

Domestic Financial Markets

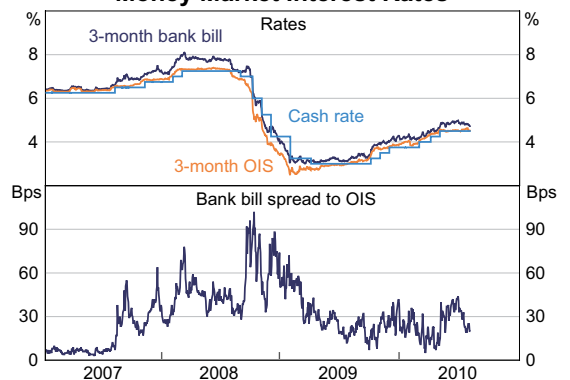
Money Markets and Bond Yields

Since the *Statement* in May, the Reserve Bank Board has maintained its target for the overnight cash rate at 4.50 per cent. An intensification in pressures in global financial markets over recent months saw domestic yields move to price in some probability that the cash rate target could be reduced later in 2010. More recently, as global conditions have stabilised and domestic indicators have pointed to a reasonably buoyant domestic outlook, money market yields have shifted to imply a small chance that monetary policy may be tightened in the year ahead.

Bank bill rates are little changed from the time of the last *Statement*. However, as global financial tensions increased from early May, there was upward pressure on bank bill rates, and relative to overnight indexed swaps (OIS), bill spreads temporarily rose to their highest level since the first quarter of 2009 (Graph 56). As the global tensions have eased, the spread has fallen back towards the centre of its recent range. Throughout this time, conditions within the domestic money markets have remained liquid and orderly. In its market operations, the Bank has generally maintained aggregate Exchange Settlement (ES) balances within a \$1½–2 billion range, having allowed balances to rise temporarily over the financial year-end.

Bond yields fell sharply during May and June in line with global developments (Graph 57). The yield on 10-year Commonwealth Government Securities (CGS) declined by around 50 basis points to reach

Graph 56
Money Market Interest Rates



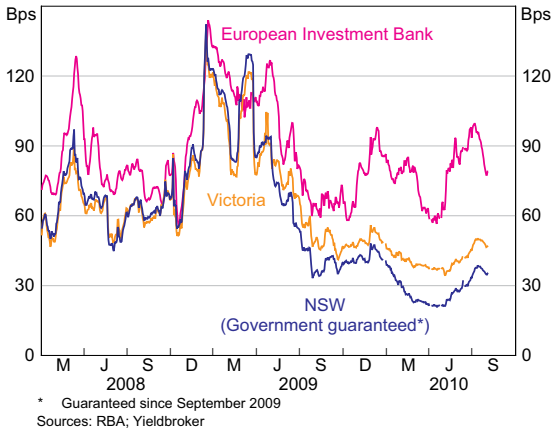
Sources: AFMA; RBA; Tullett Prebon (Australia) Pty Ltd

Graph 57
Australian Government Bond Yields



Source: RBA

Graph 58
Spreads to 5-year CGS

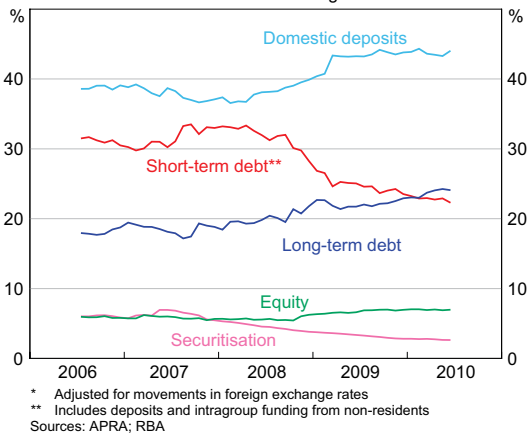


5 per cent at the start of July, with the decline in shorter-dated bond yields more pronounced. In recent weeks as market pessimism has abated, yields have rebounded from their lows. Spreads between CGS and other highly-rated paper – including state government and supranational bonds – widened during the most recent episode of financial turbulence but have since stabilised (Graph 58).

Financial Intermediaries

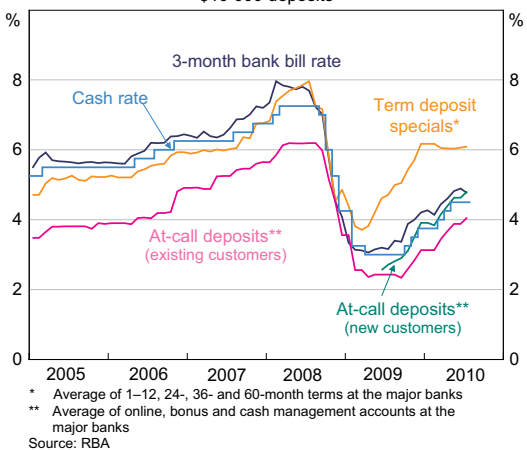
The composition of banks' funding has remained relatively stable in recent months (Graph 59). Competition in deposit markets has eased somewhat from its heightened levels earlier in the year, although pressures for retaining deposit funding at a high level remain strong. The average interest rate on the major banks' new and existing at-call deposits (including online savings, bonus saver and cash management accounts) increased slightly less than the cash rate in May. At-call rates have, however, subsequently increased a little more.

Graph 59
Funding Composition of Banks in Australia*
Per cent of funding



The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has been little changed since end April, at just over 6 per cent (Graph 60). It remains about 240 basis points higher than it was in early 2009, and around 110 basis points above market rates of equivalent duration. The major banks continue to offer higher interest rates on 'special' term deposits than on wholesale funds of equivalent maturity (both for short and long maturities). On average, the smaller Australian-owned banks' 'special' term deposit rates are also little changed since end April, and are at similar levels to those offered by the major banks.

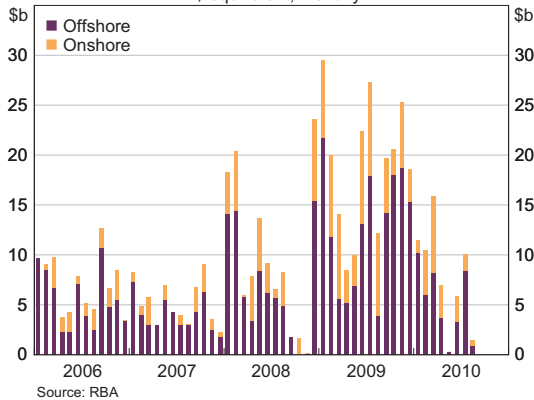
Graph 60
Deposit Rates
\$10 000 deposits



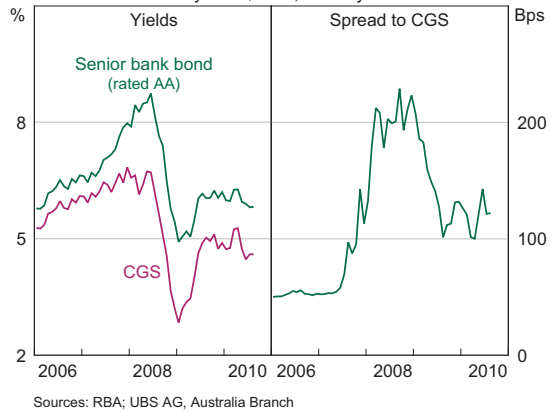
Australian bank bond issuance was subdued in May and June, reflecting the heightened uncertainty in global markets and the fact that the banks were well ahead on their funding requirements. Issuance rebounded in July as market conditions have improved. Since the previous *Statement*, domestic banks have issued bonds totalling \$17.8 billion, with around one-quarter of the issuance in the domestic market (Graph 61). The cost of the recent issuance has increased a little, broadly in line with the rise in spreads in secondary markets. Since the previous *Statement*, secondary market yields on the major banks' bonds have not fallen as much as those on CGS, with the spread widening by a little over 20 basis points (Graph 62). Nevertheless, spreads remain well below their peaks in early 2009. The recent increase in bank bond spreads has had only a small effect on banks' funding costs, as discussed in 'Box B: Developments in Bank Funding costs'.

Cross-currency basis swap spreads – which represent an additional funding cost for banks hedging foreign currency bond issuance into Australian dollars – have increased slightly since the previous *Statement* but remain below their levels early this year (Graph 63). The elevated cross currency basis swap generally

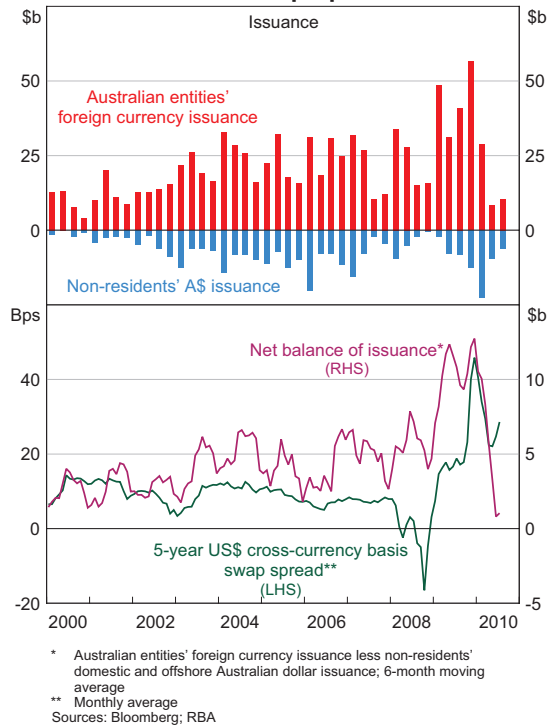
Graph 61
Australian Banks' Bond Issuance
 A\$ equivalent, monthly



Graph 62
Major Banks' Bond Pricing
 3-year A\$ debt, monthly

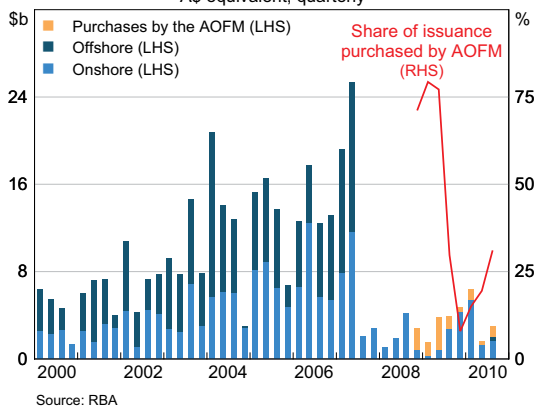


Graph 63
Bond Issuance and the Cross-currency Basis Swap Spread



encourages non-resident bond issuers – including those of Kangaroo bonds – to issue in Australian dollars and hedge into foreign currency. Kangaroo issuance, which was very strong early this year when the cross-currency basis swap was more elevated, has moderated while Australian entities’ foreign-currency issuance has also been moderate over the period as a whole. This has resulted in less liquidity in cross-currency swaps.

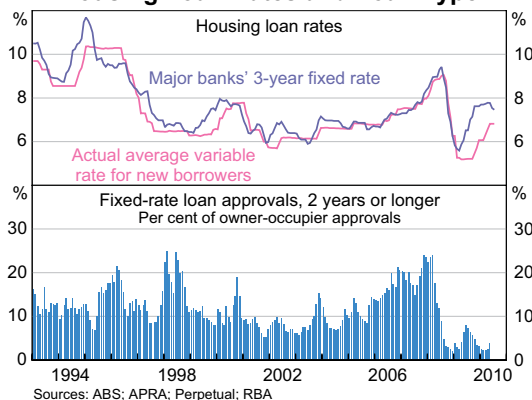
Graph 64
Australian RMBS Issuance
A\$ equivalent, quarterly



Activity in the Australian securitisation markets was subdued in the June quarter, with just \$2.3 billion of issuance. It has picked up in July with issuance amounting to around \$4.2 billion. The Australian Office of Financial Management (AOFM) has increased its participation in the residential mortgage backed securities (RMBS) market, purchasing around one-quarter of the securities issued since the previous *Statement* (Graph 64). The AOFM announced in late May that it intended to tighten pricing in the primary RMBS market by investing at lower spreads. The AOFM’s initiative reduced average spreads on primary issuance but secondary market spreads have remained broadly stable in the last few months, at around 145 basis points above the bank bill swap rate (BBSW).

In July, two securitisation transactions by Australian entities were launched in US dollars, one involving RMBS and another issue backed by auto loans. This was the first US dollar-denominated securitisation by Australian entities since May 2007, and the first offshore securitisation since the Euro market was tapped in July 2008.

Graph 65
Housing Loan Rates and Loan Type



Household Financing

Financial intermediaries largely passed on the May increase in the cash rate to variable housing loan rates (Table 9). With the cash rate unchanged since then, most lenders have also left their variable rates unchanged. Consequently, the average variable interest rate on prime full-doc loans (including discounts) has risen by 25 basis points since end April. Interest rates on low-doc loans have risen by a little more than the cash rate over this period.

The major banks’ interest rates on new 3-year fixed-rate housing loans have declined by around 30 basis points in recent months (Graph 65). This is less than the decline in corresponding swap rates, a common pricing benchmark. The decline in fixed rates over recent months has resulted in a narrowing of the spread between fixed rates and variable rates on housing loans. Nevertheless, with fixed rates still around 60 basis points above variable rates, the share

Table 9: Intermediaries' Variable Lending Rates
Per cent

	Level at end July 2010	Change since:	
		End April 2010	End April 2009
Cash rate	4.50	0.25	1.50
Housing loans			
Prime full-doc	6.82	0.25	1.63
Prime low-doc	7.48	0.31	1.68
Personal loans	12.64	0.25	1.69
Small business			
Residentially secured			
Term loans	8.59	0.25	1.51
Overdraft	9.45	0.25	1.56
Average actual rate ^(a)	8.52	0.25	1.42
Large business			
Average actual rate, variable and bill funding ^(a)	6.80	0.57	1.79

(a) RBA estimate

Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

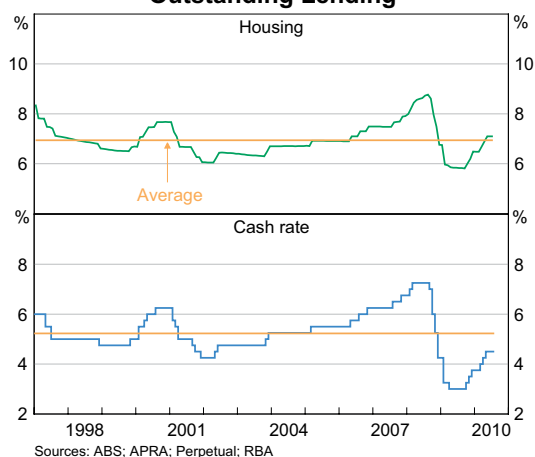
of owner-occupier loans approved at fixed rates has remained relatively low at around 4 per cent.

The average rate on all housing loans (both fixed and variable) has increased by around 130 basis points from its low in 2009, and is broadly in line with its post-1996 average (Graph 66).

After declining from late 2009, the value of housing loan approvals has been little changed in recent months (Graph 67). Owner-occupier loan approvals are well below the peak late last year, reflecting the fall in first home buyers and the rise in mortgage rates. Housing loan approvals to investors have continued to rise modestly over recent months.

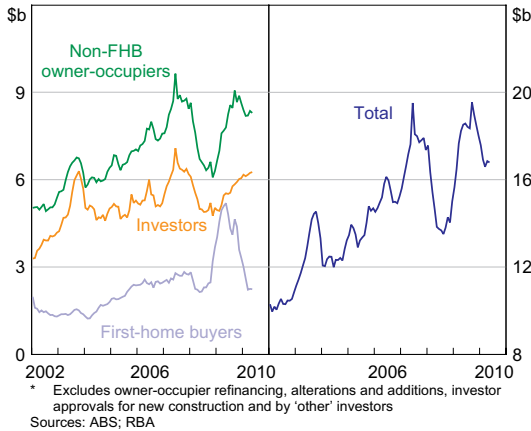
The five largest banks' share of gross owner-occupier loan approvals has declined in recent months, but remains well above its pre-crisis level. At 77 per cent, the market share of the major banks is around 6 percentage points below its peak in early 2009.

Graph 66
Average Interest Rates on Outstanding Lending

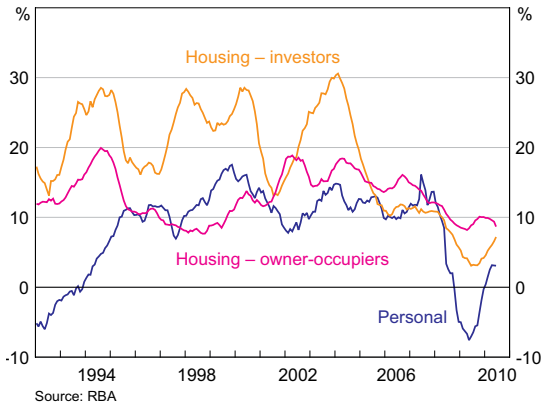


Sources: ABS; APRA; Perpetual; RBA

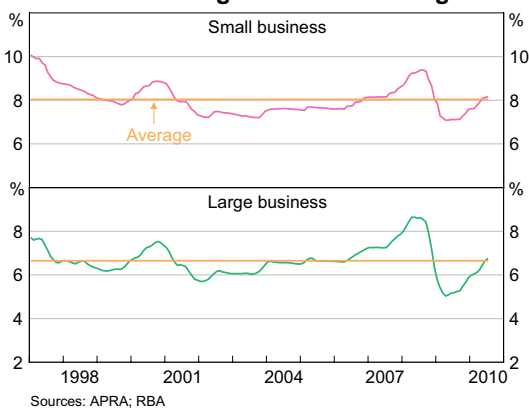
Graph 67
Value of Loan Approvals*



Graph 68
Household Credit Growth
Year-ended



Graph 69
Average Interest Rates on Outstanding Business Lending



Broadly consistent with recent trends in loan approvals, housing credit growth eased to an average 0.5 per cent per month in the June quarter (Graph 68). While owner-occupier housing credit has been the main driver of growth over the past year, growth in lending to investors has picked up in recent months.

Financial institutions' rates on most variable personal loans have increased by an average of 25 basis points in the three months to end July, with similar increases across most products, including unsecured personal loans, home equity loans, credit cards and margin loans.

Personal credit, which is a small component of household credit, decreased in the June quarter following three quarters of growth. The fall in recent months was largely due to a fall in margin lending. Despite the fall in lending, gearing levels still picked up a little due to weakness in the value of collateral (mainly equities). Nevertheless, the low level of gearing has meant that the number of margin calls also remained low (at less than one margin call per day per 1 000 clients).

Business Financing

Since the beginning of the tightening phase in October 2009, the major banks have increased their variable indicator rates on small business lending in line with increases in the cash rate. Since end April, the indicator rate has increased by 25 basis points, while indicator rates on 1-5 year fixed-rate facilities have generally decreased by around 40 basis points, broadly in line with corresponding swap rates. At 8.16 per cent, the average rate on small business loans outstanding is now around its post-1996 average (Graph 69). However, small businesses report that lending conditions remain tight, with long and involved approval processes for establishing new facilities.

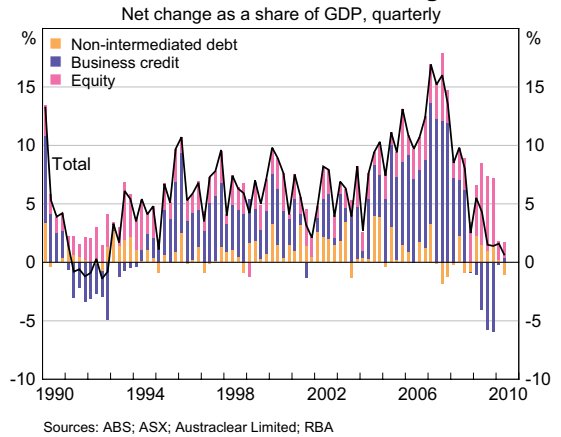
The average interest rate on banks' outstanding variable-rate lending to large business (i.e. variable-rate facilities of \$2 million or more, including bill funding) is estimated to have increased by almost 60 basis points since end April, to 6.80 per cent. These loans are repriced at regular intervals off a money market benchmark (such as the 3-month bank bill yield) with the rise in line with higher market rates and some increases in average risk margins as spreads on new loans are higher than those on existing loans. While the average spread on outstanding lending has continued to rise slowly, there are signs that credit conditions have eased somewhat over the past year for some business borrowers, with a decline in the average spread on new lending.

Net corporate external funding was little changed as a share of GDP in the June quarter, with a decline in the stock of non-intermediated debt offset by equity raisings and a small rise in business credit (Graph 70). After record equity issuance of over \$70 billion in 2009, so far this year listed corporates' have raised around \$10 billion. Commercial loan approvals have been trending higher in recent months. Following a weak start to the year, syndicated loan approvals picked up in the June quarter, with deals worth just over \$20 billion. The majority of approvals were for refinancing of existing debt, with loans for general corporate and capital expenditure purposes remaining at low levels.

Aggregate Credit

Total outstanding credit grew at an annualised rate of just under 4 per cent over the June quarter, reflecting moderate growth in household credit. Business credit was little changed over the six months to June following falls throughout 2009. Growth in broad money partly reflects banks' competition for term deposits (Table 10; Graph 71).

Graph 70
Business External Funding



Graph 71
Credit Growth

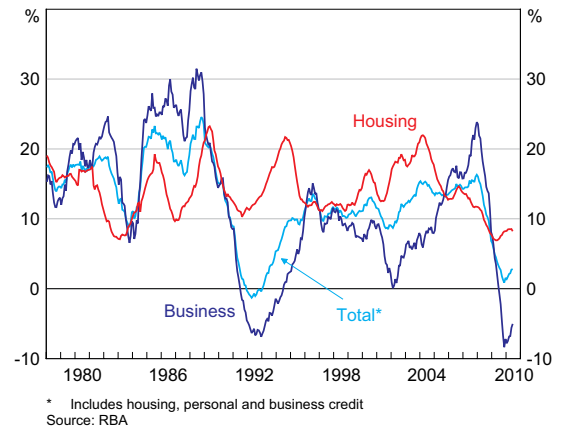


Table 10: Financial Aggregates
Percentage change

	Average monthly growth		Year to June 2010
	March quarter 2010	June quarter 2010	
Total credit	0.4	0.3	2.8
– Owner-occupier housing	0.7	0.5	8.7
– Investor housing	0.7	0.7	7.2
– Personal	0.5	–0.2	3.1
– Business	0.0	0.1	–5.0
Broad Money	0.8	0.5	2.9

Source: RBA

Graph 72
Share Price Indices
Log scale, end December 2002 = 100



Equity Markets

Since the previous *Statement*, there has been a significant increase in volatility in the Australian share market. After sharp falls in equity prices throughout May, volatility spiked in early June to levels last seen at the start of 2009. However, as Australian share prices rebounded from recent lows, volatility has declined, though it remains above its long-run average.

In net terms, the ASX 200 is little changed since the previous *Statement*, broadly in line with overseas markets (Graph 72). It remains around 33 per cent below its 2007 peak (Table 11). On a forward earnings basis – which incorporates earnings forecasts for the next 12 months – domestic equities are trading on a P/E ratio of around 12. This is its lowest level since early 2009, and compares with a long-run average of about 14.

Table 11: Sectoral Movements in the ASX 200

	Per cent change since:		
	May <i>Statement</i>	Trough (March 2009)	Peak (November 2007)
Resources	5.7	44	–21
Financials	–4.3	61	–41
Other	–1.7	29	–34
ASX 200	–0.7	44	–33

Sources: Bloomberg; RBA