

3. Domestic Financial Conditions

The reductions in the cash rate this year have resulted in more accommodative financial conditions for households and large businesses. Financial markets have priced in some chance that the cash rate will be reduced by a further 25 basis points in 2020. Government and corporate bond yields have declined over 2019 across all maturities and remain around historic lows. Consistent with the low level of the cash rate, banks' funding costs have declined to historically low levels, as have housing and business interest rates.

There has been a pick-up in approvals for housing loans in recent months alongside the stronger conditions in some housing markets. However, the increase in approvals has not yet translated into a material increase in the growth of housing credit. To date, the pick-up in new borrowing has been accompanied by faster repayment of existing loans. This is consistent with historical experience that only a small share of borrowers on variable-rate mortgages actively adjust their scheduled repayments in the months following interest rate reductions. Growth in business debt has decreased and small businesses' access to funding remains difficult. Australian equity prices have increased in recent months, in line with international markets, to be around the historically high levels reached in July. The value of the Australian dollar remains around its lowest level in some years.

The cash rate has been reduced by 75 basis points this year

Following the reductions at the June and July Board meetings, the cash rate target was

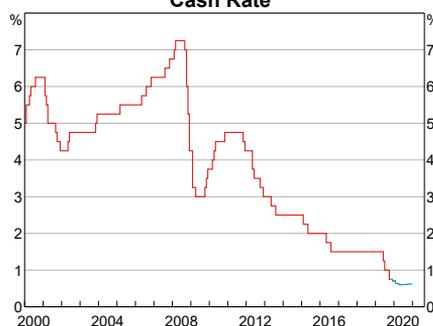
lowered by a further 25 basis points in October, to 0.75 per cent. Financial markets have priced in some chance that the cash rate will be lowered by a further 25 basis points next year (Graph 3.1).

Government bond yields remain around their historic lows

Yields on Australian Government Securities (AGS) declined over much of 2019 to reach historic lows, and have remained around these levels in recent months (Graph 3.2). This is in line with developments in yields on government bonds in other advanced economies, which have remained low against the backdrop of ongoing trade disputes, expectations for slower global growth, subdued inflation and widespread monetary policy easing. After declining for several years, the spread between US Treasury and AGS yields has been stable since early 2019; the AGS 10-year yield is currently around 60 basis points below the 10-year US Treasury yield.

Graph 3.1

Cash Rate*



* Data from November onwards are expectations derived from interbank cash rate futures
Sources: ASX; Bloomberg

Short-term money market spreads have been little changed

Following a significant decline over the first half of this year, bank bill swap (BBSW) rates increased a little relative to overnight indexed swaps (OIS) in recent months. Spreads of interest rates to OIS in the markets for repurchase agreements (repo) and 3-month foreign exchange (FX) swaps also declined since early 2019 and were broadly unchanged over recent months (Graph 3.3). For tenors of less than one month, the implied cost of obtaining Australian dollars in the AUD/USD FX swap market fell sharply relative to OIS in September for a period (Graph 3.4). This reflected an increase in net demand for US dollars in money markets, which sharply increased short-term US dollar repo rates in mid September (see ‘The International Environment’ chapter). Meanwhile, the cash rate continued to trade at the Reserve Bank Board’s target.

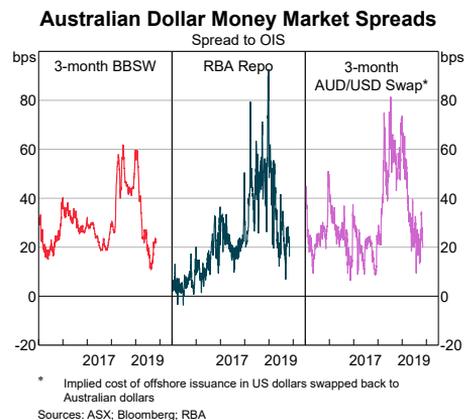
Banks’ demand for new wholesale funding remains low

Australian banks have issued around \$75 billion of senior unsecured bonds since the beginning of the year, which is about a quarter less than the average of the past few years. Issuance in net terms, which takes into account maturing bonds, has been negative (Graph 3.5). In the

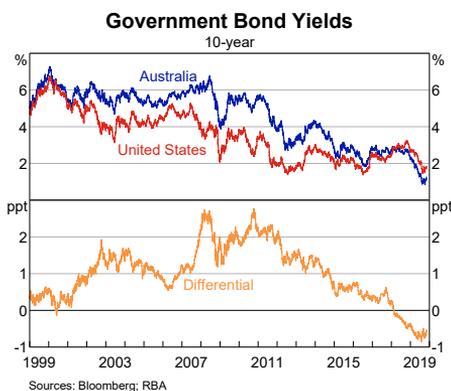
September quarter, over three-quarters of the total value of bank bonds were issued in the domestic market, where pricing has been a little more favourable than the cost of raising funds in offshore markets (after accounting for hedging costs).

The low issuance of unsecured bonds is in part because major banks have increased their issuance of Tier 2 hybrid securities significantly in recent months, issuing \$12 billion worth of these instruments after the Australian Prudential Regulation Authority (APRA) announced an increase in major bank capital requirements in July. Hybrid securities have both equity and debt features and can be used to fulfil a part of

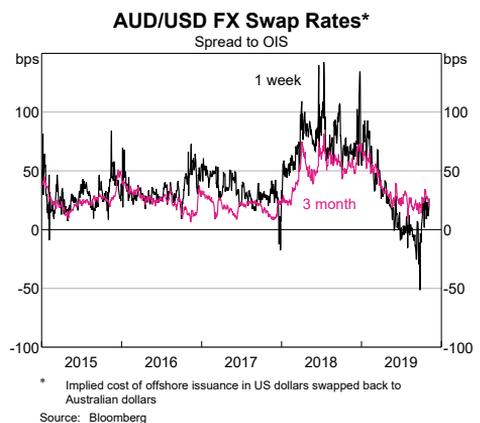
Graph 3.3



Graph 3.2



Graph 3.4



regulatory capital requirements. To date, pricing of these recently issued hybrids has been within the range of similar hybrids in recent years.

Issuance of asset-backed securities (ABS) fell back a little in the past quarter, following very high issuance in the June quarter, driven by issuance of residential mortgage-backed securities (RMBS) (Graph 3.6). A number of firms issued their first public asset-backed securities in the past few months.

Banks' funding costs are at historic lows

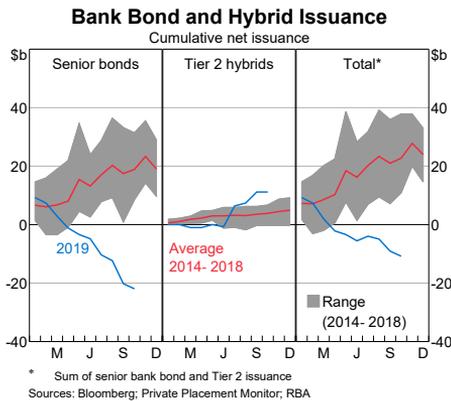
Banks' (non-equity) funding costs have declined significantly in 2019, reflecting the effect of

actual and expected reductions in the cash rate on wholesale funding costs and deposit rates and, to a lesser extent, narrower spreads on wholesale debt (Graph 3.7). Bank bond yields have fallen sharply in 2019, driven primarily by declines in the risk-free reference rates (Graph 3.8). The spreads of major bank bond yields to reference rates ticked up slightly over recent months, but remain lower than at the beginning of the year.

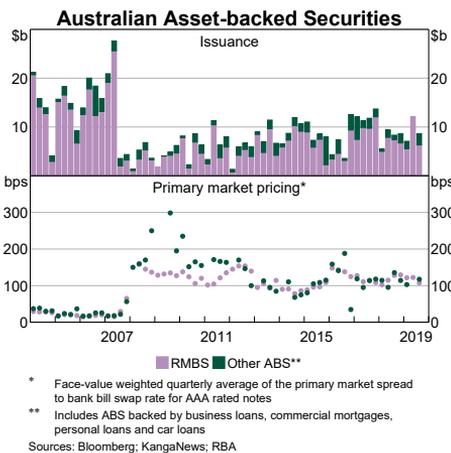
Retail deposit rates have declined to historic lows

Banks have passed through most of the reductions in the cash rate to a wide range of retail deposit rates. Following the cumulative 75 basis point reduction in the cash rate this

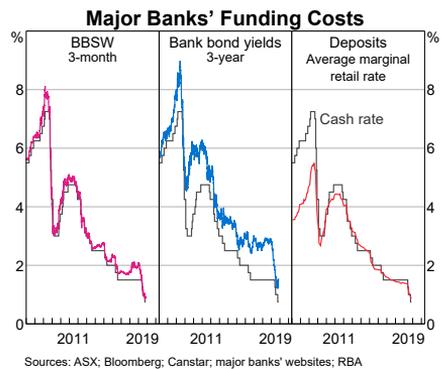
Graph 3.5



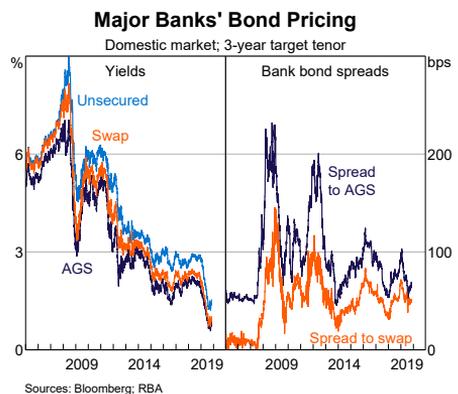
Graph 3.6



Graph 3.7



Graph 3.8



year, banks are estimated to have lowered the interest rates on at-call retail deposits by an average of 60 to 70 basis points. The major banks are estimated to have decreased their term deposit rates by around 90 basis points since the beginning of the year. However, as is typical, the interest rates on most transaction accounts (which are usually close to zero) did not change following the reductions in the cash rate.

Following the reductions in the cash rate, the major banks are estimated to be paying very low interest rates (between zero and 50 basis points) on around one-quarter of their deposit funding, compared with around 10 per cent previously. Most deposits (by value) in Australia currently receive interest over 1 per cent.

Deposits are the largest source of bank funding

The composition of the banks' funding has been little changed over the past year, with domestic deposits estimated to comprise around 55 per cent of banks' total funding liabilities (including equity) (Graph 3.9).

The Reserve Bank revised its estimates of the funding composition of banks when improved data became available with the new Economic and Financial Statistics (EFS) collection (see 'Box C: Updates to the Financial Aggregates'). The share of funding from deposits is about 55 per cent, which is a bit lower than the previous estimate (of around 60 per cent). Nevertheless, the rise in deposit funding since the financial crisis is still evident in the revised series, and deposits account for close to twice the share of funding obtained from wholesale debt markets.

Housing lending rates have also declined to historic lows

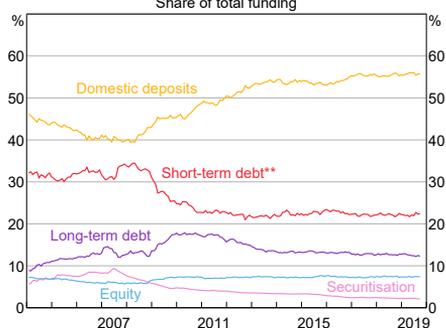
A large share of the recent monetary policy easing has been passed through to mortgage

rates paid by households. Following the cumulative 75 basis point reduction in the cash rate this year, lenders have lowered their standard variable rates (SVRs) on housing loans by an average of 60 basis points (Graph 3.10; Table 3.1). Moreover, estimates suggest that the average rate paid on outstanding variable-rate loans has declined by an additional 5 basis points or so, reflecting two trends. First, rates on new and refinanced loans tend to be lower than for existing loans amid strong competition for high-quality borrowers. Second, switching from interest-only loans to (lower-rate) principal-and-interest loans has also contributed. If these two trends continue, the average rate paid could decline further in coming months. Cumulatively, average mortgage rates paid would then have declined by almost the same amount as the cash rate has since mid year.

The extent of pass-through from the cash rate reductions to lower SVRs was similar across different types of banks. Lenders decreased their SVRs for investor interest-only (IO) loans by more than for other types of housing loans.

Between May and September – which is the latest month for which data are currently available – the average interest rate paid on outstanding variable-rate loans in the Securitisation Dataset decreased by around

Graph 3.9
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: ABS; APRA; Bloomberg; RBA; Refinitiv; Standard & Poor's

Table 3.1: The Cash Rate and SVRs

Basis points

	Cash rate change	Average SVR change
November 2011	-25	-24
December 2011	-25	-25
May 2012	-50	-37
June 2012	-25	-21
October 2012	-25	-19
December 2012	-25	-20
May 2013	-25	-25
August 2013	-25	-26
February 2015	-25	-26
May 2015	-25	-21
May 2016	-25	-23
August 2016	-25	-12
June 2019	-25	-23
July 2019	-25	-21
October 2019	-25	-15

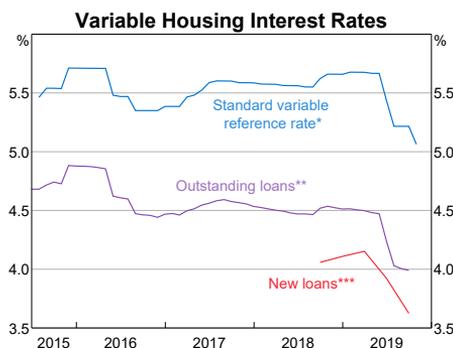
Sources: Major banks' websites; RBA

50 basis points. This compares with a 50 basis point reduction in the cash rate and a 44 basis point reduction in SVRs over this same period. Over the past few months, the interest rate paid on IO loans decreased by more than that paid on other housing loans, consistent with the larger decreases in banks' SVRs for investor IO

loans (Graph 3.11). Nonetheless, mortgage rates on IO loans remain well above those on principal-and-interest (P&I) loans.

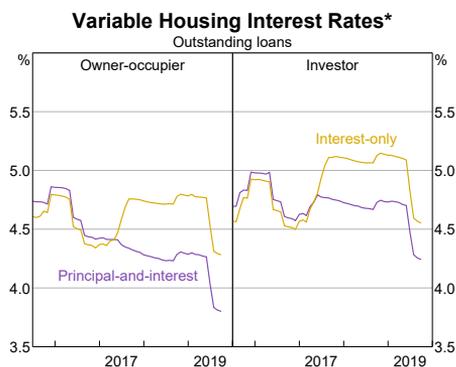
Housing interest rates paid had already been drifting lower prior to the reductions in the cash rate and SVRs. This downward drift – over and above movements in SVRs – has continued over

Graph 3.10



* Data to October; average across major banks' rates;
 ** Data to September; average of securitised loans weighted by institution housing credit share
 *** Data to September; quarter average of new lending rates based on APRA data
 Sources: APRA; major banks' websites; RBA; Securitisation System

Graph 3.11



* Data to September; average of securitised loans, re-weighted using housing credit shares
 Sources: APRA; RBA; Securitisation System

recent months (see 'Box D: The Distribution of Variable Housing Interest Rates'). Again, there are two reasons for this. First, the average interest rate on new loans – to new borrowers or to existing borrowers that refinance their loans with another institution – remains lower than that on outstanding loans. This has been a feature of the market for some time. Consistent with this, liaison with the major banks, mortgage brokers and non-authorised deposit-taking institutions (non-ADIs) indicates that competition for high-quality borrowers remains strong. Furthermore, competition for these borrowers also means that well-informed households with existing loans have been approaching their current lenders to request a reduction in their interest rate.

The second reason for the drift lower in outstanding variable rates is that households are continuing to switch from IO loans to P&I loans (which tend to have lower interest rates). Many households are doing so before their IO period expires. In the first half of 2019, around \$50 billion of IO loans were switched to P&I loans at the major banks (equivalent to around 5 per cent of the outstanding stock of housing credit at the major banks). Just under one-third of these loans were switched prior to the expiry of their IO period. This switching is estimated to have decreased outstanding interest rates by about 3 basis points over the past year.

Advertised interest rates on fixed-rate housing loans also continued to decline. The major banks reduced their owner-occupier 3-year fixed rates by an average of 100 basis points over the past year. This is consistent with lower rates on interest rate swaps, which are often used as a pricing benchmark for these loans.

To date, households have not reduced their mortgage payments

The decreases in interest rates paid following the reductions in the cash rate mean that required mortgage payments for households with

variable-rate mortgages – which account for around 80 per cent of the stock of outstanding housing credit – have declined. It is likely to take some time, however, for households to respond to mortgage rate reductions by lowering their scheduled payments. Indeed, historical evidence suggests that only a small share of borrowers actively adjust their scheduled payments in the months following an interest rate reduction.

It is possible that borrowers will reduce their scheduled payments in response to the decline in interest rates to a lesser extent than they have in the past. In particular, if there is a reduced appetite for debt among households, depending on cash-flow constraints, they would be less inclined to reduce their payments (both scheduled and unscheduled) in the face of lower interest rates. In that case, the additional cash flows they receive via lower interest rates will be used to pay down mortgages faster than otherwise, at least for a period. At the same time, however, it has become easier for lenders to communicate with their customers about their ability to reduce their scheduled payments and for customers to accept such offers – via online banking applications and emails. Moreover, borrowers do not need to reduce scheduled payments to avail themselves of their additional available cash flows after a reduction in their mortgage rates. Offset accounts (which are more prominent than they have been in the past) and redraw facilities enable households to change their spending patterns even if they choose to maintain their scheduled payments. Many households are ahead on their mortgages and have offset and/or redraw balances that will grow more rapidly to the extent that scheduled payments are unchanged in the face of lower interest rates.

Housing loan approvals have increased over the past few months

Consistent with stronger conditions in some housing markets, housing loan approvals have

Table 3.2: Financial Aggregates

Percentage change^(a)

	Three-month-ended annualised		Six-month-ended annualised	
	Jun 2019	Sep 2019	Mar 2019	Sep 2019
Total credit	1.6	2.8	3.3	2.2
– Housing	2.6	3.0	3.3	2.8
– Owner-occupier housing	4.1	5.4	4.8	4.8
– Investor housing	–0.3	–1.1	0.4	–0.7
– Personal	–4.6	–5.3	–3.8	–4.9
– Business	0.9	3.7	4.4	2.3
Broad money	2.4	3.3	5.0	2.8

(a) Seasonally adjusted and break-adjusted

Sources: ABS; APRA; RBA

increased since May (Graph 3.12). This has been driven largely by a sharp increase in owner-occupier approvals, although investor loan approvals have also increased. The increase has been broadly based across states and banks.

Credit growth has slowed in 2019, but stabilised in recent months

Total credit growth has slowed over the past year, driven by both housing and business credit, to be around 2¼ per cent on a six-month-ended annualised basis, although growth rates have stabilised in recent months (Graph 3.13;

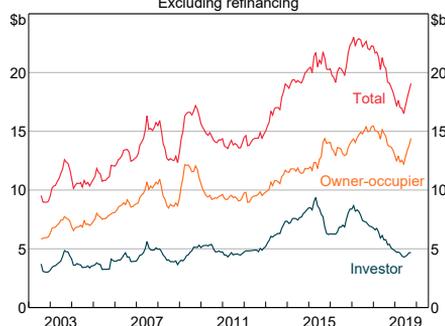
Table 3.2). The implementation of the new EFS collection has not changed the Reserve Bank’s assessment of growth in credit for Australian households and businesses (see ‘Box C: Updates to the Financial Aggregates’).

To date, the increase in owner-occupier loan approvals over the past few months is not evident in materially higher credit growth. Growth in housing credit extended to owner-occupiers has stabilised to be around 4¾ per cent in six-month-ended annualised terms (Graph 3.14). The divergence between owner-occupier loan approvals and housing

Graph 3.12

Housing Loan Approvals*

Excluding refinancing

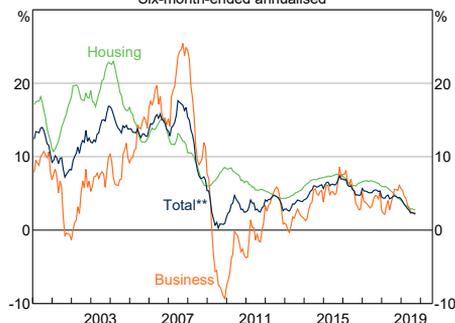


* Seasonally adjusted and break-adjusted
Sources: APRA; RBA

Graph 3.13

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

credit for owner-occupiers implies that the increase in new loans has been accompanied by faster repayment of existing loans. This is consistent with the behaviour of borrowers during the period of monetary policy easing from 2011 to 2016, when housing credit growth increased only gradually following increases in loan approvals.

The stock of housing credit for investors continued to decline a little further in September, despite recent increases in investor loan approvals. Credit extended by the major banks to investors continued to contract.

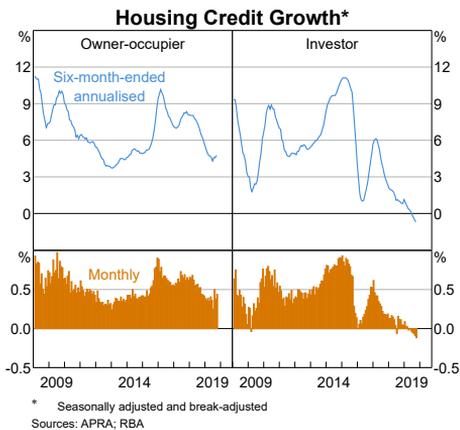
Growth in business debt slowed in recent months

Despite accommodative funding conditions for large businesses, growth in business debt decreased in September on a six-month-ended annualised basis. This was driven by slower growth in 'other' (syndicated) lending (by entities that do not report to APRA) and a further decline in the growth in borrowing from ADIs (that is, business credit) (Graph 3.15).

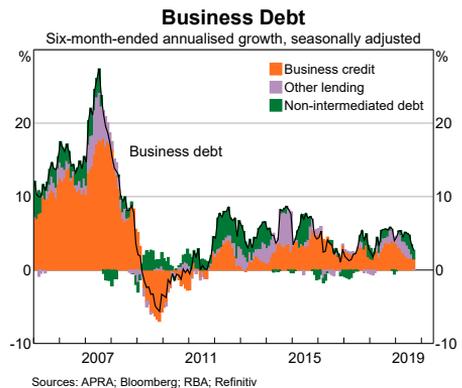
Business loan approvals have fluctuated around the same level since 2016. Loan approvals for commercial property are elevated, reflecting approvals from the major banks and foreign banks (Graph 3.16). Loan approvals for

residential property are no longer declining, following a few years of consistent declines. Liaison indicated that given weak demand – particularly from housing investors currently – it is hard for residential property developers to meet banks' lending conditions on pre-selling a sufficient number of apartments. In response, developers are obtaining finance from non-ADIs that typically accept a lower rate of pre-sales in exchange for other conditions (such as lower loan-to-valuation ratios). Loan approvals in a range of other industries have been mixed over recent months.

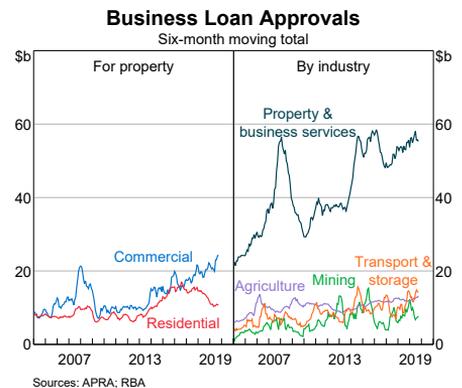
Graph 3.14



Graph 3.15



Graph 3.16



Small businesses' access to funding remains difficult

Lending to small businesses has been unchanged over the past year or so. Small businesses have reported in surveys that their access to finance has become more difficult over this period. This is consistent with liaison, in which banks reiterated that their appetite to lend to small businesses has not changed. However, they appear to be applying the more onerous responsible lending rules required for consumer lending to some small business lending. Banks note that the additional verification of income and expenses now required for housing lending has been extended to many small businesses, particularly where there is no clear separation of personal and business finances. In particular, it has become increasingly difficult for small business owners to provide the evidence required by banks that they can service a loan, as their income tends to be volatile.

Interest rates on business loans have declined to historic lows

Interest rates on loans to large businesses – which tend to move with BBSW rates – are estimated to have declined over the past six months and are at very low levels (Graph 3.17).

Lending rates on outstanding loans to small businesses decreased by around 40 basis points following the reductions in the cash rate in June and July (the latest data available are for the September quarter). Advertised rates on residentially secured small business loans decreased by around 35 basis points since May.

Australian equity prices have increased this year

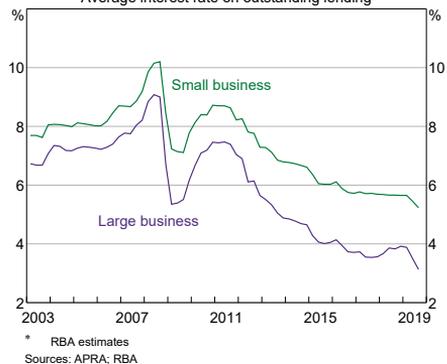
The ASX 200 is around 20 per cent higher than at the start of 2019, and has performed broadly in line with overseas markets when dividend payments are taken into account (Graph 3.18).

Market volatility was around its long-run average in recent months.

The rise in share prices since the start of the year has been broadly based (Graph 3.19). The healthcare sector has performed particularly strongly. Share prices of resource companies have increased by around 15 per cent, supported by higher iron ore and oil prices, although in recent months both commodity prices and resource stocks have declined somewhat. Banks' share prices have increased by around 10 per cent since the beginning of the year.

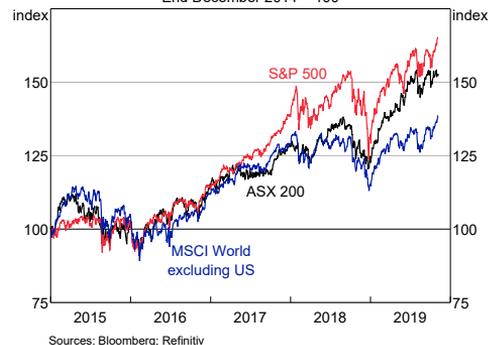
Merger and acquisition (M&A) activity has continued to be strong in recent months; recent deals have been announced in the resources,

Graph 3.17
Variable Business Lending Rates*
Average interest rate on outstanding lending



Graph 3.18

Total Return Indices
End December 2014 = 100



manufacturing and agriculture industries (Graph 3.20).

Profits of listed companies are higher than a year ago

Aggregate underlying profits of ASX 200 companies were 8 per cent higher in the first half of 2019 compared with the same period in 2018 (Graph 3.21). The increase reflected higher earnings primarily for energy, mining materials and healthcare companies. Underlying profits growth for the energy and mining materials sectors was strong, driven by increases in both sales volumes and realised prices.

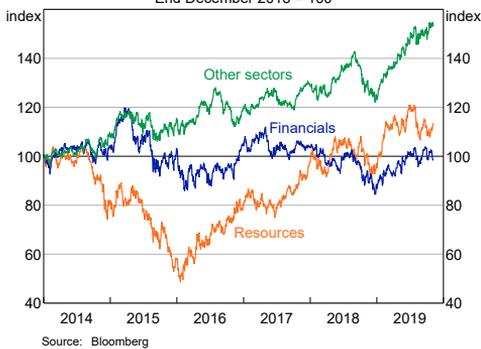
Resources firms continued to return capital to shareholders in the first half of 2019.

Underlying profits for the financial sector were little changed relative to the first half of 2018, with a decline in earnings at diversified financial corporations offset by an increase in earnings among insurers. Banks' underlying profits were flat in the half.

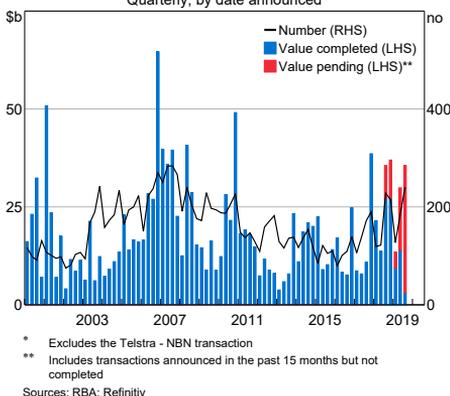
Underlying profits for listed companies outside the resources and financial sectors declined slightly compared with the same period last year. The real estate and utilities sectors, along with some construction-exposed industrial companies, reported weaker profits, while profit results within the consumer sector were mixed. The healthcare sector posted strong profits growth, supported by increased demand for health services.

At an aggregate level, Australian listed firms' dividend payments were above average in late 2018 and early 2019 (Graph 3.22). The high level of dividend payments in the past year has been concentrated among mining firms, which returned cash to shareholders following major asset sales. Outside of the energy and materials sector, dividend payments were broadly in line with underlying profits. Share buybacks, which tend to be much smaller than dividends, were also elevated in late 2018, although they

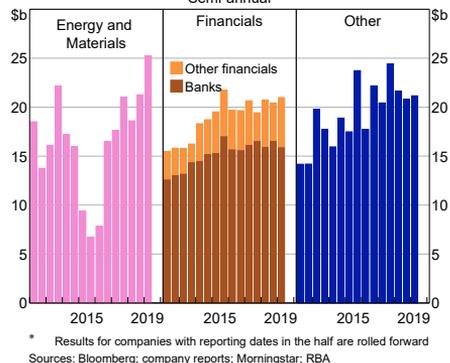
Graph 3.19
Australian Share Prices
End December 2013 = 100



Graph 3.20
M&A by Listed Australian Companies*
Quarterly, by date announced



Graph 3.21
ASX 200 Underlying Profits*
Semi-annual



declined substantially in the first half of 2019. As with dividends, the high value of buybacks in late 2018 was driven by mining firms.

The Australian dollar is around its lowest level in some years

The Australian dollar has depreciated by around 10 per cent over the past couple of years on a trade-weighted (TWI) basis and against the US dollar (Graph 3.23). This depreciation has been broad based against the currencies of Australia’s trading partners. Over this period, government bond yields in Australia have declined by more than those in major markets. This is consistent with policy rate expectations in Australia falling by a greater extent than those in other economies (some of which already had policy rates at very low levels). Following a sharp decline in August, the RBA Index of Commodity Prices is close to levels observed over the past few years. Taken together, these developments are consistent with the Australian dollar being around its lowest level for some years on a TWI basis.

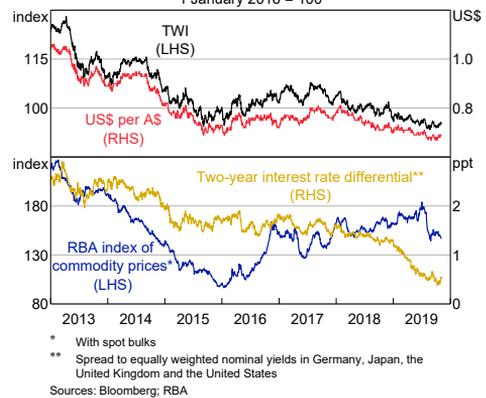
Australia was a net lender of capital in the June quarter

Gross capital outflows exceeded capital inflows in the June quarter, consistent with Australia

recording its first quarterly current account surplus since June 1975 (Graph 3.24) (see ‘Domestic Economic Conditions’ chapter). At a sectoral level, outflows from superannuation funds and other investment funds increased. There were also modest outflows from the government and mining sectors. These outflows were partly offset by inflows to the non-mining private sector (mainly in the form of foreign direct investment) and, to a lesser extent, the banks.

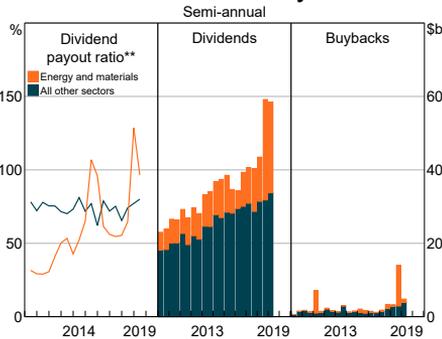
The value of Australia’s net foreign liability position remains around its lowest level since 2002. However, over this period, the

Graph 3.23
Australian Dollar
1 January 2016 = 100



Graph 3.22

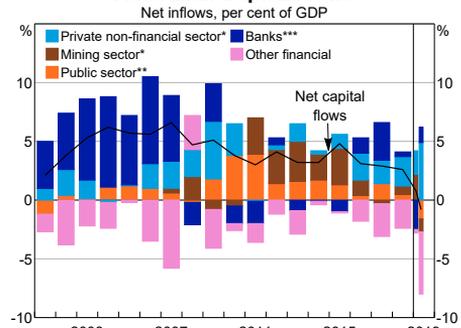
ASX Dividends and Buybacks*



* Dividend payout ratio and dividends are for ASX 200 firms; buybacks are for all ASX-listed firms.
** Dividends paid as a percentage of underlying profits
Sources: Bloomberg; Company Reports; Morningstar; RBA

Graph 3.24

Australian Capital Flows



* Prior to 2007 the mining sector is included in the private non-financial sector
** Excludes official reserves and other RBA flows
*** Adjusted for US dollar swap facility in 2008 and 2009
Sources: ABS; RBA

composition of Australia's stock of foreign liabilities and assets has changed significantly. An increase in net long-term debt liabilities has been offset by a decline in net short-term debt liabilities (Graph 3.25). In addition, Australia has moved to a net foreign equity asset position, largely reflecting the accumulation of offshore equity holdings by the superannuation sector. The value of the net foreign equity asset position has also increased over recent years due to returns on foreign equities outperforming returns on Australian equities and a depreciation of the Australian dollar (which supports the value of unhedged offshore equity holdings). ↗

Graph 3.25

Net Foreign Liabilities
By type, per cent of GDP

