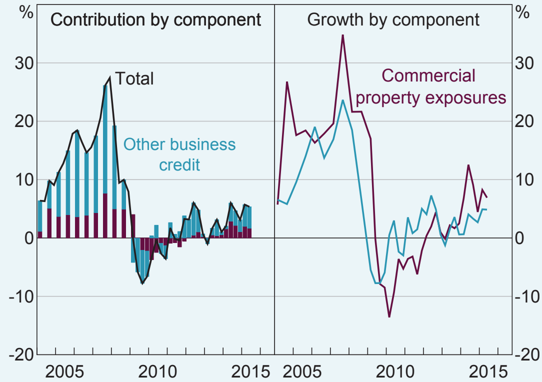
Box B

The Recent Growth in Banks' Commercial Property Exposures

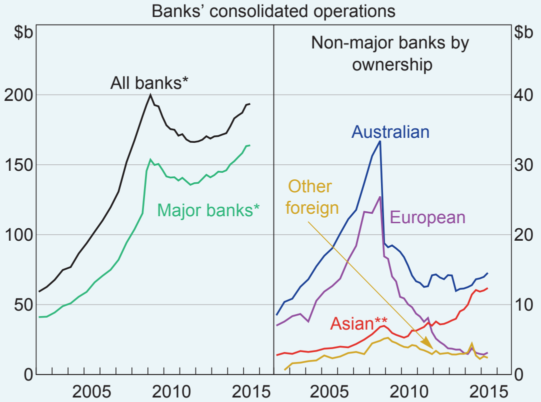
Growth in commercial property lending has picked up in recent years, while demand for business credit outside of the property sector has remained more moderate (Graph B1). Indeed, commercial property exposures, which constitute around one-quarter of the *stock* of business credit outstanding, have accounted for around two-fifths of the *growth* in business credit over the past two years.[1] Commercial property lending comprises loans provided to businesses for the development, acquisition or improvement of property, where repayment is dependent on the subsequent proceeds from sale or the rental income generated from these, or other, properties. Because downturns in commercial property markets have triggered a number of past episodes of financial instability (both domestically and overseas), growth in banks' commercial property exposures warrants particular attention.

Graph B1
Business Credit Growth
Six-month-ended, annualised, non-seasonally adjusted



Sources: APRA; RBA

Graph B2
Commercial Property Exposures
Banks' consolidated operations



* Excludes overseas exposures
** Includes HSBC
Sources: APRA; RBA

The growth in commercial property lending over recent years has been driven by the major banks and by a strong increase in lending from local Asian-owned banks (Graph B2). The major banks pulled back from commercial property lending after the market turned down during the financial crisis, but since 2012 they have steadily grown their commercial property exposures by more than 5 per cent a year. The local Asian-owned banks have increased their exposures particularly quickly over this period, albeit from a low base, growing by a bit less than 20 per cent a year. This has accompanied an increase in residential development activity in Australia, by both domestic and foreign firms, particularly in the inner-city apartment markets of Melbourne, Sydney and Brisbane. Liaison suggests that local Asian-owned banks have a prominent role in funding many foreign developers. Asian investment in existing commercial property assets in

1 These figures are broad estimates given the compositional differences between the business credit and commercial property exposures series. Business credit data include the on-balance sheet claims on banks' and non-bank financial institutions' domestic books, whereas commercial property exposures include both the on-balance sheet and credit-equivalent off-balance sheet exposures of banks' consolidated Australian operations.

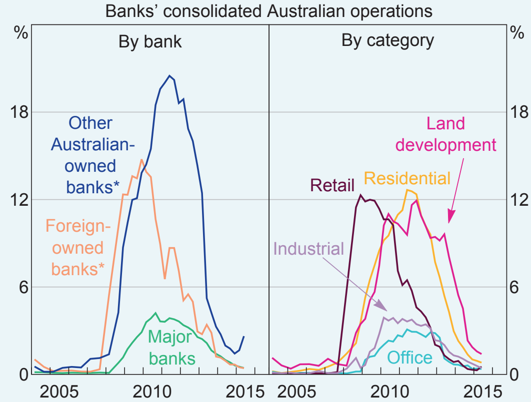
Australia has also increased strongly in recent years. The increase in lending by local Asian-owned banks has not, however, been confined to the commercial property sector; they have increased their Australian activities more broadly over recent years, consistent with growing trade and financial linkages between Australia and the Asian region.

In contrast, the commercial property lending of the non-major Australian and European-owned banks has remained relatively subdued in recent years, after these banks reduced their exposures sharply after the 2009 property market downturn. This pull-back followed a very sharp run-up in their exposures prior to the financial crisis, and was likely a reaction to the high impairment rates experienced on their commercial loan portfolios and, in the case of some European banks, to difficulties in home markets (Graph B3). This experience highlights that banks' commercial property lending can be very pro-cyclical, contributing to the build-up of risks during property market upswings and aggravating the fallout during subsequent downswings.

Although commercial property exposures increased significantly across all loan categories in the lead-up to the financial crisis, before levelling out or declining, the timing of the post-crisis recovery has varied (Graph B4). Exposures for many segments have been rising steadily for a number of years, and office and retail exposures have now surpassed their pre-crisis peaks. The growth in office property lending has been driven by strong investor demand for these properties as well as a pick-up in office building construction.

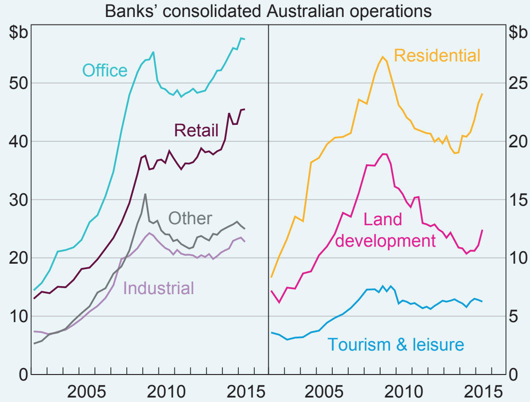
The post-crisis decline in residential and land development exposures was larger and more prolonged than for other categories, as banks tightened lending standards for property development after recording significant loan losses during the crisis. As a result, the pick-up in lending for residential and land development has been more recent, and sharper, than for other categories, driven

Graph B3
Commercial Property Impairment Rates
Banks' consolidated Australian operations



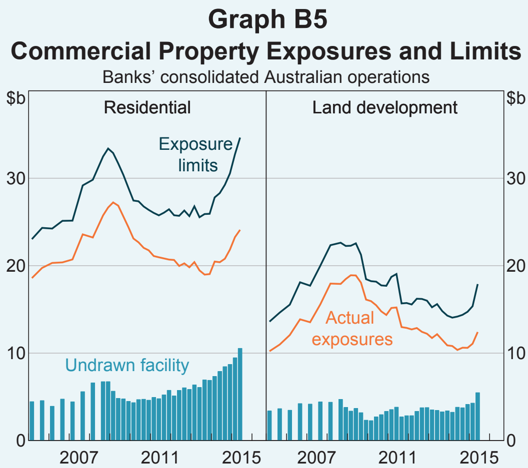
* Includes overseas exposures
Sources: APRA; RBA

Graph B4
Commercial Property Exposures by Category
Banks' consolidated Australian operations



Sources: APRA; RBA

by increased housing development activity across the major east coast cities. Among the banks, Asian-owned banks have expanded their residential and land development lending rapidly over the past five years or so, while strong growth in the major banks' exposures began much more recently. While the recent growth in residential and land development *exposures* has been strong, increases in exposure *limits* – the total value of banks' lending facilities extended to borrowers – have been even more rapid. The resulting growth in *undrawn facilities* – the difference between exposure limits and actual exposures, largely reflecting construction loans that will be drawn down over the life of the construction project – points to further increases in exposures in the near term (Graph B5). Given the current risks of oversupply in some inner-city markets – discussed in the 'Household and Business Finances' chapter – banks will need to remain vigilant in assessing the risks surrounding property development loans to ensure that this lending is prudent and appropriately covered by both capital and provisions. ✠



Sources: APRA; RBA