

# 4. Domestic Financial Markets

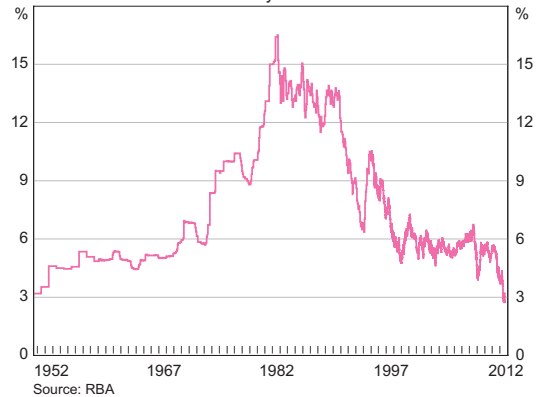
## Money Markets and Bond Yields

The Reserve Bank Board lowered the target for the cash rate by 25 basis points in June, to 3.50 per cent. Expectations for further easing in monetary policy over the next 12 months or so have moved in a wide range since the previous *Statement*, mainly reflecting changes in sentiment over European bank solvency and sovereign financing, as well as reduced expectations for global growth. Rates on overnight indexed swaps (OIS) currently imply a cash rate target close to 3 per cent by the end of 2012 (Graph 4.1). Interest rates on bank bills and certificates of deposit (CDs) have moved in line with OIS rates.

As in the major international markets, long-term government bond yields in Australia have reached historically low levels in recent months. The yield on 10-year Commonwealth Government securities (CGS) reached 2.68 per cent in mid July, its lowest level since Federation (Graph 4.2). The low yields

mostly reflect strong levels of risk aversion with the spreads between CGS and other debt securities generally much wider than their historic norms.

**Graph 4.2**  
Australian Government Bond Yield  
10-year



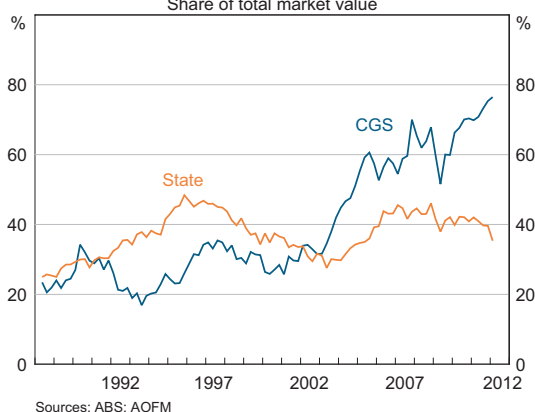
**Graph 4.1**  
Cash Rate Expectations  
Implied from OIS



The AAA rated status of Australia's sovereign debt has attracted significant foreign investor interest in recent years and, in March, the share of CGS held by non-residents reached a new high of 76 per cent (Graph 4.3). This ongoing shift in the investor base for CGS has not been mirrored to the same extent for other classes of Australian debt and has contributed to the wider yield differentials between CGS and other Australian dollar debt securities.

In June, as concerns about the European situation intensified, the spreads between CGS yields and those on state government debt ('semis') widened for a time, reaching levels comparable to those prevailing at the start of the year. Nevertheless, the state issuers were able to continue primary debt issuance throughout this period. While the spreads

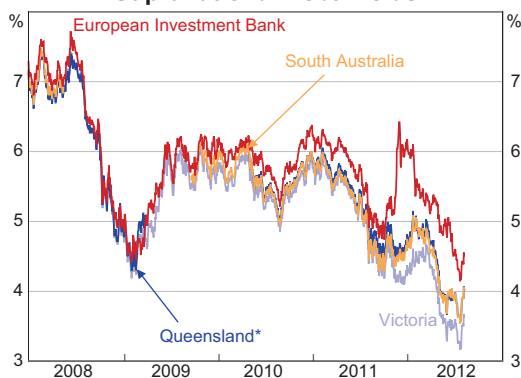
**Graph 4.3**  
**Non-resident Holdings of Australian Government Debt Securities**  
 Share of total market value



are wide, yields on semis are around their historic lows (Graph 4.4).

Primary issuance in the kangaroo bond market had been relatively light although it picked up strongly in July. With the rate at which issuers can swap their Australian dollar debt into a foreign currency being attractive, a number of regular issuers returned to the market, while Export-Import Bank of Korea (rated A) and the Canadian province of Manitoba (rated AA) priced inaugural deals. Most of the demand for kangaroo bonds continues to come from offshore investors.

**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  
 Sources: RBA; Yieldbroker

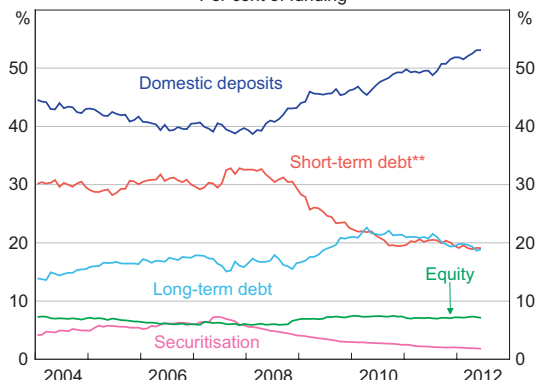
## Financial Intermediaries

Notwithstanding the narrowing in some wholesale debt market spreads, banks' outstanding funding costs relative to the cash rate are estimated to have increased further over the past quarter, driven primarily by developments in deposit funding. Spreads on newly issued bonds are around 10 to 20 basis points above the average cost of banks' outstanding stock of bonds.

Deposits remain the main source of new funding for banks' lending growth, continuing the shift away from wholesale liabilities. Deposits now account for 53 per cent of total bank funding liabilities (Graph 4.5). Although growth in term deposits has slowed slightly, they now account for almost half of total deposits, up from 30 per cent in mid 2007. Growth in deposits has generally exceeded growth in lending by about 4 percentage points over the past couple of years.

Competition for deposits remains strong. The average rate offered on the major banks' term deposit 'specials' fell by about 65 basis points over the quarter, largely reflecting a decline in benchmark rates. The spread of term deposits to wholesale benchmark rates remains at historically high levels (Graph 4.6). The average interest rate on the major banks' at-call deposits – including online savings,

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

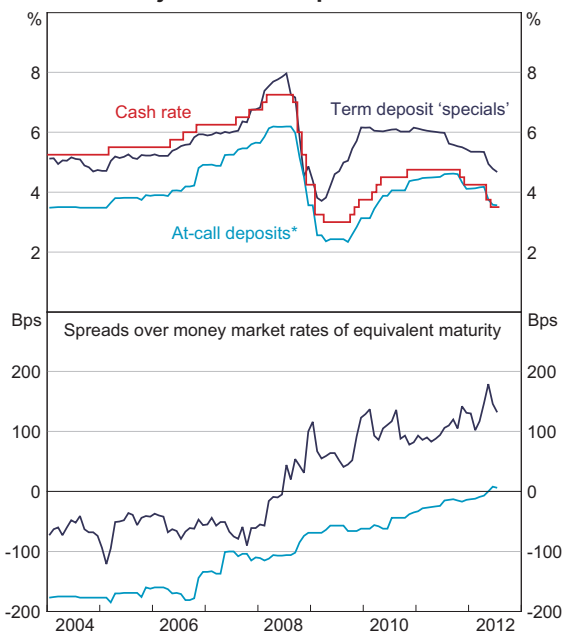


\* Adjusted for movements in foreign exchange rates  
 \*\* Includes deposits and intragroup funding from non-residents  
 Sources: APRA; RBA; Standard & Poor's

bonus saver and cash management accounts – has risen further, relative to the cash rate.

Australian banks have issued around \$29 billion worth of bonds since the previous *Statement* (Graph 4.7). Issuance was slow prior to the Greek election and Euro Summit in late June but has picked up since then.

**Graph 4.6**  
**Major Banks' Deposit Rates**



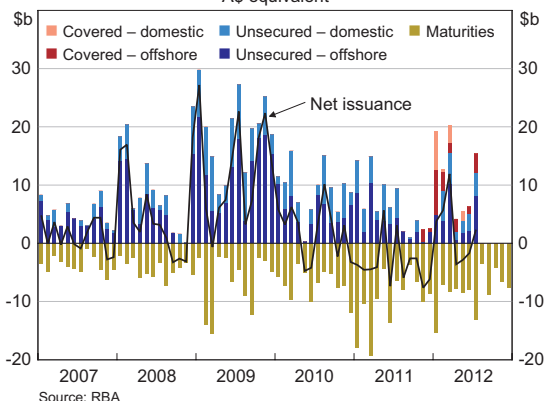
\* Average of online, bonus and cash management accounts at the major banks; existing customers only; spread to the cash rate  
Sources: Bloomberg; RBA

In tandem with modest credit growth overall, the strength in deposit funding has limited the need for banks to issue wholesale debt in large volumes. Net bond issuance for the year is now around \$17 billion. Notwithstanding the global turmoil, appetite for Australian bank paper has remained strong.

In May, Suncorp became the first non-major bank to issue a covered bond, raising \$1.6 billion in the domestic market, while ING Australia also signalled its interest in issuing this type of debt. CBA issued a small euro-denominated covered bond with a term to maturity of 19 years, the longest Australian covered bond issue to date. Major banks have, on average, utilised around a quarter of their legislated capacity for issuing covered bonds (Graph 4.8). Covered bond issuance has allowed banks to diversify their funding bases, with deal managers reporting that investors have generally been new buyers of Australian bank paper, particularly for offshore issues.

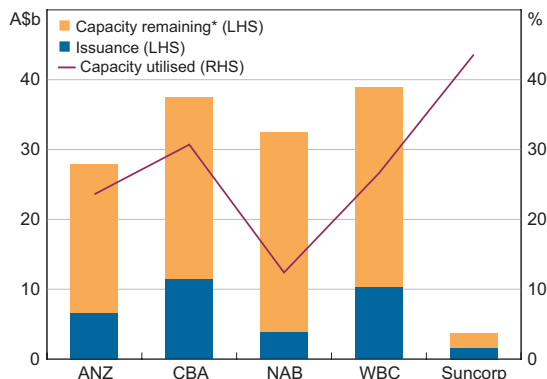
Yields on the major banks' unsecured bonds have fallen as market interest rates have declined. At the same time, spreads on this paper relative to the swap rate have also declined a little, while spreads on covered bonds to the swap rate have narrowed significantly. Secondary market covered bond spreads are around 60 basis points below senior unsecured debt of comparable maturity, the largest yield differential since covered bonds were

**Graph 4.7**  
**Banks' Bond Issuance and Maturities**  
A\$ equivalent



Source: RBA

**Graph 4.8**  
**Australian Covered Bond Issuance**

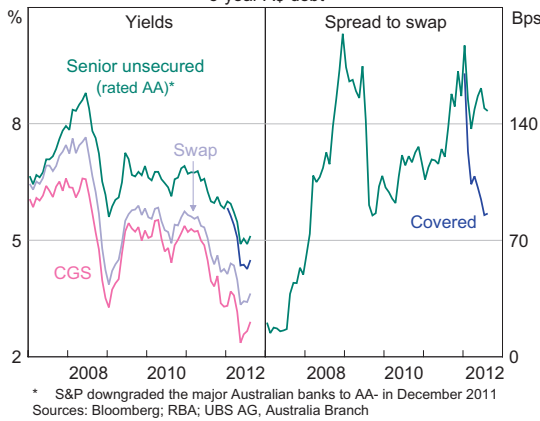


\* Issuance capacity based on the current size of bank resident assets and overcollateralisation levels  
Sources: APRA; RBA

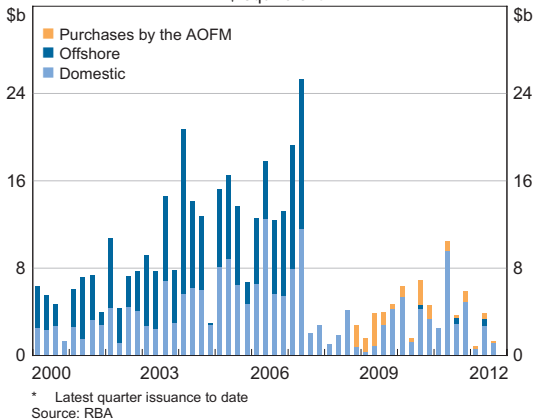
introduced late last year (Graph 4.9). CDS premia referencing Australian banks increased by around 50 basis points in May as European developments and large derivative trading losses reported by JP Morgan pushed these premia wider on banks globally. Most of this rise has subsequently been reversed.

There have been seven residential mortgage-backed securities (RMBS) transactions as well as four transactions backed by vehicle, equipment or consumer loans since the previous *Statement* (Graph 4.10). The RMBS issues amounted to \$4.2 billion in aggregate and included non-conforming deals by Pepper Homeloans and Liberty

**Graph 4.9**  
**Major Banks' Bonds**  
5-year A\$ debt



**Graph 4.10**  
**Australian RMBS Issuance\***  
A\$ equivalent



Financial. Pricing on the conforming deals was around 15–20 basis points wider than comparable issues late last year. The Australian Office of Financial Management participated in three of the issues, purchasing a total of \$500 million, as part of its effort to support competition in mortgage lending from a diverse range of lenders.

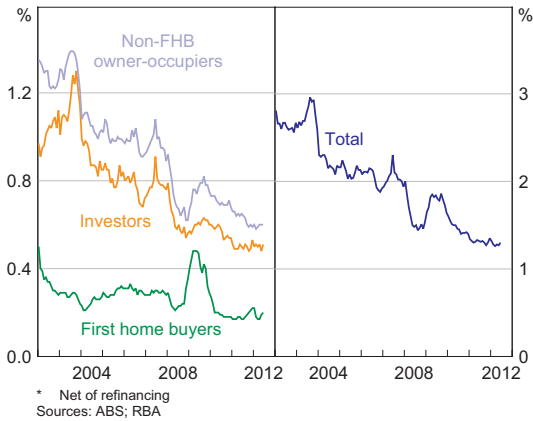
Several issuers, including major financial institutions, have been active in the retail bond market, with issuance totalling over \$3 billion in recent months. Retail bonds require a prospectus and are often hybrid instruments (combining debt and equity characteristics).

Standard & Poor's raised its rating on Bank of Queensland by one notch to BBB+, mainly reflecting the bank's equity raising of \$450 million in May, while Moody's downgraded the same institution by one notch to Baa1 (equivalent to BBB+), citing the relatively weak state of the economy in south-east Queensland and its potential to affect asset quality. Moody's also announced ratings downgrades of one to three notches for the local subsidiaries and branches of a range of global banks. Separately, Moody's placed 20 tranches from 18 RMBS transactions on review for downgrade, as part of its revised individual loan analysis model. The affected tranches have a combined value of less than \$1 billion, equivalent to only 1 per cent of total Australian outstanding RMBS.

## Household Financing

Growth in housing credit slowed to an annualised rate of about 4 per cent over the June quarter, largely on reduced growth in owner-occupier housing credit. Housing loan approvals were little changed over the three months to June with a fall in approvals to first home buyers offsetting a small rise in approvals to investors and repeat buyers (Graph 4.11). New South Wales accounted for much of the decline in approvals to first home buyers, following the expiry of some first home buyer stamp duty exemptions in December 2011. The level of approvals, together with increased prepayments (as

**Graph 4.11**  
**Value of Housing Loan Approvals\***  
 Per cent of housing credit outstanding



repayments are often held constant as mortgage interest rates fall), suggests that growth in housing credit is likely to remain around its current pace in the period ahead.

There was a small decline in the value of outstanding personal credit over the June quarter, mostly owing to a fall in revolving credit facilities. Margin lending activity has continued to decline, with volatility in global equity markets and investor risk aversion weighing on activity. This form of credit now

comprises only 1 per cent of household credit, down from around 4 per cent in late 2007.

Advertised interest rates on loans to households have fallen since the end of April. Most lenders reduced their variable housing loan indicator rates by between 55 and 60 basis points over this period, less than the 75 basis point reduction in the cash rate (Table 4.1). The average discount on housing loans was little changed over the three months to the end of July.

Rates on new fixed-rate mortgages have also fallen since the end of April, reflecting the decline in benchmark market rates. For terms of three years or less, fixed rates are about 20 to 25 basis points lower than discounted variable rates. The share of housing loans approved at fixed rates, at 10 per cent, is around its long-run average.

Overall, the average interest rate on outstanding fixed- and variable-rate housing loans has fallen by 50 basis points since the end of April, to be around 60 basis points below its post-1996 average (Graph 4.12).

Rates on personal loans – including home equity loans, unsecured personal loans and margin loans –

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

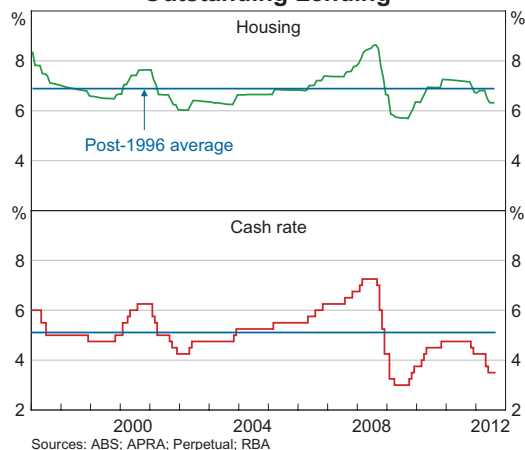
	Level at 8 August 2012	Change since:	
		End April 2012	End October 2011
<b>Housing loans<sup>(a)</sup></b>	6.14	-0.59	-0.89
<b>Personal loans</b>	12.92	-0.26	-0.30
<b>Small business</b>			
Residentially secured			
– Term loans	7.99	-0.63	-1.00
– Overdraft	8.87	-0.62	-0.99
Average rate <sup>(b)</sup>	7.68	-0.63	-1.05
<b>Large business</b>			
Average rate <sup>(b)</sup> (variable-rate and bill funding)	5.85	-0.72	-1.06

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

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

Sources: ABS; APRA; RBA

**Graph 4.12**  
Average Interest Rates on Outstanding Lending

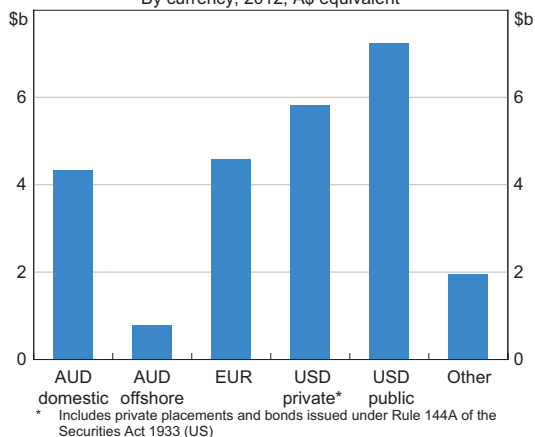


have decreased over the three months to the end of July. Rates on credit cards continue to be less sensitive to reductions in the cash rate. Since mid 2007, rates on credit cards have increased by around 4.5 percentage points, relative to the cash rate.

## Business Financing

Corporate bond issuance totalled \$8 billion since the time of the last *Statement*. The majority of corporate bonds were placed in offshore markets, including euro-denominated issues by BHP and Wesfarmers that raised over A\$3 billion collectively, and a sterling-denominated issue by Westfield that raised A\$680 million (Graph 4.13). Seven Australian corporates also issued a combined A\$2.1 billion in the US private placement market. Domestic issuance was subdued. The US public and private placement markets have a larger base of credit investors than the domestic market, and are also relatively more immune to periods of market volatility. The US markets also tend to accept longer tenors than the domestic market. Around 60 per cent of 2012 corporate issuance in the US market has been at tenors of 10 years or more, while most domestic issuance is for around 5 years. The preference to issue into offshore markets also reflects the fact that many of the largest Australian issuers, such as mining and property companies, have income streams in foreign

**Graph 4.13**  
Australian Corporate Bond Issuance  
By currency, 2012; A\$ equivalent



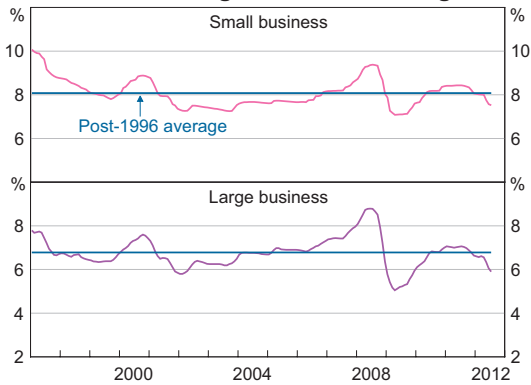
currencies that provide a natural hedge for offshore issuance. Such issuers have accounted for around half of total corporate issuance this year.

There has been a pick-up in the pace of intermediated business credit growth over the first half of this year. Lending by the major banks and Asian banks was stronger than the system average, with the latter now accounting for 6 per cent of business credit. In aggregate, lending by other bank and non-bank lenders was largely unchanged.

The cost of intermediated business borrowing declined over the three months to the end of July, with the average interest rates on outstanding small and large business lending declining by about 50 and 65 basis points (Graph 4.14). These reductions largely reflected movements in wholesale benchmark rates, although spreads did widen a little over the period. Rates on small and large business loans are now around 55 and 90 basis points below their post-1996 averages, respectively.

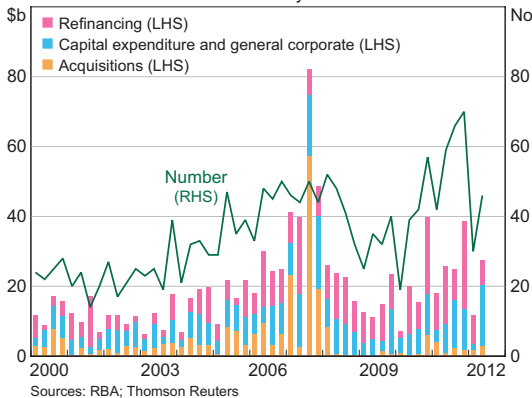
The value of domestic syndicated loan approvals increased in the June quarter, following subdued activity in March (Graph 4.15). The increase in activity was driven by a number of large deals, particularly in the energy sector. Similar to broader business credit, the value of outstanding syndicated lending by European banks continues to contract.

**Graph 4.14**  
Average Interest Rates on Outstanding Business Lending



Sources: APRA; RBA

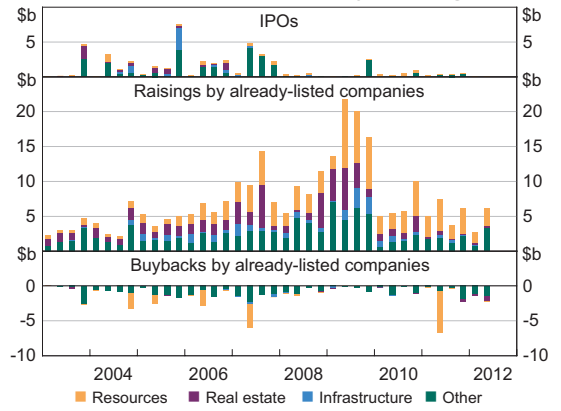
**Graph 4.15**  
Syndicated Loan Approvals  
Quarterly



Sources: RBA; Thomson Reuters

Equity raising activity in the first half of the year fell to its lowest level since 2003 as a combination of weak mergers and acquisition activity, low equity prices and generally conservative gearing combined to limit the appetite for new equity by listed companies (Graph 4.16). Initial public offerings (IPOs) were also limited, with the poor performance of recent floats and elevated uncertainty within markets causing firms to cancel or delay their IPOs. Issuance by listed companies totalled \$6 billion in the most recent quarter, most of which occurred in June. Resource companies and companies in sectors less influenced by the economic cycle, such as utilities, have generally raised funds for investment purposes.

**Graph 4.16**  
Listed Corporates' Equity Raisings\*



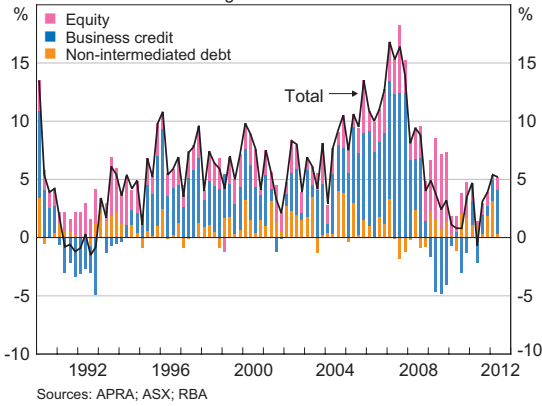
\* Excludes privatisations and hybrid conversions, which are very small  
Sources: ASX; RBA

In contrast, cyclically sensitive non-resource sectors, such as consumer discretionary and industrial firms, have raised equity to fund approaching debt maturities or to avoid breaching loan covenants. Loan covenants typically include metrics such as interest coverage, which are adversely affected by a deterioration in earnings. Ten, Seven West Media, Billabong and Echo Entertainment have all raised equity recently to pay down debt after downgrading their profit outlooks, while Brambles tapped equity markets to support its balance sheet after it cancelled plans to sell its data management subsidiary.

Mergers and acquisition activity has been around its long-run average over the past three months, with \$14 billion in deals announced since the previous *Statement*. Demand for corporate assets (outside of the resources sector) has eased over the past year as corporations limit strategic acquisitions and private equity buyers remain cautious.

Total business external funding was equivalent to 5 per cent of GDP in the June quarter and was largely sourced through credit from financial institutions (Graph 4.17). The contributions from equity and non-intermediated debt to overall external funding were marginal in recent months.

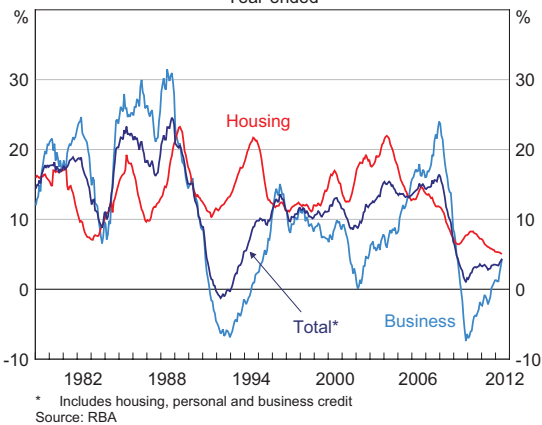
**Graph 4.17**  
**Business External Funding**  
Net change as a share of GDP



### Aggregate Credit

Total outstanding credit grew at an annualised rate of around 5 per cent over the June quarter, as the pick-up in business credit growth more than offset the small slowing in the growth rate of lending to households (Graph 4.18). Growth in broad money continues to outpace credit growth, reflecting 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 4.18**  
**Credit Growth**  
Year-ended

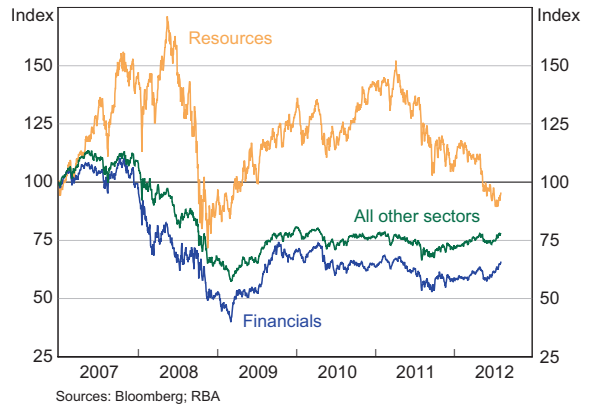


### Equity Markets

The ASX 200 has declined 3 per cent since the previous *Statement* as the situation in Europe and concerns over global growth prospects continue to weigh on sentiment. Losses on the Australian share market have generally been greater than on overseas markets due to the high domestic weighting of the resource sector. Resource stocks have declined 14 per cent over the period, with stock prices falling to their lowest level since March 2009 (Graph 4.19). Sectors such as telecommunications, utilities and consumer staples rose over the period, reflecting the general uncertainty in markets and investor demand for companies with high dividend yields (Graph 4.20). Banking stocks have also benefited from this preference for higher yielding shares, rising 5 per cent, with recent policy initiatives in Europe also providing some support. Share market volatility remains around its long-run average despite the continuing pessimism.

Private sector analysts have scaled back their earnings expectations significantly over the past year and now anticipate no profit growth for the upcoming reporting season in August. The deteriorating situation in Europe and weaker global economic data has driven the earnings downgrades,

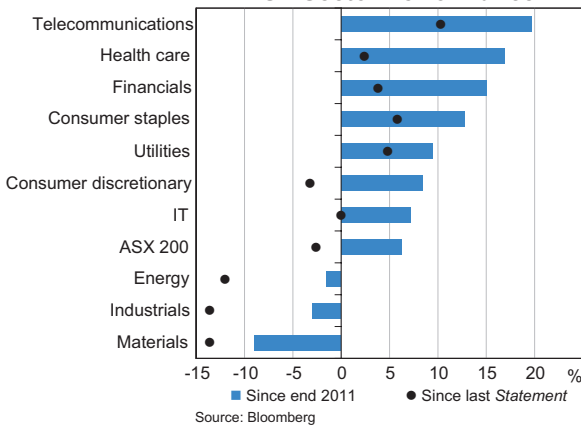
**Graph 4.19**  
**Australian Share Price Indices**  
End December 2006 = 100





particularly for the resource sector. The trailing price-earnings ratio for Australian shares remains well below average and is largely unchanged since the previous *Statement* (Graph 4.21). Price-earnings ratios for the resource and financial sectors have exhibited considerable volatility over the past few years, mainly as a result of share price volatility rather than volatility in earnings. ↕

**Graph 4.20**  
**ASX Sector Performance**



**Graph 4.21**  
**Trailing Price-earnings Ratios**

