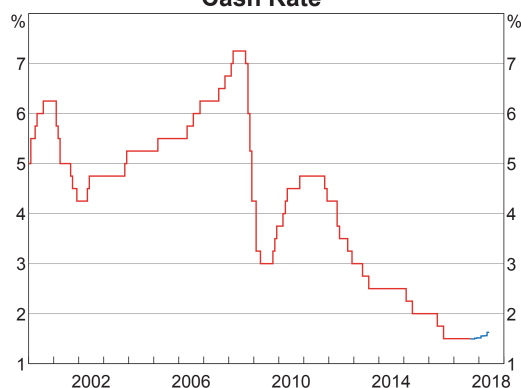
4. Domestic Financial Markets

Australian financial markets have been relatively stable over recent months. The cash rate target has remained at 1.5 per cent since last August. Financial market prices suggest that it is expected to be unchanged over the remainder of the year, with some expectation of an increase by mid next year. Australian government bond yields have increased a bit but remain at low levels. Conditions for obtaining funding remain very favourable for banks and non-financial corporations, with spreads of corporate bond yields to government bonds remaining at low levels. Growth in business debt has been subdued. Housing credit growth has been stable in recent months; investor credit growth declined, but this was largely offset by an increase in credit extended to owner-occupiers. The major banks have announced further increases to lending rates for interest-only loans, primarily in response to measures introduced by the financial regulators to reinforce sound housing lending practices. The share of new loans that are interest only has declined. Equity prices in Australia have underperformed relative to those in global markets in recent months, driven by the banking sector.

Money Markets and Bond Yields

The Reserve Bank has maintained the cash rate target at 1.5 per cent since August last year. Rates on overnight indexed swaps (OIS) imply that the cash rate is expected to remain unchanged over the remainder of this year, with some expectation of a 25 basis point increase in the cash rate priced in by mid next year (Graph 4.1).

Graph 4.1
Cash Rate*



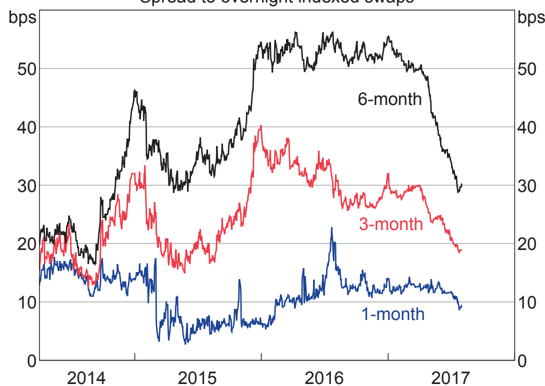
* Data from September 2017 onwards are expectations derived from interbank cash rate futures

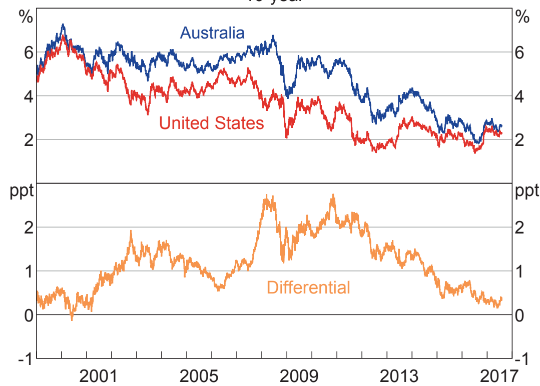
Sources: ASX; Bloomberg

Bank bill rates have declined over recent months, with spreads on 3- and 6-month bank bills relative to OIS rates narrowing to their lowest level since 2015 (Graph 4.2). This reduction in the cost of domestic short-term bank funding is likely to partly reflect developments in offshore markets, where the cost of short-term funding has also declined relative to risk-free rates.

Short-term interest rates in the repurchase agreement (repo) market have also declined over recent months, although they remain high relative to OIS rates. The wide spread of repo rates over OIS rates reflects 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 particular, in the foreign exchange swap market, Australian

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.





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 use them for such foreign exchange swap transactions. The recent decline in the spread of repo rates has coincided with a decline in the Australian dollar interest rate implied by foreign exchange swaps.

Yields on 10-year Australian Government Securities (AGS) have increased over recent months to be back around their levels at the start of the year (Graph 4.3). The spread between the 10-year AGS and US Treasury yields has increased a little but remains close to its lowest level since 2001. Demand for AGS remains strong and recent bond tenders have been well received.

The stock of outstanding semi-government bonds was little changed over 2016/17 at around $240 billion, as issuance by Western Australia was offset by maturities from New South Wales. Over 2017/18, the stock of semi-government bonds outstanding is expected to increase to $250 billion.

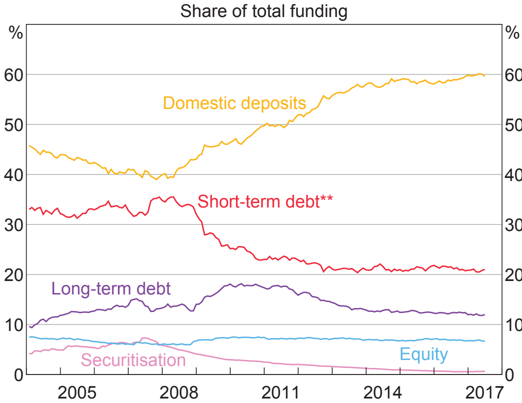
After a strong start to the year, the issuance of bonds by non-residents in the domestic market ('Kangaroo' issuance) has been subdued over the past few months. Issuance was primarily from supranational agencies and offshore banks. Secondary market spreads of AAA-rated Kangaroo bonds to AGS have remained stable over the past few years, although they have edged somewhat lower of late.

Financial Intermediaries

Domestic deposits account for the largest share of bank funding, with the share rising over the past year to around 60 per cent (Graph 4.4). Growth in deposits has been accounted for by transaction and term deposits. Both of these types of deposits are considered to be relatively stable sources of funding under the Net Stable Funding Ratio (NSFR) requirement, which will take effect from the beginning of 2018. The major banks have indicated that their NSFRs have increased over the past year and are above the regulatory minimum.

The cost of the major banks' outstanding deposit and wholesale debt funding is estimated to have declined a little this year. Interest rates on term deposits and savings accounts have declined, and the average cost of term deposits is expected to decline a little further, reflecting the maturity of deposits that were entered into at higher interest rates last year. Conditions in

Graph 4.4
Funding Composition of Banks in Australia*

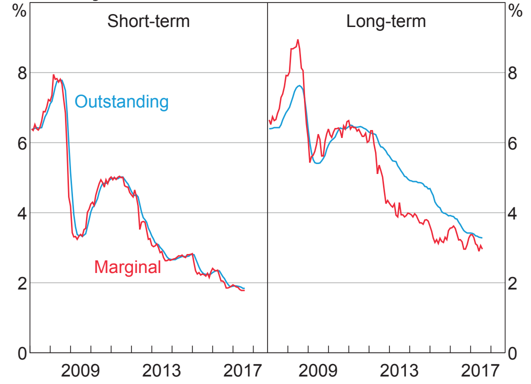


* Adjusted for movements in foreign exchange rates; tenor of debt is estimated on a residual maturity basis

** 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

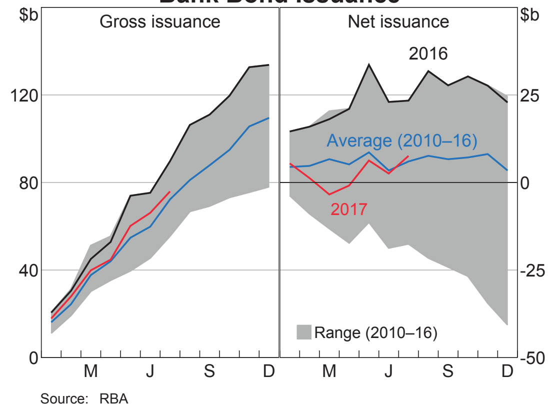
Sources: Bloomberg; RBA

wholesale debt markets remain favourable for banks, with the cost of issuing new long-term debt at historically low levels and the cost of short-term wholesale debt declining in recent months (Graph 4.5). The major banks' outstanding wholesale debt funding costs have declined over the year, and this is expected to continue as more expensive wholesale debt is replaced by new issuance at a lower cost.

The implied spread between lending rates and debt funding costs for the major banks is estimated to have increased over the past year. Most of this increase was a result of higher interest rates on investor and interest-only housing lending. Lower funding costs have also contributed to the increase in the implied spread.

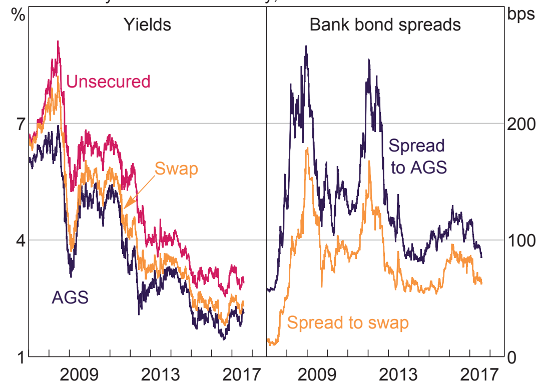
As has generally been the case in recent years, bond issuance by the banks has replaced maturities so that there has been little net issuance (Graph 4.6). Secondary market yields on bank bonds and spreads to benchmark rates have been little changed in recent months and remain around their lowest levels since 2014 (Graph 4.7). Market conditions remain favourable for bank bond issuance, with some of the major banks recently issuing sizeable 30-year

Graph 4.6
Bank Bond Issuance



Source: RBA

Graph 4.7
Major Banks' Bond Pricing



Sources: Bloomberg; UBS AG, Australia Branch

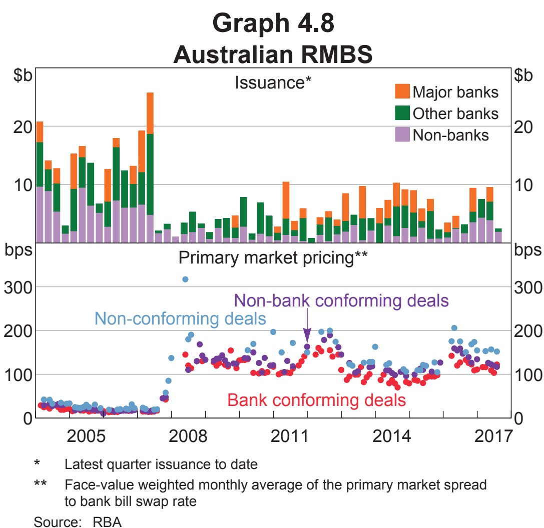
bonds into the US market, continuing a trend of lengthening tenors for bond issuance.

Issuance of residential mortgage-backed securities (RMBS) has continued at the pace seen since late last year, which is markedly stronger than in the previous year (Graph 4.8). Spreads on these securities to benchmark rates have declined to around the levels that prevailed in 2015. The characteristics of the mortgages underlying these securities have been of similar quality to previous RMBS deals issued in Australia.

Over recent months, the ratings of many Australian financial institutions have been downgraded by credit rating agencies. Ratings agencies indicated that the accumulation of debt in the household sector was a significant factor in their decisions. In late May, Standard & Poor's downgraded 23 Australian medium-size and smaller financial institutions, while affirming the ratings of the major banks and Macquarie Bank. In June, Moody's also downgraded the ratings of 12 Australian banks, including the major banks. This generally moved the bank ratings of the major credit rating agencies into alignment, with all major banks now holding an AA– rating and most regional banks holding a rating in the A or BBB range. These ratings changes appear to have had little effect on bank bond spreads.

In July, the Australian Prudential Regulation Authority (APRA) announced increases in required capital ratios for the Australian banking sector to be considered 'unquestionably strong'. The four major Australian banks will need to have capital ratios (based on common equity Tier 1 (CET1)) of at least 10.5 per cent by 1 January 2020. APRA reported that the major banks will need to increase their capital ratios, on average, by around 100 basis points from the levels at the end of 2016. APRA estimates that the major banks should be able to generate this additional capital by retaining profits, without significantly altering their business growth plans or dividend policies, and without undertaking further equity raisings. For other ADIs, the increase in capital requirements will be around 50 basis points, but most of these ADIs already hold well in excess of the new requirements. Later this year, APRA intends to release more details on its implementation of forthcoming Basel III changes to risk weights as well as measures relating to ADIs' substantial exposures to residential mortgages.

Graph 4.8
Australian RMBS



* Latest quarter issuance to date
** Face-value weighted monthly average of the primary market spread to bank bill swap rate
Source: RBA

In the 2017/18 budget, the Australian Government announced a Major Bank Levy. ADIs with liabilities of at least $100 billion are now subject to a 6 basis point levy on around three-quarters of their liabilities. The government estimates that the tax will raise around $6.2 billion over four years, which is equivalent to around 5 per cent of current profits of the affected banks.

Financial Aggregates

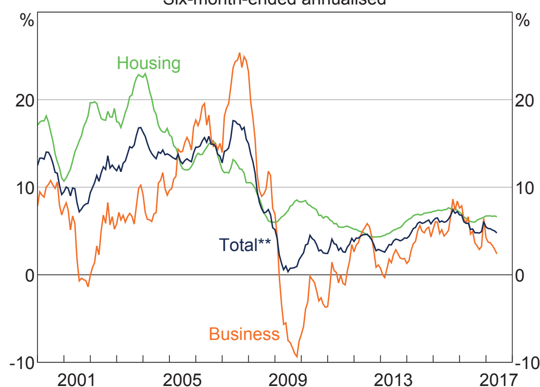
Total credit grew by around 5 per cent over the past year. Housing credit growth has been steady while business credit has grown modestly (Graph 4.9). Broad money has grown a little faster than total credit (Table 4.1).

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

	Three-month ended		Year-ended
	Mar 2017	June 2017	June 2017
Total credit	0.9	1.5	5.4
– Housing	1.7	1.6	6.6
– Owner-occupier	1.5	1.6	6.2
– Investor	2.0	1.5	7.4
– Personal	–0.5	–0.3	–1.4
– Business	–0.4	1.5	4.4
Broad money	1.9	2.1	7.7

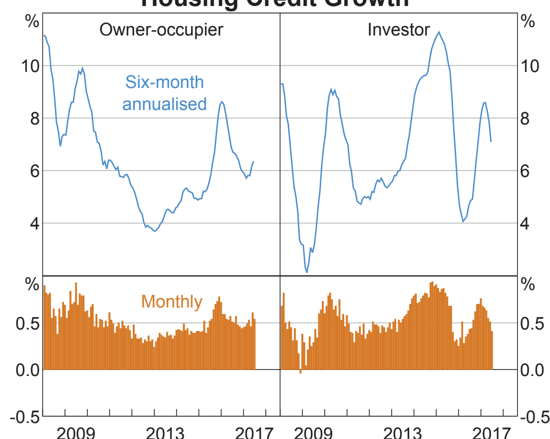
(a) Growth rates are break adjusted and seasonally adjusted
Sources: APRA; RBA

Graph 4.9
Credit Growth by Sector*
Six-month-ended annualised



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

Graph 4.10
Housing Credit Growth*



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

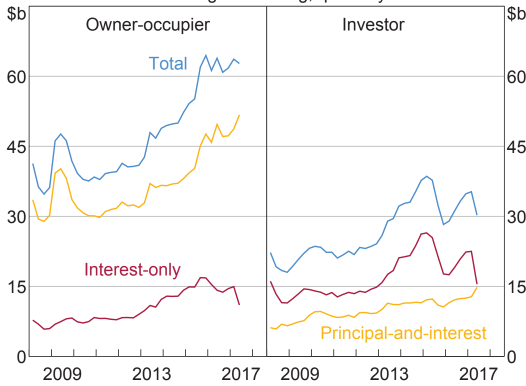
Household Financing

Housing credit growth has been stable over recent months. Growth in investor housing credit has declined recently, after accelerating through the second half of 2016. This has been largely offset by slightly faster growth in housing credit extended to owner-occupiers (Graph 4.10).

Some of the decline in investor housing credit growth is likely to reflect the effect of the increases in investor and interest-only interest rates announced by lenders since November. The tightening in lending standards in response to prudential guidance from APRA and ASIC in March and April may also have had some effect.

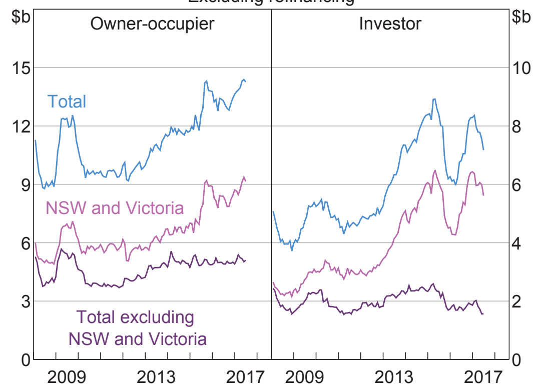
As part of the guidance, lenders are required to limit the share of interest-only lending to below 30 per cent of new loans from September onward. Consistent with this, large lenders have reported that the interest-only share of loan approvals has declined to around 30 per cent in the June quarter (Graph 4.11). Banks have also reported that existing borrowers are switching from interest-only to principal-and-interest loans in response to differences in interest rates on these products. Overall, it remains too early to assess the full impact of all of these changes in lending standards and interest rates.

Graph 4.11
Housing Loan Approvals
Including refinancing, quarterly



Sources: APRA; RBA

Graph 4.12
Housing Loan Approvals
Excluding refinancing



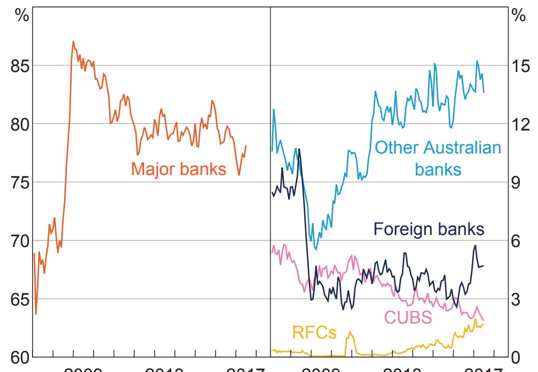
Source: ARPA; RBA

The recent moderation in the growth of investor housing credit is consistent with the reduction seen in the level of investor loan approvals. The decline in investor approvals since the turn of the year has been broadly based across the states, while owner-occupier approvals have increased only in NSW and Victoria (Graph 4.12).

The major banks' share of housing loan approvals remains around its lowest level since 2012 (Graph 4.13). Slower growth in the major banks' housing lending over the past six months was partly offset by stronger growth by other authorised deposit-taking institutions (ADIs). There was also strong growth in housing credit extended by non-ADIs, although these institutions account for less than 5 per cent of the stock of housing credit. In general, non-major lenders are running up against constraints in their capacity to process the increased volume of applications in a timely manner.

Since May, most lenders have increased their standard variable reference rates for interest-only loans by around 30 basis points and reduced standard variable rates for principal-and-interest loans to owner-occupiers by around 5 basis points (Graph 4.14; Table 4.2). By themselves,

Graph 4.13
Housing Loan Approvals*
Share of total



* Seasonally adjusted; CUBS are credit unions and building societies; RFCs are registered financial corporations

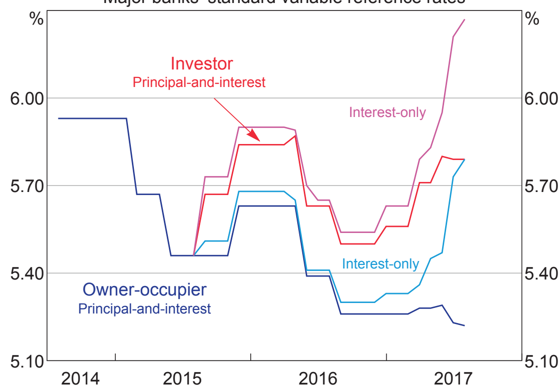
Sources: APRA; RBA

the net effect of these changes is estimated to have increased the average outstanding variable interest rate by around 5 basis points. In combination with the increases previously announced since last November, this implies a rise in the average outstanding *variable* interest rate of 15–20 basis points.

Table 4.2: Intermediaries' Fixed and Variable Lending Rates

	Interest rate Per cent	Change since November 2016 Basis points	Change since April 2016 Basis points
Housing loans			
– Variable principal-and-interest rate[(a)(b)]			
– Owner-occupier	4.41	–4	–36
– Investor	4.98	29	–3
– Variable interest-only rate[(a)(b)]			
– Owner-occupier	4.98	52	18
– Investor	5.46	73	43
– Fixed principal-and-interest rate [(a)(c)(d)]			
- Owner-occupier	4.14	3	–29
- Investor	4.45	20	–21
– Average outstanding rate[(d)]	4.63	13	–20
Personal loans			
– Variable rate[(e)]	11.46	18	10
Small business			
– Term loans variable rate[(f)]	6.43	4	–32
– Overdraft variable rate[(f)]	7.31	4	–32
– Fixed rate[(c)(f)]	5.29	–1	–13
– Average outstanding rate[(d)]	5.36	1	–32
Large business			
Average outstanding rate[(d)]	3.49	0	–48

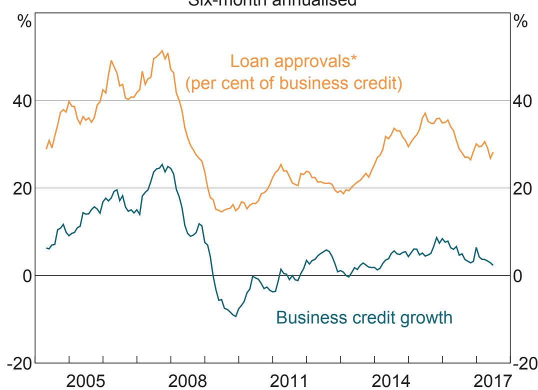
(a) Includes announced changes to new lending to August 2017
(b) Average of the major banks' discounted package rates on new, $500 000 full-doc loans
(c) Average of the major banks' 3-year fixed rates
(d) RBA estimates
(e) Weighted average of variable rate products
(f) Residentially secured, average of the major banks' advertised rates
Sources: ABS; APRA; Canstar; RBA



However, the increase in the average rate for *all* outstanding housing loans is expected to be less than this estimate for variable rate loans for several reasons. First, it is likely that some existing borrowers will switch their repayment terms from interest-only to principal-and-interest to avoid the interest rate increases on the former. Second, the lowest advertised variable interest rates from the majors and mid-sized lenders have not increased to the same extent as the reference rates. Third, interest rates on new fixed-rate loans remain below those on maturing loans, so as these loans mature, borrowers can roll over their loans at lower interest rates.

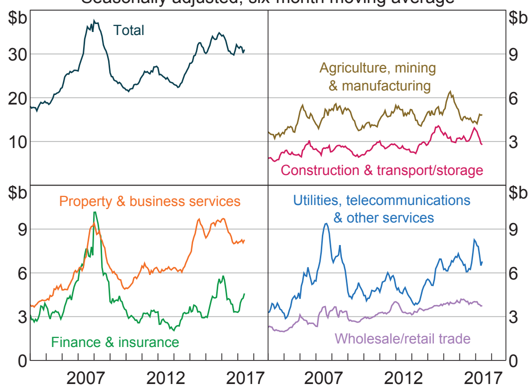
Business Financing

Business credit growth picked up over the June quarter, following weakness in the March quarter (Table 4.1). Nevertheless, growth in business credit remains modest, consistent with the level of business loan approvals (Graph 4.15).



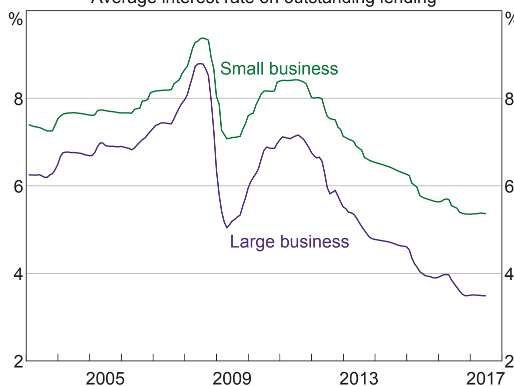
The recent pick-up in business credit growth partly reflects some stability in the level of lending to the resources sector after an earlier period of deleveraging. This is evident in a stabilisation in the stock of syndicated lending to the resources sector following noticeable declines over the preceding six months.

Outside of the resources sector, demand for credit remains uneven across industries (Graph 4.16). Recent weakness in business loan approvals has been concentrated in industries such as transport and storage, construction, telecommunications and utilities. Looking at the purpose of new loans, approvals for the construction of residential property have remained at relatively elevated levels, following very strong growth through 2016. Loan approvals for the purchase or construction of commercial property have declined in recent months.



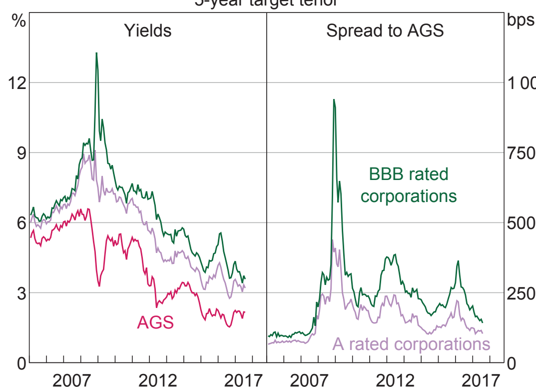
The major banks' share of new business loan approvals remains low relative to recent years. In part, this reflects the major banks' efforts to reduce exposures to selected industries and larger companies. Foreign banks' share of approvals has been relatively high, partly reflecting increased competition from Asian banks.

Business lending rates on outstanding loans to small and large businesses have been little changed over the past few months (Graph 4.17).



The stock of bonds issued by non-financial corporations has remained stable, as new issuance has been offset by maturities. Corporate bond market spreads (relative to yields on AGS) have continued to tighten, with this trend broad based across industries and credit rating bands (Graph 4.18).

Graph 4.18
Australian Corporate Bond Pricing
5-year target tenor



Sources: Bloomberg; RBA; S&P Capital IQ

Net equity raisings by non-financial corporations (including real estate companies) have increased following limited activity earlier in the year. The initial public offering (IPO) market had a particularly slow start to 2017, with a number of planned IPOs by retailers being abandoned amid unfavourable equity market conditions. The IPO market picked up a little in the June quarter, though the retail sector remained subdued.

Equity Markets

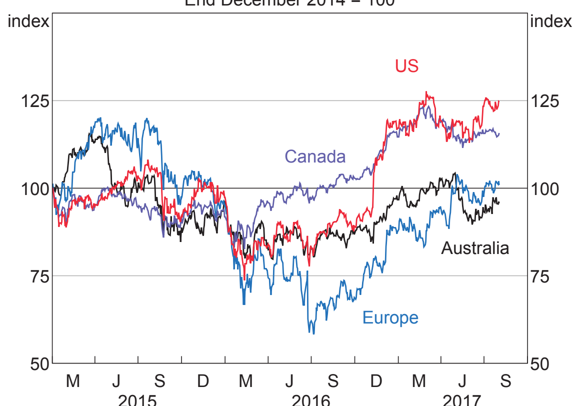
The Australian equity market has largely underperformed relative to global share markets in recent months (Graph 4.19). This was a result of declines of share prices in the banking sector, while increases in resource sector share prices provided some offset.

Graph 4.19
Share Price Accumulation Indices
End December 2016 = 100

Sources: MSCI; Thomson Reuters

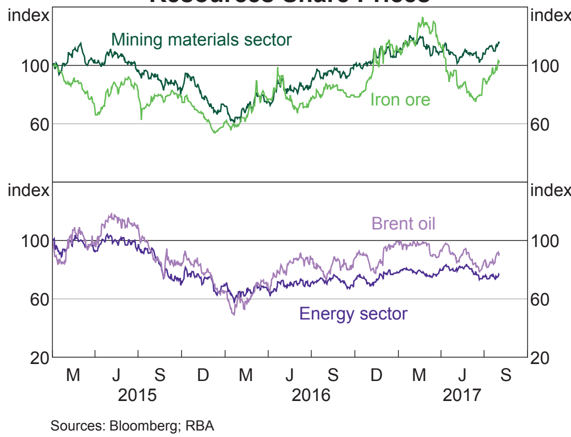
Banks' share prices in Australia are little changed from earlier this year but are down from their peak at the beginning of May. Bank share prices fell following the announcement in May of the Major Bank Levy. However, the ratings downgrades of banks by Standard & Poor's and Moody's had little apparent impact. Bank share prices have rebounded modestly in recent weeks alongside global banking stocks, and following the announcement of the additional capital requirements by APRA (Graph 4.20).

Graph 4.20
Banks' Share Prices
End December 2014 = 100



Sources: Bloomberg; RBA

Resources sector share prices have increased in recent months, driven by mining material stocks, as iron ore prices recovered some of the falls earlier in the year (Graph 4.21).



Analysts' expectations for earnings over the coming years have been revised lower, particularly for the resources sector. Nevertheless, resources sector valuations (as measured by forward price-earnings ratios) have remained around their long-term average (Graph 4.22). Valuations across the other sectors have been little changed. ✠