

3. Household and Business Finances

Risks posed to the household sector continue to stem largely from the housing and mortgage markets, especially from investor activity in some cities. This activity has led to continued strong housing price growth in Sydney and higher levels of construction, with a risk of oversupply in some regions, particularly in the inner-city areas of Melbourne and Brisbane. More broadly, the heightened level of investor activity and borrowing could amplify the housing price cycle and increase the risk of significant price falls later. The growing prevalence of interest-only lending might also increase households' vulnerability, since borrowers can pay down their loans more slowly than required under conventional principal and interest loans.

At the margin, the recent decline in mortgage interest rates will be likely to add to overall housing demand. However, the actions announced by the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC) in December – which are designed to reinforce sound housing lending practices – aim to temper risks arising from the housing market (for further discussion, see 'Box B: Responses to Risks in the Housing and Mortgage Markets'). These risks should also be placed in the context of the current low levels of household financial stress.

Risks also appear to have increased somewhat in the commercial property sector, including property development. Search for yield behaviour has underpinned strong investor demand for commercial property assets, particularly from offshore investors, which has continued to drive prices higher and yields lower both in Australia and

abroad. However, leasing conditions have remained soft in many local markets, and oversupply is emerging in the Perth and Brisbane office markets. These dynamics increase the vulnerability of the commercial property market to a price correction. Nonetheless, the consequent risk to the domestic financial system has been lessened by the significant reduction in banks' exposure to the sector since the financial crisis.

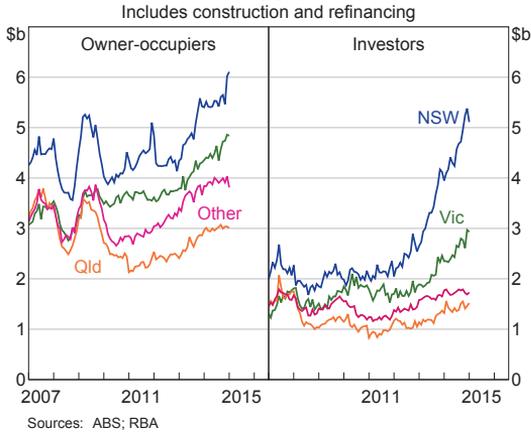
Other parts of the business sector appear to present little near-term risk to financial stability. Gearing levels are low by historical standards, and indicators of financial stress have continued to decline. While recent sharp falls in commodity prices will make it difficult for some resource-related companies to service their debt, the risks posed to the domestic financial system from these developments seem limited: the financial positions of the largest resource companies are robust, and the exposures of banks to the sector are not large.

Household Sector

Housing market developments

Investor demand continues to drive housing and mortgage markets, with low interest rates and strong competition among lenders translating into robust growth in investor lending, especially in Sydney. Investor housing loan approvals in New South Wales have increased by almost 150 per cent over the past three years, and now account for almost half the value of all housing loan approvals in that state (Graph 3.1). They have also increased quite strongly in Victoria over the same period. At the national level,

Graph 3.1
Housing Loan Approvals by State



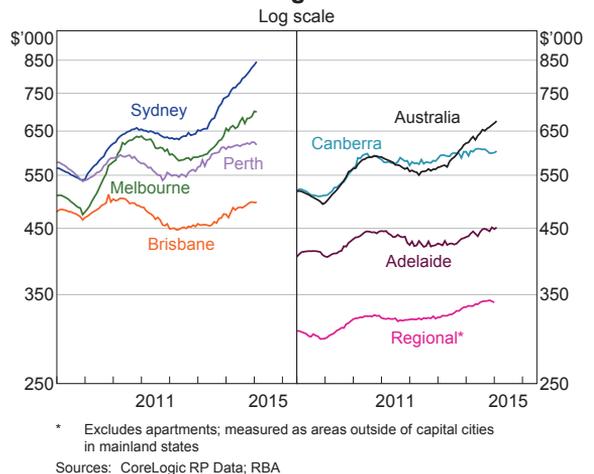
growth in investor housing credit has continued to increase over recent months, to now be around 10½ per cent in six-month-ended annualised terms. It is too early to expect a material slowing in investor loan approvals or credit growth in response to APRA's measures, partly because of the pipeline of pre-approvals already agreed before the measures were announced.

Repeat-buyer owner-occupier demand has picked up a bit over recent months, with loan approvals to repeat buyers increasing in New South Wales and Victoria. In contrast, first home buyer owner-occupiers remain a low and declining share of the mortgage market, partly due to the winding back of government incentives for first home buyers in the established dwellings market over the past two years or so.

As discussed in the previous *Review*, the main risk from the ongoing strong level of investor activity is most likely to be macroeconomic in nature. Heightened investor demand can amplify the housing price cycle, especially when it involves the use of leverage, and so increases the risk that prices later fall significantly; investors are more likely to engage in speculative behaviour than are owner-occupiers, and they face lower barriers to exiting when the market turns down. Robust investor demand has helped underpin continued

rapid housing price growth in Sydney, though price growth has been more moderate elsewhere (Graph 3.2). Periods of rising housing prices can also increase expectations for further price rises, inducing even more demand, although recent survey evidence indicates that expectations for price growth remain below the high levels reached in late 2013. Importantly, a future fall in housing prices would reduce wealth and dampen spending for the broader household sector, particularly for those households with significant housing debt, not just for the investors who contributed to the upswing.

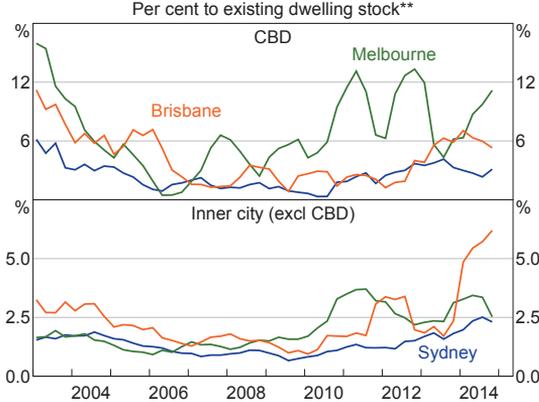
Graph 3.2
Housing Prices



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 dwelling construction has risen strongly over the past year or so, driven by low interest rates and rising housing prices, at this stage there is little to suggest that oversupply is in prospect at the national level. Nonetheless, at the local level some areas look more vulnerable (Graph 3.3):

- The risk of oversupply appears most evident in inner-city Melbourne, where the level of high-rise apartment construction has been elevated for a number of years. The rental market already looks fairly soft, with relatively high vacancy rates and little growth in rents. And given the

Graph 3.3
Dwelling Approvals*
Per cent to existing dwelling stock**



* Four-quarter rolling sum
** Dwelling stocks estimated by RBA
Sources: ABS; RBA

strength in approvals of late, and the time lags between approval and completion, significant new supply will continue to come on line over the next few years. Liaison suggests that a large amount of activity has been driven by foreign developers and foreign investors, with some of these developments consisting of smaller-sized apartments targeted at international students. These apartments may be difficult to sell in the secondary market if investors' expectations of future student demand are not met, which could place downward pressure on prices, including in the broader Melbourne apartment market.

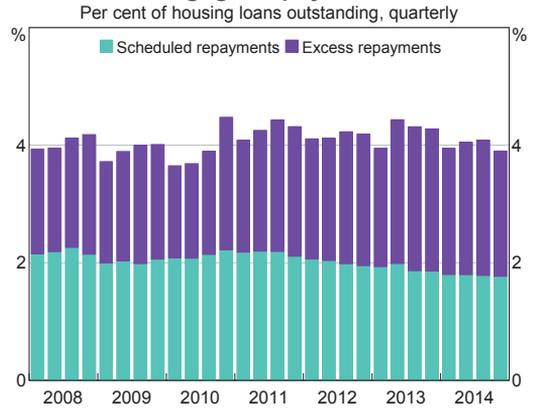
- More recently, there has been a strong increase in higher-density dwelling approvals in inner-city Brisbane. Some reports suggest that the vacancy rate has started to drift higher and that growth in rents has slowed of late. In liaison, banks and other firms have conveyed some concern about possible future oversupply in this market.

Borrowing and balance sheet position

Outside of investor housing, household sector finances are currently less cause for concern. Household credit growth has remained moderate, because new lending for purposes other than investor housing has been more subdued and because existing borrowers are taking advantage

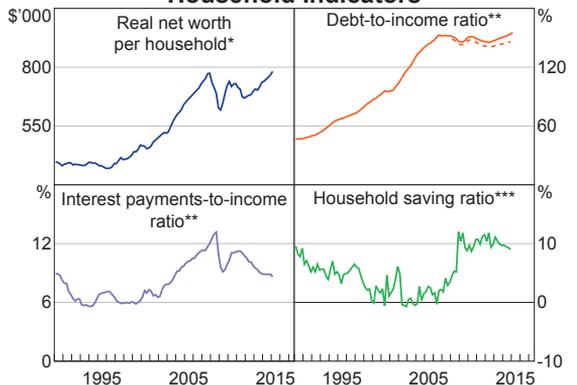
of low interest rates to pay down debt more quickly than contractually required (Graph 3.4). The aggregate mortgage buffer – as measured by balances in offset and redraw facilities – has risen to almost 16 per cent of outstanding loan balances (more than two years' worth of scheduled repayments at current interest rates). More broadly, households continue to save a greater share of their income than in the decade or so prior to the financial crisis (Graph 3.5). Households' ability to

Graph 3.4
Mortgage Repayments*
Per cent of housing loans outstanding, quarterly



* Data are backcast before December 2010 to adjust for a reporting change by one bank
Sources: APRA; RBA

Graph 3.5
Household Indicators



* In 2012/13 dollars; RBA estimates for December quarter 2014 and March quarter 2015
** RBA estimates for March quarter 2015; dashed line is net of balances in offset accounts
*** Household sector includes unincorporated businesses; net of depreciation

Sources: ABS; APRA; CoreLogic RP Data; RBA

meet interest payments on their loans is being aided by the low level of interest rates. However, while the debt-to-income ratio has been relatively stable over the past decade or so, especially once balances in offset accounts are netted off, it is high relative to its longer-run history.

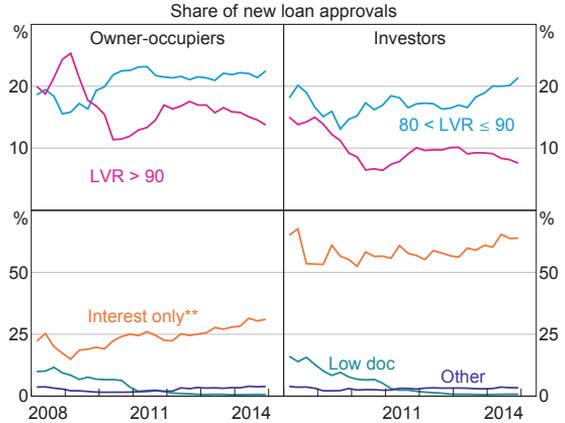
As might be expected in the low interest rate environment, some households have shown a willingness to accept increased risk in order to earn a higher return on their financial investments. For example, some retail investors have been attracted to the relatively high rates of return offered by the nascent market of peer-to-peer lenders, which provide a platform for households to lend directly to businesses or other households. ASIC has warned that investors should understand and take into account the associated financial risks of these products, which include a lack of liquidity and a difficulty in assessing the quality of the borrower.

Housing loan characteristics

While an environment of historically low interest rates, rising housing prices and strong competition in the mortgage market poses some risk that lenders will loosen housing lending standards, there are relatively few signs that this has occurred to date. The share of loan approvals with loan-to-valuation ratios (LVRs) above 90 per cent – which expose the borrower to a higher risk of falling into negative equity should housing prices decline – continued to trend lower over 2014 (Graph 3.6). This decline was led by lenders that had previously reported higher than average shares of these types of loans in their new lending; this shift might have been partly in response to APRA’s already enhanced level of supervisory intensity. Some of this higher-risk lending activity has now shifted into the 80–90 per cent LVR category, which in part accounts for the rise in that type of lending to investors since mid 2013.

A low interest rate environment can also increase the risk of households taking out larger loans than they could comfortably repay if interest rates were to rise. However, banks typically apply interest

Graph 3.6
Banks’ Housing Loan Characteristics*



* LVR = loan-to-valuation ratio; 'Other' includes loans approved outside normal debt-serviceability policies and other non-standard loans

** Series is backcast before December 2010 to adjust for a reporting change by one bank

Sources: APRA; RBA

rate buffers and minimum floor interest rates in serviceability assessments to moderate this risk, with APRA’s recently announced supervisory measures clarifying its expectations in this area. Indeed, the profile of new lending suggests that households continue to be well placed to service their loans. Some evidence suggests that only a very small share of new lending has both a high LVR and a high loan-to-income ratio, implying that few households are simultaneously exposed to the risks of falling into negative equity and of facing difficulty in making their loan repayments.

One area of potential concern is the increase in interest-only loans as a share of total housing loan approvals, for both owner-occupiers and investors. For investors, the prevalence of interest-only borrowing is consistent with the tax deductibility of investors’ mortgage interest payments, which reduces the incentive to pay down the loan principal. In liaison, banks have suggested that for owner-occupiers the trend rise in interest-only lending has been driven more by borrowers’ desire for increased flexibility in managing their repayments than affordability pressures. Some of this demand for flexibility has come from owner-occupiers who plan to later switch their dwelling into an investment

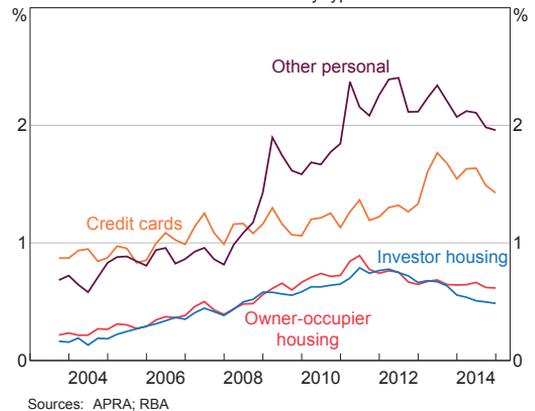
property, at which point they will have an incentive to withdraw balances that they have accumulated in attached offset accounts. The banks have indicated that many owner-occupiers with interest-only loans are in practice building sizeable buffers in attached offset accounts and redraw facilities, and that non-performance rates on these types of loans are low. They also note that, in principle, interest-only loans should not increase borrowing capacity because consumer protection regulations imply that lenders should assess a borrower's ability to service principal and interest payments following the expiry of the interest-only period. ASIC is in the process of assessing compliance with this obligation through its review of interest-only lending. Despite these considerations, interest-only loans – especially for owner-occupiers – nonetheless involve greater risk because they enable borrowers to pay down principal more slowly than a conventional principal and interest loan would require.

Loan performance and other indicators of financial stress

Indicators of overall household financial stress remain low, aided by low interest rates and rising asset prices. This comes despite the slow pace of wage growth and gradual weakening in labour market conditions seen over the past couple of years. In particular, the non-performance rates for all types of housing and non-housing related bank lending to households declined further over the six months to December 2014 (Graph 3.7). Looking ahead, however, loan performance is likely to at least partly depend on how conditions evolve in the labour market. Although forward-looking indicators of labour demand improved a little throughout 2014, they suggest only moderate employment growth in the near term.

More granular data on securitised housing loans show a broad-based improvement in housing loan performance across most regions, although arrears in mining-exposed towns seem to have picked up. As mentioned in the chapter 'The Australian Financial

Graph 3.7
Banks' Non-performing Household Loans
 Share of loans by type



System', banks have been tightening housing lending standards in many of these towns. Given further weakness in commodity prices recently, and more cuts to investment and exploration spending by resource-related firms, some further increase in financial stress among households in mining-exposed areas could be expected.

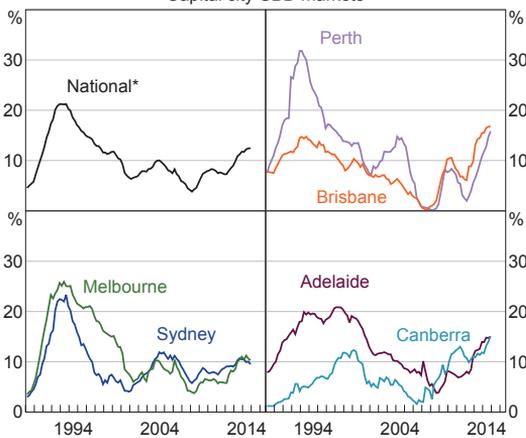
Other indicators also point to low levels of financial stress in the broader household sector. As a share of the dwelling stock, applications for property possessions continue to decline in the four largest states and have stopped rising in Tasmania. Non-business related personal administrations as a share of the adult population are also trending lower, with the decline fairly broad based across states.

Commercial Property

The commercial property sector has historically posed a disproportionately large risk to lenders' balance sheets and been responsible for a number of episodes of stress in the banking sector, both domestically and overseas. Among the reasons for this is that new supply takes time to be built, which means that supply responds to changes in tenant demand are sluggish; large swings in vacancy rates and prices often ensue. The property development part of this sector is especially cyclical, and developer failures tend to be highly correlated in a downturn.

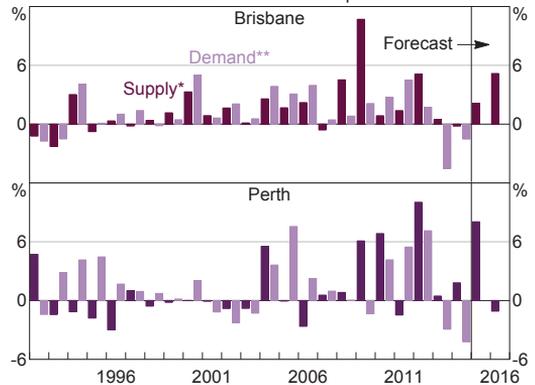
In recent years, commercial property conditions have softened significantly and there are now clear signs of an emerging oversupply in some markets. In CBD office markets, vacancy rates are high and generally increasing, rents are flat or falling, and leasing firms are offering sizeable incentives to secure tenants (Graph 3.8). Conditions appear particularly weak in Brisbane and Perth, where vacancy rates are already high and demand for office space has fallen as resource companies and, in Brisbane, the public sector have reduced their space requirements (Graph 3.9). On the supply side, a significant amount of new office space is still expected to come on line in Brisbane and Perth in the next couple of years due to earlier investment decisions. As a result, market commentators expect vacancy rates in these cities to rise further. Consistent with this weak outlook, building approvals for offices have fallen over the past year, and industry liaison suggests that some new projects are being delayed or shelved ahead of construction, due to difficulties in acquiring a sufficient level of tenant precommitments. Leasing conditions in industrial and retail property markets also appear subdued nationwide, with rents flat or falling.

Graph 3.8
Office Vacancy Rates
Capital city CBD markets



* Excluding Darwin and Hobart
Source: JLL Research

Graph 3.9
CBD Office Property
Per cent of CBD office space



* Completions net of withdrawn space; forecast is projects under construction and plans approved less average withdrawals

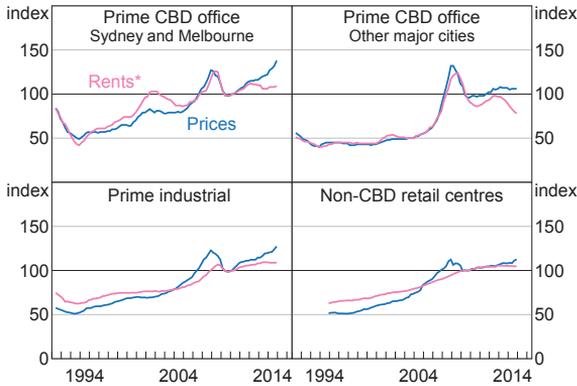
** Change in occupied space; no forecasts are available

Sources: Property Council of Australia; RBA

Despite this weakness in leasing conditions, commercial property prices have continued to rise at a national level, driven in particular by investors' search for yield in the global environment of low interest rates and ample liquidity, with the lower Australian dollar also likely to be adding some impetus to foreign demand (Graph 3.10). As a consequence, the total value of office, industrial and retail property transactions has risen sharply recently, with a notable increase in the share of transactions involving foreign purchasers, particularly in Sydney. The divergence between rising prices and falling rents in office and industrial, and to a lesser extent retail, property has widened further since the previous *Review*, with an associated fall in yields.

As a result of these developments, the risk of a large repricing and associated market dislocation in the commercial property sector has increased. This could be triggered by several factors, such as growing excess supply that prompts a reassessment of valuations, or a sharp fall in foreign investor demand, perhaps due to a rise in global interest rates or weaker conditions in foreign investors' home countries. The CBD office markets in Brisbane and Perth seem most vulnerable, with the recent fall in global commodity prices likely to weigh further on tenant demand from resource-related companies.

Graph 3.10
Commercial Property Market Conditions
 2009 = 100



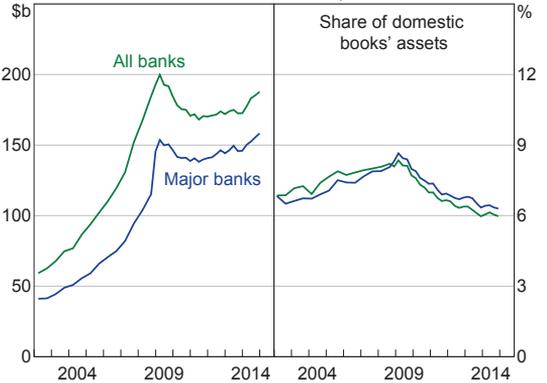
* Effective rents for offices, face rents for industrial and retail property
 Sources: ABS; JLL Research; Property Council of Australia; RBA

Property developers in some apartment markets are facing similar risks. Prices for development sites have risen sharply over the past year or so, largely reflecting strong demand from foreign residential developers. Some apartment markets, particularly in inner-city Melbourne as outlined earlier, also look vulnerable to potential oversupply, partly because apartment construction is subject to the same supply lags that affect other commercial property development. While investor demand appears strong at present, including from foreign investors, vacancy rates in these areas are relatively high and future tenant demand, including from international students, is uncertain. The current high rate of pre-sales should provide developers with some level of protection against a downturn in these apartment markets, but this protection is somewhat untested in an environment of falling prices, when investors might have the incentive to sacrifice their deposits and walk away. It is also unclear how foreign banks and developers – both of which are quite active in apartment markets on the eastern seaboard – would react to falling prices in these markets.

At this stage, the near-term risks to the domestic financial system from the commercial property sector seem relatively modest, though they are building. Banks' exposure to commercial property as a share of their total assets has fallen substantially since the

financial crisis, and has remained stable over the past year (Graph 3.11). However, with lending to this sector picking up, and reports of strong competition among lenders leading to some relaxation of lending standards, this is an area that will likely require close scrutiny for some time to come.

Graph 3.11
Banks' Commercial Property Exposures*
 Consolidated Australian operations



* Quarterly from September 2008; some banks report only on a semiannual basis
 Sources: APRA; RBA

Other Business Sectors

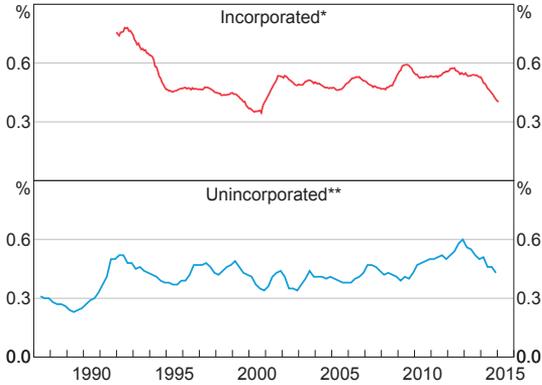
Business conditions and funding

Outside commercial property, including property development, risks to financial stability from non-financial businesses appear generally low. Survey measures of business conditions remain around long-run average levels, while business failure rates and the share of banks' business loans that is non-performing have continued to fall (Graph 3.12). Like many households, businesses remain fairly cautious in their spending and borrowing decisions, despite the low level of interest rates. Over 2014, intermediated business credit increased moderately, to be slightly above its pre-crisis level, while net issuance of corporate bonds was negative. Equity raisings picked up, but from a low base, reflecting increased IPO activity. Notwithstanding this cautious behaviour, if banks relax lending standards to gain a competitive edge amid low demand for business finance, this could pose a risk to future

Graph 3.12

Business Failures

Share of businesses in each sector, annual

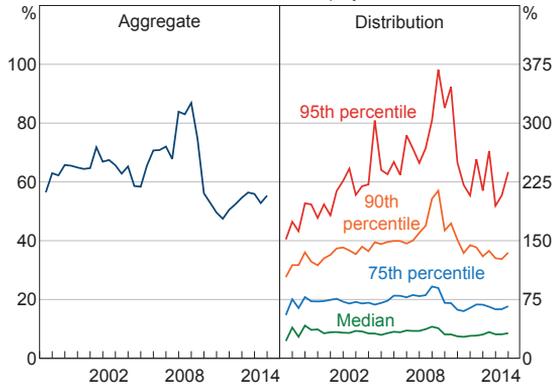


* Corporations entering external administration
 ** Business-related personal administrations and other administrations
 Sources: ABS; AFSA; ASIC; RBA

Graph 3.13

Listed Corporations' Gearing*

Book value debt-to-equity ratio



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

loan performance. As discussed in the chapter 'The Australian Financial System', despite strong pricing competition for loans to large corporations, to date loan covenants have been relaxed only for certain borrowers.

Business finances

In line with the ongoing improvement in stress indicators, business finances generally appear to be in good shape. After the sustained period of deleveraging following the financial crisis, the aggregate gearing ratio of listed corporations remains near its historical lows (Graph 3.13). Furthermore, gearing ratios in the more vulnerable tail of the distribution are significantly lower than levels seen immediately before and during the financial crisis. Partly reflecting the low level of gearing, as well as low interest rates, the business sector seems well placed to service its debts. The aggregate debt-servicing ratio of listed corporations remains at a fairly low level, with companies' net interest expense absorbing only around 10 per cent of profits, though debt owed by companies with relatively high ratios remains above its pre-crisis level.

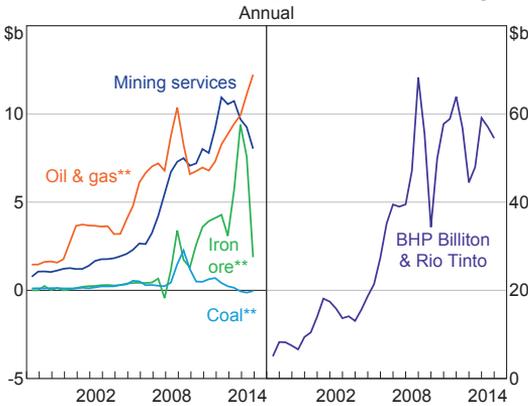
Despite this relatively benign backdrop, some potential risks from the business sector have emerged over the past six months or so.

In particular, as discussed in the chapter 'The Global Financial Environment', the prices of oil and iron ore have fallen more sharply than expected, following earlier large declines in coal prices. These lower commodity prices have reduced the profitability and cash flow of Australia's resource producers (Graph 3.14). Many of them have responded by further reducing planned capital expenditure and targeting greater efficiencies.¹ The prospects for mining services companies have therefore also weakened, compounding the already subdued conditions in this sector as the investment phase of the mining boom winds down; the profits of listed mining services companies are estimated to have fallen by more than 15 per cent in 2014. While the full effects of the falls in commodity prices are yet to be felt, these headwinds could make it more difficult for resource-related firms to service their debt, raising the risk of default. The credit ratings of some resource-related companies have already been downgraded, while ratings implied by credit default swaps and bond pricing suggest that the market expects more downgrades to follow.

Several factors are, however, limiting the risks to financial stability in Australia from these

¹ For further discussion, see RBA (2015), 'Box D: The Impact of Recent Commodity Price Movements on Resource Companies', *Statement on Monetary Policy*, February, pp 60–61.

Graph 3.14
Resource-related Corporations' Earnings*



* Listed corporations' EBITDA; excludes financial and foreign-domiciled corporations

** Excludes BHP Billiton & Rio Tinto

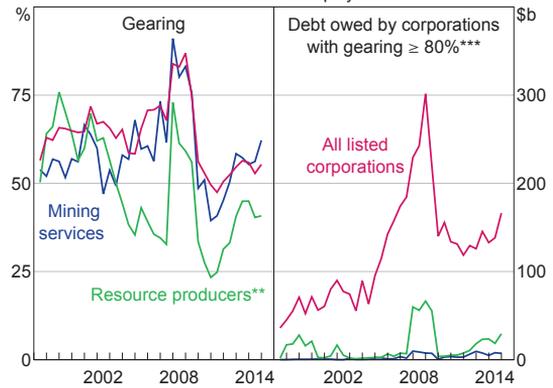
Sources: Bloomberg; Morningstar; RBA

developments. First, the domestic banks' exposure to the resource-related sector is not large. A significant share of resource-related firms' outstanding debt is either non-intermediated or sourced from foreign banks through syndicated loans. Based on the major banks' earnings reports and other data, RBA staff estimate that the combined value of exposures of the Australian banking system to resource producers and services companies is only around 2 per cent of banks' total exposures.

Second, the finances of listed resource-related corporations are generally quite robust. In aggregate, the gearing and debt-servicing ratios for resource producers remain noticeably lower than those of the broader listed corporate sector (Graph 3.15 and Graph 3.16). In addition, most of the debt is owed by large companies that have neither high gearing nor high debt-servicing ratios; these companies are generally expected to be relatively well placed to ride out a period of low commodity prices because they have reasonably strong balance sheets, low costs of production, high margins and access to other sources of funding. Nonetheless, several smaller resource producers (including in the coal and iron ore industries) are likely to struggle to cover costs at current prices.

The financial health of mining services companies looks less robust than that of the broader corporate sector: the aggregate debt-servicing ratio of listed mining services companies has increased significantly over the past couple of years as profits have fallen sharply, and is now around the peak reached during the financial crisis, while aggregate liquidity is also lower than for other listed corporations. It is likely that parts of the mining services sector will find

Graph 3.15
Resource-related Corporations' Gearing*
 Book value debt-to-equity ratio



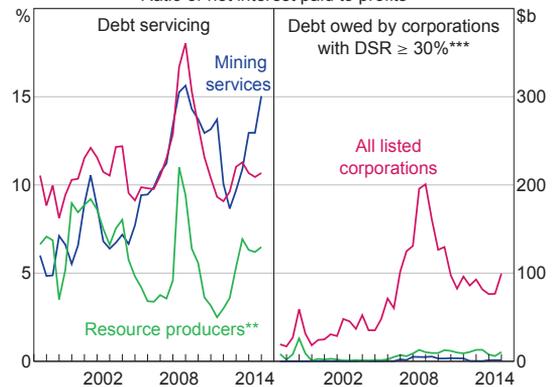
* Listed corporations; excludes financial and foreign-domiciled corporations

** Includes listed junior explorers

*** Includes corporations with negative equity

Sources: Bloomberg; Morningstar; RBA

Graph 3.16
Resource-related Corporations' Debt Servicing*
 Ratio of net interest paid to profits



* Listed corporations; excludes financial and foreign-domiciled corporations

** Includes listed junior explorers

*** Includes corporations with negative profits

Sources: Bloomberg; Morningstar; RBA

the current operating environment challenging, particularly those firms that are more exposed to resource investment or exploration. However, mining services firms account for only 16 per cent of debt owed by listed resource-related corporations, and liaison with banks suggests that loan defaults to date have generally been limited.

The depreciation of the Australian dollar over the past six months will partly offset the effect of declining global commodity prices on local resource producers' profitability, and will boost demand for trade-exposed firms in other sectors. While the recent resurgence in volatility in global currency markets is likely to make hedging currency risk more expensive, and could expose any instances of poorly designed hedging practice, the available evidence suggests that it is unlikely to pose significant risks to the non-financial business sector overall. ❖