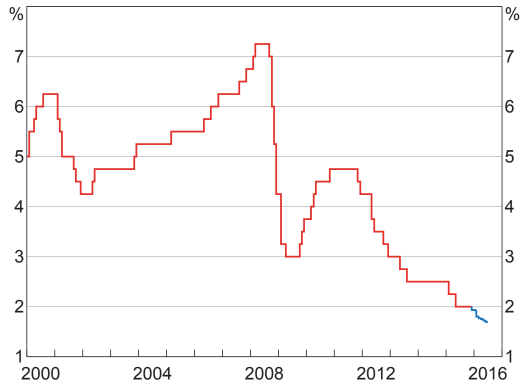
4. Domestic Financial Markets

In recent months, Australian financial markets have, at times, experienced increased volatility in line with international developments. Nevertheless, conditions continue to support the financing of domestic activity. Yields on bonds issued by governments, banks and non-financial corporations remain close to historic lows, despite spreads to benchmark rates drifting up over recent months from low levels. Interest rates on the stock of housing and business loans also remain very low, even after lenders raised housing interest rates particularly for investors. Partly in response to this, growth in lending to housing investors has slowed, while growth in lending to owner-occupiers has increased. Bank margins on housing lending have increased, while margins on business lending have fallen. Business lending has picked up in recent months, although there has been relatively little corporate bond issuance. Australian equity prices fell in August, but have partially retraced these falls more recently.

Money Markets and Bond Yields

The Reserve Bank Board has maintained the cash rate target at 2 per cent since May. Rates on overnight indexed swaps (OIS) indicate that a reduction in the cash rate target is expected sometime in the first half of 2016 (Graph 4.1). Rates on bank bills and certificates of deposit (CDs) have remained at historically low levels and, while spreads between bank bill and OIS rates have increased in recent months, they are below the levels of late last year. Rates in secured funding markets also increased relative to OIS for a time before falling back to more normal levels.

Graph 4.1
Cash Rate*



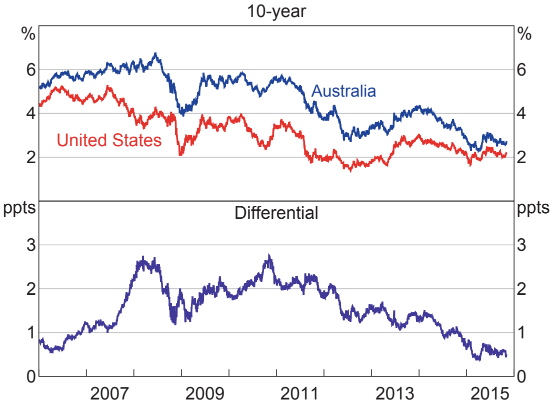
* Data from December 2015 onwards are expectations derived from interbank cash rate futures

Sources: ASX; Bloomberg

Yields on long-term Australian Government securities (AGS) have been more volatile in recent months, in line with trends in offshore bond markets. Overall, yields on AGS have declined since August, while the spread between AGS and US Treasuries has been little changed (Graph 4.2).

Demand for newly issued AGS has remained firm, with most bond tenders by the Australian Office of Financial Management (AOFM) pricing at or below secondary market yields. Coverage ratios for tenders of longer bonds have declined since the start of the financial year, coinciding with an increase in the average size of such auctions. In mid October, the AOFM issued a new June 2039 bond via syndication, which is now the longest term-to-maturity nominal AGS. After receiving around \$8 billion in orders, the AOFM issued \$4 billion of the new bond at a yield of 3.35 per cent. Offshore investors purchased around

Graph 4.2
Government Bond Yields
10-year



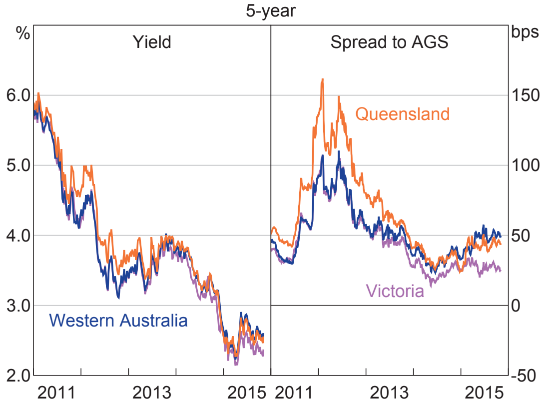
Sources: Bloomberg; RBA

a third of the new issue, similar to the previous nominal bond syndication in March.

Gross issuance of bonds by the state and territory governments ('semis') has totalled around $13 billion since the end of June. Issuance outpaced maturities by around $2 billion over this period, increasing the total stock of bonds outstanding to around $243 billion. Yields on semis remain at very low levels (Graph 4.3).

Bond issuance by non-residents into the domestic market ('Kangaroo' issuance) has continued at a moderate pace, with around $10 billion issued since the end of June. Kangaroo issuance over this period

Graph 4.3
State Government Debt
5-year



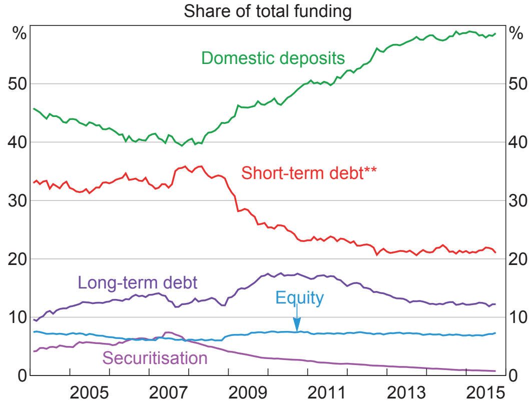
Sources: RBA; Yieldbroker

was dominated by a $2.25 billion bond issued by Apple in August – the largest corporate bond to be issued in the domestic market. Secondary market spreads to AGS on AAA rated Kangaroo bonds have been little changed since the end of June.

Financial Intermediaries

The funding composition of bank balance sheets has changed only marginally over the past year with deposits comprising close to 60 per cent of total funding (Graph 4.4). Within the mix of deposit funding, households and businesses have generally continued to place more in 'at-call' deposit products, such as bonus saver and offset accounts, than in term deposits, which offer lower interest rates (Graph 4.5).

Graph 4.4
Funding Composition of Banks in Australia*
Share of total funding



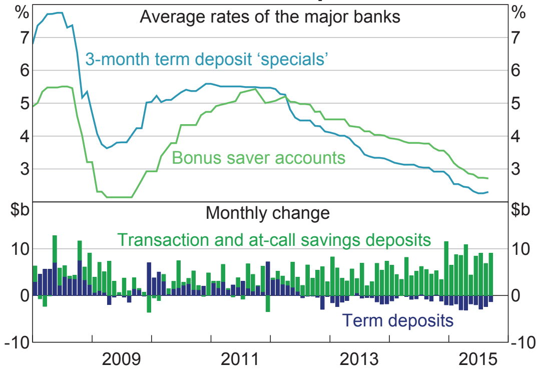
* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

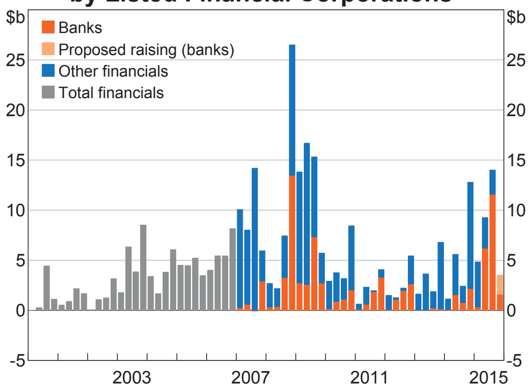
Over the past year, there have been sizeable equity raisings by listed financial corporations (Graph 4.6). The major banks have been raising common equity to meet upcoming changes to prudential regulation. ANZ and Commonwealth Bank undertook substantial capital raisings in the September quarter. This followed National Australia Bank's capital raising of $5.5 billion in the June quarter. More recently, Westpac has announced a $3.5 billion capital raising.

Graph 4.5
Household Deposits



Sources: APRA; Canstar Cannex; RBA

Graph 4.6
Net Equity Raisings by Listed Financial Corporations*



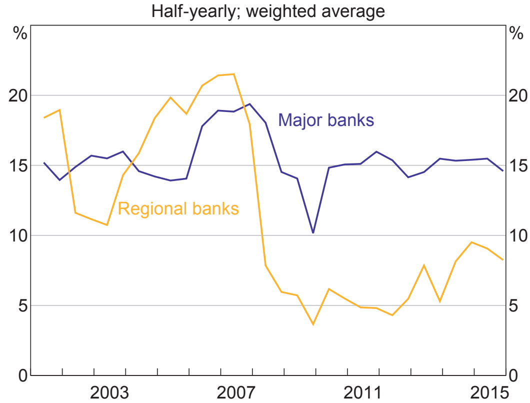
* Latest observation is quarter to date

Sources: ASX; RBA

The additional capital increases the cost base of banks as equity is a more expensive form of funding than debt (although as a share of total funding the additional capital only amounts to around ½ percentage point). Banks can adjust to this cost in three ways, which are not mutually exclusive. First, they may absorb the cost, resulting in a lower return on equity (ROE); it is estimated that if the full cost of capital raised in 2015 was absorbed, major bank ROE would decline by around 1½ percentage points. That said, higher capital levels boost the resilience of the banks and hence decrease the riskiness of equity investment in them. Second, banks can reprice assets. To maintain a 15 per cent ROE, the current average for the major banks, it is estimated that the banks would need to increase their return on assets by around 10 basis points (Graph 4.7). Third, higher equity may lower debt funding costs since creditors face less risk when equity buffers are larger, thereby offsetting some of the effect of the higher cost of the equity funding.

Graph 4.7
Underlying Return on Equity (ROE)*

Half-yearly; weighted average



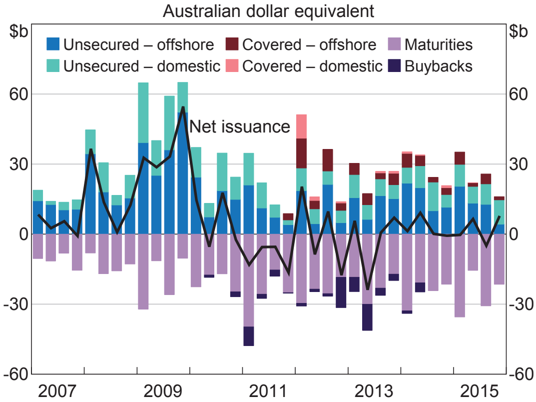
* From 2006 data are on an IFRS basis; prior years are on an AASB basis

Sources: banks' financial reports; RBA

Banks' debt funding costs have edged lower in the past few months. Since the beginning of the year, funding costs have fallen by around 15 basis points more than the cash rate, with deposit costs down by around 60 basis points and wholesale costs falling by more. Notwithstanding increases in bank bond spreads in the past few months, the costs of the banks' outstanding wholesale funding have continued to decline as the cost of new issuance has remained below the cost of outstanding issuance.

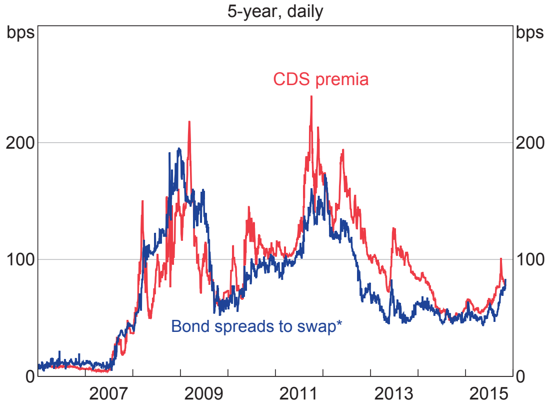
Australian banks have issued around $42 billion in bonds since June (Graph 4.8). After accounting for maturities, the stock of bonds outstanding has increased by around $3 billion over this period. A slightly higher proportion of this issuance was in the domestic market than has been the case in recent years. Secondary market spreads on the major banks' bonds have continued to widen over the past couple of months, alongside an increase in the major banks' credit default swap (CDS) premia (Graph 4.9).

Graph 4.8
Australian Banks' Bond Issuance*
Australian dollar equivalent



* Latest quarter gross issuance and net issuance are quarter to date
Source: RBA

Graph 4.9
Major Banks' Bond Spreads and CDS Premia
5-year, daily



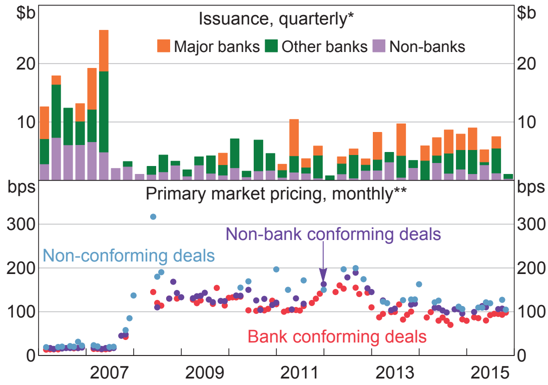
* Domestic secondary market spreads converted into US dollar spreads
Sources: Bloomberg; RBA; Thomson Reuters; UBS AG, Australia Branch

While the CDS premia tend to be somewhat more volatile than bond spreads, both indicators remain well below their peaks in 2011 and 2012.

Australian banks have issued around $1.7 billion in Basel III-compliant hybrids since June, representing a slower pace of issuance than earlier in the year. Primary market spreads on recent hybrid issuance have generally been wider than those seen in late 2014.

The pace of issuance of Australian asset-backed securities (ABS) has been robust in recent months, underpinned by issuance of residential mortgage-backed securities (RMBS) (Graph 4.10). Three securities

Graph 4.10
Australian RMBS



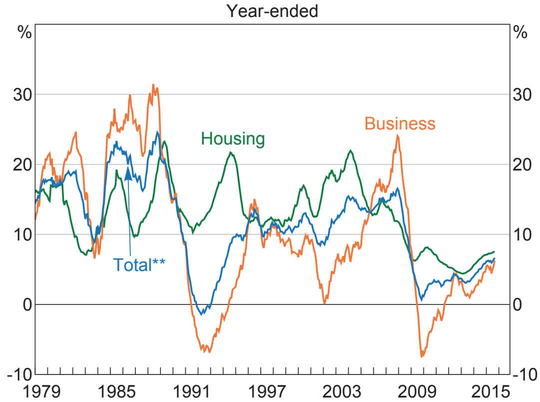
* Latest observation is quarter to date
** Face-value weighted monthly average of the primary market spread to bank bill swap rate for AAA rated notes
Source: RBA

backed by assets other than residential mortgages have also been issued, raising around $2 billion. Primary issuance spreads on senior RMBS tranches have widened slightly since the start of the year, but remain at low levels relative to the period since 2008.

Financial Aggregates

Total credit has grown by around 6½ per cent over the past year, with housing credit continuing to grow at a faster pace than business credit (Graph 4.11). Broad money has grown at a similar pace to credit over the year (Table 4.1).

Graph 4.11
Credit Growth by Sector*
Year-ended



* Seasonally adjusted and break adjusted; includes securitisation
** Includes housing, personal and business credit
Sources: ABS; APRA; RBA

Table 4.1: Financial Aggregates
Percentage change(a)

	Three-month ended June 2015	Three-month ended September 2015	Year-ended September 2015
Total credit	1.3	2.0	6.7
– Housing	1.8	1.9	7.5
– Owner-occupier	1.2	1.8	5.8
– Investor	2.7	2.0	10.4
– Personal	0.1	0.2	0.5
– Business	0.6	2.5	6.3
Broad money	1.5	1.5	6.4

(a) Growth rates are break adjusted and seasonally adjusted
Sources: ABS; APRA; RBA

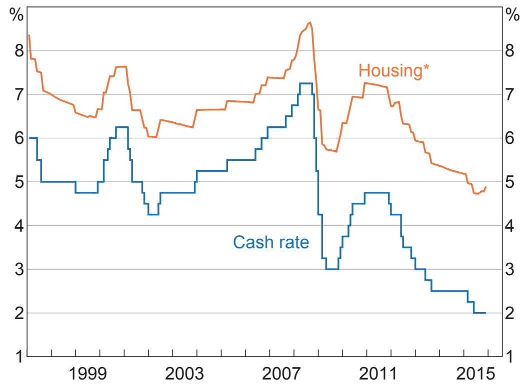
Household Financing

Over recent months, financial institutions have adjusted the interest rates they charge on housing loans. In July and August, a number of banks introduced differential pricing for owner-occupier and investor loans, increasing the standard variable rate for investor-related housing loans for new and existing borrowers by at least 20 basis points. In October, the major banks announced increases to variable rate mortgage interest rates of 15–20 basis points, attributing this to the additional cost of capital raised to meet upcoming changes to prudential regulation. Several other lenders have announced similar rate changes. Overall, these adjustments will add around 20 basis points to the outstanding housing lending rate; this followed a decline of around 50 basis points in this rate in the first half of the year (Graph 4.12; Table 4.2). These increases in housing rates contribute to a widening in bank margins on housing lending, along with the decline in funding costs.

Competition for housing lending appears to have shifted towards lending to owner-occupiers rather than investors. Interest rates on basic loan products to owner-occupiers have declined relative to standard variable rates across all lender categories over the year, in some cases by an additional 25 basis points.

Annual growth in housing credit has remained around 7 per cent over the past year. Net housing debt has continued to grow around 1½ percentage points slower than housing credit owing to rapid growth in offset account balances (Graph 4.13). Housing loan approvals have been volatile in recent months, but are consistent with the current pace of housing credit growth continuing.

Graph 4.12
Interest Rates



* Estimated outstanding rate; to November 2015
Sources: ABS; APRA; Perpetual; RBA

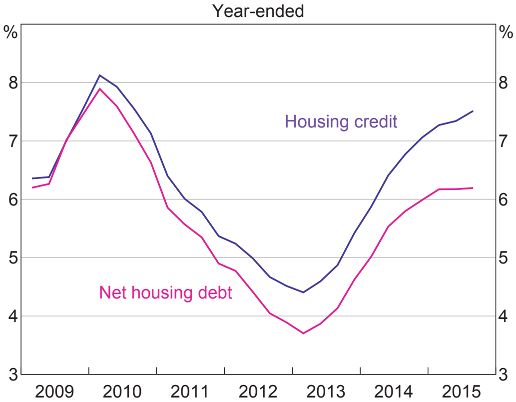
Over 2015, a number of financial institutions have made substantial revisions to the data that the RBA uses to compile housing, business and personal credit. While small revisions to historical data are not unusual, recent revisions have been large, especially in terms of the classification of investor and owner-occupier housing credit. Overall, the share of housing credit extended to investors has been revised from 35 per cent of the total to 40 per cent. As the

Table 4.2: Intermediaries' Fixed and Variable Lending Rates

	Interest rate Per cent	Change since end January 2015 Basis points
Housing loans		
– Standard variable rate[(a)(d)(e)]		
– Owner-occupier	5.63	–30
– Investor	5.90	–3
– Package variable rate[(b)(d)(e)]		
– Owner-occupier	4.83	–25
– Investor	5.11	3
– Fixed rate[(c)(d)]		
– Owner-occupier	4.50	–58
– Investor	4.82	–27
– Average outstanding rate[(d)(e)]	4.89	–28
Personal loans		
– Variable rate[(f)]	11.57	11
Small business		
– Term loans variable rate[(g)]	6.60	–50
– Overdraft variable rate[(g)]	7.47	–50
– Fixed rate[(c)(g)]	5.38	–36
– Average outstanding rate[(d)]	5.66	–57
Large business		
Average outstanding rate[(d)]	3.87	–66

(a) Average of the major banks' standard variable rates
(b) Average of the major banks' discounted package rates on new, $250 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates
(e) Reflects announced pricing changes effective in November
(f) Weighted average of variable rate products
(g) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

Graph 4.13
Housing Credit Growth*
Year-ended

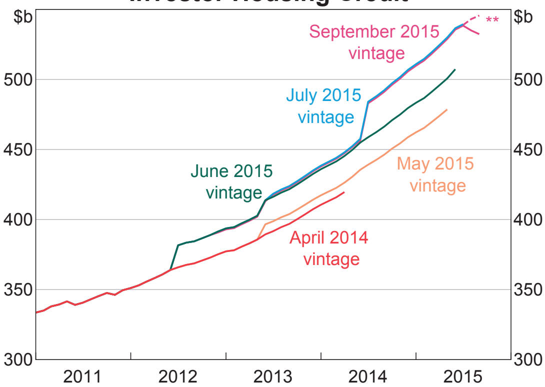


* Seasonally and break adjusted
Sources: ABS; APRA; RBA

financial institutions making the revisions have been unable to provide a full history of when many of the incorrectly classified loans were originated, the revisions have resulted in sharp breaks in the level of investor housing credit (Graph 4.14). The RBA adjusts for these breaks when measuring investor credit growth. The effect of this is that the growth rate for investor housing has only been revised up by around 1 percentage point.

The introduction of differential pricing for owner-occupier and investor housing loans has also resulted in lenders changing the reported purpose of a large number of loans from investor to owner-occupier; these changes have been initiated by

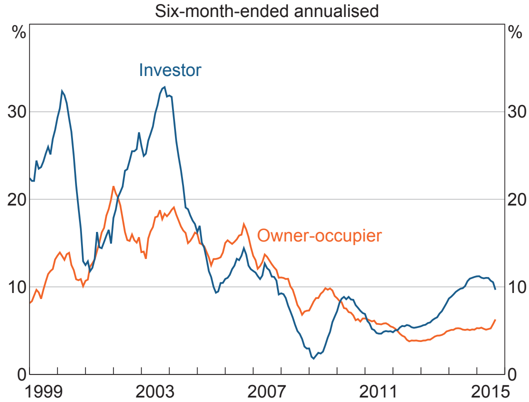
Graph 4.14
Investor Housing Credit*



* Non-break and non-seasonally adjusted
** Adjusted for loan purpose switching
Sources: APRA; RBA

borrowers updating their personal details and by lenders reviewing the owner-occupier status of loans. This is boosting the level of owner-occupier housing credit and lowering investor credit. The net value of loan purpose switching is estimated to be $13.3 billion over the September quarter. The effect of loan purpose switching has been removed from the RBA's measures of owner-occupier and investor credit growth so that these measures better reflect growth in net new lending. Putting the measurement issues aside, the differential pricing appears to be contributing to a pick-up in owner-occupier credit growth, while investor credit growth has eased (Graph 4.15).

Graph 4.15
Housing Credit Growth*
Six-month-ended annualised



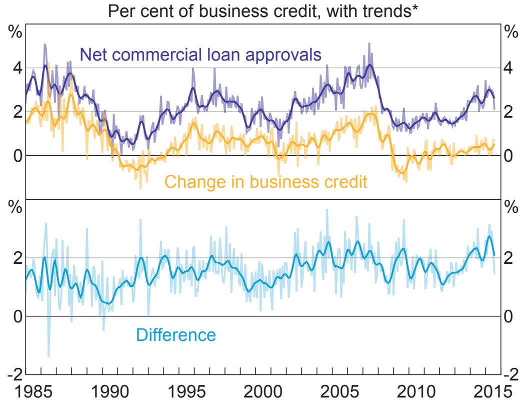
* Seasonally and break adjusted
Sources: ABS; APRA; RBA

Business Financing

External funding for businesses has grown at a moderate pace over recent months; the pace of growth in business credit has picked up, while non-intermediated debt issuance has slowed after being relatively strong in the first half of the year.

Business credit growth has accelerated over recent months. By lender, the major banks have continued to drive business credit growth, with Asian banks also making a notable contribution. Part of the growth has reflected the depreciation of the Australian dollar, which raises the Australian dollar value of existing foreign-currency denominated debt. Business loan approvals have declined a little since their peak in April 2015, but remain at a high level. While this may indicate even further strength in business credit, the conversion of business loan approvals to credit has been relatively low for some time (Graph 4.16). This divergence can be explained by a range of factors that raise loan approvals without also lifting credit growth. The most important factor recently has been vigorous competition for business lending, which is reflected in banks' willingness to extend credit lines at historically low margins and generous loans terms. At the same time, however, firms have tended to maintain more conservative gearing levels.

Graph 4.16
Commercial Loan Approvals and Credit
Per cent of business credit, with trends*

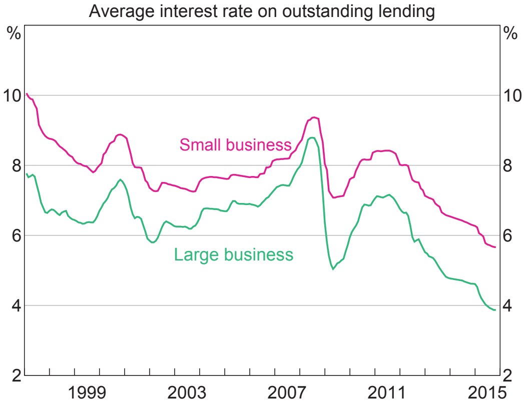


* 13-term Henderson trend
Sources: ABS; APRA; RBA

In the past few years lenders are reported to have increased the size of their offered commitments to secure business. Lenders also report that the share of loan applications being approved has been rising. Some new entrants to the business lending market have been particularly active. For example, the value of approvals from Asian banks operating in Australia increased by around 300 per cent between late 2013 and early 2015. The effect of borrowers receiving multiple approvals from competing lenders, many of which are not drawn upon, is to boost approvals relative to credit growth.

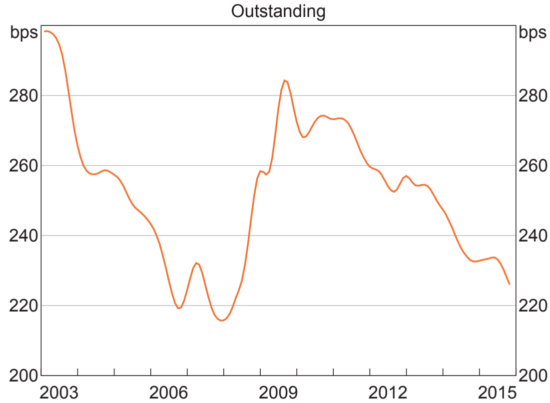
The average outstanding interest rate on intermediated business borrowing has continued to decline over recent months (Graph 4.17; Table 4.2). This has been evident for both large and small businesses, with average rates on outstanding loans having fallen by around 65 basis points since the end of January. Consistent with strong competition, bank margins in business lending have fallen to levels last seen in the mid 2000s (Graph 4.18). The increase in competition appears to be driven by the foreign banks; the average interest rate on large loans provided by the Australian operations of North American and Asian banks is significantly lower than the rate offered by other banks.

Graph 4.17
Australian Business Lending Rates*
Average interest rate on outstanding lending



* RBA estimates
Sources: APRA; RBA

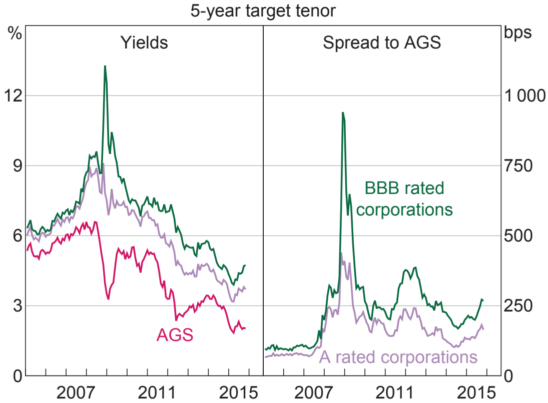
Graph 4.18
Implied Spread on Business Lending*
Outstanding



* Weighted-average interest rates on lending less funding costs; 13-term Henderson trend
Sources: APRA; Bloomberg; Financial Reports; RBA; UBS AG, Australian Branch

Bond issuance by Australian non-financial corporations has been relatively limited since June. In particular, issuance into offshore markets has been lower, coinciding with the absence of the larger resource-related issuers from bond markets. Over recent months, secondary market yields on corporate bonds have increased somewhat and spreads to AGS have widened, particularly for BBB rated corporations (Graph 4.19).

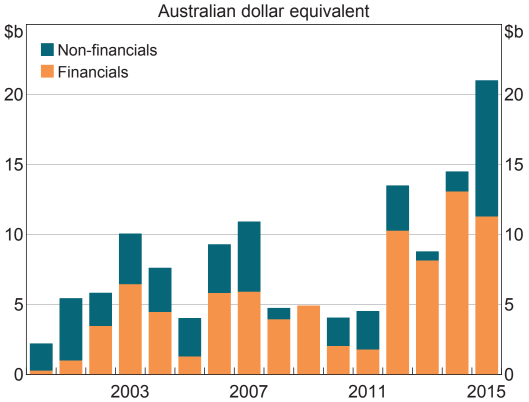
Graph 4.19
Australian Corporate Bond Pricing
5-year target tenor



Sources: Bloomberg; RBA; S&P Capital IQ

Although Australian resources companies have been largely absent from bond markets since the middle of the year, there has been some notable activity in hybrid debt markets (Graph 4.20). Hybrid debt contains both equity- and debt-like features, with Australian companies typically using such instruments to raise long-term funding and boost their equity holdings (rating agencies give recognition to some portion of hybrid debt in their measures of company equity). While issuance of these instruments by Australian non-financial companies is typically around $2.5 billion per year, BHP recently raised almost $9 billion through hybrid debt issuance, which is the largest by an Australian company.

Graph 4.20
Australian Hybrid Issuance*
Australian dollar equivalent



* Latest observation is year to date
Source: RBA

Listed equity raisings by non-financial corporations increased moderately in the September quarter. Net equity raisings by already listed companies have been broadly steady over the past year at around $3–4 billion per quarter. Initial public offering (IPO) activity increased slightly in the quarter, but remains below the levels recorded in 2014.

In the past few months, around $22 billion in mergers and acquisitions (M&A) deals have been announced by listed companies. Completed M&A activity has been concentrated in the financial and consumer discretionary sectors.

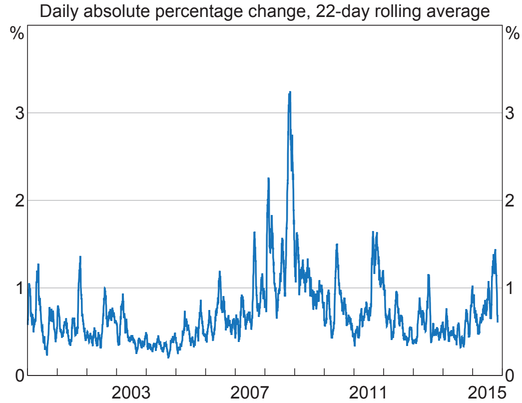
Equity Markets

The Australian equity market has largely followed movements in global share markets in recent months, falling in August in response to concerns about Chinese growth, before partially retracing these falls in early October (Graph 4.21). Continued speculation about the likely date of the first rise in the US federal funds rate has also contributed to increased volatility (Graph 4.22). Australian share prices are unchanged on a total returns basis since end 2014, underperforming US and European markets.

Graph 4.21
Total Return Share Price Indices
End December 2012 = 100

Sources: Bloomberg; MSCI; Thomson Reuters

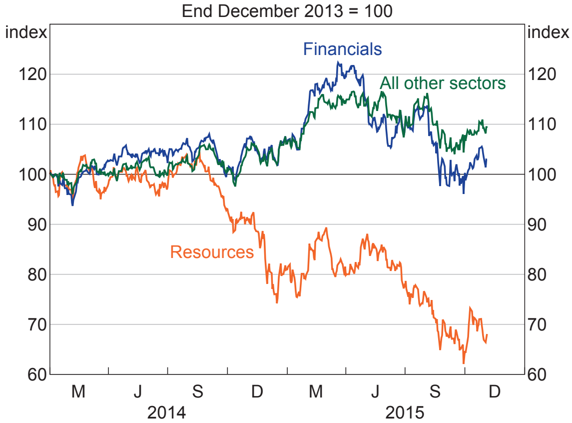
Graph 4.22
Australian Share Market Volatility
Daily absolute percentage change, 22-day rolling average



Sources: Bloomberg; RBA

Resource sector share prices have exhibited significant volatility in recent months (Graph 4.23). Energy sector share prices fell through the September quarter, but partially retraced these falls in early October alongside a recovery in the oil price; energy sector share prices remain around 23 per cent lower than at the start of the year. The share prices of materials companies have also partially recovered from their falls in the September quarter, but remain around 10 per cent lower since the start of the year.

Graph 4.23
Australian Share Price Indices
End December 2013 = 100

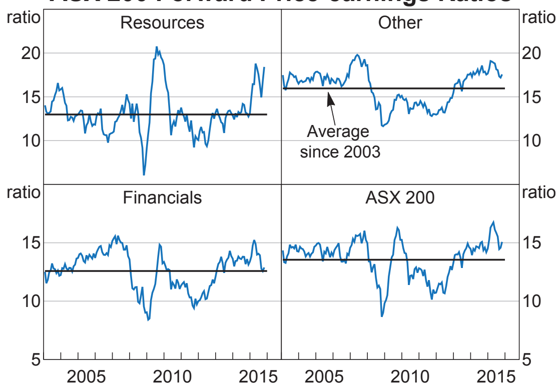


Sources: Bloomberg; RBA; Thomson Reuters

Financial sector equity prices fell in August, alongside the announcement of a number of large capital raisings by the major banks. Subsequently, financial sector equity prices have moved sideways. Equity prices for companies outside the financial and resources sectors have followed a similar pattern in aggregate. One exception was the industrials sector, which has been supported by increased M&A activity.

The valuation of Australian equities, as measured by the forward price-earnings ratio, remains a little above the average since 2003 (Graph 4.24). Valuations in the resources sector remain somewhat above average, as earnings expectations for the year ahead have fallen along with equity prices.

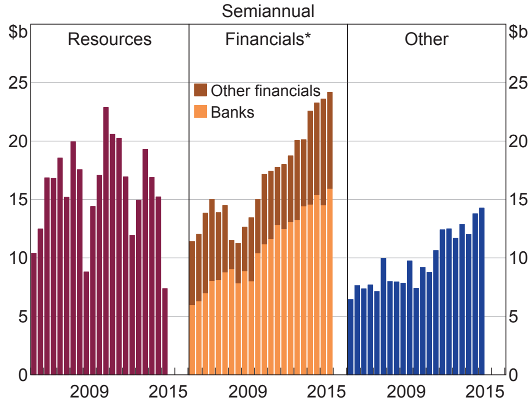
Graph 4.24
ASX 200 Forward Price-earnings Ratios



Source: Thomson Reuters

ASX 200 companies reported their June half 2015 results in August. Aggregate underlying profits (which exclude the effect of non-recurring items) declined by 13 per cent from the same period in 2014, driven by a sharp fall in resource company profits (Graph 4.25). In aggregate, profits were broadly in line with consensus analysts' expectations, although resources companies generally reported weaker-than-expected results.

Graph 4.25
ASX 200 Underlying Profits
Semiannual



* The December 2015 half observation for financial companies is based on reported results during the half and consensus expectations for companies that have not yet reported

Sources: Bloomberg; Morningstar; RBA

Resource sector profits were 56 per cent lower, driven by substantial falls in commodity prices. The fall in profits was broad based across both the larger diversified miners and smaller companies. Higher production volumes and lower costs partially offset the fall in commodity prices.

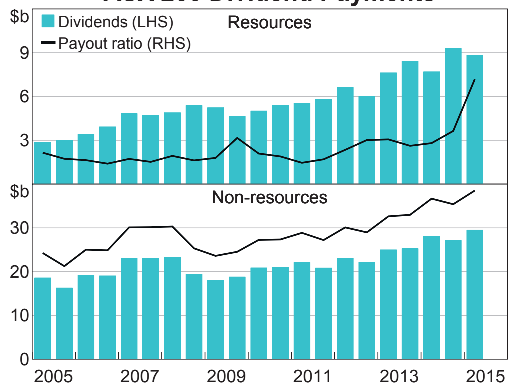
Underlying profits of financial companies rose by 5 per cent, driven by a substantial increase in profits at real estate and diversified financial companies. Real estate company profits were supported by property valuation gains, as well as strong activity in the residential housing market. The major banks reported increases in full-year profits, although growth slowed due to lower growth in non-interest income. The banks reported modest increases in net interest income over the year, driven by growth in average interest earning assets. Net interest margins contracted a little partly due to heightened competition in business lending. Bad and doubtful debt charges remained at low levels.

Underlying profits for companies outside the resources and financial sectors increased by 18 per cent. Companies in cyclical sectors, including the consumer discretionary and industrials sectors, generally reported higher profits. Profits in the industrials sector increased substantially, with lower oil prices supporting the earnings of transportation companies.

Company shareholder distributions grew strongly across most sectors compared to the same period in 2014. The aggregate payout ratio – measured as the ratio of dividends to underlying profit – rose substantially as the major miners increased dividends despite lower earnings (Graph 4.26).

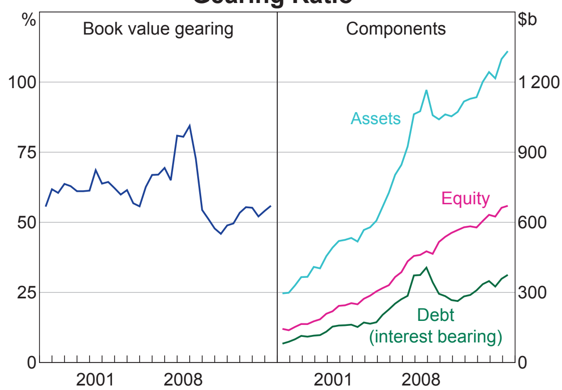
Listed corporations' balance sheets expanded by 3 per cent over the June half 2015, largely driven by an increase in the Australian dollar value of offshore assets, following the depreciation of the currency (Graph 4.27). Debt rose by 5 per cent over the half, reflecting both the use of debt to fund a number of sizeable acquisitions in the utilities and energy sectors, and an increase in the Australian dollar value of foreign-currency-denominated debt. Many Australian corporations mitigate their foreign currency exposures by generating foreign currency income that matches debt repayments, or through the use of hedges. Equity also rose, albeit at a slower rate than debt. Overall, the book value gearing ratio – the ratio of debt to equity – rose by 2 percentage points to 56 per cent, which remains below the average over the past 20 years. ✠

Graph 4.26
ASX 200 Dividend Payments



Sources: ASX; Morningstar; RBA

Graph 4.27
Listed Non-financial Corporations' Gearing Ratio*



* The gross gearing ratio is defined as the ratio of the book value of gross debt to the book value of equity; excludes foreign-domiciled companies, includes real estate companies

Sources: Morningstar; RBA; Statex