4. Domestic Financial Markets

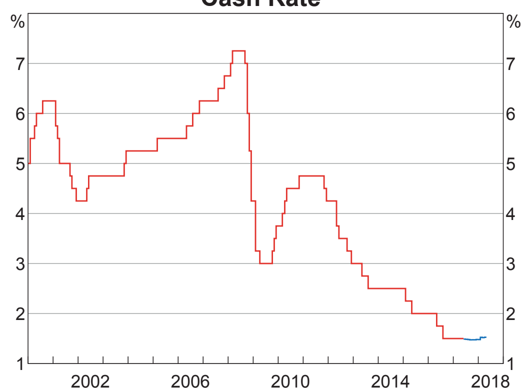
Australian financial markets have been relatively quiet in recent months. The cash rate target has remained at 1.5 per cent since last August and financial market prices suggest that it is likely to remain unchanged over the period ahead. In line with developments in global markets, Australian government bond yields have declined over recent months, partly reversing the increase observed during 2016. Conditions for obtaining funding remain favourable for banks and non-financial corporations, with spreads of corporate bond yields to government bonds narrowing to relatively low levels. Despite this, growth in credit extended to businesses has slowed and non-financial corporate bond issuance has remained low. This has been particularly the case for the resources sector, where corporations have been using increased cash flows from higher resource prices to reduce debt. Housing credit growth has been stable in recent months; investor credit growth steadied after accelerating late last year. The major banks and a number of smaller banks have announced increases to lending rates for housing investors and interest-only loans, largely associated with measures introduced by the financial regulators to reinforce sound housing lending practices. Equity prices have increased since the start of the year, reflecting both global developments and a positive reaction to domestic corporate profit announcements.

Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 1.5 per cent since August last year. Rates on overnight indexed swaps (OIS) suggest that the cash rate is likely to remain unchanged over the remainder of this year (Graph 4.1).

Short-term interest rates in the repurchase agreement (repo) market remain high relative to OIS rates. Over the past couple of years, the repo rates at which the Reserve Bank conducts its open market operations have moved from being close to OIS rates to around 30 basis points above OIS rates. The wider spreads reflect heightened demand for secured funding from market participants, particularly non-residents, and appear to be related to developments in the foreign exchange swap market and the bond futures market.[1] In particular, in the foreign exchange swap market, Australian dollars can be lent against yen at a relatively high implied Australian dollar interest rate; as a result, some investors have been borrowing Australian dollars under repo to use them for such foreign exchange swap transactions.

Graph 4.1
Cash Rate*

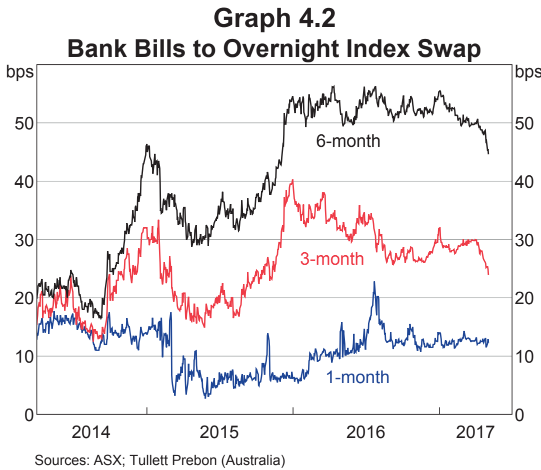


* Data from June 2017 onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

1 For more information, see Becker C, A Fang and J C Wang (2016), 'Developments in the Australian Repo Market', RBA *Bulletin*, September, pp 41–46.

Despite the elevated repo rates, short-term interest rates more closely related to bank funding costs have remained low. In particular, the unsecured interbank overnight interest rate – the cash rate – has continued to trade at the Reserve Bank's target and spreads on bank bill rates have narrowed (Graph 4.2).

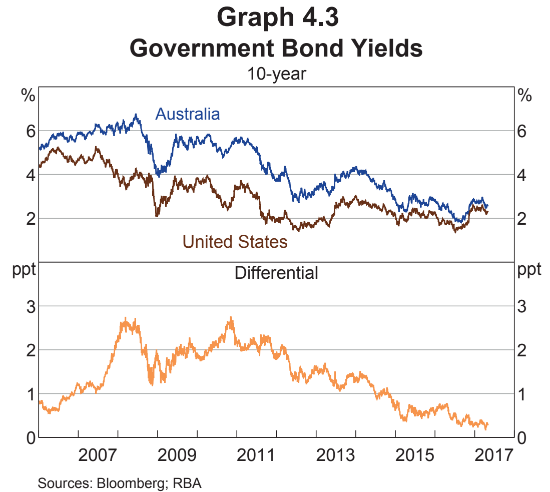


Yields on 10-year Australian Government Securities (AGS) followed movements in US Treasury yields and have declined by 40 basis points since early March (Graph 4.3). The spread between 10-year AGS and US Treasury yields has been around 30 basis points, which is close to its lowest level since 2001.

Demand for AGS remains strong and recent bond tenders have generally been well received. In addition, the Australian Office of Financial Management (AOFM) issued $11 billion of a new 10-year bond in February, which was the largest AGS syndication to date.

The level of outstanding semi-government bonds has been stable at around $240 billion so far this year, with issuance by Western Australia and Queensland offset by maturities from New South Wales.

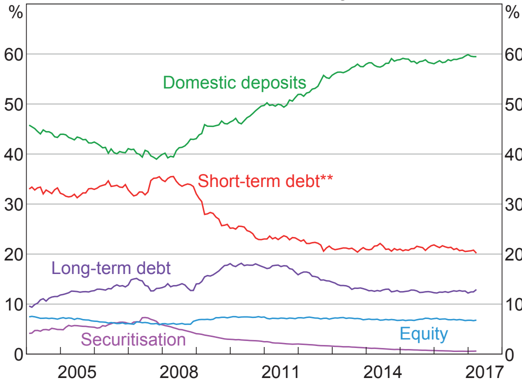
There has been a large volume of bonds issued by non-residents in the domestic market



('Kangaroo' issuance) since the beginning of the year. Issuance was mainly from supranational agencies and offshore banks and generally for longer maturities than in previous years, continuing the trend from 2016. By converting the Australian dollars they raise into foreign currency using the foreign exchange swap market, Kangaroo issuers indirectly assist Australian corporations looking to hedge funding raised offshore back into Australian dollars. Secondary market spreads of AAA-rated Kangaroo bonds to AGS have been stable over the past few years.

Financial Intermediaries

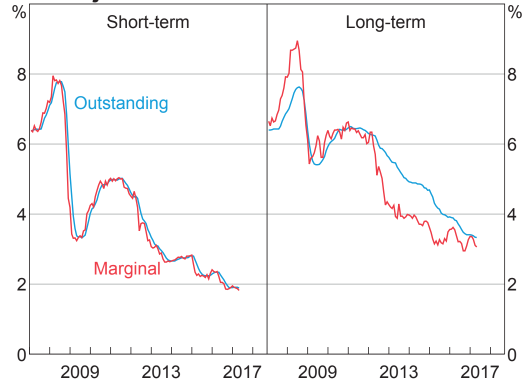
The funding composition of banks has been little changed in recent months (Graph 4.4). There has been a noticeable pick-up in the share of term deposits since 2015. These deposits are treated more favourably than other types of funding under the net stable funding ratio (NSFR), which will be introduced by the Australian Prudential Regulation Authority (APRA) in 2018. Banks have indicated that competition for funding continues to be focused on these deposits, although the major banks have all indicated that their NSFRs are at or above the regulatory minimum.



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

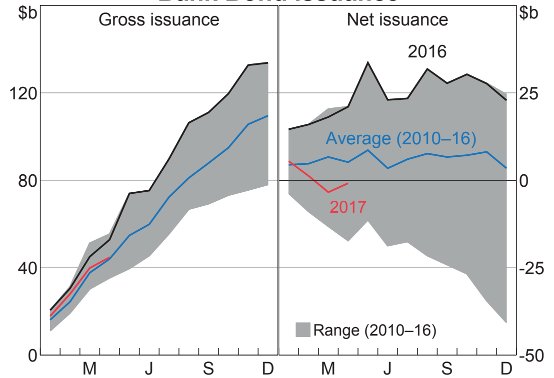
** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's



* RBA estimates; rates do not include interest rate hedges

Sources: Bloomberg; RBA



Source: RBA

Overall, deposit funding costs are also estimated to have been stable in recent months. The ongoing shift in the composition of deposits towards term deposits has added to funding costs, with the rates on term deposits remaining elevated in comparison to other deposit rates. This compositional effect has been offset by a decline in interest rates on some at-call and term deposit products. Furthermore, the average cost of term deposits has declined a little, reflecting maturities of deposits that were entered into at higher interest rates in mid 2016.

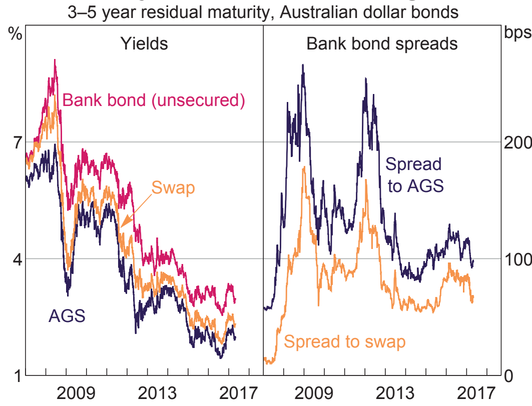
Estimates of the average cost of the major banks' debt funding have been little changed over recent months. The cost of issuing new long-term wholesale debt has declined a little, and is back below the cost of outstanding issuance (Graph 4.5). Short-term wholesale debt costs have been relatively stable.

Bond issuance by Australian banks has continued in recent months at around the average pace seen over recent years (Graph 4.6). The total level of outstanding bonds is little changed since the start of the year, as issuance has roughly matched bond maturities over that period.

Secondary market yields on the major banks' bonds have declined since the start of the year. Spreads to benchmark rates have also narrowed, to be around their lowest levels for a couple of years (Graph 4.7).

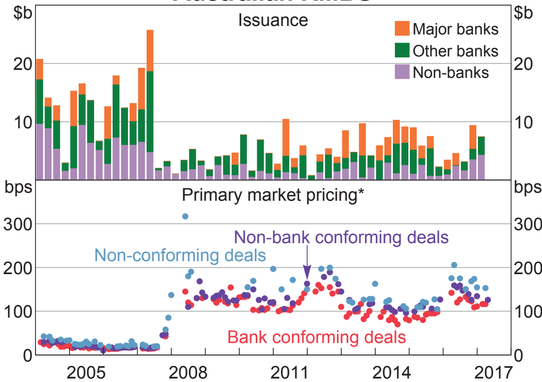
Issuance of asset-backed securities has been strong since late last year, with non-bank mortgage originators issuing a large volume of residential mortgage-backed securities (RMBS) (Graph 4.8). This includes a $1.7 billion single issuance, which was the largest RMBS by a non-bank mortgage originator since 2007. Overall, the characteristics of the mortgages underlying these securities have been of similar quality to previous RMBS deals issued in Australia.

Graph 4.7
Major Banks' Bond Pricing
3–5 year residual maturity, Australian dollar bonds



Sources: Bloomberg; UBS AG, Australia Branch

Graph 4.8
Australian RMBS



* Face-value weighted monthly average of the primary market spread to bank bill swap rate

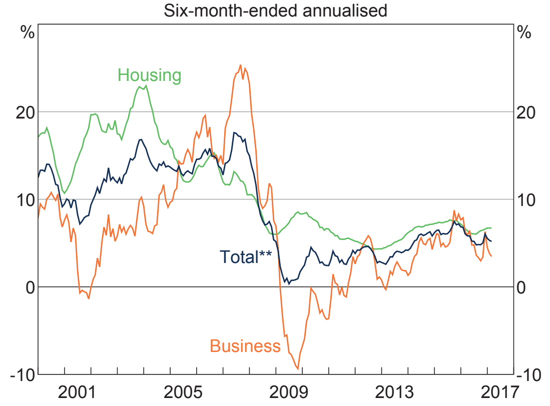
Source: RBA

There has also been sizable issuance backed by other types of loans, including car and credit card loans. Primary issuance spreads on RMBS are little changed since the start of the year.

Financial Aggregates

Total credit growth has slowed in recent months, largely due to a decline in business credit growth, while housing credit growth has remained stable (Graph 4.9). Broad money has grown faster than total credit over the past year (Table 4.1).

Graph 4.9
Credit Growth by Sector*
Six-month-ended annualised



* Seasonally adjusted and break-adjusted; including securitisation

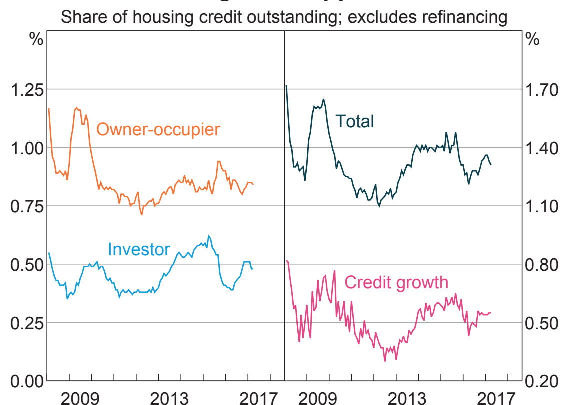
** Includes housing, personal and business credit

Sources: ABS; APRA; RBA

Household Financing

Housing credit growth was stable in recent months at an annualised rate of around 6½ per cent. Growth in credit extended to investors has steadied at an annualised pace of around 8 per cent, after accelerating through the second half of 2016. This stabilisation in investor credit growth is consistent with the slight reduction in investor loan approvals and may have been partly driven by the increases in interest rates for investors in late 2016 along with further tightening in lending standards by lenders around that time (Graph 4.10).

Graph 4.10
Housing Loan Approvals*
Share of housing credit outstanding; excludes refinancing



* Seasonally adjusted and break adjusted

Sources: APRA; RBA

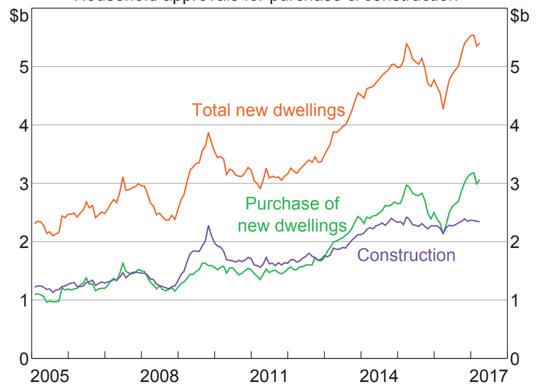
Table 4.1: Financial Aggregates
Percentage change[(a)]

	Three-month ended		Year-ended
	Dec 2016	Mar 2017	Mar 2017
Total credit	1.7	0.8	5.0
– Housing	1.6	1.7	6.5
– Owner-occupier	1.4	1.5	6.2
– Investor	2.2	2.0	7.1
– Personal	–0.3	–0.5	–1.5
– Business	2.2	–0.5	3.4
Broad money	2.2	1.9	6.7

(a) Growth rates are break adjusted and seasonally adjusted
Sources: APRA; RBA

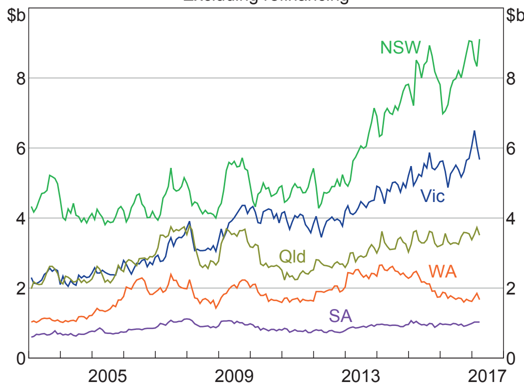
The decline in loan approvals in recent months has been driven by a decline in approvals in Victoria, while loan approvals in New South Wales have remained near record highs (Graph 4.11). Housing finance for new dwellings has been little changed recently following rapid growth through 2016; housing finance for the construction of new homes has remained stable (Graph 4.12). Overall, loans for new dwellings or dwellings under construction are estimated to have contributed more than half of credit growth over the past year. This contribution is expected to rise, based on the pipeline of residential construction work under way.

Graph 4.12
Housing Finance Approvals for New Dwellings
Household approvals for purchase & construction*



* Investor shares are RBA estimate
Sources: APRA; RBA

Graph 4.11
Housing Loan Approvals*
Excluding refinancing

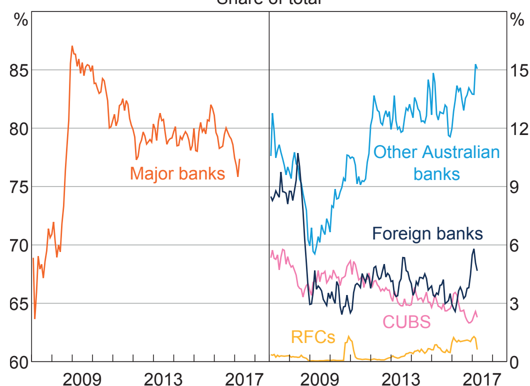


* Seasonally adjusted
Sources: APRA; RBA

The major banks' share of housing loan approvals has fallen in recent months to its lowest level since 2008. Most of this reduction appears to have been absorbed by other Australian and foreign banks (Graph 4.13). Housing credit issued by entities that are not licensed by APRA as authorised deposit-taking institutions (ADIs) is estimated to have increased slightly in recent quarters, but at around 3 per cent remains a very small share of housing credit.

The further increases in housing interest rates announced by some lenders in March and April and prudential guidance from APRA and ASIC regarding interest-only lending can be expected to affect housing credit growth over the months ahead.

Graph 4.13
Housing Loan Approvals*



* Seasonally adjusted; CUBS are credit unions and building societies; RFCs are registered financial corporations

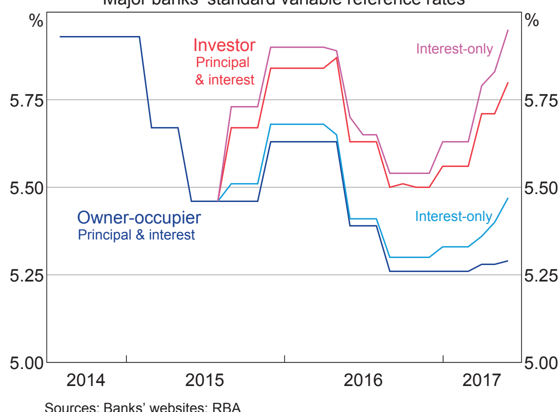
Sources: APRA; RBA

As outlined in the April *Financial Stability Review*, the Council of Financial Regulators (CFR) has been monitoring and evaluating the risks to household balance sheets. APRA announced further measures in March 2017 to reinforce sound housing lending practices. ADIs will be expected to limit new interest-only lending to 30 per cent of total new residential mortgage lending and, within that, to tightly manage new interest-only loans extended at loan-to-value ratios above 80 per cent. APRA also reinforced the importance of banks: managing their lending so as to comfortably meet the existing investor credit growth benchmark of 10 per cent; using appropriate loan serviceability assessments, including the size of net income buffers; and continuing to exercise restraint on lending growth in higher risk segments. APRA also announced that it would monitor the growth in warehouse facilities provided by ADIs. These facilities are used by non-bank mortgage originators for short-term funding of loans until they are securitised.

In addition, the Australian Securities and Investments Commission (ASIC) announced in April further steps to ensure that interest-only loans are appropriate for borrowers' circumstances and that remediation can be provided to borrowers who suffer financial distress as a consequence of shortcomings in past lending practices.

Since February, the major banks have announced an average cumulative increase to their standard variable rates of around 25 basis points for investors and a few basis points for owner-occupiers. Also, borrowers will pay an additional premium for interest-only loans of around 15 basis points for investors and 20 basis points for owner-occupiers (Graph 4.14).

Graph 4.14
Variable Housing Interest Rates



Sources: Banks' websites; RBA

The rates actually paid on new variable rate loans are likely to differ from the major banks' standard variable rates. The major banks and other lenders offer discounts to their standard variable rates, which can vary through time particularly for new borrowers; for example, in 2015, increases in interest rates on existing borrowers were reportedly accompanied by larger unadvertised discounts for new borrowers.

Overall, the increases that have been announced to date by lenders are expected to raise the average variable rate paid on outstanding housing loans by around 15 basis points. The average outstanding rate on all housing loans is expected to increase by slightly less than the variable rate since interest rates on new fixed-rate loans remain below those on outstanding fixed-rate loans (Table 4.2).

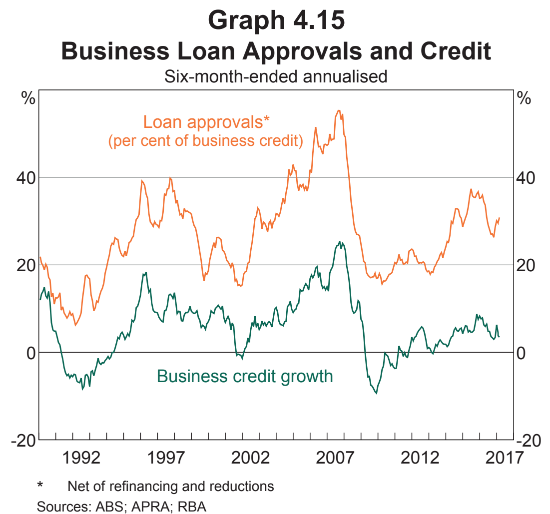
Table 4.2: Intermediaries' Lending Rates

	Interest rate Per cent	Change since November 2016 Basis points	Change since April 2016 Basis points
Housing loans			
– Variable principal-and-interest rate[a][b]			
– Owner-occupier	4.48	3	–30
– Investor	4.97	28	–4
– Variable interest-only rate[a][b]			
– Owner-occupier	4.66	10	–19
– Investor	5.12	35	3
– Average outstanding rate[d]	4.63	11	–22
Personal loans			
– Variable rate[e]	11.62	17	25
Small business			
– Term loans variable rate[f]	6.43	4	–32
– Overdraft variable rate[f]	7.31	4	–32
– Fixed rate[c][f]	5.27	–3	–15
– Average outstanding rate[d]	5.34	–2	–35
Large business			
Average outstanding rate[d]	3.50	0	–46

(a) Includes announced changes to new lending to May 2017
(b) Average of the major banks' discounted package rates on new, $500 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates, includes variable and fixed rates
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar; RBA

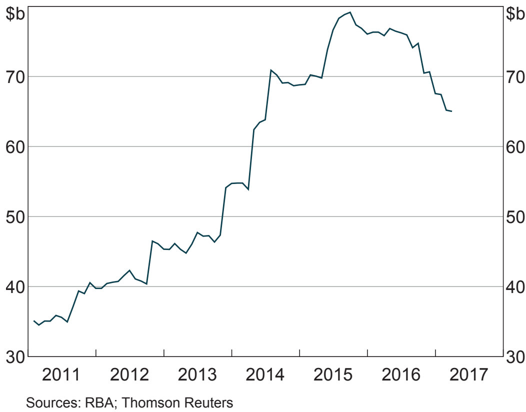
Business Financing

Business credit growth has slowed recently after a pick-up at the end of 2016 associated with the financing of several large infrastructure deals. The slowdown in business credit growth is partly due to maturities of large loans in recent months; meanwhile business loan approvals have increased recently (Graph 4.15).



The slowdown in business credit growth partly reflects deleveraging by the mining sector following strong cash flows in the second half of 2016. Resource companies have reduced their debt levels through this period, including by repaying debt and refinancing loans for smaller amounts. This has been reflected in a fall in the stock of syndicated lending to the materials sector over the past six months equivalent to a decline in total business credit of ½ per cent (Graph 4.16).

Graph 4.16
Syndicated Lending to Materials Sector



Sources: RBA; Thomson Reuters

Outside of the mining sector, demand for credit is uneven across industries. Lending to the manufacturing sector has declined, while according to liaison with banks, there has been stronger demand for credit from the infrastructure, agriculture, health and tourism sectors. Loan approvals for the construction of residential property have declined, although this follows very strong growth through 2016. In contrast, loan approvals for the purchase or construction of commercial property have risen recently.

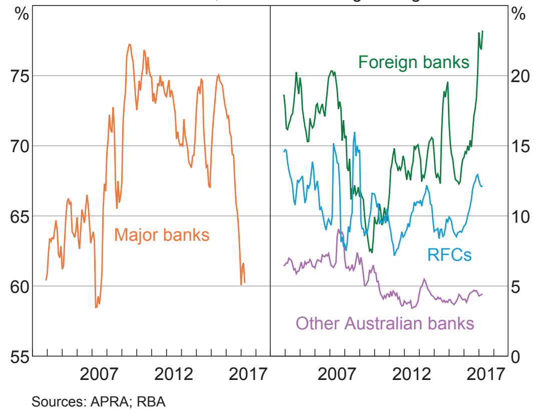
The major banks' share of new business loan approvals has fallen to relatively low levels, partly reflecting their efforts to reduce exposures to selected industries and larger companies (Graph 4.17). At the same time, foreign banks have increased their share of approvals. Asian banks have lower funding costs than many Australian banks and their increased market share is likely to partly reflect this competitive advantage. To date, most of the lending by the Asian banks has been to large businesses.

The major banks have announced increases in small business variable interest rates of up to 8 basis points. Outside of this, business lending rates have been broadly steady (Graph 4.18).

There continues to be limited bond issuance by resource companies as they have sought to reduce debt levels further (Graph 4.19). Bond issuance by other non-financial corporations has continued at a steady pace. Secondary market corporate bond spreads have continued to tighten for both resource and non resource companies back towards levels last seen in 2014 (Graph 4.20).

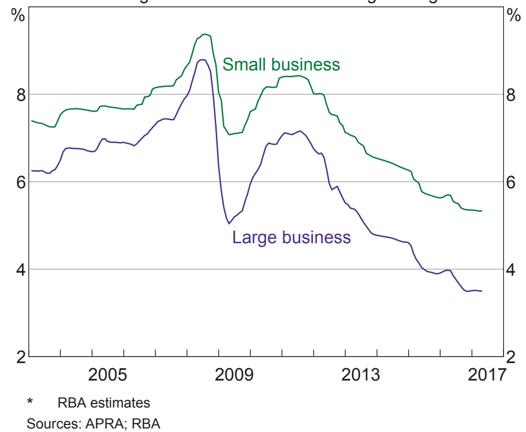
Net equity raisings by non-financial corporations was subdued in the March quarter, with no sizeable transactions of note. Following a large pick-up towards the end of 2016, merger and acquisition activity has been more modest in the year to date, with activity concentrated in the consumer discretionary, resources and industrials sectors.

Graph 4.17
Gross Business Loan Approvals
Share of total; six-month moving average



Sources: APRA; RBA

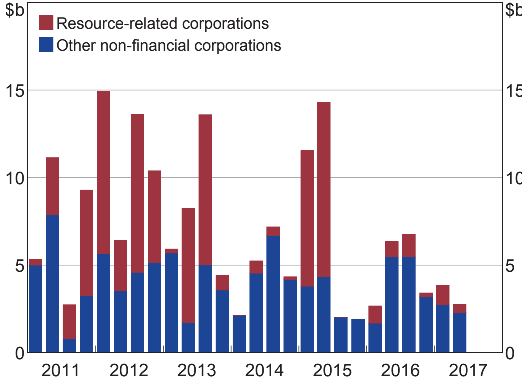
Graph 4.18
Average Business Lending Rates*
Average interest rate on outstanding lending



* RBA estimates
Sources: APRA; RBA

Graph 4.19
Australian Corporate Bond Issuance*

Australian dollar equivalent

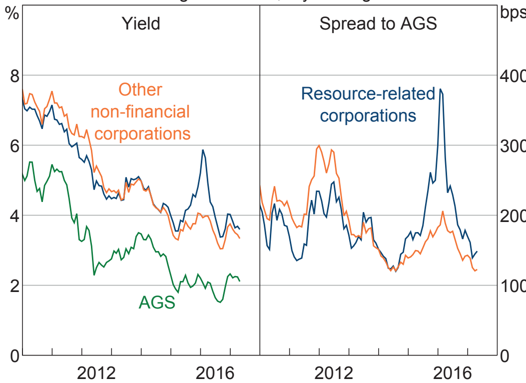


* Latest quarter issuance to date

Source: RBA

Graph 4.20
Australian Corporate Bond Pricing

Investment grade bonds, 5-year target tenor



Sources: Bloomberg; RBA; S&P Capital IQ

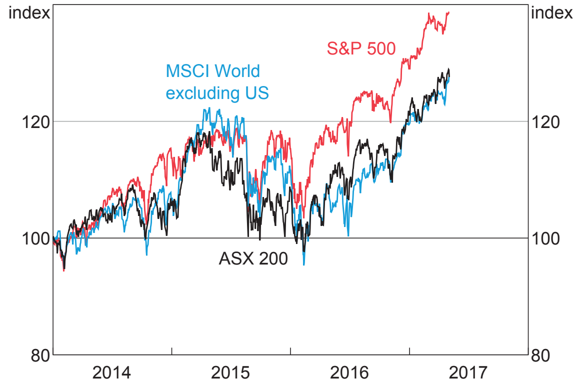
Equity Markets

Australian equity prices have largely followed global developments in recent months to be around 4 per cent higher since the start of the year (Graph 4.21). There was also a positive reaction to domestic company profit results.

Resources sector share prices have fallen since the start of the year, alongside a large fall in iron ore and oil prices. Financial sector share prices have continued their upward trend to be around 5 per cent higher since the start of the year.

Graph 4.21
Share Price Accumulation Indices

End December 2013 = 100



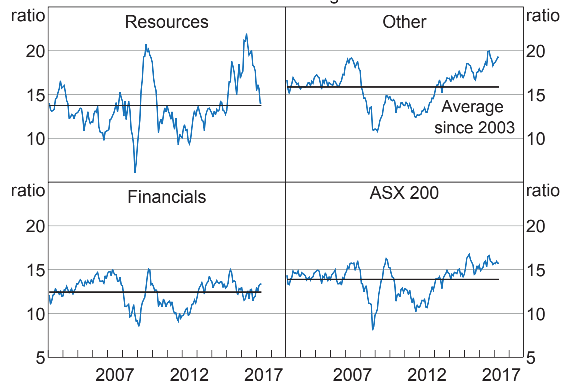
Sources: MSCI; Thomson Reuters

Equity prices for companies outside the financial and resources sectors have increased, reflecting large increases for the healthcare and utilities sectors. Telecommunication stocks declined after lower-than-expected profit results and with the prospect of increased competition in the mobile phone market.

Following the latest round of company profit results, analysts' earnings expectations for coming years were again revised higher. The sharp increase in resources sector earnings expectations has seen valuations (measured by forward price-earnings ratios) fall back towards their long-term average (Graph 4.22).

Graph 4.22
ASX 200 Price-earnings Ratios

12-month-ahead earnings forecasts

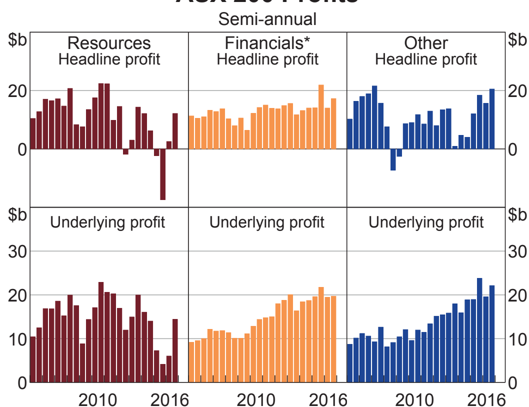


Source: Thomson Reuters

Profit Reporting

Aggregate headline profits for ASX 200 companies rose substantially over the second half of 2016 compared with the same period in 2015, largely reflecting fewer asset write-downs in the resources sector (Graph 4.23). Abstracting from these one-off items, aggregate underlying profits were 15 per cent higher compared with the same period a year earlier, driven by a sharp turnaround in resources sector profits.

Graph 4.23
ASX 200 Profits



* The results of the major banks and Macquarie Group that reported in October/November are rolled forward.

Sources: Company reports; Morningstar; RBA

Underlying profits in the resources sector more than tripled compared with the same period last year, largely due to higher commodity prices. A number of resource companies used the increased cash flows to pay down debt, boost their cash holdings and increase shareholder dividends.

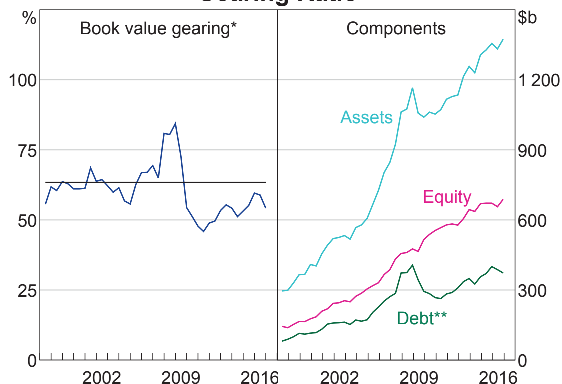
Financial companies' underlying profits declined, largely driven by profit declines for the major banks that reported in October/November. By contrast, banks that reported more recently have recorded more positive results. Profits for diversified financial companies declined, while insurers' profits rose.

Underlying profits for companies outside the resources and financial sectors declined compared with the same period last year. Increased competition and margin pressure continued to adversely affect earnings for the major supermarket chains. Meanwhile, strong residential construction and tourism activity continued to support earnings for some companies.

Aggregate shareholder distributions increased by 10 per cent in the second half of 2016 compared with the same period last year driven by the major miners paying higher dividends. Overall, dividends paid by companies outside the resources sector rose slightly.

The assets of Australian listed non-financial corporations increased by 3 per cent over the second half of 2016 (Graph 4.24). The expansion reflected an increase in resources sector assets, partly due to higher cash holdings, as well as asset growth in the healthcare and real estate sectors reflecting externally financed acquisitions and positive asset revaluations. This overall expansion in assets, together with a reduction in debt, resulted in gearing (the ratio of total debt to equity based on book values) declining by 5 percentage points to 54 per cent. ✤

Graph 4.24
Listed Non-financial Corporations' Gearing Ratio



* Ratio of gross debt to equity; excludes foreign-domiciled companies

** Debt only includes short-term and long-term loans and bonds payable; not equivalent to total liabilities

Sources: Morningstar; RBA