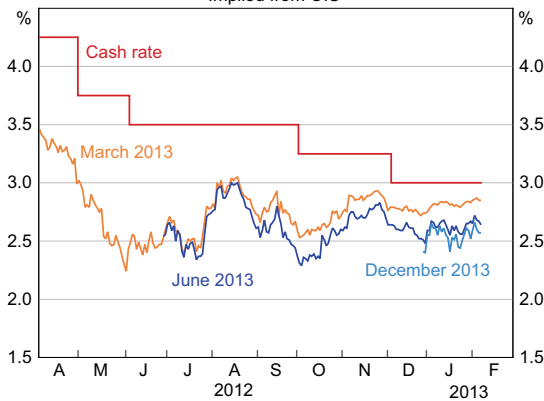


4. Domestic Financial Markets

Money Markets and Bond Yields

The Reserve Bank Board lowered its target for the cash rate by 25 basis points in December, to 3 per cent. Financial markets expect some further easing in monetary policy during 2013. Rates on overnight indexed swaps (OIS) currently imply a cash rate target of around 2.50 per cent by the end of the year (Graph 4.1).

Graph 4.1
Cash Rate Expectations
Implied from OIS

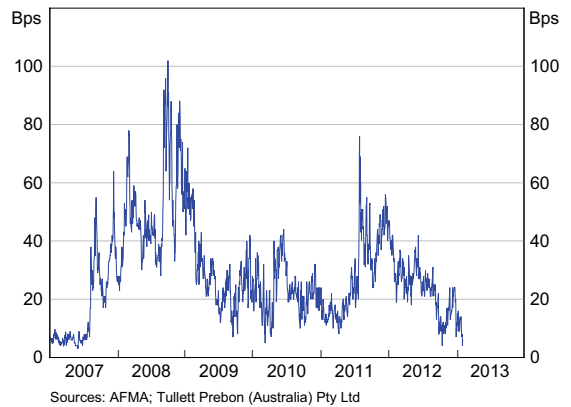


Sources: RBA; Tullett Prebon (Australia) Pty Ltd

Interest rates on 3-month bank bills and certificates of deposit (CDs) have declined by around 30 basis points since the previous *Statement*, to be just below 3 per cent, their lowest level since mid 2009. Spreads of bank bills and CDs over OIS widened somewhat towards the end of 2012 as trading conditions thinned over year end, but with issuance activity remaining subdued and minimal credit concerns, the 3-month spread has since narrowed to less than

10 basis points. This is close to the low level seen prior to the onset of the financial crisis in mid 2007 (Graph 4.2).

Graph 4.2
Spread of 3-month Bank Bills to OIS



Sources: AFMA; Tullett Prebon (Australia) Pty Ltd

Yields on long-term government bonds have responded to the more positive tone within global markets. As a result, the yield on 10-year Commonwealth Government securities (CGS) has increased by around 40 basis points since the previous *Statement*, to be around 3.5 per cent, still low by historical standards (Graph 4.3). The yield differential between CGS and US Treasuries is around 150 basis points.

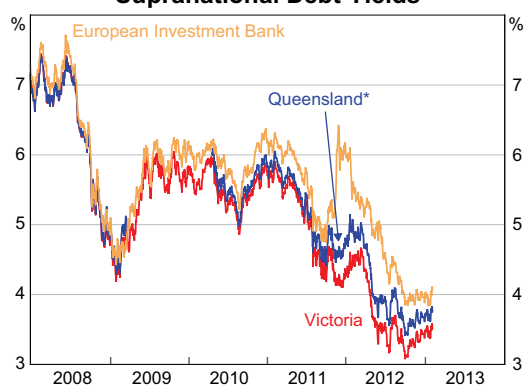
Spreads between yields on 5-year CGS and those on state government debt ('semis') have narrowed by between 10 and 25 basis points since the previous *Statement* and, in absolute terms, semi yields also remain around their historic lows (Graph 4.4). Moody's change to negative of the outlooks on

Graph 4.3
Australian Government Bond Yields



Source: RBA

Graph 4.4
5-year State Government and Supranational Debt Yields



* State guaranteed debt; from March 2009 to April 2010 all debt of this maturity was guaranteed by the Australian Government

Source: Yieldbroker

Queensland's and Western Australia's credit ratings did not have a material impact on the states' ability to access wholesale debt markets, nor the prices at which such debt is issued. Planned borrowing by the states for the current fiscal year is, in aggregate, broadly in line with issuance in the previous year (Table 4.1). In recent years, the most active purchasers of semi-government debt have been domestic banks, who have increased their holdings of liquid assets ahead of the introduction of more stringent prudential requirements in 2015 ('Basel III'). Banks now hold around one-third of the semi-government debt on issue, up from around 5 per cent in 2007.

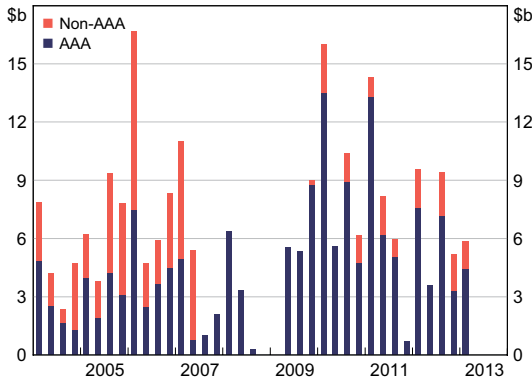
Bond issuance by non-resident entities ('Kangaroos') was strong in 2012, with around \$28 billion issued over the year. This was similar to the outcome in 2011. Most of the \$8 billion in Kangaroo bonds issued since the previous *Statement* has occurred in the early part of 2013 (Graph 4.5). Kangaroo issuance is typically strong in January, and this year it has been further supported by the return of some European issuers who were largely absent from the market in 2012. Investor appetite for these European names has improved in recent months as concerns about the euro area have eased. Secondary market spreads for Kangaroo bonds trended down towards the end of 2012 and are now at their lowest levels since early 2011.

Table 4.1: Term Borrowing by State Authorities

Issuer	2011/12	2012/13	
	Issuance \$ billion	Issuance to date \$ billion	Indicative target \$ billion
New South Wales	10.6	4.9	6.9
Queensland	14.2	7.7	13.7
South Australia	2.2	2.1	~4
Tasmania	1.4	0.6	1.0
Victoria	6.2	4.6	7.2
Western Australia	4.1	3.2	8.6
Memo: Australian Government	60.3	28.9	47.0

Sources: Australian Office of Financial Management; New South Wales Treasury Corporation; Queensland Treasury Corporation; South Australian Government Financing Authority; Treasury Corporation of Victoria; Western Australian Treasury Corporation; UBS AG, Australia Branch

Graph 4.5
Kangaroo Bond Issuance*



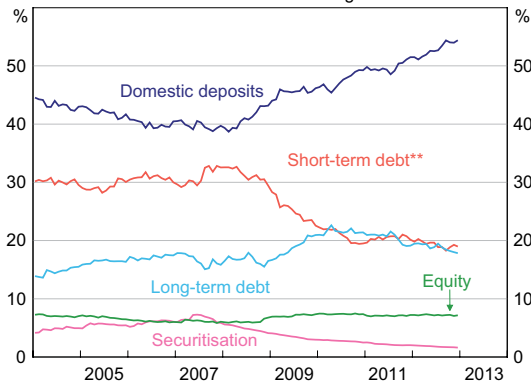
* Latest quarter issuance to date
Source: RBA

Financial Intermediaries

The composition of banks' funding has been broadly unchanged since the previous *Statement*. Domestic deposits account for about 54 per cent of total bank funding, while the share attributed to wholesale funding has remained less than 40 per cent (Graph 4.6).

Competition for deposits remains strong and deposits continue to be priced at a premium to wholesale benchmark rates. Since the previous *Statement*, the average interest rate on the major banks' at-call deposits – including online savings, bonus saver and cash management accounts

Graph 4.6
Funding Composition of Banks in Australia*
Share of total funding

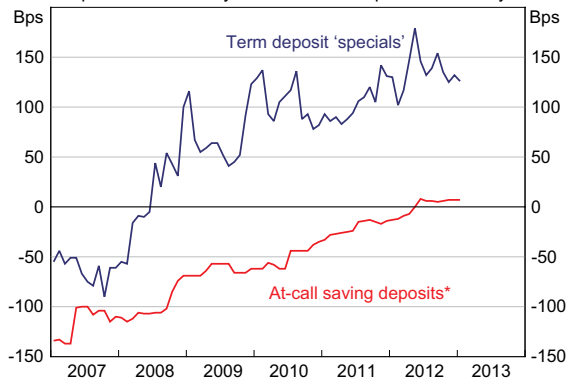


* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

– has fallen by around 25 basis points, which is consistent with the movement in the cash rate. The average rate offered on the major banks' term deposit 'specials' has fallen by about 10 basis points since November 2011, which is broadly in line with changes in wholesale benchmark rates (Graph 4.7).

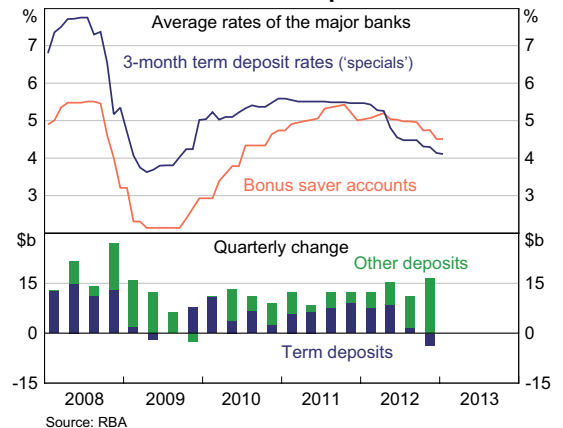
A number of institutions have been offering higher interest rates on bonus saver accounts than on term deposits, which has contributed to the ongoing shift of deposits away from term deposits to at-call savings accounts (Graph 4.8). The rates offered on bonus saver accounts, relative to the cash rate, have increased substantially over recent years, with the

Graph 4.7
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 4.8
Household Deposits

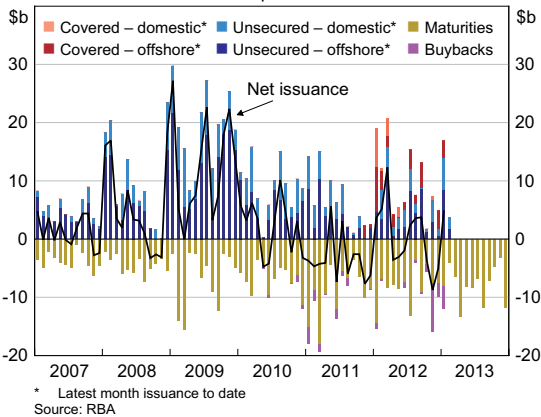


average bonus saver rate offered by the major banks having increased by almost 250 basis points relative to the cash rate since 2009.

Bond issuance by Australian banks was relatively subdued in the December quarter, mainly reflecting the banks' preference for deposit funding and slow credit growth, though it has picked up more recently. Despite the \$31 billion of bonds issued by the banks since the previous *Statement*, outstanding bank bonds have declined by \$7 billion (Graph 4.9). In part, the decline reflects a pick-up in buybacks of government guaranteed debt (see 'Box D: Buybacks of Government Guaranteed Securities'). Primary market pricing has continued to tighten since the previous *Statement*, with the banks issuing bonds recently at spreads that are half the levels in early 2012.

Graph 4.9

Banks' Bond Issuance and Maturities
A\$ equivalent



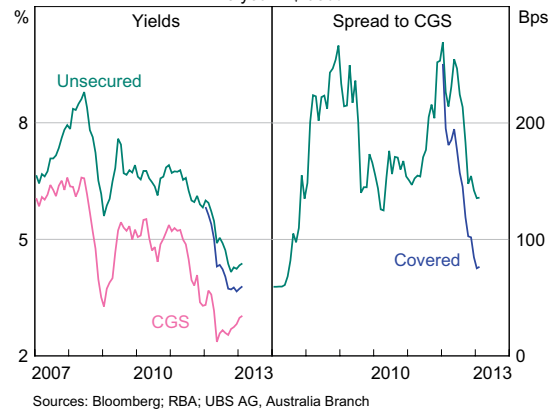
Around two-thirds of the banks' issuance since the previous *Statement* has been in offshore markets, mainly in unsecured form. Covered bonds issuance has totalled \$6 billion and was predominantly in US dollars. However, there was a €1 billion issue that took advantage of the ongoing lack of highly rated issuance in the euro market and a £750 million issue in the UK. The major banks have utilised around 20–40 per cent of their covered bond issuance capacity. Recent domestic issuance by the banks has been entirely in unsecured form, including \$1.9 billion of subordinated notes (these securities

qualify as Tier 2 capital under the Australian Prudential Regulation Authority's capital standards). A further \$1.3 billion of Tier 1 hybrid issuance has also been announced

As in primary markets, the ongoing improvement in financial market sentiment since the previous *Statement* has seen spreads on the major banks' unsecured and covered bonds tighten further within secondary markets (Graph 4.10). Relative to CGS, secondary market spreads have fallen by 125 basis points since their most recent highs, which were recorded around the peak in concerns regarding the sovereign debt situation in the euro area. Unsecured bond spreads are now close to their lowest level since the start of the global financial crisis, and covered bond spreads are at their lowest level since the banks started issuing these types of bonds in November 2011.

Graph 4.10

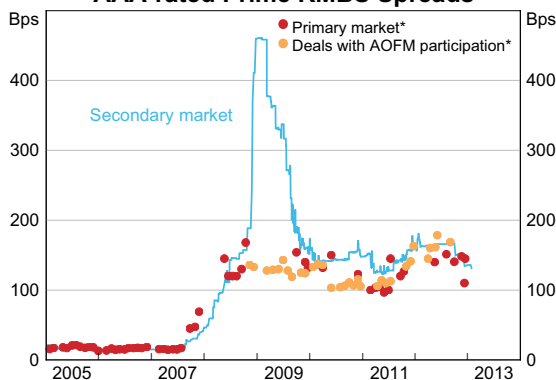
Major Banks' Bonds
4–6 year A\$ debt



Relative to the cash rate, banks' outstanding funding costs are estimated to have been broadly unchanged over the past three months. The relative cost of banks' outstanding long-term wholesale debt remained stable over the period, with the large reduction in spreads for new bond issuance having only a minimal effect on banks' outstanding wholesale funding costs at this stage. It will take some time for the reduction in spreads to flow through to overall bank funding costs owing to the relatively subdued growth in credit and the slow run-off of wholesale debt issued previously at higher spreads.

Conditions in the Australian securitisation market have also continued to improve in recent months, with a number of residential mortgage-backed securities (RMBS) and asset-backed securities executed at spreads that were around 20 basis points narrower than those achieved on similar deals in the third quarter of 2012. In December, National Australia Bank priced the most senior tranche of its 3-year RMBS at 110 basis points above the 1-month bank bill swap reference rate, the tightest pricing on a transaction of this type since mid 2011 (Graph 4.11). Around \$3 billion in RMBS and \$1.7 billion in other asset-backed securities have been issued since the previous *Statement*, with the continuing decline in covered bond spreads helping to entice investors back into the RMBS market. Given the strong demand from the private sector, the Australian Office of Financial Management did not participate in any of these RMBS deals, and has recently sold \$275 million of its RMBS holdings to private investors.

Graph 4.11
AAA-rated Prime RMBS Spreads



* Primary market spreads are face value weighted monthly averages of AAA-rated RMBS with conservative average LVRs and low proportion of low-doc loans
Sources: RBA; Royal Bank of Scotland; Westpac

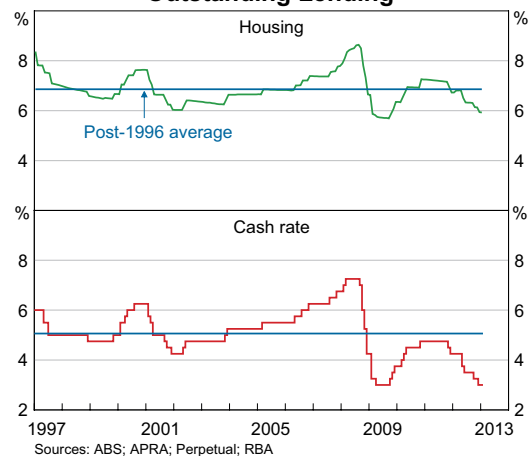
Moody's has downgraded the ratings on most Australian mortgage insurers to the low single A range. This follows an update to Moody's rating methodology which now takes into account the state of housing markets and revised capital adequacy metrics. Separately, both Standard & Poor's and Moody's revised their outlooks on QBE's group rating (currently A and A3, respectively) to negative,

following a profit warning from the company due to revised claims estimates mostly related to Hurricane Sandy in the United States.

Household Financing

Following the Reserve Bank Board's announcement of a 25 basis point reduction in the cash rate target in December, most lenders reduced their standard variable housing loan rates by 20 basis points (Table 4.2). Rates on new three-year, fixed-rate mortgages have generally moved in line with three-year benchmark rates. Overall, the average interest rate on outstanding housing loans is now about 25 basis points above its 2009 low (Graph 4.12).

Graph 4.12
Average Interest Rates on Outstanding Lending



Discounts offered on certain variable-rate mortgage products have not changed much since the end of October, although a number of banks have either introduced or extended some other competitive measures to attract loan customers. One major bank's subsidiary has introduced a temporary offer for new customers to undercut any advertised home loan rate offered by the major banks, while a major bank extended its offer to undercut the fixed rates of the other major banks. Some lenders have extended cash-back offers or temporarily waived or reduced some of their mortgage application fees.

Table 4.2: Intermediaries' Variable Lending Rates
Per cent

	Level at end January 2013	Change since:	
		End October 2012	End October 2011
Cash rate	3.00	-0.25	-1.75
Housing loans			
– Standard variable rate ^(a)	6.44	-0.20	-1.35
– Package variable rate ^(b)	5.69	-0.21	-1.34
– Fixed rate ^(c)	5.52	-0.02	-1.00
Personal loans			
– Variable rate	12.89	-0.03	-0.37
Small business (variable rates)			
Residentially secured, advertised			
– Term loans	7.60	-0.20	-1.40
– Overdraft	8.47	-0.20	-1.38
Average rate ^(d)	7.33	-0.20	-1.30
Large business			
Average rate ^(d) (variable rate and bill funding)	5.36	-0.29	-1.67

(a) Average of the major banks' standard variable rates

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

(c) Average of the major banks' three-year fixed rates

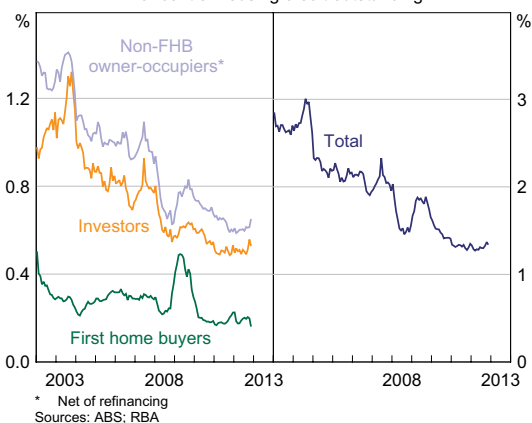
(d) Rates on outstanding business lending (includes discount)

Sources: ABS; APRA; RBA

Decreases in lending rates since late 2011 have contributed to an increase in the value of housing loan approvals, which grew by 7¼ per cent over the year to November (Graph 4.13). In recent months, approvals for first home buyers have been affected by changes to grants in New South Wales and Queensland, resulting in large falls in housing loan approvals for first home buyers in those two states. However, approvals for other owner-occupiers and investors have been growing more strongly over recent months. The stock of housing credit has continued to grow at a relatively subdued pace, increasing by 4.5 per cent over the year to December. Growth in investor credit has outpaced growth in owner-occupier credit, which is in part due to owner-occupiers using the low interest rate environment to repay their mortgages at a faster rate. Investors do not have as strong an incentive to prepay their mortgage given the tax deductibility of interest payments for them.

The value of outstanding personal credit grew slightly during the December quarter owing to a larger volume of fixed-term loans. Some of the increase in fixed-term loans relates to growth in car finance, reflecting recent growth in motor vehicle

Graph 4.13
Value of Housing Loan Approvals
Per cent of housing credit outstanding



sales. Interest rates on variable-rate personal loans declined by less than 5 basis points in the quarter. Since October 2011, the spreads on personal loans over the cash rate have widened by 138 basis points. This has been primarily driven by rates on personal credit cards, which are generally less sensitive to changes in the cash rate.

Business Financing

Australian non-financial corporates have issued \$5.6 billion of bonds since the previous *Statement*, with a multi-currency offshore deal by Rio Tinto in early December accounting for just under half of that issuance (Graph 4.14). Robust corporate bond issuance in the last few months of 2012 capped off an active year for the domestic market and the strongest year on record for offshore issuance. Despite two large issuers – BHP Billiton and Rio Tinto – together accounting for half of the total volume, 2012 was also notable for having the highest number of individual issuers.

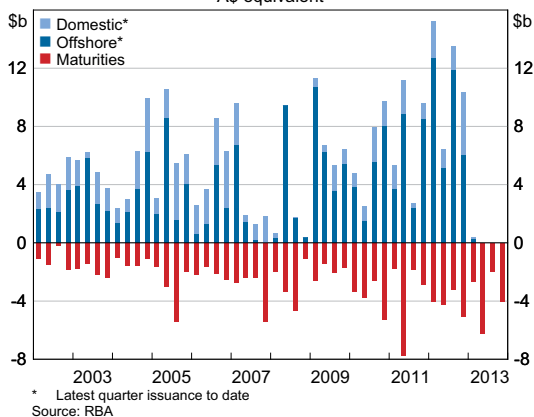
Non-intermediated markets remain favourable for corporates, with investor appetite for new issuance high and yields at multi-year lows. Spreads over CGS have declined by around 20 to 35 basis points since the previous *Statement* and are around their lowest levels since the start of the financial crisis (Graph 4.15).

In January, the Australian Government announced legal initiatives aimed at reducing the cost of retail corporate bond issuance by allowing the use of streamlined two-part prospectuses – a short offer prospectus and a more detailed ‘base prospectus’ – and reducing directors’ liability to only misstatements or omissions from disclosure documents that are due to misleading or deceptive conduct. Most retail issuance to date has been in the form of high-yielding hybrid securities, which are not covered under the proposals.

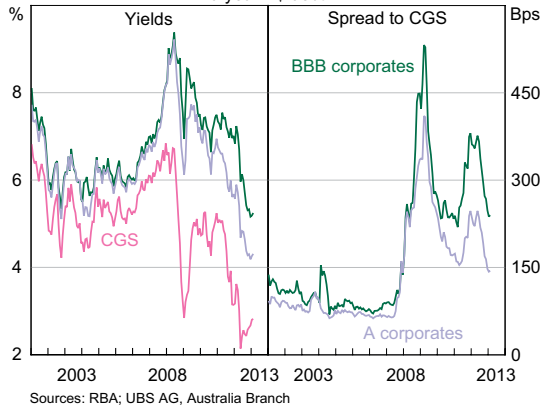
Intermediated business credit fell by 0.3 per cent over the December quarter. The fall was driven by lower lending to private trading corporations,

while lending to unincorporated businesses continued to grow modestly over the period (Graph 4.16). The lower lending to private trading corporations witnessed over the past six months has coincided with greater net bond issuance by Australian corporates and may reflect some businesses substituting intermediated debt with non-intermediated debt. Growth in business credit during the December quarter was also affected by loan refinancings that moved credit off the books of domestic financial institutions (which are captured in the Reserve Bank’s financial aggregates) and onto the books of offshore institutions (which are not captured).

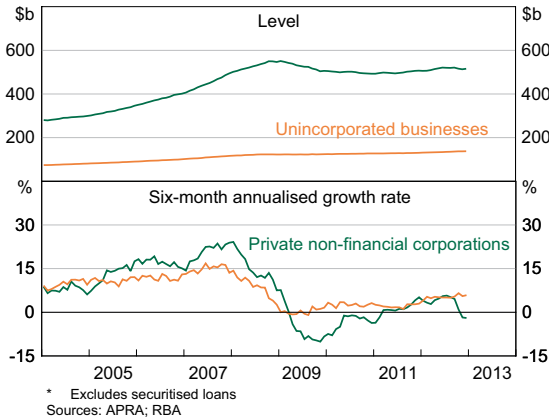
Graph 4.14
Australian Corporates’ Bond Issuance
 A\$ equivalent



Graph 4.15
Australian Corporates’ Bond Pricing
 3-year A\$ debt



Graph 4.16
Business Credit
By borrower type*

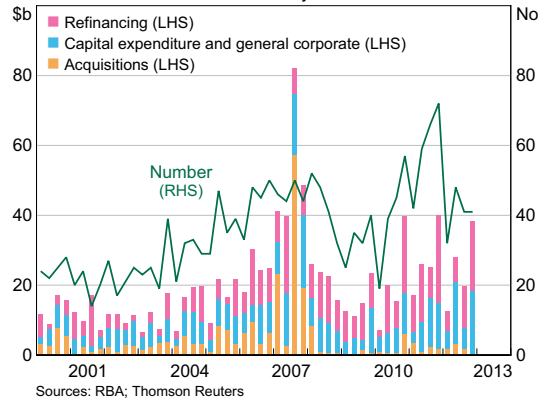


Activity within the Australian syndicated lending market increased in the December quarter, although the volume of loan approvals remains well below the level seen in late 2011 (Graph 4.17). The increase in activity in the quarter was driven by a number of large new loans, particularly to the energy sector. Lending by Asian banks continued to grow faster than the system average and was largely concentrated in lending to resource-related borrowers.

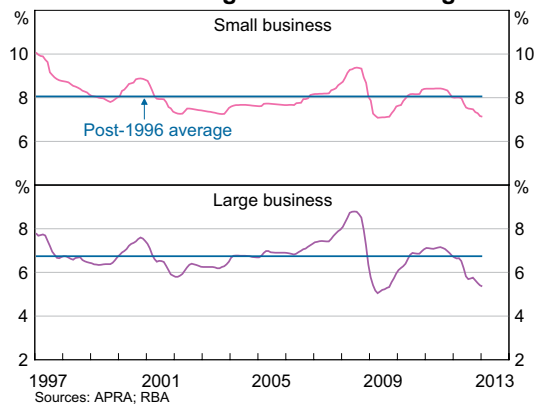
The cost of intermediated business borrowing declined over the December quarter, with the average interest rate on outstanding bank loans to both small and large businesses falling by about 30 basis points (Graph 4.18). The decline in average business rates broadly reflected movements in wholesale benchmark rates, with spreads on business rates increasing only slightly. Average rates on small and large business loans are now around their lowest level since September 2009.

Equity raising activity has remained subdued, although there was a modest increase in the December quarter (Graph 4.19). Initial public offerings (IPOs) picked up somewhat following the spin-off of Woolworths' property portfolio and the listing of the dairy cooperative Fonterra. Notwithstanding this increase in activity, total equity raisings for the 2012 calendar year were broadly the same as the year earlier, which was the lowest annual level since 2004.

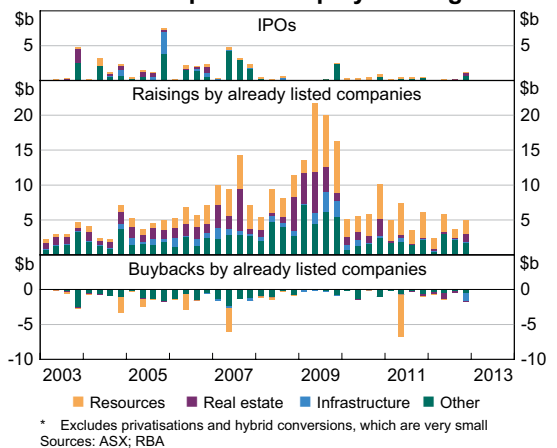
Graph 4.17
Syndicated Loan Approvals
Quarterly



Graph 4.18
Average Interest Rates on Outstanding Business Lending



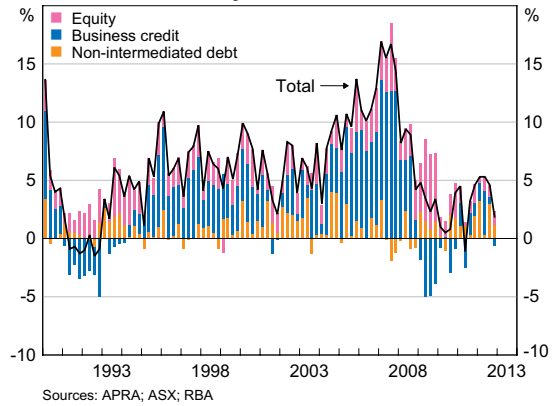
Graph 4.19
Listed Corporates' Equity Raisings*



Mergers and acquisitions (M&A) activity has also remained low, with only \$6.2 billion in M&A deals involving ASX-listed companies announced since the last *Statement*. The largest deals were transfers of equity stakes in natural gas projects; BHP Billiton sold its remaining stake in the Woodside-led Browse Basin LNG project, while Woodside Petroleum purchased a portion of the Leviathan gas field off the coast of Israel. Like equity raisings, 2012 was a subdued year for M&A transactions, with only \$37 billion in deals announced during the year, the lowest level of activity since 2004.

Net new business external funding eased to 1.8 per cent of GDP in the December quarter, driven by a fall in credit advanced by financial institutions. As discussed above, the recent decline in business credit has been offset to some extent by non-intermediated funding, although issuance of such debt did slow during the quarter. The overall contribution from equity raisings was broadly stable (Graph 4.20).

Graph 4.20
Business External Funding
Net change as a share of GDP



Aggregate Credit

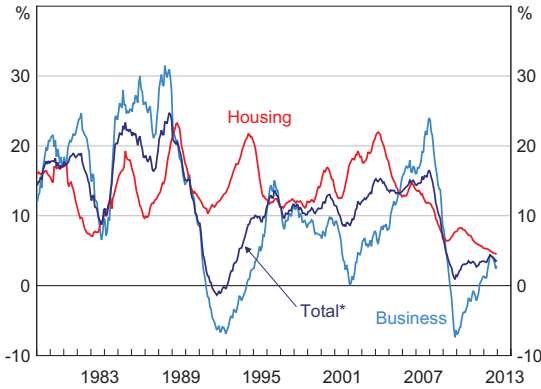
Growth in total outstanding credit slowed to a rate of around 0.5 per cent in the December quarter, driven by the softness in business credit (Table 4.3, Graph 4.21). Over the year, broad money growth has outpaced credit growth; although the two have changed by similar amounts in dollar terms.

Table 4.3: Growth in Financial Aggregates^(a)
Per cent

	Three-month-ended		Year-ended
	Sep 2012	Dec 2012	Dec 2012
Total credit	0.8	0.5	3.6
– Household	1.0	1.0	4.0
– Housing	1.1	1.1	4.5
– Owner-occupier	1.0	1.0	4.1
– Investor	1.2	1.4	5.5
– Personal	–0.2	0.1	–0.3
– Business	0.3	–0.3	2.8
M3	1.4	1.1	7.2
Broad money	1.3	1.0	6.6

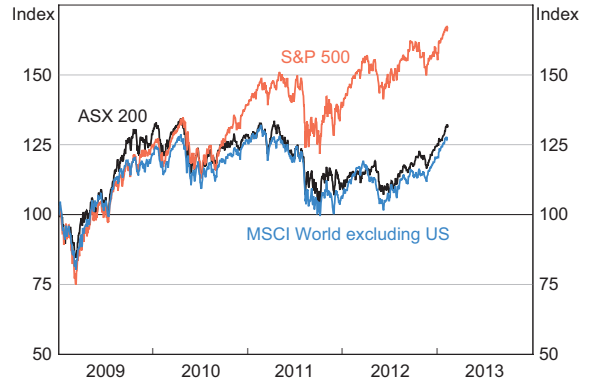
(a) Growth rates are break adjusted and seasonally adjusted
Source: RBA

Graph 4.21
Credit Growth
Year-ended



* Includes housing, personal and business credit
Source: RBA

Graph 4.22
Share Price Indices
End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

Equity Markets

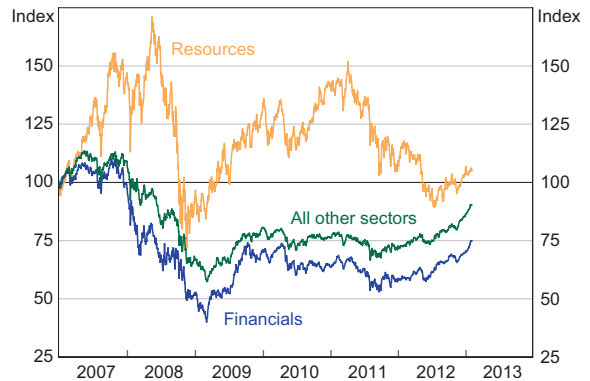
Australian equity prices have increased by 10 per cent since the previous *Statement*, broadly in line with overseas markets (Graph 4.22). Globally, equity markets have been supported by positive international policy developments, including a partial agreement by US lawmakers that averted severe fiscal consolidation, and a rebound in some commodity prices. Australian equity prices rose by 15 per cent over 2012, and are currently at their highest level since April 2011.

The increase in equity prices since the previous *Statement* has been broad based (Graph 4.23). In the resources sector, the share prices of iron ore producers rose following the rebound in the commodity's price. In January, Rio Tinto announced that it expects to report an impairment charge of US\$14 billion for the 2012 financial year, mainly comprised of a writedown to its aluminium assets.

Bank share prices have risen since the previous *Statement* as investors continue to seek high-yielding stocks. Share prices within the insurance sector have increased, despite a profit downgrade by QBE, one of Australia's largest insurers by market capitalisation.

The improvement in share market sentiment has come despite ongoing downgrades to analysts' earnings expectations. In particular, private sector forecasts for resources sector earnings in the current

Graph 4.23
Australian Share Price Indices
End December 2006 = 100

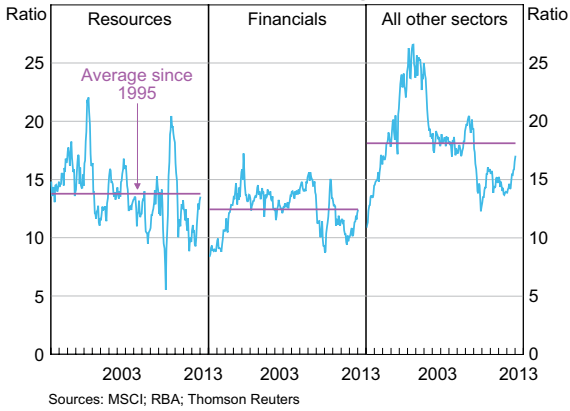


Sources: Bloomberg; RBA

financial year have declined by a further 3 per cent since the previous *Statement*. This, and the gains in equity prices, have lifted valuations well above their mid 2012 lows, with price-earnings ratios close to their average levels of the past two decades (Graph 4.24).

Within the domestic share market, trading activity has remained subdued since the previous *Statement*, with traded volumes falling close to their lowest level in more than five years. Similarly, volatility has remained low, with volatility implied by option prices declining to be near its lowest level since early 2006 (Graph 4.25). The trend towards lower volatility and trading volume has also been observed in overseas markets (see 'Box B: Financial Market Volatility').

Graph 4.24
Forward Price-earnings Ratios



Graph 4.25
Equity Volatility and Trading Activity

