larger fall in exposures.

Graph 6

Australian Commercial Property Impaired Assets

Per cent of outstandings, by bank type*



* Consolidated, Australian operations; matched sample of 27 banks; figures for December 2009 are preliminary estimates.
** Includes St George, and Bankwest from March 2009.
Sources: APRA; RBA

For the five large banks that have **overseas commercial property** exposures, the impaired assets ratio fell by 25 basis points over the quarter, to 3.2 per cent. This ratio is now broadly in line with these banks' Australian exposures (3.1 per cent). The reduction over the December quarter was fairly broad-based across property types and individual lenders. It is unclear whether this reflects an increase in assets returning to performing status or banks writing-off bad debts from their balance sheets. The major banks' relatively low commercial property impaired asset ratios in countries that have experienced more difficult economic conditions (New Zealand and the United Kingdom) may reflect their conservative lending profile. For example, the Bank of England estimates that the major United Kingdom banks' losses on commercial property were around 7 per cent of total exposures in 2009.[13] In contrast, the major Australian banks reported a specific provisions ratio for overseas commercial property lending of around 1 per cent as at December 2009.

Ben Mowatt and Lara Pendle
Financial Stability Department
10 February 2009
2010

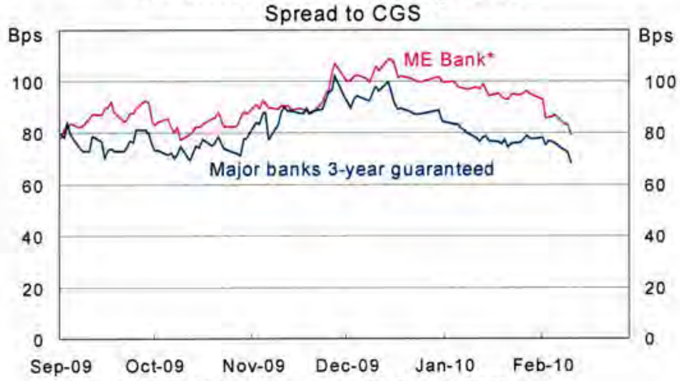
[13] See Bank of England Financial Stability Report December 2009

HACK, Mark

From: HACK, Mark
Sent: Thursday, 11 February 2010 08:52
To: BLACK, Susan
Subject: RE: Government Guaranteed Bank Bonds 11 February 2010 [SEC=UNCLASSIFIED]

Security Classification:
UNCLASSIFIED

Guaranteed Bond Spreads
Spread to CGS



* 3-year domestic bond issued on 13 August 2009.
Source: UBS AG, Australia Branch

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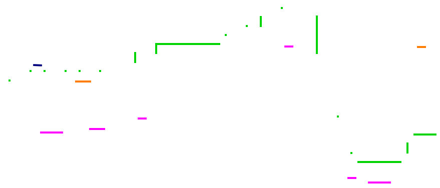
Fortnightly Briefing on Lending

4. Bank funding

Spreads on major banks'

guaranteed bonds trading in the domestic secondary market have fallen around 10 basis points since the announcement that the Guarantee Scheme would be withdrawn, as investors have factored a 'scarcity premium' into the price of these bonds. In contrast, the cost of unguaranteed debt has remained broadly unchanged.



Reserve Bank of Australia and Australian Prudential Regulation Authority

12 February 2010

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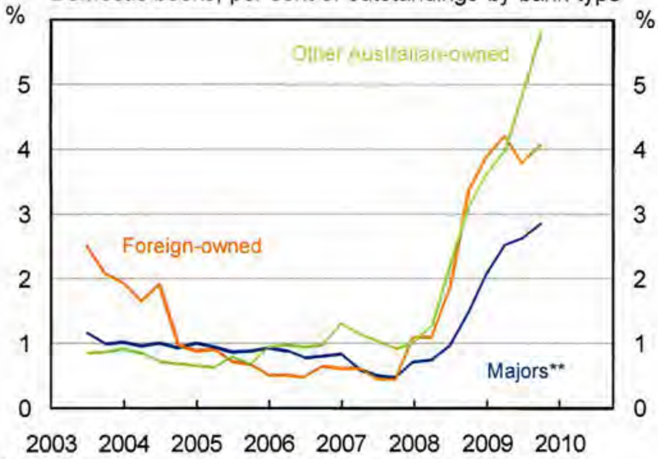
BANKS' DOMESTIC NON-PERFORMING ASSETS – DECEMBER QUARTER 2009[1]

The major banks' business NPL ratio rose slightly over the past six months, but at 2.8 per cent remains lower than for the other bank types.

Graph 6

Non-performing Business and Other Loans*

Domestic books, per cent of outstandings by bank type

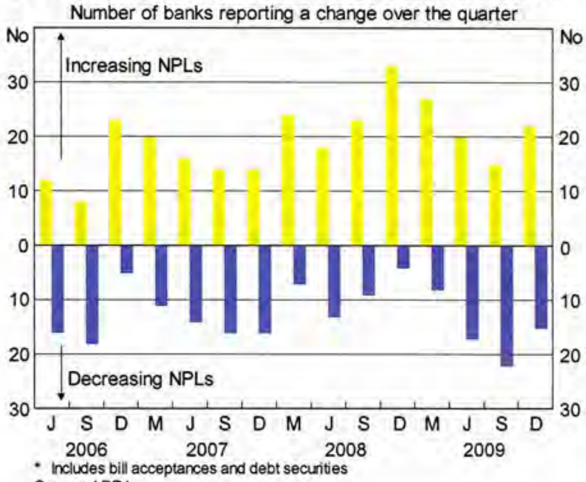


* Includes bill acceptances and debt securities
** Includes St George, and Bankwest from March 2009
Source: APRA

Graph 7

Non-performing Business and Other Loans*

Number of banks reporting a change over the quarter



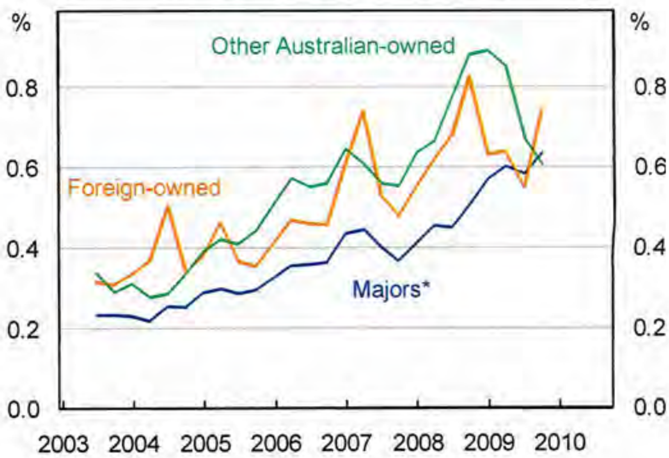
* Includes bill acceptances and debt securities
Source: APRA

Housing loans

Graph 9

Non-performing Housing Loans

Domestic books, per cent of outstandings by bank type*

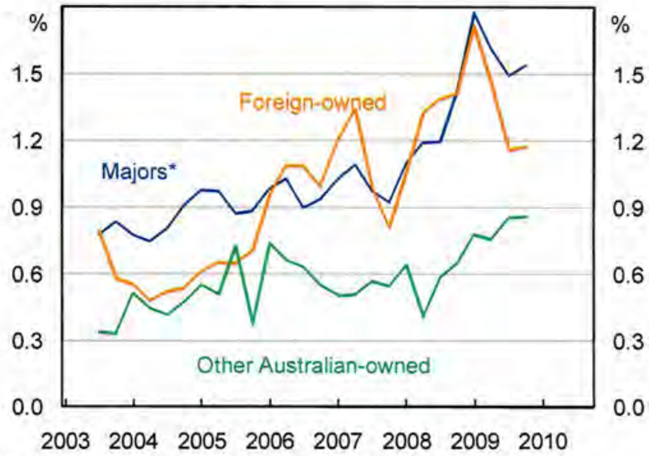


* Includes St George, and Bankwest from March 2009
Source: APRA

Graph 13

Non-performing Personal Loans

Domestic books, per cent of outstandings by bank type

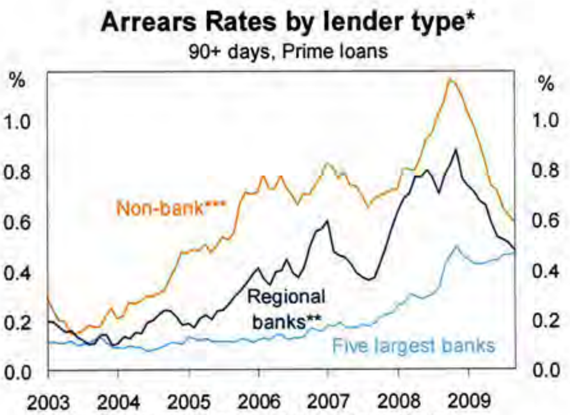


* Includes St George, and Bankwest from March 2009
Source: APRA

Ben Mowatt
Financial Stability Department
18 February 2010

SECURITISED HOUSING LOAN ARREARS – DECEMBER 2009

Graph 7



* Full-doc and low-doc loans. Excludes self-securitisations.
** Includes Adelaide Bank, Bank of Queensland, Bendigo Bank and Suncorp-Metway
*** Includes Macquarie Securitisation.
Sources: Perpetual; RBA

Rob Johnson
Financial Stability Department
23 February 2010

Fortnightly Briefing on Lending

4. Bank funding

Overall, spreads on major banks' bonds trading in the domestic secondary market are little changed over the past fortnight. Guaranteed spreads remain around 10 basis points below their level prior to the Treasurer's announcement on 7 February, as investors have factored a 'scarcity premium' into the price of these bonds.

Reserve Bank of Australia and Australian Prudential Regulation Authority

26 February 2010

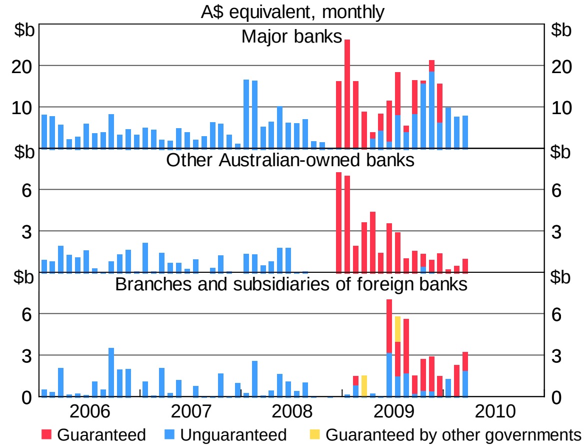
DOMESTIC MARKETS REVIEW: MARCH 2010

Summary

- There has been a narrowing in secondary market spreads on major banks' unguaranteed bonds this month, while spreads on guaranteed bonds have remained broadly unchanged.

NON-INTERMEDIATED MARKETS

Australian Banks' Bond Issuance



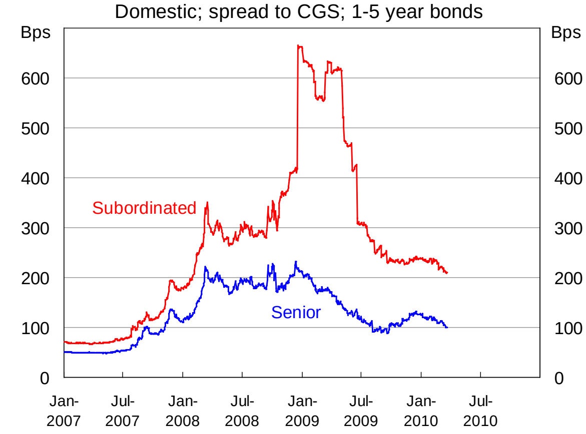
Source: RBA

The largest offshore issue in March was a US$3.5 billion ($3.8 billion) privately-placed deal by CBA which comprised 3-, 5- and 10-year tranches. While spreads paid on the bond were slightly higher than recent comparable deals by a major bank, a fall in hedging costs meant the (hedged) cost of the deal was 20-35 basis points below other US$ deals.

Spreads on major banks' guaranteed bonds trading in the domestic secondary market are little changed over the past month.

Major Banks' Unguaranteed Bond Spreads

Domestic; spread to CGS; 1-5 year bonds

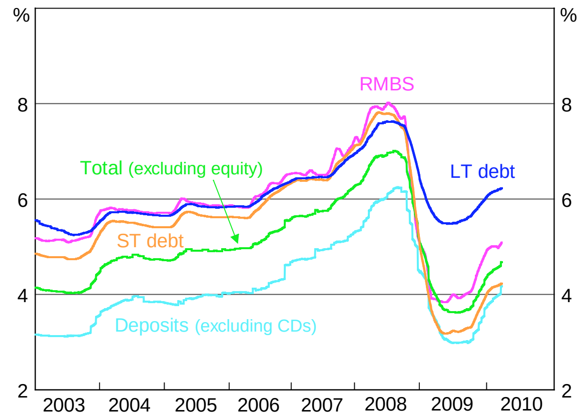


Source: UBS AG, Australia Branch

Spreads on the major banks' domestically-issued subordinated bonds have fallen by around 10 basis points since end February, to 210 basis points over CGS, bringing the index to its lowest level since February 2008. Like the fall in spreads on senior bonds, the decline in spreads on subordinated debt was broad based.

INTERMEDIATED MARKETS

Major Banks' Average Funding Costs

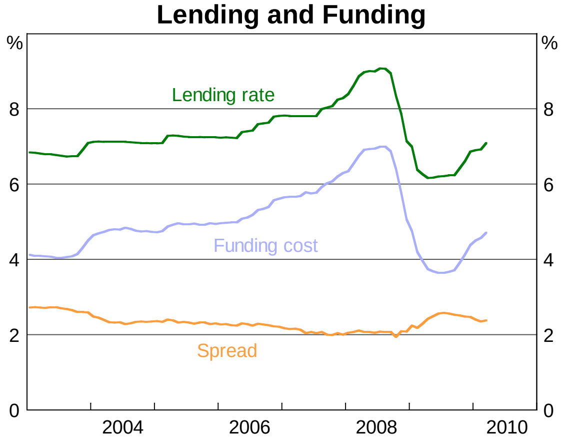


Sources: APRA; Bloomberg; Financial reports; RBA; UBS Australia AG

Cost of Funding

We estimate that the major banks' net interest margin (NIM) on their outstanding interest-earning assets and liabilities has increased only slightly since end February (3 basis points).

Average Rates on Major Banks' Outstanding Lending and Funding



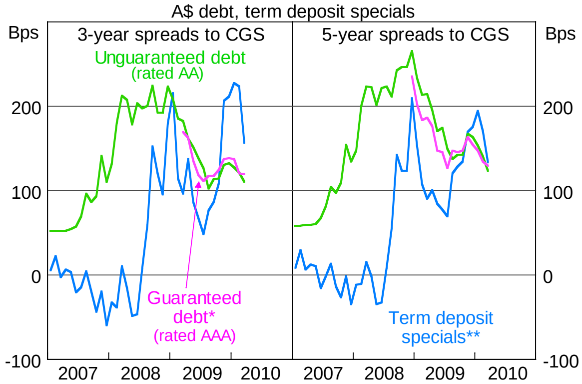
Sources: APRA; Bloomberg; Financial reports; RBA; UBS AG, Australia Branch

The major banks' average funding cost is estimated to have increased by 14 basis points since end February, with the cost of deposits increasing by about 21 basis points and short and long-term capital market funding increasing between 5-10 basis points.

The major banks also continue to offer higher rates on term deposits with longer tenors relative to the rates on bonds of equivalent maturities (particularly at the 3-year maturity), although the gap has narrowed recently.

Major Banks' Pricing of Term Deposits and Bonds

A$ debt, term deposit specials



* Includes fee for guaranteed issues

** Prior to September 2008 it is the 24-month spread

Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

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MEMORANDUM FOR THE BOARD **MARCH 2010 MEETING**

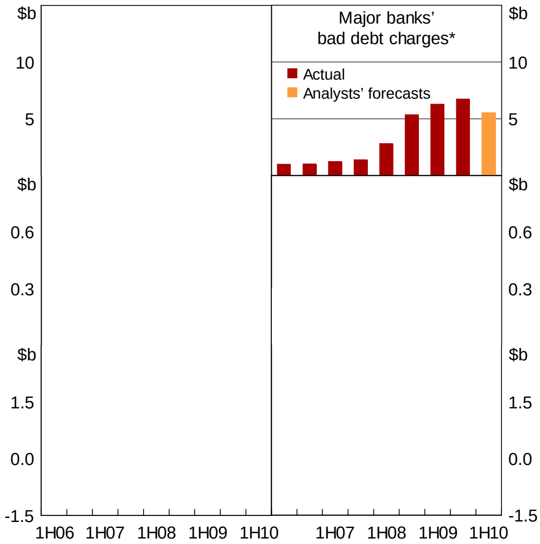
Financial Stability

The Australian Financial System

The profitability of the largest Australian banks has remained very solid. Though provisions for bad loans have reduced profits from the buoyant pre-crisis levels, average return on equity has remained in double digits, and analysts generally forecast that the provision cycle has peaked. Funding conditions have improved markedly since the height of the crisis, allowing banks to make less use of liquidity facilities provided by the Reserve Bank and increasingly issue bonds without using the Government wholesale funding guarantee scheme.

Profits and asset quality

Graph 10
Australian Banks' Profitability



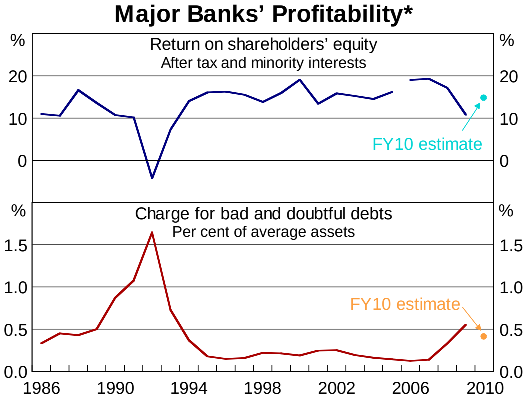
* Second half figures are half year to December for CBA and half year to September for ANZ, NAB and Westpac. Includes St George, and Bankwest from the first half of 2009.

Sources: APRA; Citigroup; Morgan Stanley; UBS; banks' annual and interim reports

Provisioning charges have been the main factor weighing on profits in the recent period. After adjusting for mergers, the major banks reported charges for bad and doubtful debts of $7 billion in the latest half year, compared with $6 billion in the same period a year earlier. The recent rise partly reflects higher provisions on exposures to small-to-medium-sized enterprises, and a relatively larger rise in provisions against the business conducted by the major banks in New Zealand and the United Kingdom than on operations in Australia. The foreign subsidiaries have also seen their bad debt charges increase slightly over the year

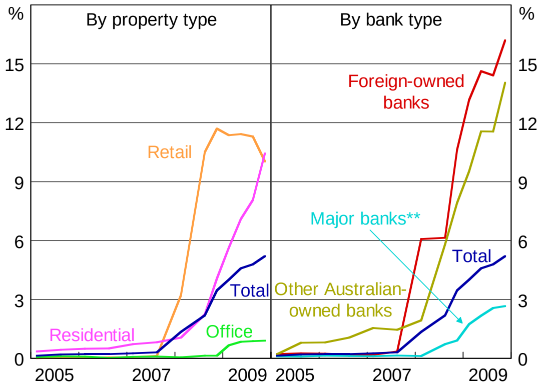
Despite the increase in charges for bad and doubtful debts over the latest period, recent commentary by the major banks and equity analysts suggests that charges may have already peaked or will do so in the first half of this year (Graph 11).

Graph 11
Major Banks' Profitability*



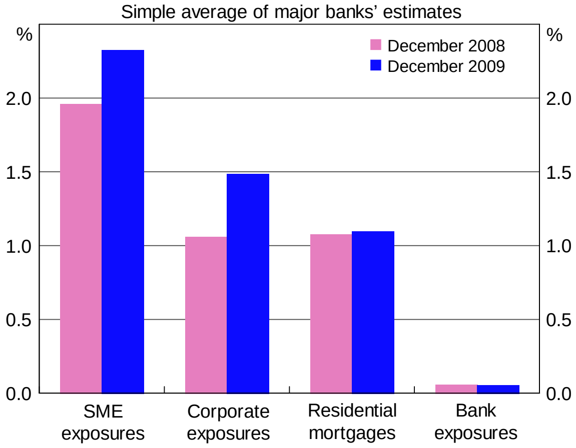
* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis. Includes St George, and Bankwest from 2009.
Sources: Citigroup; Credit Suisse; Deutsche Bank; Morgan Stanley; RBA; UBS; banks' annual and interim reports

Graph 14
Commercial Property Impaired Assets
Per cent of outstandings*



* Consolidated, Australian operations; matched sample of 27 banks.
** Includes St George, and Bankwest from March 2009.
Source: APRA

Graph 18
Default Probabilities*
Simple average of major banks' estimates



* On-balance sheet portfolios assessed under Internal Ratings-based Approach only
Source: APRA

Funding conditions and guarantee arrangements

Funding conditions have generally continued to improve over the past six months, and banks have increasingly accessed funding without use of the Government guarantee arrangements. In bond markets, it has generally become cost effective for the major Australian banks to issue unguaranteed, without paying the guarantee fee, and so the share of bond issuance that is guaranteed was close to zero in January, after accounting for virtually all issuance a year earlier

Financial Stability Department
25 February 2010

FABBRO, Daniel

From: FABBRO, Daniel
Sent: Wednesday, 3 March 2010 11:51
To: DAVIES, Michael
Subject: FW: COFR briefing [SEC=UNCLASSIFIED]

Attachments: 2a Guarantee Scheme Market Developments.doc
Security Classification: UNCLASSIFIED

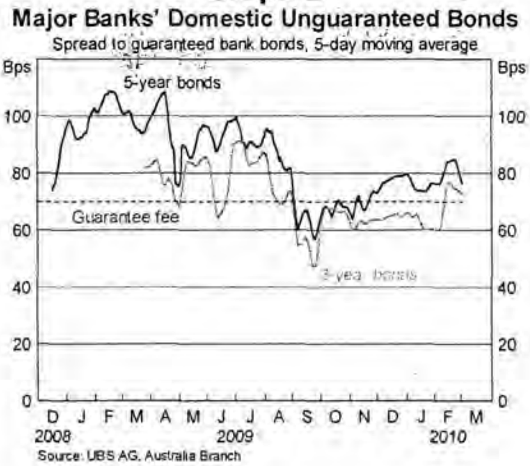
Mike,
Here is the FS briefing for tomorrow's COFR meeting

Agenda Item 2(a) Wholesale Funding Guarantee: Recent Market Developments

On 7 February, the Government announced that the Guarantee Scheme will be closed to new issuance on 31 March 2010.

Consistent with this, the indicative spread between the major banks' guaranteed and unguaranteed three-year debt widened by around 10 basis points immediately after the announcement (Graph 2). This spread has since narrowed somewhat, with the growing supply of guaranteed issues having slightly increased the relative yield of guaranteed debt.

Graph 2



Reserve Bank of Australia
2 March 2010

Fortnightly Briefing on Lending and Funding

4. Bank funding

- Spreads on the major banks' unguaranteed bonds trading in the secondary market have fallen 5-10 basis points over the past fortnight, to be at their lowest since around October 2009.

Reserve Bank of Australia and Australian Prudential Regulation Authority

12 March 2010