

## 2. Household and Business Finances

---

Risks posed to the Australian household sector continue to stem largely from the housing and mortgage markets. Investor demand has remained high in an environment of ongoing strong growth in housing prices in Sydney and Melbourne and vigorous competition among lenders. As noted in previous *Reviews*, heightened investor activity and borrowing can amplify the upswing in housing prices and increase the risk of significant price falls later on. It can also lead to excessive housing construction, especially given the typical lags involved in completing new apartment buildings; the risk of oversupply is rising in some apartment markets. While housing lending standards have been better in recent years than in the years leading up to the financial crisis, recent investigations by regulators have revealed that standards were somewhat weaker than had originally been thought. As a result, some borrowers have had less of a safety margin against unexpected falls in income, increases in expenses or increases in interest rates.

However, in response to the supervisory actions undertaken by the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) in 2015 to date, many lenders have changed their price and non-price lending terms and conditions. Lending practices and standards have therefore strengthened and there are now tentative signs of a slowdown in the pace of growth in investor credit. Furthermore, although the gross household debt-to-income ratio has risen to new highs, households continue to build up mortgage buffers

and indicators suggest that financial stress in the household sector remains low.

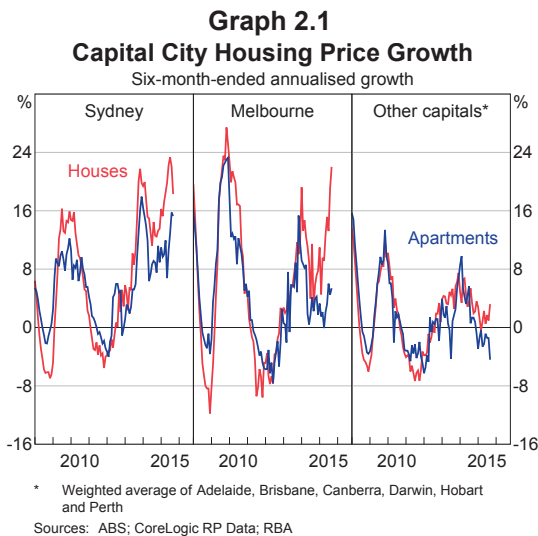
Risks are rising in the commercial property sector. Yields have fallen to low levels, due to continued strength in offshore and local investor demand, despite generally soft leasing conditions. Oversupply is also evident in the Perth and Brisbane office markets. The risk that prices might fall in the future has therefore increased, particularly if global interest rates were to rise or foreign investor demand was to weaken. The possibility of a downturn in some apartment markets has also increased risks for residential property developers. Any such fall in prices would reduce developers' equity in projects underway and increase the likelihood of settlement failures on pre-sold apartments in these areas. Nonetheless, the risks to the domestic financial system have been lessened by the significant decline since the financial crisis in banks' exposures to the commercial property sector, as a proportion of their assets, although growth in such lending has started to pick up again in recent years.

Other parts of the business sector continue to pose little near-term risk to the financial system. While the sustained falls in commodity prices have weighed on resource-related companies' ability to service their debts, particularly for smaller resource producers and mining-services companies, the domestic banks' exposure to this sector is fairly limited. In the non-mining sector, business finances generally remain in good shape and indicators of financial stress are low.

## Household Sector

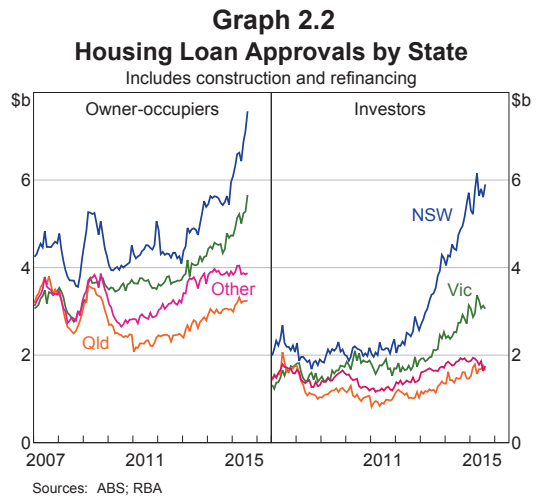
### Housing market developments

Housing price growth has picked up to a very rapid pace in Sydney and Melbourne over the past six months, particularly for detached houses (Graph 2.1). Growth in apartment prices has been slower, as strong demand from investors has in part been met by a large increase in new apartment supply in these cities. Outside of Sydney and Melbourne, investor demand has remained more modest and housing price growth has been much slower and generally more similar across houses and apartments. Recently there have been tentative signs of some slowing in the Sydney and Melbourne housing markets: auction clearance rates have fallen and price growth has eased in Sydney of late.



At the time of the previous *Review*, APRA and ASIC had recently announced a range of measures in response to risks relating to lending for housing. These included guidance from APRA that it may take supervisory action where an individual authorised deposit-taking institution's (ADI's) investor housing loan portfolio grows by materially more than 10 per cent a year. While annual growth in investor housing credit nationwide has since stabilised at slightly above 10 per cent, after picking up through 2014,

loan approvals data suggest that the overall level of investor demand has remained strong, especially in New South Wales and Victoria (Graph 2.2). Loan approvals for owner-occupiers have reportedly increased sharply in the past month or so. Large data resubmissions by several banks also indicate that the level of investor lending over recent years has been higher than had initially been reported. Over recent months, lenders have announced changes to a range of price and non-price lending terms and conditions to strengthen lending practices and respond to supervisory expectations (for details, see 'The Australian Financial System' chapter). Since then, there have been tentative signs that investor demand has started to cool.

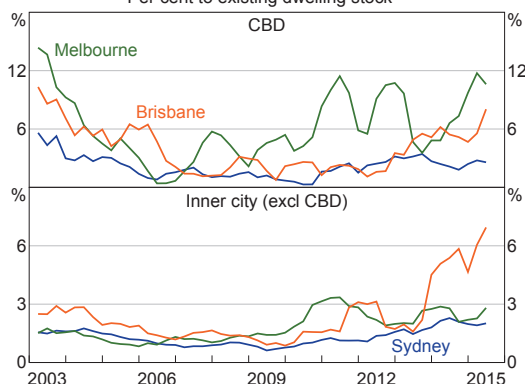


As discussed in previous *Reviews*, the main risk from a high level of investor activity arises from its potential impact on housing prices and its interaction with leverage. Specifically, this activity can amplify the run-up in housing prices and hence increase the risk of prices falling significantly later on. Investors are more likely to contribute to the run-up in prices than owner-occupiers because the rationales for their purchases differ: capital gains are likely a greater motivating factor for investors, and rising prices can induce even more investor demand by increasing expectations for future price rises. Investors also tend to face fewer barriers to exit when the market turns down. Because most home buyers, whether

owner-occupiers or investors, purchase with leverage, a sizeable price fall could induce financial distress for some households. More generally, it could affect financial stability indirectly, by weighing on wealth and spending across the household sector and thereby dampening the broader economy and labour market. Furthermore, the risk to the stability of financial institutions increases the longer the elevated rates of investor lending and housing price growth persist.

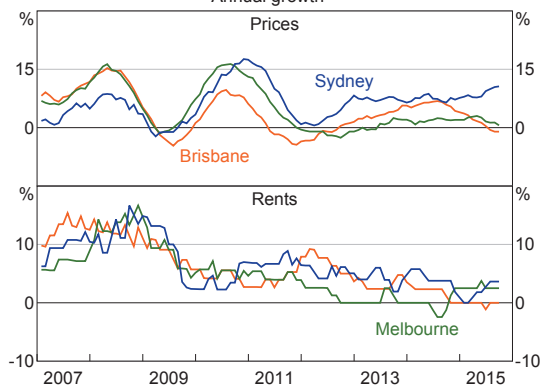
Another risk arising from robust investor activity is that speculative demand could lead to an excessive increase in construction activity and future supply overhang. While the housing market remains a long way from oversupply nationwide, some geographic areas appear to be reaching that point, particularly the inner-city areas of Melbourne and Brisbane. Apartment approvals remain at very high levels in these areas, even though these rental markets already look soft; apartment prices have been little changed in the past year, rental vacancy rates are relatively high and growth in rents is subdued (Graph 2.3 and Graph 2.4). If prices were to fall significantly in these areas due to oversupply, the main risk to financial stability would be through negative effects on the financial health of residential developers (see the 'Commercial Property' section below).

**Graph 2.3**  
**Residential Building Approvals\***  
Per cent to existing dwelling stock\*\*



\* Four-quarter rolling sum  
\*\* Dwelling stocks estimated by RBA  
Sources: ABS; CoreLogic RP Data; RBA

**Graph 2.4**  
**Inner City Apartments\***  
Annual growth\*\*



\* SA4 regions: Sydney – City and Inner South, Melbourne – Inner and Brisbane – Inner City  
\*\* Rolling 12-month average growth rate  
Sources: CoreLogic RP Data; RBA

Investment in residential property by self-managed superannuation funds (SMSFs) continues to grow quickly. According to Australian Taxation Office data, borrowing for such investment also continues to increase, with the level of borrowing recently revised significantly higher, although it still amounts to less than 3 per cent of SMSFs' total assets. As noted in previous *Reviews*, borrowing by SMSFs for property investment could, at the margin, introduce new vulnerabilities in the financial system, because it provides a vehicle for potentially speculative property demand that did not exist in the past. This is one reason why the Reserve Bank, in its submissions to the Financial System Inquiry, recommended that borrowing by superannuation funds be restricted.<sup>1</sup>

## Housing lending standards

Recent investigations by regulators have revealed that housing lending standards in recent years have been somewhat weaker than had originally been thought (though still better than in the years leading up to the global financial crisis). In some cases, practices have not met prudential expectations, potentially placing lenders at risk of breaching their responsible lending obligations under consumer

<sup>1</sup> See RBA (2014), *Supplementary Submission to the Financial System Inquiry*, August, pp 19–20.

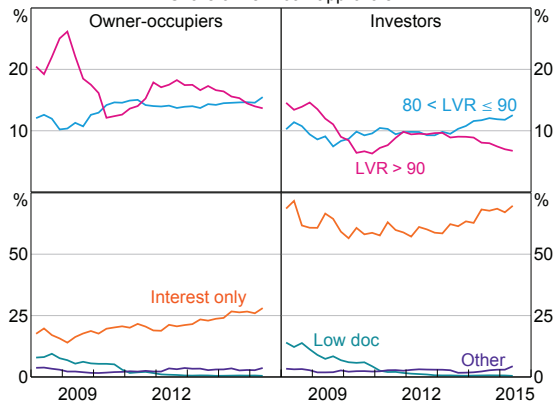
protection laws.<sup>2</sup> In particular, poor documentation and verification by lenders in many instances suggests that some borrowers may have been given interest-only loans that were not suitable for them. Serviceability assessments also seem to have been especially problematic: the common (and prudent) practice of applying a buffer to the interest rate used when calculating the allowable new loan size had in some cases been undermined by overly aggressive assumptions in other parts of the serviceability calculations (for details, see 'The Australian Financial System' chapter). As a result, some borrowers have had less of a safety margin against unexpected falls in income, increases in expenses or increases in interest rates than it had appeared.

Banks have tightened lending standards across the residential mortgage market over recent months in response to this regulatory scrutiny, including through stricter loan serviceability assessment criteria, lower maximum loan-to-valuation ratios (LVRs) for investor loans and shorter interest-only periods for owner-occupiers. These changes will increase the resilience of the household sector, as new borrowers will be somewhat better placed to withstand possible negative shocks such as lower income or a fall in housing prices. This is particularly important at a time when risks in the housing market are already heightened, interest rates remain at historic lows, and competition in the owner-occupier lending market remains strong (especially as lenders focus less on investor loans).

Because many of these changes took effect within the past few months, they had little impact on the June quarter data on the characteristics of new housing loans. Recent data revisions have revealed that loans with LVRs above 80 per cent and interest-only loans to owner-occupiers were somewhat less common than previously reported. These revised data show that the share of lending with LVRs above 90 per cent edged down over the first half of 2015, while the

share of interest-only lending to owner-occupiers drifted up further (Graph 2.5).

**Graph 2.5**  
**ADIs' Housing Loan Characteristics\***  
Share of new loan approvals



\* Series are break-adjusted for reporting changes; 'Other' includes loans approved outside normal debt-serviceability policies and other non-standard loans

Sources: APRA; RBA

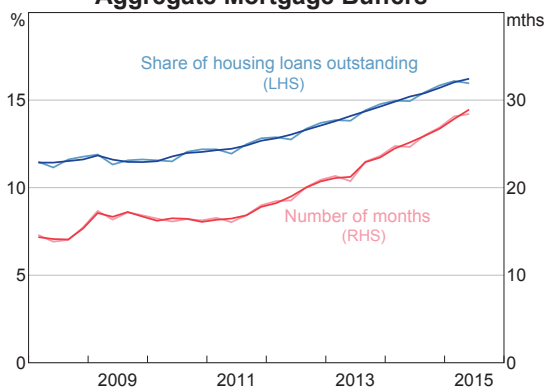
The increased prevalence of interest-only lending has been a concern for regulators; these loans can involve greater risk than principal and interest loans because borrowers need not pay down any principal during the interest-only period. For example, ASIC noted in their recent review of interest-only lending that, in the first five years of a principal and interest loan, a borrower making scheduled repayments at current interest rates would typically pay down about 10 per cent of the principal, establishing a sizeable cushion against any fall in housing prices. Anecdotal information also suggests that some owner-occupier borrowers may be using interest-only loans as a means of affording a larger loan. Nonetheless, ASIC found that interest-only loans made in recent years have been less risky in some other respects: they have tended to be taken out by higher-income borrowers, have lower LVRs at origination, and on average have been paid down more quickly than a typical principal and interest loan when balances in offset accounts are taken into account. Looking ahead, the challenge for lenders will be to ensure that the risk profile of these loans does not deteriorate.

2 See Byres W (2015), 'Sound Lending Standards and Adequate Capital: Preconditions for Long-term Success', Speech to the COBA CEO & Director Forum, Sydney, 13 May; and ASIC (2015), 'Review of Interest-only Home Loans', Report No. 445, August.

## Financial position and indicators of stress

Household credit growth overall has remained moderate, because new lending for purposes other than investor housing has been fairly subdued, although it looks to be picking up. Many existing borrowers also continue to take advantage of lower interest rates to effectively pay down their mortgages faster than required. This includes building up balances in offset accounts, which continue to grow rapidly.<sup>3</sup> Aggregate mortgage buffers – as measured by balances in offset and redraw facilities – remain around 16 per cent of outstanding loan balances, equivalent to more than two years of scheduled repayments at current interest rates (Graph 2.6).

**Graph 2.6**  
**Aggregate Mortgage Buffers\***



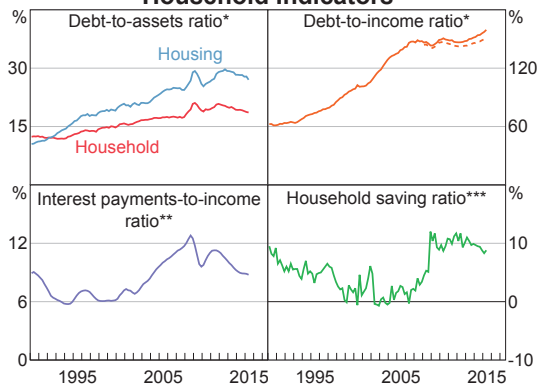
\* Data are adjusted for reporting changes; darker lines are seasonally adjusted

Sources: APRA; RBA

An increased willingness by some households to take on more debt, coupled with slow wage growth, has resulted in a further pick-up in the gross debt-to-income ratio, which has now reached new highs. Net of balances in offset accounts, though, the increase has been quite moderate (Graph 2.7). While still at high levels, the debt-to-assets ratio has declined over the past few years as the value of household assets has grown faster than household debt. Households with higher debt-to-assets or

**Graph 2.7**

## Household Indicators



\* Debt to the financial sector; dashed line is net of offset account balances

\*\* Excludes unincorporated enterprises

\*\*\* Net of depreciation

Sources: ABS; APRA; RBA

debt-to-income ratios also tend to have higher incomes, suggesting that leverage is concentrated among households that are more able to service it. The current low level of interest rates is also aiding households' ability to service their debts, and as the latest reductions in the cash rate flowed through to mortgage rates, the proportion of income required to meet interest payments has fallen further over the year to date. Households also continue to save a greater share of their income than in the decade or so prior to the financial crisis, though the saving ratio has fallen a little in the past couple of years.

Indicators suggest that household financial stress remains fairly benign, despite measures of unemployment being somewhat elevated. While the share of banks' housing loans that are non-performing has edged higher recently, it remains low. As a share of the dwelling stock, applications for property possessions have declined in the four largest states since 2011. Similarly, non-business related personal administrations as a share of the adult population continue to trend lower, and nationally are around the lowest level in more than a decade. Labour market conditions, which strongly influence the extent of household financial stress, have improved so far this year. However, forward-looking indicators are more mixed.

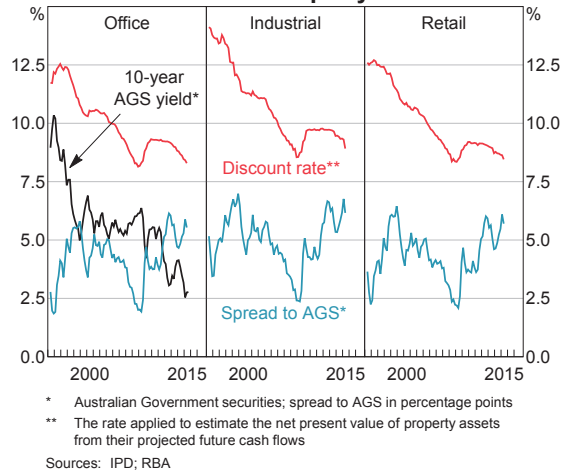
<sup>3</sup> For further details on the impact of offset account balances on net housing debt, see RBA (2015), 'Box E: Offset Account Balances and Housing Credit', *Statement on Monetary Policy*, August, p 56.

## Commercial Property

In a global environment of low interest rates and ample liquidity, investor demand for commercial property has been strong, particularly from foreign investors, which has pushed prices sharply higher. However, leasing conditions have generally been soft, creating a growing divergence between prices and rents (Graph 2.8). As a result, commercial property yields have fallen to low levels (Graph 2.9). The spread of these yields to that for long-term government bonds remains relatively wide, suggesting that the decline in commercial property yields might not be excessive. Current prices could seem less justifiable, however, were global interest rates to increase. Prices could also fall if foreign demand were to weaken significantly. Given that commercial property lending has historically been a key source of financial sector losses during episodes of financial instability, both in Australia and overseas, it is important that lenders and regulators remain alert to the risks in this market.

The strength in investor demand has been broad based across property types and most pronounced in the eastern seaboard capitals. The total value of office, retail and industrial property transactions has increased considerably over recent years, to be

**Graph 2.9**  
**Commercial Property Yields**

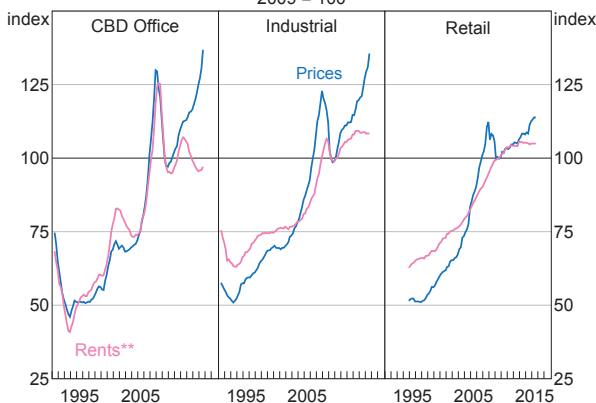


50 per cent higher in the year to June 2015 than its pre-crisis peak (Graph 2.10). Foreign buyers have become more prominent, directly accounting for around one-third of purchases during the past two years. Investors from Asia, especially China, have driven much of this increase. Foreign capital has also been flowing into the residential property development sector across the eastern seaboard capitals, particularly inner-city Melbourne.

In the office property market, the risk of a fall in prices appears most pronounced in Brisbane and Perth, where signs of oversupply are most clearly visible. Lower tenant demand from resource-related companies and, in Brisbane, the public sector, has put downward pressure on rents and pushed vacancy rates to high levels (Graph 2.11). The large amount of space under construction in both cities is likely to see vacancy rates rise even further as projects are completed, though relatively few developments in earlier stages of planning are expected to proceed in coming years.

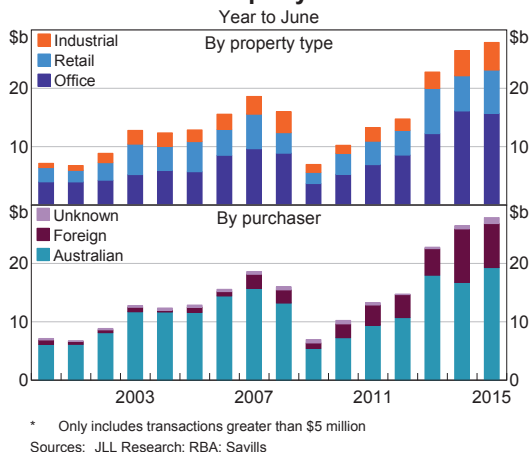
Conditions are noticeably firmer in the Sydney and Melbourne office leasing markets. Vacancy rates have remained lower than in other capital cities and have recently fallen due to a pick-up in tenant demand. Effective rents have also risen of late, after being stagnant for a number of years. While significant

**Graph 2.8**  
**Commercial Property\***  
2009 = 100

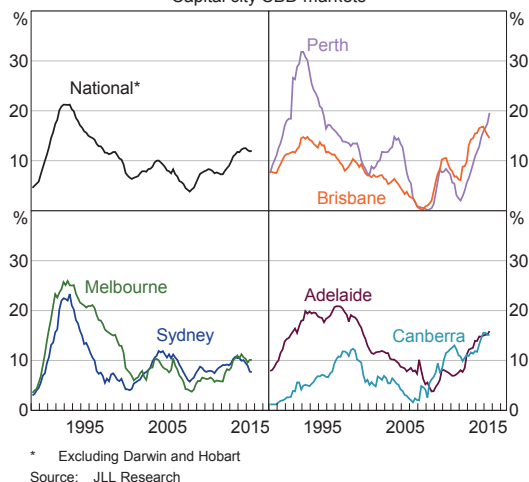


\* CBD office and industrial are prime property, retail is regional (non-CBD) centres  
\*\* CBD office is effective rents, industrial and retail are face rents  
Sources: ABS; JLL Research; RBA

**Graph 2.10**  
**Commercial Property Transactions\***



**Graph 2.11**  
**Office Vacancy Rates**  
Capital city CBD markets



construction is either underway or mooted in both cities, this new supply is likely to be more easily absorbed than in other cities. Consistent with these more positive leasing conditions, investor demand has been strongest in Sydney and Melbourne, and prices there have grown rapidly. The recent sale of a large portfolio of office properties in these cities at low yields points to further strong price growth and yield compression.

Reflecting these differences in risk across cities, banks have expressed caution about lending into

the Brisbane and Perth office markets. Similarly, liaison suggests that developers would require much higher precommitment rates before commencing office projects in Brisbane and Perth (reportedly around 80 per cent) than in Sydney and Melbourne (around 50–60 per cent).

Yields have also fallen in industrial and retail property markets, as prices and rents have diverged. Tenant demand for industrial space has been weak, although supply-side factors – namely limited construction and the significant withdrawal of space for redevelopment into apartments – have moderated the impact on leasing conditions. This has resulted in a modest decline in rents over recent years. At the same time, prices have risen sharply on the back of strong growth in investor demand, including from foreign investors. Similarly, subdued leasing conditions contrast with robust investor demand in the retail property market. While price growth has been more modest than for office and industrial property, it has recently picked up, in part due to increased interest from offshore.

As noted, risks to residential property developers appear to have increased over the past six months. The large volume of apartment construction currently underway and planned has continued to grow, and the price of development sites has increased rapidly due to strong developer demand. Foreign developers have contributed to this dynamic, and are reportedly willing to pay more for development sites than many local developers.

The risk of a downturn in apartment markets is greatest in the inner-city regions of Melbourne and Brisbane, which look susceptible to potential oversupply. While investor demand appears strong at present, including from foreign investors, apartment markets in these areas already look soft, and future tenant demand, including from international students, is uncertain. Highlighting this uncertainty, recent international student net arrivals were less than the Department of Immigration and Border Protection's forecasts, and the Department's forecasts for coming years have been revised down

significantly. More generally, population growth has slowed noticeably of late.

Any downturn in apartment market conditions would weigh directly on the developers' equity in projects underway, and would increase the risk of off-the-plan sales falling through. In liaison, some banks have expressed concern about this settlement risk on pre-sold apartments, particularly in light of the recent regulatory measures aimed at moderating investor demand, though they have also noted that pre-sale defaults have been very limited so far. A number of banks have responded to this, and the risk of oversupply more generally, by tightening lending standards to apartment developers in the more at-risk areas.

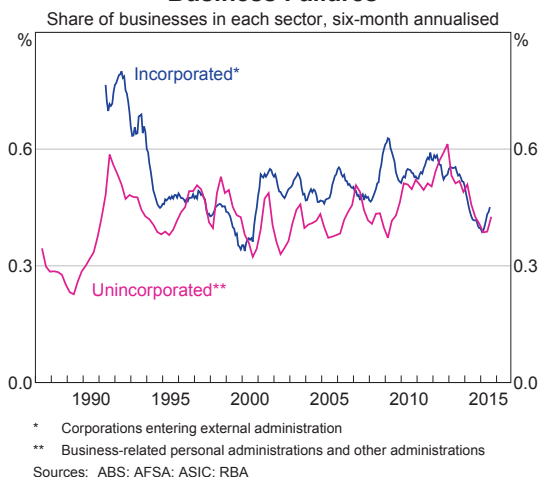
So far, the near-term risks to the domestic financial system from the commercial property sector appear modest, but they are rising. Although banks' commercial property exposures declined as a share of their total assets after the financial crisis, growth in this type of lending has picked up in recent years, driven by the major Australian banks and by Asian-owned banks (see 'Box B: The Recent Growth in Banks' Commercial Property Exposures'). Competition among lenders is strong, putting considerable pressure on lenders' margins, so the commercial property sector will require continued close monitoring for some time yet.

## Other Business Sectors

### Business conditions and finances

Outside the property sector, risks to the financial system from non-financial businesses remain low and the sector's finances are generally in good shape. Business failure rates have fallen significantly across most industries and states over recent years and, in aggregate, are close to decade lows, although business failures have picked up a little in recent months (Graph 2.12). The share of banks' business loans that are non-performing has also continued to decline across most industries.

**Graph 2.12**  
**Business Failures**



The sizeable deleveraging of the business sector following the financial crisis has contributed to these trends, as has the low level of interest rates. Further, the large depreciation of the Australian dollar over the past year or so will have benefited businesses in a number of industries, although the increased volatility in currency markets could expose any instances of poorly designed hedging practice (or lack of hedging altogether).

Business demand for new intermediated credit has been fairly soft over much of 2015, despite the low level of interest rates, consistent with subdued non-mining investment (Graph 2.13). At the same time, implied repayment rates on existing loans are high, as some businesses use surplus cash to deleverage. The current environment of low demand for intermediated business debt creates a risk that banks may further relax lending standards in order to attract customers. As discussed in 'The Australian Financial System' chapter below, price competition for business lending has continued to strengthen over the past six months, and loan covenants have also been relaxed in some instances.

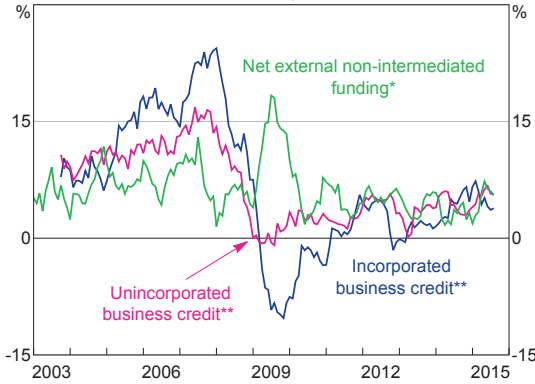
Overall, the business sector appears well placed to service its debt. The aggregate gearing ratio of listed corporations increased recently, but remains



**Graph 2.13**

**Non-financial Business Funding Growth**

Six-month-ended, annualised



\* Excludes equity raisings by unlisted businesses

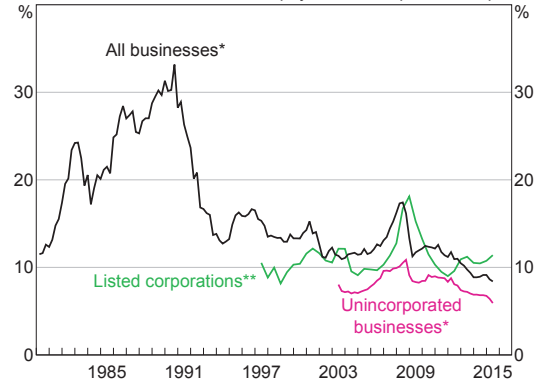
\*\* Excludes securitised loans

Sources: ABS; APRA; ASX; Austraclear; Morningstar; RBA

**Graph 2.15**

**Debt-servicing Ratio**

Non-financial businesses' interest payments as a per cent to profits



\* Gross interest paid on intermediated debt from Australian-located financial institutions

\*\* Net interest paid on all debt; excludes foreign-domiciled corporations

Sources: ABS; APRA; Bloomberg; Morningstar; RBA

within the range seen since the crisis, as do gearing ratios in the more vulnerable tail of the distribution (Graph 2.14). The sector's aggregate debt-servicing ratio also increased recently, but remains fairly low (Graph 2.15). In addition, the share of debt owed by businesses in the more vulnerable tail of the distribution has declined over recent years. The aggregate debt-servicing ratios for unlisted corporations as well as unincorporated businesses have fallen steadily since 2008 as interest rates have declined.

**Resource-related sector**

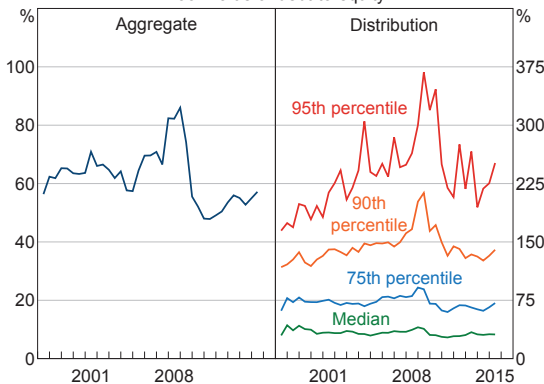
In contrast to the benign overall conditions in much of the business sector, risks appear to have increased further in the resource-related sector over the past six months. The sustained falls in coal, iron ore and oil prices are weighing heavily on the earnings and cash flow of producers of these commodities, particularly those higher up the cost curve. Most smaller producers are struggling to cover costs at current prices, with many already reporting losses. Where producers have been cutting costs to preserve profit margins, further cuts could prove progressively harder. The dwindling investment pipeline and ongoing cost-cutting by resource producers have in turn reduced the output and earnings of mining services companies. Overall, the earnings of businesses in the resource-related sector have fallen sharply over the past two years, although consensus analyst forecasts point to some recovery in earnings over the coming years (Graph 2.16).

Bank lending to the resource sector has increased rapidly in recent years, and large resource producers have increased their issuance of debt into financial markets, especially offshore, even as they cut investment spending. Higher debt and the steep fall in profits have resulted in a significant rise in the debt-servicing ratios of smaller resource producers;

**Graph 2.14**

**Listed Corporations' Gearing Ratios\***

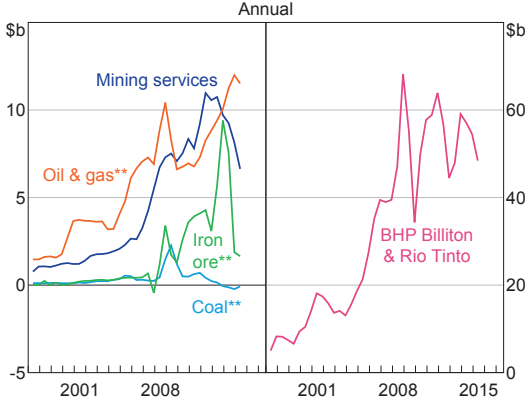
Book value of debt-to-equity



\* Excludes financial and foreign-domiciled corporations

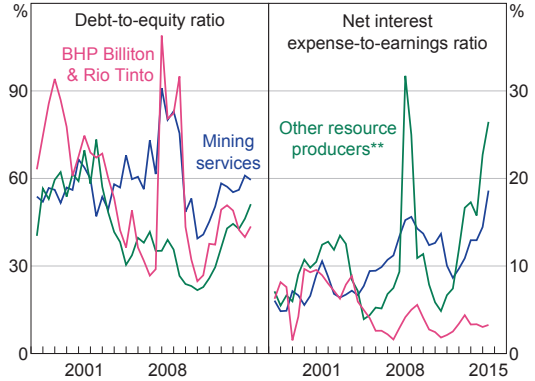
Sources: Bloomberg; Morningstar; RBA

**Graph 2.16**  
Resource-related Corporations' Earnings\*



\* Listed corporations' EBITDA; excludes foreign-domiciled corporations  
 \*\* Excludes BHP Billiton & Rio Tinto  
 Sources: Bloomberg; Morningstar; RBA

**Graph 2.17**  
Listed Resource-related Corporations' Financial Position\*



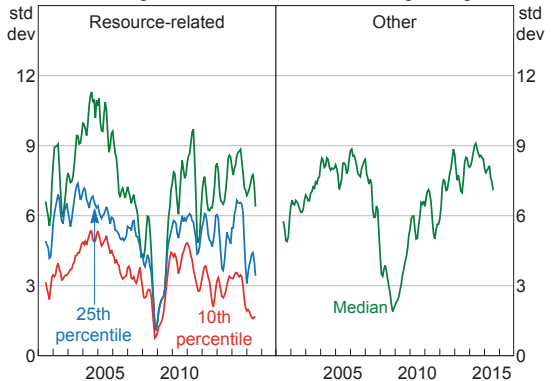
\* Excludes foreign-domiciled corporations; book value  
 \*\* Includes listed junior explorers  
 Sources: Bloomberg; Morningstar; RBA

the aggregate debt-servicing ratio of listed mining services companies has also risen (Graph 2.17). Although the debt-servicing capacity of many of the smaller resource producers has been supported by strong liquidity positions to date, continued low commodity prices would erode these positions in time. Indeed, some smaller resource producers have come close to breaching debt covenants and a range of firms have had their credit ratings downgraded. Putting further pressure on their debt-servicing ability, resource-related companies may face difficulty rolling over their debt, with the bonds of some companies currently trading at very high yields. Despite the low business failure rate, banks indicated in liaison that the performance of their resource-related loans had deteriorated somewhat. They also noted that the low level of interest rates could be masking underlying stress in this sector.

In line with these developments, a market-based measure of default risk for listed corporations – derived from equity prices and reported liabilities – suggests that the financial health of some parts of the resource-related sector has deteriorated noticeably as commodity prices have fallen. Over the past year, the distance-to-default

estimated for the more vulnerable (and usually smaller) resource producers and mining services companies have fallen to their lowest levels since the financial crisis (Graph 2.18).<sup>4</sup>

**Graph 2.18**  
Distance-to-Default of Listed Corporations\*  
Debt-weighted, three-month centred moving average



\* Excludes financial and foreign-domiciled corporations  
 Sources: Bloomberg; Morningstar; RBA

<sup>4</sup> Distance-to-default measures the expected difference between the market value of firms' assets and the book value of their liabilities at some horizon, in this case one year, expressed in terms of the asset return volatility. For further details on this measure, see Robson M (2015), 'Default Risk Among Australian Listed Corporations', RBA Bulletin, September, pp 47–54.

In contrast, the continued financial strength of the largest resource producers has limited the decline in the median distance-to-default. As a result, the sector's implied debt-at-risk – measuring the stock of debt expected to be defaulted on – has been fairly stable over recent years at very low levels.

Consistent with the low levels of debt-at-risk, risks to the domestic banks arising from the resource-related sector are limited because their exposure to the sector is fairly low, though it has increased in recent years. Most of the sector's debt outstanding is sourced from corporate debt markets rather than domestic banks; foreign banks are also an important source of funding. RBA staff estimate that only around 2 per cent of the Australian banking system's consolidated group exposures are to resource-related businesses, and this is reportedly skewed towards the more highly rated or lower-cost resource producers. ↘