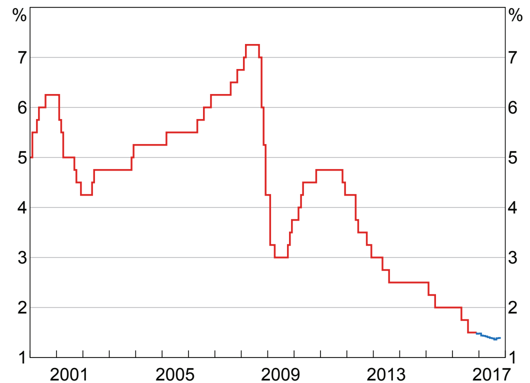
4. Domestic Financial Markets

Australian financial markets have been relatively quiet over recent months. Housing and business lending rates are at historic lows following the cash rate reduction in August. Bond yields are also at very low levels. The Australian Government and the major banks have been able to issue significant volumes of bonds at longer-than-usual maturities. Notwithstanding historically low interest rates, credit growth has continued to ease. Credit extended to businesses has slowed since earlier in the year and non-financial corporate bond issuance has remained low, particularly in the resources sector. Housing credit growth has also slowed a little, consistent with a reduction in turnover in the housing market. Equity prices have declined in recent months after having risen earlier in the year.

Money Markets and Bond Yields

After lowering the cash rate target in two 25 basis point steps in May and August, the Reserve Bank has maintained the cash rate target at 1.5 per cent. Rates on overnight indexed swaps (OIS) imply some chance of a further reduction in the cash rate over the year ahead (Graph 4.1).



* Data from December 2016 onwards are expectations derived from interbank cash rate futures

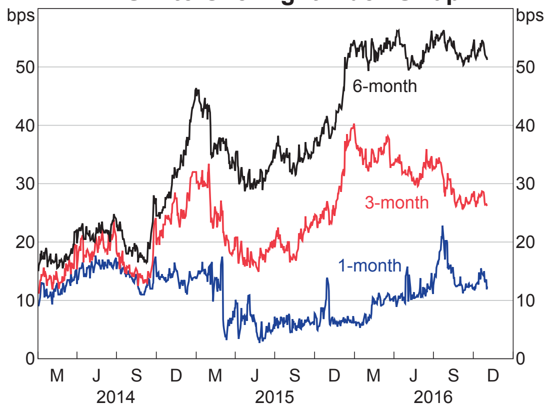
Sources: ASX; Bloomberg

Short-term secured interest rates in the repurchase agreement (repo) market have risen relative to OIS rates, though these spreads have retreated from their highs in recent weeks. The wider repo spreads reflect heightened demand for secured funding from market participants, particularly non-residents, and appears to be related to developments in the foreign exchange swap market and the bond futures market.[1] In the foreign exchange swap market, Australian dollars can be lent against yen at a relatively high implied Australian dollar interest rate; as a result, some investors have been borrowing Australian dollars under repo to do this. Bond futures have also been trading at higher implied prices than the basket of bonds that underlie the futures and, in response, some investors have sold the futures and bought the bonds using repo funding.

Short-term interest rates more closely related to bank funding costs have remained low. The unsecured interbank overnight interest rate – the cash rate – has continued to trade at the Reserve Bank's target. Since the start of the year, 3-month bank bill rates (BBSW) have declined relative to OIS rates, while spreads for 6-month bank bill rates have remained broadly steady (Graph 4.2).

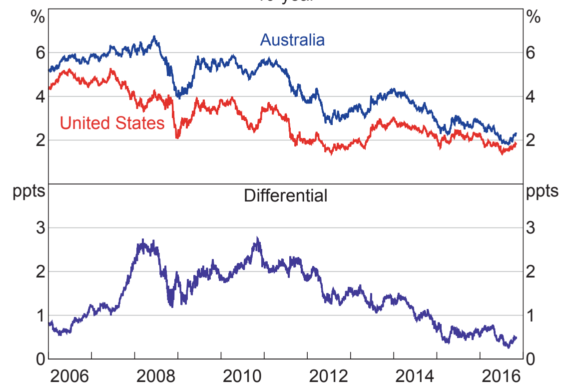
1 For more information, see Becker C, A Fang and J C Wang (2016), 'Developments in the Australian Repo Market', RBA *Bulletin*, September, pp 41–46.

Graph 4.2
BBSW to Overnight Index Swap



Sources: AFMA; Tullett Prebon (Australia)

Graph 4.3
Government Bond Yields



Sources: Bloomberg; RBA

After reaching an historic low of 1.8 per cent in August, yields on 10-year Australian Government Securities (AGS) have subsequently increased by around 50 basis points, primarily reflecting global developments (Graph 4.3). The spread between AGS and US Treasury yields, after narrowing earlier this year, is currently around 50 basis points. Of note, the Australian Office of Financial Management (AOFM) issued a 30-year bond for the first time in October, raising $7.6 billion via syndication at a yield to maturity of 3.27 per cent. The bond had greater international participation than seen at prior syndications, particularly from fund managers in Europe and North America.

State and territory governments have raised $33 billion in bonds ('semis') in the year to date. After taking into account maturities, the total stock of bonds outstanding has been little changed at around $242 billion. Funding requirements for the 2016/17 financial year are expected to be modest compared to recent years, reflecting asset sales such as the Port of Melbourne and Ausgrid.

Bond issuance by non-residents in the domestic market ('Kangaroo' issuance) over the past year has been below the average of recent years. Several US corporations issued large volumes of bonds earlier in the year, but issuance by supranational institutions, foreign sovereigns and agencies has been slightly below average in recent months.

Secondary market spreads to AGS for AAA rated issuers have tightened in recent months and are back around levels seen in late 2015.

Financial Intermediaries

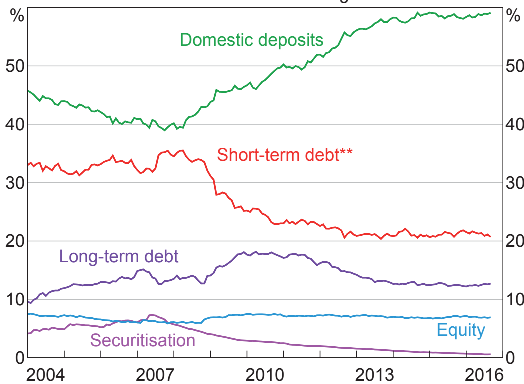
Growth in banks' balance sheets has continued to be a little slower than in 2015. The composition of banks' funding has remained fairly steady (Graph 4.4). Recent growth in liabilities has been driven by term deposits and long-term wholesale debt.

The introduction of the Net Stable Funding Ratio (NSFR) in January 2018 is influencing the composition of banks' balance sheets. The NSFR forms part of the Basel III liquidity reforms and provides an incentive for banks to fund their assets and off-balance sheet activities with more stable sources of funding such as retail deposits, term deposits, long-term debt and equity, while encouraging less reliance on short-term wholesale liabilities.

Following the May and August cash rate reductions, estimates of the major banks' debt funding costs have come down. Since the beginning of the year, these costs have declined by a little less than the cash rate, mainly reflecting less than complete pass-through of the cash rate reductions to term deposit rates (see below). Estimated funding costs are expected to fall further as the cost of new wholesale debt remains below the cost of outstanding debt (Graph 4.5).

Graph 4.4
Funding Composition of Banks in Australia*

Share of total funding

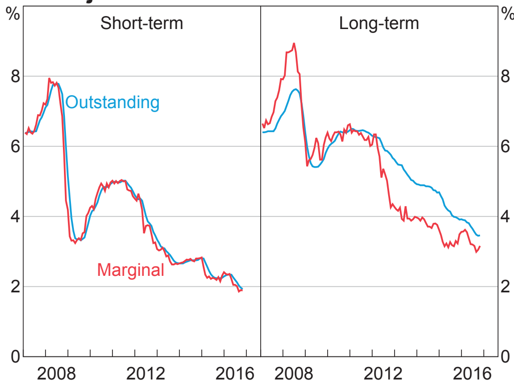


* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** Includes deposits and intragroup funding from non-residents

Sources: APRA; RBA; Standard & Poor's

Graph 4.5
Major Banks' Wholesale Debt Cost*



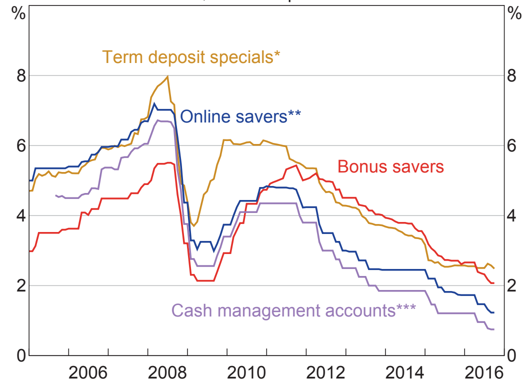
* RBA estimates; rates do not include interest rate hedges

Sources: Bloomberg; RBA

Competition for retail deposits, particularly term deposits, has increased over 2016 and banks expect this to continue over the next year, ahead of the introduction of the NSFR. The May and August cash rate reductions have been largely reflected in lower advertised rates for at-call deposits, while the major banks have only partially reduced term-deposit rates (Graph 4.6). In fact, following the August cash rate reduction the major banks increased rates on longer-dated term deposits, which comprise less than 2 per cent of total funding, although some of these increases have subsequently been reversed.

Graph 4.6
Major Banks' Deposit Rates

$10 000 deposits



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

** Excludes temporary bonus rates

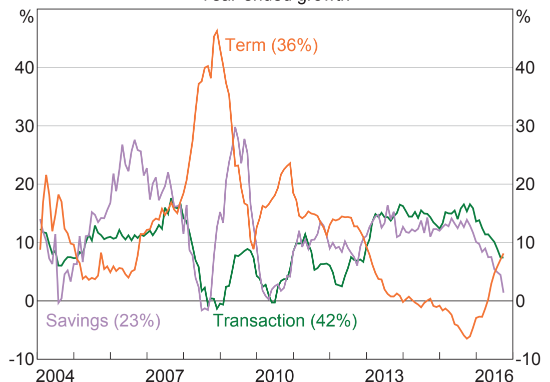
*** Deposits over $250 000

Sources: Canstar Cannex; RBA

The recent widening in the spread between term deposit rates and the cash rate follows a period of several years when term deposit rates were relatively low compared to interest rates on other funding sources, such as short-term wholesale funding and bonus saver accounts. Consistent with interest rates on term deposits becoming more attractive than other deposit types, stronger growth in term deposits has been observed more recently (Graph 4.7).

Graph 4.7
Deposits by Product Type*

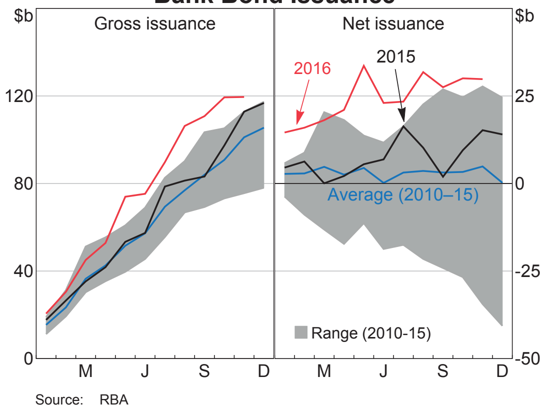
Year-ended growth



* Break-adjusted; not seasonally adjusted; excludes foreign currency, intra-group deposits and certificates of deposit; values in brackets represent share of AUD deposits

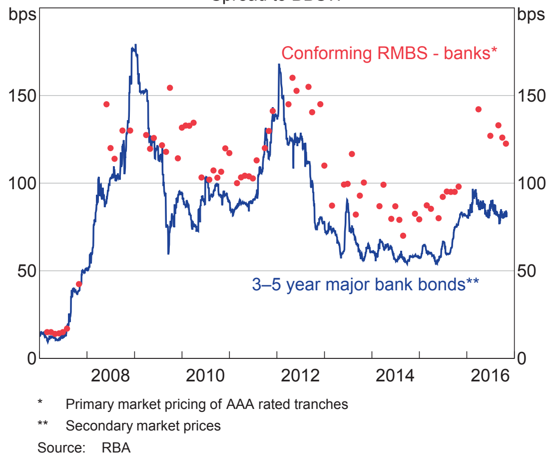
Sources: APRA; RBA

Australian banks have issued a large volume of bonds this year, with net bond issuance well above the average over the past few years (Graph 4.8). Some of this issuance is in advance of some large maturities over coming quarters. Banks are also responding to strong demand for longer-term paper by issuing more bonds at the 10-year tenor. This continues the trend seen over the past couple of years, and the average tenor of new bank bond issuance has increased from four years in 2014 to around five years now. Secondary market yields on major banks' bonds remain very low, while spreads to benchmark rates have narrowed since earlier in the year.



Activity in the asset-backed securities (ABS) market has been below average in the year to October, owing mainly to a reduction in residential mortgage-backed securities (RMBS) issuance by the major banks. Other issuers, including non-bank originators and issuers of securities backed by automotive loans and leases, recorded low issuance early in the year, although their issuance has picked up in recent months. Primary market spreads to bank bills remain elevated, particularly relative to spreads on unsecured bank debt, although they have narrowed since their peak earlier in the year (Graph 4.9).

Hybrid issuance by Australian financial institutions has continued at a pace above that of recent years, with $17 billion issued so far this year. Recent deals



have included a Basel III-compliant Additional Tier 1 (AT1) hybrid by a major bank and Tier 2 issuance by a range of banks and insurance companies.

Financial Aggregates

Total credit growth has continued to slow in recent months (Graph 4.10). Growth in housing credit has eased relative to the pace seen in 2015, while business credit growth has softened further. Total credit has been growing at around the same pace as broad money (Table 4.1).

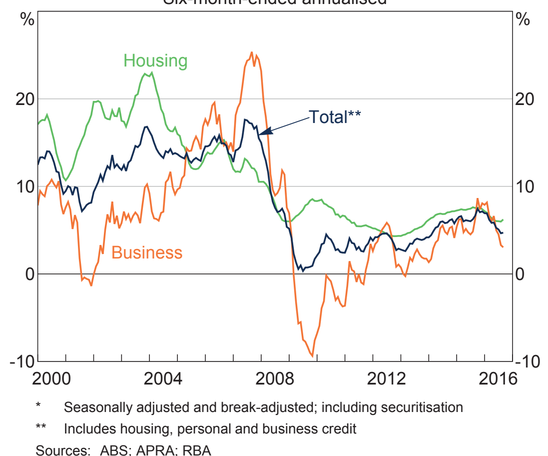


Table 4.1: Financial Aggregates
Percentage change[(a)]

	Three-month ended		Year-ended
	June 2016	Sep 2016	Sep 2016
Total credit	1.1	1.2	5.4
– Housing	1.5	1.6	6.4
– Owner-occupier	1.6	1.6	7.3
– Investor	1.1	1.6	4.8
– Personal	–0.3	–0.5	–1.3
– Business	0.8	0.6	4.7
Broad money	1.1	1.3	5.8

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

Household Financing

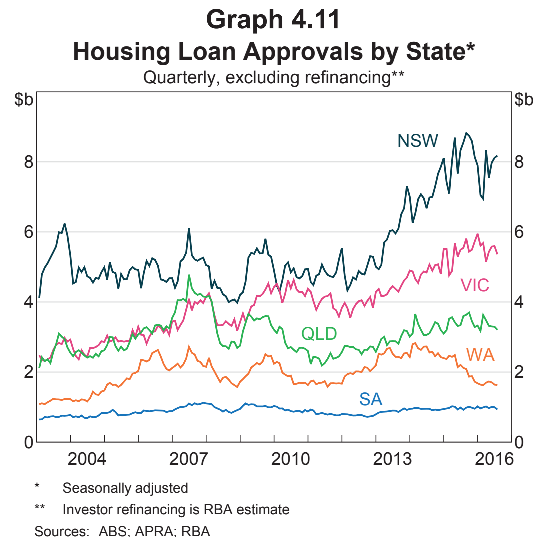
Housing credit growth has eased to an annualised pace of around 6 per cent. Growth in net housing debt is about 1 percentage point below growth in housing credit due to ongoing strong growth in deposits in mortgage offset accounts.

While the slowing in housing credit growth and loan approvals has been reasonably broad based, there remains some divergence in the pace of growth across states (Graph 4.11). The slowing in loan approvals has been particularly pronounced in Western Australia; while loan approvals in NSW have also eased over the past year, they continue at a pace noticeably above the national average.

Growth in credit advanced to investors has increased a little in recent months, consistent with a pick-up in investor housing loan approvals. In contrast, growth in credit advanced to owner-occupiers has eased a little recently. The current level of approvals is consistent with housing credit growth continuing at around its current pace (Graph 4.12).

The slowing in housing loan approvals over the past year is consistent with the decline in turnover in the housing market. It also reflects slower growth in average dwelling prices and a decrease in the average loan-to-valuation ratio. The latter follows the introduction of measures by the Australian Prudential Regulation Authority (APRA) to strengthen lending standards. Another factor that

Graph 4.11
Housing Loan Approvals by State*
Quarterly, excluding refinancing**

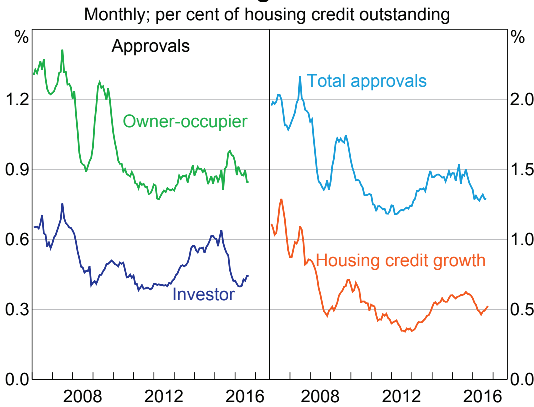


* Seasonally adjusted
** Investor refinancing is RBA estimate
Sources: ABS; APRA; RBA

may be contributing to the easing in housing credit growth over the past year is an increase in the share of off-the-plan purchases, which are yet to flow through to the demand for credit. These transactions do not involve a mortgage at the time the dwelling is purchased off the plan, but add to the stock of housing credit when a mortgage is provided to the purchaser upon completion of the dwelling.

Around half of the August cash rate reduction was passed through to most advertised housing lending rates. The average outstanding housing interest rate has fallen by around 35 basis points this year and is likely to decline a little further as maturing loans are replaced with loans on lower

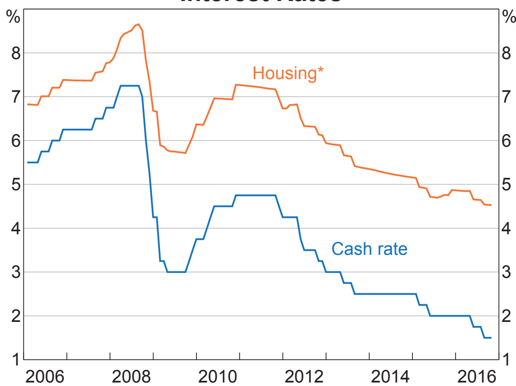
Graph 4.12
Housing Loans*
Monthly; per cent of housing credit outstanding



* Seasonally and break-adjusted; as share of housing credit; net of refinancing (investor refinancing is RBA estimate)
Sources: ABS; APRA; RBA

interest rates (Table 4.2; Graph 4.13). The lowest available variable interest rates are more than 50 basis points below the average outstanding interest rate and, reflecting the lower rates on offer, the level of refinancing activity remains relatively high. One bank has recently introduced a loan product with the interest rate margin fixed at 249 basis points above the cash rate.

Graph 4.13
Interest Rates

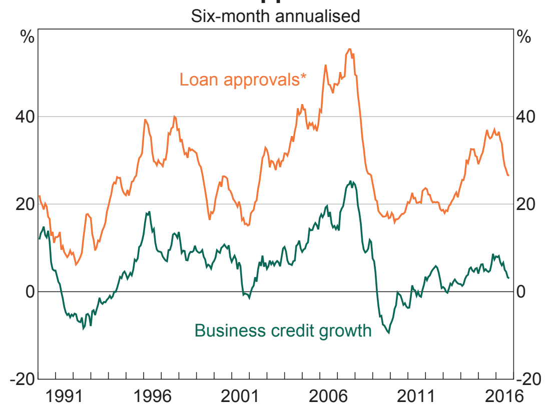


* Estimated outstanding rate
Sources: ABS; APRA; Perpetual; RBA

Business Financing

Business credit growth has slowed over the past six months, consistent with the fall in business loan approvals (Graph 4.14). The decline in credit growth

Graph 4.14
Business Loan Approvals and Credit
Six-month annualised



* Net of refinancing and reductions; as a share of business credit
Sources: ABS; APRA; RBA

has been largely driven by a slowdown in lending to larger businesses. Some banks have been reducing exposures to businesses in selected industries, such as mining and resources, and to sectors with higher non-performing loans. Business credit continues to grow at a stronger pace than a broader measure of business debt, reflecting very modest wholesale debt issuance and slow growth in cross-border syndicated lending.

The slowdown in business loan approvals has been reasonably broad based outside the residential property sector. This reflects some easing in loan approvals to sectors such as finance and insurance, manufacturing, mining and property, business and other services (Table 4.3). Business loan approvals for residential property development have remained at a high level, while loan approvals for commercial property have declined.

Business lending rates have declined by less than the cash rate this year. Major banks passed through a little over half of the August cash rate reduction to their business lending rates. Banks have tightened underwriting standards and increased their margins on some lending to large businesses over the past year (Graph 4.15).

Bond and hybrid issuance by Australian corporations remains relatively low this year (Graph 4.16). This

Table 4.2: Intermediaries' Lending Rates

	Interest rate	Change since July 2016	Change since December 2015
	Per cent	Basis points	Basis points
Housing loans			
– Standard variable rate[a][d]			
– Owner-occupier	5.26	–13	–36
– Investor	5.50	–13	–39
– Package variable rate[b][d]			
– Owner-occupier	4.51	–8	–31
– Investor	4.75	–8	–36
– Fixed rate[c][d]			
– Owner-occupier	4.02	–26	–41
– Investor	4.13	–35	–57
– Average outstanding rate[d]	4.53	–12	–33
Personal loans			
– Variable rate[e]	11.27	–10	1
Small business			
– Term loans variable rate[f]	6.39	–11	–21
– Overdraft variable rate[f]	7.27	–11	–21
– Fixed rate[c][f]	5.22	–4	–21
– Average outstanding rate[d]	5.34	–15	–29
Large business			
Average outstanding rate[d]	3.51	–20	–40

(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) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar Cannex; RBA

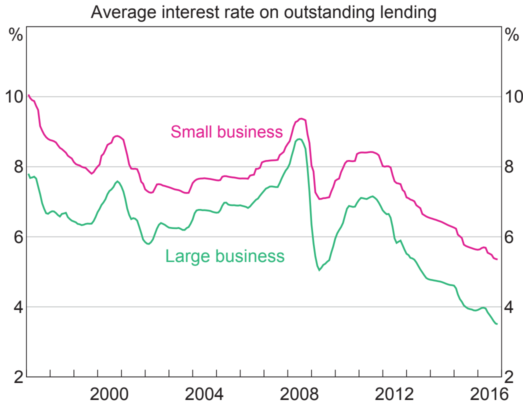
Table 4.3: Business Loan Approvals by Industry[a]

Percentage change

	Year-ended	Industry share of credit
	September quarter 2016	June 2016
Property, business and other services	–10	48
Finance and Insurance	–6	19
Wholesale and retail trade and transport	8	13
Agriculture, forestry and fishing	1	7
Manufacturing	–27	5
Mining	–60	4
Construction	10	4
Total	**–8**	**100**

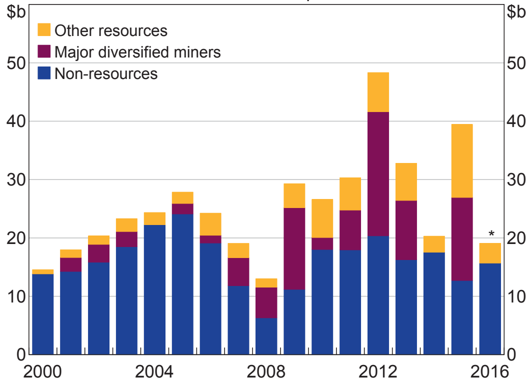
(a) Loan approvals by industry are gross of refinancing and reductions
Sources: APRA; RBA

Graph 4.15
Business Lending Rates*
Average interest rate on outstanding lending



* RBA estimates
Sources: APRA; RBA

Graph 4.16
Corporate Bond and Hybrid Issuance
Australian dollar equivalent

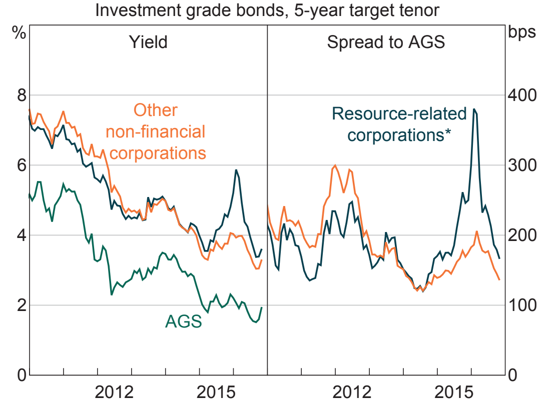


* Issuance is year to date
Source: RBA

mostly reflects the continued absence of issuance by the major diversified miners. However, in recent months there has been an increase in issuance by other non-financial corporations, with a range of deals issued in the domestic bond market and offshore. Yields for both resource-related and other non-financial corporations' bonds are around historic lows; spreads to AGS have continued to tighten in recent months and have reversed the widening that occurred over the second half of 2015 (Graph 4.17).

Net equity raisings by non-financial corporations totalled around $9 billion in the September

Graph 4.17
Australian Corporate Bond Pricing
Investment grade bonds, 5-year target tenor



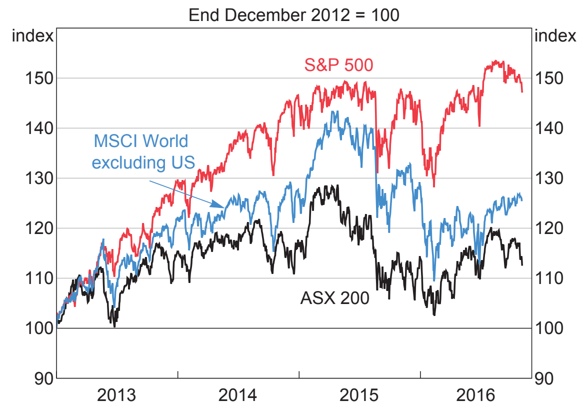
* Includes Origin Energy
Sources: Bloomberg; RBA; S&P Capital IQ

quarter. This includes a few large transactions by listed corporations to fund acquisitions, as well as initial public offerings by two real estate investment companies. Merger and acquisition activity by listed companies has totalled $41 billion this year, with activity concentrated in the industrials and consumer discretionary sectors.

Equity Markets

Australian equity prices have declined in recent months, after having risen earlier in the year (Graph 4.18).

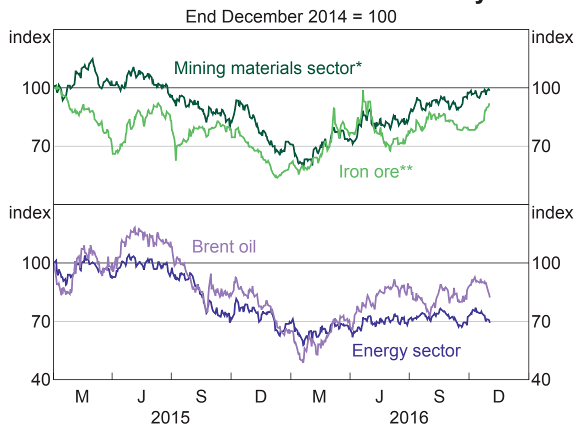
Graph 4.18
Share Price Indices
End December 2012 = 100



Source: Bloomberg

Resources share prices have risen notably since their trough at the beginning of 2016, with a particularly sharp recovery in the mining materials sector, reflecting an increase in a number of commodity prices (Graph 4.19).

Graph 4.19
Resources Share Prices and Commodity Prices



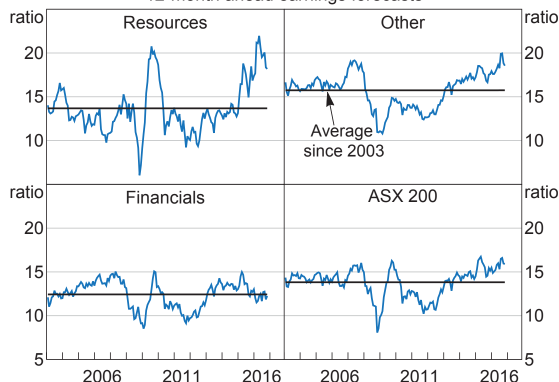
* Derived from resources sector share prices
** Qingdao import iron ore spot price
Sources: Bloomberg; RBA

Financial sector share prices have declined in recent months, and remain lower than at the beginning of the year. Share prices for companies outside the resources and financial sectors have declined more recently, with falls in healthcare, real estate, telecommunication and utilities stocks.

The valuations of Australian equities, as measured by forward price-earnings ratios, remain at or above their long-term averages (Graph 4.20). The high valuations in the resources sector partly reflect low earnings expectations, although analysts have revised up their earnings expectations since the beginning of the year alongside the increase in commodity prices.

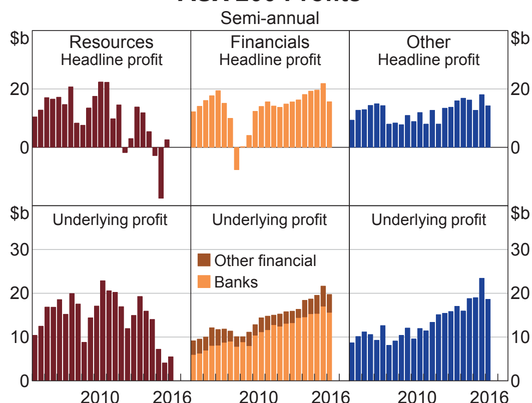
ASX 200 companies reported their results for the first half of 2016 in August. Aggregate headline profits rose by 5 per cent from the same period in 2015 (Graph 4.21). This was driven by the resources sector, as there were fewer sizeable asset write-downs by mining companies.

Graph 4.20
ASX 200 Forward Price-earnings Ratios



Source: Thomson Reuters

Graph 4.21
ASX 200 Profits



Sources: Bloomberg; Morningstar; RBA

Abstracting from the effect of these one-off items, aggregate underlying profits declined by 5 per cent in the first half of 2016 from the same period a year earlier. This decline was primarily due to a 16 per cent fall in resources sector profits over the year. Resources sector revenues declined substantially due to lower commodity prices than in the first half of 2015, and this more than offset the effects of cost cutting and reduced capital expenditure. However, resources sector profits increased relative to the second half of 2015, owing to the recovery in commodity prices.

The underlying profits of financial companies were little changed in the first half of 2016 compared

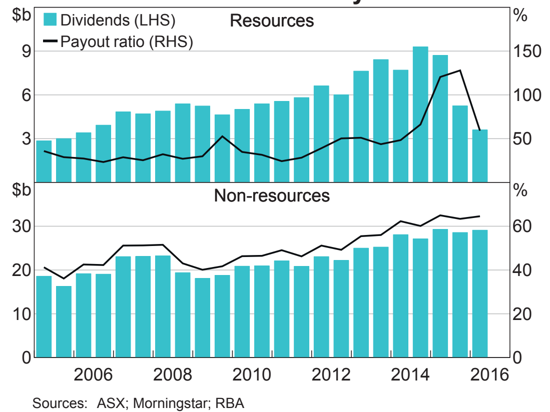
with the same period a year earlier. However, headline profits declined reflecting losses incurred by NAB associated with the divestment of its UK subsidiary Clydesdale. The major banks reported slightly higher underlying profits, with a modest increase in net interest income, reflecting continued growth in mortgage lending, only partly offset by higher funding costs. Net interest margins were broadly unchanged, though bad and doubtful debt charges increased for most banks. However, insurers' profits declined, largely reflecting weaker underwriting profits.

Underlying profits for the other sectors declined over the year. Heightened competition and further price deflation resulted in sizeable profit declines for the major supermarket chains. Both major supermarket chains also recognised sizeable asset impairments. In contrast, companies with exposure to residential housing construction, healthcare and tourism generally recorded higher profits.

Alongside a decline in aggregate underlying profits, distributions to shareholders fell over the year. This was largely due to significantly lower dividends paid by resource companies (Graph 4.22). The resources sector's payout ratio, as measured by the ratio of dividends to underlying profit, fell sharply to around 60 per cent, as the major diversified miners ended their 'progressive dividend policies' under which they had committed to maintain or increase dividend payments per share. The payout ratio in the non-resources sector was little changed.

In aggregate, listed corporations' balance sheets were little changed in the first half of 2016 compared to the second half of 2015. The value of resources sector assets fell due to write-downs (albeit fewer than there had been in the second half of 2015) and insufficient capital investment to offset depreciation.

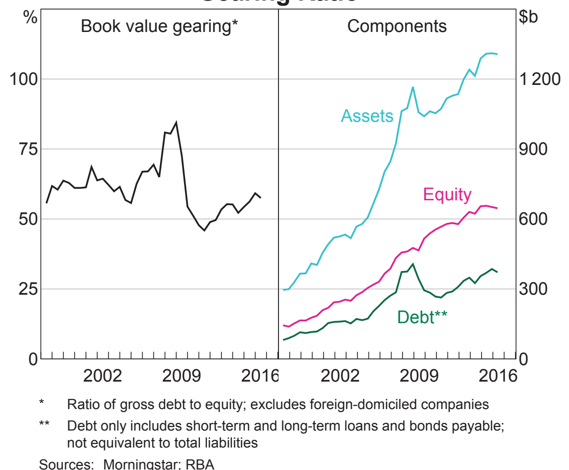
Graph 4.22
ASX 200 Dividend Payments



Sources: ASX; Morningstar; RBA

Working in the other direction, the value of assets grew in the healthcare, telecommunications and real estate sectors because of acquisitions and asset revaluations. The resources sector repaid debt during the first half of 2016, which contributed to a 4 per cent reduction in aggregate debt and a slight decline in the overall gearing ratio (the ratio of debt to equity; Graph 4.23). Nevertheless, the aggregate gearing ratio has been on an upward trend over recent years.

Graph 4.23
Listed Non-financial Corporations' Gearing Ratio



* Ratio of gross debt to equity; excludes foreign-domiciled companies

** Debt only includes short-term and long-term loans and bonds payable; not equivalent to total liabilities

Sources: Morningstar; RBA