3. Domestic Financial Conditions

Domestic financial conditions are accommodative for most households and large businesses, and have become increasingly so following the reductions in the cash rate in June and July. Financial market prices imply that market participants expect the cash rate to be reduced by a further 25 basis points later this year. Government and corporate bond yields have continued to decline over 2019 across all maturities to be at historic lows. Banks' funding costs also declined to historically low levels. Notwithstanding recent declines, Australian equity prices have risen across all sectors since the start of the year. The value of the Australian dollar is at its lowest level in some time.

Banks have passed through most of the reductions in the cash rate to housing interest rates and to retail deposit rates. Both housing loan and deposit rates are very low by historical standards, as are rates on business loans. Growth in housing credit continued to decline, largely reflecting weaker demand for housing over the past year. However, there was a rise in housing loan approvals in the month of June, consistent with improvement in other indicators of housing market conditions. Meanwhile, growth in business debt remains higher than the average of recent years. However, this has been driven entirely by lending to large businesses, whereas access to funding for small businesses has tightened further over the past year or so.

Investors expect a further reduction in the cash rate later this year

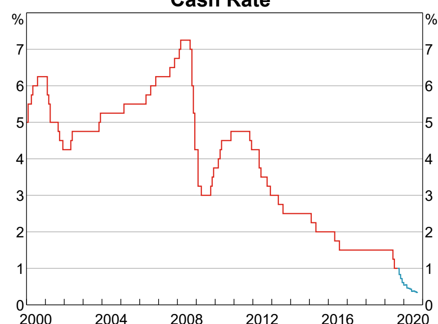
The cash rate target stands at 1.0 per cent, following two 25 basis point reductions at the June and July Board meetings. Financial market prices imply that participants expect the cash rate to be lowered by a further 25 basis points later in 2019 (Graph 3.1).

Government bond yields have continued to decline

Yields on Australian Government Securities (AGS) have declined over 2019 across all maturities, with 10-year AGS yields reaching a historic low of around 1 per cent (Graph 3.2). In recent months this has reflected expectations for an easing of monetary policy, and was broadly in line with changes in yields on government securities in a number of advanced economies; weaker-than-expected domestic data also contributed. The spread between US

Graph 3.1

Cash Rate*



* Data from September onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

Treasury and AGS yields has stabilised, with the AGS 10-year yield around 75 basis points below the 10-year US Treasury yield. AGS yields for even longer maturities have also declined over 2019. The yield on the longest AGS (maturing in March 2047) has declined by around 110 basis points over 2019, to be below 1.70 per cent.

Short-term money market spreads have narrowed a little further

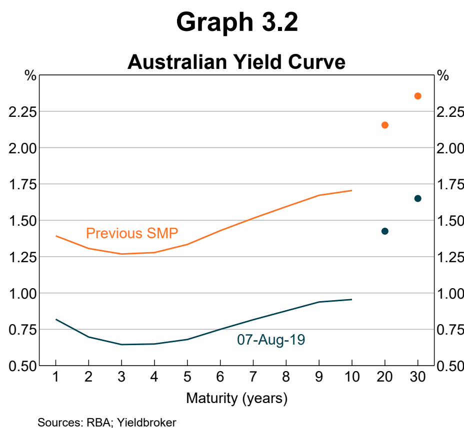
After declining over the first quarter of this year, spreads of interest rates to overnight indexed swaps (OIS) in the markets for bank bills and foreign exchange (FX) swaps declined a little further in recent months. The spread of 3-month bank bills relative to OIS moved lower over the June quarter, to be around 15 basis points, which is around its lowest level in the past 5 years (Graph 3.3). Similarly, the cost of raising US dollar funding and then converting these funds into Australian dollars for a short term in the FX swap market declined a little relative to OIS over recent months. Repurchase agreement (repo) rates were little changed relative to OIS overall in recent months. The cash rate continued to trade at the Reserve Bank Board's target.

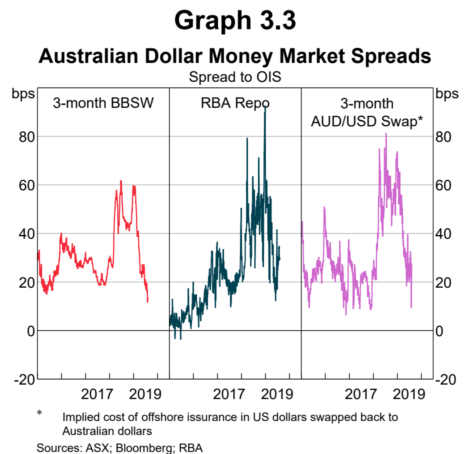
Banks' senior bond issuance has slowed …

Australian banks have issued bonds at a slower pace than in previous years, with around $60 billion of bonds issued in the first seven months of 2019 (Graph 3.4). Given that the volume of scheduled maturities is higher than gross issuance, this means that net issuance is negative. The decline in net issuance is consistent with lower funding needs due to slower asset growth. In July, the Australian Prudential Regulation Authority (APRA) announced that it would require major banks to increase their total capital by 3 percentage points by January 2024. It is likely that this additional capital will be sourced from issuance of Tier 2 hybrid instruments. Hybrid securities have both equity and debt features and can be used to fulfil a part of regulatory capital requirements. Because this capital represents an additional source of bank funding, this requirement is also likely to reduce the need for banks to issue senior unsecured debt for a time.

… while RMBS issuance increased in the June quarter

Issuance of residential mortgage-backed securities (RMBS) increased strongly in the June quarter to its highest level since the global





financial crisis (Graph 3.5). The increase was driven by non-authorised deposit-taking institutions (non-ADIs) and non-major banks; this reflects the strong credit growth in 2018 by non-ADIs (who are largely funded via securitisations).

Banks' funding costs continued to decline to new historical lows

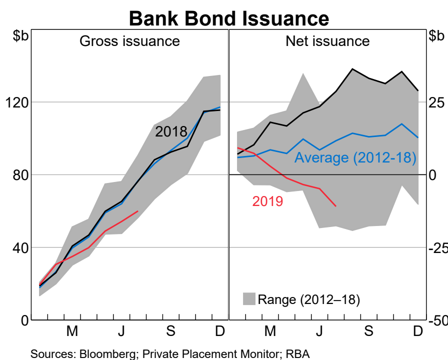
Banks' funding costs are at a very low level, reflecting both low wholesale funding costs – including as a result of decreases in bank bill swap (BBSW) rates – and low deposit rates. Bank bond yields have declined since the since the start of 2019, in line with declines in other market rates. The spreads of major bank bond yields to reference rates also declined over the first half of the year (Graph 3.6).

Banks passed through most of the cash rate cuts to retail deposit rates

Over recent months, banks lowered the interest rates on a large share of the value of their retail deposits (which account for one-third of debt funding) (Graph 3.7). As is typical, however, the interest rates on transaction accounts (which are close to zero) did not change following the reductions in the cash rate. Other at-call deposit rates are estimated to have decreased by 40 to 45 basis points. A number of banks also reduced their interest rates on term deposits by around 20 to 60 basis points over recent months.

Graph 3.4

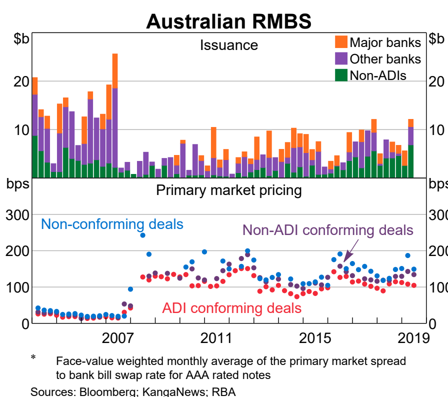
Bank Bond Issuance



Sources: Bloomberg; Private Placement Monitor; RBA

Graph 3.5

Australian RMBS



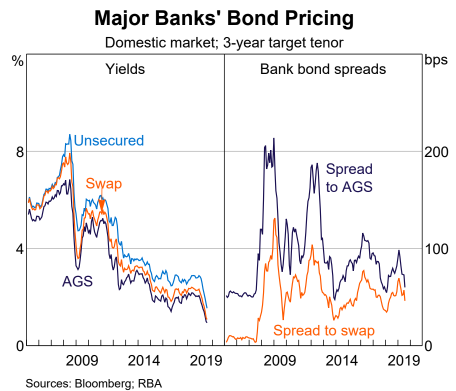
* Face-value weighted monthly average of the primary market spread to bank bill swap rate for AAA rated notes

Sources: Bloomberg; KangaNews; RBA

Graph 3.6

Major Banks' Bond Pricing

Domestic market; 3-year target tenor

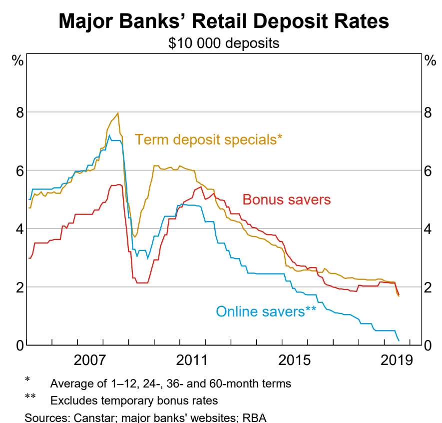


Sources: Bloomberg; RBA

Graph 3.7

Major Banks' Retail Deposit Rates

$10 000 deposits



* Average of 1–12, 24-, 36- and 60-month terms

** Excludes temporary bonus rates

Sources: Canstar; major banks' websites; RBA

Prior to the most recent reduction in the cash rate in July, the major banks reported in June that they paid no interest on just under 10 per cent of the value of their (retail and wholesale) deposits (Graph 3.8). This share is estimated to have increased only marginally since February. The share of deposits that paid some interest, but less than 50 basis points, was also a little under 10 per cent in June (up from around 5 per cent of deposits in February).

Lenders passed through most of the cash rate cuts to housing interest rates

Following the reductions in the cash rate, lenders reduced their standard variable rates (SVRs) on housing loans by an average of 44 basis points (23 basis points in June and 21 basis points in July). The extent of pass-through was similar across different types of banks.

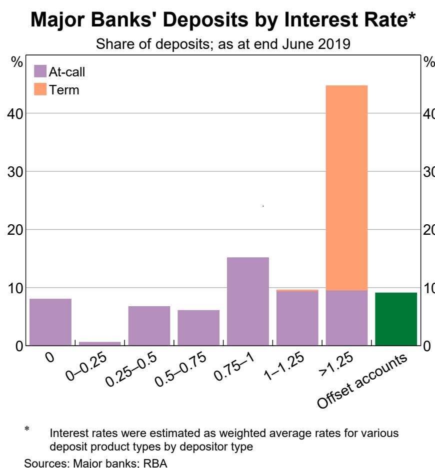
The average interest rate paid on outstanding variable-rate loans in the Securitisation Dataset decreased by 23 basis points in June, the same as the average reduction in SVRs announced by the banks (Graph 3.9 and Graph 3.10). Moreover, preliminary data suggest that actual rates paid on new loans decreased by more than the SVR decreases in the June quarter for some banks.

The average outstanding interest rate paid had already been drifting lower over the eight months before June, reflecting the fact that interest rates on new loans remain well below those on outstanding loans and existing customers have been refinancing at these lower rates. In addition, customers have been continuing to switch from interest-only to principal-and-interest loans with lower interest rates. Consistent with this, liaison with the major banks, mortgage brokers and non-ADI lenders indicates that competition for high-quality borrowers remains strong.

Interest rates on fixed-rate housing loans also continued to decline. Advertised fixed rates have fallen substantially over the past year. This is consistent with lower interest rate swap rates, which are often used as a pricing benchmark.

Credit growth slowed across all components

Total credit growth slowed to 2¼ per cent on a six-month-ended annualised basis in June (Graph 3.11 and Table 3.1). This was driven by a slowing in housing and business credit growth, although growth of a broader measure of business debt has been stable over the course of this year.



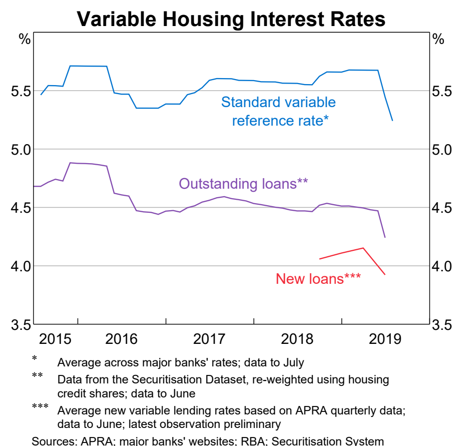


Table 3.1: Financial Aggregates

Percentage change[a]

	Three-month-ended annualised		Six-month-ended annualised	
	Mar 2019	Jun 2019	Dec 2018	Jun 2019
Total credit	3.1	1.4	4.3	2.2
– Housing	3.1	2.7	4.1	2.9
– Owner-occupier housing	4.4	4.1	5.6	4.2
– Investor housing	0.3	–0.2	1.0	0.0
– Personal	–3.9	–4.4	–2.8	–4.1
– Business	4.4	–0.2	6.1	2.1
Broad money	9.9	1.9	2.2	5.8

(a) Seasonally-adjusted and break-adjusted

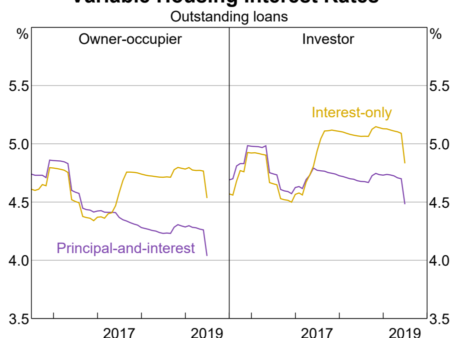
Sources: ABS; APRA; RBA

From the July 2019 release onwards, the financial aggregates published by the Reserve Bank will incorporate an improved conceptual framework and a new data collection. The changes are likely to result in revisions, some of which may be significant. For further information about the upcoming changes and the new data collection, see Updates to Australia's Financial Aggregates.

Housing credit extended to owner-occupiers grew by around 4¼ per cent on a six-month-ended annualised basis over the first half of 2019, down from its recent peak of 10 per cent in 2016 (Graph 3.12). Loan approvals to owner-occupiers picked up in June but were little changed in the first half of 2019, after declining from their 2017 peak (Graph 3.13).

Housing credit for investors was unchanged over the past six months. Credit extended by the major banks to investors has contracted since mid 2018. Investor credit extended by other financial institutions has been a little stronger and has offset the reduction of investor lending by the major banks in recent months. Loan approvals to investors have declined for the past two years, to be around 50 per cent below their

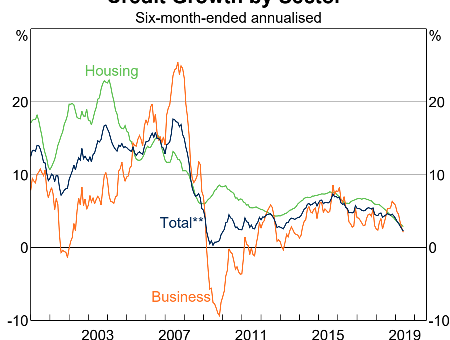
Graph 3.10



* Average of securitised loans, re-weighted using housing credit shares; data to June

Sources: RBA; Securitisation System

Graph 3.11



* Seasonally adjusted and break-adjusted; including securitisation

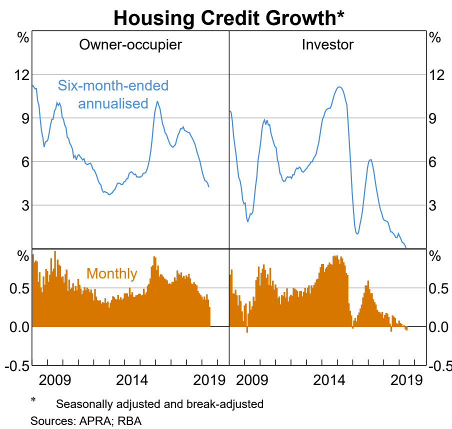
** Includes housing, personal and business credit

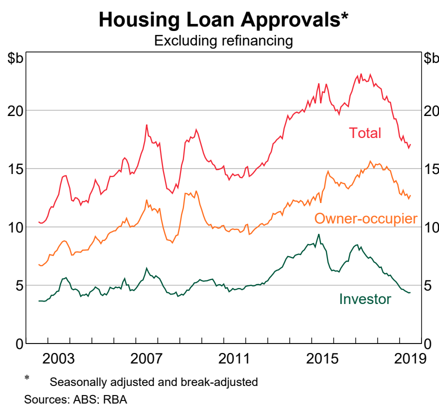
Sources: ABS; APRA; RBA

level in early 2017, although they, too, increased slightly in June.

Demand for housing credit remains weak …

The soft conditions in the housing market have contributed to the slowing in housing credit growth over the past couple of years. The declines in housing prices and the associated reduction in housing turnover have reduced the demand for credit, particularly from investors, who are especially sensitive to expectations of capital losses. Liaison with mortgage brokers, banks and non-ADIs suggests that housing loan applications are well down over the past year.





However, consistent with the increase in loan approvals in June, in liaison some lenders have reported tentative signs of a pick-up in applications since May.

… and banks' assessment of mortgage applications continues to evolve

Housing credit conditions tightened following the strengthening of lending policies and practices over recent years. These changes reduced the maximum loan size available to many households, though only a small share of households borrow close to the maximum amount that they are offered. One way in which banks improved their processes for assessing mortgages has been the more thorough verification of expenses in loan applications. In liaison, the banks indicated that they have recently made this process more efficient, following an increase last year in the time it took to approve loans. The banks also noted that the rates of loan applications that are approved were little changed at high levels and that over the past year, households' maximum borrowing capacity has not changed materially.

Banks are continuing to make a number of changes to the way that they assess serviceability. Comprehensive credit reporting (CCR) is being expanded from consumer credit to mortgages. In liaison, the banks indicated that CCR is not expected to have a significant effect on the supply of credit. The income and expenses verification process should already be picking up existing mortgages through examination of bank statements and the banks have found little deliberate misreporting so far.

APRA has amended its guidance to ADIs on the interest rates they use in serviceability assessments for residential mortgage applications.[1] ADIs now use the higher of an interest-rate floor they set themselves and an interest rate that is a minimum 2.5 percentage points over a loan's actual interest rate.

Previously, ADIs were required to use the higher of interest rates comfortably above a floor of 7 per cent and a 2 percentage point buffer over a loan's interest rate (in practice, ADIs were using the higher of 7.25 per cent or a 2.25 percentage point buffer). ADIs have announced interest-rate floors of around 5¼ to 5¾ per cent. These changes will have different effects on different borrowers. They will generally result in an increase in borrowing capacity for borrowers eligible for lower-rate loans, such as owner-occupier principal-and-interest loans. By contrast, there would be little change, or even a small tightening, in borrowing capacity for borrowers that pay higher interest rates, which is more typical of investors with interest-only loans.

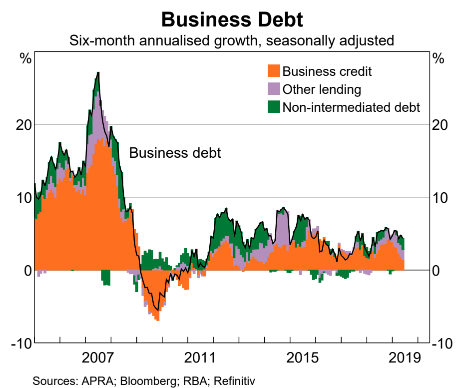
Large businesses' funding conditions remain accommodative …

Growth in business borrowing has been little changed at a relatively strong pace over 2019, although the composition of this borrowing has changed. A pick-up in growth in borrowing through bond issuance and continued growth in borrowing through syndicated lending has offset slower growth in borrowing from ADIs (that is, business credit) (Graph 3.14). The slowing in growth in business credit over the past six months was driven by a decline in credit extended by the major banks and slower growth in credit extended by the foreign banks (Graph 3.15). Lending to large businesses accounted for all of the growth in business credit over the past year or so; lending to small businesses declined over this period.

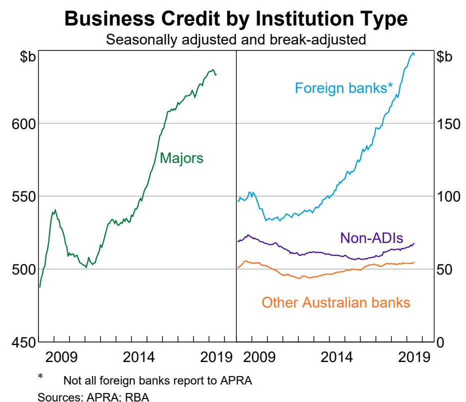
Over the past few months, business loan approvals picked up, retracing much of their decrease earlier in the year. This reflects an increase in loan approvals for commercial property and across a range of other industries including manufacturing, property & business services and transportation & storage. By contrast, loan approvals for residential property are around 40 per cent lower than their peak in 2016, reflecting a decrease in approvals for both the purchase and construction of residential property.

As noted above, a pick-up in business borrowing through bond issuance in 2019 has offset the slowing growth in business borrowing from banks. The pace of bond issuance by non-financial corporations continued to increase in the June quarter (Graph 3.16). Issuance by companies in the infrastructure sector has driven non-resource related bond issuance. Secondary market yields continued to decline, further easing funding conditions for large corporations.

Graph 3.14

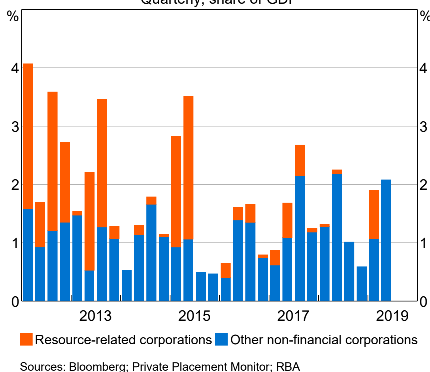


Graph 3.15



… while small businesses' access to funding remains difficult

Lending to small businesses declined over the past year. Small businesses also reported in surveys that they are finding it difficult to obtain finance. In July, the Reserve Bank hosted the 27th Small Business Finance Advisory Panel, which provided valuable information on the financial conditions facing small businesses throughout Australia.[2] The panellists indicated that banks' heightened verification of expenses and income has made it more difficult to access finance. This is consistent with liaison with banks that suggests that the verification process for lending to consumers (including lending for housing) has been extended to many small businesses. While the Australian Securities and Investments Commission does not require consumer responsible lending obligations to be applied to business lending, the distinction between business and personal borrowing for small businesses is often unclear. Relatedly, the panellists suggested that small businesses find that it has become increasingly difficult to provide the evidence required by banks that they can service a loan. The panellists noted that non-traditional sources of finance are being increasingly used by small businesses, but these sources are often expensive.



Interest rates on business loans are low

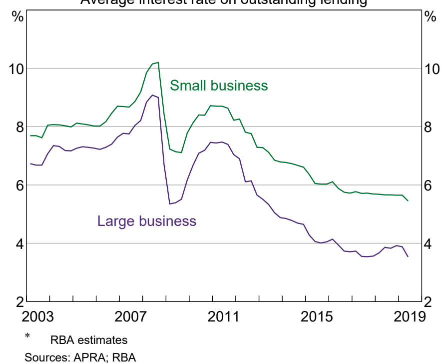
Interest rates on loans to large businesses – which tend to move with BBSW rates – are estimated to have declined over recent months (Graph 3.17). Large business interest rates are at low levels.

Lending rates on outstanding loans to small businesses decreased by around 20 basis points following the reduction in the cash rate in June (the latest data available). Small business lending rates are noticeably higher than interest rates for large businesses. This partly reflects the higher default rates associated with small business loans.

Australian equity prices have increased this year

The ASX 200 is 20 per cent higher than its trough at the end of 2018, and has moved broadly in line with overseas markets since the beginning of the year (Graph 3.18). The ASX 200 reached a record high at the end of July, before uncertainty related to the US–China dispute led to some price falls.

Share prices across all industry sectors of the ASX 200 are materially higher than they were at the start of the year (Graph 3.19). Share prices of resources companies have been supported by higher iron ore prices. The industrials and



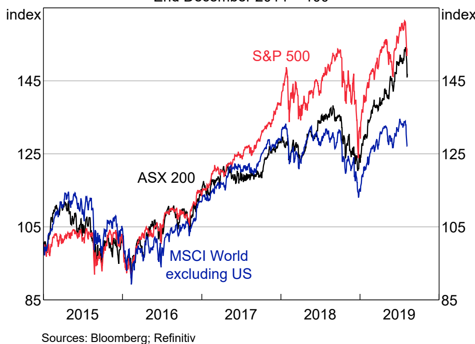
communications sectors have also performed strongly since the start of the year. Banks' share prices have risen this year but have underperformed the broader market, following weakness in global banking stocks and recent reductions in the official cash rate.

Analysts' forecast earnings for the broader share market were little changed overall in recent months. Earnings expectations for resources companies were revised up due to higher commodity prices, while earnings forecasts for most sectors outside of resources declined marginally. Consistent with earnings expectations, price-to-earnings ratios for resources ticked down slightly, while those of financials edged up (Graph 3.20). Ratios for other sectors remain elevated.

Graph 3.18

Total Return Indices

End December 2014 = 100



Sources: Bloomberg; Refinitiv

The Australian dollar is at its lowest level in some years

Over the past year, the Australian dollar depreciated by about 7 per cent on a trade-weighted (TWI) basis to be at its lowest level in some time (Graph 3.21). Over this period, Australian Government bond yields declined further relative to those in major markets as market participants revised lower their expectations for monetary policy in Australia, and notwithstanding expectations of lower policy rates also in major economies. The RBA Index of Commodity Prices fell in recent weeks but is little changed over the past year. The net effect of these developments is consistent with the Australian dollar being around its lowest level for some time on a TWI basis.

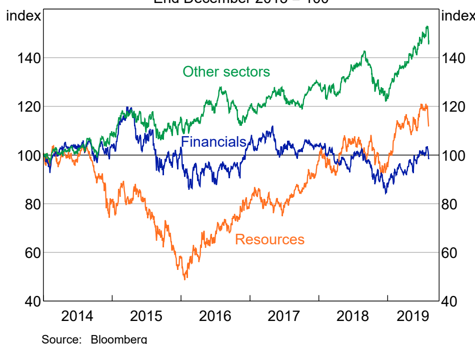
Net capital inflows to Australia declined in recent quarters, consistent with the decline in the current account deficit (Graph 3.22) (see 'Domestic Economic Conditions' chapter). At a sectoral level, there were increased flows of foreign investment to the non-mining corporate sector and a decline in flows to the mining sector in the past few years.

Australia's net foreign liability position declined as a share of GDP over recent years to be around its lowest level since 2002 (Graph 3.23). This reflected a decline in net capital inflows at a time when nominal output was growing. The

Graph 3.19

Australian Share Prices

End December 2013 = 100

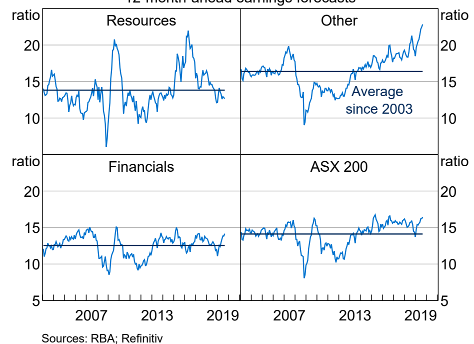


Source: Bloomberg

Graph 3.20

ASX 200 Price-earnings Ratios

12-month-ahead earnings forecasts

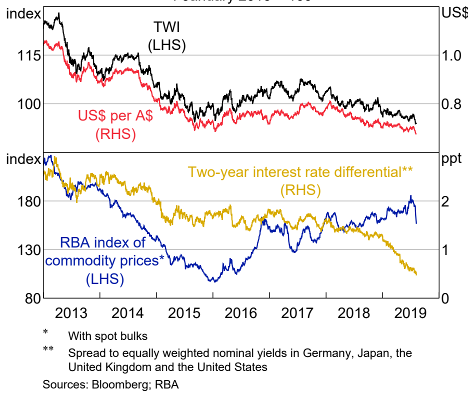


Sources: RBA; Refinitiv

value of the net foreign liability position has been little changed since early 2016, as a modest increase in the value of net foreign long-term debt liabilities has been offset by an increase in Australia's net foreign equity asset position. This is consistent with the sizeable offshore equity holdings of the Australian superannuation sector, and foreign equities outperforming Australian equities over the past couple of years. ✠

Graph 3.21

Australian Dollar



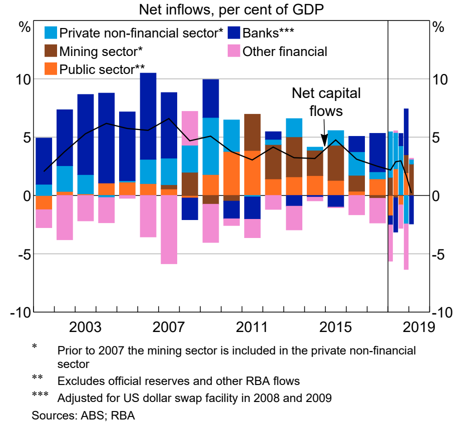
* With spot bulks

** Spread to equally weighted nominal yields in Germany, Japan, the United Kingdom and the United States

Sources: Bloomberg; RBA

Graph 3.22

Australian Capital Flows



* Prior to 2007 the mining sector is included in the private non-financial sector

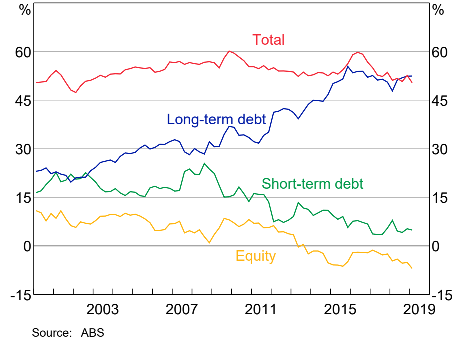
** Excludes official reserves and other RBA flows

*** Adjusted for US dollar swap facility in 2008 and 2009

Sources: ABS; RBA

Graph 3.23

Net Foreign Liabilities



Source: ABS

Endnotes

[1] See APRA (Australian Prudential Regulation Authority) (2019), 'APRA finalises amendments to guidance on residential mortgage lending', Media Release, 5 July. Available at <apra.gov.au/media-centre/media-releases/apra-finalises-amendments-guidance-residential-mortgage-lending>.

[2] For information about the small business advisory panel see the Reserve Bank website at <https://www.rba.gov.au/about-rba/panels/small-business-finance-advisory-panel.html>. Available at <https://www.rba.gov.au/about-rba/panels/small-business-finance-advisory-panel.html>.