

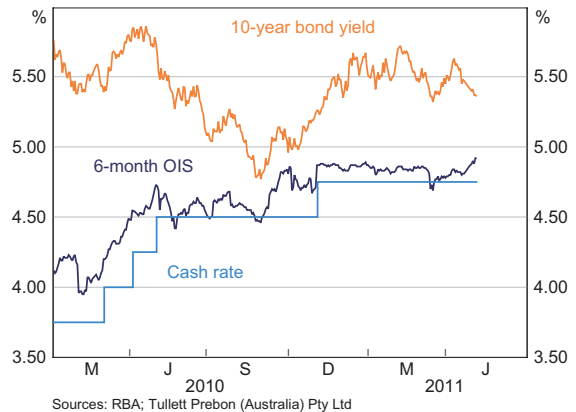
4. Domestic Financial Markets

Money and Bond Markets

The Reserve Bank has maintained the target for the overnight cash rate at 4.75 per cent since November last year (Graph 4.1). Money market yields declined in March reflecting concerns about nuclear security in Japan, but subsequently increased as the concerns were allayed and following the publication of the March quarter inflation data. Market yields currently indicate an expectation of a higher cash rate towards the end of the year. In addition, credit spreads have narrowed: the spread between 3-month bank bills and the overnight indexed swap (OIS) rate has fallen to around 10 basis points, close to its pre-crisis level and well below its peak of just over 100 basis points in late 2008.

Long-term bond yields are currently towards the bottom half of a 50 basis point range that has existed for the past six months. Daily movements in yields since the previous *Statement* have largely been influenced by offshore developments, and the spread to US Treasuries has remained a little over 200 basis points over the past few months. The spreads of highly rated domestic debt securities have narrowed, with some semi-government debt now trading around the narrowest spreads to Commonwealth Government Securities (CGS) since the financial crisis began (Graph 4.2). In contrast, spreads on supranational debt remain wider, particularly for debt issued by European-based institutions.

Graph 4.1
Interest Rates

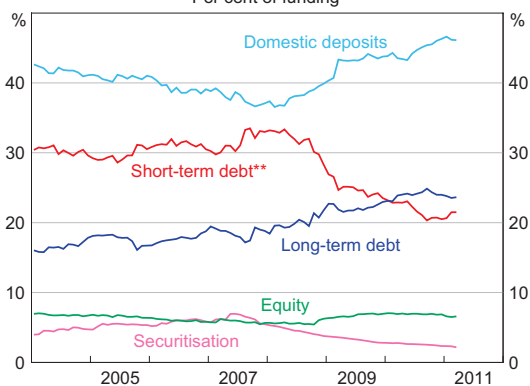


Graph 4.2
Spreads to 5-year CGS



Graph 4.3

Funding Composition of Banks in Australia*
Per cent of funding



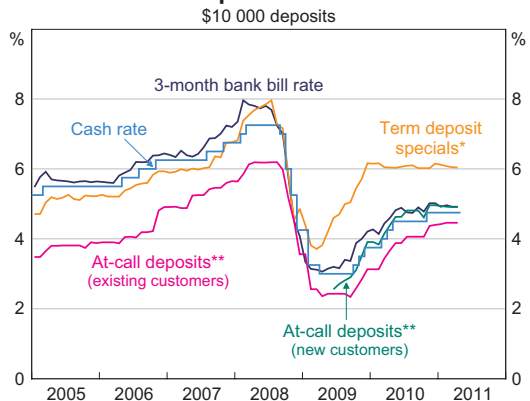
* Adjusted for movements in foreign exchange rates

** 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

Graph 4.5

Major Banks' Net Interest Margin*
Australian operations



* From 2006 data are on an IFRS basis; prior years are on an AGAAP basis; data exclude St. George Bank and Bankwest prior to 2009

Sources: RBA; banks' financial reports

Financial Intermediaries

After a significant shift in the composition of bank liabilities over the past two years, funding shares have stabilised over recent months (Graph 4.3). Short-term debt continues to account for a significantly smaller share of funding than it did previously, with deposits and longer-term wholesale funding accounting for a larger share.

There has been little movement in interest rates on deposits over recent months as the intense competition for deposits has abated somewhat. The average interest rate on the major banks' at-call deposits (including online savings, bonus saver and cash management accounts) is currently about 4½ per cent (Graph 4.4). The average rate on the major banks' term deposit 'specials', the most relevant rate for term deposit pricing, is just over 6 per cent, having stabilised at just under 100 basis points above equivalent duration market rates. On average, the smaller Australian-owned banks' 'special' term deposit rates are at similar levels to those offered by the major banks.

While the average cost of major banks' variable-rate bond funding continues to gradually rise, as bonds issued pre-crisis are rolled over at higher spreads, this process has mostly run its course. As there was also a rise in average interest rates on loans following the November cash rate increase, the major banks reported, on average, little change in their net interest margins in the first half of their 2011 financial years (Graph 4.5). Overall, margins have fluctuated in a relatively narrow range since 2004.

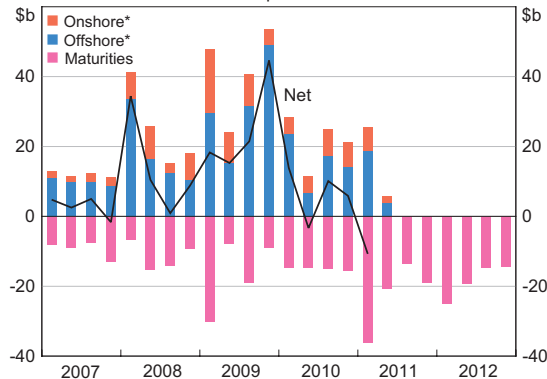
Australian major banks have issued around \$20 billion worth of bonds since the previous *Statement*, with much of the proceeds being used to roll over maturities in the March quarter of

around \$36 billion (Graph 4.6). Over the remainder of 2011, maturities are expected to average around \$18 billion per quarter. Over two-thirds of Australian major bank issuance was offshore, predominantly in the US dollar and euro markets. The banks tapped a range of maturities spanning one to seven year terms, reflecting ongoing efforts to lengthen the maturity of their funding. The recent declines in cross-currency basis swap spreads, due in part to the large volume of Kangaroo bond issuance in the March quarter (see below), have increased the attractiveness of issuing offshore for Australian banks (Graph 4.7).

In the domestic market, the cost of bank bond issuance, as measured by the spread of domestically issued bank bonds to swap, has been steady since the previous *Statement* (Graph 4.8). The announcement by Moody's in February that it had placed Australia's four major banks on review for a possible downgrade, reflecting ongoing changes to its ratings methodology, had no effect on the market.

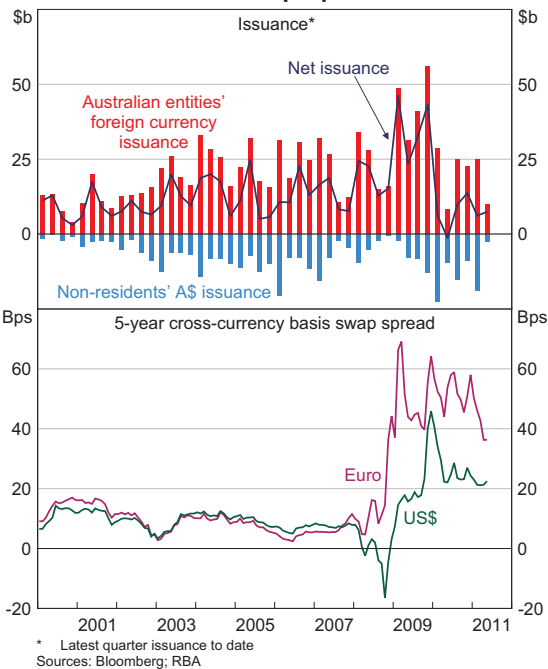
Activity in the securitisation market has picked up in recent months. Since the February *Statement*, issuance of Australian residential mortgage-backed securities (RMBS) has totalled around \$8 billion, representing eight transactions from seven issuers comprising major and smaller banks, a non-ADI

Graph 4.6
Major Banks' Bond Issuance
A\$ equivalent



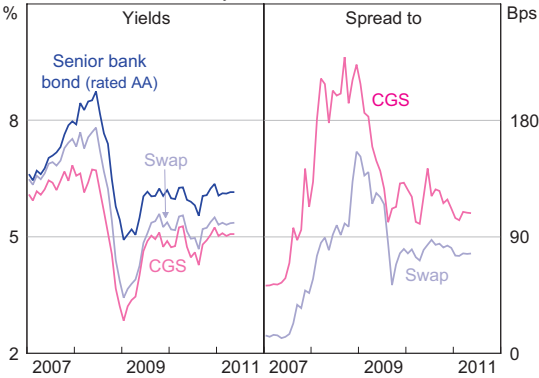
* Latest quarter issuance to date
Source: RBA

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



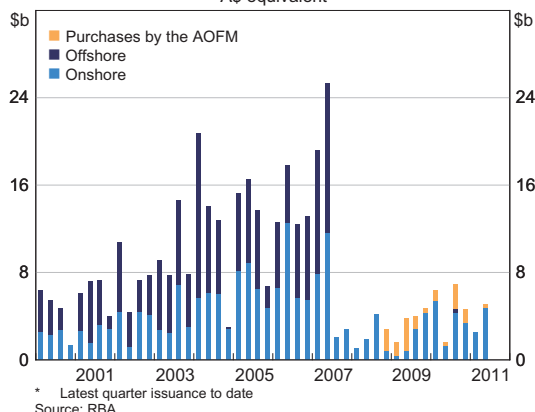
* Latest quarter issuance to date
Sources: Bloomberg; RBA

Graph 4.8
Major Banks' Bond Pricing
3-year A\$ debt

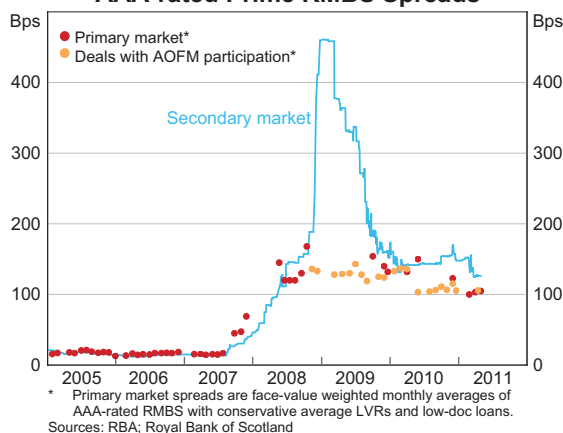


Sources: RBA; UBS AG, Australia Branch

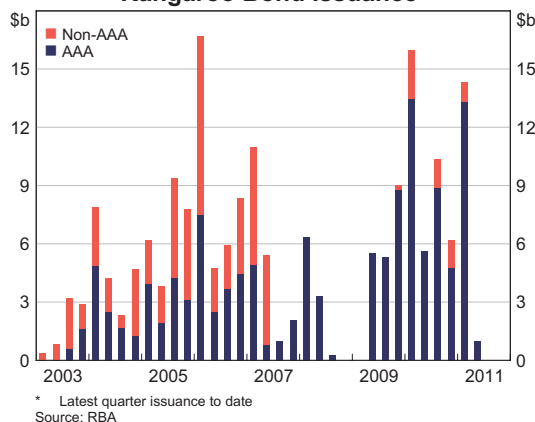
Graph 4.9
Australian RMBS Issuance*
A\$ equivalent



Graph 4.10
AAA-rated Prime RMBS Spreads



Graph 4.11
Kangaroo Bond Issuance*



issuer and a credit union (Graph 4.9). A \$3 billion issue by the Commonwealth Bank was the largest securitisation since 2007. It was issued at the lowest average weighted spread in over two years; the most senior tranche was issued with a spread of 95 basis points. The increase in demand for newly issued prime RMBS reflects a significant reduction in supply in the secondary market and more generally in the stock of outstanding RMBS. Secondary market RMBS spreads have declined to a post financial crisis low of around 125 basis points (Graph 4.10).

Private investor demand has been strong for longer-dated RMBS tranches, allowing the Australian Office of Financial Management (AOFM) to scale back its involvement to zero in some issues. The Treasurer recently announced that the AOFM will have a further \$4 billion to invest in AAA-rated Australian RMBS, taking the total amount the AOFM is permitted to invest in Australian RMBS from non-major banks to \$20 billion. To date, the AOFM has invested \$12.8 billion across 45 transactions, supporting 19 issuers.

The Australian Government has also released draft legislation that will enable Australian ADIs to issue covered bonds. After a period of consultation with industry, the legislation will be introduced to Parliament later this year. The proposed legislation sets a limit on the value of the cover pool of assets of 8 per cent of an ADI's Australian assets and modifies the depositor preference provisions of the *Banking Act 1959*.

In April, Moody's placed 56 tranches of 25 Australian RMBS transactions totalling around \$6.5 billion on review for a possible downgrade of their credit ratings. Following recent adjustments to its methodology, Moody's judged that the liquidity support in these transactions could be insufficient to mitigate the risks of payment disruptions to RMBS investors. The review, which is expected to take three months, will take into account any strengthening of liquidity support arrangements that the issuers of the RMBS put in place during that time.

Kangaroo bond issuance was particularly strong in the March quarter, totalling \$14 billion (Graph 4.11).

A significant share of this was issued by sovereign and supranational agencies from Europe, which tend to be most active at the start of the year to fund their balance sheets. Two new AAA-rated issuers have entered the market since the start of 2011.

Household Financing

Most lenders have left their indicator rates on standard variable-rate housing loans unchanged in recent months. Fixed rates were also little changed. However, competition in the mortgage market has picked up this year. In particular, the major banks have increased the discounts available on some mortgage products by as much as 20 basis points, and have waived some fees or offered new mortgage products with no fees (Table 4.1). Furthermore, some of the major banks have temporarily offered to pay the costs incurred by other institutions' customers in switching to one of their mortgage products. There has also been an increase in the maximum loan-to-valuation ratios lenders are willing to offer on loans

to new customers, although this follows reductions in 2008 and 2009.

Overall, the average interest rate on all outstanding housing loans (fixed and variable) remains a little above its post-1996 average, having risen by around 155 basis points since its trough in 2009 (Graph 4.12).

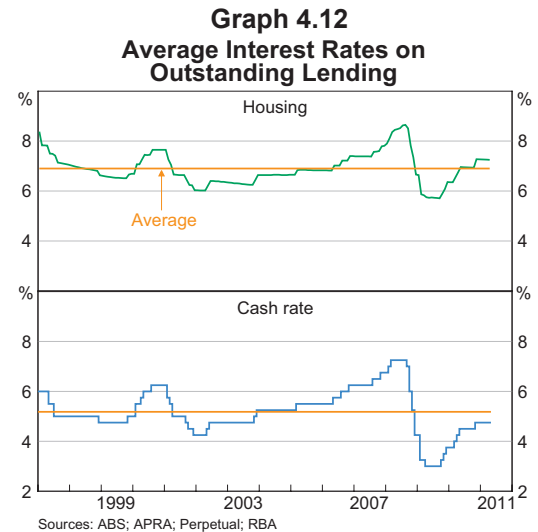


Table 4.1: Intermediaries' Lending Rates^(a)
Per cent

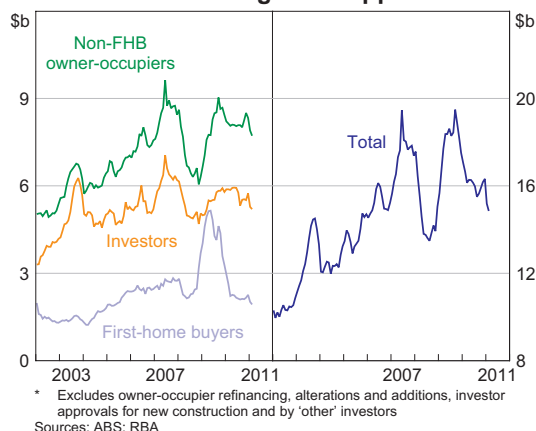
	Level at end April 2011	Change since:	
		February Statement	End April 2010
Cash rate	4.75	0.00	0.50
Housing loans^(b)	7.09	-0.06	0.59
Personal loans	12.89	-0.01	0.65
Small business			
Residentially secured			
– Term loans	8.99	0.00	0.65
– Overdraft	9.86	0.00	0.65
Average actual rate	8.82	0.00	0.48
Large business			
Average actual rate (variable and bill funding)	6.97	-0.10	0.63

(a) Variable interest rates unless otherwise indicated

(b) Average of the major banks' discounted package rates on \$250 000 full-doc loans

Sources: ABS; APRA; Perpetual; RBA

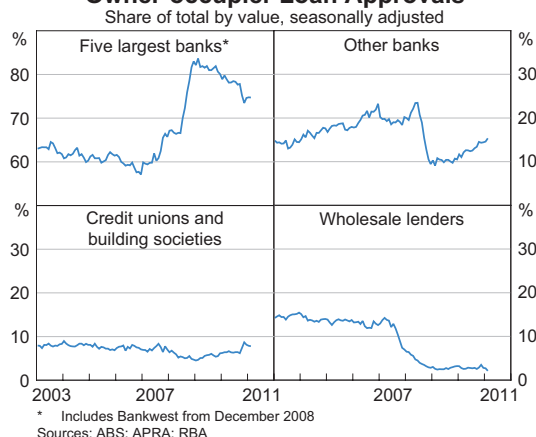
Graph 4.13
Value of Housing Loan Approvals*



The total value of housing loan approvals declined over the first two months of the year, with a reduction in approvals to both owner-occupiers and investors (Graph 4.13); the level of total approvals is now similar to that seen in late 2008. Bank liaison suggests that approvals may have fallen further in March. Some of the recent weakness in loan approvals appears to be due to the effects of flooding in the eastern states.

The recent decline in owner-occupier lending activity has been fairly broad-based across types of lenders. Over a longer period, the share of new lending by the major banks has fallen by 9 percentage points from its peak in early 2009, while the share of the regional and foreign banks has increased by 6 percentage points (Graph 4.14).

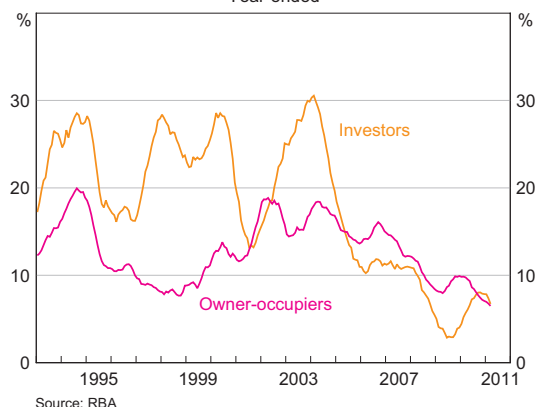
Graph 4.14
Owner-occupier Loan Approvals
Share of total by value, seasonally adjusted



Housing credit growth has continued at a monthly average pace of 0.5 per cent in the March quarter with a similar pace of lending to investors and owner-occupiers (Graph 4.15). The level of loan approvals implies a continuation of credit growth for housing at around its current pace.

Most interest rates on variable personal loans – including credit cards, home equity loans and margin loans – have remained unchanged since the end of January. Personal credit, which is a small component of household credit, rose at a monthly average rate of 0.3 per cent over the March quarter. The modest growth in recent months was largely due to increased credit card lending, while other personal lending has been broadly unchanged. The value of margin lending outstanding remains around 10½ per cent lower over the year. Margin calls remain low (at less than one call per day per 1 000 clients), reflecting low gearing levels.

Graph 4.15
Housing Credit Growth
Year-ended



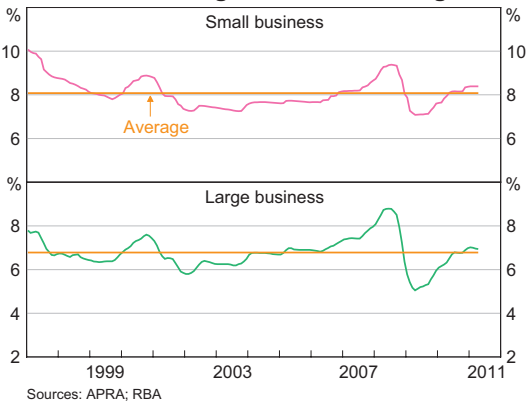
Business Financing

Indicator rates on most small business loans are little changed since the previous *Statement*. The average rate on outstanding small business loans remains about 30 basis points above its post-1996 average (Graph 4.16). The average interest rate on banks' outstanding variable-rate lending to large business (bill and term facilities of \$2 million or more) is estimated to have decreased by 10 basis points since the end of January. These loans are repriced at regular intervals off money market benchmark rates (such as the 3-month bank bill rate), which have decreased slightly in recent months. The average risk margin that banks charge above these benchmark rates appears to have stabilised, as margins on new loans have moved closer to the average margin on existing loans.

In recent months, corporate bond activity has picked up considerably (Graph 4.17), as conditions have become more favourable for corporate debt funding in a range of markets, especially the US dollar market where the bulk of recent Australian corporate issuance has taken place. A broad range of Australian companies have issued bonds for terms of between 5 and 10 years in the US dollar market, providing them with access to long-term funding, which is more difficult to obtain in the domestic corporate bond market. In the domestic market, there has also been a pick-up in investor demand for corporate debt with bonds being issued with terms of up to 5½ years and priced at narrower spreads than was the case last year.

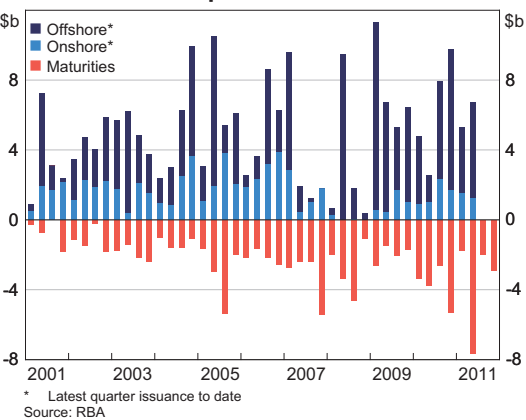
Business net external funding rose as a share of GDP in the March quarter, largely reflecting a recovery in business credit, which grew at an annualised rate of around 7 per cent over the quarter (Graph 4.18). On the other hand, equity issuance was more subdued, with corporates raising around \$5 billion of net equity in the first quarter, compared with around \$9 billion in the previous quarter.

Graph 4.16
Average Interest Rates on Outstanding Business Lending



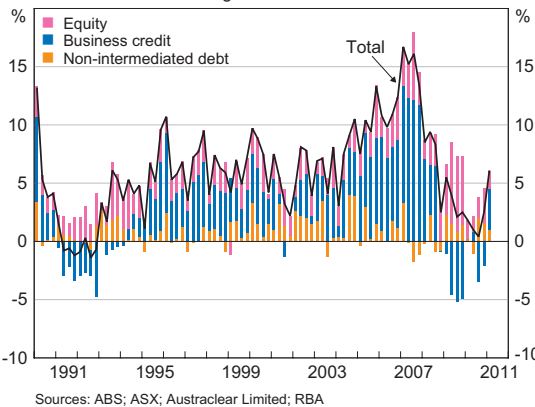
Sources: APRA; RBA

Graph 4.17
Australian Corporates' Bond Issuance



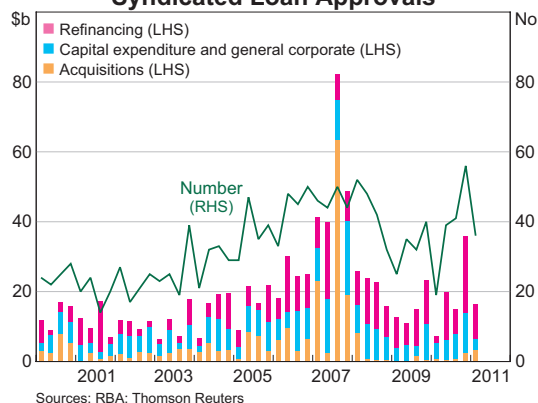
* Latest quarter issuance to date
Source: RBA

Graph 4.18
Business External Funding
Net change as a share of GDP



Sources: ABS; ASX; Austraclear Limited; RBA

Graph 4.19
Syndicated Loan Approvals

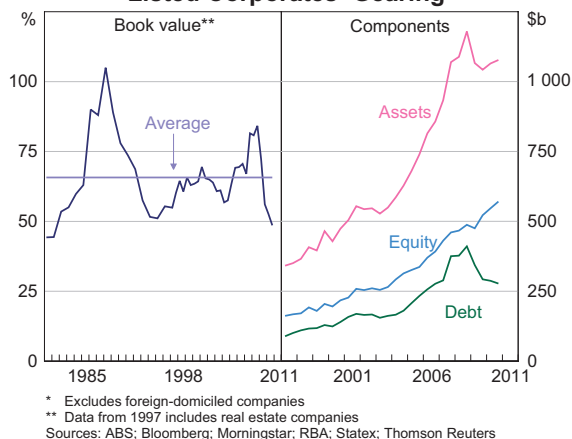


There were 36 syndicated loan deals worth around \$16 billion approved in the March quarter (Graph 4.19). While this is a significant fall from the December quarter 2010, the March quarter is traditionally the slowest of the year, and approvals were more than double their level in the March quarter 2010.

Reflecting the recent subdued pace of borrowing, there was only a marginal expansion of listed corporates' balance sheets in the second half of 2010 and gearing ratios reached cyclical lows (Graph 4.20). Book value gearing – the ratio of debt to the book value of shareholders' equity – declined to 49 per cent, the lowest level since the early 1980s. Repeating the pattern seen in the first half of 2010, the decline in gearing in the second half of the year was driven by both higher retained profits and lower debt.

Resource companies, which continue to enjoy significant increases in both profits and retained earnings, experienced the sharpest reduction in gearing and were influential in driving down the aggregate level of gearing (Graph 4.21). Real estate companies also continued to reduce their gearing, which is around 30 percentage points lower than the peak of 108 per cent in December 2008.

Graph 4.20
Listed Corporates' Gearing*



Aggregate Credit

Total outstanding credit grew at an annualised rate of around 6 per cent over the March quarter, reflecting moderate growth in household credit and a solid increase in lending to businesses. The recent growth in business credit follows falls throughout the latter half of 2010 (Table 4.2; Graph 4.22). Broad money has grown at about the same pace as the nominal economy over the year, partly reflecting a preference to hold assets in the form of deposits.

Graph 4.21
Gearing Ratios by Sector*
Listed corporates

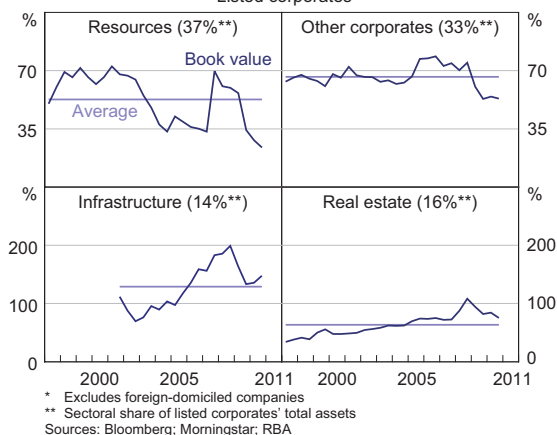
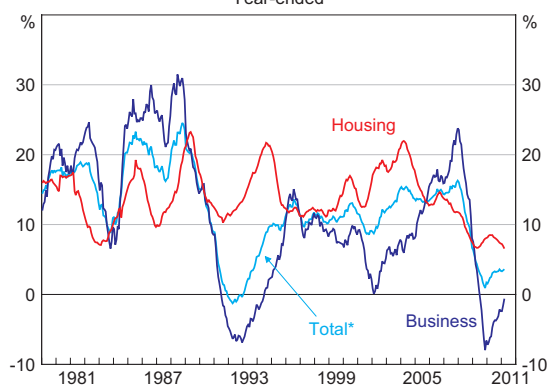


Table 4.2: Financial Aggregates
Percentage change

	Average monthly growth		Year to March 2011
	December quarter 2010	March quarter 2011	
Total credit	0.2	0.5	3.6
– Owner-occupier housing	0.6	0.5	6.5
– Investor housing	0.5	0.4	6.7
– Personal	0.0	0.3	1.0
– Business	–0.4	0.6	–0.6
Broad money	0.7	0.6	7.6

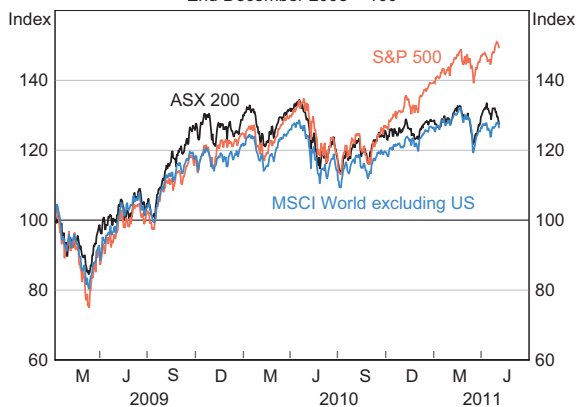
Source: RBA

Graph 4.22
Credit Growth
Year-ended



Source: RBA

Graph 4.23
Share Price Indices
End December 2008 = 100



Sources: Bloomberg; Thomson Reuters

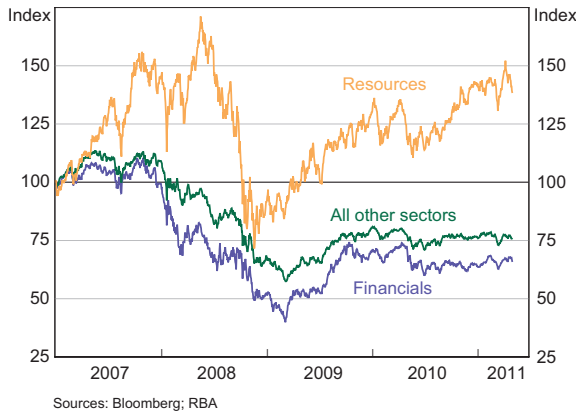
Equity Markets

Both the local and offshore equity markets fell sharply in response to the natural catastrophes in Japan (Graph 4.23). After recovering all of its decline, the Australian equity market has trended downwards, in part due to the appreciation of the Australian dollar and notwithstanding the fact that profits announced by Australian listed companies during the recent reporting season were, on average, close to market expectations. Underlying profits – which exclude

asset revaluations and other significant items – rose 34 per cent compared with the corresponding period in 2009, to \$52 billion.

Resource stocks outperformed other sectors to reach levels last seen in mid 2008, although they have subsequently retreated owing to concerns about the impact of extreme weather on production in the Australian mining sector (Graph 4.24). Earnings for resource companies increased by 39 per cent from

Graph 4.24
Australian Share Price Indices
 End December 2006 = 100



the first half of 2010 and contributed the most to the aggregate increase in profits, representing around 50 per cent of total market earnings. This increase was mainly driven by higher commodity prices.

The non-bank financial sector reported a 47 per cent increase in profits, driven mainly by the real estate investment trust and insurance sectors. Apart from resource and financial companies, other companies reported a 36 per cent rise in profits, although this partly reflects seasonal factors. Compared with earnings in the second half of 2009, other companies' profits rose just 2 per cent.

For the first half of the 2011 financial year, the major banks reported that underlying, after-tax profits were 9 per cent higher than the first half of the 2010 financial year at \$11 billion. The banks' underlying, after-tax return on equity rose by 0.3 percentage points to 15 per cent, reflecting a further reduction in bad and doubtful debt expenses. Profits were also supported by modest balance sheet growth.

Shareholder distributions for the market as a whole rose sharply in the most recent half compared with the previous period, largely owing to share buybacks by BHP and Rio Tinto.

Since the previous *Statement*, just over \$13 billion worth of merger and acquisition deals were announced. AMP's \$13 billion acquisition of AXA Asia Pacific proceeded in early April. Other large deals announced include a \$4 billion tie up between West Australian Newspapers and Seven Media Group, and BHP's purchase of Chesapeake Energy's gas-producing assets in Arkansas, United States, for \$5 billion. Around \$27 billion of deals are pending. However, Singapore Stock Exchange's \$8.3 billion proposed merger with the ASX was formally rejected by the Federal Treasurer on the recommendation from the Foreign Investment Review Board that the proposal was not in the national interest. ❖