

4. Domestic Financial Markets

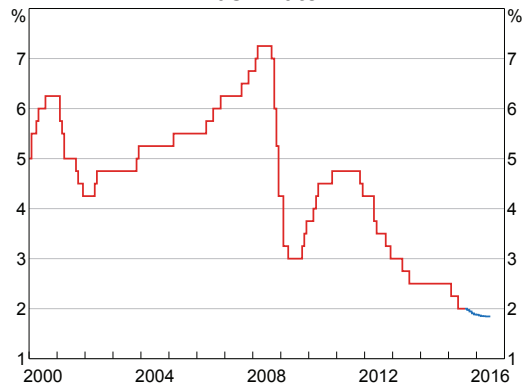
Conditions in Australian financial markets continue to support the financing of the business and household sectors. While yields on bonds issued by governments, banks and non-financial corporations are above their levels in early April, they remain close to historic lows. Reflecting the easing of monetary policy earlier in the year, interest rates on owner-occupier housing and business loans have declined notably, though by less for investor loans, which continue to drive the growth in housing lending. Growth in business lending has slowed over recent months, although corporate bond issuance has picked up over the year to date. Australian equity prices have been little changed over recent months, with volatility increasing in response to international developments.

Money Markets and Bond Yields

After lowering the cash rate target from 2½ per cent to 2 per cent in two steps earlier in the year, the Reserve Bank has maintained the cash rate target at 2 per cent since May 2015. Rates on overnight indexed swaps (OIS) suggest some chance of a reduction in the cash rate by the end of the year (Graph 4.1). Rates on bank bills and certificates of deposit (CDs) remain low and are little changed over recent months. Spreads between bank bill and OIS rates remain below their peak late last year.

Yields on long-term Australian Government securities (AGS) have experienced some volatility, largely reflecting movements in sovereign yields internationally. Overall, yields on AGS have declined over recent months with the spread between AGS and US Treasuries narrowing, while the yield curve has been little changed (Graph 4.2).

**Graph 4.1
Cash Rate***



* Data from September 2015 onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

**Graph 4.2
Australian Government Bond Yields**



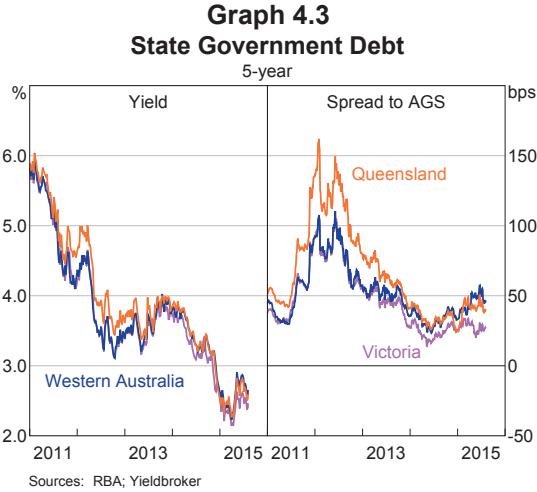
Source: RBA

Following the release of the Australian Government Budget in May, the Australian Office of Financial Management (AOFM) announced its updated financing requirement for 2015/16. The AOFM

expects net issuance of around \$40 billion, with total AGS on issue expected to reach around \$430 billion by June 2016. The face value of AGS on issue is expected to reach a peak of around \$540 billion during 2018/19. The ASX plans to introduce a 20-year AGS bond futures contract in the September quarter 2015. The initial basket of securities on which the contract would be based would comprise bonds maturing in April 2033, June 2035 and April 2037, representing total outstanding issuance of \$22 billion.

The stock of bonds issued by the state and territory governments ('semis') increased by \$4 billion over the 2014/15 financial year, to be \$242 billion at the end of June. This is the smallest annual increase since 2005/06. Gross issuance by states was \$38 billion, with New South Wales, Queensland and Western Australia accounting for the bulk of issuance in recent months. However, a large portion of this was used to roll over existing debt. Yields on semis remain at very low levels; spreads between semis and AGS have picked up since mid last year, though they remain relatively low (Graph 4.3).

The states have announced their 2015/16 budgets and updated their long-term borrowing programs (Table 4.1). In the current financial year, gross long-term issuance by states is forecast to be \$28 billion. The stock of outstanding state government debt is expected to increase by \$8 billion after accounting



for scheduled maturities; however, the proceeds from some planned asset privatisations have not been included in forecasts of net borrowing requirements, which may result in lower net issuance.

Bond issuance by non-residents into the domestic market ('Kangaroo' issuance) over the year to date has been similar to the average of recent years. Most of this issuance has been by banks and supranational issuers. A European bank became the first to issue a Basel-III compliant Tier 2 hybrid Kangaroo bond, raising \$700 million. Secondary market spreads on Kangaroo bonds have widened by around 10 basis points for AAA rated issuers over recent months.

Table 4.1: Long-term Bond Issuance by State Treasury Corporations^(a)

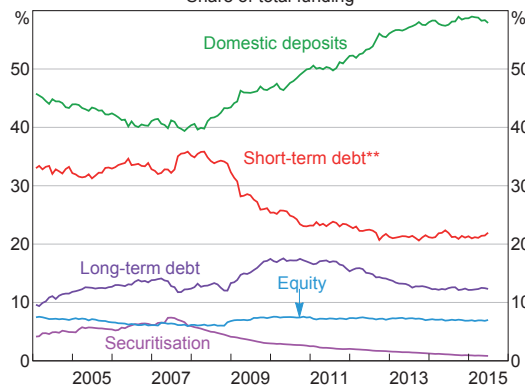
Issuer	Outstanding as at end June 2015 \$billion	2014/15 issuance \$billion	2015/16 indicative target \$billion
New South Wales	62	10	7
Queensland	87	11	7
South Australia	15	4	2
Tasmania	3	1	1
Victoria	34	2	2
Western Australia	34	10	10
All States	235	38	28

(a) Securities with an original term to maturity of greater than one year; figures are rounded to the nearest whole number; projections are based on the latest funding program forecasts for gross term issuance
Sources: RBA; State Treasury Corporations

Financial Intermediaries

Bank balance sheets have continued to grow moderately. The funding composition of bank balance sheets has remained broadly unchanged over the past year with deposits as a share of funding remaining a little under 60 per cent (Graph 4.4).

Graph 4.4
Funding Composition of Banks in Australia*
Share of total funding



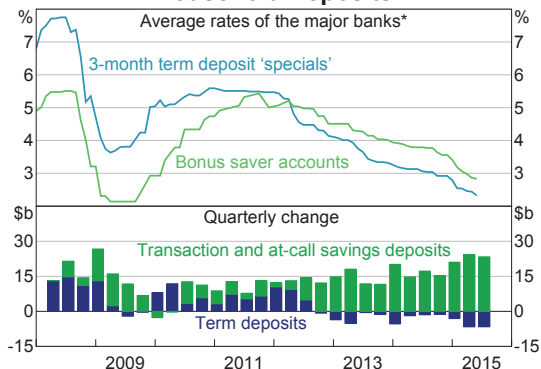
* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Banks' average funding costs have continued to decline. Since the beginning of the year, funding costs have fallen by a little more than the cash rate, mainly reflecting lower wholesale funding costs, although deposit rates have also fallen. Since the May cash rate reduction, both average outstanding deposit funding and wholesale funding costs have fallen by around 20 basis points. Households have generally continued to invest more in 'at-call' deposit products, such as bonus saver accounts, which offer higher interest rates than term deposits (Graph 4.5).

Graph 4.5
Household Deposits

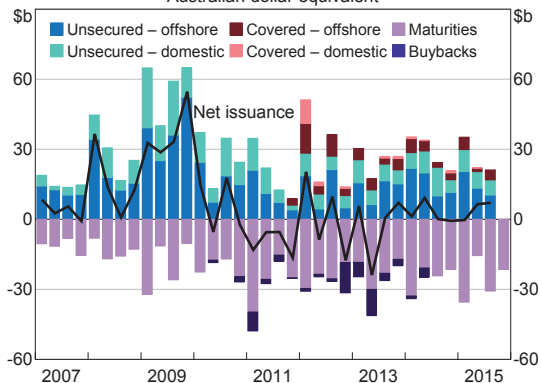


* Prior to the May cash rate reduction

Sources: APRA; CANSTAR; RBA

Australian banks have issued around \$78 billion in bonds since the start of the year; after accounting for maturities, the stock of outstanding bonds has increased by around \$13 billion over this period (Graph 4.6). Similar to recent years, a little over half of banks' offshore issuance in the June quarter was denominated in US dollars. The share of euro-denominated bond issuance fell in the June quarter, consistent with the cost of hedging euro-denominated issuance back into Australian dollars being elevated, while the share of sterling-denominated issuance has picked up recently. Australian banks' presence in the offshore renminbi bond issuance market has continued to develop,

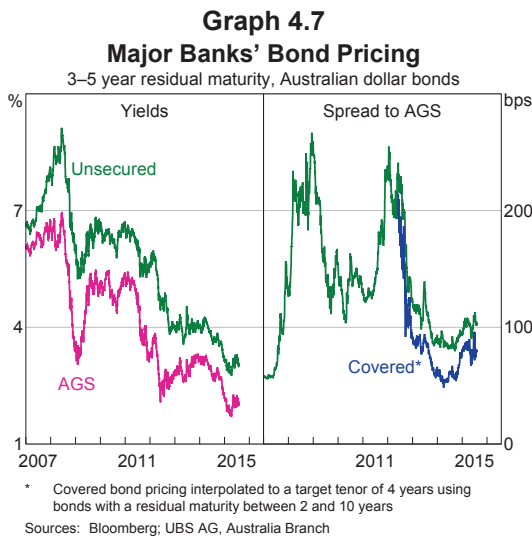
Graph 4.6
Australian Banks' Bond Issuance*
Australian dollar equivalent



* Latest quarter gross issuance and net issuance are quarter to date

Source: RBA

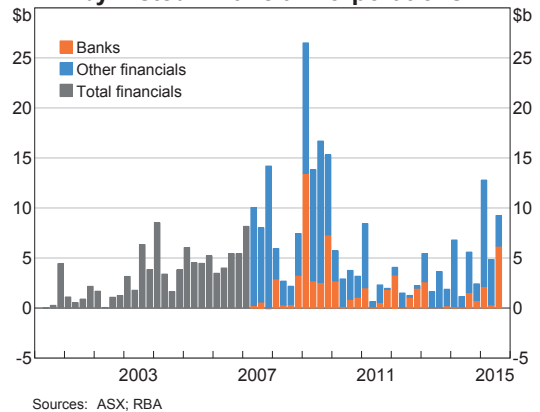
with deal sizes increasing; nevertheless, the stock of renminbi-denominated bonds remains very small relative to total bank issuance. Secondary market spreads over AGS on the major banks' bonds have widened over the past year, but they remain at relatively low levels compared to the period since 2007 (Graph 4.7).



Issuance of hybrid securities by Australian banks has been relatively high over the past year. In recent months, institutions other than major banks have issued around \$2 billion in hybrids. Issuance has consisted mainly of Basel III-compliant Tier 2 hybrids (which count towards banks' regulatory capital); a large share of these hybrids were issued offshore and denominated in foreign currencies. In addition, a major bank has announced its intention to raise around \$1.25 billion through the issuance of a Tier 1 hybrid. Primary market spreads on recent hybrid issuance have generally been wider than those seen in late 2014, particularly for Tier 1 securities.

Net equity raisings by listed financial corporations increased in the June quarter, driven by a \$5.5 billion capital raising by National Australia Bank (Graph 4.8). The June quarter was the strongest quarter for equity raisings by banks since 2009, with major banks seeking to increase their common equity Tier 1 ratios, partly in anticipation of regulatory

Graph 4.8
Net Equity Raisings
by Listed Financial Corporations



changes (see 'Household Financing' section). ANZ recently announced an equity raising of \$3 billion.

The pace of issuance of Australian asset-backed securities (ABS) slowed over recent months, following robust issuance in the first quarter. Issuance of residential mortgage-backed securities (RMBS) was fairly evenly split between major banks, other banks and non-banks. Two securitisations backed by assets other than residential mortgages have been issued in recent months, raising a total of \$1 billion. Primary issuance spreads on senior RMBS tranches have widened slightly since the start of the year, but have remained fairly stable over the past two years at low levels relative to the period since 2008.

The AOFM announced in May that it would commence divestment of its \$4.6 billion RMBS portfolio. The AOFM, which is selling these securities through monthly auctions, has raised around \$260 million in total in the first two auctions.

Mandatory reporting of details of ABS eligible to be used as collateral in the Reserve Bank's domestic market operations commenced on 30 June 2015. In addition to the information being made available to the RBA, some of the required information will also be made available to permitted users, thereby promoting greater transparency in the market.¹

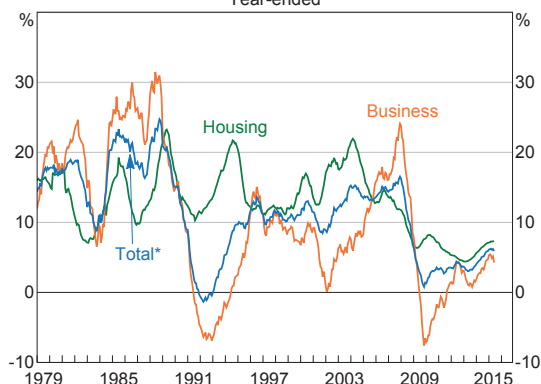
¹ For further details, see www.rba.gov.au/securitisations/system/

Around 400 ABS, mainly RMBS, are currently eligible to be used as collateral in the Bank's domestic market operations.

Financial Aggregates

Total credit growth has been steady at around 6 per cent over the past year (Graph 4.9). Housing credit growth has remained around 7 per cent, while business credit growth has slowed to around 4 per cent. Growth in credit has been a little below that in broad money, which grew by around 7 per cent over the year (Table 4.2).

Graph 4.9
Credit Growth by Sector
Year-ended



* Includes housing, personal and business credit

Sources: ABS; APRA; RBA

Household Financing

Annual growth in housing credit has been around 7 per cent. Some of this growth has been driven by loan products that provide borrowers with access to offset accounts (see 'Box E: Offset Account Balances and Housing Credit'). Since offset account balances have been growing much more rapidly than housing credit, annual growth in net housing debt is about 1 percentage point below growth in housing credit.

Housing credit growth has continued to be driven by investors, with the pace of investor credit growth around double that of owner-occupiers. In addition, investor credit growth has been revised slightly higher, and owner-occupier credit growth revised slightly lower, as a result of data revisions by a bank. The level of total housing loan approvals is consistent with housing credit growth remaining around its recent pace (Graph 4.10). Loans to owner-occupier first home buyers remain a small share of total approvals relative to their historical average.

Standard variable housing rates for owner-occupiers are around 50 basis points lower following the two cash rate reductions earlier this year (Graph 4.11; Table 4.3). The aggregate decline in outstanding rates has been similar. Many lenders have increased interest rates on loans offered to investors relative to owner-occupiers. This has been achieved by raising advertised rates for investors, as well as reducing

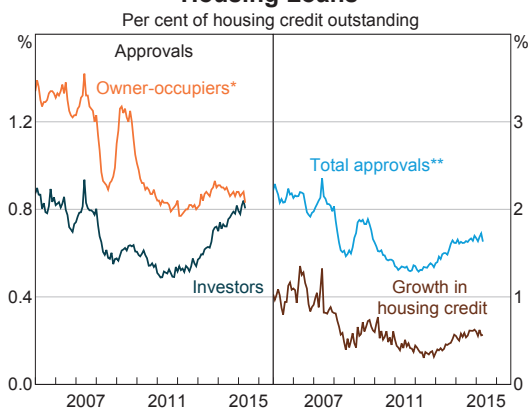
Table 4.2: Financial Aggregates
Percentage change^(a)

	Three-month-ended		Year-ended
	March 2015	June 2015	June 2015
Total credit	1.6	1.2	5.9
– Housing	1.8	1.8	7.3
– Owner-occupier	1.4	1.3	5.5
– Investor	2.5	2.7	10.7
– Personal	0.0	-0.2	0.4
– Business	1.5	0.3	4.3
Broad money	1.8	1.1	6.6

(a) Growth rates are break adjusted and seasonally adjusted

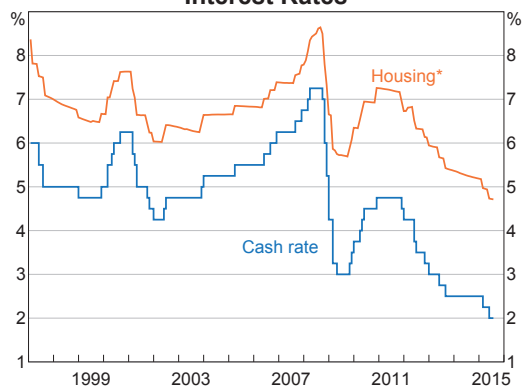
Sources: ABS; APRA; RBA

**Graph 4.10
Housing Loans**



* Net of refinancing
** Excluding refinancing of repeat-buyer owner-occupiers
Sources: ABS; RBA

**Graph 4.11
Interest Rates**



* Estimated outstanding rate
Sources: ABS; APRA; Perpetual; RBA

Table 4.3: Intermediaries' Fixed and Variable Lending Rates

	Level at 4 August 2015 Per cent	Change since end January 2015 Basis points
Housing loans		
– Standard variable rate ^{(a) (d)}		
– Owner-occupier	5.46	–47
– Investor	5.73	–20
– Package variable rate ^{(b) (d)}		
– Owner-occupier	4.67	–41
– Investor	4.94	–14
– Fixed rate ^{(c) (d)}		
– Owner-occupier	4.56	–52
– Investor	5.02	–6
– Average outstanding rate ^(d)	4.71	–46
Personal loans		
– Variable rate ^(e)	11.23	–9
Small business		
– Term loans variable rate ^(f)	6.60	–50
– Overdraft variable rate ^(f)	7.47	–50
– Fixed rate ^{(c), (f)}	5.38	–36
– Average outstanding rate ^(d)	5.69	–50
Large business		
Average outstanding rate ^(d)	3.79	–48

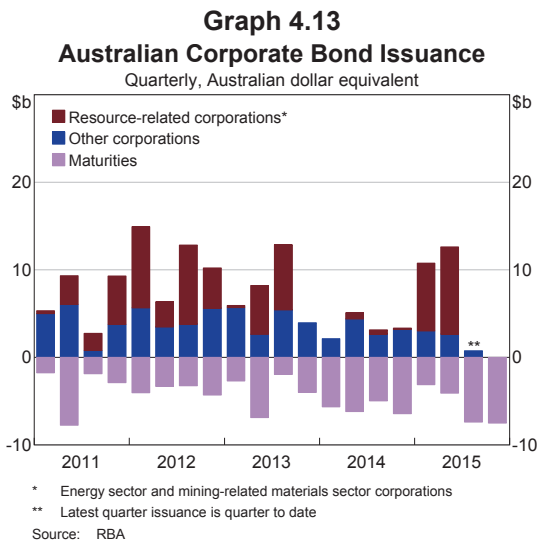
(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on new, \$250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates; housing investor rates include all recently announced changes
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; CANSTAR; RBA

discretionary or advertised discounts that can be offered to some borrowers. Meanwhile, several lenders have introduced special lending offers with lower interest rates for owner-occupiers. Most of the changes will apply from August. A number of banks are reported to have tightened conditions on new loans, particularly to property investors. The tightening of conditions follows APRA's decision to increase supervisory oversight of mortgage lending, and its recently announced decision to increase the risk weights applying to residential mortgages (other than lending to small businesses) for banks using the internal ratings-based (IRB) approach to assessing credit risk.

Business Financing

Growth in external business funding slowed in the June quarter, and was equivalent to around 3 per cent of GDP (Graph 4.12). This reflected a softening in the pace of growth in business credit, while non-intermediated debt issuance continued to be relatively strong.

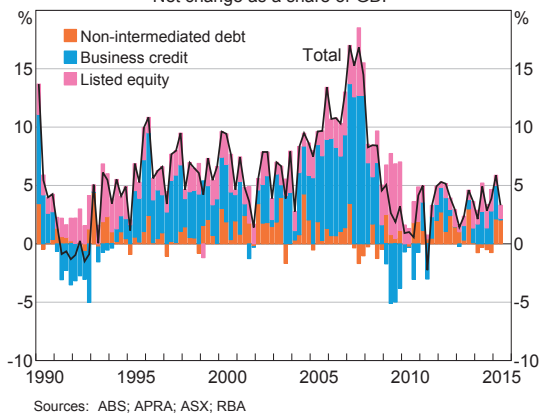
Bond issuance by Australian non-financial corporations has been driven by resource-related corporations (Graph 4.13). Several major transactions were undertaken to refinance existing debt, rather than to fund new investment. Corporate bond yields



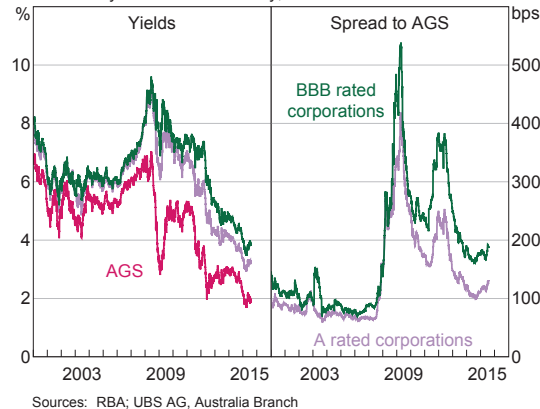
remain at very low levels, while spreads to AGS have tended to widen over the past year (Graph 4.14). This is broadly consistent with movements seen in other advanced markets.

Business credit growth has moderated over the June quarter, following stronger growth in the previous few quarters. Lending to both private non-financial corporations and unincorporated (typically smaller) businesses has slowed. Part of the growth in business credit over the year-to-date reflects the depreciation of the Australian dollar, which increases

Graph 4.12
Business External Funding
Net change as a share of GDP

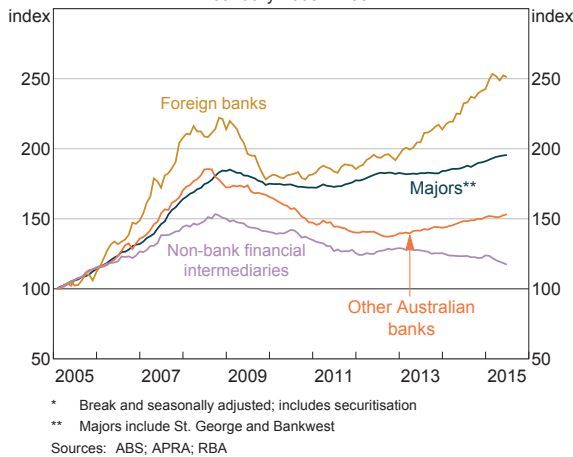


Graph 4.14
Australian Corporate Bond Pricing
1–5 year residual maturity, Australian dollar bonds



the Australian dollar value of foreign-currency denominated business credit. By lender, the major and foreign banks have continued to drive business credit growth, with Asian banks making a notable contribution (Graph 4.15).

Graph 4.15
Business Credit by Source*
January 2005 = 100

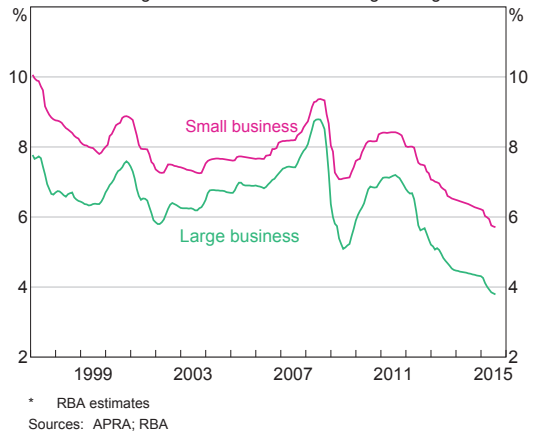


The cost of intermediated business borrowing for both small and large businesses has declined following the two cash rate reductions earlier this year (Graph 4.16). Banks' advertised variable rates on small business loans have fallen by around 50 basis points, fully reflecting the cash rate reductions. Average rates on outstanding small and large business loans have also fallen by around 50 basis points since the end of January.

Listed equity raisings by non-financial corporations moderated over the first half of 2015 from their robust pace in 2014. Initial public offerings (IPOs) picked up in the June quarter, but were below the pace of activity seen in 2014. Net equity raisings by already-listed companies fell slightly in the quarter, as an increase in buyback activity more than offset a slight increase in raisings.

Mergers and acquisitions (M&A) activity declined in the June quarter, but remains well above 2012 levels as measured by the value of deals announced.

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



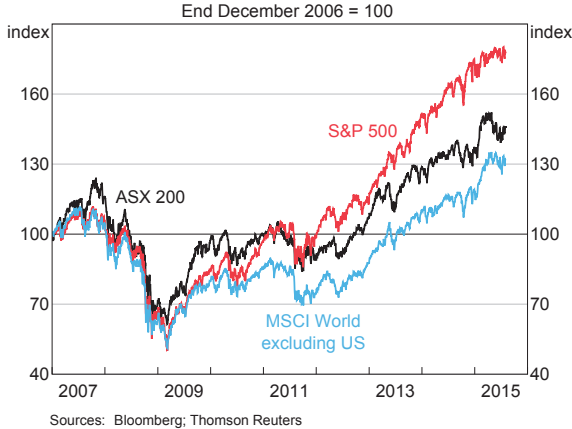
Around \$18 billion in deals have been announced by listed companies in the past few months. Activity has been concentrated in the industrials sector, and includes Brookfield Infrastructure Partners' recently announced \$8.8 billion proposed acquisition of Asciano.

Equity Markets

Australian equity prices have been broadly unchanged over recent months, but are around 5 per cent higher than at the beginning of the year. The Australian market has performed similarly to other advanced equity markets over the more recent period (Graph 4.17). The Australian market continued to be weighed down in recent months by lower resource sector share prices, while share prices rose slightly in the financial sector and most other sectors (Graph 4.18). Volatility in equity prices increased following developments in Greece and the Chinese equity market, though it remains well below the levels experienced in 2008/09.

Within the resource sector, share prices of the larger miners – which have lower costs of production – have tended to outperform those of smaller miners. Energy sector share prices have also declined over the past few months, alongside lower oil

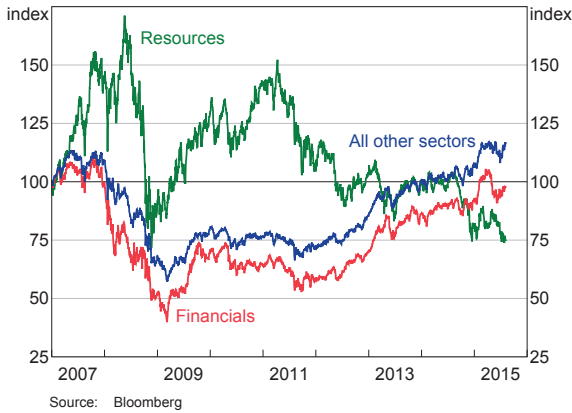
Graph 4.17
Share Price Accumulation Indices



prices. Financial sector equity prices have risen slightly over the past few months. Outside the financial and resource sectors, share prices in other sectors were mixed: consumer sector share prices underperformed after a number of companies issued earnings downgrades, while industrials share prices increased alongside increased M&A activity in the sector.

Forward price-earnings (PE) ratios for Australian equities have decreased in recent months as earnings expectations have risen slightly (Graph 4.19). Similarly to other advanced equity markets, forward PE ratios remain above their historical averages. ↘

Graph 4.18
Australian Share Price Indices



Graph 4.19
Australian Forward Price-earnings Ratios

