

4. Domestic Financial Markets

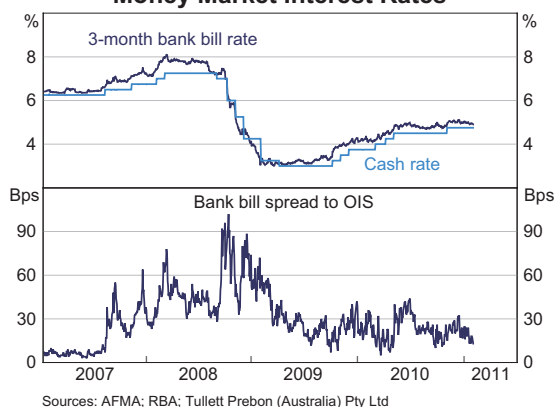
Money Markets and Bond Yields

The Reserve Bank Board has maintained its target for the overnight cash rate at 4.75 per cent since November (Graph 4.1). At the time of the November *Statement*, market yields pointed to expectations of a further increase in the cash rate in the first half of 2011, but over the past three months those expectations have been scaled back, in part reflecting the lower inflation data and concerns about the drag on economic activity from the floods.

To maintain the cash rate at the Board's target, the Bank has kept exchange settlement (ES) balances around \$1¼ billion, although higher balances were temporarily accommodated over year-end. Rates on 3-month bank bills have remained relatively steady at just below 5 per cent and the spread to overnight indexed swaps (OIS) is close to its lowest level over the past three years.

Reflecting global developments, long-term bond yields have risen since November (Graph 4.2). However, the rise has been less than in the major offshore markets, which has seen the spread between CGS and US government bond yields narrow significantly from its recent peak late last year. Spreads between other highly rated domestic securities and CGS – including state-government and supranational paper – have generally remained steady, with the exception of spreads on European-based issuers which have widened.

Graph 4.1
Money Market Interest Rates



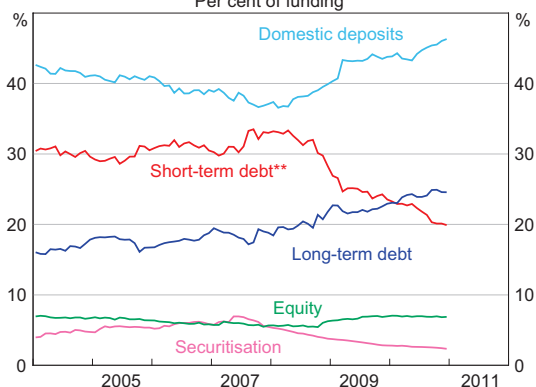
Graph 4.2
Australian Government Bond Yields



Financial Intermediaries

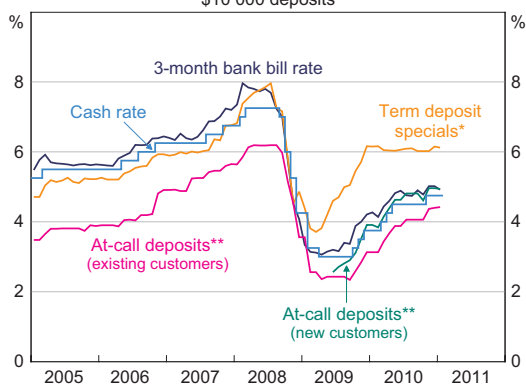
The trends in bank financing evident over the past couple of years have continued (Graph 4.3). The share of funding accounted for by short-term debt has fallen to close to 20 per cent, well down from its share prior to the onset of the global financial crisis. This decline has been offset by a marked increase in deposits and an increase in the share of funding from long-term debt, both of which are relatively more expensive sources of funding. These changes in funding reflect both regulatory and market pressures.

Graph 4.3
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

Graph 4.4
Deposit Rates
\$10 000 deposits



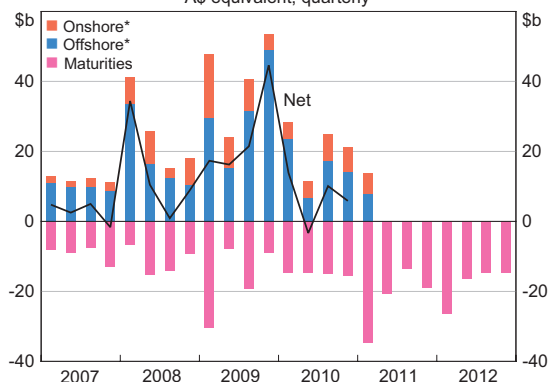
* Average of 1–12, 24–, 36- and 60-month terms at the major banks
** Average of online, bonus and cash management accounts at the major banks
Source: RBA

The announcement of new global standards for liquidity by the Basel Committee in December, that will come into effect in 2015, is one factor that has contributed to this. Banking institutions will need to have sufficient high-quality liquid assets to survive an acute stress scenario lasting for one month. Increasing the share of funding from longer-term debt can reduce the size of the liquidity portfolio that needs to be held under that scenario. The Basel standard prescribes that high-quality liquid assets will take the form of government securities, which in Australia's case are limited. As a consequence, APRA and the Bank have announced that the Bank will offer a committed secured liquidity facility, sufficient in size to cover any shortfall between a banking institution's holdings of high-quality liquid assets and the liquidity requirement. In return for this committed facility, the Bank will charge a market-based fee.

Banks have continued to compete for deposits in recent months. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) has increased by around 35 basis points since the previous *Statement*, more than the increase in the cash rate (Graph 4.4). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, has also risen a little to around 6.12 per cent. This rate is almost 2½ percentage points higher than it was in early 2009, a considerably larger increase than the cash rate over this period. Over the past year, rates on term deposit 'specials' have remained approximately 100 basis points above equivalent duration market rates (bank bill and swap rates). On average, the smaller Australian-owned banks' 'special' term deposit rates are at similar levels to those offered by the major banks.

Australian banks continue to take opportunities to lengthen the maturity of their funding. Around \$35 billion of bonds has been issued in domestic and international wholesale markets since the November *Statement* (Graph 4.5). While around two-

Graph 4.5
Major Banks' Bond Issuance
A\$ equivalent, quarterly



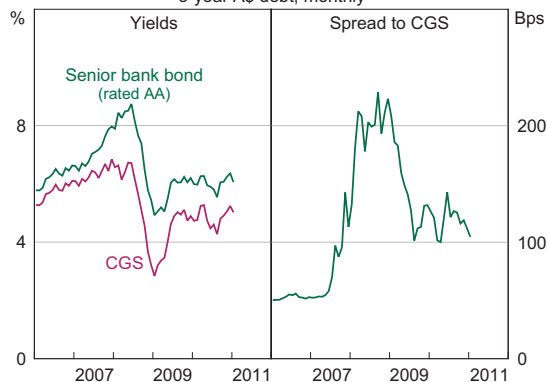
* Latest quarter issuance to date
Source: RBA

thirds of recent issuance has been offshore, local issuance has included a record \$2½ billion deal by a major bank. The cost of recent issuance has remained broadly stable since the previous *Statement* (Graph 4.6).

A number of banks, including three of the major banks, have repurchased around \$6 billion of their government-guaranteed debt on issue. Repurchases have been concentrated in debt with a relatively short residual maturity of around one year, as the guarantee fee on this debt exceeds the current market spread on equivalent unguaranteed funding.

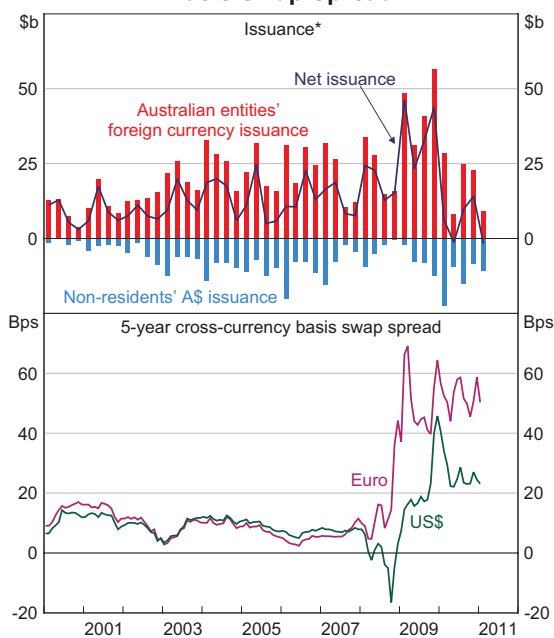
Cross-currency basis swap spreads – which represent the hedging cost of Australian issuers swapping foreign currency funding into Australian dollars – have been relatively stable over recent months at above their pre-crisis levels (Graph 4.7). Combined with strong demand for Australian dollar assets, including from Australian banks looking to purchase high-grade liquid assets, these favourable spreads continue to attract foreign issuers into the local market. Issuance by offshore entities in Australian dollars (the kangaroo bond market) totalled over \$7 billion in January alone, around twice the average monthly issuance in 2010.

Graph 4.6
Major Banks' Bond Pricing
3-year A\$ debt, monthly



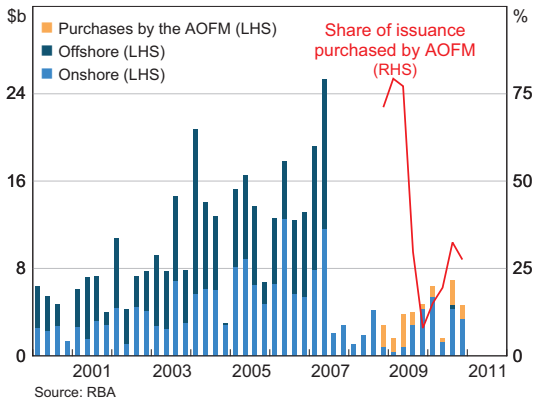
Sources: RBA; UBS AG, Australia Branch

Graph 4.7
Bond Issuance and the Cross-currency Basis Swap Spread



* Latest quarter issuance to date
Sources: Bloomberg; RBA

Graph 4.8
Australian RMBS Issuance
A\$ equivalent, quarterly



There have been a number of positive developments in the domestic securitisation market in recent months. Several deals, including the first involving

non-conforming mortgages since early 2008, have priced without AOFM support (Graph 4.8). Some deals have also included 'bullet' structures, which aim to appeal to a broader base of investors. Pricing for both primary issuance and in secondary markets has been little changed over recent months.

Household Financing

Most bank and non-bank lenders raised their variable housing loan rates by more than the increase in the cash rate in November (Table 4.1). Interest rates on new full-doc variable-rate housing loans have increased by an average of 39 basis points, and are a little more than 200 basis points above their lows in 2009. Around the time of the November interest rate announcements, two lenders also announced the removal of early termination fees on new and existing mortgages.

Table 4.1: Intermediaries' Lending Rates^(a)
Per cent

	Level at 2 February 2011	Change since: End October 2010	End April 2009
Cash rate	4.75	0.25	1.75
Swap rate, 3-year	5.47	0.18	1.55
Housing loans			
Prime full-doc	7.22	0.39	2.03
Prime full-doc, 3-year fixed rate	7.42	-0.01	1.55
Prime low-doc	7.88	0.40	2.08
Personal loans	12.88	0.28	1.93
Small business			
Term loans			
– Residentially secured	8.99	0.41	1.91
– Residentially secured, 3-year fixed rate	8.53	0.05	1.64
– Other security	9.70	0.36	1.81
Overdraft			
– Residentially secured	9.86	0.41	1.96
– Other security	10.67	0.36	1.86
Average actual rate	8.92	0.41	1.81
Large business			
Average actual rate (variable and bill funding)	6.98	0.20	1.95

(a) Variable interest rates unless otherwise indicated
Sources: ABS; APRA; Canstar Cannex; Perpetual; RBA

The major banks' interest rates on new fixed-rate housing loans have been little changed in recent months. Relative to corresponding swap rates, a common pricing benchmark, these rates have declined further from their peaks in mid 2010. As the spread between fixed and variables rates has narrowed, the share of housing loans approved at fixed rates has picked up, although it remains below its longer-run average.

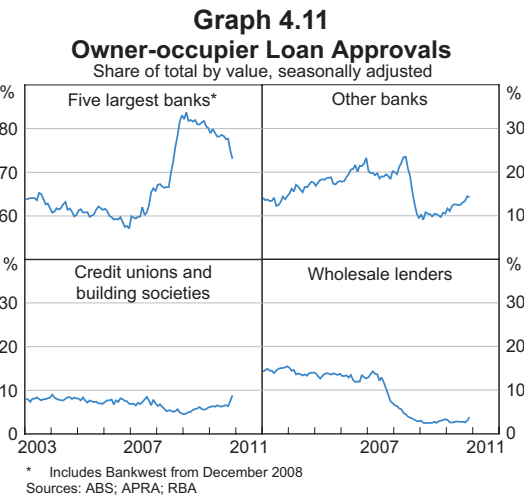
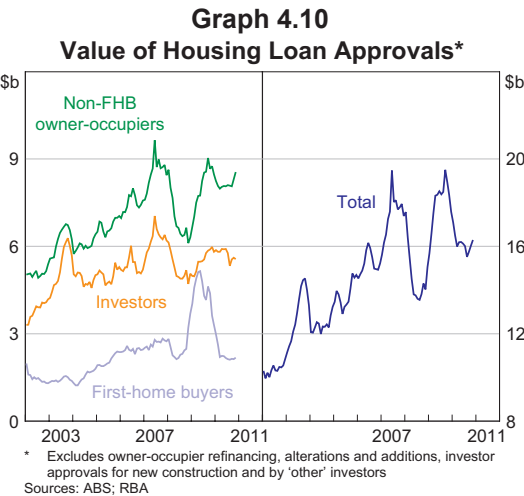
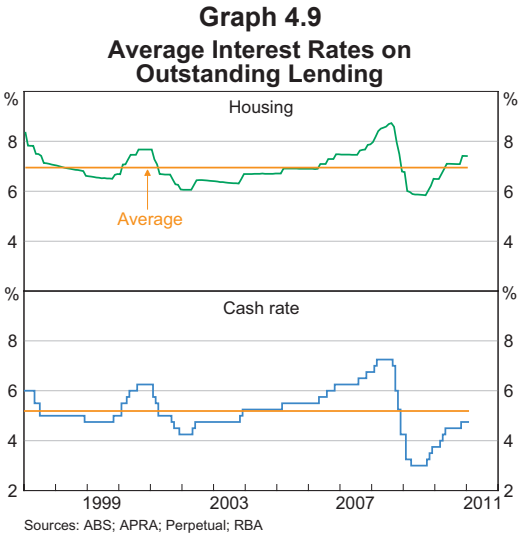
Overall, the average interest rate on all outstanding housing loans (fixed and variable) is estimated to be around 45 basis points above its post-1996 average, having risen by around 155 basis points since its trough in 2009 (Graph 4.9).

The total value of housing loan approvals has increased a little in recent months, largely as a result of demand from owner-occupiers (excluding first-home buyers) (Graph 4.10). The increase in approvals has been most significant for credit unions and building societies, and to a lesser extent for wholesale lenders and smaller banks. The major banks have continued to experience a decline in their market share, which is now under three-quarters, around 11 percentage points below its early 2009 peak (Graph 4.11).

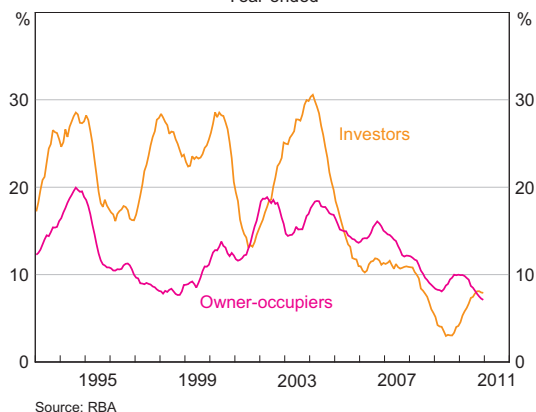
Over the December quarter, the growth of housing credit averaged 0.5 per cent per month, little changed from the pace of the previous six months. Owner-occupier credit and investor credit have grown at broadly similar rates over the past year (Graph 4.12).

Financial institutions' rates on variable personal loans have increased by an average of 28 basis points since the end of October. Average variable rates on unsecured personal loans, credit cards and margin loans have increased by 25 basis points, while rates on home equity loans have increased by around 40 basis points.

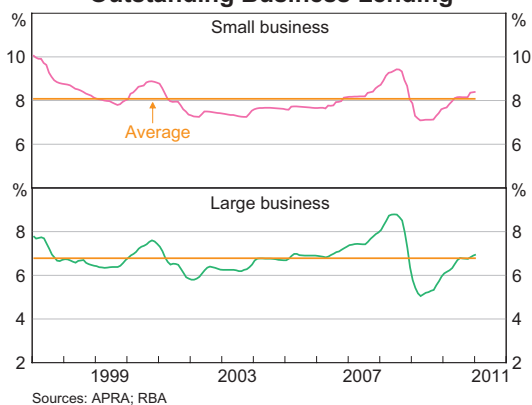
Personal credit, which is a small component of household credit, rose at a monthly average rate of 0.1 per cent over the December quarter. The modest growth in recent months was largely due to increased credit card lending. The value of



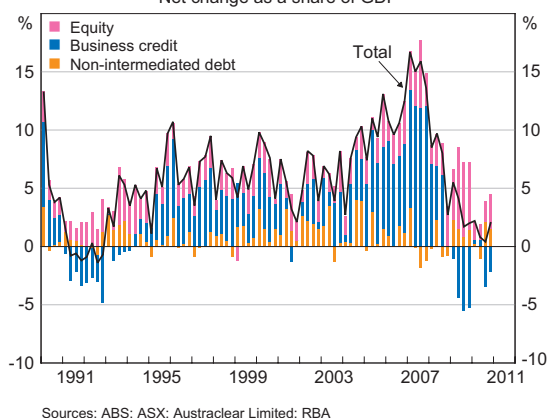
Graph 4.12
Housing Credit Growth
Year-ended



Graph 4.13
Average Interest Rates on Outstanding Business Lending



Graph 4.14
Business External Funding
Net change as a share of GDP



outstanding margin lending continued to decline over the quarter despite favourable conditions in equity markets. As such, an increase in the value of collateral backing margin loans has meant that gearing remains at low levels.

Business Financing

In November, the major banks increased their indicator rates on residentially-secured small business loans by an average of 41 basis points, to 8.99 per cent, in line with the increase in their variable housing rates. Indicator rates on 1–5 year fixed-rate facilities have also generally increased by around 5 to 15 basis points, slightly less than corresponding swap rates. At 8.40 per cent, the average rate on outstanding small business loans is about 30 basis points above its post-1996 average (Graph 4.13).

The average interest rate on banks' variable-rate lending to large business is estimated to have increased by about 20 basis points since the end of October, to 6.98 per cent. These loans are repriced at regular intervals from money market benchmark rates (such as the 3-month bank bill yield), which have increased in recent months. The risk margins that banks charge above these benchmark rates for new customers have tended to decline somewhat over 2010, after rising substantially over the previous couple of years.

Net external business funding picked up slightly as a share of GDP in the December quarter, with a decline in business credit more than offset by robust corporate debt issuance and solid equity raisings, particularly by resource companies (Graph 4.14). Debt issuance by Australian corporates reached \$10 billion in the December quarter, with around \$6 billion of that placed in the US market by large resource companies seeking funding for new projects. Bond spreads for Australian corporates have tightened slightly, with resource firms in particular benefiting from strong demand for Australian debt. Resource companies also accounted for much of the pick-up in equity raisings in the quarter. Most of the equity raisings have been by smaller resource

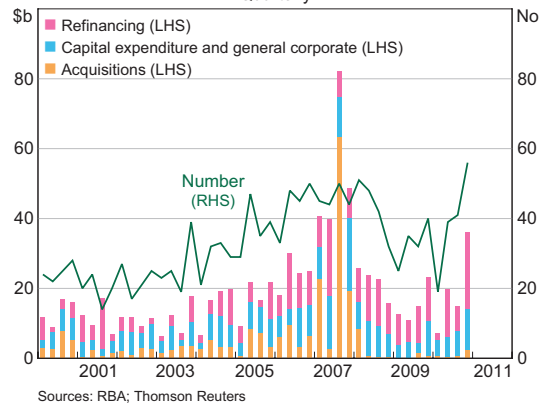
companies, as the larger resource firms have sufficient equity financing through retained profits and, in some cases, have announced that they will be returning surplus capital to shareholders via share buybacks.

The decline in business credit has been driven by falls in lending to corporates, while lending to unincorporated enterprises has been broadly stable. Although commercial loan approvals have been steady over the year, syndicated loan approvals picked up strongly in the December quarter, with 56 deals worth around \$35 billion (Graph 4.15). This is the largest quarter of approvals since 2007. Refinancing of existing facilities accounted for most of the increase, although lending for the purpose of funding acquisitions, capital expenditure and general corporate purposes also rose. A broader trend in syndicated lending in the past couple of years has been the sizeable increase in the market share of Asian banks, albeit from a relatively low base.

Aggregate Credit

Total outstanding credit grew at an annualised rate of around 2½ per cent over the December quarter, reflecting moderate growth in household credit and a decline in lending to businesses (Graph 4.16, Table 4.2). Growth in broad money remained solid over 2010, partly reflecting a preference to hold assets in deposits. Reflecting the increase in deposits, the growth of broad money has outpaced credit since the latter half of 2007.

Graph 4.15
Syndicated Loan Approvals
Quarterly



Graph 4.16
Credit Growth
Year-ended

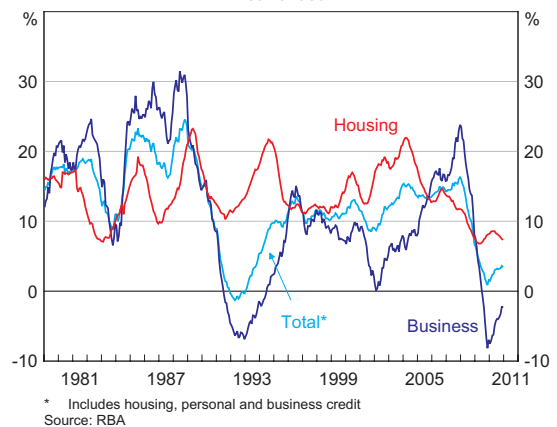
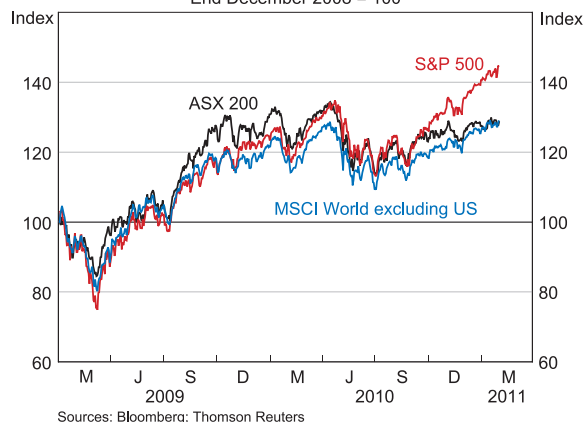


Table 4.2: Financial Aggregates
Percentage change

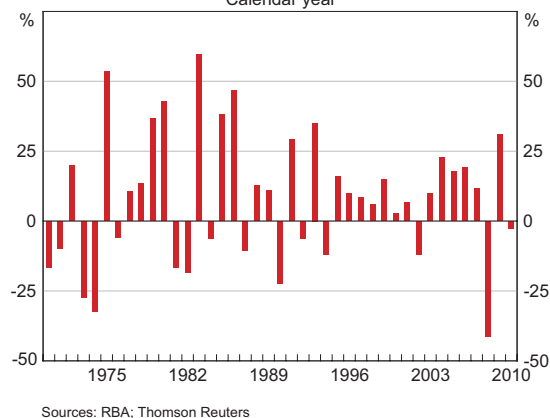
	Monthly average		Year to December 2010
	September quarter 2010	December quarter 2010	
Total credit	0.1	0.2	3.4
– Owner-occupier housing	0.5	0.6	7.1
– Investor housing	0.7	0.5	7.9
– Personal	0.0	0.1	1.2
– Business	–0.6	–0.4	–2.3
Broad money	0.5	0.8	8.1

Source: RBA

Graph 4.17
Share Price Indices
End December 2008 = 100



Graph 4.18
Australian Equity Market Annual Returns
Calendar year



Equity Markets

Despite the solid improvement in global equity markets over recent months, the Australian equity market is only slightly higher since the previous *Statement* (Graph 4.17). In net terms, it is little changed since late 2009 having fallen slightly over 2010 following the strong recovery in 2009 (Graph 4.18). At the sectoral level, the continued rally in resource firms' share prices has led the market higher, partly offset by a decline in the share price of financials (Table 4.3). Forward P/E ratios remain below historical averages with valuations continuing to be supported by analysts' forecasts for solid profit growth over the next two years.

The Queensland floods and Cyclone Yasi have led to some volatility in the share prices of insurance firms but the net effect has been relatively muted with insurers indicating that weather-related claims will be capped by reinsurance. A number of mining firms have indicated that production has been hampered by the adverse weather conditions.

There was a relatively high level of merger and acquisition activity in the second half of 2010, with a number of large announced deals – including the ASX/SGX merger and AXA Asia Pacific takeover – still subject to regulatory or shareholder approval. Currently just over \$50 billion of M&A deals remain pending. ✎

Table 4.3: Sectoral Movements in the ASX 200
Per cent

	Change since:		
	November <i>Statement</i>	Trough (March 2009)	Peak (November 2007)
Resources	5.2	64	–9
Financials	–0.6	62	–41
Other	0.6	34	–32
ASX 200	1.6	52	–30

Source: ASX