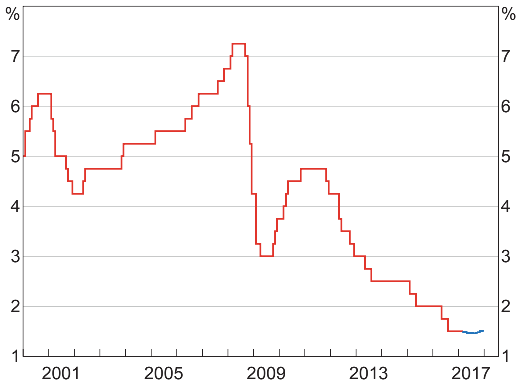
# 4. Domestic Financial Markets

Conditions in domestic financial markets have been relatively stable over recent months. The cash rate target has remained at 1.5 per cent since the August Board meeting and financial market prices do not imply a change over the period ahead. In line with global developments, Australian government bond yields have risen significantly since August, although they have only returned to the levels that prevailed in early 2016. The increase in bond yields has put a little upward pressure on banks' funding costs and, partly in response to this, banks have increased some lending rates. Nevertheless, conditions for obtaining funding remain favourable, with the Australian Government and the major banks having issued significant volumes of bonds over recent months. After slowing in the first half of last year, credit growth has picked up, although it remains below the pace that prevailed in 2015. The increase in credit growth has been driven by lending to larger businesses. Housing credit growth has also risen a little, with lending to investors picking up strongly in recent months. At the same time, some banks have raised their lending rates for housing investors. Equity prices have increased over recent months, with resource sector share prices having risen in response to higher prices for many commodities.

## 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) imply that markets expect the cash rate to remain unchanged over the course of this year (Graph 4.1).

**Graph 4.1**
**Cash Rate***




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

Sources: ASX; Bloomberg

Short-term interest rates in the repurchase agreement (repo) market have risen relative to OIS rates, though these spreads have retreated from their highs recently. Since June 2015, the repo rates at which the Reserve Bank conducts its open market operations have risen from spreads to OIS of around 2 basis points to around 30 basis points. The wider spreads on repo rates reflect heightened demand for secured funding from market participants, particularly non-residents, and appears to be related to developments in the foreign exchange swap and the bond futures markets.[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.

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

Despite the higher repo rates, short-term interest rates that are more closely related to bank funding costs have remained low. The unsecured interbank overnight interest rate – the cash rate – has continued to trade at the Reserve Bank's target, while spreads on bank bill rates have remained broadly steady (Graph 4.2).

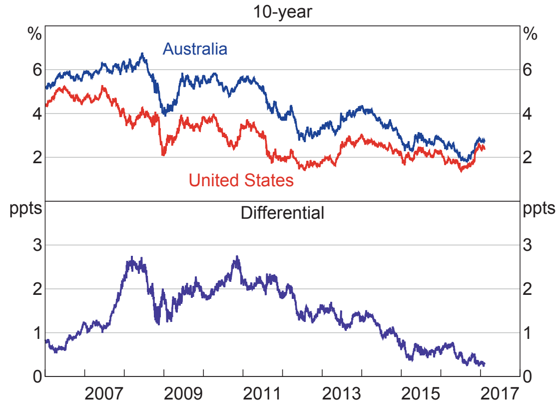
**Graph 4.2**
**Bank Bill Rates to Overnight Indexed Swap**


Sources: AFMA; ASX; Tullett Prebon (Australia)

Yields on 10-year Australian Government Securities (AGS) have increased by around 1 percentage point since the record lows reached in August last year (Graph 4.3). They are currently around the levels that prevailed about a year ago. The increase in Australian yields has been in line with international developments, with the spread between AGS and US Treasury yields remaining around 35 basis points. Long-term measures of inflation compensation have risen in conjunction with nominal bond yields.

The Australian Office of Financial Management (AOFM) revised its planned issuance of AGS in the 2016/17 financial year in response to updated economic and budget forecasts in the Mid-Year Economic and Fiscal Outlook. Net issuance during 2016/17 is now expected to be around $74 billion, $5 billion higher than at the time of the 2016/17 budget. Demand for AGS remains strong, with the AOFM recently issuing $9.3 billion of a new

**Graph 4.3**
**Government Bond Yields**




Sources: Bloomberg; RBA

5-year bond via syndication at a yield to maturity of 2.24 per cent. This follows the issuance of $7.6 billion of a 30-year bond in October 2016.

The level of outstanding semi-government bonds has been relatively stable since 2014, at around $240 billion. In the December quarter, state and territory governments raised a total of $6.6 billion, reflecting issuance from Queensland, South Australia and Western Australia, which was largely offset by maturing bonds.

There has been a decline in bond issuance by non-residents in the domestic market ('Kangaroo' issuance) over the past few years, with a total of $25 billion raised in 2016. This is despite further issuance by US corporations, with large deals by Apple and Coca-Cola earlier in the year. By converting the Australian dollars they raise into foreign currency, Kangaroo issuers act as indirect counterparties for Australian corporations looking to convert funds raised offshore back into Australian dollars. Spreads of AAA-rated Kangaroo bonds to AGS were little changed over 2016.

## Financial Intermediaries

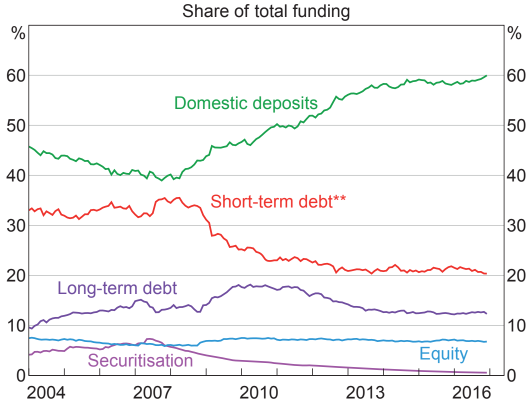
Deposits have increased to 60 per cent of bank funding, in part reflecting slower growth in short-term wholesale debt and equity funding

(Graph 4.4). The growth in deposits has been driven by term deposits, while growth in savings and transaction deposits has eased (Graph 4.5).

One of the factors influencing the composition of banks' balance sheets is the introduction of the Net Stable Funding Ratio (NSFR) in January 2018. The NSFR forms part of the Basel III liquidity reforms overseen by the Australian Prudential Regulatory Authority (APRA). It provides an incentive for banks to fund their assets and off-balance sheet activities with more stable sources of funding such as retail deposits, term deposits, long-term debt and equity. It also encourages less reliance on short-term wholesale liabilities.

Estimates of the average cost of the major banks' debt funding declined over 2016 but by a little less than the cash rate, mainly reflecting incomplete pass-through of the cash rate reductions to term deposit rates. More recently, overall debt funding costs are estimated to have been stable, despite a little upward pressure from the increasing share and cost of long-term debt and deposit funding (Graph 4.6).

**Graph 4.4**
**Funding Composition of Banks in Australia***
Share of total funding

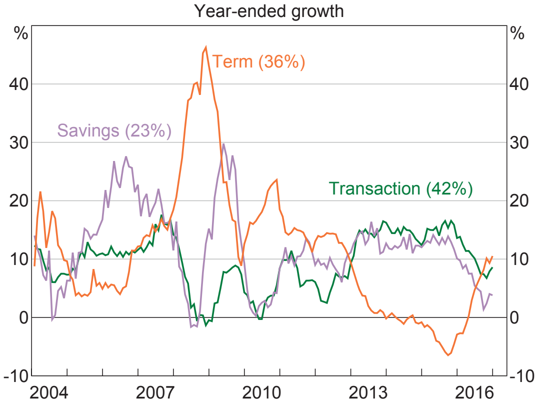



* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

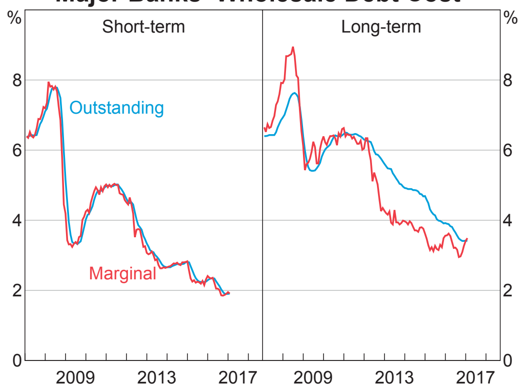
**Graph 4.5**
**Deposits by Product Type***
Year-ended growth




* Break-adjusted; not seasonally adjusted; excludes foreign currency, intra-group deposits and certificates of deposit; values in brackets represent share of AUD deposits

Sources: APRA; RBA

**Graph 4.6**
**Major Banks' Wholesale Debt Cost***



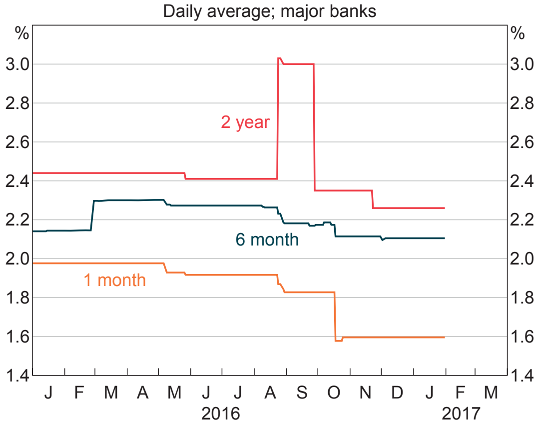

* RBA estimates; rates do not include interest rate hedges

Sources: Bloomberg; RBA

Overall, deposit funding costs are estimated to have been stable in recent months, although there have been some offsetting effects. An increase in the share of term deposit funding is adding to funding costs, along with relatively higher interest rates on some of these products (Graph 4.7). These effects have been partly offset by lower interest rates on some at-call savings accounts and shorter-maturity deposits (Graph 4.8).

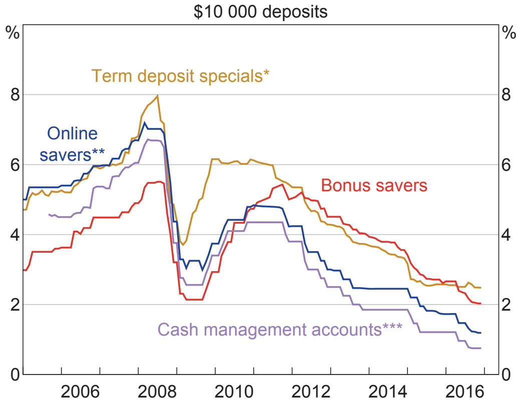
The pick-up in term deposit funding follows several years of little growth, during which interest rates on term deposits were relatively low compared to interest rates on other funding

## Graph 4.7
### Advertised Term Deposit Rates
Daily average; major banks




Sources: Canstar; RBA

## Graph 4.8
### Major Banks' Deposit Rates
$10 000 deposits

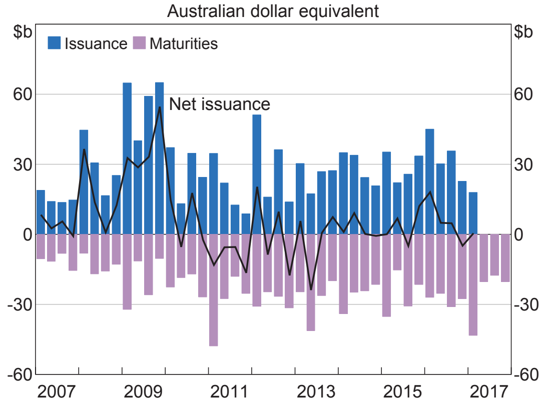



* Average of 1-12, 24-, 36- and 60-month terms
** Excludes temporary bonus rates
*** Deposits over $250 000
Sources: Canstar; RBA

sources such as wholesale funding and bonus saver accounts. Through 2016, banks increased the relative interest rates on term deposits; in particular some longer-maturity term deposit interest rates were raised in August. Some of these increases to term deposit rates have been subsequently reversed.

Bond issuance by Australian banks in 2016 reached its highest level since 2010. After accounting for maturities, the stock of bank bonds increased by $23 billion over 2016 to $517 billion (Graph 4.9). Banks continued to issue bonds predominately in offshore markets and the average tenor of new issuance increased to 5½ years over 2016. There has also been substantial issuance in early 2017, as a number of the major banks issued sizeable deals ahead of relatively large maturities this quarter.

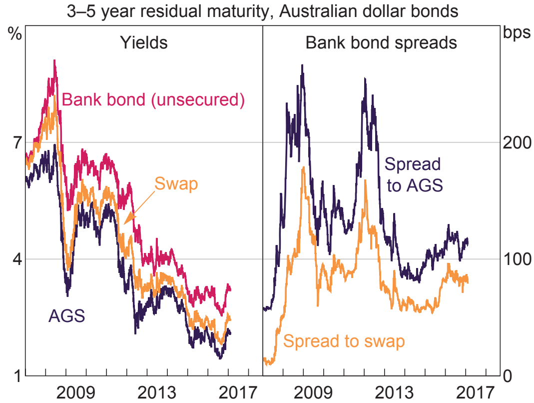
## Graph 4.9
### Australian Banks' Bond Issuance*
Australian dollar equivalent




* Latest quarter issuance to date
Source: RBA

Secondary market yields on major banks' bonds have increased over recent months, alongside the rise in bond yields globally (Graph 4.10). Bank bond spreads to benchmark rates have increased a little, but remain around the levels experienced in 2016.

## Graph 4.10
### Major Banks' Bond Pricing
3–5 year residual maturity, Australian dollar bonds

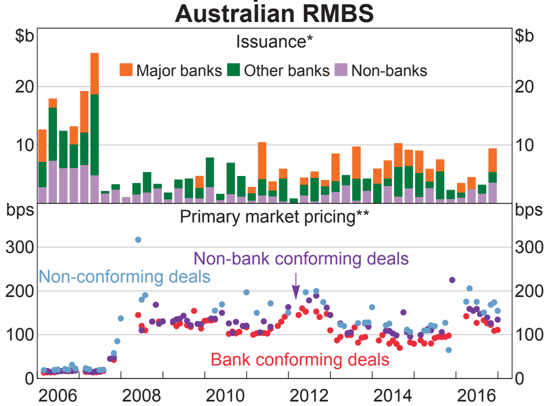



Sources: Bloomberg; UBS AG, Australia Branch

Australian banks issued a record volume of hybrid securities in 2016 with a total of $17 billion raised, ahead of large maturities. Issuance was split evenly between domestic and offshore markets, and included the first offshore Tier 1 issuance by a major bank since 2009. Primary issuance spreads on hybrid securities narrowed over 2016 after widening earlier in the year.

Australian asset-backed issuance was around average in 2016 at $28 billion. As in previous years, this was dominated by issuance of residential mortgage-backed securities (RMBS) (Graph 4.11). The pace of RMBS issuance increased strongly in the December quarter, with $9 billion raised.

**Graph 4.11**
**Australian RMBS**

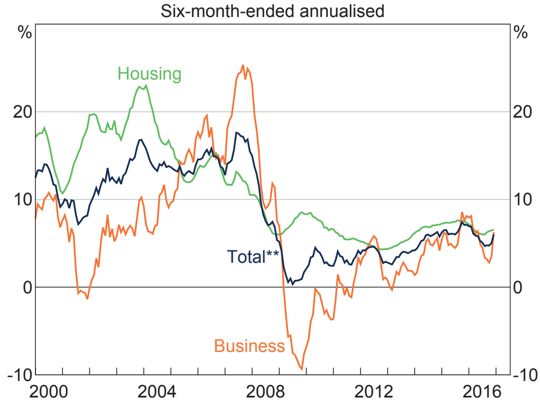



* Latest quarter issuance to date
** Face-value weighted monthly average of the primary market spread to bank bill swap rate
Source: RBA

## Financial Aggregates

Total credit growth has picked up in recent months after slowing in the first half of 2016, but remains slower than the pace seen in 2015 (Graph 4.12). The slowdown and recovery in credit growth has been mainly driven by business credit (Table 4.1). Broad money has grown a little faster than total credit over the past year.

**Graph 4.12**
**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

**Table 4.1: Financial Aggregates**
Percentage change(a)

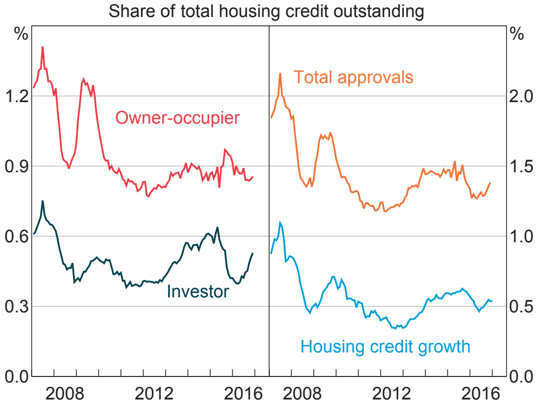
| | Three-month ended | | Year-ended |
|---|---|---|---|
| | Sep 2016 | Dec 2016 | Dec 2016 |
| Total credit | 1.2 | 1.7 | 5.6 |
| – Housing | 1.6 | 1.6 | 6.3 |
| – Owner-occupier | 1.6 | 1.3 | 6.4 |
| – Investor | 1.6 | 2.2 | 6.2 |
| – Personal | –0.4 | –0.2 | –1.3 |
| – Business | 0.8 | 2.3 | 5.6 |
| Broad money | 1.3 | 2.2 | 6.8 |

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

## Household Financing

Housing credit growth increased a little in recent months to an annualised rate of around 6½ per cent, but remains below the pace seen in 2015. The pick-up in housing credit growth reflected faster growth in credit extended to investors more than offsetting slower growth in owner-occupier credit, and has been consistent with trends in housing loan approvals (Graph 4.13).

**Graph 4.13**
**Housing Loan Approvals and Credit***
Share of total housing credit outstanding

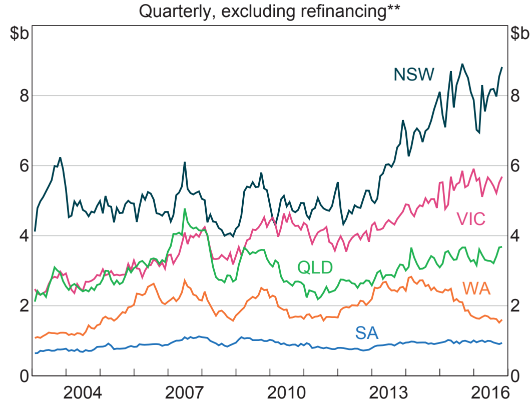



* Seasonally adjusted; excludes refinancing
Sources: ABS; RBA

The recent strength in housing loan approvals was concentrated in New South Wales and Victoria, while conditions remain weak in Western Australia (Graph 4.14). The recent increase in overall housing loan approvals is consistent with a pick-up in housing price growth and turnover. Average loan-to-valuation ratios are continuing to decline, reflecting the effects of tighter lending standards that were in part prompted by the measures introduced earlier by APRA.

A significant portion of the increase in investor credit growth is also likely to reflect the extension of credit to investors settling the payment of newly completed apartments that were purchased off the plan at an earlier time. The

**Graph 4.14**
**Housing Loan Approvals by State***
Quarterly, excluding refinancing**




* Seasonally adjusted
** Investor refinancing is RBA estimate
Sources: ABS; APRA; RBA

pick-up in investor credit growth also follows reductions in interest rates through the middle of 2016.

Since November, most lenders have increased fixed and some variable housing interest rates, especially for investors or borrowers with interest-only loans. Three of the four major banks have increased their standard variable rates for investor loans by 7–15 basis points but have left owner-occupier rates unchanged. Two major banks also announced increases in interest rates for interest-only loans. Other lenders have increased variable lending rates to both owner-occupiers and investors by 10–15 basis points. Some lenders have indicated that they have implemented these changes in response to higher funding costs and to meet regulatory requirements, such as APRA's guidance for a maximum growth rate on investor credit of 10 per cent. Overall, these interest rate increases are estimated to have boosted the average outstanding housing interest rate by less than 5 basis points (see Table 4.2).

In addition to increasing the differential between advertised interest rates for new owner-occupier and investor loans, many lenders appear to have

## Table 4.2: Intermediaries' Fixed and Variable Lending Rates

| | Interest rate<br>Per cent | Change since November 2016<br>Basis points | Change since April 2016<br>Basis points |
|---|---|---|---|
| **Housing loans** | | | |
| – Standard variable rate[(a)(d)] | | | |
| – Owner-occupier | 5.26 | 0 | –36 |
| – Investor | 5.56 | 6 | –30 |
| – Package variable rate[(b)(d)] | | | |
| – Owner-occupier | 4.51 | 0 | –31 |
| – Investor | 4.81 | 6 | –25 |
| – Fixed rate[(c)(d)] | | | |
| – Owner-occupier | 4.26 | 15 | –17 |
| – Investor | 4.46 | 21 | –20 |
| – Average outstanding rate[(d)] | 4.52 | 2 | –31 |
| **Personal loans** | | | |
| – Variable rate[(e)] | 11.56 | 17 | 20 |
| **Small business** | | | |
| – Term loans variable rate[(f)] | 6.39 | 0 | –36 |
| – Overdraft variable rate[(f)] | 7.27 | 0 | –36 |
| – Fixed rate[(c)(f)] | 5.34 | 4 | –8 |
| – Average outstanding rate[(d)] | 5.34 | 0 | –35 |
| **Large business** | | | |
| Average outstanding rate[(d)] | 3.50 | 1 | –41 |

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on new $250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar; RBA

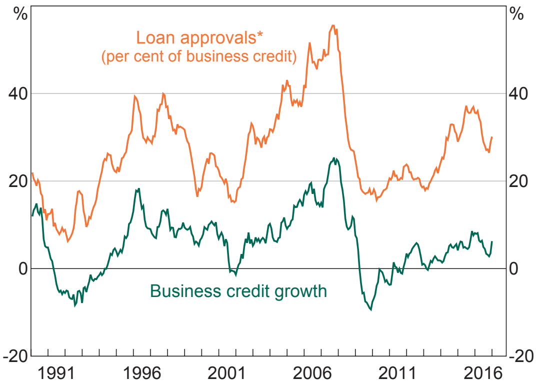
reduced the discretionary discounts available to new borrowers.

## Business Financing

Business credit growth has picked up recently after slowing over the first half of 2016. This is consistent with business loan approvals, which have grown strongly in recent months, partly due to the financing of some large infrastructure privatisations (Graph 4.15). Consistent with this, the recovery in business credit growth has been driven by credit extended to large businesses, while credit extended to smaller businesses has continued to grow at a moderate pace.

Across industries, business credit growth to the transport and storage and utilities industries has picked up, consistent with those few large infrastructure privatisation deals. Lending for residential property development also remains strong. Outside of this, lending remains mixed, partly reflecting decisions by some lenders to reduce credit exposures to businesses in selected

## Graph 4.15
## Business Loan Approvals and Credit
Six-month annualised

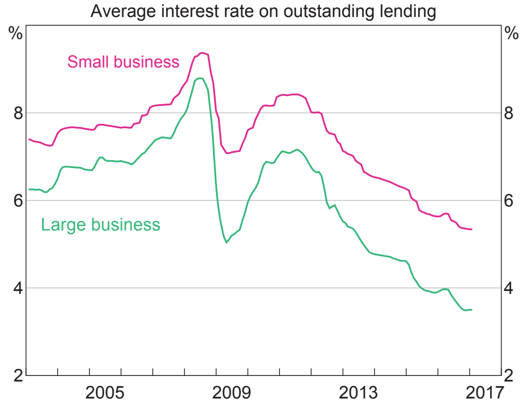



* Net of refinancing and reductions
Sources: ABS; APRA; RBA

industries, such as mining and manufacturing. Consistent with the announced intentions of some major banks to improve the profitability of their business lending, the implied spread on major banks' business lending stabilised in 2016, having fallen over the previous few years.

The interest rates on outstanding small and large business borrowing are estimated to have been little changed over the past few months (Graph 4.16). For large business, interest rates on new fixed-rate loans have increased recently,

## Graph 4.16
## Business Lending Rates*
Average interest rate on outstanding lending




* RBA estimates
Sources: APRA; RBA

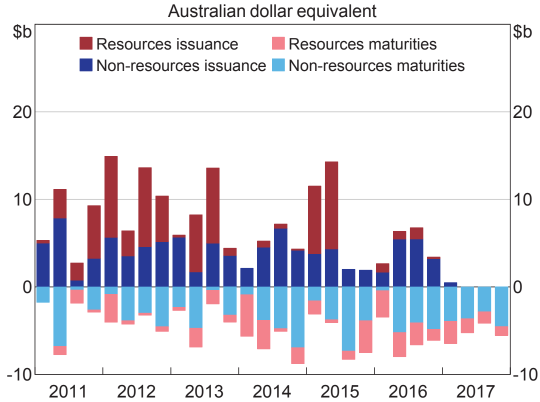
although rates on new loans continue to be lower than average outstanding rates.

In contrast to the stronger growth in business credit, wholesale debt issuance and cross-border syndicated lending have been relatively subdued. Bond issuance by Australian non-financial corporations in 2016 totalled $20 billion, well below 2015 levels (Graph 4.17). The stock of non-financial corporate bonds declined, reflecting limited issuance by resource-related corporations and also sizeable maturities for non-resource corporations. Secondary market pricing of Australian corporate bonds has increased in recent months alongside higher global bond yields, although yields and spreads to AGS remain relatively low (Graph 4.18).

Non-financial corporations raised $23 billion in net equity in 2016, which was broadly in line with recent years. Activity picked up in the second half of the year following a few sizeable transactions to fund acquisitions.

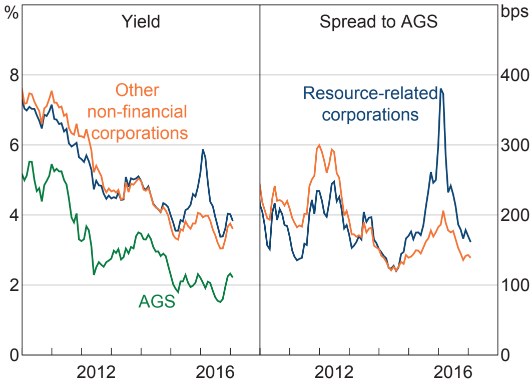
Listed companies announced $62 billion of merger and acquisitions (M&A) in 2016. Activity was concentrated in the consumer discretionary, utilities and industrials sectors. There was a large

## Graph 4.17
## Australian Corporate Bond Issuance*
Australian dollar equivalent



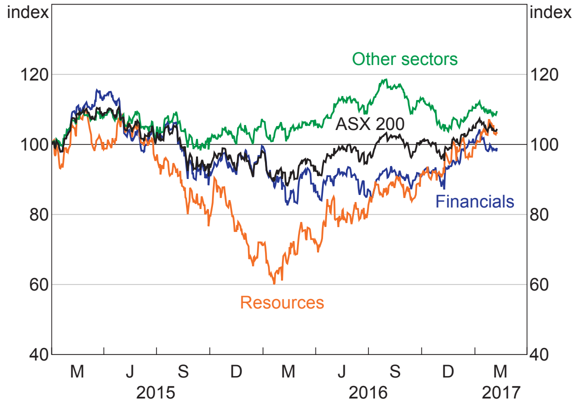

* Latest quarter issuance to date
Source: RBA

Graph 4.18
Australian Corporate Bond Pricing
Investment grade bonds, 5-year target tenor



Sources: Bloomberg; RBA; S&P Capital IQ

Graph 4.19
Australian Share Prices



Source: Bloomberg

pick-up in M&A activity in the December quarter including the $7 billion acquisition of DUET Group by Cheung Kong Infrastructure and the $6 billion merger of Tatts Group and Tabcorp.

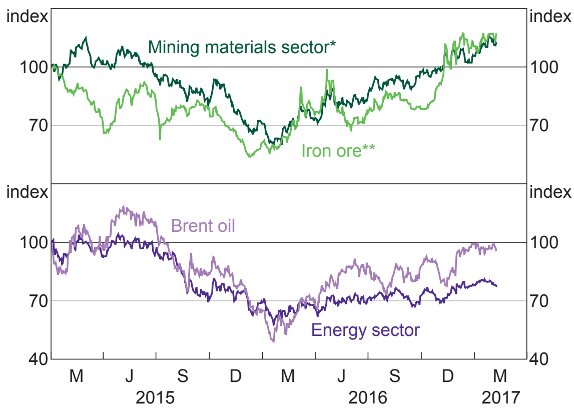
## Equity Markets

The Australian equity market largely followed the swings in global investor sentiment over 2016 and is little changed since the start of the year (Graph 4.19). Resources sector prices increased by around 40 per cent over 2016, largely in response to higher commodity prices. As a result, the Australian market generally outperformed other developed equity markets globally.

The rise in resource share prices was driven by the materials sector, following an 80 per cent increase in the iron ore price (Graph 4.20). Also supporting the sector was continued cost cutting and a reduction in capital expenditure, particularly by the major diversified miners. Increases in energy sector share prices were more modest. Resource share prices have increased further in early 2017.

Financial sector share prices underperformed the broader market throughout 2016 and traded in a wide range. Banking share prices declined throughout most of the year alongside a slowing

Graph 4.20
Resources Share Prices and Commodity Prices



* Derived from resources sector share prices
** Qingdao import iron ore spot price
Sources: Bloomberg; RBA

in profit growth and falls in global banking stocks. Bank share prices rebounded towards the end of 2016 following global developments (see 'International and Foreign Exchange Markets' chapter).

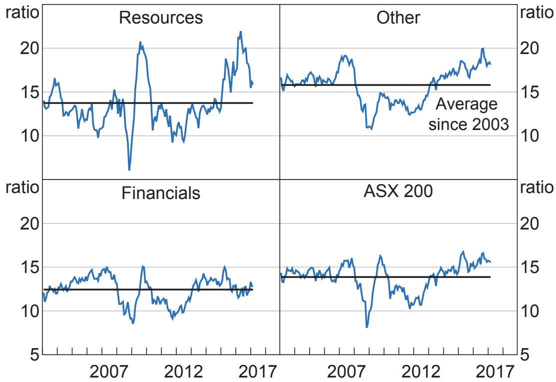
Equity prices for companies outside the financial and resources sectors rose slightly over 2016. The utilities, real estate and industrials sectors outperformed while the telecommunications and healthcare sectors underperformed the market.

Analysts' earnings expectations for coming years were revised higher in the December quarter. Resources sector earnings expectations increased sharply from low levels, alongside the recovery in commodity prices. At the same time, resources sector valuations (measured by forward price-earnings ratios) have converged back towards their long-term average (Graph 4.21). ✠

**Graph 4.21**

**ASX 200 Price-earnings Ratios**

12-month-ahead earnings forecasts




Source: Thomson Reuters