

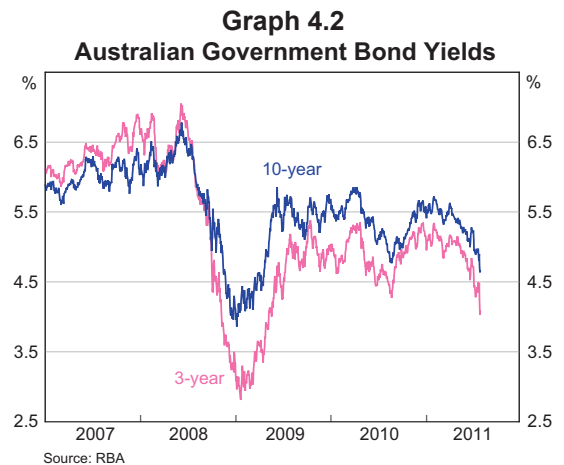
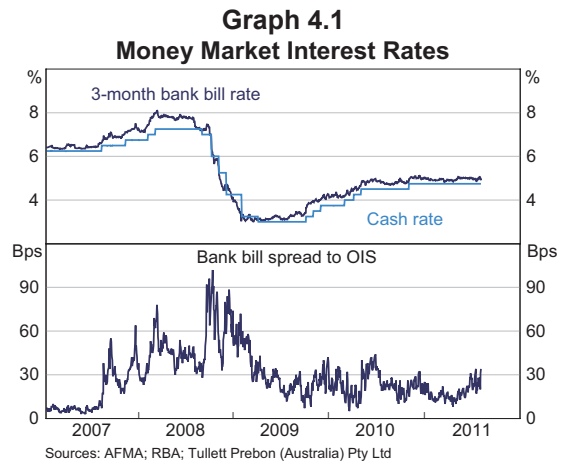
4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board has maintained its target for the overnight cash rate at 4.75 per cent since November last year. At the time of the previous *Statement*, money market yields implied that the cash rate would increase towards the end of 2011. Subsequently, market expectations for policy have fluctuated in a wide range, reflecting changes in sentiment about US and European sovereign debt, the release of softer economic data – both domestically and overseas – and the stronger-than-expected CPI release. Currently, financial markets expect a reduction in the cash rate by the end of this year.

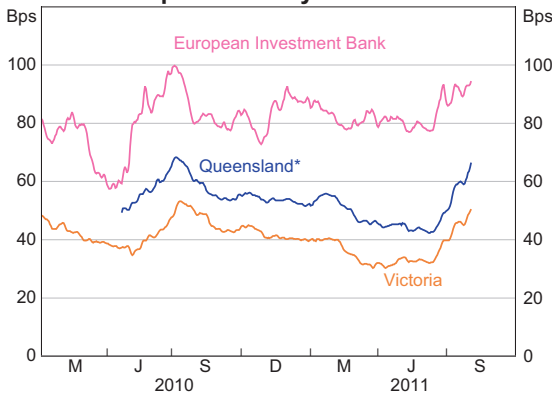
Despite the global volatility, there is little evidence of tension in domestic money markets. While bank bill rates did not initially decline to the same extent as overnight indexed swaps (OIS), spreads have remained narrower than they were either during the financial crisis or the emergence of sovereign debt concerns in 2010 (Graph 4.1). To maintain the cash rate at the Board's target, the Reserve Bank has kept aggregate exchange settlement (ES) balances around \$1¼ billion, although temporarily higher balances have been accommodated around balancing dates, such as month-end.

Long-term bond yields have declined sharply over the past three months, reflecting developments in major-economy bond yields associated with sovereign debt concerns, strong foreign demand for Commonwealth Government Securities (CGS) and the change in policy expectations (Graph 4.2). With yields on 3- and 10-year CGS falling by around 105 and 75 basis points, respectively, bond yields



now lie below the current level of the cash rate. The spread between yields on 10-year CGS and 10-year US Treasury bonds had narrowed since the beginning of June to below 200 basis points, but has widened more recently.

Graph 4.3
Spreads to 5-year CGS



* From March 2009 to April 2010 all debt of this maturity was guaranteed by the Australian Government
Sources: RBA; Yieldbroker

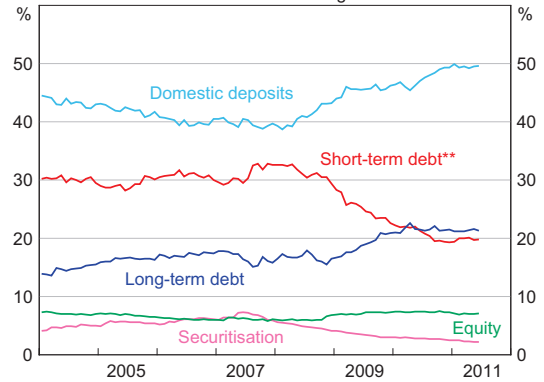
As is common in periods of heightened market uncertainty, the spreads between CGS and other highly rated debt (such as that issued by state borrowing authorities and supranational agencies) have widened appreciably over recent months (Graph 4.3). Notwithstanding this, the level of these yields has actually fallen.

Financial Intermediaries

Having undergone substantial changes in the period 2008–2010, the composition of bank funding has been stable since the beginning of the year and banks have not been adversely affected by the recent increase in volatility in financial markets (Graph 4.4). Deposits currently account for about half of banks' funding liabilities, compared with 40 per cent in early 2008. Short-term wholesale liabilities continue to account for about one-fifth of banks' funding while long-term wholesale liabilities account for a slightly greater share.

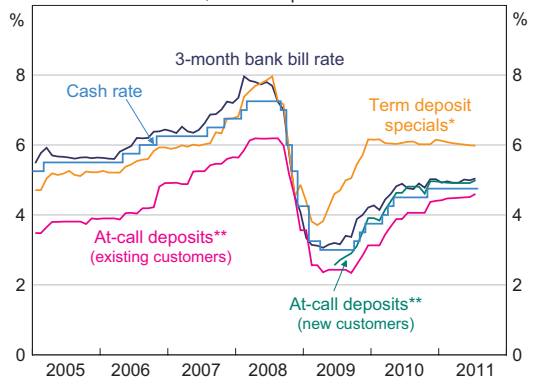
The average rate on major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has remained little changed for more than a year and a half, even though the spread to equivalent duration market rates has widened over the past couple of months (Graph 4.5). On average, the smaller Australian-owned banks' 'special' term deposit rates are at similar levels to those offered by the major

Graph 4.4
Funding Composition of Banks in Australia*
Per cent of funding



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.5
Deposit Rates
\$10 000 deposits



* Average of 1–12, 24-, 36- and 60-month terms at the major banks
** Average of online savings, bonus saver and cash management accounts at the major banks
Source: RBA

banks. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has moved a little higher since the beginning of the year, and is slightly above 4½ per cent.

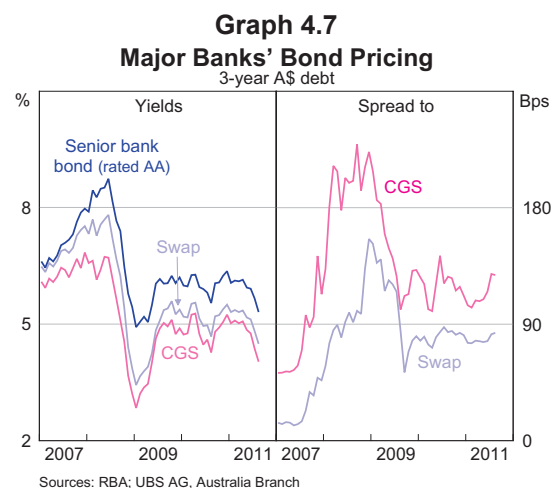
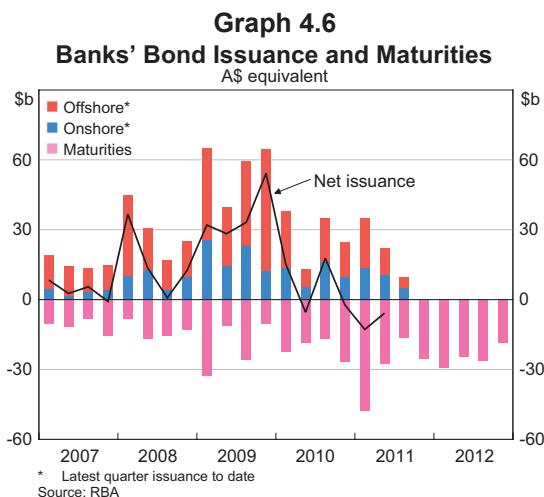
Australian banks have issued around \$24 billion worth of bonds since the *May Statement* (Graph 4.6). This issuance was evenly divided between the domestic and offshore markets, and over 80 per cent of it was issued by the major banks. As has been the case for the past year, much of this debt issuance has replaced maturing bonds, reflecting

the banks' modest funding task in an environment of strong deposit growth and slower credit expansion. Banks have also repurchased more than \$2 billion of their government-guaranteed bonds since April, as it remains more economic to replace this debt in the market than to pay the guarantee fee to the Federal Government. Reflecting continued efforts to lengthen the maturity of their funding, the banks have targeted a range of maturities in the bond markets spanning 2- to 7-year terms. There was good investor demand for these longer-term bonds, particularly in domestic markets.

Recent declines in cross-currency basis swap spreads have reduced the hedging costs of issuing offshore for Australian banks. These declines are partly the result of the significant pick-up in Kangaroo bond issuance since the beginning of the year, with issuance totalling over \$27 billion amid large redemptions and good investor demand. Reflecting this, non-AAA rated issuers such as Goldman Sachs (rated A) and Morgan Stanley (rated A) entered the Kangaroo market for the first time since the onset of the financial crisis. The intensification of sovereign debt concerns more recently has dampened investor appetite for non-AAA rated Kangaroo bonds and recent issuance has been from highly rated institutions, including two new issuers of AAA rated covered bonds, Bank of New Zealand and a Norwegian bank, DNB NoR Boligkreditt.

Australian branches of Asian banks have been more active in domestic bond markets in recent months. The Australian branches of Industrial and Commercial Bank of China (rated A) and Oversea-Chinese Banking Corporation (rated A+) issued \$900 million of long-term bonds. This follows the first bond issuance by United Overseas Bank's Sydney branch in April.

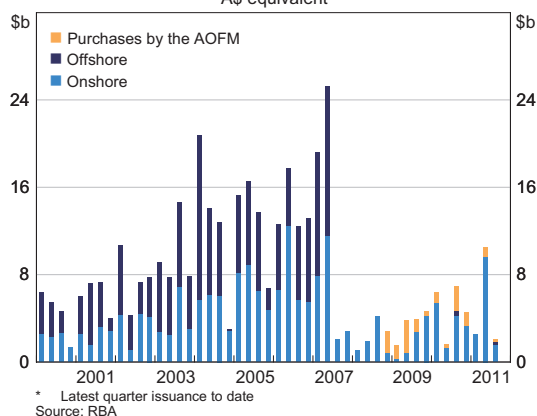
In the domestic market, while the spread of domestically issued bank bonds to CGS has increased, the yield on these securities has actually fallen and the spread to swap rates is little changed (Graph 4.7). The decision by Moody's to downgrade the four major Australian banks and their subsidiaries



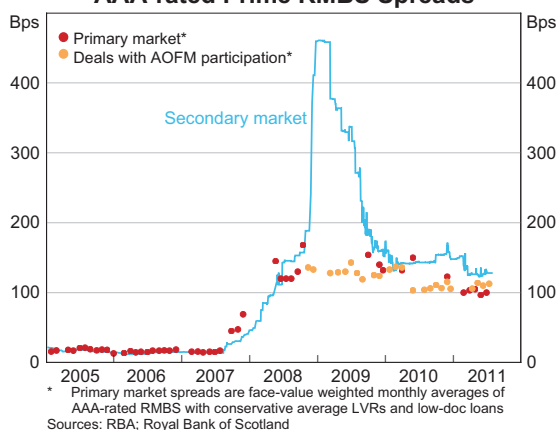
by one notch to Aa2 from Aa1 had little impact on these spreads, as it was widely expected. The revision brings Moody's credit ratings of the major Australian banks broadly into line with those of S&P and Fitch.

In other credit rating developments, S&P revised Bendigo and Adelaide Bank's BBB+ rating outlook from 'stable' to 'positive' on better earnings. In contrast, Fitch downgraded Suncorp Metway's long-term credit rating by one notch from A+ to A. The downgrade reflected Fitch's concerns over Suncorp's asset quality, noting a high level of impaired assets coupled with relatively low provisioning compared with similarly rated peers. Citing similar concerns

Graph 4.8
Australian RMBS Issuance*
A\$ equivalent



Graph 4.9
AAA-rated Prime RMBS Spreads



over asset quality, S&P placed Bank of Queensland on negative credit watch with a one in three chance of a one notch downgrade from BBB+ if the level of non-performing loans is not stabilised.

Activity in the Australian residential mortgage-backed securities (RMBS) market reached a post-financial crisis high in the June quarter with over \$10 billion of issuance (Graph 4.8). Over the past three months, seven prime RMBS transactions totalling just over \$7 billion have been issued by a diverse range of financial institutions, including five banks, a building society and a non-bank mortgage originator. Of particular note, almost one-quarter of

a prime RMBS transaction by Bendigo and Adelaide Bank was denominated in Japanese yen. This was the first foreign currency RMBS transaction in over a year. Issuance of securities backed by assets other than residential mortgages has also picked up over the past few months.

Private sector demand for the longer-dated tranches of prime RMBS has continued to improve. The recent transactions were composed primarily of large 3-year tranches priced around 100 basis points over the relevant interest rate swap and the Australian Office of Financial Management (AOFM) supported only 11 per cent of transactions (Graph 4.9).

Fitch published an exposure draft on proposed changes to its Australian RMBS ratings criteria. The proposal follows a review that indicated households have become more sensitive to interest rate changes over the past decade owing to increases in household debt and property prices. The proposed changes are not expected to have a significant effect since issuers have been strengthening the credit quality of their securities by increasing subordination to provide more protection to investors holding the senior tranches. Moody's has also announced that it is undertaking a similar review.

Household Financing

Most lenders have left their indicator rates on standard variable-rate housing loans unchanged over recent months, although fixed rates have fallen, reflecting the decline in market yields (Table 4.1). Overall, the average interest rate on all outstanding housing loans (fixed and variable) remains a little above its post-1996 average. A pick-up in competition has, however, been evident in other aspects of housing lending. In particular, the major banks have continued to increase the discounts offered on some products, by as much as 20 basis points. In addition, a number of banks abolished early exit fees prior to the introduction of the Government's ban from 1 July.

Table 4.1: Intermediaries' Variable Lending Rates

Per cent

	Level at end July 2011	Change since:	
		May Statement	End July 2010
Cash rate	4.75	0.00	0.25
Housing loans^(a)	7.04	-0.05	0.29
Personal loans	13.10	0.01	0.31
Small business			
Residentially secured			
– Term loans	8.99	0.00	0.40
– Overdraft	9.86	0.00	0.40
Average actual rate	8.81	0.00	0.27
Large business			
Average actual rate (variable and bill funding)	7.05	0.06	0.22

(a) Average of the major banks' discounted package rates on \$250 000 full-doc loans
Sources: ABS; APRA; Perpetual; RBA

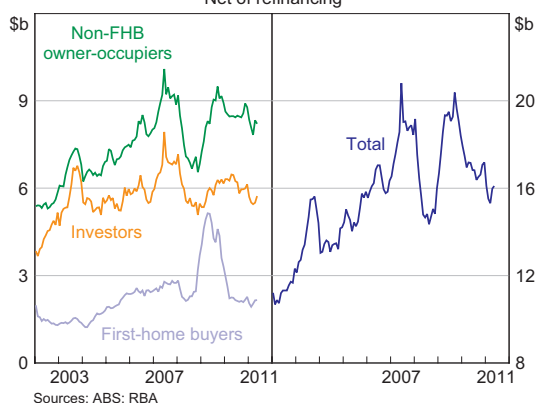
The increase in competition within the mortgage market has contributed to an increase in refinancing activity in recent months: the value of housing loan approvals for refinancing purposes rose by 18 per cent over the three months to May. Demand for new housing finance, however, remains at a relatively low level, particularly from first-home buyers and investors (Graph 4.10).

In line with this, housing credit growth has eased further (Graph 4.11). Over the June quarter, housing credit grew by 1.2 per cent. On a year-ended basis, owner-occupier and investor housing credit are growing at around 6 per cent, well down on the double digit growth rates recorded earlier in the decade.

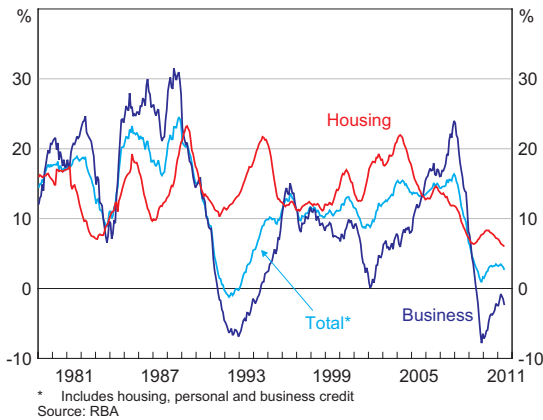
Financial institutions' interest rates on most variable personal loans – including credit cards, home equity loans and margin loans – have remained little changed since the beginning of the year. Personal credit fell modestly over the June quarter, as a pick-up in other personal lending was more than offset by declines in margin lending and credit card lending.

The ongoing declines in margin lending partly reflect unfavourable conditions in global equity markets. The number of margin calls increased slightly in the June quarter to almost one margin call per day per 1 000 clients.

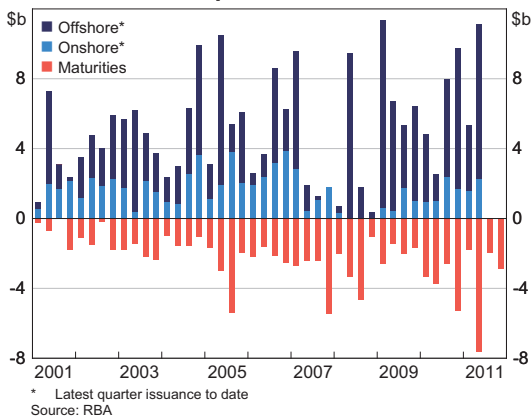
Graph 4.10
Value of Housing Loan Approvals
Net of refinancing



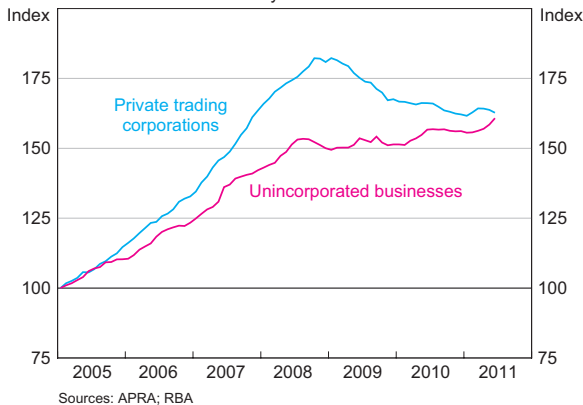
Graph 4.11
Credit Growth
Year-ended



Graph 4.12
Australian Corporates' Bond Issuance



Graph 4.13
Business Credit by Type of Borrower
January 2005 = 100



Business Financing

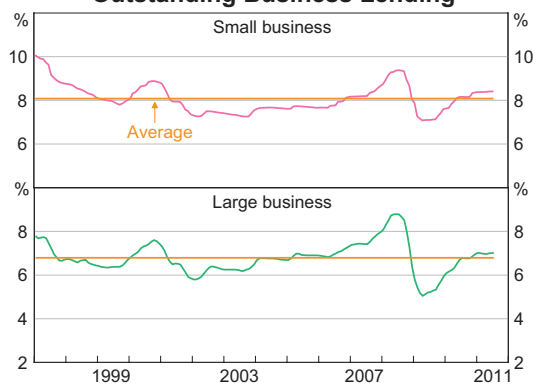
Corporate bond issuance has totalled around \$4½ billion since the previous *Statement*. Conditions have generally been favourable for Australian non-financial corporate borrowers, especially in the US dollar market where the bulk of issuance was executed. The large volume of issuance in the June quarter was partly driven by larger-than-usual maturities (Graph 4.12). A broad range of investment-grade Australian corporates placed bonds in the US dollar market spanning terms of between 5 and 29 years. These longer maturities are more difficult to achieve in the domestic corporate bond market. In the domestic market, activity remained subdued with under \$1 billion of issuance over the past three months. Spreads between corporate bond yields and CGS have increased a little over the past few months but remain well below the levels of the past few years.

Intermediated business credit contracted at an annualised rate of about 5 per cent over the June quarter, driven by a decline in credit extended to private trading corporations that was offset to some extent by growth in lending to unincorporated businesses (Graph 4.13). Commercial loan approvals have been broadly steady in recent months, after trending higher over the preceding 12 months.

There were 54 syndicated loan approvals worth \$25 billion in the June quarter. The number and value of approvals have generally been rising over the past few years, and both are currently around 2006 levels. Lending for capital and general corporate expenditure has been driving this trend increase.

There has been little change in the cost of intermediated business borrowing since the beginning of the year. Indicator rates on variable-rate business loans are unchanged, while indicator rates on fixed-rate business loans have fallen slightly, but by less than movements in market interest rates. The average rate on outstanding small business loans remains about 30 basis points above its post-

Graph 4.14
Average Interest Rates on Outstanding Business Lending

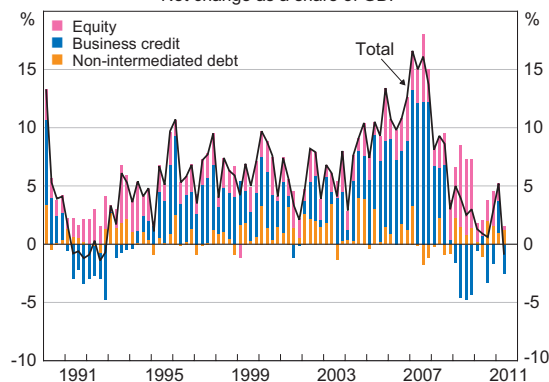


Sources: APRA; RBA

1996 average at 8.4 per cent (Graph 4.14). Similarly, the average interest rate on banks' outstanding lending to large business has been little changed at 7.0 per cent, approximately 20 basis points above its post-1996 average.

Reflecting these various developments, net business external funding declined marginally as a share of GDP in the June quarter (Graph 4.15). This was driven by weakness in business credit which was partly offset by corporate debt issuance and modest equity raisings. The latter was affected by BHP's \$6 billion buyback of its domestically listed shares in April.

Graph 4.15
Business External Funding
Net change as a share of GDP



Sources: ABS; ASX; Austraclear Limited; RBA

Aggregate Credit

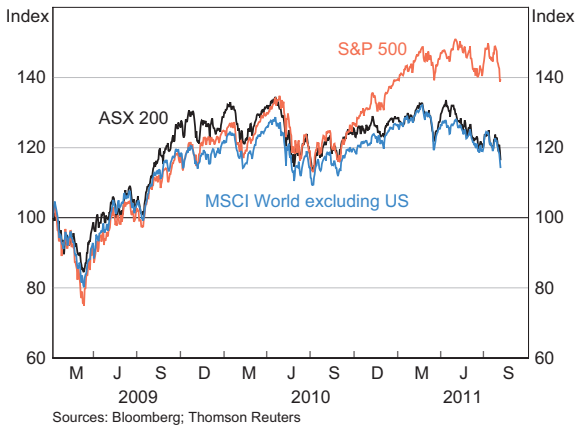
Total outstanding credit grew at an annualised rate of around 1 per cent over the June quarter, with modest growth in housing credit offset to some extent by declines in lending to businesses (Graph 4.11, Table 4.2). Growth in broad money has been more solid over the year, and has outpaced credit growth since the latter half of 2007, partly reflecting the more conservative attitude of households and business towards debt and a preference to hold a greater share of their assets as deposits.

Table 4.2: Financial Aggregates
Percentage change

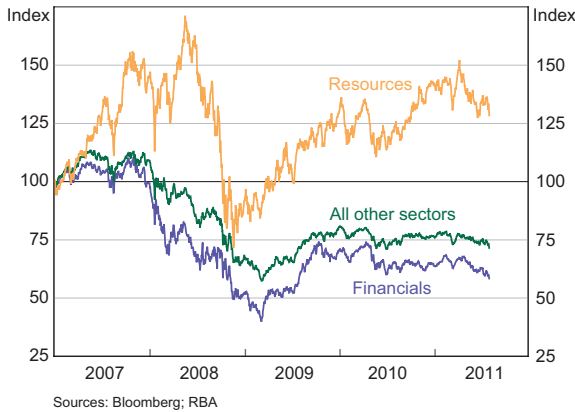
	Average monthly growth		
	March quarter 2011	June quarter 2011	Year to June 2011
Total credit	0.5	0.1	2.7
– Owner-occupier housing	0.5	0.4	6.3
– Investor housing	0.4	0.3	5.4
– Personal	0.3	–0.3	0.3
– Business	0.5	–0.4	–2.4
Broad money	0.6	0.3	6.8

Source: RBA

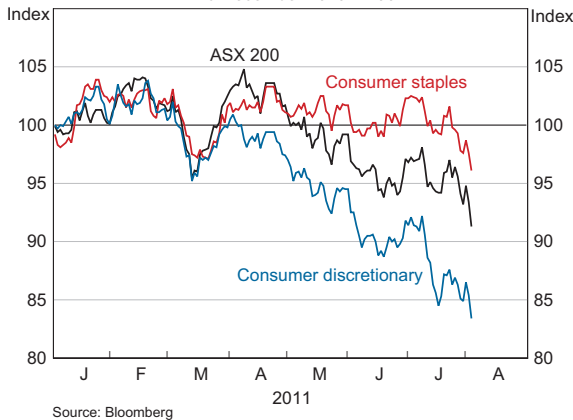
Graph 4.16
Share Price Indices
End December 2008 = 100



Graph 4.17
Australian Share Price Indices
End December 2006 = 100



Graph 4.18
Share Price Indices
End December 2010 = 100



Equity Markets

The Australian share market has fallen in line with overseas equity markets (Graph 4.16). Concerns over European sovereign debt and the pace of the global recovery have weighed heavily on investor sentiment, as have domestic factors such as the weakness in consumer discretionary spending.

At the sectoral level, financial stocks have declined by more than the overall market, which is consistent with the underperformance of financial stocks globally (Graph 4.17). This decline has been associated with an increase in short selling of shares of the major banks (see 'Box D: Recent Trends in Short Selling' for more details). A number of insurance groups have also announced that they expect their margins to come under pressure as a result of prospective increases in reinsurance costs. Resource stocks have also declined and they are now 16 per cent below their two-year peak reached in April. The falls mostly reflect some levelling out in commodity prices and concerns that Chinese authorities may seek to slow growth amid rising inflationary pressures.

Consumer discretionary stocks have significantly underperformed the broader market (Graph 4.18). Worse-than-expected sales as well as lower profit guidance by some major groups in the sector have underscored the difficult operating environment, including aggressive discounting, consumer caution and increased competition from online shopping.

Despite the decline in the Australian share market, there has been a steady flow of takeover activity, with three major acquisitions announced over the past three months. BHP announced that it has agreed to buy Petrohawk Energy for US\$12.1 billion in an all-cash offer. Petrohawk's board of directors has unanimously recommended that its shareholders accept the offer. SABMiller announced a \$9.5 billion takeover bid for Foster's Group, which has rejected the offer on the grounds that it significantly undervalues the company. Finally, Peabody Energy and Arcelor Mittal announced a \$4.7 billion cash takeover bid for Macarthur Coal, although the bid has been rejected by the Macarthur Coal Board.