

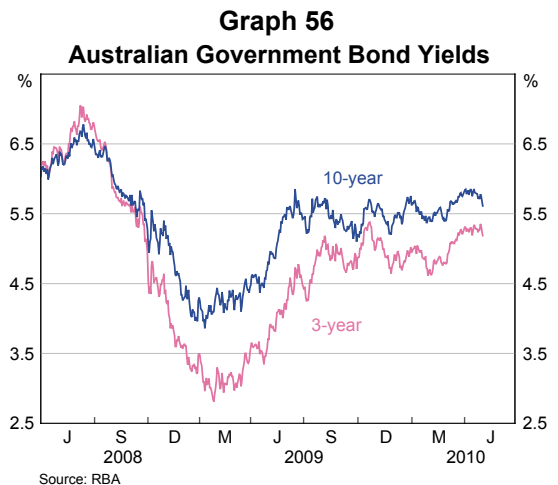
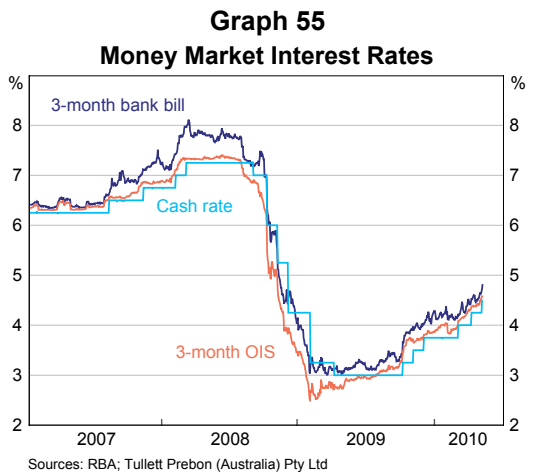
Domestic Financial Markets

Money Markets and Bond Yields

Over the past three months, the Reserve Bank Board has increased its target for the cash rate to 4.50 per cent. Money market yields indicate that the target is expected to rise to about 5 per cent by year-end. Bank bill rates have risen with the cash rate but have continued to be somewhat volatile (Graph 55). On average, bank bill spreads to overnight indexed swaps (OIS) have narrowed to pre-crisis levels for short maturities and are around their lowest since the onset of the crisis for longer maturities. Through its market operations, the Bank has kept exchange settlement (ES) balances around \$1½ billion, although it accommodated somewhat higher ES balances over the quarter-end.

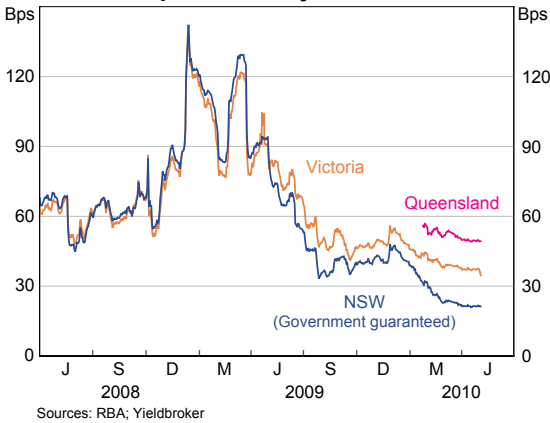
The yield on 10-year Commonwealth Government Securities (CGS) has increased by about 20 basis points since the February *Statement* to around 5.60 per cent, largely reflecting the strength of recent economic data. This has seen the spread to US Treasuries widen by a similar amount to reach 200 basis points. Yields on shorter-dated CGS have increased by a greater amount, as they are generally more responsive to changes in cash rate expectations. As a consequence, the yield curve has flattened with the spread between 10- and 3-year bonds declining by 30 basis points over the period (Graph 56). The issuance by the Australian Government continues to be met by strong investor demand, with bid-to-cover ratios averaging well above 3.

In February, the Australian Government announced that it would no longer offer a guarantee on new State and Territory borrowings after 2010. Both

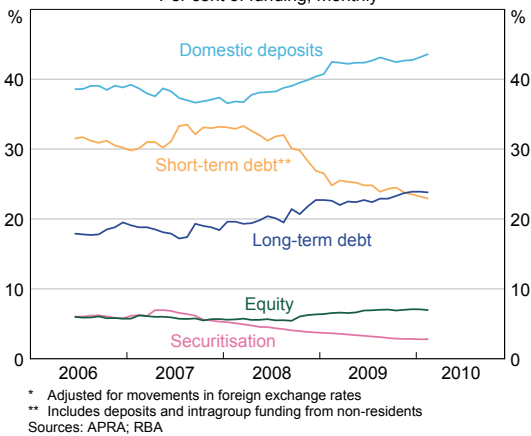


NSW and Queensland – the two states to make use of the guarantee – have since issued several new unguaranteed securities of significant size, cheaper than if they had used the guarantee. NSW has also offered investors the capacity to switch from

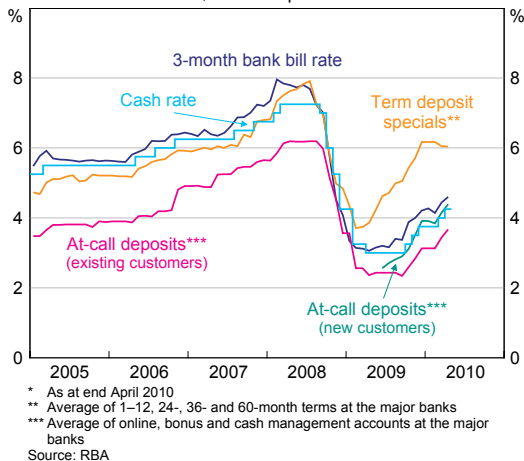
Graph 57
Spreads to 5-year CGS



Graph 58
Funding Composition of Banks in Australia*
Per cent of funding, monthly



Graph 59
Deposit Rates*
\$10 000 deposits



some existing guaranteed debt into unguaranteed securities; the latter trades about 15 basis points higher in yield than the former (Graph 57). For Queensland, which has a lower credit rating, the spread between guaranteed and unguaranteed debt is about 20 basis points.

Financial Intermediaries

There has been a small change in the composition of banks' funding in the March quarter, with an increase in the share of funding sourced from deposits (Graph 58). There has been little change in the share of funding that comes from long-term capital market debt and domestic equity, while banks' use of short-term capital market debt continued to contract.

The intense competition for deposits has eased somewhat, though pressures for retaining deposit funding at a high level remain strong. The average interest rate on the major banks' existing at-call deposits (including online savings, bonus saver and cash management accounts) has risen broadly in line with the cash rate (Graph 59). Rates on new at-call deposits have also risen in line with the cash rate.

The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has declined slightly since end January. Nevertheless, it is still about 230 basis points higher than its level in early 2009, and around 80 basis points above market rates of equivalent duration. The major banks continue to offer higher interest rates on 'special' term deposits than on wholesale funds of equivalent maturity (both for short and long maturities). The smaller Australian banks' 'special' term deposit rates have increased by an average of 5 basis points since end January, to be slightly above the major banks' average rates.

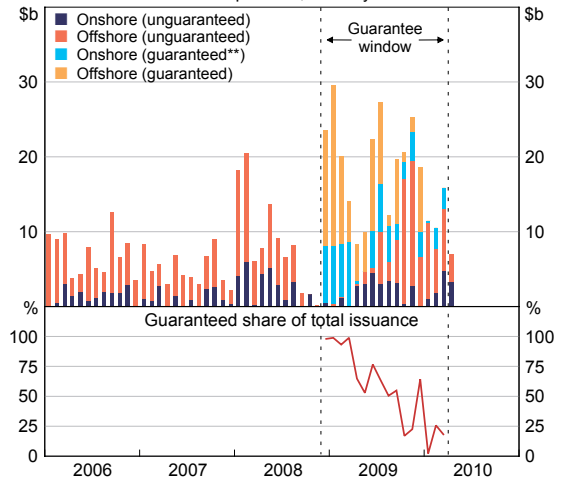
Australian bank bond issuance proceeded at a more moderate pace over recent months after the large amount of issuance observed last year (Graph 60). Since the previous *Statement*, Australian banks issued

a total of \$40 billion of bonds and continued to access a wide range of markets and currencies. Just over half of the issuance has been offshore and Australian banks have continued to lengthen the maturity of their liabilities by issuing longer-dated bonds. The average tenor of bonds issued recently is 4.4 years, up from 3.6 years a year ago.

In early February, the Australian Government announced that the Government Guarantee Scheme would close to new issuance on 31 March. In the months prior to the closure of the Scheme, the guarantee was only used by non-major financial institutions. Since the inception of the Scheme in October 2008, a total of \$171 billion was raised through the issuance of guaranteed bonds with a term of one year or more. About two-thirds of this total was issued in foreign currency, mainly US dollars, but also in eight other denominations. The maturity profile of Australian banks' guaranteed bonds is concentrated in 2012 and 2014 (reflecting sizeable issuance of 3- and 5-year guaranteed debt in 2009). Maturities in 2010 amount to around \$10 billion, \$730 million of which has already matured (Graph 61).

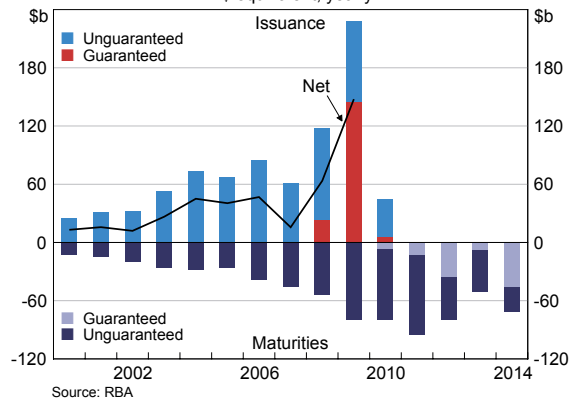
Over the last few months, secondary market spreads on guaranteed and unguaranteed bonds issued domestically by the major banks have narrowed and are around the lowest level since October 2007. The cross-currency basis swap spread – which represents an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – declined substantially over the last few months to around the levels of mid 2009, though it remains elevated compared with pre-crisis levels (Graph 62). The elevated cross-currency basis swap provides an incentive to non-resident issuers who borrow in Australian dollars and hedge into foreign currencies, including Kangaroo bonds which are issued in the Australian market. Over recent months, Kangaroo issuance has been very strong with the total amount outstanding reaching a record level

Graph 60
Australian Banks' Bond Issuance*
A\$ equivalent, monthly

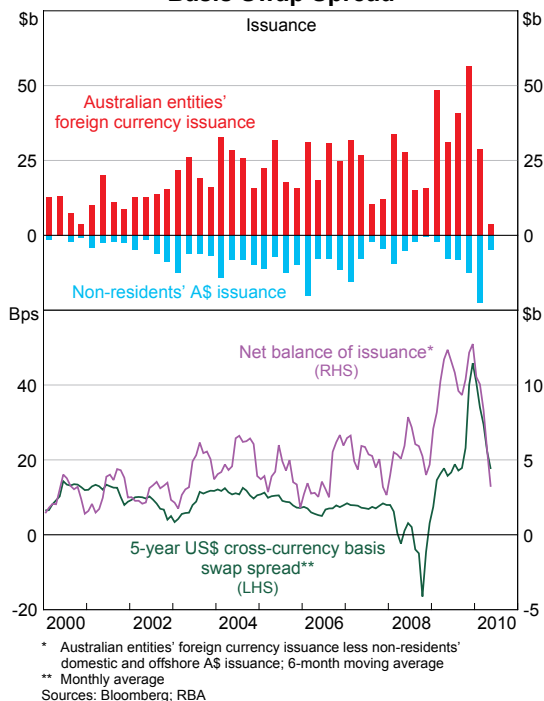


* Includes 12–15 month paper, considered as 'short-term' under the Australian Government Guarantee Scheme
** Includes A\$3.25 billion of issuance guaranteed by the UK government
Source: RBA

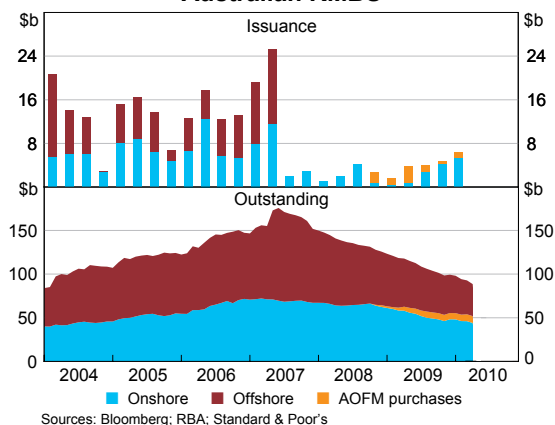
Graph 61
Australian Banks' Bonds
A\$ equivalent, yearly



Graph 62
Bond Issuance and the Cross-currency
Basis Swap Spread



Graph 63
Australian RMBS



of \$125 billion. At the same time, foreign currency issuance that Australian resident issuers hedge into Australian dollars has slowed, broadly reflecting the more moderate pace of Australian bank bond issuance. This combination of issuance patterns has put downward pressure on the cross-currency basis swap spread.

Conditions in securitisation markets have continued to show signs of improvement, with issuance in the March quarter totalling \$7½ billion, the largest quarterly amount issued since June 2007 (Graph 63). Since the last *Statement*, seven residential mortgage-backed securities (RMBS) deals amounting to \$5.4 billion have been issued. This includes two deals totalling \$1.8 billion issued without the support of the Australian Office of Financial Management (AOFM), one of which consisted of a larger share of low-doc loans than in recent deals. Around 15 per cent of issuance during the March quarter was purchased by the AOFM, down from around 80 per cent over the first half of 2009.

Domestic issuance of RMBS is around the levels required to offset the ongoing amortisation of principal (i.e. mortgage repayments). However, with no new offshore issuance since mid 2007 the stock outstanding has continued to decline, to be around half its June 2007 peak.

Spreads on AAA-rated RMBS tranches trading in the secondary market have remained broadly stable in the last few months, at around 140 basis points above BBSW, close to the spreads on new issues. At these spreads, new issues are likely to have been marginally profitable for issuers. Over the past year there has been a substantial narrowing in the gap between secondary and primary market spreads, suggesting the market has worked through much of the overhang of supply created by the portfolio liquidation of structured investment vehicles, which used to account for around one-third of the investor base.

The high quality of underlying collateral continues to underpin Australian securitisation markets. Losses on Australian RMBS (after proceeds from property sales),

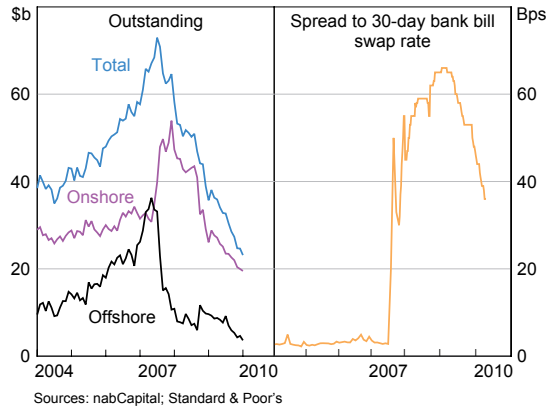
remain low as a share of the stock outstanding, at around 8 basis points per annum for prime and 165 basis points for non-conforming RMBS. Credit enhancements, such as lenders' mortgage insurance and the profits of securitisation vehicles, continue to provide cover for losses.

Conditions in shorter-term securitisation markets have improved over recent months. Spreads on asset-backed commercial paper (ABCP) have declined substantially and are now back to the level observed in November 2007, at 35 basis points (Graph 64). However, the amount of ABCP outstanding continues to decline, to \$23 billion in January 2010 (the latest comprehensive data available). This reflects the ongoing amortisation of existing loan pools (i.e. loan repayments) as well as some reduction in the supply of assets typically funded by ABCP (such as lending by mortgage originators).

Household Financing

Financial intermediaries have largely passed on the March and April cash rate increases to variable housing rates (Table 9). On average, variable interest

Graph 64
Australian ABCP



rates on prime full-doc housing loans (including discounts) increased by 50 basis points to 6.57 per cent in the three months to end April, though there was some variation across individual lenders. At the time of writing, the major banks have announced rate increases in line with the cash rate increase in May.

The major banks' interest rates on new 3-year and 5-year fixed rates on housing loans have increased

Table 9: Intermediaries' Variable Lending Rates
Per cent

	Level at end April 2010	Change since:		
		End Jan 2009	End April 2009	End Aug 2008
Cash rate	4.25	0.50	1.25	-3.00
Housing loans				
Prime full-doc	6.57	0.50	1.38	-2.48
Prime low-doc	7.17	0.50	1.36	-2.25
Personal loans	12.39	0.52	1.44	-0.70
Small business				
Residentially secured				
Term loans	8.34	0.50	1.26	-1.76
Overdraft	9.20	0.50	1.31	-1.71
Average actual rate ^(a)	8.26	0.50	1.15	-2.03
Large business				
Average actual rate, variable and bill funding ^(a)	6.36	0.33	1.35	-2.24

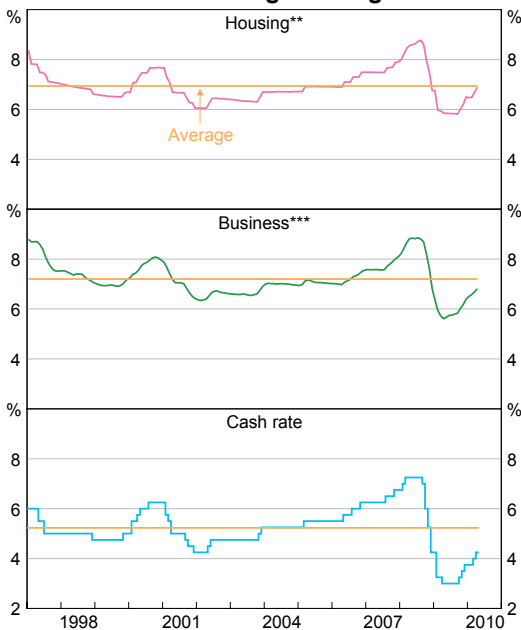
(a) RBA estimate

Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

slightly since end January, reflecting increases in capital market yields. With fixed rates around 1½ percentage points higher than variable rates, the share of owner-occupier loan approvals at fixed rates has remained around its historical low of 2 per cent. This share has been well below its decade average of 11 per cent for almost two years, with the result that the share of outstanding loans at fixed rates has declined substantially. This has meant that the average interest rate on all outstanding housing loans (variable and fixed) has tended to move more in line with the variable housing rate during the latest tightening cycle, having increased by around 110 basis points from its low in 2009. It is now broadly in line with its average since 1997 (Graph 65).

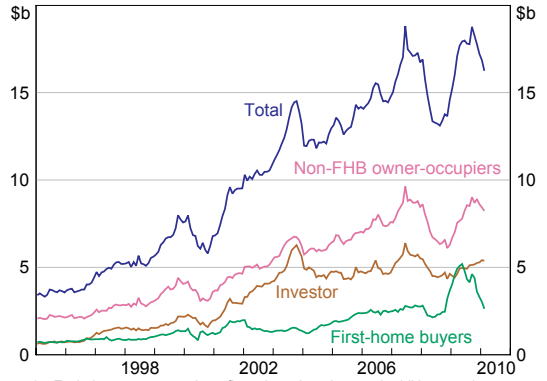
The value of housing loan approvals has fallen in recent months, after levelling out in mid 2009, with approvals to owner-occupiers decreasing by over 20 per cent since their peak in September 2009 (Graph 66). Preliminary evidence suggests that

Graph 65
Average Interest Rates on Outstanding Lending*



* As at end April 2010
 ** RBA estimates prior to 2001
 *** RBA estimates; includes small and large businesses
 Sources: ABS; APRA; Perpetual; RBA

Graph 66
Housing Loan Approvals*
Seasonally adjusted



* Excludes owner-occupier refinancing, alterations and additions, and investor approvals for new construction and by 'others'
 Sources: ABS; RBA

the value of loan approvals to first-home buyers has more than halved since its peak in May 2009, as government incentives were wound back from October and interest rates have risen. Housing loan approvals to investors have picked up.

The five largest banks' share of gross owner-occupier loan approvals has declined a little over the 12 months to February, to around 79 per cent, though it is still well up from 60 per cent prior to the onset of the financial market turbulence in mid 2007. Correspondingly, the market shares of the smaller banks and credit unions and building societies have picked up slightly in recent months, while wholesale lenders' were little changed.

Housing credit growth has continued at a monthly average pace of 0.7 per cent in the March quarter (Graph 67). While owner-occupier housing credit has been the main driver of growth over the past year, lending to investors has picked up in the March quarter.

Financial institutions' rates on variable personal loans have risen by an average of 48 basis points in the three months to end April. Average variable rates on unsecured personal loans, home equity loans and standard credit cards have increased by 50 basis points, while rates on margin loans and low-rate credit cards have risen by around 45 basis points.

At the time of writing, most institutions had yet to announce any changes resulting from the May cash rate increase.

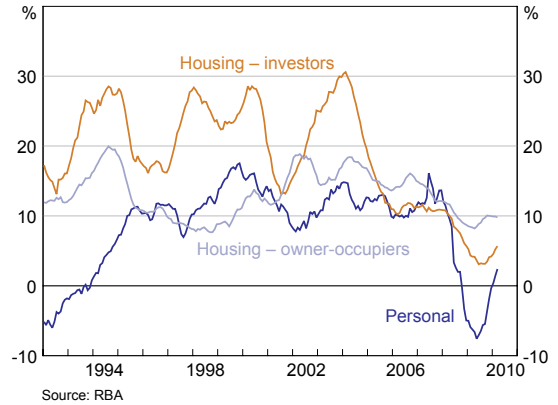
Personal credit, which is a small component of household credit, rose at a monthly average pace of 0.5 per cent during the March quarter. Growth in recent quarters was largely due to increased credit card lending together with more favourable conditions in the equity market supporting growth in margin lending. Despite the recent pick-up, the value of margin loans outstanding is little changed over the year, at around \$19 billion. Given there was only a slight increase in volatility in equity markets over the quarter, the incidence of margin calls remained very low (at less than one margin call per day per 1 000 clients). Borrowers' gearing levels have also remained broadly stable at 35 per cent, as the value of collateral was largely unchanged.

Business Financing

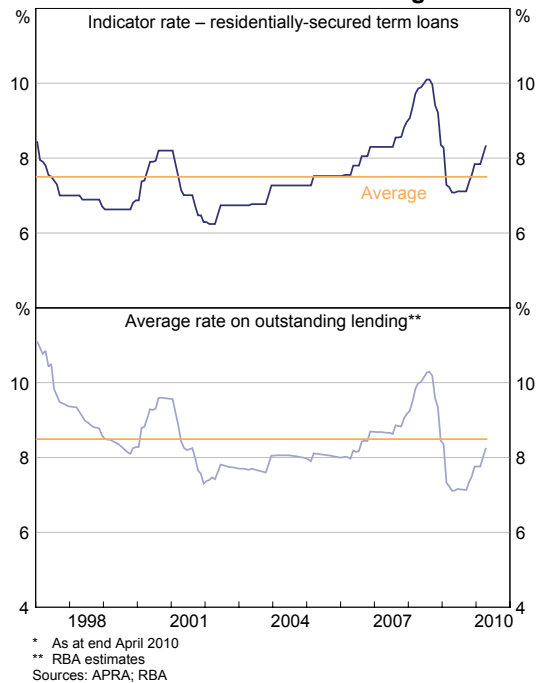
The major banks have increased their variable indicator rates on small business lending in line with the 125 basis points increase in the cash rate since the beginning of monetary policy tightening in October 2009 to end April (Table 9, Graph 68). Several of the larger banks have announced increases in their indicator rates following the latest tightening earlier this month. Average indicator rates on 1–5 year fixed-rate facilities have increased by 20–30 basis points since end January, broadly in line with corresponding swap rates.

Despite indicator rates on small business loans generally being above their averages since 1997, the average rate actually paid on outstanding small business loans will be around its average once the effects of the May tightening flow through to borrowers (Graph 68). The outstanding rate is more representative of the cost of finance to businesses, because it captures the fact that businesses have shifted to lower-interest rate products. Over the past decade, in particular, small businesses have made increasing use of loans secured by residential property. These loans usually do not have significant

Graph 67
Household Credit Growth
Year-ended



Graph 68
Small Business Variable Lending Rates*



additional risk margins attached to them and are more cost-effective than unsecured borrowings.

The average interest rate on banks' outstanding variable-rate lending to large business (i.e. variable-rate facilities of \$2 million or more, including bill funding) is estimated to have increased by 33 basis points in the three months to end April, to 6.36 per cent. These loans are repriced at regular intervals off a money market benchmark (e.g. the 3-month bill yield) with the rise in line with higher market rates and a small increase in average risk margins as spreads on new loans are higher than those on existing loans. While the average spread on outstanding lending has continued to rise slowly, there are signs that

credit conditions are easing for some borrowers and that the average spread on new lending has declined from mid 2009.

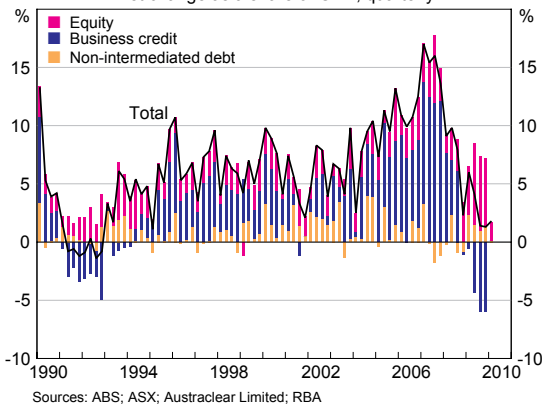
Net corporate external funding was little changed over the March quarter, reflecting a moderate amount of equity raisings. Non-intermediated debt and business credit were little changed (Graph 69).

Commercial loan approvals have picked up modestly since last year. The process of corporate balance sheet consolidation that was occurring through most of last year seems to have run its course, with estimates of the rate of debt repayments declining in recent months. While there were only a small number of syndicated loan approvals in the March quarter, this followed a significant pick-up in syndicated loan approvals during the second half of 2009.

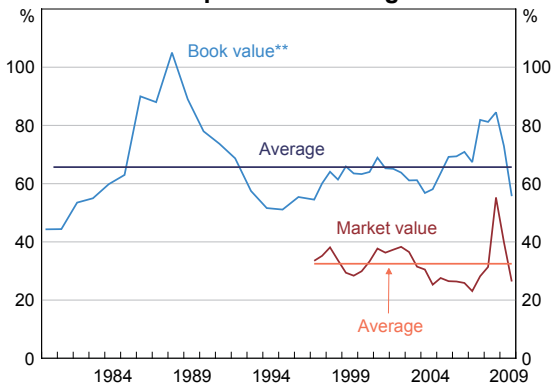
This balance sheet consolidation saw a continued reduction in listed corporates' gearing ratios. Book value gearing – the ratio of debt to the book value of shareholders' equity – declined by 17 percentage points over the December half 2009 to 56 per cent, to be around 30 percentage points lower than its peak in December 2008. This measure of gearing is currently around its lowest level since June 1997, and around 10 percentage points below its longer-run average (Graph 70). Declines in gearing were broadly based, with the largest reductions made by the most highly geared corporates (see 'Box B: Listed Corporates' Gearing Ratios').

Graph 69
Business External Funding

Net change as a share of GDP, quarterly



Graph 70
Listed Corporates' Gearing Ratio*



* Data exclude foreign-domiciled companies
** Data from 1997 include real estate companies

Aggregate Credit

Total outstanding credit increased over the March quarter, reflecting the solid growth in household credit. Business credit was little changed over the quarter following falls throughout 2009 (Table 10). Growth in broad money has increased in recent months, partly reflecting a pick-up in term deposits. Over the year to March, broad money increased by about 4 per cent.

Table 10: Financial Aggregates
Percentage change

	Average monthly growth		Year to March 2010
	December quarter 2009	March quarter 2010	
Total credit	0.1	0.4	2.1
– Owner-occupier housing	0.8	0.7	9.8
– Investor housing	0.5	0.7	5.7
– Personal	0.6	0.5	2.4
– Business	–0.9	0.0	–6.9
Broad money	–0.3	0.8	3.8

Source: RBA

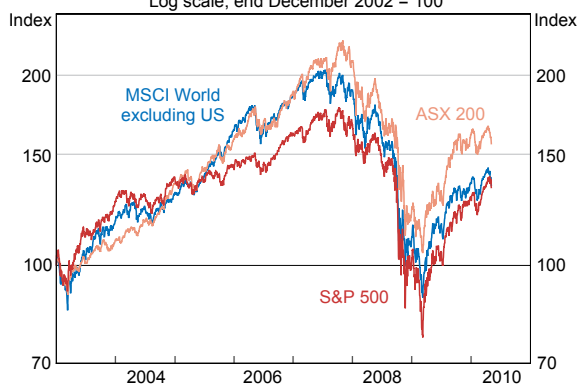
Equity Markets

Since the previous *Statement*, the ASX 200 is up 1 per cent, underperforming overseas markets. While the index is around 50 per cent higher than its March 2009 trough, it remains more than 30 per cent below its 2007 peak (Graph 71, Table 11). Falls in resources' share prices were more than offset by gains in financials' share prices, with rises reflecting stronger-than-expected earnings announcements by banks, both in Australia and overseas.

Graph 71

Share Price Indices

Log scale, end December 2002 = 100



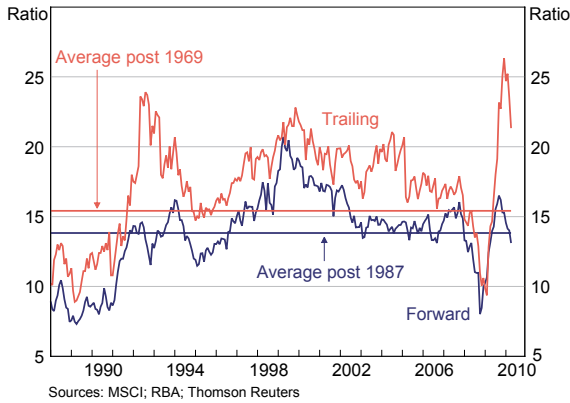
Sources: Bloomberg; Thomson Reuters

Table 11: Sectoral Movements in the ASX 200

	February <i>Statement</i>	Per cent change since:	
		Trough (March 2009)	Peak (November 2007)
Resources	–2	38	–24
Financials	4	74	–36
Other	0	33	–32
ASX 200	1	49	–32

Sources: Bloomberg; RBA

Graph 72
Australian P/E Ratios



Incorporating improved earnings expectations, the forward P/E ratio – which uses earnings forecasts for the next 12 months – is currently around 13, close to its long-run average (Graph 72). In contrast, the trailing P/E ratio remains high as share prices incorporate the anticipated rebound in earnings from the recently low reported earnings used in the trailing P/E ratio.

There has been a pick-up in M&A activity since the February *Statement* with a total of around \$25 billion of deals announced. Recent deals continue to be funded by companies' high levels of cash holdings and by equity rather than by debt. As a percentage of assets, cash held by non-financial corporates is at its highest level since at least June 1997.