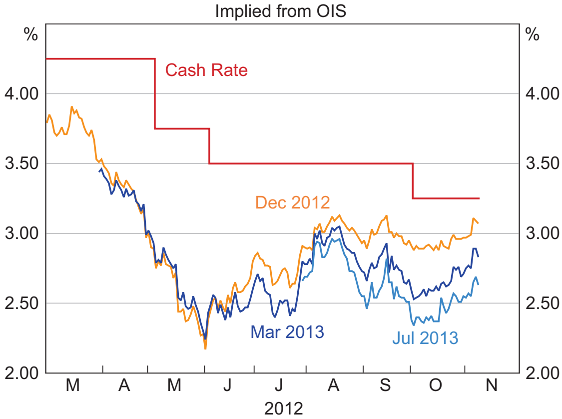
# 4. Domestic Financial Markets

## Money Markets and Bond Yields

The Reserve Bank Board lowered its target for the cash rate by 25 basis points in October, to 3.25 per cent. Within financial markets, expectations for further easing in monetary policy over the next 12 months or so have remained broadly unchanged over the past couple of months. Rates on overnight indexed swaps (OIS) currently imply a cash rate target of 3 per cent by early 2013 and around 2.75 per cent by mid 2013 (Graph 4.1).

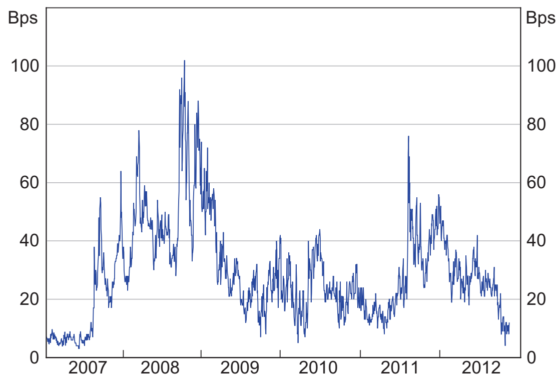
**Graph 4.1**
**Cash Rate Expectations**
Implied from OIS



Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Interest rates on 90-day bank bills and certificates of deposit (CDs) have declined by 35 basis points since the previous *Statement*, to around 3.25 per cent, their lowest level since mid 2009. With the major Australian banks reducing their issuance of short-term debt, as well as minimal credit concerns, the spread of bank bills over OIS narrowed to less than 10 basis points, its lowest level since June 2007 (Graph 4.2).

**Graph 4.2**
**Spread of 3-month Bank Bills to OIS**

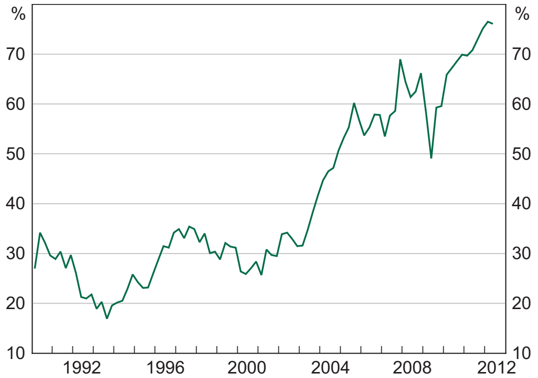


Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

The yield on 10-year Commonwealth Government securities (CGS) is broadly unchanged since the previous *Statement*, and at around 3.10 per cent, it remains very low by historical standards. CGS yields remain underpinned by strong demand from international investors for AAA rated sovereign debt. The most recent data show that the share of CGS held by foreign residents was stable in the June quarter at around 77 per cent (Graph 4.3).

Following the release of the Australian Government's Mid-Year Economic and Fiscal Outlook in late October, the Australian Office of Financial Management (AOFM) announced that it would extend the average maturity of its debt raisings by reducing issuance of short-term Treasury Notes in favour of longer-term Treasury Bonds. Earlier that month, the AOFM extended its conventional yield curve by selling $3¼ billion of a new 2029 bond through a syndication.

## Graph 4.3
### Foreign Ownership of CGS
Share of total market value




Sources: ABS; AOFM

Long-term credit ratings for Queensland, Tasmania and South Australia have all been lowered in recent months, while New South Wales and Western Australia have been put on negative outlook by the ratings agencies. These actions have had little effect on the states' ability to access wholesale debt markets. Spreads between 5-year CGS yields and those on state government debt ('semis') have narrowed slightly since the previous *Statement* and, in absolute terms, yields on semis remain around their historic lows (Graph 4.4).

Non-resident entities have issued $7 billion worth of 'Kangaroo' bonds domestically since the last *Statement*. Reflecting the general improvement in financial market sentiment, secondary market spreads on Kangaroo bonds have fallen to their lowest levels since late 2011. Around half of the recent issuance has come from financial institutions or other corporates, including some first-time issuers who have benefited from strong investor appetite for highly rated paper from non-European issuers. There has been less issuance by European-based supranational agencies, in part reflecting less advantageous hedging costs associated with swapping Australian dollars into euros.

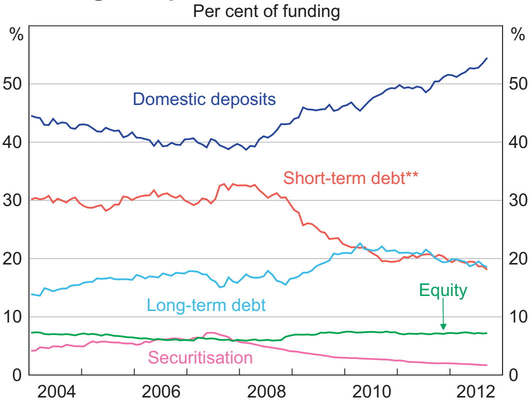
## Graph 4.4
### 5-year State Government Debt


Sources: RBA; Yieldbroker

## Financial Intermediaries

In recent months, the shift in the composition of bank funding away from both short- and long-term wholesale liabilities towards domestic deposits has continued. Deposits now account for 54 per cent of total bank funding liabilities (Graph 4.5). Over the past quarter, growth in at-call deposits has been somewhat stronger than growth in term deposits reflecting the number of at-call products with yields above those on term deposit rates, particularly bonus saver accounts. In part, this reflects the inverted yield curve for maturities out to 12 months. Term deposits currently account for about half of total deposits. Within long-term wholesale debt, there has been a general lengthening by banks of the term of newly issued wholesale debt over recent years.

## 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

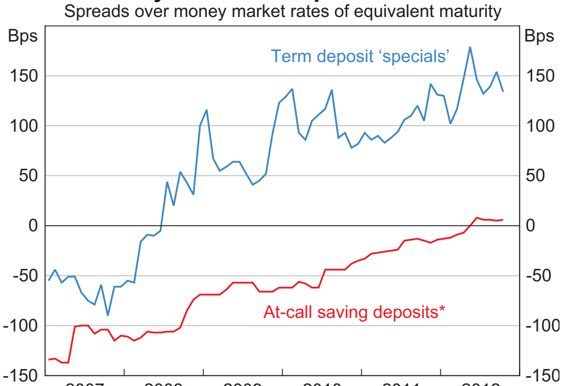
Sources: APRA; RBA; Standard & Poor's

Bank funding costs – relative to the cash rate – have risen by about 50 basis points over the past year, but are estimated to have been broadly unchanged since the previous *Statement*. In absolute terms, interest paid by banks is declining (as is interest received). The rise in bank funding costs relative to the cash rate over the past year largely reflects the increased cost of deposits. The interest in deposits is largely in response to pressure from banks, investors and regulators globally to secure notionally more stable funding sources.

More recently, the average quoted rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has fallen by around 25 basis points since the previous *Statement*, in line with the reduction in the cash rate (Graph 4.6). Average interest rates on new term deposit 'specials' at the major banks remain well above those on equivalent bank wholesale funding instruments (Graph 4.7).

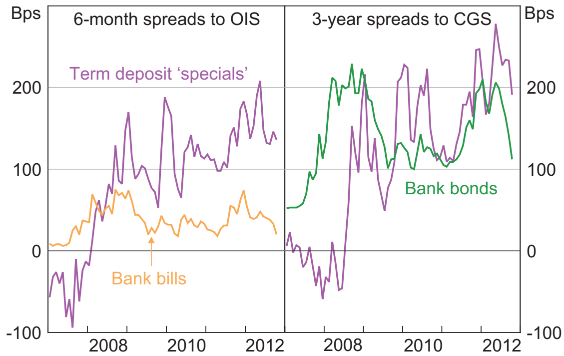
A number of banks have recently reported profit results for their 2012 financial years. Higher funding costs contributed to a small decline in net interest margins. Over the past few years, the major banks' average net interest margin has fluctuated in a relatively narrow range (Graph 4.8).

## Graph 4.6
## Major Banks' Deposit Rates
Spreads over money market rates of equivalent maturity



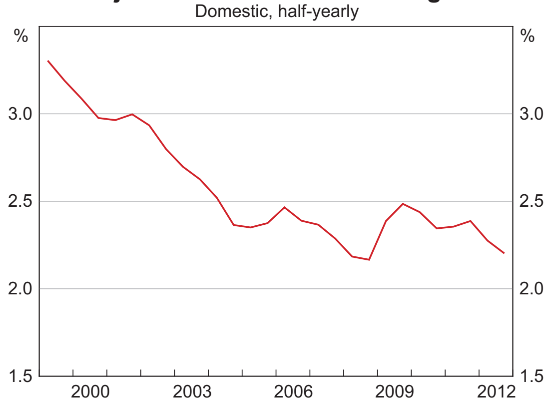

* Spread to cash rate; existing customers only; excludes temporary bonus rates
Sources: Bloomberg; RBA

## Graph 4.7
## Major Banks' Pricing of Term Deposits and Bonds
A$ debt




Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

## Graph 4.8
## Major Banks' Net Interest Margin*
Domestic, half-yearly




* From 2006 data are on an IFRS basis; prior years are on AGAAP basis; excludes St George Bank and Bankwest prior to the first half of 2009
Sources: Banks' financial reports; RBA

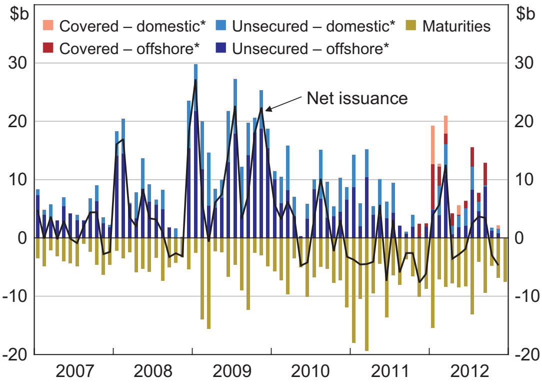
Australian banks have taken advantage of the improvement in market sentiment associated with policy developments in the US and the euro area to issue long-term debt. Since the previous *Statement*, around $23 billion of bank debt has been issued, with primary market pricing tightening considerably. Banks have generally used wholesale markets to roll over maturing debt or retire existing government-guaranteed debt, while funding balance sheet growth with increases in deposits.

Unlike earlier in the year, a large share of the wholesale issuance has been in offshore markets and in unsecured form (Graph 4.9). Much of this

Graph 4.9

Banks' Bond Issuance and Maturities

A$ equivalent




* Latest month issuance to date

Source: RBA

issuance has been in US dollars and for terms of 3 to 5 years. This contrasts with unsecured issuance around the turn of the year, which was primarily for shorter terms as wholesale funding conditions were particularly difficult. There has been some small onshore issuance, including Bendigo and Adelaide Bank's 3-year floating-rate bond worth $400 million, its first public unsecured wholesale issue since the two entities merged in November 2007.

Around $6 billion of covered bonds have been issued since the previous *Statement*. Two of the major banks issued securities for terms of 14 and 15 years in sterling and euros, benefiting from the dearth of issuance by European banks that have used self-securitised securities as collateral to borrow from European central banks. Suncorp-Metway also issued $600 million in 5-year covered bonds, its second such issue. The Australian banks have sought to retain some capacity to issue these bonds; currently, the major banks have utilised around 20–35 per cent of their covered bond issuance capacity.

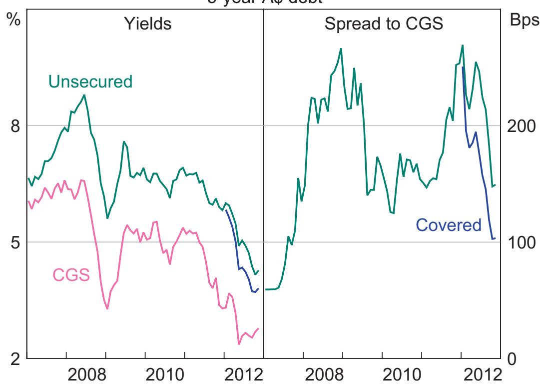
Banks have issued around $2 billion in hybrid securities since the last *Statement*. This issuance has continued the trend since late 2011 facilitated by clarification of the nature of forthcoming regulatory changes (see 'Box C: Recent Trends in Hybrid Issuance').

The improvement in financial market sentiment since the previous *Statement* has caused major banks' unsecured and covered bond spreads to tighten by over 50 basis points relative to CGS in the secondary market (Graph 4.10). These spreads are at their lowest level since the intensification of euro area concerns in mid 2011. Yields on bank bonds are at historically low levels.

Graph 4.10

Major Banks' Bonds

5-year A$ debt

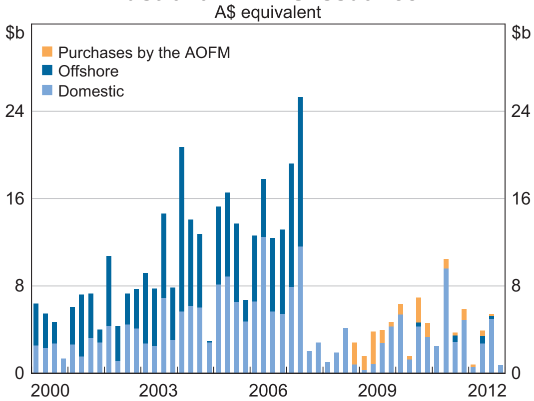



Sources: Bloomberg; RBA; UBS AG, Australia Branch

Conditions in the Australian securitisation market have also improved in recent months, with a number of residential mortgage-backed securities (RMBS) and other asset-backed securities (ABS) transactions executed at spreads that were 10–15 basis points narrower than those achieved on similar deals priced earlier in the year. Around $5 billion RMBS and $2 billion in other ABS have been issued since the previous *Statement* (Graph 4.11). Among other drivers, the continuing decline in covered bond spreads has helped entice investors back into the RMBS market. Reflecting strong demand from the private sector, the AOFM has had only minimal participation in recent deals.

Moody's has revised the way in which it evaluates lender's mortgage insurance (LMI) in Australian RMBS. The new methodology will likely reduce its estimate of the ratings support from LMI. In October, Standard & Poor's (S&P) changed the ratings outlook on the

Graph 4.11
Australian RMBS Issuance*




* Latest quarter issuance to date
Source: RBA

mortgage insurer Genworth Australia (rated AA-) to negative following the ratings downgrade of its US parent. Notwithstanding the change in outlook, a subsequent review of outstanding Australian RMBS by S&P saw ratings on numerous subordinated tranches raised to AAA, reflecting the strong collateral performance and build-up of credit support within these structures.

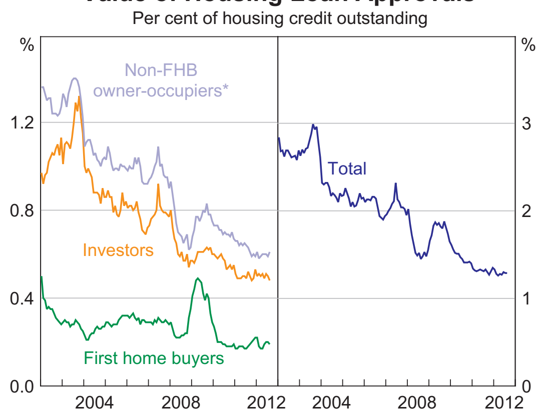
The Reserve Bank announced its intention to require issuers to provide more information on asset-backed securities if they are to remain eligible for the Bank's market operations. In addition to assisting the Bank to more precisely value the securities, the changes are designed to improve transparency in the RMBS market – as a condition of eligibility, the information will have to be available to the public and kept up to date.

APRA also announced possible changes to securitisation regulations, with implementation planned for 2014. APRA proposes to simplify securitisation structures by allowing only two levels of subordination – senior and junior notes. Authorised deposit-taking institutions will be required to retain at least 20 per cent of the junior notes in order to ensure that they have some 'skin in the game'.

## Household Financing

Growth in housing credit continued over the September quarter at an annualised rate of around 4½ per cent. There is some evidence of customers increasing prepayments over the past year as lending rates have declined. Housing loan approvals increased slightly over the three months to August. As a share of housing credit, there has been little change in approvals over the past year and a half, suggesting a continuation of the current growth rate of housing credit in the period ahead (Graph 4.12).

Graph 4.12
Value of Housing Loan Approvals




* Net of refinancing
Sources: ABS; RBA

Following the 25 basis point reduction in the cash rate in October, most lenders reduced their indicator rates on variable-rate housing loans by around 20 basis points (Table 4.1). Rates on new, three-year, fixed-rate mortgages have also fallen, and are about 30 basis points below advertised variable rates. Overall, the average interest rate on outstanding housing loans (fixed and variable) is estimated to be around 75 basis points below its post-1996 average, having fallen by around 100 basis points over the past year (Graph 4.13).

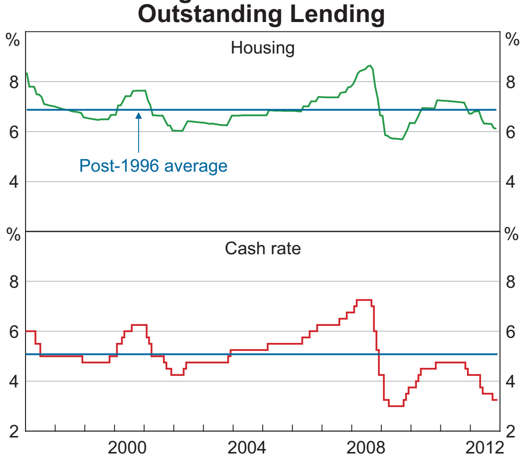
Some lenders have increased the discounts offered on certain variable-rate mortgage products by between 5 and 20 basis points. One major bank introduced a temporary offer to undercut the fixed rates of the other major banks. A number of

**Table 4.1: Intermediaries' Variable Lending Rates**
Per cent

| | Level at 8 November 2012 | Change since: End July 2012 | End October 2011 |
|---|---|---|---|
| **Housing loans** | | | |
| – Standard variable rate[a] | 6.64 | –0.19 | –1.15 |
| – Package rate[b] | 5.85 | –0.29 | –1.18 |
| **Personal loans** | 12.91 | –0.07 | –0.36 |
| **Small business** | | | |
| Residentially secured, advertised | | | |
| – Term loans | 7.80 | –0.20 | –1.20 |
| – Overdraft | 8.67 | –0.20 | –1.18 |
| Average rate[c] | 7.50 | –0.20 | –1.13 |
| **Large business** | | | |
| Average rate[c] (variable-rate and bill funding) | 5.46 | –0.13 | –1.56 |

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

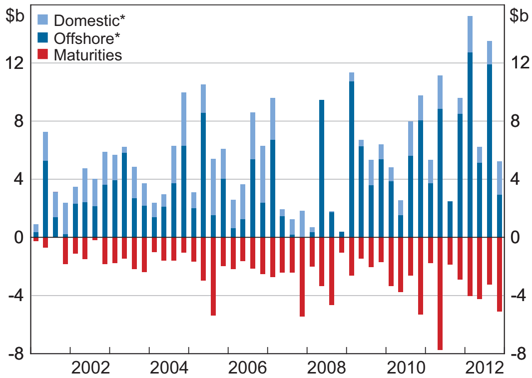
lenders also introduced temporary cash-back offers, or temporarily waived or reduced some of their mortgage application fees.

The value of outstanding personal credit fell slightly in the September quarter owing to a decline in revolving credit facilities, including credit card lending and lending secured by residential mortgages. Rates on personal loans have fallen since the end of July, primarily driven by rate reductions on home equity loans and unsecured personal loans.

## Business Financing

Corporate bond issuance has been strong in recent months, with around $16 billion issued since the previous *Statement* (Graph 4.14). The bulk of this issuance was through a few large offshore deals by resources companies, including a US$3 billion issue by Rio Tinto and a A$5.2 billion transaction by BHP Billiton in euros and sterling. The BHP Billiton deal was the second largest single-day issuance by an Australian company. BHP Billiton also issued its first bond in the domestic market since 2001, raising $1 billion for five years, which is the largest non-credit wrapped issue in the Australian market by a corporate issuer. Fortescue Metals completed a major refinancing of its bank loans after a fall in iron ore prices raised concerns about its earnings-related debt covenants. The five-year deal was completed

## Graph 4.14
### Australian Corporates' Bond Issuance
A$ equivalent

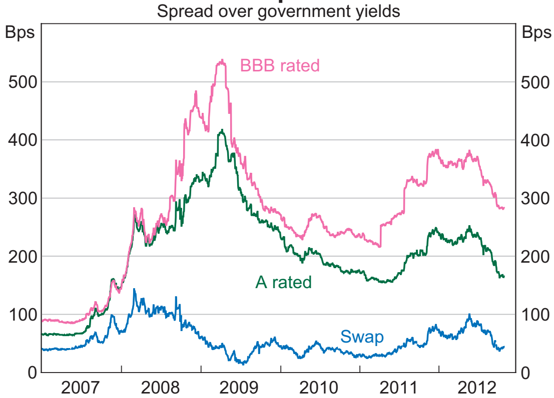



* Latest quarter issuance to date
Source: RBA

in a short time and suggests that larger companies are facing few difficulties in obtaining debt funding. Corporate bond spreads have tightened by around 40 to 50 basis points since the previous *Statement* and are now around mid 2011 levels (Graph 4.15).

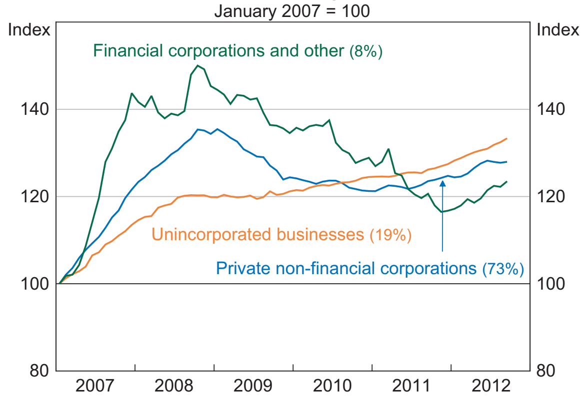
Intermediated business credit continued to grow in the September quarter, but at a somewhat slower pace than the growth witnessed over the first six months of 2012. While lending to unincorporated, and generally smaller, businesses continues to grow at a moderate pace, lending to non-financial corporations was broadly unchanged in recent months (Graph 4.16).

## Graph 4.15
### Australian Non-financial Corporate Bond Spreads*
Spread over government yields




* Swap spreads are for 3-year maturity; corporate bond spreads are a weighted average of senior bonds with remaining maturities of 1 to 5 years
Sources: Bloomberg; RBA; UBS AG, Australia Branch

## Graph 4.16
### Business Credit by Borrower*
January 2007 = 100

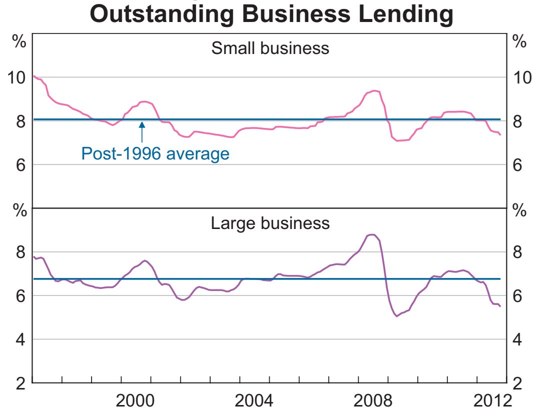



* Excludes securitised loans
Sources: APRA; RBA

The cost of intermediated business borrowing has declined over the past three months, with the average interest rates on outstanding small and large business loans both falling by around 10 to 20 basis points (Graph 4.17). These declines broadly reflected movements in wholesale benchmark rates, although spreads on business rates increased modestly over the period. Rates on small business and large business loans are now around 75 and 125 basis points, respectively, below their post-1996 averages, to be at their lowest level since September 2009.

Activity in the Australian syndicated lending market softened in the September quarter and the volume of new loans is well below the level of a year ago.

## Graph 4.17
### Average Interest Rates on Outstanding Business Lending




Sources: APRA; RBA

Over the past three months, the value of outstanding syndicated lending has declined by 4 per cent. This has coincided with reduced lending activity by both domestic and European financial institutions.

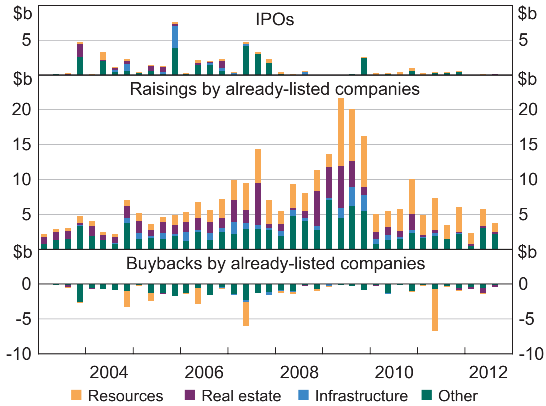
The weakness in equity capital raisings that has been evident since the end of 2009 continued in the September quarter. Only $3.7 billion was raised by already-listed corporates in the quarter, about half the decade's average. Initial public offerings (IPOs) were also very low at only $170 million (Graph 4.18). In aggregate, equity raisings this year have been the weakest since 2005 in dollar terms and the second weakest since at least 1990 relative to GDP. This subdued activity is due to a combination of factors, including persistent weak global economic growth and uncertainty and low corporate gearing in Australia that has limited the need for equity raisings.

The number of mergers and acquisitions (M&A) announcements has increased recently, reflecting a large number of low-value deals in the resources sector. By value though, M&A remains subdued, with $9.4 billion in M&A deals involving listed companies pending or completed since the last *Statement*. The largest deal outside of the resources sector was a $2.7 billion offer for GrainCorp. In aggregate, $30 billion in M&A deals have been announced this year, the lowest level since 2004.

Total business external funding grew by 4½ per cent of GDP in the September quarter. Unlike the June quarter, funding was sourced almost completely from capital markets, particularly from non-intermediated debt (Graph 4.19). Growth over the past year has been considerably stronger than in the two preceding years.

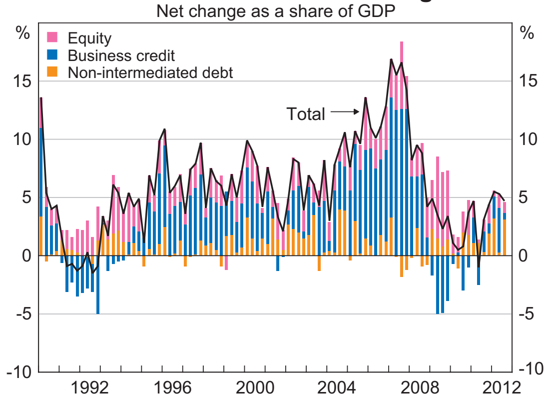
Data for the first half of 2012 show that listed corporates' balance sheets continued to grow at a moderate pace. The growth in balance sheets was largely funded through debt and retained earnings amid the ongoing weakness in equity raisings. Despite a small increase in gearing ratios, book value gearing – the ratio of debt to shareholder equity – remains close to its multi-decade lows at around 50 per cent (Graph 4.20). The increase in gearing

**Graph 4.18**
**Listed Corporates' Equity Raisings***



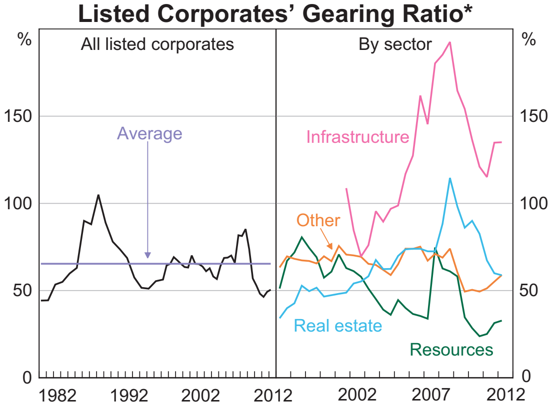

* Excludes privatisations and hybrid conversions, which are very small
Sources: ASX; RBA

**Graph 4.19**
**Business External Funding**
Net change as a share of GDP




Sources: APRA; ASX; RBA

**Graph 4.20**
**Listed Corporates' Gearing Ratio***



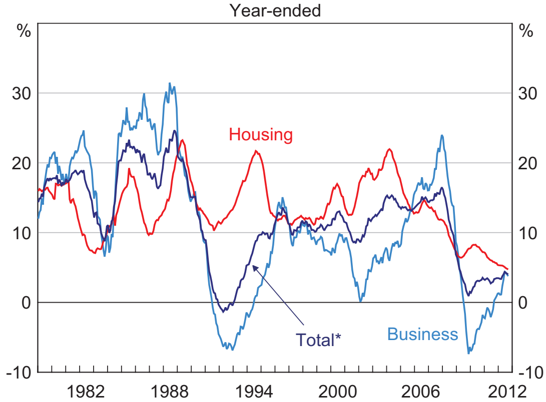

* Excludes foreign-domiciled companies; includes real estate companies from 1997; book value debt over equity
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

was driven by the resources, utilities and consumer discretionary sectors.

## Aggregate Credit

Credit growth slowed to an annualised rate of around 3 per cent in the September quarter (Graph 4.21). Broad money growth has outpaced credit growth for each of the past five years. This growth reflects changes not only in the composition of banks' assets and liabilities, but also the preferences of households and businesses to hold a greater share of their assets as deposits.

**Graph 4.21**
**Credit Growth**
Year-ended



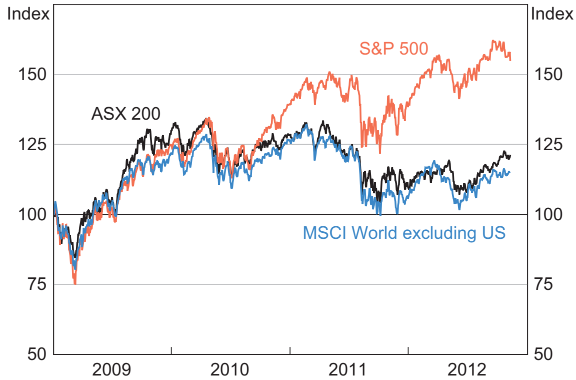

* Includes housing, personal and business credit
Source: RBA

## Equity Markets

The general improvement in risk appetite has seen Australian equity prices rise by 5 per cent since the last *Statement*. Since reaching a low in June, the Australian market has increased by 13 per cent, similar to increases in the major offshore markets (Graph 4.22).

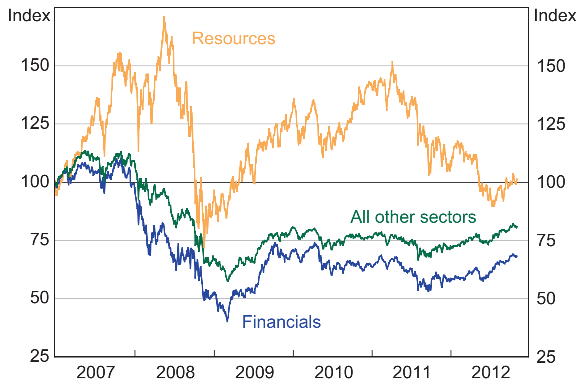
The recent increase in domestic share prices has been broad based (Graph 4.23). The share prices of resource companies came under pressure in early September as concerns over the Chinese growth outlook intensified and spot commodity prices, particularly for iron ore, experienced sharp declines. However, as iron ore prices recovered from their sharp decline, so did the share prices of most resource companies.

**Graph 4.22**
**Share Price Indices**
End December 2008 = 100




Sources: Bloomberg; Thomson Reuters

**Graph 4.23**
**Australian Share Price Indices**
End December 2006 = 100

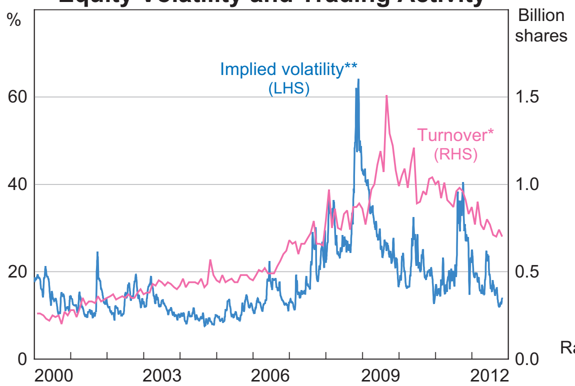



Sources: Bloomberg; RBA

In line with global trends, equity market trading activity in Australia has been relatively subdued recently, with turnover falling to levels last seen in late 2007. Equity market volatility has also been relatively low and close to its levels prior to the global financial crisis (Graph 4.24).

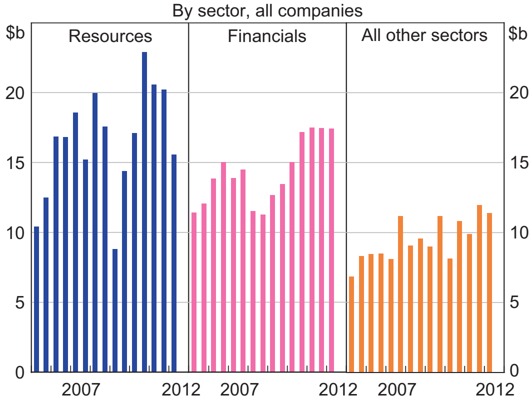
ASX 200 listed corporates reported a decline in profits during the June reporting season, with underlying net earnings, which exclude gains and losses from asset revaluations and other significant one-off items, falling by 9½ per cent from a year earlier. Headline profits fell by 28 per cent over the same period owing to significant impairment charges reported by BHP Billiton and Fairfax. The decline in profits was largely due to a decline in resources sector earnings, with underlying net profits of the sector falling 30 per cent over the year (Graph 4.25). Miners' earnings were affected by lower commodities prices, despite record iron ore production, with higher costs also contributing to the fall in profits.

**Graph 4.24**
**Equity Volatility and Trading Activity**




* Average daily ASX 200 turnover volume per month, seasonally adjusted
** 5-day moving average, ASX VIX from 2008, implied volatility from ASX SPI options prior to 2008
Sources: ASX; Bloomberg; RBA; Thomson Reuters

**Graph 4.25**
**Underlying Profits of ASX 200 Companies**
By sector, all companies

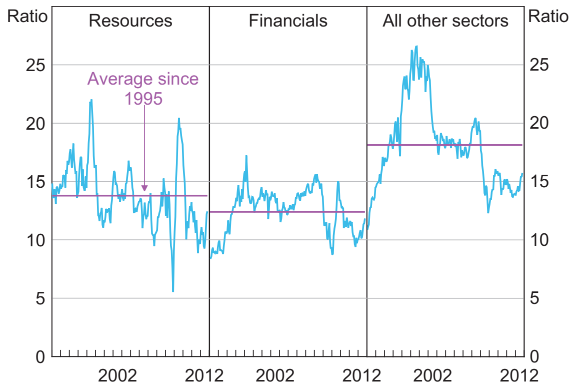



Sources: Morningstar; RBA; company reports

Financials' earnings have been little changed in aggregate over the past two years. Outside the resource and financial sectors, underlying profits have generally increased over the year, largely driven by higher earnings in sectors such as consumer staples and health care.

Dividends were modestly higher during the June 2012 half, increasing by 4½ per cent. This mostly reflected dividends paid by the major banks. High dividend paying stocks, such as financials, telecommunications companies and health care, have generally outperformed the rest of the market in 2012. Forward price-to-earnings ratios have begun to retrace from their recent lows, but remain below average across all sectors (Graph 4.26).

**Graph 4.26**
**Forward Price-earnings Ratios**




Sources: MSCI; RBA; Thomson Reuters