

3. Household and Business Finances

The financial position of the household sector overall was little changed in 2013, although there is evidence that the risk appetite of some households has increased, particularly for purchasing property. The momentum in housing lending has broadened over the last six months. At the time of the September 2013 *Financial Stability Review*, a sharp pick-up in lending to investors and repeat-buyer owner-occupiers in New South Wales was evident, but in the past six months lending in some other states has also increased solidly. Present conditions in the housing market are not assessed as posing a near-term risk to financial stability. Nonetheless, the recent pick-up in momentum warrants close monitoring. It will be important for both investors and owner-occupiers to understand that a cyclical upswing in housing prices when interest rates are low cannot continue indefinitely, and they should therefore not base their decisions on an extrapolation of recent outcomes.

The financial position of the business sector is also little changed from that reported in September 2013. Balance sheets are generally in good shape with gearing and interest burdens at fairly low levels. Conditions appear to have improved over recent months to be around their long-run average level and indicators of business distress have generally continued to ease. In line with moderate investment intentions, businesses' appetite for debt remains subdued, although the process of deleveraging that occurred following the financial crisis appears to be now largely complete. In the commercial property market, the disconnect between prices and rents that was reported six months ago for office property

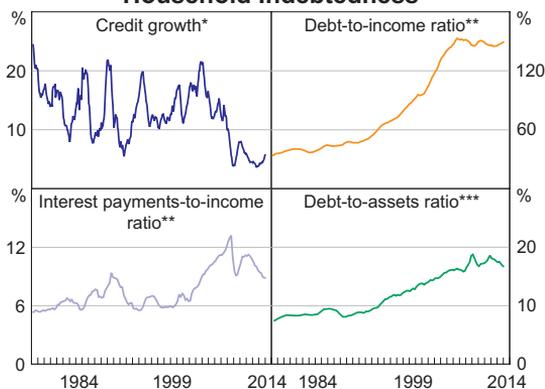
has continued and broadened beyond Sydney and Melbourne.

Household Sector

Saving and borrowing behaviour

Households have continued to demonstrate greater prudence in managing their finances than they did a decade ago. The household saving ratio has remained within its range of recent years, at around 10 per cent. The proportion of disposable income required to meet interest payments on household debt is estimated to have stabilised over the past six months, having previously declined in line with the fall in mortgage interest rates in recent years (Graph 3.1). Many households have used lower interest rates to continue paying down their mortgages more quickly than required. As a

**Graph 3.1
Household Indebtedness**



* Six-month annualised
 ** RBA estimate for March quarter 2014
 *** RBA estimates for December quarter 2013 and March quarter 2014
 Sources: ABS; APRA; RBA; RP Data-Rismark

result, the aggregate mortgage buffer – balances in mortgage offset and redraw facilities – has risen to almost 15 per cent of outstanding balances, which is equivalent to around 24 months of total scheduled repayments at current interest rates. This suggests that many households have considerable scope to continue to meet their debt obligations even in the event of a temporary spell of reduced income or unemployment.

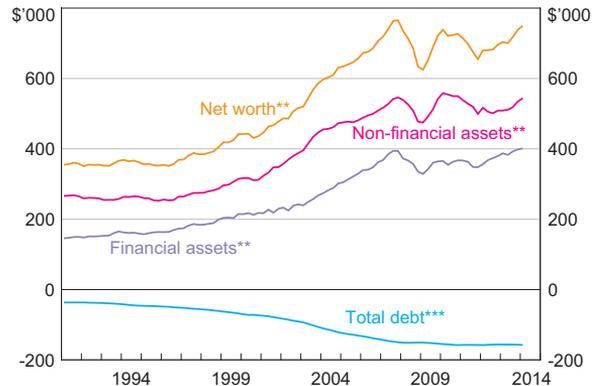
Households' appetite for debt appears to have increased modestly since the previous *Financial Stability Review*, driven by low mortgage interest rates and increasing asset prices. In line with this, household credit growth (which had been subdued over the previous three years or so) picked up to around 6 per cent in annualised terms over the six months to January. This was despite credit growth continuing to be held down by prepayments and the low value of first home buyer loan approvals (discussed below), which typically translate into larger increases in housing credit than loans to other borrowers. Household gearing and indebtedness remain around historically high levels; hence, with the unemployment rate trending upwards, continued prudent borrowing and saving behaviour is needed to underpin households' financial resilience.

Wealth and investment preferences

Household wealth has continued to increase in recent quarters: real net worth per household is estimated to have risen by around 6½ per cent over the year to March, though it remains 2 per cent below its 2007 peak (Graph 3.2). Since the recent trough in December 2011, the recovery in real net worth per household has been due to growth in both households' financial and non-financial assets, reflecting rising share and housing prices and continued net inflows into superannuation.

The continued low interest rate environment, together with rising asset prices, has encouraged a shift in households' preferences toward riskier, and potentially higher-yielding, investment options. In particular, there has been a marked pick-up in

Graph 3.2
Real Household Wealth and Debt*
Per household



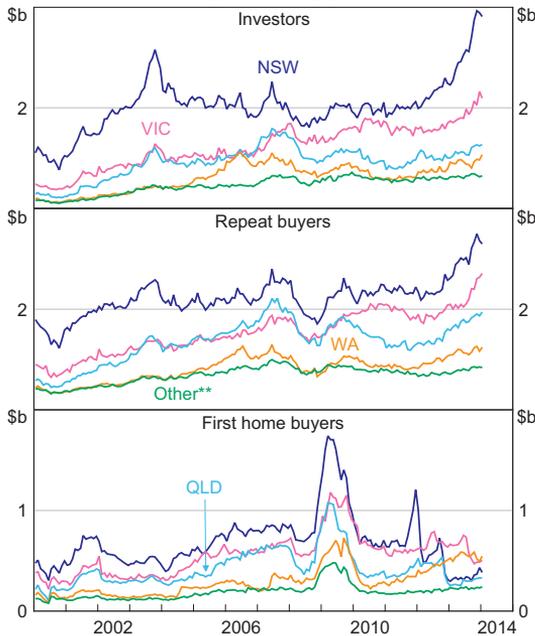
* In 2011/12 dollars; deflated using the household final consumption expenditure implicit price deflator
 ** RBA estimates for December quarter 2013 and March quarter 2014; includes unincorporated businesses
 *** RBA estimate for March quarter 2014; excludes unincorporated businesses
 Sources: ABS; RBA; RP Data-Rismark

housing loan approvals to investors, as well as to repeat-buyer owner-occupiers (although there may be some misreporting that is suppressing indicators for the first home buyer category). Six months ago, a sharp increase in housing lending to these types of borrowers was underway in New South Wales but, more recently, prices and demand have begun to pick up in some other states (Graph 3.3).

Housing demand has been particularly strong in Sydney and Melbourne and the strengthening in these markets is evident in a range of indicators (Graph 3.4). For instance, investors now make up more than 40 per cent of the value of total housing loan approvals in New South Wales – similar to the previous peak reached in 2003 – and the share is also approaching earlier peaks in Victoria. In addition, in Sydney the auction clearance rate remains at a historically high level and housing turnover (sales) has picked up since the middle of 2013. Improved market conditions are also boosting dwelling construction, particularly for higher-density housing in Sydney and Melbourne.

Stronger activity in the housing market, particularly by investors, can be a signal of speculative demand, which can exacerbate property price cycles and encourage unrealistic expectations of future

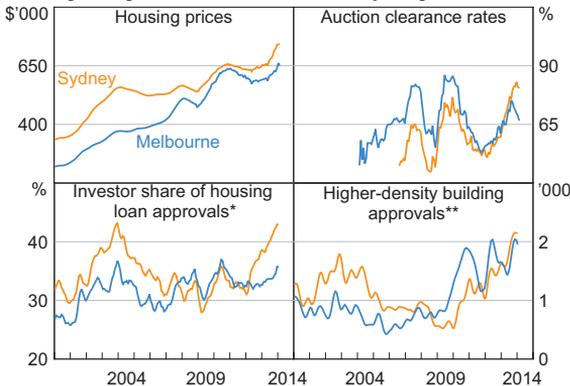
Graph 3.3
Housing Loan Approvals*



* Excludes construction; investor approvals include refinancing
 ** Other includes Australian Capital Territory, Northern Territory, South Australia and Tasmania
 Sources: ABS; APRA; RBA

- banks' practices in assessing loan serviceability. Typically, the interest rate used by banks to calculate maximum loan sizes does not fall by as much as actual interest rates (if at all) because many banks apply interest rate add-ons that have increased as interest rates have fallen. Consequently, borrowers who are more constrained by the serviceability criteria, such as first home buyers, have relatively less scope to increase their loan size as interest rates fall. However, borrowers for whom these constraints are not binding (such as investors, who tend to have higher incomes and/or larger deposits) can increase their loan size and are therefore able to make higher offers to secure a property
- reductions in state government incentives for first home buyers, notably for established dwellings. These changes to incentives have led to reduced demand by first home buyers relative to other buyers, particularly in New South Wales, Victoria and Queensland. Incentives for new construction, however, remain in all states.

Graph 3.4
Sydney and Melbourne Property Markets



* Data for New South Wales and Victoria; three-month moving average; excludes construction, includes refinancing
 ** Monthly; 13-period Henderson trend
 Sources: ABS; APM; RBA; REIV; RP Data-Rismark

More generally, an upsurge in speculative housing demand would be more likely to generate financial stability risks if it brought forth an increase in construction of a scale that led to a future overhang of supply and a subsequent decline in housing prices. At a national level, Australia is a long way from the point of housing oversupply, though localised pockets of overbuilding are still possible. While the recent pick-up in higher-density dwelling construction approvals in Sydney and Melbourne warrants some monitoring, the near-term risk of oversupply in those cities seems low. Indeed, concerns expressed by lenders about possible oversupply in the Melbourne apartment market over the past year seem to have lessened, despite rental yields there remaining quite low.

housing price growth among property purchasers. Alongside the low interest rate environment, factors that have contributed to the recent increase in the investor share of new lending include:

A build-up in investor activity may also imply a changing risk profile in lenders' mortgage exposures. Because the tax deductibility of interest expenses on investment property reduces an investor's incentive to pay down loans more quickly than required, investor housing loans tend to amortise more

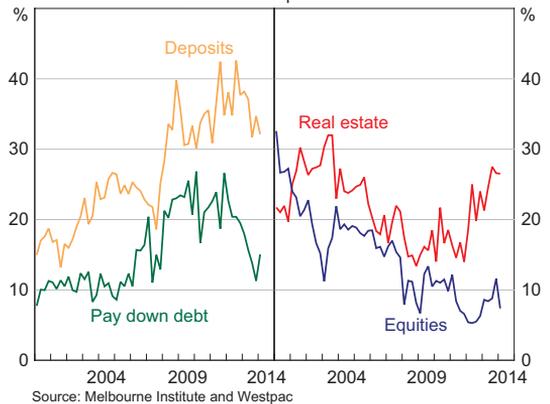
slowly than owner-occupier loans. They are also more likely to be taken out on interest-only terms. While these factors increase the chance of investors experiencing negative equity, and thus generating loan losses for lenders if they default, the lower share of investors than owner-occupiers who have high initial loan-to-valuation ratios (LVRs; that is an LVR of 90 per cent or higher) potentially offsets this. Indeed, the performance of investor housing loans has historically been in line with that of owner-occupier housing loans (see discussion of recent trends in loan performance in the following section).

Available evidence suggests that there are two sources that are providing some additional demand for housing: non-resident investors and self-managed superannuation funds (SMSFs). Lending to these borrowers, however, remains only a small share of total housing lending. As highlighted in the previous *Financial Stability Review*, the rapid growth in SMSF assets as a share of total superannuation assets is noteworthy given that SMSFs tend, compared with other funds, to allocate a high share of their assets to direct property holdings (around 16 per cent) for which they can borrow under limited recourse arrangements. In December 2013, Genworth – the largest insurer in the Australian mortgage market – tightened their underwriting criteria for residential property loans to SMSFs. New criteria included a minimum asset requirement and a restriction on the use of new property – that is, property that has been completed for less than 12 months and/or has not been previously sold since construction – as collateral. The major banks that lend to SMSFs also have their own criteria in place.

On balance, therefore, while the pick-up in investor activity in the housing market does not appear to pose near-term risks to financial stability, developments will continue to be monitored closely for signs of excessive speculation and riskier lending practices.

Alongside the increase in housing demand, there is some evidence to suggest that the continued low interest rate environment is encouraging a broader increase in households' appetite for risk. According to survey data, the share of households that are of the view that paying down debt is the 'wisest' use of their savings has fallen significantly since late 2011 (Graph 3.5). Similarly, the share favouring deposits remains well below its 2012 peak. At the same time, and consistent with the increase in investor activity in the housing market, the share of households favouring real estate has risen to a level approaching that of the early 2000s property market boom.

Graph 3.5
Wisest Place to Save
Share of respondents



Another avenue through which households may be taking more risk is by investing in complex high-yielding securities. In recent years, mortgage originators have established investment funds that make the high-risk tranches of mortgage-backed securities more accessible to retail investors. Although the size of these retail securitisation funds is currently quite small, they have grown strongly. It is important that the potential risks associated with these products are adequately communicated to, and understood by, households.

Loan performance and other indicators of household financial stress

Aggregate indicators of financial stress generally remain low, despite the gradual increase in the unemployment rate since early 2012. As noted in the chapter ‘The Australian Financial System’, the share of banks’ housing loans that are non-performing has steadily declined since peaking in mid 2011, and this has been broadly based across owner-occupiers and investors (Graph 3.6). Non-performance rates on banks’ credit card and other personal lending – which are inherently riskier and less likely to be secured than housing loans – have declined slightly over the six months to December 2013, following an upward trend over the previous five years. These loan types account for a very small share of total household credit.

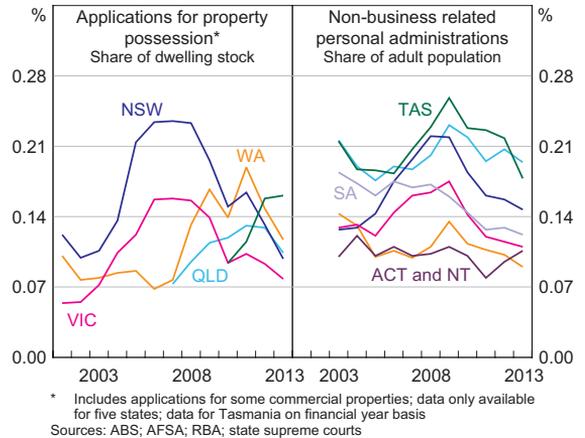
Other indicators of household financial stress are consistent with the generally low and declining housing loan non-performance rates. The total number of court applications for property possession in the mainland states (for which data are available) declined in 2013, but was higher in Tasmania, consistent with the upward trend in housing loan arrears in that state since the mid 2000s (Graph 3.7). The total number of non-business related personal administrations – bankruptcies, debt agreements

Graph 3.6
Banks’ Non-performing Household Loans
Share of loans by type



Graph 3.7

Indicators of Financial Stress

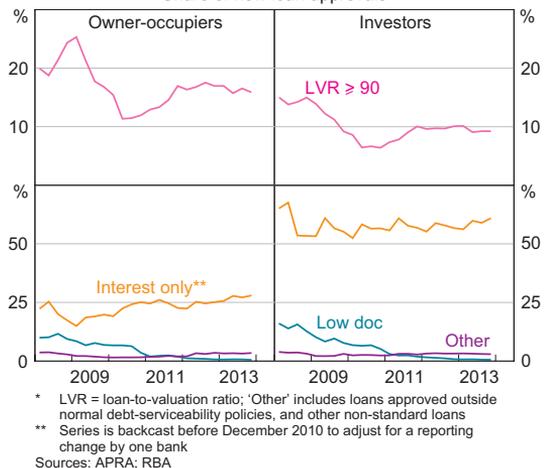


and personal insolvency agreements – was lower across most of Australia in 2013.

Lending standards

Given that low interest rates and rising housing prices have the potential to encourage speculative activity in the housing market, one area that warrants particular attention is banks’ housing loan practices. Data on the characteristics of housing loan approvals suggest that lending standards in aggregate have generally been little changed since late 2011 (Graph 3.8). While there are signs

Graph 3.8
Banks’ Housing Loan Characteristics*
Share of new loan approvals



of an increase in high-LVR lending among some institutions, the aggregate share of banks' housing loan approvals with high LVRs is around 13 per cent and has remained fairly steady for the past two years. Low-doc lending continued to account for less than 1 per cent of loan approvals in the December quarter 2013.

In aggregate, the interest-only share of new lending has been slightly below 40 per cent in recent quarters, following its gradual rise since 2009. While interest-only loans tend to amortise more slowly than standard loans that require the repayment of principal and interest, banks have noted in liaison that some borrowers with interest-only loans pay back principal during the interest-only period and therefore build up mortgage buffers. It is also common practice for banks to require borrowers to demonstrate the ability to service the higher principal and interest payments that follow expiry of the interest-only period, potentially reducing the number of borrowers that may fall into difficulty when required repayments increase. This practice is consistent with requirements under the *National Consumer Credit Protection Act 2009*, which strengthened the responsible lending obligations on lenders.

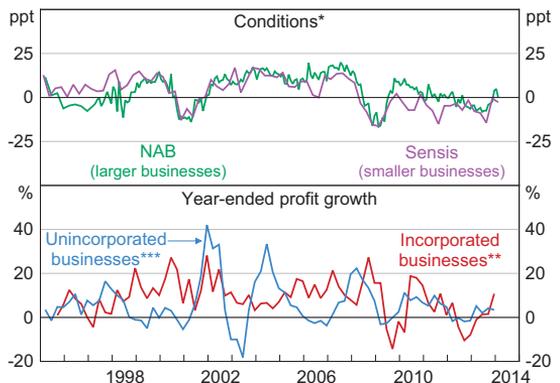
Changes to Australia's consumer credit-scoring framework (facilitated by amendments to the *Privacy Act 1988*) came into effect in March 2014. These changes, known as comprehensive credit reporting (CCR), allow credit providers to share a broader array of borrower information with credit-scoring agencies than previously, including borrowers' credit limits and detailed information on repayment behaviour over the previous two years. Similar reporting systems are already operating overseas. Formerly, credit-scoring agencies' access to borrower repayment information was limited to negative credit events, such as defaults and bankruptcies. CCR should act to reduce informational asymmetries between borrowers and lenders, and may allow lenders to be more risk sensitive in their lending decisions (for example, through more risk-based loan pricing), especially for new customers. The transition to CCR is likely to be gradual over the next few years.

Business Sector

Business conditions and indicators of business stress

Conditions have generally improved for businesses over the past six months, supported by increased spending by households, low business lending interest rates and the depreciation of the Australian dollar. This is reflected in business survey measures that indicate that conditions for both smaller and larger businesses are now around long-run average levels (Graph 3.9). This improvement has been broadly based across industries, although there are some industries where conditions are still some way below long-run average levels. There are also a few sectors that are facing structural challenges. Therefore, despite the general improvement in conditions, some businesses are likely to continue with a more conservative approach to managing their finances in the period ahead.

Graph 3.9
Business Conditions and Profitability



* Net balance, deviations from average since 1989; Sensis data scaled to have the same mean and standard deviation as the NAB survey

** Gross operating profits; inventory-valuation adjusted

*** Gross mixed income

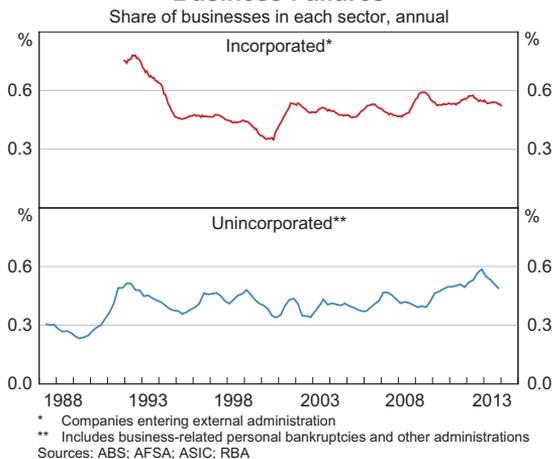
Sources: ABS; NAB; RBA; Sensis

With improved conditions, business profits increased over 2013, after contracting through most of 2012. Profits of non-financial incorporated (typically larger) businesses grew around 11 per cent over the year to December 2013; this was driven by a 35 per cent

increase in mining profits, while for incorporated businesses outside of the mining sector profits rose by 1 per cent. Profits of unincorporated (typically smaller) businesses grew only modestly over the year. Analysts expect more broadly based profit growth for ASX 200 companies in 2014/15, forecasting growth of around 10 per cent for both resources companies and other non-financial corporations.

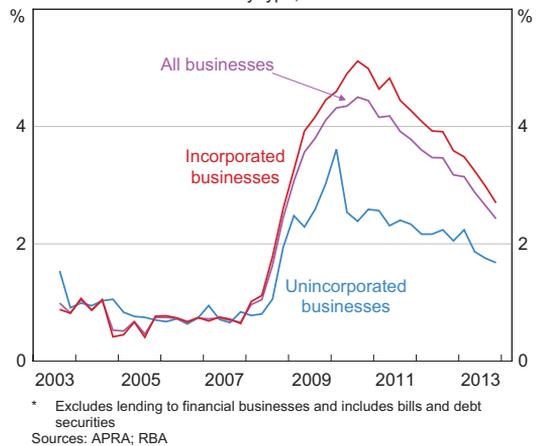
The early signs of improvement in the business sector's operating environment are reflected in some indicators of business stress. This is particularly evident for unincorporated businesses, for which the failure rate declined in 2013, reversing a steady increase for several years prior (Graph 3.10). The rate for incorporated businesses has fallen steadily since early 2012. Failures of incorporated businesses remained concentrated in the business and personal services, and construction industries, although the pick-up in activity in the housing market should help underpin financial performance in some parts of the construction industry in the period ahead.

**Graph 3.10
Business Failures**



As discussed in the chapter 'The Australian Financial System', the share of banks' business loans that are non-performing has continued to decline in recent quarters, with the rates for both incorporated and unincorporated businesses steadily trending lower since their respective peaks in 2010 (Graph 3.11).

**Graph 3.11
Banks' Non-performing Business Loans***
Share of loans by type, domestic books



The decline in the share of non-performing loans over recent years primarily reflects a sharp fall in the rate of impaired commercial property loans (discussed further below). Over the past six months, non-performing loans for most industries have declined, although there is some evidence of a slight deterioration in the performance of loans to the farm sector, due to the ongoing droughts in Queensland and northern New South Wales.

Financing and balance sheet position

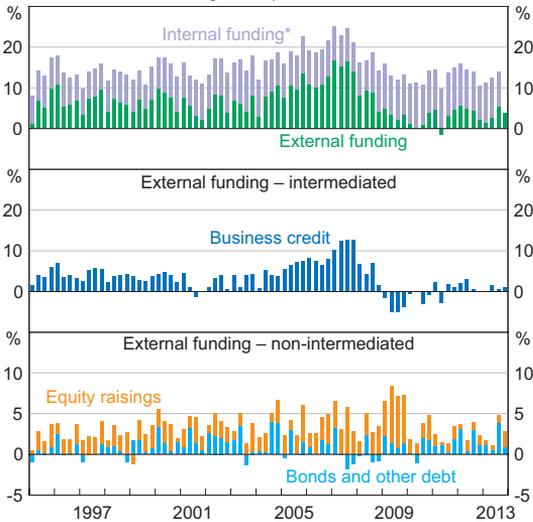
Overall, business funding remained lower, relative to GDP, in the second half of 2013 than in the years prior to the crisis (Graph 3.12). Businesses' demand for external funding remains subdued despite improved business conditions and the continued decline in business lending rates. The limited demand for funding likely reflects realised and prospective declines in mining investment and subdued investment intentions in the non-mining sector; the previous period of businesses deleveraging their balance sheets following the crisis is likely to have now run its course.

Market-sourced funding picked up over the second half of 2013, mainly driven by an increase in bond issuance with the majority of this issued into offshore markets. There was also a rise in longer-term domestic bond issuance; this was mainly by

Graph 3.12

Business Funding

Net change as a per cent to GDP



* September 2013 observation is the latest available
Sources: ABS; APRA; ASX; Austraclear; RBA

lower-rated companies, suggesting that a wider range of larger businesses may be gaining access to some alternative forms of funding. Similarly, funding from equity raisings also increased strongly over the half year, likely encouraged by higher share prices and relatively subdued market volatility over this period. The increase in equity raisings was driven by a sharp increase in initial public offerings in the December quarter 2013, which is expected to continue into 2014. Equity raisings by already listed firms also increased over the second half of 2013.

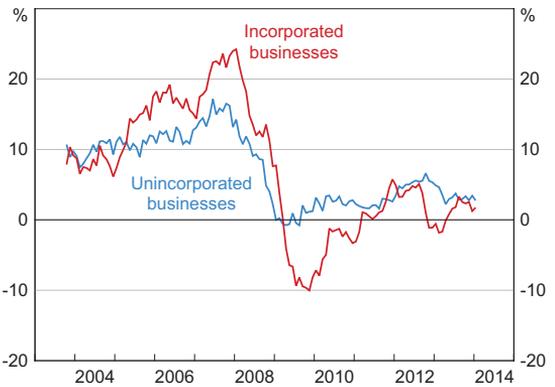
Demand for intermediated business credit remains weak. The pace of incorporated business credit growth was fairly subdued at an annualised rate of 1½ per cent over the six months to January 2014, though lending growth to unincorporated businesses (which do not have access to market-based sources of funding) was a little stronger (Graph 3.13). Liaison with banks and industries suggests that access to credit, for those businesses seeking this source of funding, has generally improved over the past year.

Preliminary estimates suggest that the gearing ratio – the book value of debt to equity – of listed

Graph 3.13

Business Credit Growth*

Six-month annualised

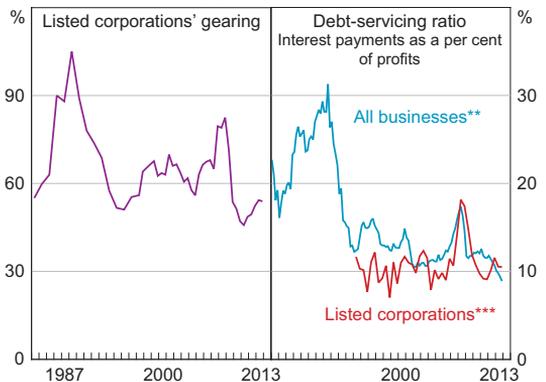


* Excludes securitised loans
Sources: APRA; RBA

corporations was little changed over the second half of 2013, remaining below its average level of recent decades and around 30 percentage points below its 2008 peak (Graph 3.14). The share of listed corporations' profits required to service their interest payments was also largely unchanged over the second half of 2013, remaining relatively low due to the continued easing in business lending rates and the stabilisation of corporate bond yields at historically low levels. This combination of low gearing and debt-servicing burden should provide support to future loan performance.

Graph 3.14

Business Indebtedness*

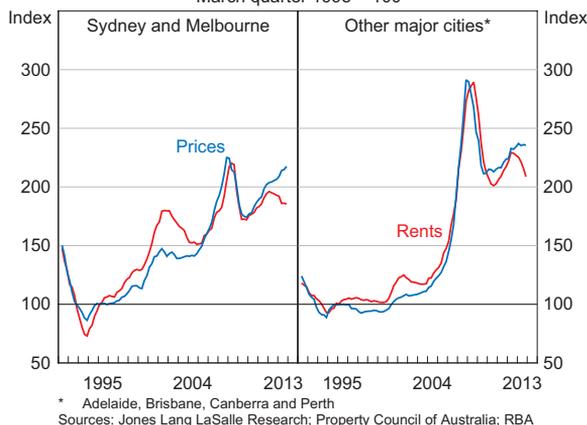


* Listed corporations exclude foreign-domiciled companies
** Gross interest paid on intermediated debt from Australian-located financial institutions
*** Net interest paid on all debt
Sources: ABS; APRA; Bloomberg; Morningstar; RBA; Statex

Commercial Property

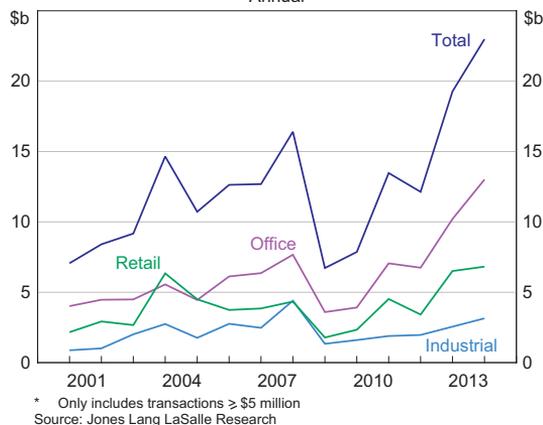
The disconnect between prices and rents in the CBD office property market has continued and broadened beyond Sydney and Melbourne (Graph 3.15). Leasing conditions softened further over the second half of 2013, despite the improvement in business conditions. This has mainly been driven by additional supply in early 2013, as well as weaker tenant demand, particularly from resource-related companies in Perth and Brisbane. Effective rents for CBD office property continued to fall, driven by an increase in incentives (such as rent-free months), which are now at their highest level as a share of contractual rents since the mid 1990s. At the same time, the aggregate CBD office vacancy rate has continued to increase.

Graph 3.15
Prime CBD Office Property
 March quarter 1995 = 100



Despite the weaker leasing conditions, the value of office property transactions increased in 2013, in part driven by investor demand (Graph 3.16). This has contributed to the increase in prices, at least in most CBDs, and consequently led to further divergence of rents and prices. This divergence has been present in Sydney and Melbourne for some time and is now more evident in some other capital cities, particularly Adelaide and Perth. The strong investor demand has reportedly been driven by

Graph 3.16
Value of Commercial Property Transactions*
 Annual

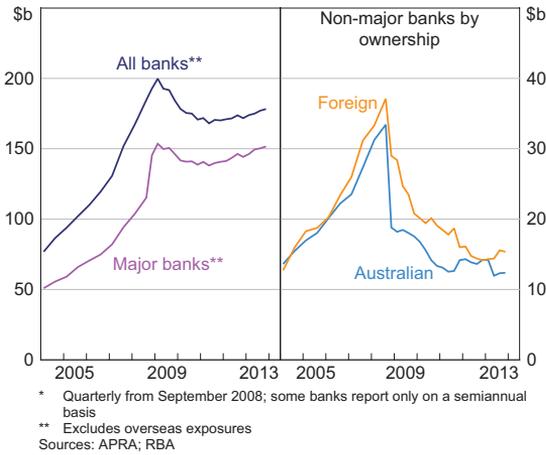


attractive yields on Australian office property relative to major overseas markets and other domestic investments. According to liaison with industry, part of the demand for office property has been driven by offshore investors, particularly in Sydney and Melbourne, though domestic investors have become more active recently.

One potential risk of the current level of activity in the office property market may be oversupply that leads to a further weakening in leasing conditions and potential price declines. The value of building approvals for office property has increased strongly in recent months, although some of this has been driven by approvals for a few large projects and most of the addition to supply is not expected until at least 2015–16. Industry liaison suggests that the potential risks of oversupply from these developments may be tempered somewhat by the conversion of older office space into residential property. It has also been noted in industry liaison that some developments have recently commenced with lower rates of precommitments than those observed in the previous few years. Most of the resulting increase in the risk of lack of tenants is likely to be borne by developers and their investment partners, as banks are reportedly generally unwilling to fund projects with low precommitments.

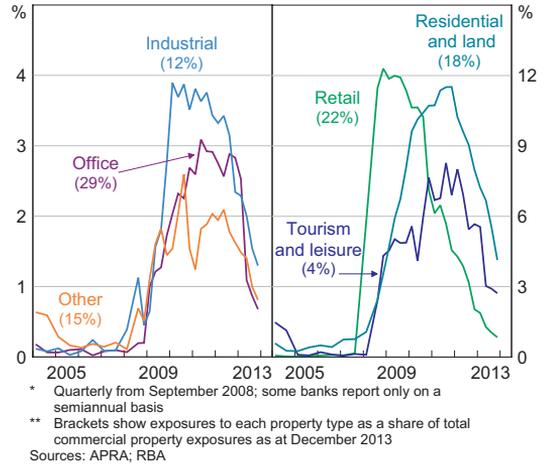
Even though transactions in the commercial property market have increased, the commercial property exposures of banks have grown only modestly over the past two years and remain well below their 2009 peak (Graph 3.17). Most of the increase has been driven by the exposures of the major Australian banks to the office property and 'other' (including education, healthcare and infrastructure) segments. Asian-owned banks' exposures have also increased over the past two years, particularly to the retail and 'other' segments. In contrast, European and smaller Australian-owned banks have been reducing their exposures for some time, partly by selling non-performing loans, although this process has probably largely run its course.

Graph 3.17
Banks' Commercial Property Exposures*
 Consolidated operations



Against this background, the impairment rate on banks' commercial property exposures has fallen significantly since its peak in late 2010 (Graph 3.18). The decline has been broadly based across property types, mainly reflecting the disposal or write-off of impaired loans.

Graph 3.18
Commercial Property Impairment Rate*
 Consolidated Australian operations, by property type**



In terms of future loan performance, compared with six months ago the major banks appear to be less concerned about their exposures to Melbourne's residential apartment market. Previously, concerns had been raised that the high level of approvals, particularly in the inner city, could lead to oversupply. However, there does remain some concern by banks about an increase in supply of smaller apartments targeted at international students, which may not perform well in the secondary market if student numbers do not increase as forecast and demand from other types of tenants is not forthcoming. Liaison with industry appears to be more mixed on the outlook; some contacts are concerned about the market's ability to absorb the volume of supply due for completion in the coming years, while others point to ongoing growth in demand, particularly from offshore investors. ↘