

2. Household and Business Finances

In the household sector, risks have ameliorated somewhat since the previous *Review* as housing price growth has eased and – more importantly – banks have further tightened lending standards on mortgages. Attitudes toward investing in housing appear to have adjusted to the softer housing market conditions, with investors less active in the housing market compared with a few months ago. The tightening in lending standards has put recent borrowers on a sounder footing to cope with any deterioration in economic conditions, fall in housing prices or individual adverse events. Overall indicators of household resilience remain sound, supported by solid employment growth and low interest rates.

An ongoing risk comes from the significant and geographically concentrated growth in supply of new apartments in Sydney, Melbourne and Brisbane due for completion over the next few years. This new supply may weigh on prices and rents in these areas. If that occurs, investors will need to service their mortgages while earning lower rental income and any households facing difficulties making repayments may not be able to resolve their situation easily by selling the property. This is one reason why it remains important to have prudent lending standards ahead of such a possibility.

For the developers of these apartments, risks appear to have increased since the previous *Review*. With demand for apartments softening in some areas, particularly in Brisbane and Perth, and households facing tighter access to credit, settlement failures might increase. A downturn in apartment markets could weaken the financial health of these developers.

For other types of commercial property, the compression in yields has continued. Price growth remains rapid, supported by strong investor demand, particularly from foreign investors. However, there is some uncertainty as to how these foreign buyers would react to a downturn in their home countries or in the Australian property market. While yield compression is fairly common across the capital cities, there is a divergence in market conditions. In Sydney and Melbourne investment demand is strongest and leasing conditions are generally firm, while in Brisbane and Perth conditions are challenging, resulting from the fairly large amount of supply still coming on line and the downturn in the resource-related sector. Despite these challenges, banks' lending for commercial property has picked up over recent years across a range of categories, including residential development, though as a share of their total lending it remains below the levels reached during the financial crisis.

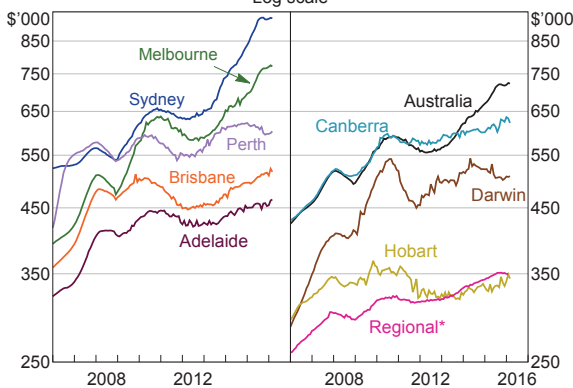
Outside the property sector, businesses' finances generally remain in good shape and broad indicators of financial stress are low. An exception is the resource-related sector where there are several signs of stress. Falls in global commodity prices have weighed on the earnings of resource-related companies and the ability of these companies to service their debts. Banks are reporting higher rates of non-performance among their resource-related exposures, but their lending to the sector is only a small share of their total lending. In liaison, the major banks also note signs of broader stress emerging in mining-exposed geographic regions, where the performance of other business and household loans has deteriorated.

Household Sector

Housing and mortgage markets

The pace of housing price growth has eased somewhat since the previous *Review* largely because of slowing growth in Sydney and Melbourne where prices had previously risen most rapidly (Graph 2.1). Auction clearance rates and other high-frequency indicators also point to moderately softer housing market conditions. Consistent with this slowing, attitudes towards investing in housing have become less optimistic; survey data suggest that households' expectations of future housing price growth have eased and the share of households that view real estate as the wisest place for their savings has declined. An ongoing risk is that the significant construction of apartments that is already underway, particularly in inner-city Melbourne and Brisbane, may lead to price falls in these areas if demand fails to keep pace.

Graph 2.1
Housing Prices
Log scale



* Excludes apartments; measured as areas outside of capital cities in mainland states

Sources: CoreLogic RP Data; RBA

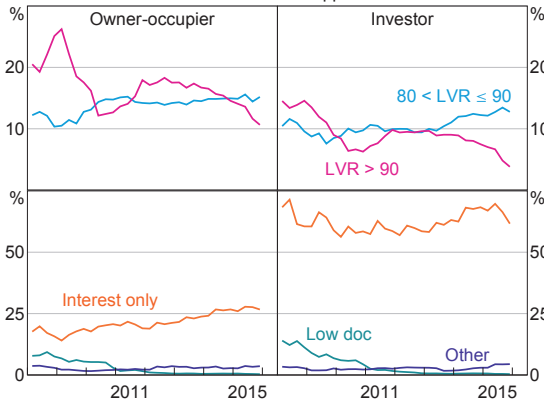
A contributing factor for the softening in housing market conditions was the actions of regulators starting from late 2014 to address the increasing risks stemming from the housing sector. These included measures to rein in growth in lending to investors and to reinforce sound and responsible lending practices. These measures were introduced at a

time of heightened investor activity and borrowing. Had that continued, it could have amplified the upswing in housing prices and increased the risk of subsequent significant price falls. In response, authorised deposit-taking institutions (ADIs) have increased interest rates on investor loans, so that advertised pricing is about 25 basis points higher than for owner-occupier loans. Lenders also reduced the size of discretionary discounts available to investors. More recently, however, competition for investor loans has strengthened with many ADIs increasing discounting and lowering advertised rates for investors. ADIs also now apply stricter loan serviceability assessment criteria across all types of housing lending.

The effects of this tightening are now apparent in data on the characteristics of housing loan approvals (Graph 2.2). Over the second half of 2015, the shares of owner-occupier and investment lending at high loan-to-valuation ratios (LVRs; greater than 90 per cent) declined markedly and the share of interest-only lending also fell, particularly for investors. The average size of loan approvals is now lower than a few months ago, consistent with the reduced availability of high-LVR loans and the tighter serviceability standards. The Australian Prudential Regulation Authority's (APRA) second hypothetical borrower exercise in September 2015 found that the maximum loan size that could have been extended to the four hypothetical borrowers in the scenario fell by around 12 per cent for investors, and by around 6 per cent for owner-occupiers. Given that some ADIs have continued to phase in the tightening required by the regulators, some further falls in the share of high-LVR lending and interest-only lending in the period ahead could be expected.

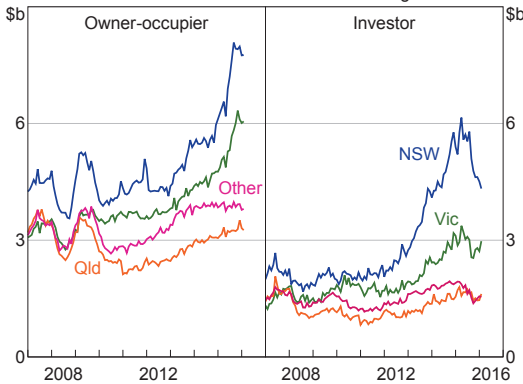
The share of investors in housing finance has also declined as a result of these changes in loan pricing and terms. Investor loan approvals have fallen and owner-occupier approvals have increased sharply, particularly in New South Wales and Victoria (Graph 2.3). As a consequence, the composition

Graph 2.2
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

Graph 2.3
Housing Loan Approvals by State
 Includes construction and refinancing



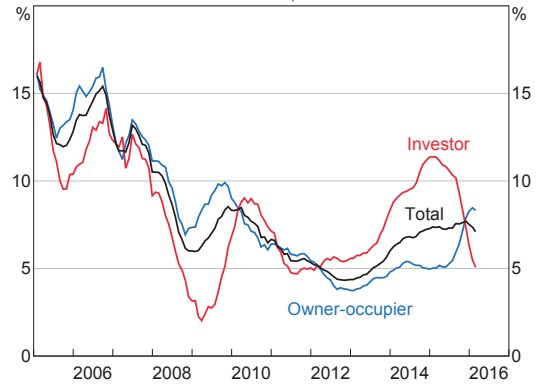
Sources: ABS; RBA

of housing credit growth has shifted away from investors towards owner-occupiers, though this may, in part, reflect investors switching their loan purpose to owner-occupiers.¹ In particular, investor

¹ The pricing differential has created an incentive for borrowers with investment loans to switch to owner-occupier loans in circumstances where the purpose of their original loan has changed, which has resulted in a substantial amount of loan switching. Banks are checking to ensure loans are recorded accurately, such as comparing the address of the borrowers' residence and the property securing the loan, and requesting account information or tax returns for evidence of rental income. The credit data cited here look through these loan reclassifications but can only account for cases where the borrower does not change lender at the same time.

credit expanded at an annual rate of 5 per cent over the six months to February 2016, down from its recent peak of 11 per cent in early 2015 and well below APRA's benchmark of 10 per cent (Graph 2.4). Overall housing credit growth has, however, declined only modestly.

Graph 2.4
Housing Credit Growth
 Six-month-ended, annualised

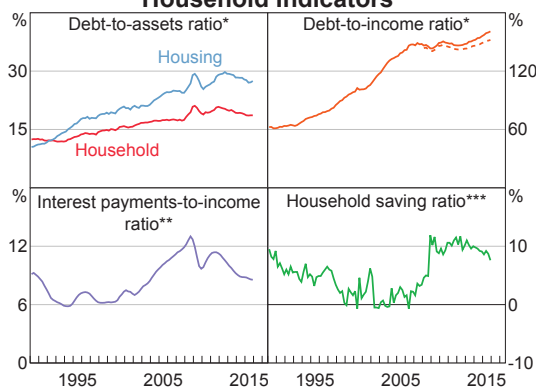


Sources: APRA; RBA

Financial position and indicators of stress

The tightening in lending standards has left recent purchasers better placed to withstand weaker economic conditions, an easing in housing prices or other adverse events. While, in principle, borrowers who accessed credit under looser lending conditions in the past couple of years may be more vulnerable than recent borrowers, indicators of household financial stress remain fairly benign, aided by low interest rates and ongoing employment growth. In particular, the current low interest rate environment continues to support households' debt-servicing ability and households continue to save a greater share of their income than in the decade or so prior to the financial crisis (despite recent declines in this share; Graph 2.5). Around half of total household debt is owed by households in the top income quintile, a pattern that is broadly consistent across the states, suggesting that debt is owed by those households most able to service it. Finally, aggregate

Graph 2.5
Household Indicators

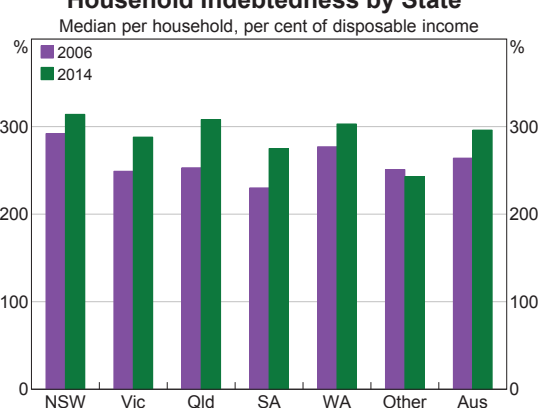


* Debt to the financial sector; dashed line is net of offset account balances
 ** Excludes unincorporated enterprises
 *** Net of depreciation
 Sources: ABS; APRA; RBA

mortgage buffers – balances in offset accounts and redraw facilities – have increased further since the previous *Review*, to now be around 17 per cent of outstanding loan balances, which is equivalent to more than 2½ years of scheduled repayments at current interest rates. However, survey evidence indicates that households considered more likely to experience financial stress, such as those with lower net wealth and income or higher leverage, are less likely to have mortgage buffers and that these buffers tend to be smaller than for other households.

Nonetheless, the gross debt-to-income ratio continues to rise from already high levels as households take on more housing debt and income growth has slowed. Net of balances in offset accounts, the increase has been less pronounced, though it has still reached new highs of late. Although housing price growth has varied substantially across the states, recent evidence on households with mortgages indicates that the household debt-to-income ratio is higher than a decade ago and fairly uniform across the country (Graph 2.6). The increase in indebtedness has tended to be larger in those states that previously had lower debt-to-income ratios. With incomes

Graph 2.6
Household Indebtedness by State*

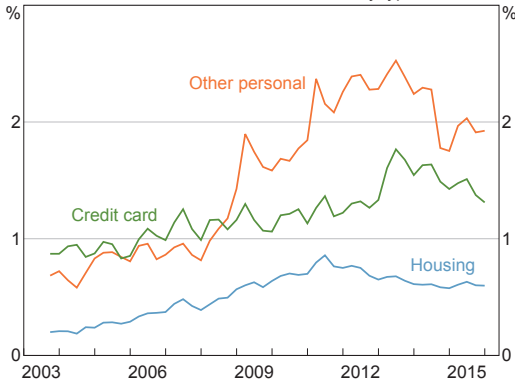


* Indebted households with any form of housing debt
 Sources: HILDA Release 14.0; RBA

growing more slowly in the past few years compared with the previous decade, households may not be able to rely as much on future income growth to reduce debt-servicing burdens.

Indicators of overall stress in banks' household loan portfolios remain low. The share of banks' housing loans that are non-performing ticked down over the second half of 2015, to 0.6 per cent (Graph 2.7). Non-performing rates for credit card and other personal loans have also declined over recent quarters. An exception to this general theme is that regions heavily reliant on the mining sector have experienced large falls in housing prices and deteriorations in credit performance. Public disclosures by the major banks indicate that arrears on housing loans are higher in Queensland and Western Australia than in the rest of the country. Applications for property possessions in Western Australia have edged higher recently, although nationally they continue to decline as a share of the dwelling stock. Personal administrations as a share of the labour force are higher in mining regions compared with non-mining regions. These developments will need to be monitored in the period ahead.

Graph 2.7
Banks' Non-performing Household Loans
 Domestic books, share of loans by type



Source: APRA

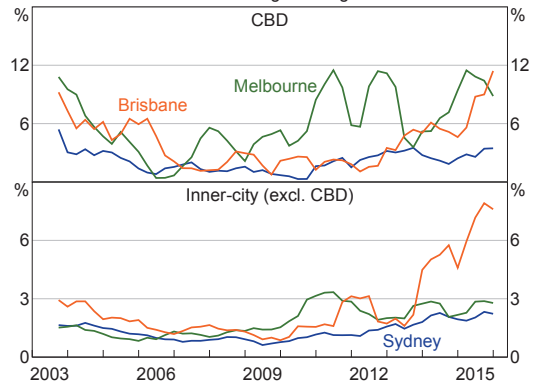
Commercial Property

Residential development

The near-term risks for residential property developers have increased, with a mismatch between a growing supply of geographically concentrated apartments on the east coast and concerns about softening demand for these apartments in some areas (given the rebalancing of housing demand and strengthened lending standards). As the supply of new apartments has continued to come on line, price growth has slowed over the past six months and rental growth has been modest (Graph 2.8 and Graph 2.9). Industry liaison suggests that developers in Brisbane are having increasing difficulty securing pre-sales, leading to wider use of rental guarantees and other buyer incentives, project delays and, in some cases, sales of development sites. Conditions in Perth have also deteriorated, as the new supply of apartments is being sold into a weaker local economy.

Industry contacts report that the large volume of new apartments still planned and under construction in the major capital cities has also put pressure on developers' finances by driving up developer site and construction costs. And while the prices of off-the-plan apartments have been supported by ongoing strong interest from foreign buyers, particularly in Sydney and Melbourne, it

Graph 2.8
Residential Building Approvals*
 Per cent to existing dwelling stock**

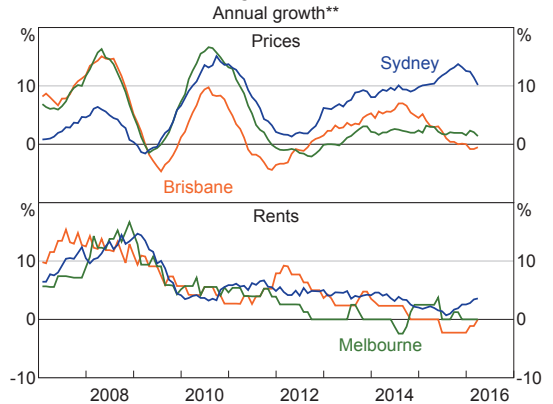


* Four-quarter rolling sum

** Dwelling stocks estimated by RBA

Sources: ABS; CoreLogic RP Data; RBA

Graph 2.9
Inner-city Apartments*
 Annual growth**



* SA4 regions: Melbourne – Inner and Brisbane – Inner City; Sydney is an average of SA4 regions: Sydney – City and Inner South, Sydney – Inner West, Sydney – Inner South West and Sydney – Eastern Suburbs

** Rolling 12-month average growth rate

Sources: CoreLogic RP Data; RBA

is unclear how these buyers would respond to a downturn in their own economy or the Australian property market (see 'Box B: Chinese Demand for Australian Property').

Whatever the cause, a downturn in apartment markets could weigh on developers' financial health through a number of channels. Values of sites and incomplete developments would be likely to fall the most, and the value of apartments held on developers' books would also decline.

Falling apartment prices also increase the risk that off-the-plan purchases fail to settle, although liaison suggests that settlement failures have, to date, remained uncommon and are generally expected to increase significantly only if housing prices fall substantially. At present, listed developers' balance sheets generally appear healthy; many of these companies deleveraged significantly following the financial crisis. However, liquidity ratios have declined in some cases and the limited available data on unlisted developers suggest that near-term risks may be higher for them, because they tend to rely more on (bank) debt financing.

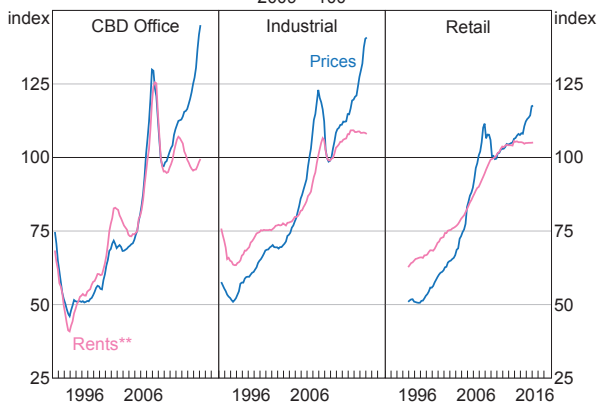
Non-residential property

Conditions and risks in the non-residential property market vary across the major cities although a broad-based phenomenon has been declining yields as prices and rents diverge. Prices for office, industrial and retail property continue to rise sharply on the back of strong investor demand (Graph 2.10). Foreign investors, especially from China and elsewhere in Asia, have been an important factor behind the marked compression in Australian commercial property yields by contributing to this rapid price growth (see 'Box B: Chinese Demand for Australian Property').

Conditions are particularly weak in the Perth and Brisbane office markets (Graph 2.11). Resource-related tenants and, in Brisbane, the public sector, have scaled back office space requirements at a time when significant new supply continues to come on line. The vacancy rate is climbing sharply in Perth, reaching almost one-quarter of properties, and remains high in Brisbane, and rents are falling (Graph 2.12). Vacancies are particularly high for lower-grade properties as tenants are moving into newly constructed offices. In Brisbane, some of these lower-grade properties are being withdrawn for refurbishment or conversion into residential property, student accommodation or hotels.

In contrast, conditions in the Sydney and Melbourne office markets are much firmer and have improved over the past year, reflecting the stronger economic conditions in these cities. Vacancy rates have declined and rents have risen as tenant demand for space has increased strongly, both within and outside the CBD areas. The office markets in Sydney and, to a lesser extent, Melbourne have also been supported by the high level of activity in apartment markets; strong competition for the limited available development sites has prompted some developers, particularly from China, to purchase lower-grade office buildings for redevelopment or conversion into apartments.

Graph 2.10
Commercial Property*
2009 = 100



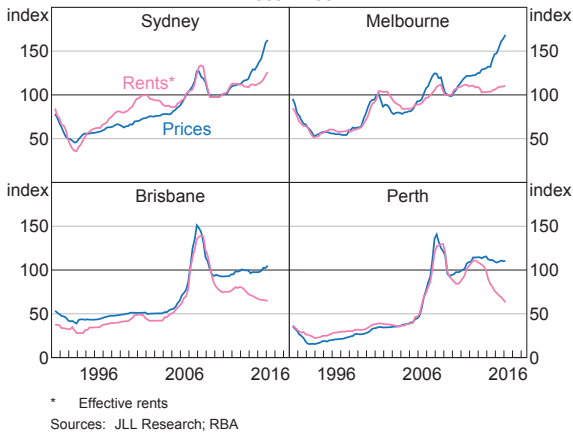
* CBD office and industrial are prime property, retail is regional (non-CBD) centres

** CBD office is effective rents, industrial and retail are face rents

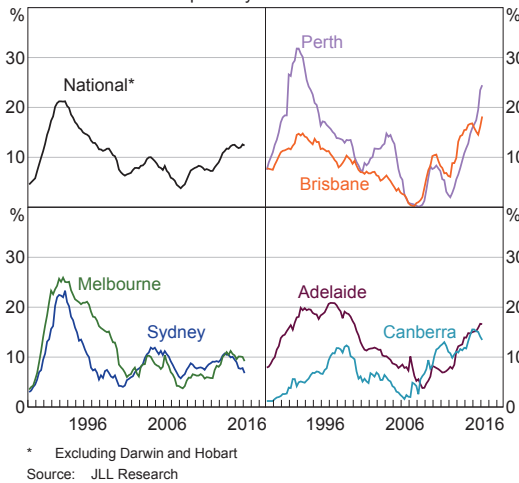
Sources: ABS; JLL Research; RBA

For industrial and retail property, yields have also fallen as continued strength in investor demand, including from foreign investors, has driven solid price growth in these sectors, while at the national level rents have been flat. Again, conditions vary somewhat across the cities. For industrial property, price growth has been most rapid in Sydney, in part reflecting the purchase of sites by residential developers and the government for infrastructure projects. This withdrawal of industrial space has also supported rental growth in Sydney. Consistent with economic conditions, investor and tenant demand have been solid in Melbourne and much weaker in

Graph 2.11
Prime CBD Office Property
 2009 = 100



Graph 2.12
Office Vacancy Rates
 Capital city CBD markets



Brisbane and Perth. In the retail sector, conditions have also been noticeably firmer in Sydney and Melbourne than in Brisbane and Perth.

Other Business Sectors

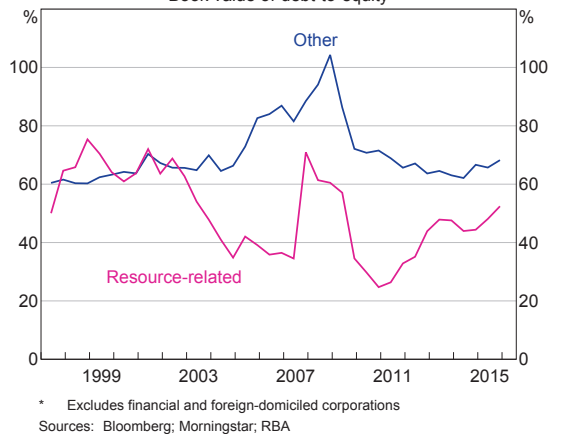
Business conditions and finances

Outside the property sector, businesses' finances generally remain in good shape and broad indicators of financial stress are low. Setting

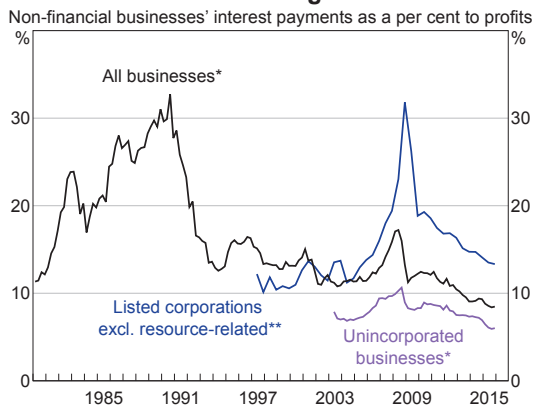
aside the resource-related sector – where there are several signs of stress – survey measures of business conditions are above their long-run average levels, business loan performance has continued to improve and business failure rates are fairly low. The low level of interest rates and the sizeable deleveraging of the business sector following the financial crisis have contributed to this positive environment. The large depreciation of the Australian dollar since mid 2014 has also supported businesses in a number of industries and the decline in oil and other commodity prices has generally benefited companies outside the resources sector.

Businesses outside the resource-related sector appear well placed to meet their financial obligations. The gearing ratio of listed corporations outside the resource-related sector has remained fairly steady over the past few years, though it has drifted up a little of late (Graph 2.13). Aided by lower interest rates, the aggregate debt-servicing ratio of these listed corporations declined over recent years (Graph 2.14). The aggregate debt-servicing ratios for both unlisted corporations and unincorporated businesses have also trended lower over the period, to be around historic lows.

Graph 2.13
Listed Corporations' Gearing Ratios*
 Book value of debt-to-equity



Graph 2.14
Debt-servicing Ratio

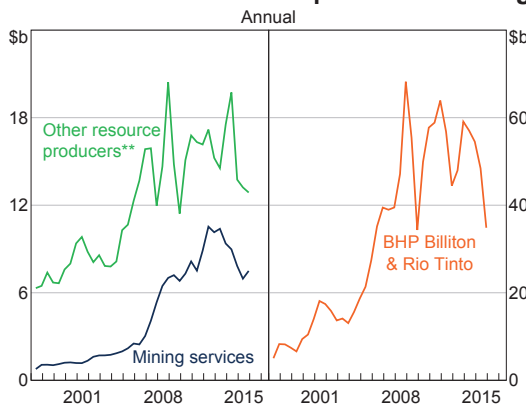


* Gross interest paid on intermediated debt from Australian-located financial institutions

** Net interest paid on all debt as a per cent to EBITDA; excludes foreign-domiciled corporations

Sources: ABS; APRA; Bloomberg; Morningstar; RBA

Graph 2.15
Listed Resource-related Corporations' Earnings*



* Listed corporations' EBITDA; excludes foreign-domiciled corporations

** Includes listed junior explorers

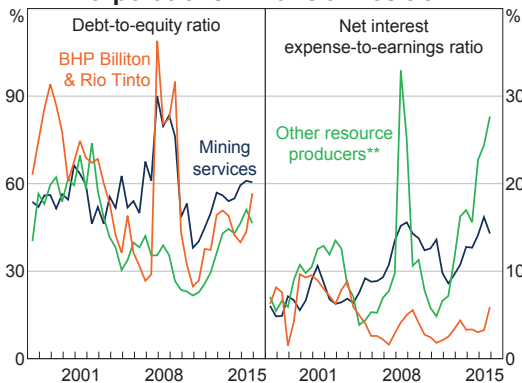
Sources: Bloomberg; Morningstar; RBA

Resource-related sector

For the resource-related sector, conditions are challenging as commodity prices remain well below their levels of recent years. This has led to a further significant decline in the earnings of resource-related companies, including the large, low-cost producers (Graph 2.15). The oil and gas sector has been particularly affected; in 2015, the earnings of listed oil and gas companies fell by more than 40 per cent. Most smaller resource producers are struggling to cover costs at current prices, leading some to suspend operations at higher-cost mines. While producers have further reduced costs, industry liaison suggests that additional cost cutting is proving progressively more difficult.

The steep fall in earnings has weighed on resource-related companies' capacity to meet their debt-servicing obligations; excluding BHP Billiton and Rio Tinto, net interest expenses absorbed more than one-quarter of resource producers' earnings in 2015 (Graph 2.16). Book value measures of gearing ratios have also increased over recent years, indicating a decline in the ability to repay debt through asset sales should this be required. When measured using the market value of equity – which may better reflect the realisable value of assets – gearing has increased even more sharply.

Graph 2.16
Listed Resource-related Corporations' Financial Position*



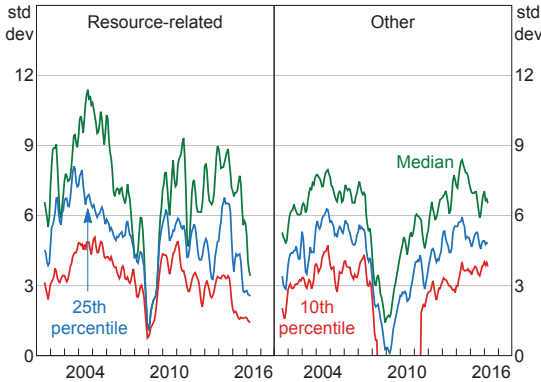
* Excludes foreign-domiciled corporations; book value

** Includes listed junior explorers

Sources: Bloomberg; Morningstar; RBA

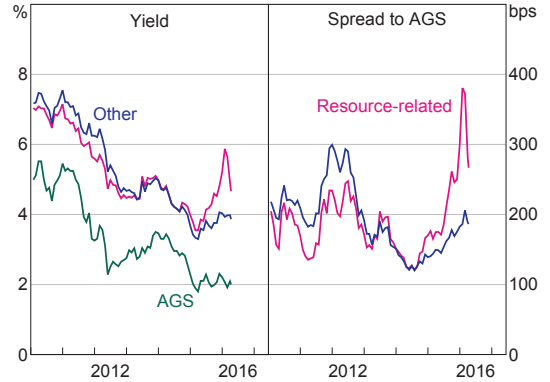
Consistent with these developments, listed resource-related companies' distances-to-default – market-based measures of default risk using equity prices and reported liabilities – suggest that the financial health of the sector has deteriorated significantly over the past six months (Graph 2.17). The measures are generally at their weakest levels since the financial crisis, unlike the corresponding measures for firms outside this sector. During that period, these forward-looking measures fell below zero (theoretically suggesting an imminent default) for a number of non-resource-related companies and, of these, around one-third went on to fail.

Graph 2.17
Listed Corporations' Distance-to-Default*
 Debt-weighted, three-month moving average



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

Graph 2.18
Australian Corporate Bond Pricing*
 Investment grade bonds, 5-year target tenor

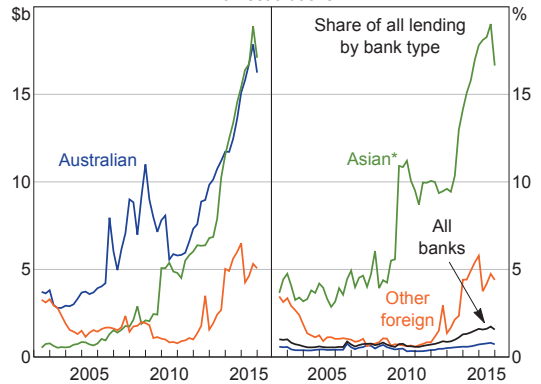


* Excludes financial and foreign-domiciled corporations
 Sources: Bloomberg; RBA; S&P Capital IQ

Following widespread downgrades to credit ratings and outlooks across the sector, the bonds of many resource-related companies are currently trading at high yields (Graph 2.18). In particular, yields for lower-rated companies have risen sharply over the past year. This increases the risk that resource-related companies will have difficulty rolling over their debt, putting further pressure on their debt-servicing ability. Generally though, those companies with especially high yields have little market-sourced debt maturing in the next two years, and resource-related companies more broadly will likely have lower funding requirements in the near term given they have cut back on capital expenditure.

Nonetheless, as discussed in previous *Reviews*, direct risks to the domestic financial system arising from these stresses in the resource-related sector are limited. Banks' exposure to the sector remains fairly low at around 2 per cent of consolidated group exposures. However, some banks, particularly Asian banks, do have significant and concentrated resource-related exposures and hence are vulnerable to the deteriorating conditions facing the sector (Graph 2.19). For the major banks, the share of these loans that are non-performing has roughly doubled over the past six months and, in recent public announcements, some of these

Graph 2.19
Banks' Lending to the Mining Sector
 Domestic books



* Includes HSBC
 Sources: APRA; RBA

banks indicated that their provisioning for such lending has increased. Although resource-related non-performing assets remain a small part of total non-performing assets, they are likely to rise further in the period ahead, especially if commodity prices do not recover further. In recent liaison, the major banks also noted signs of broader stress emerging in mining-exposed geographic regions, where the performance of other business and property loans has deteriorated. In this environment, it is particularly important that banks accurately value the collateral underlying their resource-related loans and adequately provision for future losses. ❖