

4. Domestic Financial Conditions

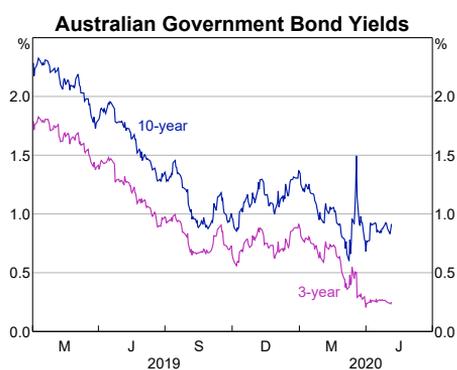
Following the outbreak of COVID-19, financial conditions in Australia – as in other economies – tightened in late February and through March, with a very sharp rise in volatility. There were also periods of dysfunction across a number of financial markets. In response, in March, the Reserve Bank Board lowered the cash rate by a cumulative 50 basis points and implemented a comprehensive package of policy measures to lower funding costs across the economy and support the supply of credit to households and businesses. This helped to ease financial market conditions and improve market functioning, although conditions remain difficult, in corporate wholesale funding markets in particular. The policy measures have reduced Australian banks' funding costs and housing and business interest rates, which have all reached historic lows. Lenders have also taken steps to ease loan payment burdens for households and businesses whose incomes are affected by the COVID-19 disruptions. While finance extended to the household and business sector continued to grow up until March, the demand for funding is expected to decline in response to the economic impacts associated with COVID-19. After a period of sharp declines and extreme volatility, Australian equity prices have increased over recent weeks but remain well below their February peak.

Financial conditions tightened and government bond markets became impaired as COVID-19 spread

With the growing realisation from late February through early March of the pervasiveness of

COVID-19 and the implementation of strong containment measures, the outlook for economic activity worsened dramatically and investors sought to move away from risky assets and into risk-free government bonds. That contributed to a sharp decline in the price of risky assets, including equities, and an increase in the prices of government bonds (i.e. a fall in their yields; Graph 4.1). However, the fall in risky asset prices and sharp increase in volatility led to a range of investors needing to raise cash to reduce leverage and meet margin calls, and many investors chose to sell relatively liquid government bonds to do this. Among those selling were investors with leveraged positions that had been directed at trading the bond futures basis, which involves arbitraging small yield differences between cash bonds and futures, as well as between on- and off-the-run bonds (that is, Australian government bonds that are in the highly liquid futures baskets and those that are not).^[1]

Graph 4.1



Source: RBA

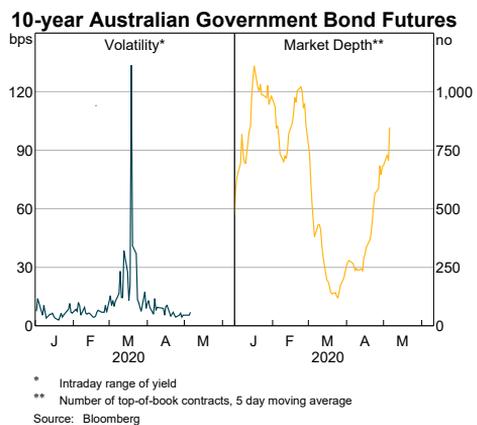
Bond dealers absorbed these sales of government bonds through this period, but their capacity to undertake further bond trades became stretched as their own balance sheets began to run up against internal risk limits. As a result, dealers' ability to undertake further bond trades and assist the process of price discovery deteriorated, contributing to impaired market liquidity and increasing the cost of transacting in these critical markets. The result was a rise in government bond yields, even as the outlook for economic activity and inflation was worsening. These dynamics played out in Australia and around the world, including in US Treasury markets. Given the critical role that risk-free government bond yields play as financial benchmarks, stress in these markets was transmitted to markets for other financial securities and contributed to the tightening in financial conditions. The effect of the stresses in US Treasury markets was particularly widespread, given their role as a benchmark for a broad range of markets globally.

The impairment in government bond markets was evident in a sharp rise in the volatility of yields as well as an associated widening in bid-offer spreads (that is, the difference between the prices offered by market makers to buy and to sell bonds (Graph 4.2; Graph 4.3). Measures of market 'depth' – the volume of bonds that can be bought and sold at the best bid and offer prices – also declined sharply, indicating that it was becoming harder to buy or sell bonds without having a marked effect on their prices. As noted above, the extreme volatility seen in markets had prompted certain leveraged traders to significantly reduce their activity, and these types of traders, in normal circumstances, contribute to the liquidity seen in government bond markets. Accordingly, the bond-futures basis for both 3-year and 10-year AGS increased sharply.

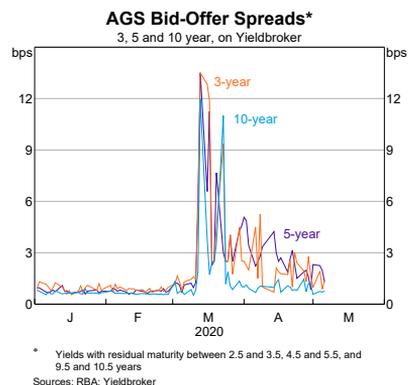
The Reserve Bank is implementing a comprehensive package of policy measures to support the Australian economy

Against this background, over March, the Bank announced a comprehensive package of policy measures to support the Australian economy in the face of the significant disruption to economic activity associated with the COVID-19 outbreak. The package included measures to address the broad-based tightening in financial conditions and significant dislocations in government bond markets. It was aimed at lowering funding costs across the economy and supporting the provision of credit,

Graph 4.2



Graph 4.3



especially to small and medium-sized businesses. The policy package comprised:

- a cumulative 50 basis point cut in the cash rate to 0.25 per cent
- a target for the yield on 3-year Australian Government Securities (AGS) of around 0.25 per cent
- purchases of government bonds in secondary markets to achieve the yield target and address dislocations in government bond markets
- the Term Funding Facility (TFF) for the banking system, under which authorised deposit-taking institutions (ADIs) have access to funding from the Reserve Bank for three years at 25 basis points, with additional funding available if ADIs increase lending to businesses, especially small and medium-sized businesses
- an increase in the amount and maturity of daily reverse repurchase (repo) operations, to support liquidity in the financial system
- exchange settlement (ES) balances at the Reserve Bank to be remunerated at 10 basis points, rather than zero, to mitigate the cost to the banking system associated with the large increase in banks' ES balances resulting from the above measures
- establishment of a swap line with the US Federal Reserve, to provide up to US\$60 billion of US dollar liquidity to market participants in Australia.

The Bank purchased bonds to support the target for the 3-year AGS yield as well as to address market impairment

The Bank commenced government bond purchases in the secondary market on 20 March to support the target for yields on 3-year AGS of around 25 basis points. It also purchased AGS and securities issued by the state and territory central borrowing authorities (known as semi-

government securities or semis) to address the impairment in those markets. These purchases have been conducted via a competitive reverse auction process, where the Bank announces which bonds it intends to purchase and the total amount, and asks market participants to submit offers to sell those bonds over a five-minute window.

To date, the Bank has purchased around \$50 billion of AGS and semis (in face value) (Table 4.1). The purchases have been spread across maturities of 1 to 10 years. Auctions have been well subscribed, with most bonds having been bought at a higher yield (lower price) compared with prevailing mid-market yields (prices) – that is, at a yield a little above the middle of the bid-ask spread – indicating that the Bank's bond purchases have helped to balance the supply and demand in these markets. In particular, the Bank's bond purchases have helped to alleviate the capacity constraints on bond dealers' balance sheets.

3-year AGS yields declined to the target of around 25 basis points

Immediately following the 19 March policy announcement, the yield on 3-year AGS fell from around 60 basis points to 30 basis points (Graph 4.1). Since then it has declined further, supported by the Bank's bond purchases, and has been consistent with the target of around 25 basis points.

Meanwhile, the yield on 10-year AGS has declined over recent months, consistent with the decline in the Reserve Bank's policy rate and the weaker outlook for economic activity and inflation. The sharp but very short-lived spike in the 10-year yield in mid March reflected low levels of liquidity in government bond markets at that time, as discussed above, and only a limited volume of trades occurred at these higher yields. The yields on 10-year AGS are now above those on 10-year US Treasuries for the first time in two years, following the substantial

Table 4.1: RBA Bond Purchases

20 March to 6 May 2020

	Face value \$m
Total AGS	40,250
Remaining maturity ≤ 3 years	12,329
Remaining maturity 3 to 6 years	8,942
Remaining maturity 6 to 10 years	18,979
Total Semis	11,098
Remaining maturity ≤ 6 years	4,598
Remaining maturity 6 to 10 years	6,500

Source: RBA

decline in US Treasury yields over the past couple of months associated with the US Federal Reserve's policy easing (Graph 4.4).

Conditions in government bond markets have improved

In Australia, the Bank's bond purchases have contributed to a significant improvement in market conditions for government bonds. A slight easing in uncertainty, as the rate of spread of COVID-19 slowed, has also played a role. The improvements here have also been observed in other advanced economies.

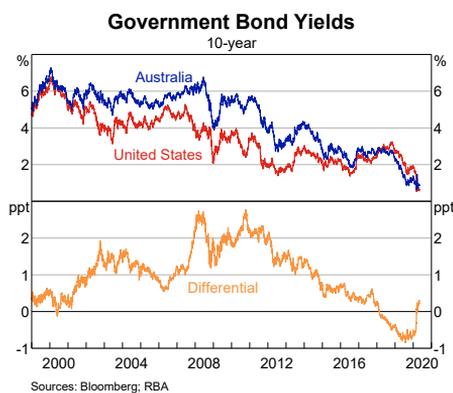
Much, though not all, of the sharp increase in bid-offer spreads on AGS in the first half of

March has been unwound as volatility has declined. The large increase at that time in the bond-futures basis for both 3-year and 10-year AGS has also been largely unwound and market depth has increased from its lows in mid March.

Conditions in the semi-government bond markets have also improved over recent weeks. In particular, bid-offer spreads on semis have declined from their March peaks, although liaison suggests that there is not consistent depth nor breadth of investor interest across maturities (Graph 4.5). Spreads of semis to AGS have also narrowed, to be in line with levels observed over the past few years. Given the decline in AGS yields over recent months, yields on semis are now lower than prior to the outbreak of COVID-19. It should be noted, however, that the Reserve Bank's bond purchases are not directed towards achieving any particular yield or spread for semis.

The Bank has adjusted its bond purchases in response to market conditions

The Bank's initial daily auctions in March entailed purchases of \$4-5 billion worth of bonds. The extent of the Bank's purchases of government bonds has since been scaled back in response to the achievement of the yield target for 3-year AGS and the improvement in market conditions.

Graph 4.4

The frequency of auctions has been reduced to several times a week and the amount purchased at individual auctions has also declined (Graph 4.6). Nevertheless, the Bank is prepared to scale-up these purchases again if necessary to achieve the yield target for 3-year AGS and to ensure that government bond markets remain functional.

The Bank increased the liquidity provided to financial institutions

Another important element of the Bank's package of policy measures was to substantially increase the amount and maturity of its daily market operations, in response to the increased

demand for liquidity in mid March. These operations provide liquidity to financial institutions via repo operations, in which financial institutions bid for cash in exchange for high-quality collateral over terms determined by the Bank. By the beginning of April, \$50 billion of additional liquidity had been provided through repos and the average residual maturity of the Bank's repo book had increased to around 70 days, compared with an average of around one month in recent years. Over April, the size of the Bank's daily market operations declined in response to improved market conditions, reflecting the large amount of liquidity already in the system and reduced demand from the banking system as a whole.^[2] The system cash provided as part of the bond purchases and the commencement of the TFF also supported market conditions.

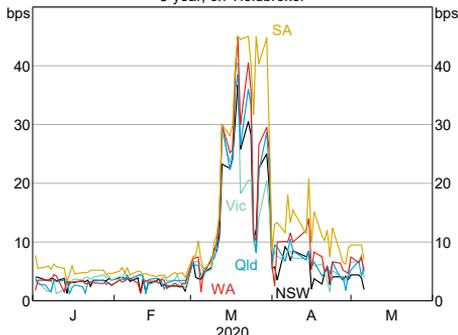
In early May, to assist with the smooth functioning of Australian capital markets the Bank broadened the range of eligible collateral for its daily market operations to include Australian dollar securities issued by non-bank corporations with an investment grade credit rating.

Cash balances in the banking system have increased significantly

The various policy measures announced as part of the March package have contributed to an increase in the Reserve Bank's assets of around \$80 billion since February (Graph 4.7). This change largely reflects (the cash value of) the outright purchases of government bonds, as well as an increase in securities held under repo given the increased provision of liquidity in the daily open market operations.^[3] The initial draws on the TFF have also made a modest contribution. The increase in assets has been accompanied on the liabilities side by a rise in institutions' balances held in Exchange Settlement (ES) accounts. Balances held in ES accounts are currently around \$70 billion higher

Graph 4.5

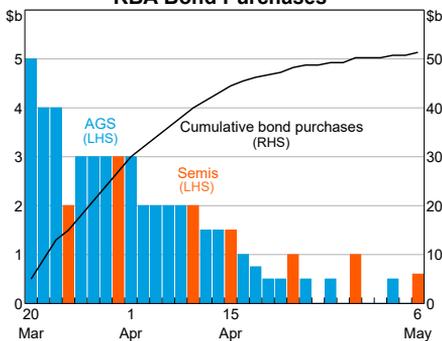
Semi Bid-Offer Spreads*
5-year, on Yieldbroker



* Yields with residual maturity between 4.5 and 5.5 years
Sources: RBA; Yieldbroker

Graph 4.6

RBA Bond Purchases*



* Face value
Sources: RBA; Yieldbroker

than in February, given the usual other flows that affect the Reserve Bank's balance sheet (which include government receipts and payments, including from debt issuance, as well as the sale and return of bank notes and other Reserve Bank transactions).

As a result, the cash rate has declined further and activity in the overnight cash market has declined significantly

In response to the very large rise in cash balances in the banking system, as expected, the cash rate has declined below 25 basis points. It is currently trading at a rate of 14 basis points. This decline has been consistent with the experience of other central banks that have pursued programs that significantly increased cash reserves in the banking system. For many years in Australia, there had been a very strong market convention for overnight cash market transactions to be conducted at the target cash rate.^[4] However, given the very high level of ES balances, with most banks' balances well above holdings sufficient for usual payment activities, market participants have now begun to trade below 25 basis points when lending cash overnight.^[5] In line with ample system liquidity, activity in the overnight cash market has dropped substantially (Graph 4.8). Indeed, very

recently activity dropped on one day below the thresholds required to calculate the published cash rate from actual transactions. In accordance with the published fall-back procedures, the published cash rate on that day was recorded as the last cash rate published based on sufficient transactions (which was from the previous day).^[6]

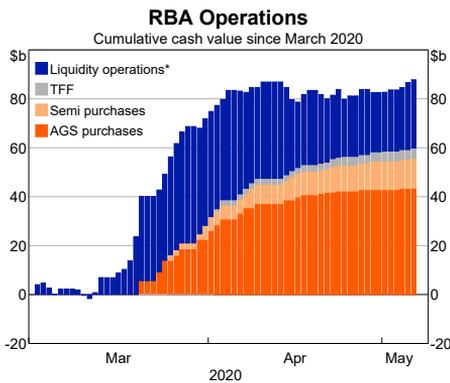
Investors expect the cash rate to remain around its current level for some time

Investors' expectations for the actual cash rate declined below 25 basis points following the Reserve Bank policy announcements on 19 March, consistent with the expected drift lower in the cash rate as described above and the large volume of surplus ES balances in the system (Graph 4.9). Financial market prices covering the year ahead imply that participants expect the cash rate to remain little changed from current levels.

Spreads of money market rates are low

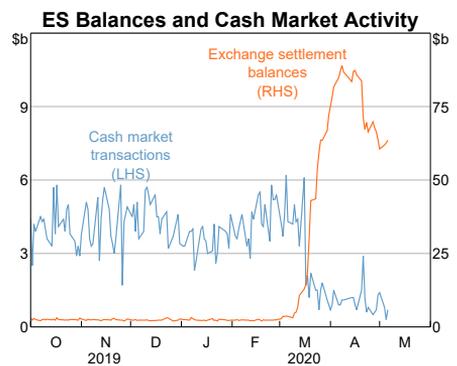
The spread of 3-month bank bill swap rates (BBSW) to overnight indexed swap rates (OIS) increased noticeably in early March, although not to the levels reached in 2018-19 and it remained well below the levels reached during the global financial crisis. This rise in spreads occurred as liquidity conditions deteriorated in

Graph 4.7



* Liquidity injections net of drains and maturities; mainly contracted in OMOs and FX swaps
Source: RBA

Graph 4.8



Source: RBA

the face of escalating concerns about the economic effects of the COVID-19 outbreak (Graph 4.10). Spreads then declined in the weeks following the Board’s policy announcement on 19 March. Traded volumes in the BBSW market remained around recent levels throughout this period, although redemptions increased as a share of activity, as investor demand for liquidity increased. Nevertheless, banks have sustained issuance throughout this period as a whole, and the amount of bank bills outstanding is around its level of recent years (Graph 4.11). Ample alternative sources of liquidity for the large banks resulting from the Bank’s policy measures, as well as renewed investor demand for liquid bank bills as market functioning has improved and uncertainty eased, has helped to place downward pressure on the BBSW rate in recent weeks. 3-month BBSW has been trading around the level of 3-month OIS rates for the first time in almost a decade.

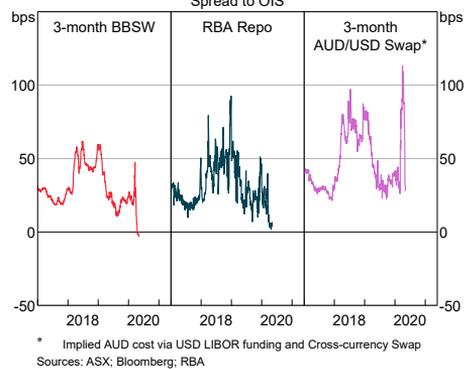
Repo rates at the Bank’s daily open market operations also increased relative to OIS in early March, before declining noticeably following the substantial increase in liquidity provided through these operations. Repo rates are currently a few basis points above OIS. Rates for obtaining Australian dollars in the foreign exchange swap market had risen sharply in early March, but this increase has since unwound.

Australian banks have not needed to access US dollar markets to raise funds, due to sizeable issuance around the start of the year. Also, they have access to other, more attractively priced sources of funding, including the TFF.

The TFF is easing pressure on funding costs for ADIs and reducing the need for banks to issue bonds

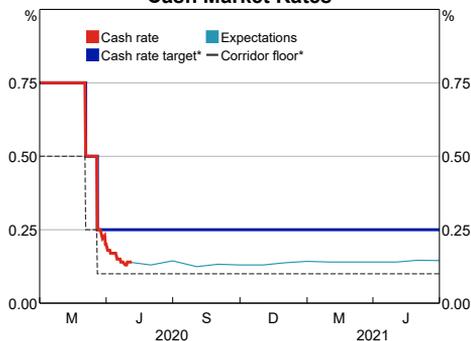
ADIs have access to three-year funding through the Reserve Bank’s TFF at a fixed rate of 25 basis points. This is substantially lower than ADIs’ marginal cost of funding around that same maturity. For example, for the major banks the estimated cost of sourcing three-year unsecured

Graph 4.10
Australian Dollar Money Market Spreads
Spread to OIS



Graph 4.9

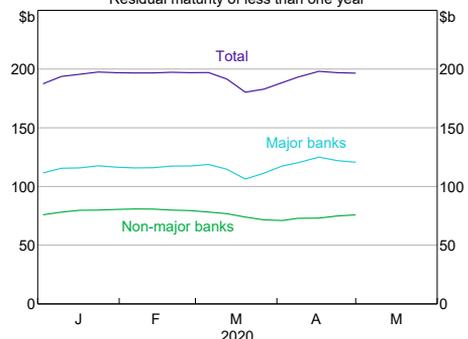
Cash Market Rates



Graph 4.11

Outstanding Stock of Bank Bills*

Residual maturity of less than one year



funding in domestic wholesale debt markets is currently around 1 per cent.

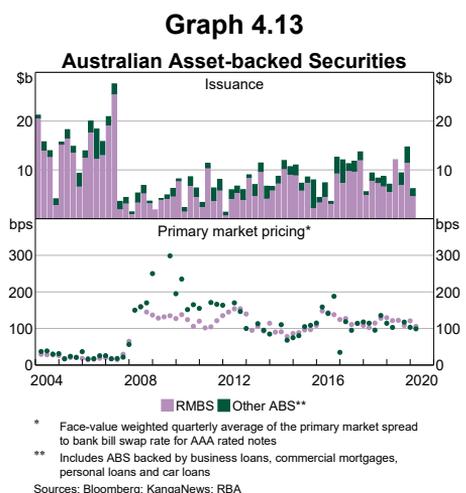
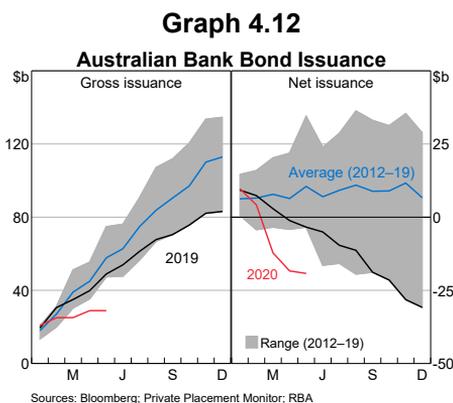
For the banking system as a whole, the initial TFF allocation is sufficient to replace almost all of ADIs' maturing bond funding over the next six months. So far, ADIs have only drawn down around \$4 billion, representing 3½ per cent of their aggregate TFF allowances. The size of the facility has increased from \$90 billion at its inception to \$115 billion in May. This reflects growth of ADIs' lending to business, which increases their allowances under the facility.

While some ADIs are expected to increasingly draw upon their TFF allowances as existing funding matures, term funding needs more generally have been low. Indeed, Australian banks have issued just \$8.3 billion of bonds since the end of January, well below issuance over the past few years (Graph 4.12). Local branches of non-resident banks have accounted for more than half of this issuance. Issuance by the major banks in the domestic market was particularly low, with \$0.5 billion issued. This is likely to have reflected several factors. As discussed, the TFF has reduced the need for banks to access funding markets. Moreover, strong liquidity positions, helped by strong deposit inflows, and slow balance sheet growth mean that the major banks do not need to issue bonds for some time.

Asset-backed securities markets have been supported by investment from the Government

Issuance of asset-backed securities (ABS) was robust at \$1.5 billion in February (Graph 4.13). Since the end of February, however, only one deal has been issued. A number of other residential mortgage-backed securities (RMBS) deals scheduled to be issued in March did not proceed.

On 19 March, the Government announced that the Australian Office of Financial Management (AOFM) will invest up to \$15 billion in the warehousing and securitisation market, with the aim of reducing funding costs for small ADIs as well as non-ADIs, who cannot access support through the TFF. The AOFM invested in its first deal in late March and expressed support for upcoming deals with a particular focus on mezzanine tranches. In addition, the AOFM noted that unfavourable market conditions have resulted in distorted pricing in the secondary market for ABS. As a result, it will also purchase existing securities from investors who commit to supporting activity in the primary market.



Australian bond markets have been accessed by Kangaroo bond issuers

High-quality non-resident issuers continued to access Australia's debt markets throughout recent months. Since the end of January, \$6.5 billion in Kangaroo bonds have been issued in Australia, which is only slightly below the average quarterly issuance over the past decade. Kangaroo bonds are issued in the Australian market by non-resident entities and are denominated in Australian dollars. Approximately half of the issuance was AAA-rated covered bonds issued by Canadian banks, which priced at spreads much wider than other covered bonds issued in the Kangaroo market over recent years (Graph 4.14).

Banks' overall funding costs have declined to historically low levels ...

Banks' (non-equity) funding costs are estimated to have declined to historically low levels despite the financial market turbulence since February. Much of the major banks' wholesale debt and deposit costs are ultimately linked (either directly or via hedging) to BBSW rates, which have declined by around 65-70 basis points since the end of February.

Banks have passed through a large share of the recent reductions in the cash rate to retail

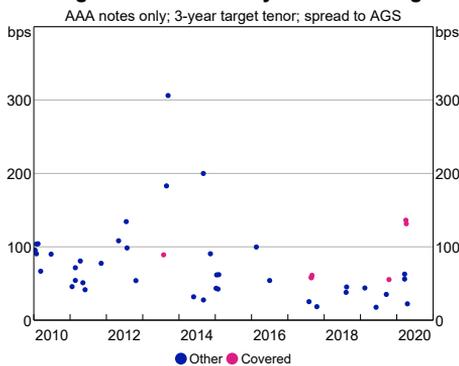
deposit rates (Graph 4.15). Since May 2019, the major banks are estimated to have lowered the interest rates on at-call retail deposits by an average of 85 to 100 basis points. Several lenders, including the major banks, announced a rise in rates on selected term deposits following the second reduction in the cash rate in March. Notwithstanding this, rates on most new term deposits have fallen substantially over the past year, by around 100 basis points on average. The interest rates on many transaction accounts, which are usually close to zero, have been little changed.

... even though secondary market spreads on bank bonds have widened

Bank bond spreads in secondary markets increased substantially from late February as concerns about the COVID-19 outbreak escalated (Graph 4.16). Spreads declined after the announcement of the various policy responses to the shock in mid March. While spreads remain wider than levels seen in recent years, yields remain low, aided by the decline in yields on 3-year AGS to around 25 basis points. Even so, yields in secondary long-term bond markets do not directly affect bank funding costs because the cost to the banks of a bond is determined at issuance in the primary market.

Graph 4.14

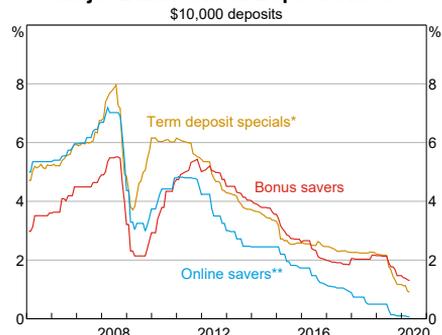
Kangaroo Bond Primary Market Pricing*



* Excludes spreads that are negative and issuance under \$100 million
Sources: Bloomberg; RBA

Graph 4.15

Major Banks' Retail Deposit Rates



* Average of selected terms
** Excludes temporary bonus rates
Sources: Major banks' websites; RBA

Most banks have ample liquidity, including through the Reserve Bank's policy measures, and so they do not need to access bond markets again for a time.

Banks have lowered interest rates for business loans considerably ...

Banks have lowered interest rates on small business loans by up to 100 basis points since early March (Graph 4.17). Around 20 basis points of this was announced after the 25 basis point reduction in the cash rate target on 4 March, and a further 80 basis points reduction followed the announcement of the comprehensive package of policy measures on 19 March, including a further 25 basis point cut to the cash rate target. Major banks also lowered interest rates on unsecured loans to small and medium-sized businesses by up to 650 basis points following the government's announcement of the SME Loan Guarantee Scheme (see below). More generally, interest rates on business loans have declined further to be at historically low levels.

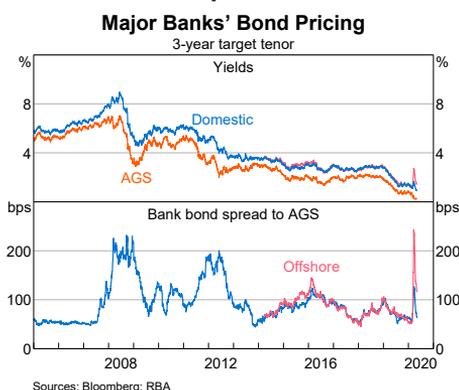
... and several initiatives have been announced to support lending to business, especially small and medium enterprises

The Reserve Bank, Government, and commercial banks have announced various complementary

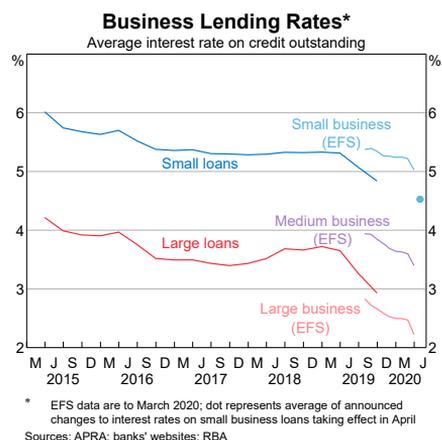
initiatives aimed at supporting lending to businesses, especially small and medium enterprises (SMEs), in the period ahead:

- ADIs will be able to access at least \$90 billion of funding at a fixed rate of 0.25 per cent for three years through the TFF. Additional funding will be available from the Reserve Bank equal to the amount of any net increase in an ADI's lending to large businesses and five times the amount of any increase in their lending to SMEs.
- The Government announced a complementary \$40 billion SME Loan Guarantee Scheme, which provides lenders a 50 per cent guarantee on new unsecured loans of up to \$250,000 to SMEs that use the funds for working capital.
- The Australian Banking Association announced that small business customers that experience financial hardship due to COVID-19 can request a deferral of payments on their loans for up to six months. Individual banks have also announced additional measures to support small business customers, such as deferrals on credit card payments and temporary increases in overdraft facilities.

Graph 4.16



Graph 4.17



Business credit growth increased sharply in March

Lending to businesses increased sharply in March (Graph 4.18). This follows an increase in commitments for new loans in the few months prior to the COVID-19 outbreak and is consistent with businesses drawing on existing credit lines in late March. The application by many businesses to defer loan repayments, the implementation of the Reserve Bank's TFF and the Government's previously announced initiatives, will provide some support to business credit in the coming months. However, businesses that are under significant pressure from the impacts of COVID-19 are likely to be reluctant to take on new loans for some time.

Credit limits available under revolving credit facilities increased in March and the portion of these limits that has been drawn down also increased (Graph 4.19). There may be further increases in credit limits available through revolving credit facilities as businesses arrange such facilities with their lenders. Indeed, a number of ASX-listed companies announced the arrangement of such facilities.

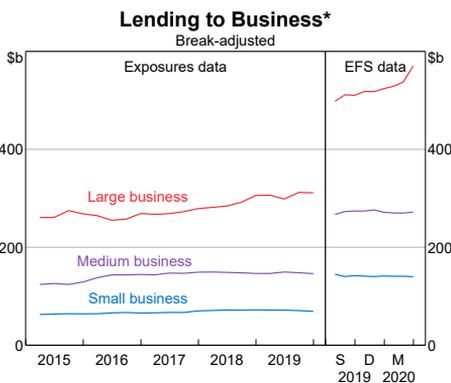
Reports from banks suggest that approximately 20 per cent of SME borrowers have requested, or have automatically been given, deferrals on their

loan payments for up to six months. Many have also been provided with an option to extend the maturity of their loans. The bulk of these deferrals started in April. All else equal, this would boost growth in business credit over the next six months by about 4 per cent on a six-month-ended annualised basis. Loans extended under the Government's \$40 billion SME loan guarantee scheme will also have a six month payment deferral period.

To date, 42 lenders have signed up to the Government's SME loan guarantee scheme, which was announced in late March. The extent to which this scheme supports credit will likely become evident from the April data (available in May); the first release of APRA's new data collection for the SME loan guarantee scheme, which captured lending up to 17 April, suggested that there was a modest take-up to date.

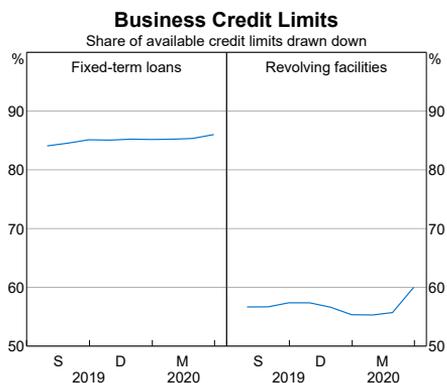
The strong growth in business lending in March contributed to an increase in growth in the broader measure of business debt (Graph 4.20). The volume of syndicated lending remained around recent levels in March. Non-intermediated debt fell in March, reflecting the fact that Australian non-financial businesses have issued few bonds since February.

Graph 4.18



* Exposures data capture credit exposures on the balance sheets of banks allowed by APRA to use an internal ratings-based approach for credit risk management; EFS data are based on reporting of banks and finance companies that have \$2 billion or more of business credit
Sources: APRA; RBA

Graph 4.19



Sources: APRA; RBA

Some non-financial corporations have been able to access offshore funding markets

There has been impairment in secondary markets for non-financial corporate bonds as the COVID-19 outbreak has escalated. Bid-ask spreads have widened and trading has been difficult. These difficulties began around the same time as they arose in other fixed-income markets. However, conditions in Australian non-financial corporate bond markets have been slower to recover than in markets for government bonds and bonds issued by financial institutions, as is generally the case. Nevertheless, a few Australian companies have accessed offshore markets of late (Graph 4.21). In April, \$3.5 billion of bonds were issued in offshore markets by several large and well-rated corporations across a range of industries.

Lenders have lowered housing interest rates ...

A large share of the 125 basis points of monetary policy easing since May 2019 has flowed through to the mortgage interest rates paid by households (Graph 4.22; Table 4.2). Standard variable rates (SVRs) have declined by around 90 basis points since May 2019. Interest rates on outstanding variable-rate housing loans have declined by around 100 basis points over that

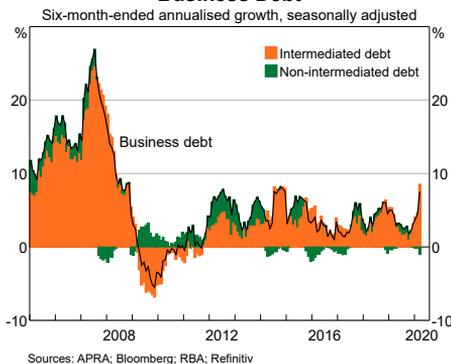
period, reflecting the decline in SVRs, as well as the downward drift due to ongoing competition for new high-quality borrowers and households continuing to switch from interest-only to lower-rate principal-and-interest loans.

Most lenders reduced standard variable rates (SVRs) on housing loans by 25 basis points following the 25 basis point reduction in the cash rate in early March. Only a few lenders decreased SVRs following the second 25 basis point cash rate reduction in mid March. Some lenders have also increased interest rates for new loans with high loan-to-valuation ratios and are scrutinising the loan serviceability of borrowers whose employment prospects have been adversely affected by COVID-19. In response to more difficult funding conditions, some non-ADI lenders have announced higher interest rates for new loans.

Rates for new fixed-rate housing loans have declined to historically low levels (Graph 4.23). A number of banks, including the major banks, announced substantial reductions in interest rates for new fixed-rate loans following the announcement of the Bank's comprehensive package of policy measures in mid March. Over the past year, the major banks have reduced their advertised 3-year fixed lending rates for owner-occupiers by around 150 basis points. The reduction in fixed interest rates is consistent

Graph 4.20

Business Debt



Graph 4.21

Australian Corporate Bond Issuance

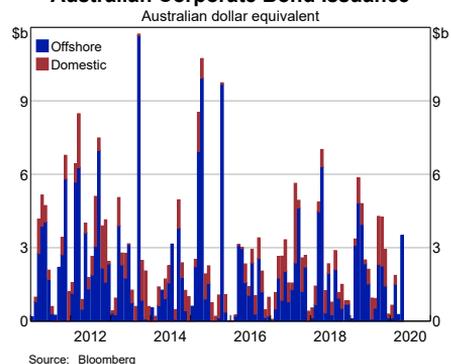


Table 4.2: Average Outstanding Housing Rates

March 2020

	Interest rate Per cent	Change since May 2019 Basis points
Variable rate loans		
– Owner-occupier	3.31	–93
– Investor	3.69	–112
All variable-rate loans	3.45	–100
Fixed-rate loans		
– Owner-occupier	3.68	–
– Investor	3.98	–
By repayment type ^(a)		
– Principal-and-interest	3.40	–86
– Interest-only	4.02	–83

(a) Weighted average across fixed- and variable-rate loans.

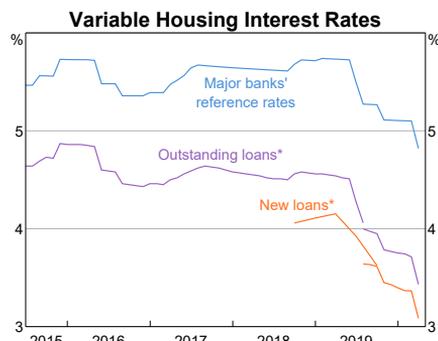
Sources: APRA; RBA; Securitisation System

with the decline in fixed interest rates derived from interest rate swaps (the benchmark for pricing fixed-rate loans) and, more recently, the low-cost term funding available via the TFF. Accordingly, the differential between interest rates on new variable-rate loans and fixed-rate loans has widened; on average, new 3-year fixed rates are now around 20-30 basis points below new variable rates.

... and eased loan payment burdens for borrowers

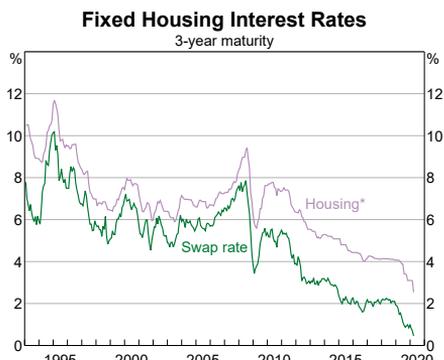
Lenders have announced that customers can defer housing loan payments by up to six months in an effort to support borrowers' cash flows. Two major banks have also announced that customers' scheduled loan payments will be reduced to the minimum required amount; customers of those banks that want to maintain their scheduled loan payments will need to contact their bank to arrange this.

Graph 4.22



* Series break in July 2019; thereafter, data based on EFS collection
Sources: APRA; banks' websites; CANSTAR; RBA; Securitisation System

Graph 4.23



* Available to owner-occupiers
Sources: Banks' websites; Bloomberg; CANSTAR; RBA

In March, housing loan payments remained around the levels of recent months (Graph 4.24). The recently announced reductions in housing loan interest rates are likely to have flowed through to borrowers in April. Major banks have reported that around 9 per cent of borrowers have applied to defer their loan payments for up to six months, with effect from April. By itself, this would tend to push up housing credit growth by around ½ percentage point in year-ended terms over the next six months. Bank liaison indicates that some households have been accessing funds in available redraw or offset accounts to help support their cash flows. This will also reduce total loan repayments and contribute to stronger credit growth.^[7] At the same time, and working in the other direction, bank liaison suggests that at this stage, on balance, borrowers have been making additional payments. They may be doing this for precautionary reasons or merely because their other opportunities for spending have been curtailed.

Demand for mortgages is expected to decline

Housing loan commitments (excluding refinancing) have been little changed in recent months, but remain above the May 2019 trough

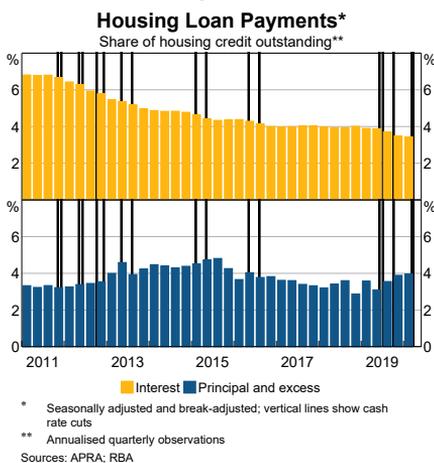
(Graph 4.25). More timely indicators of housing market activity, including auction clearance rates and housing turnover, suggest that commitments will decline in coming months. This would also be consistent with the sharp decline in economic activity and incomes.

Notwithstanding the recent decline in commitments, borrowers appear to be taking advantage of the very low level of housing interest rates. Housing loan commitments for refinancing have increased sharply since mid 2019. This largely reflects refinancing by owner-occupiers, though refinancing by investors has also risen over this period.

Total credit growth increased in March, but is likely to decline in the period ahead

Total credit growth jumped to 5¼ per cent on a six-month-ended annualised basis in March, up from 3½ per cent in February (Graph 4.26; Table 4.3). The increase was driven by the strong growth in lending to businesses, which increased by 10¾ per cent on a six-month-ended annualised basis, up from 5½ per cent in the month prior. The sharp increase in broad money indicates that businesses increased their holdings of deposits at the same time. Growth in housing credit extended to owner-occupiers has remained steady at around 5½ per cent on a six-

Graph 4.24



Graph 4.25

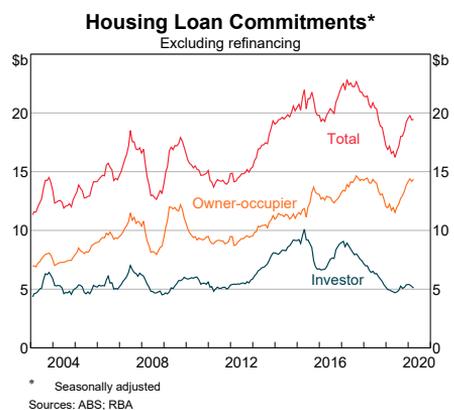


Table 4.3: Financial AggregatesPercentage change^(a)

	Three-month annualised		Six-month annualised	
	Dec 2019	Mar 2020	Sep 2019	Mar 2020
Total credit	2.8	7.7	2.0	5.2
– Household	2.8	2.3	2.1	2.6
– Housing	3.6	3.6	2.7	3.6
– Owner-occupier	5.7	5.6	4.7	5.7
– Investor	–0.1	0.0	–0.6	–0.1
– Personal	–6.2	–9.5	–5.1	–7.9
– Business	2.7	19.3	2.1	10.7
Broad money	4.7	14.7	3.1	9.6

(a) Seasonally-adjusted and break-adjusted

Sources: ABS; APRA; RBA

month-ended annualised basis in recent months, up from 4½ per cent in mid 2019. The stock of investor housing credit was little changed, after declining for much of 2019. Personal credit declined by 8 per cent on a six-month-ended annualised basis in March. This was a faster rate of decline from that seen in recent years and is consistent with the decline in economic activity after measures were introduced to contain the virus.

In the coming months, the sharp decline in economic activity and difficulties facing many businesses and households in sectors most affected by measures to contain COVID-19 are likely to dampen the overall demand for credit.

Australian equity prices declined sharply and have been extremely volatile

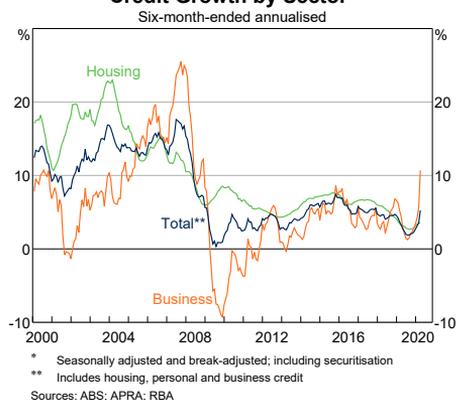
The ASX 200 is around 25 per cent below its mid February peak as a result of the COVID-19 shock. Australian share prices fell very sharply from mid February, as the COVID-19 pandemic escalated, before recovering somewhat since late March (Graph 4.27). Australian equity prices have moved broadly in line with those overseas. Average absolute daily market volatility in March surpassed the levels seen during the Global

Financial Crisis (Graph 4.28). It has since declined but remains elevated.

Financial companies underperformed the broader market, including because of guidance from the Australian Prudential Regulation Authority (APRA) that banks' and insurers' dividend policies should be consistent with their financial situation (Graph 4.29). Prices in the resources sector have declined by around 20 per cent, following a drop in global oil prices and weakening demand. Prices in the 'other' sector are also around 20 per cent below their level in mid February. Equity prices of firms in

Graph 4.26

Credit Growth by Sector*



the industrials and consumer discretionary industries continued to weigh on the 'other' sector as social distancing rules have led to businesses temporarily or permanently closing down (Graph 4.30). Government regulations specifying that property owners should also share the impact of COVID-19 with their tenants has added to further falls in the real estate sector.

Listed companies' earnings increased over the year to the December-half, although uncertainty about the future is high

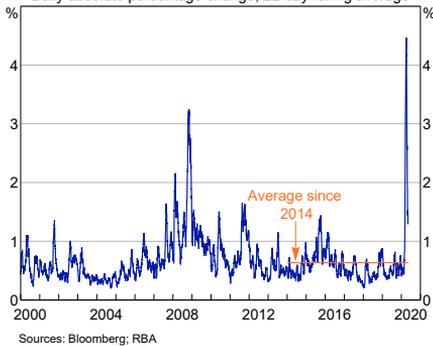
Profits for the December-half were generally higher than a year ago, driven by profits from the resources and the 'other' sector (Graph 4.31).

Uncertainty about the effects of the COVID-19 outbreak was commonly cited as a reason for lower expected earnings for the remainder of 2019/20 in half-year results and trading updates. More recently, many firms have chosen to withdraw their guidance on earnings and have cancelled or postponed interim and future dividends in response to the COVID-19 crisis. Many have also taken out additional bank facilities, and some have completed capital raisings, at significant discounts to their current price. Analysts have

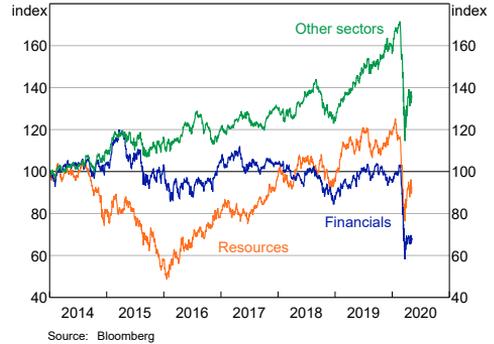
Graph 4.27
Total Return Indices
End December 2014 = 100



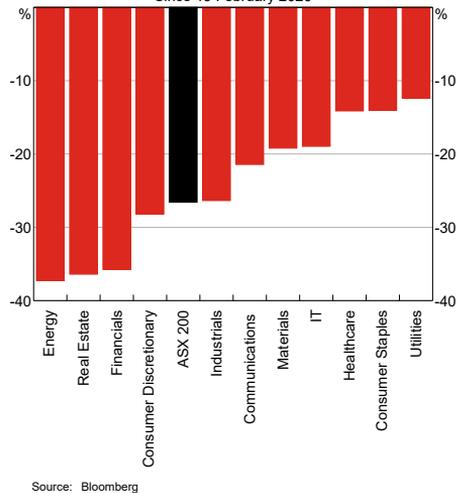
Graph 4.28
Australian Share Market Volatility
Daily absolute percentage change, 22-day rolling average



Graph 4.29
Australian Share Prices
End December 2013 = 100



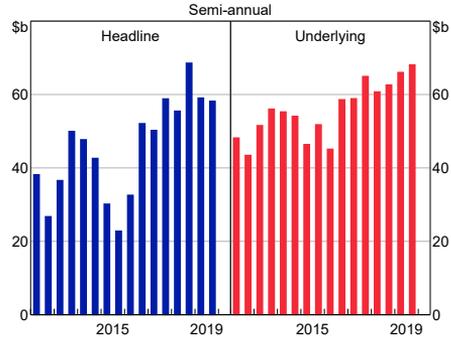
Graph 4.30
Change in Equity Prices by Sector
Since 19 February 2020



downgraded future earnings expectations across resources and non-resources sectors. ✖

Graph 4.31

ASX 200 Profits*



* Results for companies with reporting dates in the half are rolled forward
Sources: Bloomberg; Company reports; Morningstar; RBA

Endnotes

- [1] The bond futures basis measures the difference between the yield on a bond futures contract and the current yield on the bonds underlying the contract, plus the cost of financing the bonds via repo until the futures expiry. In a well-functioning market, arbitrage between these two activities should largely eliminate this basis.
- [2] Liquidity operations also declined in the second half of April as no new Australian dollar-denominated foreign exchange swaps were contracted and existing positions expired. This was consistent with the substantial rise in liquidity through other parts of the program.
- [3] The cash value of a bond (that is, the price paid) will be greater than the face value of the bond when the bond's coupon rate is above the bond's yield.
- [4] This was supported by the Reserve Bank conducting open market operations to achieve a level of ES balances it assessed that financial institutions would need to meet their end-of-day settlement requirements. It was also supported by the Reserve Bank's corridor system for the cash rate: the Reserve Bank stands ready to lend cash overnight to financial institutions at an interest rate that is 25 basis points above the target cash rate and to pay interest on ES balances held with the Reserve Bank overnight at a rate that was 25 basis points below the target cash rate. Now the rate paid on balances held overnight is 15 basis points below the target cash rate.
- [5] The 10 basis points of interest paid by the Reserve Bank on surplus ES balances provides a lower bound for the cash rate given that banks have no incentive to lend cash overnight on an unsecured basis at a rate below this.
- [6] See <https://www.rba.gov.au/mkt-operations/resources/cash-rate-methodology/expert-judgement.html> Available at <<https://www.rba.gov.au/mkt-operations/resources/cash-rate-methodology/expert-judgement.html>>.
- [7] Around 60 per cent of customers have less than six months of funds available in redraw or offset accounts to meet future scheduled payments.

