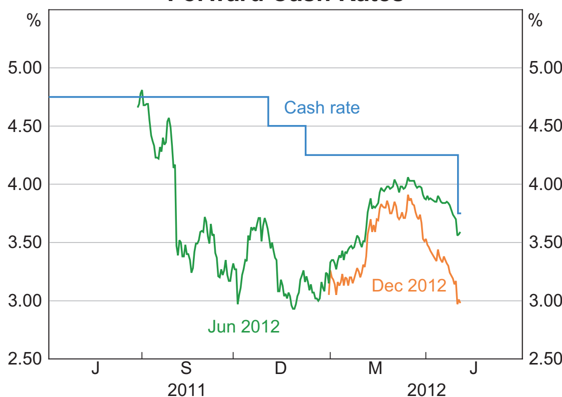
# 4. Domestic Financial Markets

The Reserve Bank Board lowered its target for the cash rate by 50 basis points in May, to 3.75 per cent. Prior to this, money market yields had been pointing to an expectation of easier monetary policy, although the amount of easing anticipated by market participants had moved in quite a wide range (Graph 4.1). Rates on overnight indexed swaps (OIS) currently imply an expectation of a cash rate of around 3 per cent at the end of 2012.

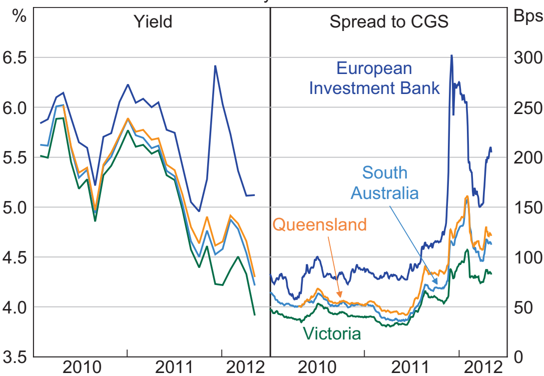



Rates on short-term bank bills and certificates of deposit (CDs) have also declined in line with the movement in cash rate expectations. As a result, spreads between bank bill and OIS rates have been reasonably stable. At around 25 basis points, the 3-month spread is considerably narrower than it was at the beginning of this year.

Long-term government bond yields have fallen since the previous *Statement* with the yield on 10-year Commonwealth Government securities (CGS) reaching a 60-year low of 3.54 per cent in early May (Graph 4.2). While the bond market remains sensitive to news about sovereign debt problems in the euro area and economic data in the United States and China, the recent decline in Australian yields largely reflects the easier stance of domestic monetary policy. There continues to be strong demand from offshore investors for CGS, with around 75 per cent of CGS on issue now held by non-residents. Relative to swap rates, yields on Australian government debt are noticeably lower than for other countries (for more details, see 'Box E: Yields on Sovereign Debt').

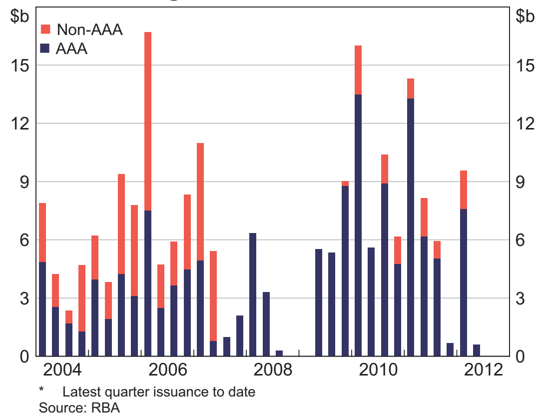
The improvement in market conditions for other government-related issuers, evident at the time of the last *Statement*, has largely been maintained. It has been driven by improved investor sentiment in the wake of Greece's sovereign debt restructuring and the European Central Bank's second 3-year

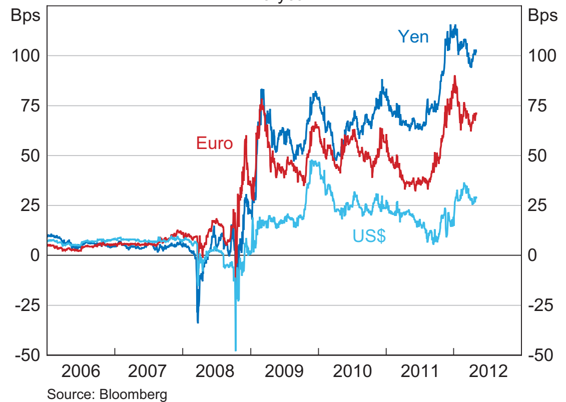
longer-term refinancing operation. Primary market issuance by the Australian states and territories was particularly strong in February as they took advantage of the improvement in financial markets. Most of the states have now largely completed their funding tasks for the current fiscal year. Notwithstanding the increased issuance, spreads to CGS continued to narrow through February and March, though they have widened a little more recently as concerns about sovereign issuers within the euro area have re-emerged (Graph 4.3). Yields are currently around their historical lows for the various state borrowers.




Also reflecting the generally improved conditions in financial markets, Kangaroo bond issuance has picked up substantially since the previous *Statement* after a six-month lull (Graph 4.4). Around $8 billion of Kangaroo bonds have been issued over the past three months, compared with around $4 billion in the previous six months. Spreads between Kangaroo bonds and CGS have narrowed from their peaks reached late last year. The substantial issuance of Kangaroo bonds over the March quarter has placed some downward pressure on the cross-currency basis swap spread, which has reduced costs for Australian borrowers raising funds offshore (Graph 4.5).

Two Australian fixed income exchange-traded funds (ETFs) based on UBS and Deutsche Bank indices have been launched on the ASX. This follows a change to the ASX operating rules that allowed ETFs based on fixed income securities to trade in Australia and reflects growing interest in the fixed income asset class. The underlying physical bonds in the available ETFs comprise a mix of government, sovereign supranational agency and corporate bonds.



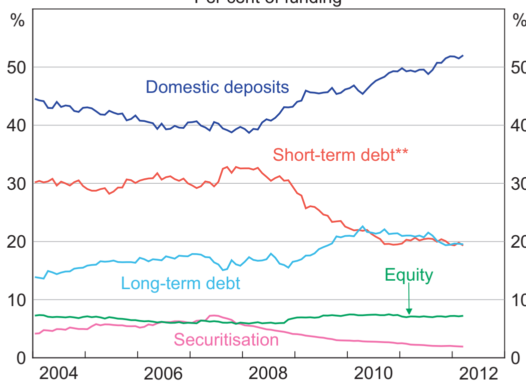




## Financial Intermediaries

The composition of bank funding was little changed over the March quarter, though the deposit share of total funding has increased by 3 percentage points over the past year. Deposits now account for

52 per cent of total bank funding (Graph 4.6). Within bank deposits, there has been a marked shift towards term deposits. With investors attracted by relatively high interest rates, term deposits now account for about 45 per cent of bank deposits, compared with 30 per cent in the middle of 2007. A detailed discussion of developments in bank funding costs is in the March 2012 RBA *Bulletin*.[1]

**Graph 4.6**
**Funding Composition of Banks in Australia***
Per cent of funding

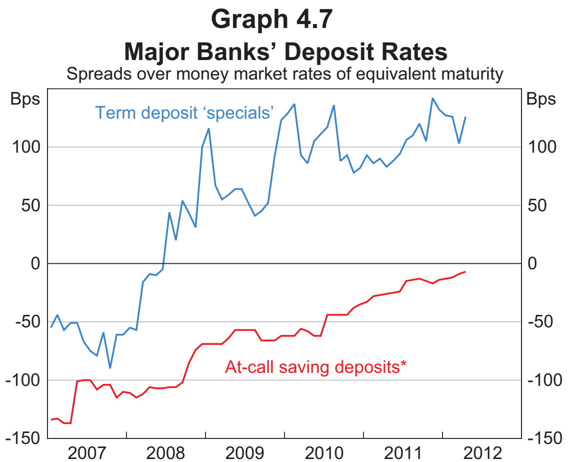



* Adjusted for movements in foreign exchange rates
** Includes deposits and intragroup funding from non-residents
Sources: APRA; RBA; Standard & Poor's

Competition for deposits has remained strong in 2012, with the average interest rate on the major banks' at-call deposits – including online savings, bonus saver and cash management accounts – rising slightly relative to the cash rate (Graph 4.7). The spread of term deposit 'specials' to equivalent duration market rates has fallen slightly, but remains very high by historical standards. Households, businesses, and superannuation and managed funds continue to take advantage of the high term deposit rates.

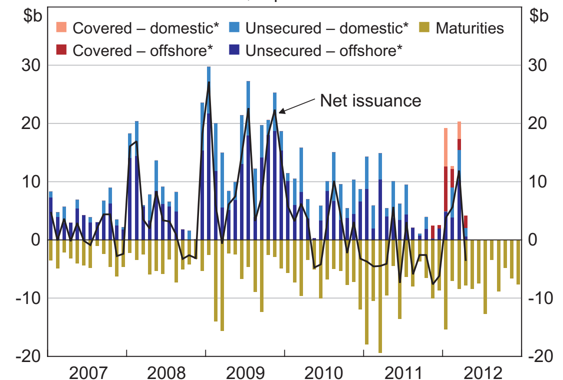
Australian banks issued around $52 billion of bonds in the March quarter (Graph 4.8). Over these months, however, there has been a shift away from the issuance of covered bonds to unsecured issuance, which totalled $15 billion in March, its highest monthly level in more than two years. Net issuance also reached its highest level in over two years in March as bank bond maturities declined following large redemptions in January. The major banks drew on a range of currencies and maturities but were also active in the domestic market. A number of foreign banks accessed the domestic market for the first time through their local branches, including the Bank of China, Bank of Tokyo-Mitsubishi UFJ and ING Bank NV.

**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**
**Banks' Bond Issuance and Maturities**
A$ equivalent

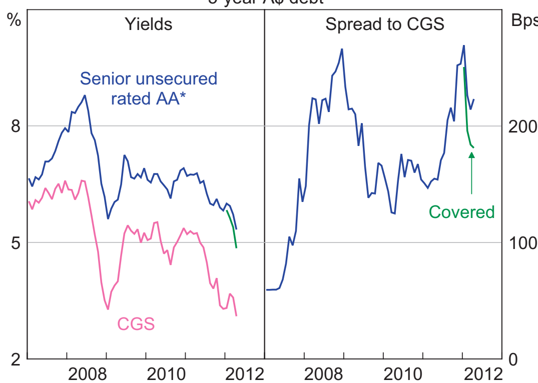



* Latest month issuance to date
Source: RBA

The improvement in market conditions has led to unsecured and covered bank bond spreads relative to CGS declining substantially over recent months, despite the substantial increase in issuance

1 See Deans C and C Stewart, 'Banks' Funding Costs and Lending Rates', RBA *Bulletin*, March, pp 37–43.

(Graph 4.9). NAB issued a large 5-year unsecured bond in the domestic market at a spread not much wider than where covered bonds were issued in the second half of January, while Australian dollar-denominated 5-year covered bond spreads to CGS have fallen by about 70 basis points from mid January. Since the previous *Statement*, the decline in 5-year senior unsecured and covered bank bond spreads relative to CGS has been about 30 basis points. Notwithstanding this fall, unsecured bank bond spreads remain around 55 basis points higher than in mid 2011.

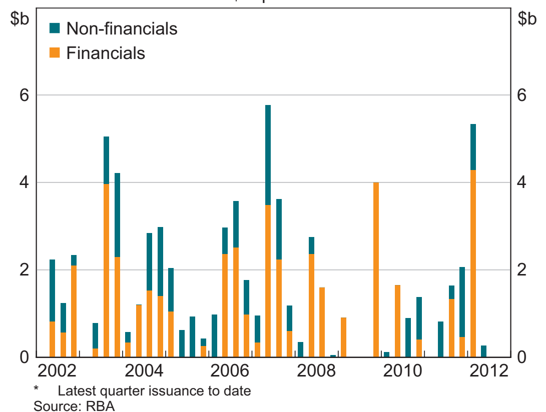



* S&P downgraded the major Australian banks to AA- in December 2011
Sources: Bloomberg; RBA; UBS AG, Australia Branch

In contrast to bank bond issuance, activity in the securitisation market has remained subdued over recent months. There have been two residential mortgage-backed securities (RMBS) transactions by ING and ME Bank, as well as a $530 million transaction from Macquarie Leasing backed mainly by car loans and leases. The RMBS issues amounted to $1.8 billion in aggregate and pricing of the senior tranches was around 10 to 15 basis points wider than similar issuance in November last year. ME Bank issued just under half of its transaction in US dollars with the remainder pricing in the domestic market. The Australian Office of Financial Management (AOFM) participated in both transactions, purchasing a total of $325 million. In March the AOFM sold $50 million of its RMBS holdings in the market as part of its portfolio management activity and to provide some pricing guidance to the market.

Several issuers, including major financial institutions, have been active in the hybrid bond market, with issuance totalling around $6 billion over recent months (Graph 4.10). Hybrid bonds, which combine debt and equity characteristics, usually pay a fixed rate of return or dividend until a certain date, at which point the holder may have a number of options including converting the securities to ordinary shares. Some of the hybrid bonds issued over recent months convert to ordinary shares at a specified time or on a capital event trigger, while others are subordinated debt instruments that are more senior in the capital structure than convertible issues. These hybrid securities are generally intended to receive recognition as equity from credit rating agencies, or to qualify as regulatory capital.

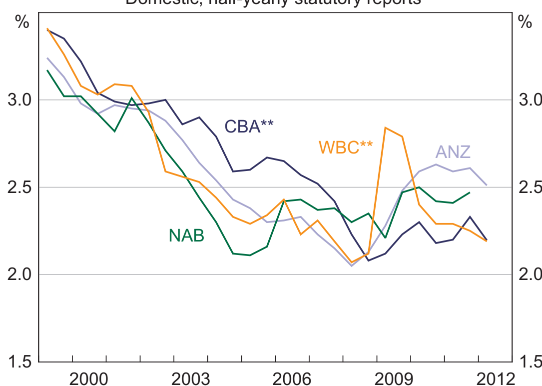
Banks' outstanding funding costs relative to the cash rate are estimated to have increased by about 20 basis points since mid 2011. This partly reflects the effects of ongoing competition for deposits. In addition, while spreads on bank bonds have fallen since the previous *Statement*, the cost of these newly issued bonds is still around 20 basis points higher than the average cost of banks' outstanding bonds. Consistent with this, most of the major banks reported, on average, narrower net interest




* Latest quarter issuance to date
Source: RBA

margins in the first half of their 2012 financial years (Graph 4.11). Despite the narrower net interest margins, underlying profits generally increased, reflecting stronger trading and investment income.

Fitch downgraded its long-term credit ratings of three of the four Australian major banks as part of its global banking review, citing the major banks' reliance on offshore wholesale funding. It now rates all the Australian major banks AA-, as do Moody's and Standard & Poor's (S&P). Moody's and Fitch lowered the credit ratings on Macquarie Bank and Macquarie Group by one notch to S&P's equivalent of A and A-, respectively, as part of their broad reviews of the global banking industry. Suncorp-Metway was upgraded one notch to A+ by Fitch, reflecting Fitch's reassessment of support from Suncorp Group.




## Household Financing

Most bank and non-bank lenders increased their variable housing loan indicator rates over the three months to the end of April, by between 5 and 15 basis points (Table 4.1). Furthermore, the average discount on housing loans fell over this period, with some individual institutions reducing discounts by up to 15 basis points. The changes in discounts and indicator rates increased overall rates on new variable-rate housing loans by an average of 14 basis points.

At the time of writing, a number of banks had announced reductions in their indicator rates on their variable-rate housing loans following the reduction in the cash rate at the Reserve Bank's May Board meeting. The announced reductions were between 30 and 40 basis points.

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

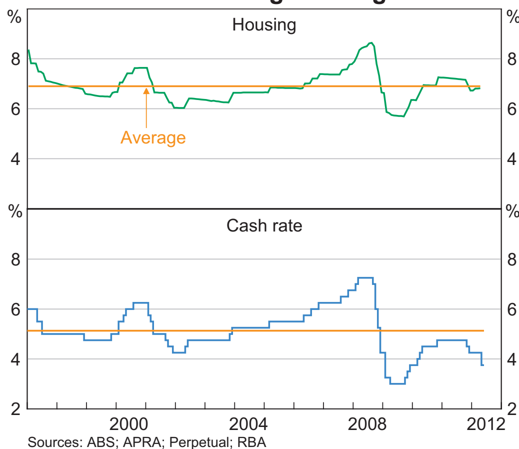
| | | Change since: | |
|---|---|---|---|
| | **Level at 30 April 2012** | February *Statement* | End October 2011 |
| **Housing loans**[(a)] | 6.72 | 0.14 | –0.30 |
| **Personal loans** | 13.17 | 0.07 | –0.04 |
| **Small business** | | | |
| Residentially secured | | | |
| – Term loans | 8.62 | 0.10 | –0.37 |
| – Overdraft | 9.48 | 0.10 | –0.37 |
| Average rate[(b)] | 8.43 | 0.10 | –0.30 |
| **Large business** | | | |
| Average rate[(b)] (variable-rate and bill funding) | 6.41 | –0.15 | –0.50 |

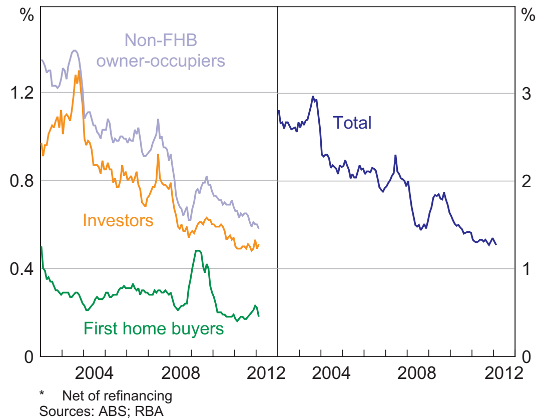
(a) Average of the major banks' discounted package rates on $250 000 full-doc loans
(b) Rates on outstanding, as opposed to new, business lending
Sources: ABS; APRA; RBA

Rates on new fixed-rate loans increased slightly in the three months to the end of April. However, fixed rates were still around 35 basis points lower than variable rates. The share of housing loans approved at fixed rates, at around 15 per cent, is now above its long-run average. Overall, the average interest rate on outstanding housing loans (fixed and variable) increased by around 10 basis points, to be around 8 basis points below its post-1996 average (Graph 4.12).

The value of housing loan approvals decreased over the three months to February, following the recent expiry of some first home buyer stamp duty exemptions in New South Wales (Graph 4.13). Abstracting from this, approvals data suggest only modest growth in credit. Housing credit increased at an average rate of 0.4 per cent over the March quarter – similar to the average rate of growth over the past year.

Most interest rates on variable personal loans – including credit card loans, home equity loans and margin loans – rose over the three months to the end of April. The amount of personal credit outstanding has also been little changed, with falls in margin and credit card lending being offset by a rise in 'other personal' lending (which includes loans for motor vehicles, holidays and household effects).



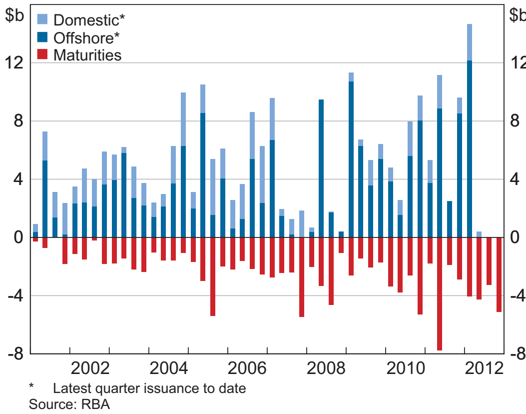

## Business Financing

Corporate bond issuance has been strong in 2012. Around $14 billion of corporate bonds have been issued over the past three months, with more than 80 per cent issued in offshore markets (Graph 4.14). Resource companies such as BHP Billiton, Rio Tinto and Fortescue Metals were the main Australian participants in the US dollar market with maturities of up to 30 years. Issuers in the domestic market included Wesfarmers and Woolworths, both rated A-, who placed 7-year bonds at a cost equivalent to where AA- rated Australian major banks have been pricing their shorter maturity unsecured issuance.

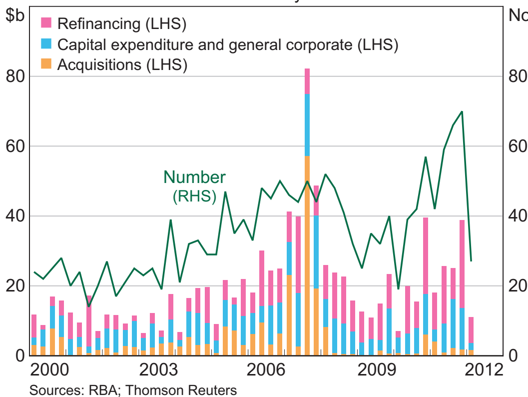
Intermediated business credit grew at an annualised rate of around 3½ per cent over the three months to March. Credit extended to financial corporations increased most quickly, but tends to be volatile; credit extended to private trading corporations and unincorporated businesses also rose, albeit only slightly. Business lending by Asian bank branches and subsidiaries grew faster than the system average over the quarter, and has been doing so since late 2009.

Activity in the Australian syndicated lending market softened in the March quarter, and by more than is typical at the start of the calendar year (Graph 4.15). The decline in activity was broad based across domestic and foreign lenders; lending by Asian institutions again grew faster than the system average.

**Graph 4.14**
**Australian Corporates' Bond Issuance**




**Graph 4.15**
**Syndicated Loan Approvals**
Quarterly

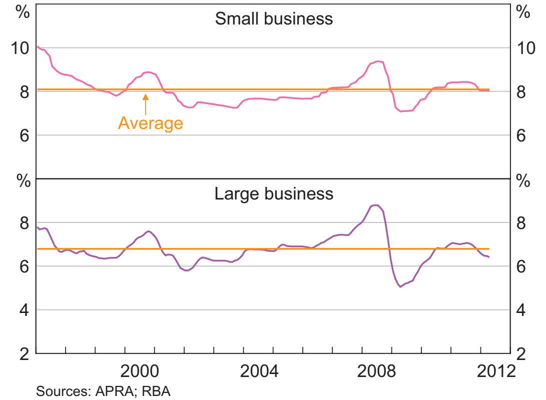



The cost of new intermediated business borrowing declined modestly over the three months to the end of April. Interest rates for small businesses rose, while for large businesses they declined by 14 basis points, reflecting falls in benchmark rates for large business lending (Graph 4.16). Accordingly, rates on small business and large business loans were 6 basis points and 38 basis points below their post-1996 averages at the end of April 2012.

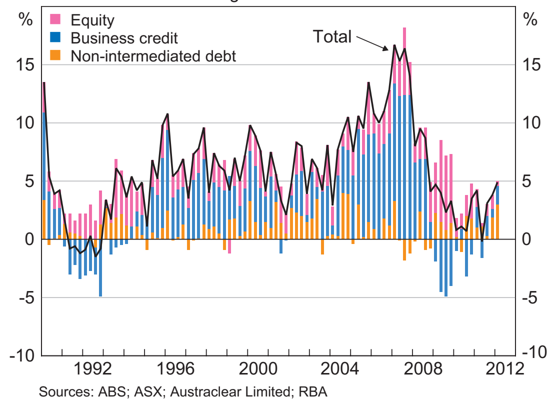
At the time of writing, a few banks had announced reductions of between 30 and 40 basis points to their indicator rates on variable-rate small business loans following the reduction in the cash rate at the Reserve Bank's May Board meeting.

Reflecting these trends, the rise in business external funding was equivalent to 4.9 per cent of GDP in the March quarter (Graph 4.17). Growth in non-intermediated debt increased to its highest level since March 2007.

**Graph 4.16**
**Average Interest Rates on Outstanding Business Lending**




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




## Aggregate Credit

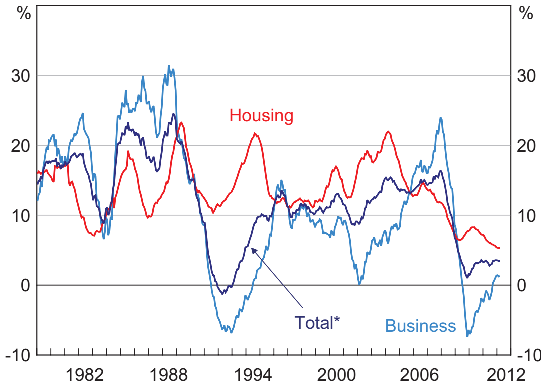
Total outstanding credit grew at an annualised rate of 4.4 per cent over the March quarter, with modest growth in household and business credit (Graph 4.18). Growth in broad money continued to outpace credit growth over the March quarter, partly reflecting an ongoing preference by households and businesses to hold their assets in deposits, especially term deposits (Table 4.2).

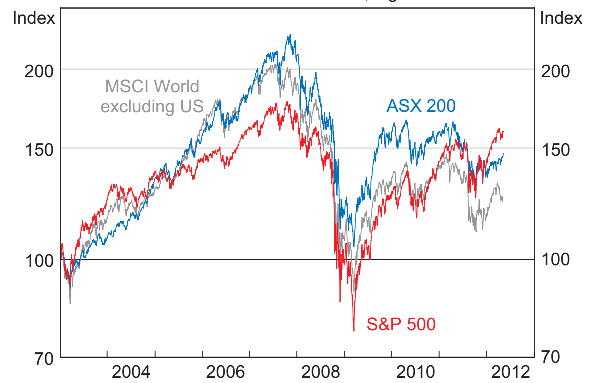
## Table 4.2: Financial Aggregates

Percentage change

| | Average monthly growth | | |
|---|---|---|---|
| | December quarter 2011 | March quarter 2012 | **Year to March 2012** |
| Total credit | 0.3 | 0.4 | 3.4 |
| – Owner-occupier housing | 0.5 | 0.4 | 5.5 |
| – Investor housing | 0.3 | 0.5 | 4.8 |
| – Personal | –0.1 | 0.1 | –1.5 |
| – Business | 0.1 | 0.3 | 1.3 |
| Broad money | 0.5 | 0.5 | 7.1 |

Source: RBA

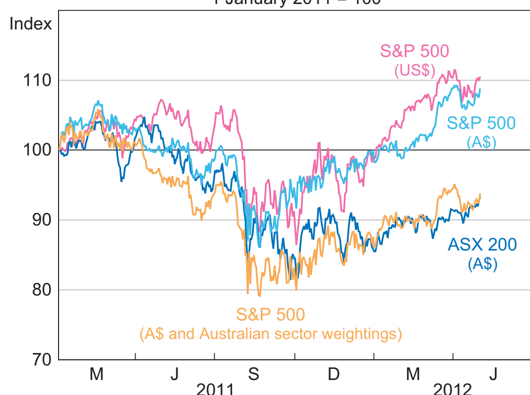


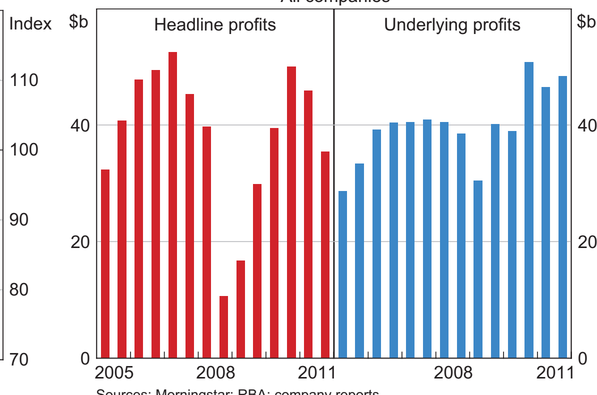




## Equity Markets

Australian equity prices have increased since the previous *Statement* with the ASX 200 rising by around 4 per cent, while market volatility has been below average (Graph 4.19). Resources shares underperformed the broader market amid concerns over slower economic growth in China. Mining shares, in particular, have been adversely affected with prices down 6½ per cent since the previous *Statement*. Share prices of financial corporations rose by 7 per cent reflecting an improvement in investor sentiment for the sector.

The Australian share market has underperformed the US share market since the beginning of the year (Graph 4.20). The relative underperformance vis-a-vis the US market mostly reflects differences in sectoral composition as the mining and financial sectors, which have underperformed the overall market, account for around two-thirds of the ASX 200 but less than one-fifth of the S&P 500. Earnings expectations for the other non-financial and resource sectors have also deteriorated more sharply in Australia than in the United States.




Listed companies with June and December balance dates reported their earnings for the December half 2011. Aggregate underlying profit, which excludes gains and losses from asset revaluations and other significant one-off factors, rose by 2 per cent compared with the June half 2011. In contrast, headline profits declined by 23 per cent from the June half, mainly reflecting an unusually large impairment cost reported by Rio Tinto, worth $8.6 billion, relating to the company's global aluminium operations (Graph 4.21).

By sector, resource company profits declined by 3 per cent from the June half of 2011 reflecting weaker base metals prices, especially for copper and aluminium, and disruptions to offshore copper production. Financial sector profits increased by 5 per cent driven by strong profit growth of commercial banks, while diversified financial and insurance company profits declined by 12 per cent and 26 per cent, respectively. Profits from the other non-financial sector companies increased by 2 per cent in the half and by 10 per cent from the corresponding period a year earlier. The industrial and consumer discretionary sectors reported strong results compared with both the June 2011 and December 2010 halves, with strength in media companies' profits offsetting weaker results from some retailers. Profit growth in consumer staples was driven by a pick-up in profits at Woolworths and Wesfarmers.

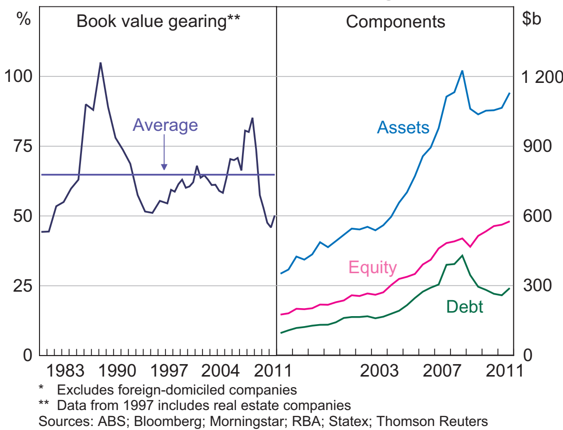
Shareholder distributions – the sum of buybacks and dividends – declined substantially in the December 2011 half when compared with the same period a year earlier. This was mainly due to a sharp decline in buybacks owing to the near completion of earlier buybacks by Rio Tinto and BHP Billiton; dividends also decreased by 1½ per cent. The lower dividend payments reflected lower earnings, as the payout ratio was unchanged.

Corporate balance sheets expanded by around 6 per cent in the December half 2011. To fund this growth, corporates increased their debt by 12 per cent, over half of which was sourced from offshore – including syndicated loans and bonds. Equity funding increased by 2½ per cent, largely as a result of retained earnings.

Reflecting these developments, corporate gearing – the ratio of debt to the book value of equity – rose by 4 percentage points to 50 per cent over the December half 2011. Nonetheless, the gearing ratio remains at a low level (Graph 4.22).

The liquidity position of listed corporations declined over the December half with cash balances decreasing by 6 per cent, while short-term debt

## Graph 4.22
### Listed Corporates' Gearing Ratio*




* Excludes foreign-domiciled companies
** Data from 1997 includes real estate companies
Sources: ABS; Bloomberg; Morningstar; RBA; Statex; Thomson Reuters

rose by 20 per cent. The result was largely driven by developments in the resource sector; outside this sector, corporations are now more liquid in aggregate compared with the average over the past decade.

Around $16 billion in merger and acquisition activity has been announced over the past three months. Some of the larger deals involve companies in the energy sector. AGL Energy announced that it had entered into conditional agreements worth $2.9 billion to acquire Great Energy Alliance, owner of Loy Yang A, Victoria's largest power station, and an adjacent brown coal mine. The deal requires approval from the Australian Competition and Consumer Commission. In the mining sector, a consortium consisting of Korean firms Posco and STX Corporation, along with Japanese firm Marubeni Corporation, will acquire a 30 per cent stake in the Roy Hill iron ore project owned by Hancock Prospecting for $3.2 billion. The consortium will pay $750 million up front with the balance provided after debt financing commitments for the rest of the project's costs have been secured. On 1 May, Woodside announced that it will sell a $2 billion stake in its Browse Basin project (LNG) to a Japanese joint venture.