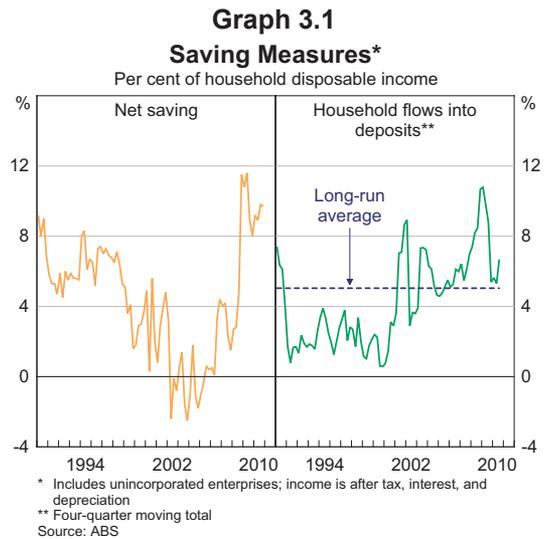


3. Household and Business Balance Sheets

Households are benefiting from solid growth in employment and wage incomes. They are continuing to consolidate their finances, saving at a much higher rate in recent years and slowing the pace of debt accumulation. Even so, household indebtedness is still at historically high levels, and debt-servicing requirements have recently increased. While indicators of financial stress remain muted, a continuation of the current period of borrowing restraint would help build additional resilience into household balance sheets. In the corporate sector, overall profit levels are high, but conditions diverge between sectors. The resources sector is benefiting from strong profit growth, robust balance sheets and good access to external funding. For non-resources companies, balance sheets also have been strengthened in recent years, but profit growth is not as robust and some sectors' access to funding has been more restricted.

Household Sector

In recent years, the household sector has adopted a more cautious attitude towards its borrowing and investment behaviour, which has been reflected in a sharp increase in the net household saving rate and a slower rate of balance sheet expansion. The net household saving rate was around 10 per cent in 2010, in contrast to the mid 2000s when there was very little net saving (Graph 3.1). Some households are using the increase in saving to pay down debt more quickly; this has been part of the reason why the pace of debt accumulation has slowed. Households have also been investing a larger share of their savings in deposits, reflecting an increase in



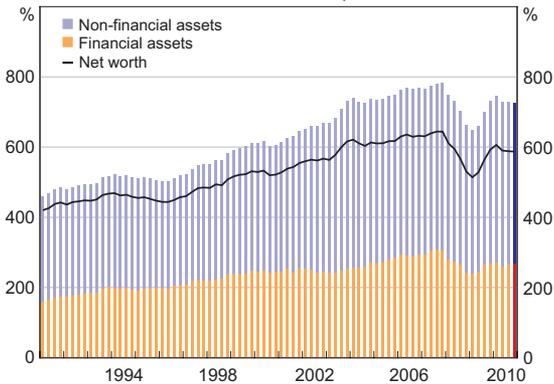
deposits' relative return as well as their perceived safety. Overall, aggregate household debt and assets were both broadly stable as a proportion of household disposable income in 2010; household net worth remained around six times annual disposable income (Graph 3.2). Financial assets expanded by 6 per cent in 2010, with the share held as currency and deposits rising from 19 per cent to 26 per cent since 2007.

The change in household financial attitudes is also evident in survey data. According to Melbourne Institute surveys, the proportion of households that report that they are saving has risen in recent years, as has the share of households that believe that bank deposits and paying down debt are the 'wisest place for saving'; fewer now nominate equities or real estate in answer to this question. While mortgage refinancing activity picked up in 2010, an industry

Graph 3.2

Household Assets and Net Worth

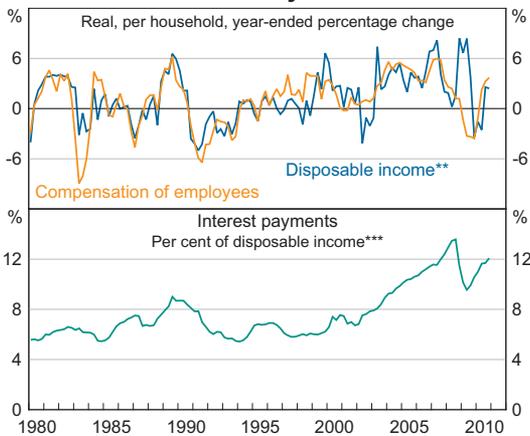
Per cent of annual household disposable income*



* Before the deduction of interest payments; includes unincorporated enterprises; estimate for December 2010
Sources: ABS; RBA

Graph 3.3

Household Income Growth and Interest Payments*



* Household sector excludes unincorporated enterprises
** After the deduction of interest payments
*** Before the deduction of interest payments
Sources: ABS; RBA

survey suggests that the most common motivations for refinancing were to switch to a cheaper loan and consolidate debt, rather than increase the loan amount.

This apparent increase in the household sector's caution towards its finances is occurring alongside solid growth in incomes. As the labour market improved from 2009, real compensation of employees also recovered, increasing 3.7 per cent per household over the year to the December

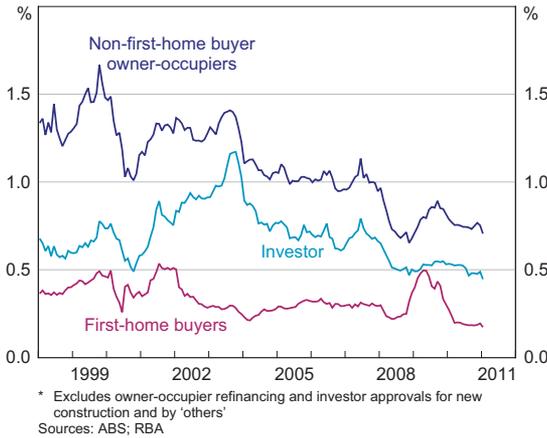
quarter 2010 (Graph 3.3). The outlook for employment – and thus labour income growth – is also favourable, given the strength in forward-looking indicators, such as job vacancies and advertisements.

The increase in saving and the reduced pace of debt accumulation by households are likely to have reflected a combination of factors. The saving rate had in fact already begun to turn around in about 2005, once the extended period of adjustment to lower inflation and financial deregulation was largely completed. The experience of the financial crisis and the increased uncertainty regarding future asset returns has prompted a further shift to greater financial caution across a range of fronts, including in the household sector. More recently, the increases in domestic interest rates from their recent trough have been making borrowing less attractive. Household interest payments as a share of disposable income increased from 10.6 per cent in the December quarter 2009 to 12.1 per cent in the December quarter 2010. This is still below the peak of 13.6 per cent reached in the September quarter 2008, and even with higher interest payments, real disposable income per household (after interest payments) increased by 2.4 per cent over the year to the December quarter 2010.

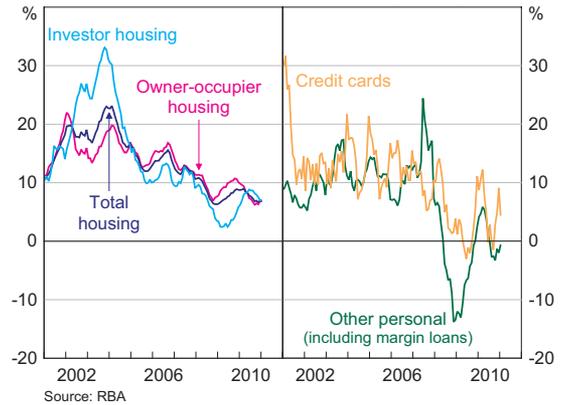
Reflecting all these factors, household debt has continued to grow at a much slower rate than in earlier years. Housing loan approvals as a share of credit were broadly flat in 2010 following falls from the elevated levels of 2009, when activity had been boosted by temporary, additional government subsidies for first-home buyers (FHBs) (Graph 3.4). This moderation in approvals has seen annualised growth in housing credit ease from 9 per cent over the six months to March 2010 to 7 per cent over the six months to January 2011 (Graph 3.5). Growth in both the owner-occupier and investor components have stabilised over the past few months, and are currently tracking at roughly the same rate.

Other forms of borrowing by households are also relatively subdued; growth in credit card lending picked up in the second half of 2010 but has since

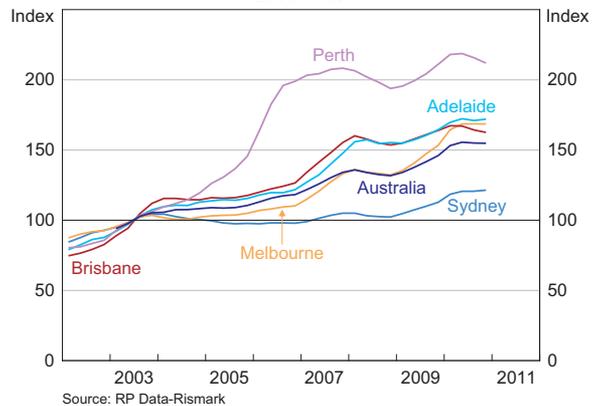
Graph 3.4
Housing Loan Approvals*
 Per cent of housing credit outstanding



Graph 3.5
Household Debt Components
 Six-month-ended annualised percentage change



Graph 3.6
Capital City Dwelling Prices
 2003 = 100



declined and is well below the average pace of recent years, while the level of all other personal credit outstanding has recently been contracting.

The moderation in demand for housing finance contributed to some cooling in the housing market in 2010. Nationwide housing prices rose 6 per cent over the year, compared with 11 per cent in 2009, and were fairly flat in the second half (Graph 3.6). The ratio of dwelling prices to income was broadly stable in 2010, at around the same level as in 2004. Although rental yields declined somewhat from their peak in 2008, they have generally been trending up since 2004. The increased propensity to pay down debt has also contributed to an increase in the rate of housing equity injection in the past few years.

Within the national average, though, there has been some regional divergence. Housing prices were firmer in Sydney and Melbourne for much of 2010, but have been drifting down in Perth and Brisbane. The strength in prices in Melbourne has occurred despite a greater expansion in housing supply than in the other cities, and is likely to have been driven by stronger than average growth in both population and loan approvals in Victoria.

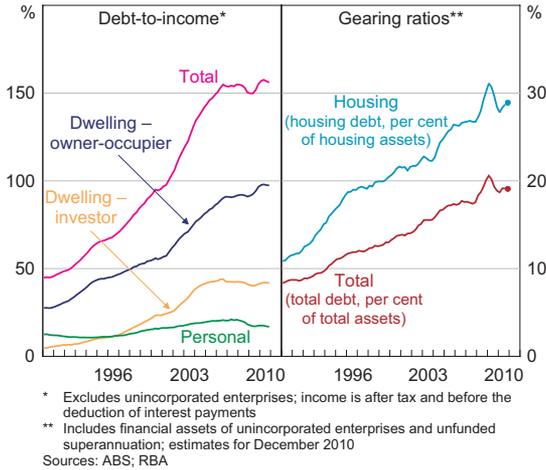
Even though the pace of debt accumulation has moderated in recent years, aggregate household

indebtedness and gearing remain around historically high levels (Graph 3.7). This means some households could now be more exposed to shocks to their incomes and financial circumstances. A continuation of the recent borrowing restraint would thus be a welcome development, as it would add further resilience to household balance sheets and avoid a build-up of risk in the household financial position.

That said, a range of financial stress indicators show that the household sector is coping reasonably well with its debt levels and higher interest rates. While arrears rates on mortgages are higher than the low levels reached during the late 1990s and

Graph 3.7

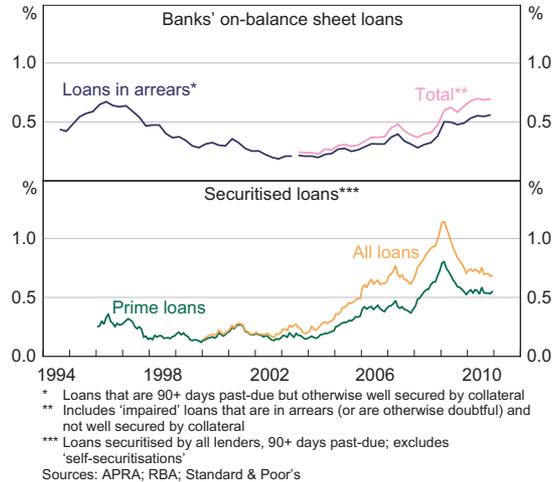
Household Indebtedness and Gearing



Graph 3.8

Non-performing Housing Loans

Per cent of outstandings



early 2000s, they remain low by international standards (Graph 3.8). By loan value, the share of non-performing housing loans on banks' balance sheets was around 0.7 per cent in December 2010, broadly unchanged since March 2010, and up 6 basis points from December 2009; the vast majority of these loans are well covered by collateral. Arrears on securitised housing loans were also stable in 2010, at about 0.7 per cent, though these data are becoming less representative of overall housing loan quality

given the gradual decline in residential mortgage-backed securities outstanding (down about 47 per cent from the peak in 2007). As with housing loans, personal and credit card loan arrears have been little changed over the past year. As at December 2010, the non-performing rate for credit cards was 1.1 per cent, broadly unchanged since March 2008. The equivalent figure for other personal loans was 1.7 per cent in December 2010, which was up a little over the year, but well down from the peak in early 2009.

That housing loan arrears stabilised in 2010, despite further increases in interest rates, reflects a number of factors. First, unemployment declined. Second, a large share of borrowers repay ahead of schedule; recent liaison with major banks indicates that many borrowers have been able to absorb the recent increases in interest rates by reducing their prepayment rates without lifting their overall repayment by much, if at all. Recently, some borrowers have been looking to reduce their interest-rate exposure by shifting to fixed-rate loans. The share of new owner-occupier loans at fixed rates rose to about 8 per cent in January 2011, up from a low of about 2 per cent in early 2010.

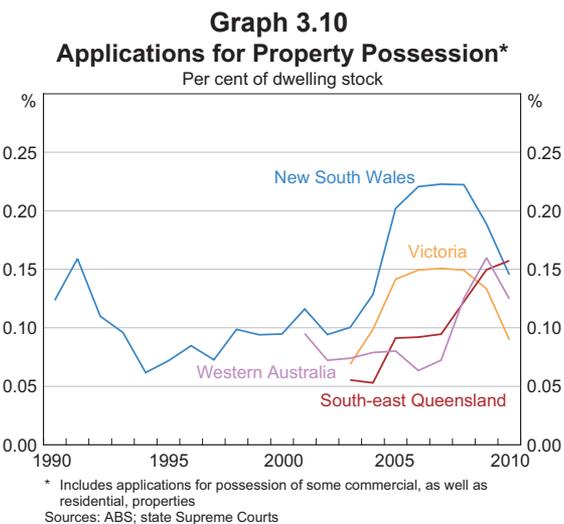
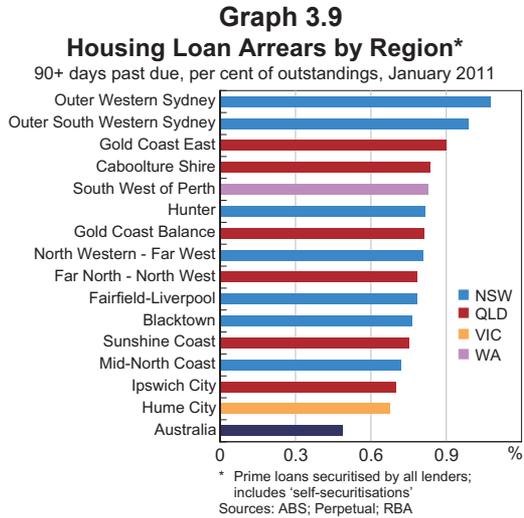
According to securitised loan data (including self-securitised loans), the housing loan arrears rate remains higher in New South Wales than in the other states, but increased more sharply in Western Australia and Queensland, rising by 12 and 18 basis points, respectively, over the year to January 2011. Similar trends are evident at the regional level. While a small number of regions in western Sydney remain among the most affected by housing loan stress, Queensland has become more heavily represented. As at January 2011, six regions in Queensland were among the 15 regions nationwide that had the highest rates of housing loan arrears, compared with three in January 2010 (Graph 3.9). Even so, the overall arrears rates in these regions remain low in absolute terms.

The pick-up in arrears in Queensland, which was evident even before the onset of the recent floods, is consistent with the softer property market in

the state, and has been exacerbated recently by higher-than-average unemployment. In response to the floods, many banks put in place hardship relief packages, including temporary repayment holidays, to help affected borrowers. While banks reported a large uptake in this hardship assistance, the floods are unlikely to cause a major increase in housing arrears to the extent that borrowers remain in employment.

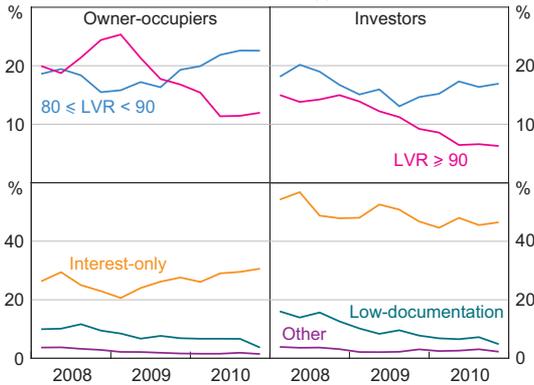
Other indicators of financial stress confirm that household financial circumstances are, in aggregate, relatively strong. Rates of mortgagees' applications for property possession generally declined in the second half of 2010; for the year as a whole, these rates were below those seen in recent years (Graph 3.10). The exception was south-east Queensland (comparable data are not available for the entire state), where the rate of mortgagees' applications for property possession has continued to increase over the past few years. The nationwide rate of bankruptcies and other personal administrations declined further in the second half of 2010, and is now well below the peak in 2009.

The relatively benign picture painted by these aggregate indicators of financial stress is consistent with household surveys, which show that only a small proportion of borrowers are highly geared. The latest Household, Income and Labour Dynamics in Australia (HILDA) Survey, for 2009 (before most of the recent increase in interest rates took place), showed a sharp decline in the share of households considered most vulnerable, that is, with both high debt-servicing ratios (DSRs) and high loan-to-valuation ratios (LVRs) (see also 'Box C: Household Experiences in the Downturn: Evidence from the HILDA Survey'). As well, less than 5 per cent of owner-occupier households in 2009 were in the lowest two income quintiles and had DSRs above 50 per cent. Even with the increase in interest rates since 2009, our estimates suggest that the share of such vulnerable households would still only be about 6 per cent of owner-occupiers with a mortgage and less than 2 per cent of all households.



The risk profile of mortgage lending has also benefited from tighter lending standards in recent years. The share of new housing loans approved by banks with LVRs above 90 per cent was stable in the second half of 2010 after declining over the previous few years, while the proportion of low-documentation loans has continued to trend lower (Graph 3.11). While the share of new investor housing loans that are interest-only has always been relatively high, reflecting tax considerations, recently the interest-only share of owner-occupier loans has increased as well. Liaison indicates that these loans

Graph 3.11
Banks' Housing Loan Characteristics*
 Share of new loan approvals



* LVR = loan-to-valuation ratio; 'Other' includes loans approved outside normal policies, and other non-standard loans; 'Interest-only' includes mortgages with 100 per cent offset accounts
 Source: APRA

are popular because of the repayment flexibility they offer. The majority of borrowers with these loans continue to make principal repayments either directly into the loan or into a linked offset account; their repayment behaviour is not much different from those borrowers with standard principal-and-interest loans. Moreover, most lenders assess debt serviceability on the basis of principal and interest payments, not just interest payments.

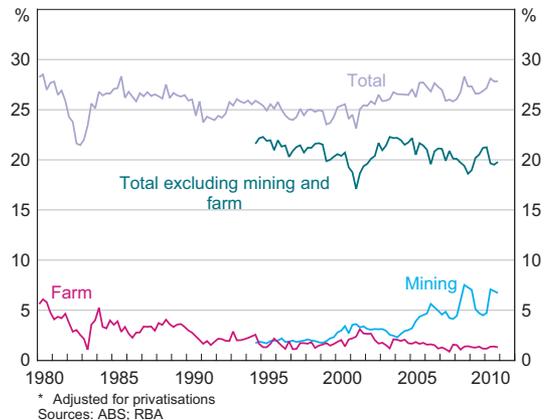
The performance of the 2009 cohort of FHBs is of particular interest given it has a high share of lower-income borrowers who made their home purchase during a period of low interest rates and at relatively high LVRs. Despite the increase in interest rates since 2009, liaison with major banks indicates that the 2009 cohort of FHBs is performing no worse, and in some cases better, than earlier cohorts. These FHBs are likely to have reduced their LVRs since they purchased their homes, given that they have made some principal repayments and housing prices have risen. Indications are that they have paid down their debt at a similar rate as earlier FHB cohorts had done after a year.

Business Sector

The economic recovery has seen the business profit share of GDP return to close to its 2008 peak. However, there are divergent outcomes at the sectoral level, with the share of mining sector profits well above its average level, while earnings for other non-financial businesses have been more stable relative to GDP (Graph 3.12). Mining profits rose by around 60 per cent in 2010, as the sector recovered from its recent profit downturn; in contrast, profits of other non-financial, non-farm businesses were slightly lower over the year. This divergence is also evident in company announcements during the latest corporate reporting season. On a matched sample basis, underlying profits for listed ASX 200 resources companies were around 68 per cent higher in the second half of 2010 compared with the corresponding period in 2009, while profits for other non-financial companies were little changed. In line with this stronger performance, share market analysts are forecasting listed resources companies' earnings to increase by 64 per cent in the 2010/11 financial year, compared with expected growth of around 4 per cent in the earnings of other listed non-financial companies (Graph 3.13).

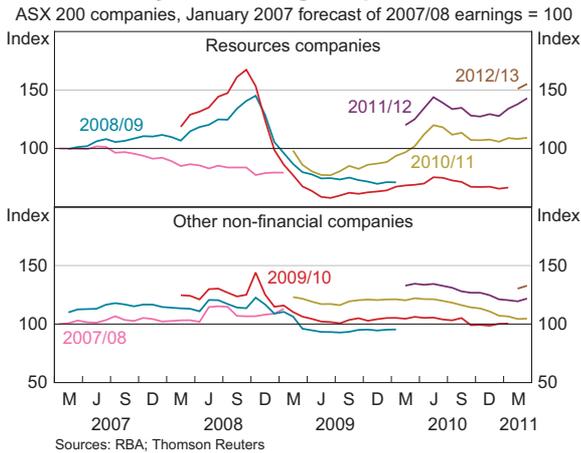
Earnings expectations have been revised down for the retail sector, reflecting the more cautious approach to spending by consumers, while the

Graph 3.12
Business Profits*
 Per cent of GDP



* Adjusted for privatisations
 Sources: ABS; RBA

Graph 3.13
Analysts' Earnings Expectations



stronger Australian dollar is expected to weigh on profits in sectors such as manufacturing and tourism. The recent heavy rain and flooding in Queensland have also reduced earnings expectations for some

large non-financial firms with significant exposures to Queensland. However, these firms' geographically diversified operations and the likely boost from future reconstruction work have limited this. The floods also adversely affected survey measures of business conditions and confidence, but indications are that the fall will be temporary.

In the unlisted (generally smaller) business sector, preliminary credit bureau data suggest that profitability improved in 2010, but remains below pre-crisis levels: the median after-tax return on assets of firms in the sample was 5.5 per cent in 2010 compared with 6.3 per cent in 2007. The share of loss-making businesses returned to pre-crisis levels, falling by 5 percentage points to 20 per cent in 2010, although among smaller firms the share that is loss-making remains above average (Table 3.1). By sector, the improvement in profitability among unlisted companies appears to be more broadly based than among listed companies.

Table 3.1: Unlisted Loss-makers^(a)
Per cent

	2005	2006	2007	2008	2009	2010
By size (total assets)						
Less than \$1 million	23	26	27	27	36	37
\$1 million to \$10 million	21	18	21	22	26	22
\$10 million to \$100 million	18	18	18	18	22	18
\$100 million or greater	18	17	17	17	22	14
By industry						
Agriculture, forestry & fishing	26	36	30	32	35	35
Utilities	18	23	27	23	29	18
Manufacturing	18	18	19	18	23	18
Mining	46	39	41	43	41	34
Rental, hiring & real estate services	21	19	22	21	33	18
Services	23	22	23	25	29	24
Wholesale & retail trade	15	15	15	13	18	14
Construction, transport & other	16	11	12	10	17	13
Total	21	19	20	20	25	20

(a) Share of firms with negative net profit after tax in the year
Sources: Dun & Bradstreet (Australia); RBA

Another indicator of the profitability of smaller businesses is the profit share of GDP of unincorporated enterprises. This has hovered around 8 per cent since 2007, after declining from an average of 10 per cent in the 1980s, as some small firms and partnerships incorporated, and traditionally unincorporated businesses in some sectors, such as agriculture, declined as a share of output. In contrast, the corporate profit share has risen from an average of 16 per cent in the 1980s to 19 per cent since 2007.

Strong profits overall have translated to robust internal funding for businesses in recent years, with these funds accounting for 10 per cent of GDP in the September quarter 2010, compared with a long-run average of about 8 per cent (Graph 3.14, top panel). Firms' retained earnings rose as they initially responded to the financial crisis by retaining cash and paying down debt (thus lowering interest payments), with the recent recovery in earnings growth also supportive. However, it is likely that a large part of these retained earnings has been concentrated in the mining sector, where strong profit growth has been accompanied by a traditionally lower dividend payout ratio

than other sectors. Resources companies have recently announced plans to significantly increase distributions, which could result in a decline in the share of internal funding in the future.

Equity raisings moderated in 2010, following a period when firms sought to rebalance their capital structure away from debt and towards equity in response to the crisis. Listed corporates' net equity raisings amounted to \$26 billion in 2010, which is roughly in line with the annual average between 2003 and 2007, though down from the \$74 billion raised in 2009. Equity raisings were strong in the final quarter of 2010, however, driven mainly by increased issuance by real estate and resources companies.

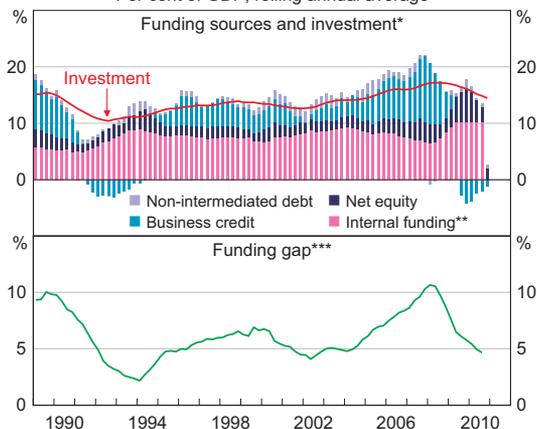
External debt funding remains subdued, with a decline in business credit in the second half of 2010 offsetting solid corporate non-intermediated debt issuance. Bond issuance by non-financial corporates was weak in the first half of 2010, but picked up in the second half of the year, with issuance over the six months to January 2011 reaching \$15.6 billion, compared with \$9.7 billion over the previous six-month period. Most of this recent issuance has been into offshore markets, with much of it being placed by resources companies seeking funding for new projects. The strong demand from offshore investors reflects the strength of the Australian economy, strong commodity prices, and some credit rating upgrades in 2010.

After broadly stabilising in the first half of 2010, business credit began to contract again in the second half of the year, falling by 5 per cent in annualised terms over the six months to January 2011 (Graph 3.15). However, the most recent monthly figures show that the rate of decline has slowed. The decline in business credit over the second half of 2010 was mainly driven by falls in lending to corporates, with lending to (generally smaller) unincorporated enterprises more stable. Even so, syndicated loan approvals (to large non-financial businesses) picked up strongly in the December quarter, with around \$32 billion in deals, the largest quarter of approvals since

Graph 3.14

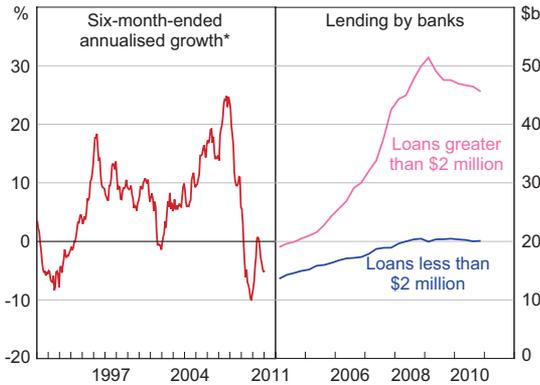
Business Funding and Investment

Per cent of GDP, rolling annual average



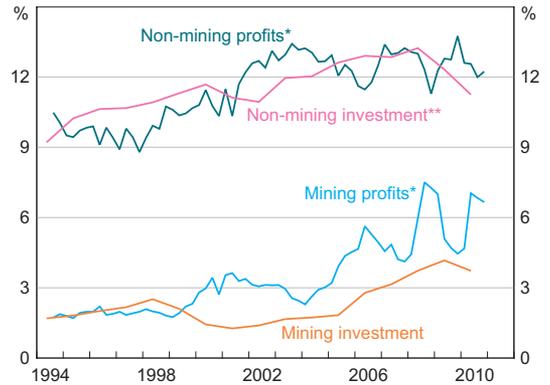
* Does not capture loans by institutions domiciled outside Australia
 ** Internal funding for December 2010 is not yet available
 *** Investment less internal funding
 Sources: ABS; ASX; Austraclear; RBA

Graph 3.15
Lending to Businesses



* Seasonally adjusted and break adjusted; includes lending by non-bank financial institutions and securitised loans, but excludes lending to non-residents
Sources: APRA; RBA

Graph 3.16
Business Profits and Investment
Per cent of GDP



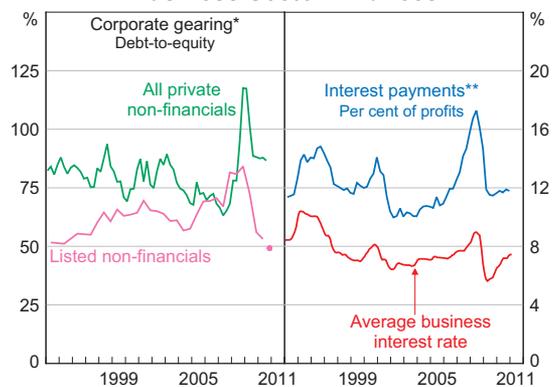
* Gross operating profits; inventory-valuation adjusted; excludes unincorporates
** Excluding livestock; adjusted for second-hand asset transfers between private and other sectors
Sources: ABS; RBA

December 2007. Although reduced appetite for debt and tighter credit supply are likely to have weighed on business borrowing in recent quarters, ongoing weakness in large business borrowing also reflects firms turning to alternative forms of finance, including offshore bond markets.

Overall, it is unlikely that firms are facing widespread financial constraints to their investment capacity. Investment as a share of GDP has fallen since its 2008 peak. Combined with strong internal funding, this has seen firms' aggregate external funding requirements fall significantly (Graph 3.14, bottom panel). There is some divergence between sectors: mining investment is at historically high levels, supported by robust retained earnings and good access to external funding, while credit remains more difficult to access for firms in some other sectors, such as small property developers (Graph 3.16).

Declining business debt levels together with solid profits and equity raisings in recent years have seen a further reduction in business gearing. Book value gearing for listed non-financial corporates fell to 49 per cent in the second half of 2010 from a peak of 84 per cent in 2008, and well below the long-run average level of 66 per cent (Graph 3.17, left panel). The fall was primarily driven by strong growth in

Graph 3.17
Business Sector Finances

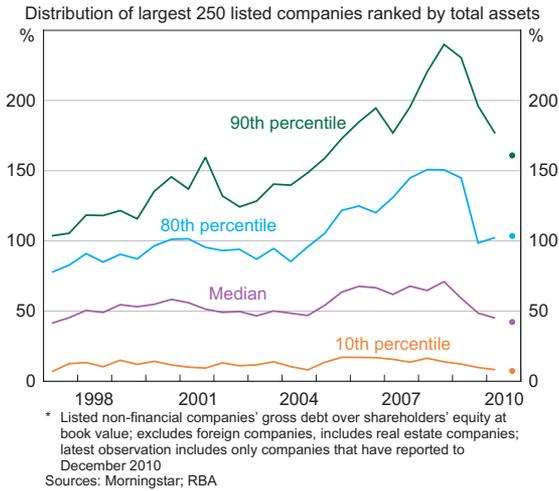


* Listed is book value, includes real estate companies and excludes foreign companies, and its latest observation includes only companies that have reported to December 2010; all private is market value
** Interest on intermediated debt from Australian-domiciled financial institutions
Sources: ABS; APRA; Morningstar; RBA; Statex

retained earnings and reductions in debt by resources companies. The post-2004 run-up in gearing of the most highly leveraged companies has now been largely unwound (Graph 3.18). Like households, many companies are apparently adopting a more cautious approach to the use of debt; in the case of some of these firms, though, this might have been at the behest of their creditors. Credit bureau data suggests that gearing of unlisted companies also declined over 2010, particularly for the most

Graph 3.18

Listed Companies' Gearing Ratios*



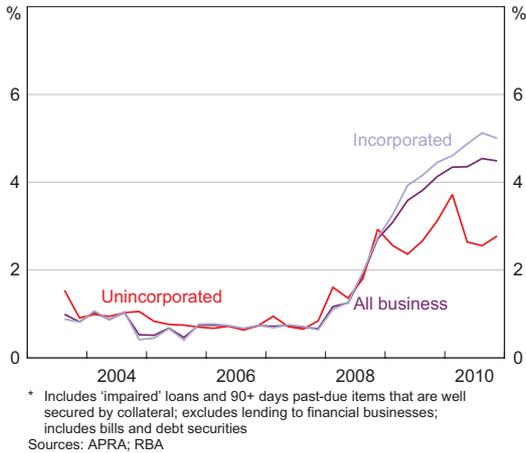
This deleveraging has seen business interest payments as a share of profits remain well below long-run average levels despite the recent increases in business loan interest rates. Interest payments accounted for 12 per cent of business profits in the December quarter 2010, below the peak of 17 per cent in the June quarter 2008 (Graph 3.17, right panel). Within this, the ratio of unincorporated businesses' interest payments to their profits fell from its June quarter 2008 peak of 11 per cent to 8 per cent in the December quarter 2010.

The non-performing domestic business loan ratio levelled out over 2010, and now stands at 4.4 per cent for non-financial businesses (Graph 3.19). Within this, a little less than one half of the troubled loans are to the commercial property sector, including developers of residential property. The non-performance rate remains higher for loans to the incorporated sector at 5 per cent in December 2010, up from 4.5 per cent a year earlier. Over the year to December, the non-performing ratio for loans to unincorporated businesses declined a little, to 2.8 per cent. While most firms have been resilient in the face of tighter financing conditions, a few had taken on significant amounts of leverage, and not all of them have been able to refinance in the new environment. It is likely that these firms account for much of the deterioration in loan performance over the cycle.

Graph 3.19

Banks' Non-performing Business Assets*

Domestic books, per cent of outstandings by type



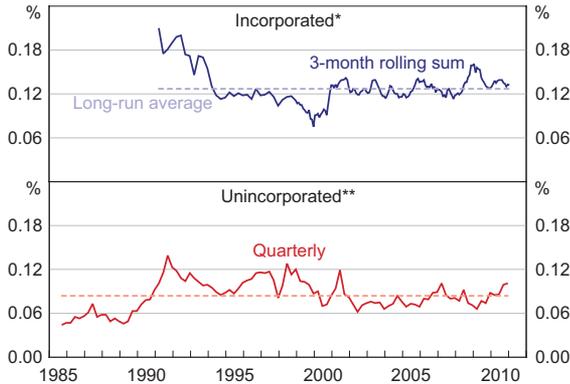
Business failures, a lagging indicator of business financial health, remain modest. The rate at which incorporated businesses are entering external administration fell over the second half of the year to around its long-run average level (Graph 3.20). Queensland, which experienced a sharper increase in corporate failures than the rest of the country during 2008 and early 2009, continues to have an above-average rate of failures. The failure rate among unincorporated businesses has picked up over the past two years, and is now a little above average.

leveraged companies, mainly reflecting increases in equity. Unlisted firms appear to have retained a greater share of their profits in 2010. These firms may be relying more on internal funding to finance their daily activities, with a survey of small to medium-sized businesses showing cash flow management to be a persistent concern since the onset of the crisis, although this has diminished recently.

Graph 3.20

Business Failures

Per cent of businesses in each sector

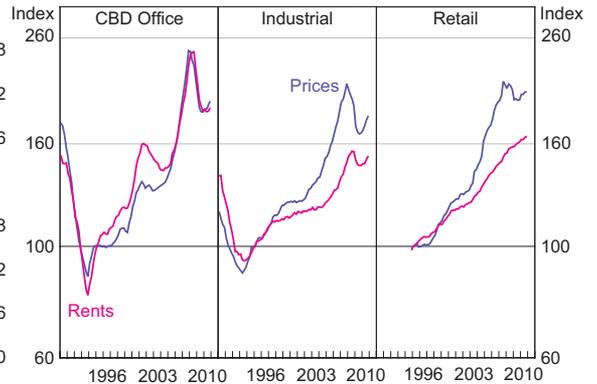


* Companies entering external administration, pre-1999 data are quarterly
 ** Business bankruptcies
 Sources: ABS; ASIC; ITSA; RBA

Graph 3.21

Commercial Property

March 1995 = 100, log scale



Sources: Jones Lang LaSalle; Property Council of Australia; RBA

Commercial Property

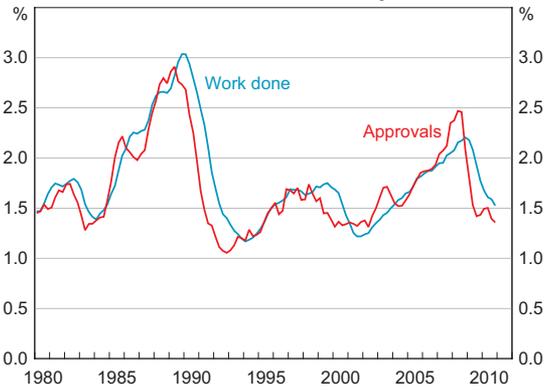
Conditions in the commercial property market have continued to stabilise, with rents and property prices recovering in most segments (Graph 3.21). The recent downturn in the commercial property market has been much less severe than that in the early 1990s, particularly for the office property sector. This is largely attributable to the smaller supply overhang and the less pronounced economic slowdown compared with the earlier episode. Vacancy rates now look to have peaked, falling modestly since June 2010. Construction activity is still subdued, but appears to be stabilising, with the share of approvals broadly levelling out since late 2009. Commercial property approvals and work done as a share of GDP have fallen by around 45 per cent and 31 per cent from their respective peaks (Graph 3.22).

The weakness in new commercial property development in part reflects ongoing tightness in lending conditions. Industry liaison suggests that developers continue to face stricter collateral and covenant requirements, as well as higher pre-commitment/pre-sales ratios. Data for December 2010 indicate that banks have reduced their domestic commercial property exposures (actual and limits) by about 15 per cent since

Graph 3.22

Commercial Property Construction

Per cent of GDP, 12-month rolling sum

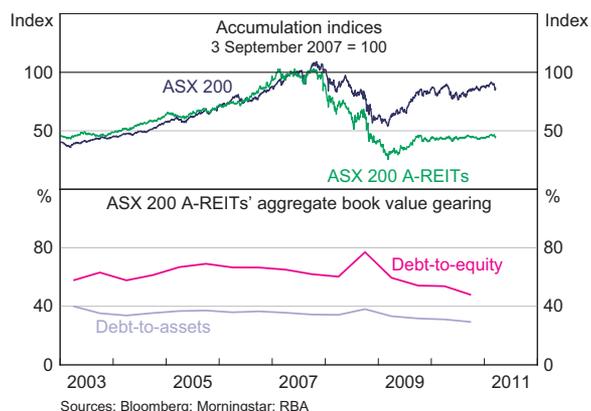


Sources: ABS; RBA

March 2009, although the pace of contraction is slowing. Commercial property loan impairments also appear to be stabilising. The share of banks' commercial property exposures that were impaired fell over the December quarter, as banks liquidated a number of large bad debts. Commercial property exposures nonetheless still account for a disproportionate share of banks' impaired business assets.

Non-bank sources of commercial property finance remain constrained. Commercial mortgage-backed security markets reopened in 2010, but aggregate issuance has been well below the levels prevailing

Graph 3.23
Listed Real Estate Investment Trusts



before the crisis, while mortgage trusts have seen a sharp fall in funds under management since 2007. In response, some larger developers have turned to non-intermediated debt to meet their financing needs. Superannuation funds – which are attracted by the higher yields on offer in the sector – are also investing, albeit on a small scale.

Equity raisings by Australian Real Estate Investment Trusts (A-REITs) slowed over 2010 to \$4.5 billion compared with \$13.5 billion in 2009. This may partly reflect these trusts having achieved their target balance sheet restructuring – the aggregate debt-to-equity ratio of ASX 200 A-REITs has fallen from 77 per cent in December 2008 to 48 per cent as at December 2010 (Graph 3.23). It may, however, also reflect weaker market conditions – between September 2007 and December 2010, the ASX 200 A-REITs accumulation index underperformed the broader market index and price-to-book ratios fell below one. More recently, ASX 200 A-REITs' equity market returns have edged up as the sector stabilised. December 2010 half profits broadly exceeded market expectations, with aggregate headline profits for a matched sample of ASX 200 real estate companies rising by 19 per cent compared with the June 2010 half year.