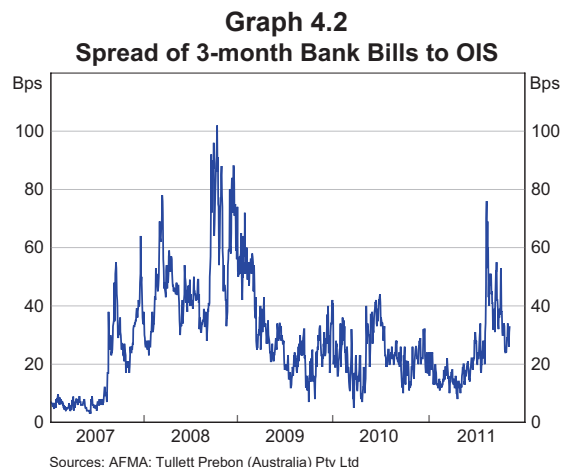
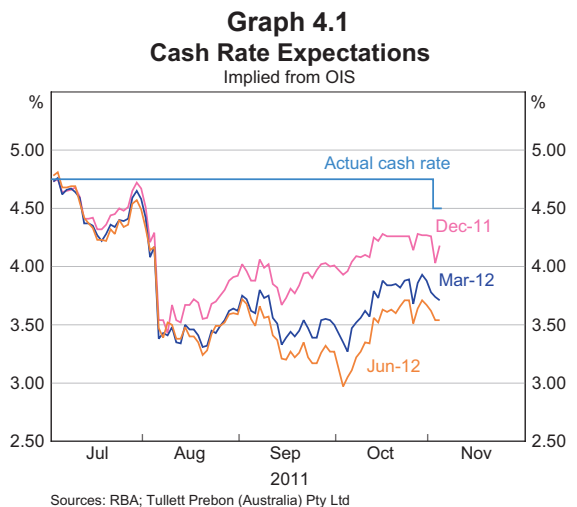


4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board lowered its target for the cash rate from 4.75 per cent to 4.50 per cent in November, the first change in the target since November 2010 (Graph 4.1). In recent months, there has been a significant reassessment of the outlook for domestic monetary policy by market participants, mainly reflecting uncertainty about how the sovereign debt and banking problems in Europe might be resolved and the effects on global economic activity. Market pricing at one point embodied an expectation of aggressive reductions in the cash rate – including possible moves between Board meetings – in the event of a sharply weaker world economy. Reflecting this, rates on overnight indexed swaps (OIS) fell significantly in August, although the volatility of these rates suggested that sizeable adjustments in derivative positions, at times, may have compromised the liquidity of the market. In subsequent months, the extent of expected easing has lessened, though OIS rates still imply that the cash rate will reach a low of 3½ per cent by the middle of 2012.

Interest rates on bank bills have also declined. As in previous periods of market turmoil, the spreads between bank bill and OIS rates widened (Graph 4.2). From 20 basis points at the time of the previous *Statement*, the spread between 3-month bills and OIS briefly rose to over 75 basis points in mid August but much of this reflected the large fall in OIS rates. As liquidity in the OIS market has improved, and volatility has abated, the 3-month spread on bank bills has settled back at around 30 basis points. More generally, the domestic



interbank market has functioned smoothly in recent months and, in contrast to Europe where the European Central Bank has had to intermediate the interbank market to circumvent counterparty concerns, the Bank has not had to make any

adjustments to the way it operates in financial markets. Through its open market operations, the Reserve Bank has kept the level of exchange settlement (ES) balances steady at around \$1¼ billion for more than 12 months, although temporarily higher demand for balances continues to be accommodated on key balancing dates, such as quarter-ends.

Government bond yields have been volatile, driven by developments offshore. Through to early October, long-term bond yields declined as global bond markets rallied and expectations for an easing in domestic monetary policy intensified (Graph 4.3). The yield on 10-year Commonwealth Government securities (CGS) reached a low of 4 per cent in early October, before rising with increased optimism for a satisfactory resolution of the problems in Europe.

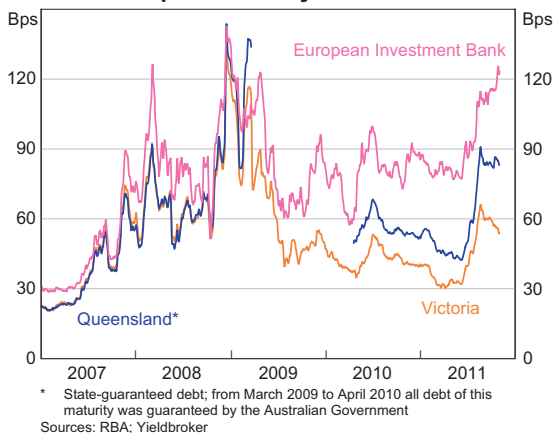
In mid October, the nominal CGS yield curve was extended by the issuance of a 15-year bond, the first time bonds of this maturity have been issued since the 1980s. (The Australian Office of Financial Management (AOFM) regularly issues inflation-indexed bonds with as much as 20 years to maturity.) The AOFM issued \$3.26 billion – a relatively large amount for a new line with a long maturity – at a yield that was 23 basis points above the yield on 12-year CGS. In contrast to many government securities overseas, yields on long-term CGS continue to trade at a significant margin below the equivalent swap rate, reflecting their relative scarcity.

Spreads between CGS and other government-related securities (such as those issued by the state borrowing authorities and the supranational agencies) widened appreciably during August (Graph 4.4). However, given the large decline in CGS yields, borrowing costs still declined in most cases, notwithstanding the widening in spreads. While primary issuance was curtailed for a short period, borrowers have subsequently returned to the market. Spreads have stabilised and, for certain issuers, have begun to decline. The spreads on supranational debt, particularly for European-based issuers, remain wide.

Graph 4.3
Australian Government Bond Yields



Graph 4.4
Spreads to 5-year CGS



Financial Intermediaries

Continued strong growth in deposits and negative net bond issuance have contributed to a further shift in the composition of banks' funding towards deposits (Graph 4.5). This trend has been evident since 2008. Deposits currently represent just over 51 per cent of banks' funding, while long- and short-term wholesale funding each make up about one-fifth.

The average rate on major banks' new term deposit 'specials' fell by around 40 basis points over the past quarter, reflecting the decline in market benchmark rates (Graph 4.6). Banks have been bidding less aggressively for some forms of wholesale deposits,

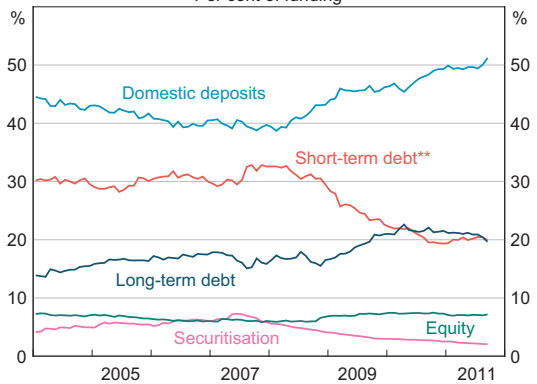
particularly deposits from other financial institutions. Nonetheless, the spread paid on term deposits continues to be well above spreads on wholesale funding at both shorter and longer maturities. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) was broadly unchanged over the three months to the end of October.

Around \$6.6 billion worth of Australian bank bonds have been issued since the August *Statement* compared with almost \$25 billion in the previous three months. The bulk of this issuance was from the major banks and more than three-fifths was in offshore markets (Graph 4.7). The reduction in supply partly reflects volatile conditions in debt markets, but also a reduced need for wholesale funding due to the strength of deposit growth relative to credit growth (see below).

Bank bond yields have declined since the previous *Statement* and are currently around 90 basis points below their average for the first half of 2011 (Graph 4.8). Notwithstanding this fall, domestic secondary market spreads of bank bonds over CGS have widened by around 25 basis points since the previous *Statement*, primarily reflecting the deterioration of conditions in global debt markets.

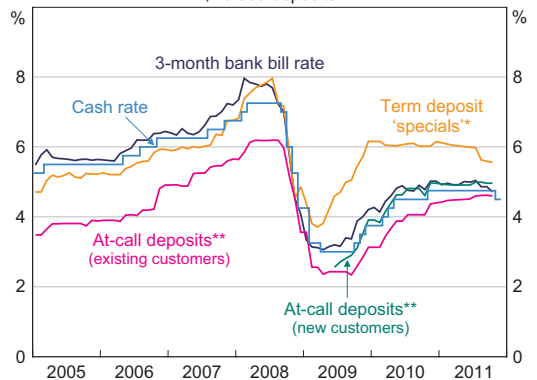
Credit default swap (CDS) premia for Australian banks have also risen over recent months, and to a greater extent than the rise in unsecured bank bond spreads (Graph 4.9). This reflects a broader trend across similarly rated banks elsewhere in the world and could be the result of market participants buying protection against the occurrence of unlikely but significant events, like the advent of a global recession. Although CDS contracts are more standardised than bonds and trading activity is concentrated in a small number of maturities (most notably 5 years), trading volume is very low and it is difficult to arbitrage the two markets, particularly when the CDS premium is above the bond spread.

Graph 4.5
Funding Composition of Banks in Australia*
Per cent of funding



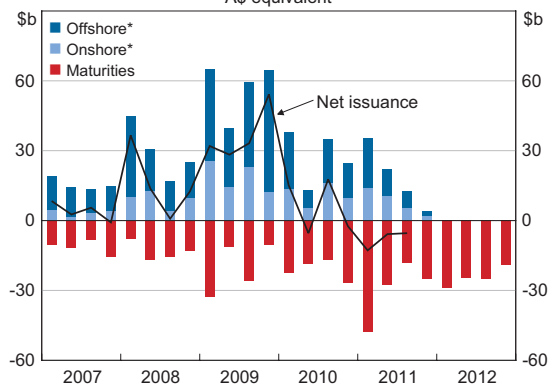
* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Graph 4.6
Deposit Rates
\$10 000 deposits



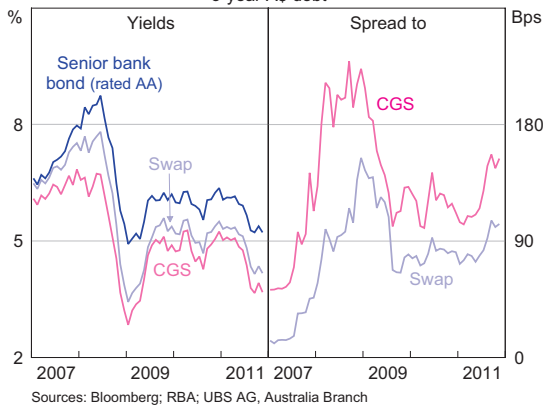
* Average of 1-, 12-, 24-, 36- and 60-month terms at the major banks
** Average of online, bonus saver and cash management accounts at the major banks
Source: RBA

Graph 4.7
Banks' Bond Issuance
A\$ equivalent

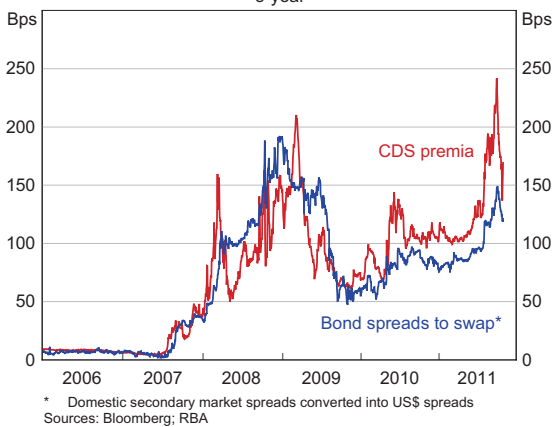


* Latest quarter issuance to date
Source: RBA

Graph 4.8
Major Banks' Bond Pricing
3-year A\$ debt



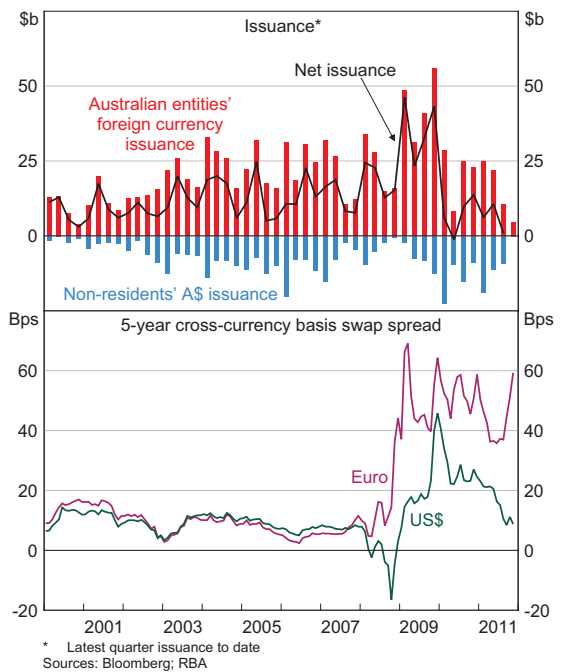
Graph 4.9
Major Banks' Bond Spreads and CDS Premia
5-year



Lower offshore issuance by the Australian banks placed downward pressure on the US dollar cross-currency basis swap spread for much of the past three months (Graph 4.10). This reduced the hedging costs of issuing offshore for Australian banks but made the Australian dollar market less advantageous for Kangaroo issuers swapping the funds raised out of Australian dollars.

Since the previous *Statement*, Kangaroo issuance has totalled \$1.7 billion, slowing from the larger supply in the first half of the year. In recent months, heightened concerns over European sovereign debt have also weighed on investor sentiment in the Kangaroo bond market, where European issuers are quite

Graph 4.10
Bond Issuance and the Cross-currency Basis Swap Spread

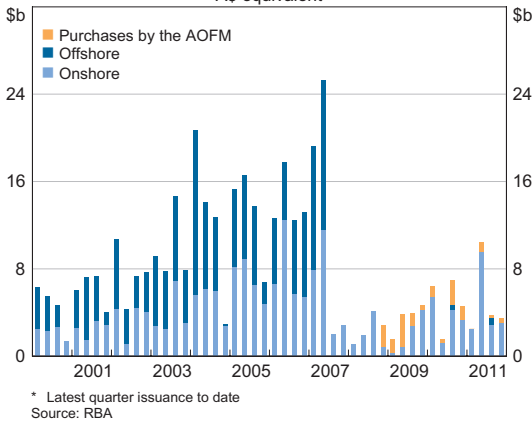


active. As a result, Kangaroo bond spreads in the domestic secondary market have remained elevated since mid 2011, further reducing the attractiveness of issuing in the domestic market.

Five prime residential mortgage-backed securities (RMBS) transactions totalling just over \$5 billion have been issued over the past three months (Graph 4.11). Private investor demand continued to underpin these RMBS transactions, most of which included large 3-year tranches. The AOFM invested \$391 million in two RMBS deals from non-major banks. Issuance spreads were around 25 basis points higher than those prevailing in the June quarter.

There were a number of other asset-backed deals in the quarter, including two commercial mortgage-backed securities (CMBS) and three asset-backed securities (ABS). CMBS worth \$453 million in aggregate were issued, however issuance in this sector remains subdued as investors remain cautious towards commercial property. A total of \$1.9 billion

Graph 4.11
Australian RMBS Issuance*
 A\$ equivalent

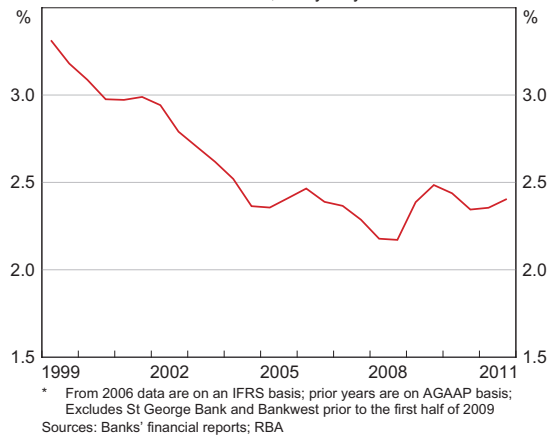


in ABS has been issued since the previous *Statement*. The underlying collateral backing the securities was mostly composed of auto loans and leases, as well as equipment leases.

Legislation allowing Australian authorised deposit-taking institutions (ADIs) to issue covered bonds was passed in Parliament. Eligible cover pool assets include commercial and residential property loans in Australia, as well as liquid assets such as at-call deposits convertible to cash within two business days and Commonwealth or state government bonds and notes. The total amount of covered bonds that can be issued by an ADI is capped at 8 per cent of the value of its Australian assets to ensure that ADIs' unsecured creditors, such as depositors, are not excessively subordinated by covered bondholders. A minimum over-collateralisation of 3 per cent is also prescribed, and is included in the 8 per cent cap. Broad prudential powers have been given to APRA and rules have been prescribed for independent cover pool monitors and the need for ADIs to maintain cover pool registers. Indications are that some of the major banks may tap this market before the end of the year.

The major banks have reported profit results for their 2011 financial years. Each bank reported a slight increase in its domestic net interest margin in the second half of the reporting period. In aggregate, the net interest margin of the major banks has fluctuated in a narrow range since 2004, of between 2¼ and 2½ percentage points (Graph 4.12).

Graph 4.12
Major Banks' Net Interest Margin*
 Domestic, half-yearly



Household Financing

Most lenders left their indicator rates on new standard variable-rate housing loans unchanged over the three months to the end of October, although one major bank introduced a temporary offer to undercut the rates of the other major banks (Table 4.1). In contrast, rates on new fixed-rate mortgages continued to fall. Competition remained strong in other aspects of housing lending, with one major bank announcing a cash-back offer for new mortgages. Overall, the average rate on outstanding housing loans (fixed and variable) fell by about 9 basis points between the beginning of the year and the end of October, to be a little above its post-1996 average (Graph 4.13).

Most banks have announced reductions in their indicator rates on variable-rate housing loans following the decrease in the cash rate at the November Board meeting.

Table 4.1: Intermediaries' Variable Lending Rates
Per cent

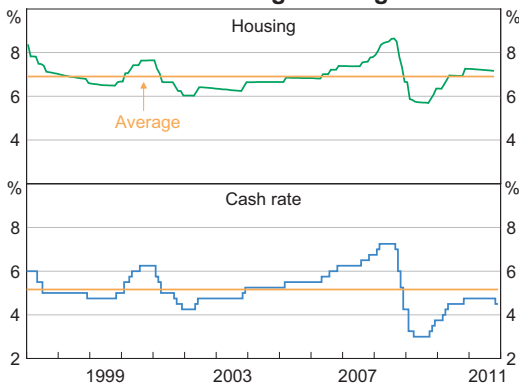
	Level at end October 2011	August Statement	Change since: End October 2010
Housing loans^(a)	7.03	-0.01	0.28
Personal loans	13.07	-0.03	0.27
Small business			
Residentially secured, advertised			
– Term loans	8.99	0.00	0.40
– Overdraft	9.86	0.00	0.40
Average rate ^(b)	8.81	0.00	0.29
Large business			
Average rate ^(b) (variable-rate and bill funding)	6.86	-0.17	0.07

(a) Average of the major banks' discounted package rates on \$250 000 full-doc loans

(b) Rates on outstanding, as opposed to new, business lending

Sources: ABS; APRA; RBA

Graph 4.13
Average Interest Rates on Outstanding Lending

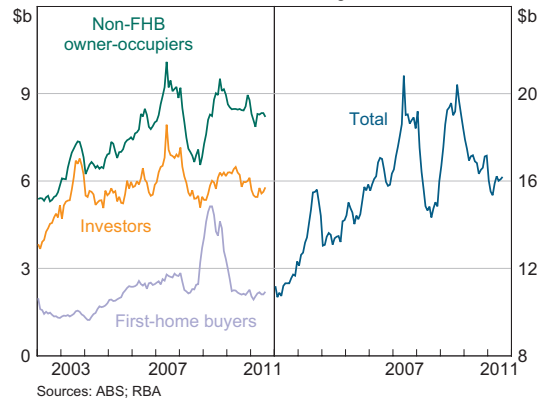


Sources: ABS; APRA; Perpetual; RBA

Competition in the mortgage market contributed to an increase in refinancing activity, with the value of housing loan approvals for refinancing purposes rising by 11 per cent over the three months to August, compared to a decade average of about 3 per cent. The value of housing loan approvals is currently around 6½ per cent below its level at the end of 2010 (Graph 4.14).

Housing credit grew at an annualised rate of 5.9 per cent over the September quarter. Investor

Graph 4.14
Value of Housing Loan Approvals
Net of refinancing

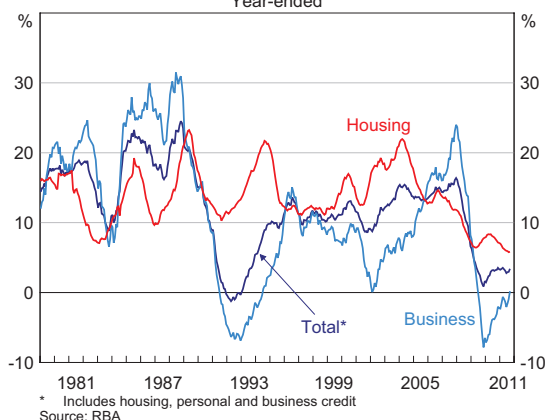


Sources: ABS; RBA

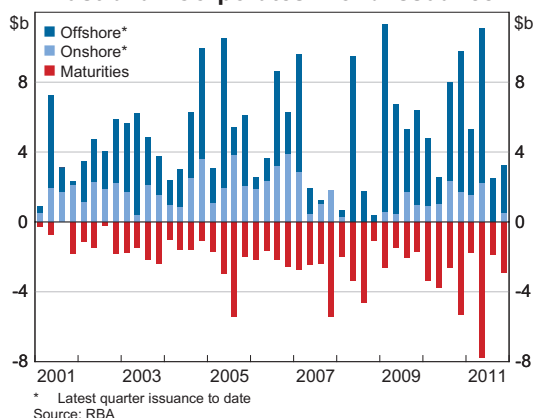
housing credit is still growing less quickly than owner-occupier credit, as has been the case since early 2011. In year-ended terms, total housing credit is growing at its slowest rate in a couple of decades (Graph 4.15).

Personal credit continued to fall in the September quarter. This is largely the result of falls in margin lending as recent volatility in global equity markets has led to less demand for margin loans. Credit card lending has also fallen slightly since early in 2011.

Graph 4.15
Credit Growth
Year-ended



Graph 4.16
Australian Corporates' Bond Issuance



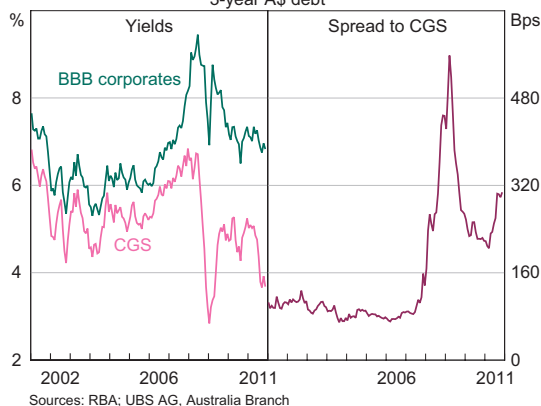
Business Financing

Corporate bond issuance has picked up since August, when issuance was particularly affected by uncertainty arising from the European sovereign debt crisis (Graph 4.16). Around \$5.7 billion has been issued since the previous *Statement*; bond maturities over recent months have been modest, reducing the refinancing task of Australian corporates.

A few investment-grade Australian corporates, such as Rio Tinto, placed bonds in the US dollar market for terms ranging from 5 to 29 years, which is difficult to achieve in the domestic corporate bond market. Origin Energy issued a 10-year bond, raising US\$500 million that will be used to help fund the company's Australia Pacific coal seam gas to LNG project. Fortescue, which is below investment grade, raised US\$1.5 billion in an 8-year private placement. Corporate bond spreads have widened by around 50 basis points since the previous *Statement* reflecting increased risk aversion (Graph 4.17).

Intermediated business credit grew at an annualised rate of around 2 per cent over the September quarter. The increase in business credit was driven by a rise in the value of foreign currency denominated lending, some of which was a consequence of the depreciation of the Australian dollar. Approvals for

Graph 4.17
Australian Corporates' Bond Pricing
3-year A\$ debt

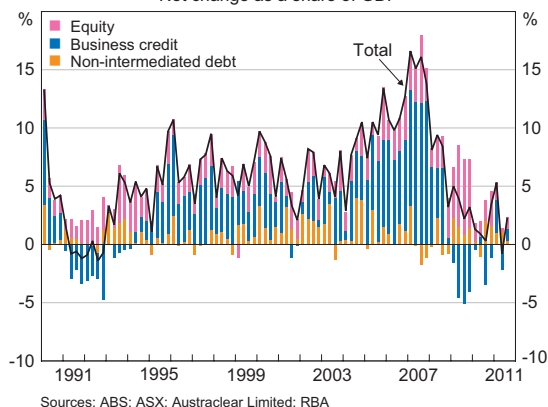


syndicated loans were solid over the September quarter, at almost \$24 billion. The number of syndicated loan approvals has been rising slowly since the end of 2008, although the value of approvals has remained steady. The majority of syndicated lending has been for capital and general corporate expenditure.

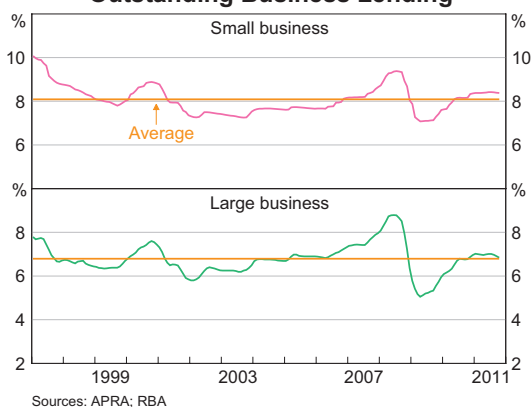
Net corporate external funding increased in the September quarter with small increases in all three components (Graph 4.18).

The cost of intermediated business borrowing has fallen over the past three months, mainly reflecting a decline in market benchmark rates. Indicator rates on

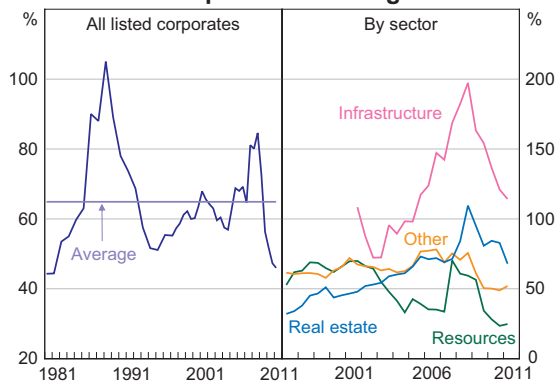
Graph 4.18
Business External Funding
 Net change as a share of GDP



Graph 4.19
Average Interest Rates on Outstanding Business Lending



Graph 4.20
Listed Corporates' Gearing Ratio*



new fixed-rate business loans have fallen by around 60 basis points since July, while indicator rates on new variable-rate loans were largely unchanged at the end of October. The average rate on banks' outstanding lending to large business fell by 16 basis points over the three months to the end of October, to be only slightly above its post-1996 average (Graph 4.19). The average rate on outstanding small business loans was little changed at 8.4 per cent, about 30 basis points above its post-1996 average.

Listed corporates' balance sheets continued to expand marginally in the June half of 2011 and gearing ratios declined further, to reach their lowest level since the early 1980s. Book value gearing – the ratio of debt to the book value of shareholders' equity – declined to 46 per cent, well below the cyclical peak of over 80 per cent in December 2008 (Graph 4.20).

The decline in leverage reflected a small rise in equity – due to higher retained profits – but was mainly driven by debt restructuring by some prominent real estate and infrastructure companies. The restructuring of Centro Properties Group contributed to a 15 percentage point reduction in the gearing ratio of real estate companies, which now stands at around the levels of the mid 2000s. Resource company gearing rose marginally as a result of acquisitions by Rio Tinto and Origin Energy that were partly funded by debt. BHP and Rio Tinto's buyback operations also contributed, as did BHP's purchase in cash of Chesapeake Energy for US\$4.7 billion. Gearing in other sectors was marginally higher.

Aggregate Credit

Total outstanding credit grew at an annualised rate of around 4 per cent over the September quarter, with moderate growth in household credit and a small increase in business credit (Table 4.2). Growth in broad money was considerably stronger than growth in credit, reflecting a preference by households and businesses to hold their assets in deposits, particularly given the uncertainty surrounding equity markets.

Table 4.2: Financial Aggregates
Percentage change

	Average monthly growth		
	June quarter 2011	September quarter 2011	Year to September 2011
Total credit	0.1	0.3	3.4
– Owner-occupier housing	0.5	0.5	6.4
– Investor housing	0.3	0.4	4.6
– Personal	-0.3	-0.3	-0.9
– Business	-0.4	0.2	0.2
Broad money	0.3	1.0	8.3

Source: RBA

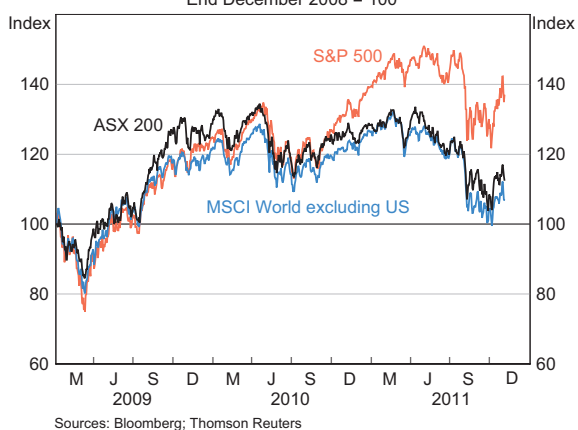
Equity Markets

The intensification of European sovereign debt concerns and uncertainty over the pace of the global recovery weighed heavily on the local share market in August and September (Graph 4.21). Volatility increased significantly to levels last seen during the financial crisis. Resource stocks, which have a weight of around one-third in the ASX 200, fell by 18 per cent over August and September as commodity prices declined (Graph 4.22). However, with global growth concerns dissipating somewhat, resource stocks have subsequently rebounded and are now 10 per cent lower than they were three months ago. The ASX 200 is currently around 16 per cent below its peak in April this year.

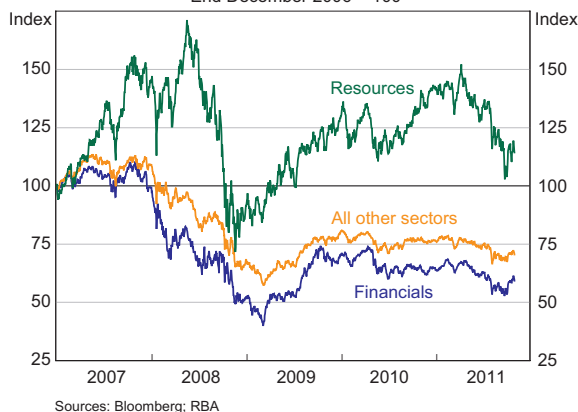
Share prices of financials have risen by 4 per cent since the previous *Statement*. Share prices of commercial banks have led the financial sector, while diversified financials have fallen as analysts have downgraded their earnings forecasts for the larger institutions. Some insurance groups also experienced large falls on the back of concerns over the impact of lower domestic and global interest rates on future investment income.

Profits announced by ASX 200 listed companies during the recent reporting season rose substantially over the year, broadly matching expectations. Underlying profits – which exclude significant items and asset revaluations/sales – rose by 20 per cent in the June half of 2011 from the corresponding

Graph 4.21
Share Price Indices
End December 2008 = 100



Graph 4.22
Australian Share Price Indices
End December 2006 = 100

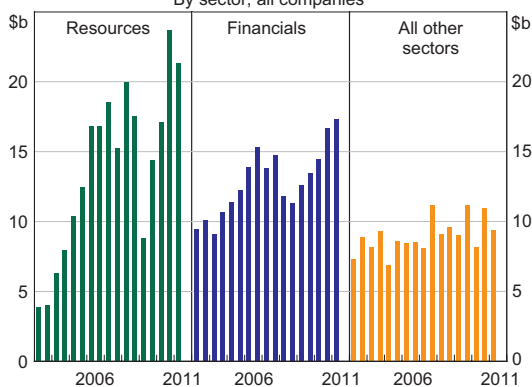


period in 2010. Profits were stronger across most sectors, although the resource sector made the largest contribution to the increase in aggregate profits. Bolstered by higher commodity prices, resource profits rose 25 per cent from the same period in 2010, but declined by 10 per cent from their record level in the December half of 2010, reflecting the impact of weather-related disruptions to production, cost increases and currency valuation effects (Graph 4.23).

Graph 4.23

Underlying Profits of ASX 200 Companies*

By sector, all companies



* From December 2004 figures reported under IFRS
Sources: Morningstar; RBA; company reports

Financials' profits rose by 16 per cent from the June half of 2010, with real estate companies' profits rising by 34 per cent compared with their depressed levels in the June half of 2010. Profits at insurance companies increased by 28 per cent from the June half of 2010 with a few large companies driving most of the improvement on the back of acquisitions and a reassessment of claims such as those stemming from natural disasters. The profits of other companies rose by 15 per cent, but have been broadly steady for the past few years.

With share prices having declined and profits strong, price earnings ratios for Australian companies are well their below long-run averages. Similarly, dividend yields have risen. Aggregate dividends in the first half of 2011 were marginally higher than those over recent reporting periods. New announcements of buybacks, which were very large in the second half of 2010, declined sharply in the June half of 2011, causing a substantial decline in total shareholder distributions – the sum of buybacks and aggregate dividends. This was driven by the large mining companies. Rio Tinto announced that it would increase its buyback program by US\$2 billion, while BHP did not announce any new buyback commitments as it proceeds with completing some large acquisitions.

There has been around \$10 billion of merger and acquisition activity announced over the past three months, comprised of a number of small deals. The board of Fosters has recommended that its shareholders accept an improved offer of \$10.7 billion from SABMiller when they vote on the proposed takeover in December. Peabody Energy has acquired a majority stake in Macarthur Coal after shareholders accepted a \$4.9 billion bid for the company. ❖