

# 3. Household and Business Finances

The pick-up in household risk appetite that was evident six months ago appears to have continued, as has the associated willingness to take on some types of debt. Housing prices have been rising strongly in the larger cities. To some extent, these outcomes are to be expected given the low interest rate environment and the search for yield behaviour of investors more generally, both here and overseas. However, the composition of housing and mortgage markets is becoming unbalanced. This has been most evident in the current strength of investor activity in the housing market, and in its concentration in Sydney and Melbourne. The apparent increase in the use of interest-only loans by both owner-occupiers and investors might also be consistent with increasingly speculative motives behind current housing demand.

At this stage, the main risk from this strong investor activity appears to be that the extra demand may exacerbate the housing price cycle and increase the potential for prices to fall later. The risks from the consequent declines in household wealth and spending are likely to be macroeconomic, rather than direct risks to the stability of financial institutions. In other respects, some households have continued to foster sustainable financial positions by taking advantage of lower interest rates to pay down debt. Although the household saving rate has drifted down a little, it remains much higher than in recent decades.

Near-term risks from the non-financial business sector appear to be low, with a possible exception of the commercial property sector, where strong

demand from domestic and foreign investors has meant the divergence between rising prices and soft leasing conditions has persisted. With attractive yields on Australian commercial property, many of the dynamics evident in investor housing are also playing out in this market, increasing the vulnerability of the commercial property market to a price correction. More broadly, business conditions remain around long-run average levels and corporate balance sheets appear generally to be in good shape, with gearing low and the ability to service debt fairly high. For businesses outside the property sector, there is moderate appetite for taking on debt for investment purposes, despite ready access to credit. At this stage, lending standards have been little changed overall and the performance of existing business loans has continued to improve.

## Household Sector

### Borrowing and balance sheet position

Households' appetite for risk has continued to increase over 2014. This trend has been evident for the past year or so and is to some extent an expected reaction to low interest rates; housing price inflation and, more recently, competition amongst lenders on price have also played a role. Accordingly, household credit growth has picked up, almost entirely driven by investor housing credit, which is growing at its fastest pace since late 2007 (Graph 3.1).

The willingness of some households to take on more debt, combined with slower growth in incomes, means that the debt-to-income ratio has picked

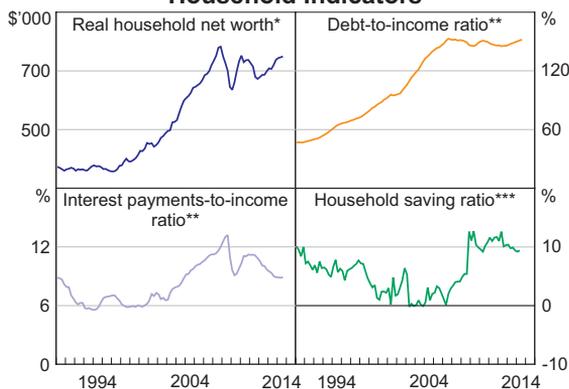
**Graph 3.1**  
**Housing Credit Growth**



Sources: APRA; RBA

up a little in the past six months. While this ratio is still within its range of the past eight years at around 150 per cent, it is historically high and hence any further increases in household indebtedness would be taking place from an already high base (Graph 3.2). Households' ability to service their debt has been aided by ongoing low interest rates. The proportion of disposable income required to meet interest payments on household debt has stabilised accordingly, at around 9 per cent.

**Graph 3.2**  
**Household Indicators**



\* In 2011/12 dollars; deflated using the household final consumption expenditure implicit price deflator; RBA estimates for June quarter 2014 and September quarter 2014

\*\* RBA estimate for September quarter 2014

\*\*\* Household sector includes unincorporated businesses; net of depreciation

Sources: ABS; APRA; RBA; RP Data-Rismark

Households continue to take advantage of lower interest rates to pay down their mortgages more quickly than required. The aggregate mortgage buffer – balances in mortgage offset and redraw facilities – has risen to be around 15 per cent of outstanding balances, which is equivalent to more than two years of scheduled repayments at current interest rates. Prepayment rates and the proportion of borrowers ahead of schedule on their mortgage repayments are also high according to liaison with banks. Part of this prepayment behaviour has been due to some banks' systems not automatically changing customer repayment amounts as interest rates have declined, while in many cases households have not actively sought to reduce their repayments. This might be a sign that household stress is currently limited. The household saving ratio, although trending down a little lately, remains high at just under 10 per cent. Households' aggregate balance sheet position has continued to improve in recent quarters: real net worth per household is estimated to have increased by 4 per cent over the year to September 2014.

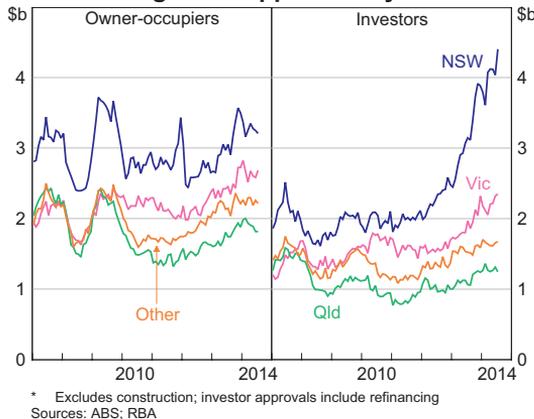
Outside of property investment, households have also shown some appetite for risk in their financial investments. As discussed in 'The Australian Financial System' chapter, retail investors have been attracted to the relatively high yields on non-common-equity instruments issued by banks (often referred to as 'hybrids'). These instruments are complex in nature and feature elements of both debt and equity. The Australian Securities and Investments Commission has in the past issued public warnings about the risks involved in holding hybrid instruments and, as with any complex instrument, households should understand and take into account the associated financial risks.

### Housing market activity

The increase in household risk appetite is most evident in the continued strength of investor activity in the housing market. The momentum in investor housing activity has been concentrated in Sydney

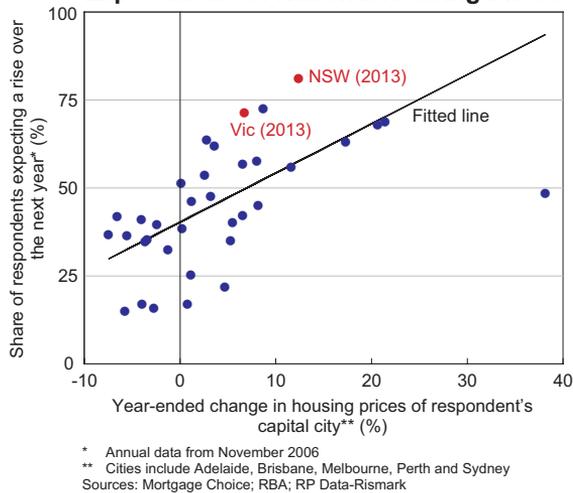
and (to a lesser extent) Melbourne: investor housing loan approvals are almost 90 per cent higher in New South Wales than they were two years ago and are 50 per cent higher over the same period in Victoria (Graph 3.3). As a share of approvals, both are back around previous peaks. By contrast, the momentum in the owner-occupier market appears to have slowed over the past six months or so, with loan approvals to owner-occupiers little changed. Some potential first home buyers are likely to have been priced out of parts of the market by investors, who typically have higher incomes and are therefore able to bid up prices. The broad-based reduction in grants to first home buyers for established housing since late 2012 has also contributed to reduced demand from these buyers.

**Graph 3.3**  
**Housing Loan Approvals by State\***



Strong investor demand can be a sign of speculative excess, with the risk that additional speculative demand can amplify the cycle in housing prices and increase the potential for prices to fall later. This is particularly the case if that demand is largely based on unrealistic expectations of future price growth, perhaps extrapolated from recent experience. A Mortgage Choice survey shows a positive relationship between the share of households expecting further housing price inflation and the rate of price inflation in the current year; that is, expectations of future housing prices seem to be influenced by the recent past (Graph 3.4). This

**Graph 3.4**  
**Expectations of National Housing Prices**

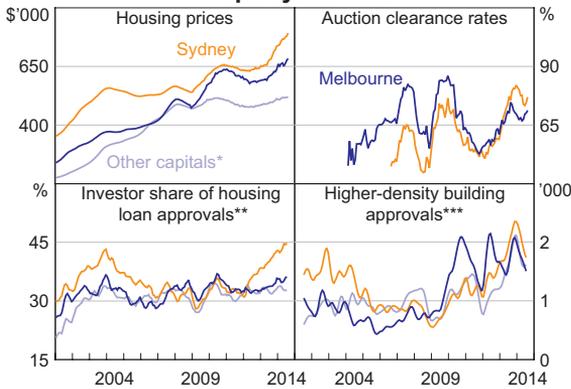


tendency was stronger than average in New South Wales and Victoria at the end of last year. The risks associated with this behaviour are likely to be macroeconomic in nature if households were to react to declines in their wealth and any repayment difficulties by cutting back their spending.

A speculative upswing in demand can also be damaging if it brings forth an increase in construction on a scale that leads to a future overhang of supply. This risk is more likely to arise in particular local markets than at the national level. Nationally, Australia is a long way from an oversupply of housing and some increase in supply is to be expected in response to higher prices, which should also help to temper those rising prices.

- The pick-up in housing prices and investor lending has been most pronounced in Sydney (Graph 3.5). Construction of new dwellings has also recovered over the past two years, but this follows a reasonably long period of limited new supply. In addition, the pick-up in construction has been spread geographically in both the inner and middle areas of Sydney, and has also been for both higher-density (apartments) and detached dwellings. These factors reduce the risk that pockets of oversupply in particular regions or of a particular dwelling type will emerge.

**Graph 3.5**  
**Property Markets**



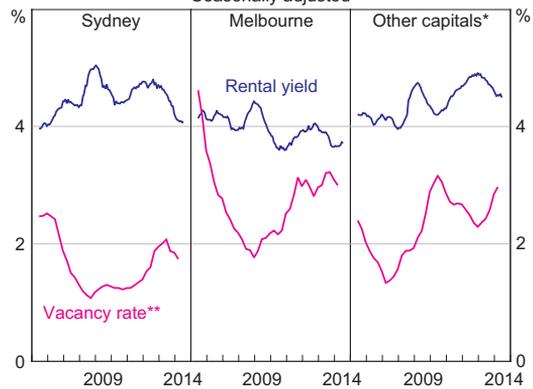
\* Adelaide, Brisbane, Canberra, Darwin, Hobart and Perth  
 \*\* Data for all states and territories; three-month moving average; excludes construction, includes refinancing  
 \*\*\* 13-period Henderson trend  
 Sources: ABS; APM; RBA; REIV; RP Data-Rismark

- The risk of localised oversupply seems somewhat higher in Melbourne where there has been greater geographic concentration of building activity recently. Apartment construction in the inner city has been at high levels for some time and, given the time lags in completing higher density constructions, is expected to remain elevated for the next few years. That said, liaison suggests that construction in Melbourne continues to be driven by strong demand, including from foreign investors, with pre-sale levels remaining high.
- A related risk, which is likely to be currently most pronounced in Melbourne, is that some new developments may appeal to a relatively narrow segment of tenant or owner demand. For example, some new developments involve smaller-sized apartments that are targeted at international students, which could be harder to sell in the secondary market than more traditional-sized apartments. This could place downward pressure on apartment prices if student demand weakens or if there are other shocks that reduce foreign investors' appetite for these apartments.

Despite the activity and housing price inflation in the Sydney and Melbourne property markets, rental yields have not declined to a significant extent

and vacancy rates in these cities remain fairly low (Graph 3.6). However, rental yields may come under pressure if the momentum in housing price inflation continues. Households should therefore be mindful of the risks when making investment property decisions in these conditions (for discussion of the financial position of investor households, see 'Box C: Households' Investment Property Exposures: Evidence from Tax and Survey Data).

**Graph 3.6**  
**Rental Market**  
Seasonally adjusted



\* Adelaide, Brisbane, Canberra and Perth; rental yield also includes Darwin and Hobart  
 \*\* Four-quarter moving average  
 Sources: ABS; RBA; REIA; RP Data-Rismark

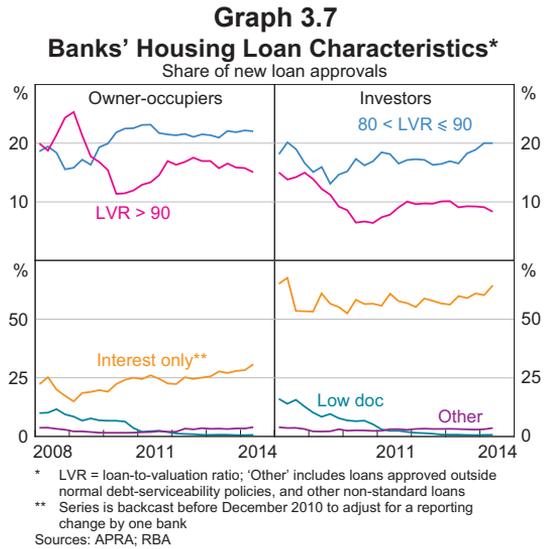
### Housing loan characteristics

In an environment of historically low interest rates, rising housing prices and strong price competition in the mortgage market, there is some risk that households may attempt to take out loans that they would not be able to service comfortably if interest rates were to rise. Lenders' credit decisions and policies should be, and in Australia generally are, designed to prevent this. As discussed in the chapter 'The Australian Financial System', to help mitigate this risk further, the Australian Prudential Regulation Authority's (APRA) draft Prudential Practice Guide on mortgage lending emphasises that banks should apply an interest rate add-on to the mortgage rate, in conjunction with an interest rate 'floor', in assessing a borrower's capacity to service their loan. The lending behaviour of banks in this environment, including

their adherence to prudent practices like the use of add-ons and floors in assessing serviceability, is particularly important; it is no surprise that APRA is keeping a close watch on this. So far, it appears that banks' lending standards have been holding fairly steady overall; while some elements or market segments have eased a little, others have tightened up a bit (Graph 3.7).

- The share of loan approvals with loan-to-valuation ratios (LVRs) over 90 per cent has trended down since early 2013 for both owner-occupiers and investors, though some of this seems to have shifted into the group of approvals with LVRs between 80 and 90 per cent.
- Some institutions appear to be lending at high loan-to-income ratios and, overall, the average size of new loans has risen recently. Importantly from a household risk perspective, only a small share of new lending currently appears to have both a high LVR and a high loan-to-income ratio, which implies that few households are simultaneously exposed to the risks of falling into negative equity and facing difficulty making their loan repayments. Any increase from the current small share of new lending with both a high LVR and high loan-to-income ratio would, however, be undesirable and this configuration of lending continues to be closely monitored.

Another feature worthy of close monitoring is the aggregate interest-only share of banks' new lending, which has continued to increase for both investors and owner-occupiers in 2014. This might be indicative of speculative demand motivating a rising share of housing purchases. Consistent with mortgage interest payments being tax-deductible for investors, the interest-only share of approvals to investors remains substantially higher than to owner-occupiers. According to liaison with banks, the trend in interest-only owner-occupier borrowing has been largely because these loans provide increased flexibility to the borrower. It does not necessarily mean that borrowers are taking on debt that they may not be able to service if both interest



and principal repayments are made. Rather, some of these borrowers are likely to be building up buffers in offset accounts.

In any case, APRA's draft Prudential Practice Guide emphasises that a prudent authorised deposit-taking institution would assess customers' ability to service principal and interest payments following the expiry of the interest-only period. More broadly, consumer protection regulations require that lenders do not provide credit products and services that are unsuitable because, for example, the consumer does not have the capacity to meet the repayments.

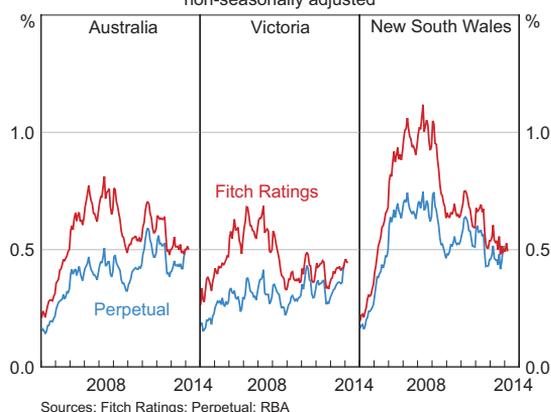
### Loan performance and other indicators of household financial stress

Aggregate indicators suggest that household financial stress is generally low, despite the increase in the unemployment rate over the past year. The share of banks' housing loans that are non-performing has declined for both owner-occupiers and investors since reaching a peak in the middle of 2011. Data on securitised housing loans show that the share that are 90 days or more past due has declined over the year for most states, coinciding with lower interest rates and rising housing prices (Graph 3.8). In Victoria, however, loan performance has deteriorated slightly, particularly in those geographic regions

**Graph 3.8**

**Securitised Housing Loan Arrears**

90+ days in arrears, share of outstandings by value, non-seasonally adjusted



such as outer-west and north Melbourne where unemployment rates have either increased recently or are at elevated levels. The large volume of supply coming online in the Melbourne inner-city apartment market increases the risk of further deterioration in loan performance in Victoria. More generally, future housing loan performance is likely to at least partly depend on labour market performance. Although forward-looking indicators of labour demand have generally improved since last year, they remain consistent with only moderate employment growth in the near term.

Other indicators also point to fairly low levels of stress in the household sector. Applications for property possessions as a share of the dwelling stock have trended down since 2011 in the states for which data are available (New South Wales, Queensland, Victoria and Western Australia) and are currently at their lowest levels in more than seven years. The 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 been little changed in recent quarters. These loans remain a small share of total household credit.

## Commercial Property

The commercial property sector is especially important from a financial stability perspective,

given that it accounts for almost 30 per cent of banks' domestic non-financial business lending. Historically, the sector has also comprised a disproportionately large share of banks' non-performing loans. Many of the dynamics discussed for the housing market are also relevant in the commercial property market, in part due to the role of residential property development in the sector. The attractive yields on Australian commercial property relative to returns overseas and on other asset classes have also added to these dynamics.

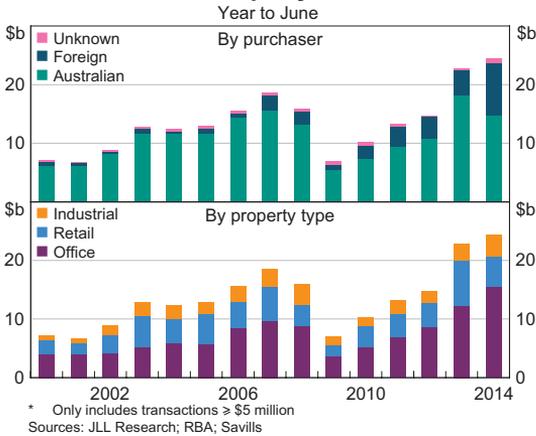
In particular, in the global environment of low interest rates and the consequent search for yield, the high yield on Australian commercial property has attracted strong investor demand, with a sharp increase in the total value of office, retail and industrial property transactions over the past two years (Graph 3.9). This demand has come from both domestic and foreign investors; the flow of foreign capital into the sector increased strongly over the past year.<sup>1</sup> Foreign capital is also flowing into residential property development, particularly in the inner-city Melbourne apartment market.

The strong demand for commercial property continues to boost prices, especially for CBD office and industrial properties, despite weak leasing conditions and subdued tenant demand in some states (Graph 3.10). In particular, lower demand from government organisations in Brisbane and mining-related companies in Brisbane and Perth has weighed on conditions in these CBD office markets. By contrast, the Sydney office market, where price rises have been greatest, has been somewhat shielded from the effects of weaker tenant demand, in part because withdrawals of property from the market (particularly the conversion of older office space to residential property) have constrained supply.

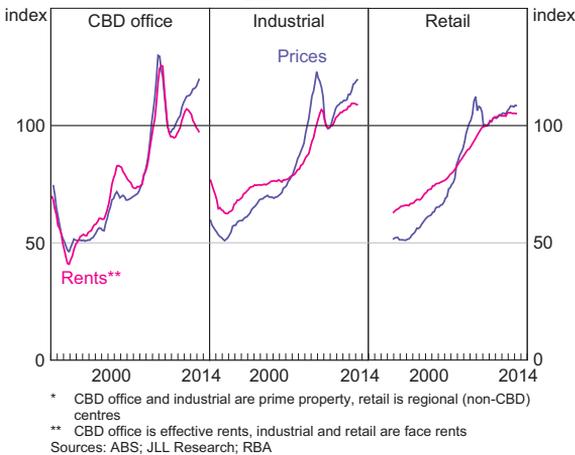
A substantial supply of office properties is under construction or being refurbished and is therefore expected to come online in the next couple of

<sup>1</sup> For further detail on foreign investment in the commercial property market, see Lane K, A Sinclair and D Orsmond (2014), 'Foreign Investment in Australian Commercial Property', RBA *Bulletin*, September, pp 21–26.

**Graph 3.9**  
**Commercial Property Transactions\***



**Graph 3.10**  
**Commercial Property\***  
2009 = 100



years in Sydney, Brisbane and Perth. Beyond this, industry liaison indicates that the current softness in tenant demand has led to some projects being delayed or cancelled, and building approvals have declined over the first half of this year. Supply-side pressure in the retail sector should remain limited, with the increase in construction activity over the past few years largely related to the refurbishment and modest expansion of existing centres, and construction of 'large format' retail centres (occupied by a single retailer).

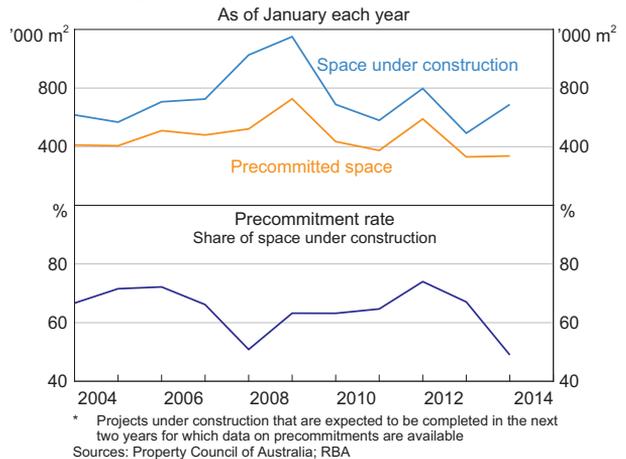
One risk facing the commercial property sector is that a reversal in the strong growth in investor demand might expose the market to a sharp

repricing. In particular, inflows of foreign capital could slow or cease once global interest rates start to rise or if conditions were to weaken in foreign investors' home countries. The risk may also be exacerbated by further weakness in commercial property leasing conditions.

Another risk facing commercial property lending, especially lending for new property development, is tenancy risk – that is, the risk that the developer fails to secure tenants for their property and consequently struggles to meet their loan repayments. This risk is higher for developments with a lower precommitment rate. For office property, the strength in investment demand and relative weakness in tenant demand have contributed to a decline in the average precommitment rate (Graph 3.11), though available data for selected years from the early 1990s suggest it remains significantly higher now than it was in the lead-up to the severe market downturn in the early 1990s. By contrast, pre-sales currently remain high for residential property.

At this stage, the direct risk to Australian-owned lenders from these factors appears limited; liaison with industry suggests that office projects with lower precommitment rates are generally financed from developers' own equity (or that of their investment partners). Also, as discussed above, while some residential developments that are targeted at

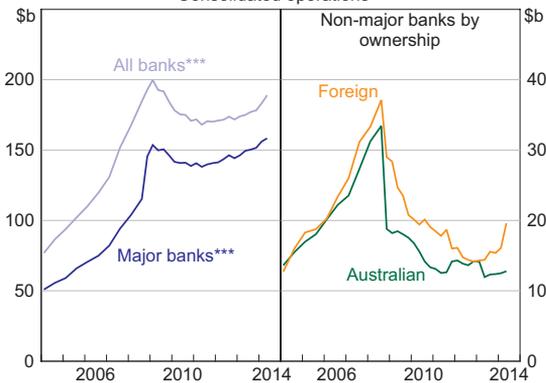
**Graph 3.11**  
**CBD Office Tenant Precommitments\***



foreign investors comprise smaller-sized apartments that may be harder to sell in the secondary market, many of these are being constructed by foreign developers that are funded by equity or foreign banks. Still, a downturn in the markets for these properties could weigh on prices of nearby property and therefore affect banks' portfolios indirectly.

More broadly, the near-term risks to the domestic financial system from the commercial property sector appear modest. Although banks' commercial property exposures are increasing, they are a smaller share of banks' total assets than prior to the financial crisis. The increase in exposures has been driven by the major banks and Asian-owned banks, particularly for the retail, office and 'other' (including some property trusts, healthcare and education) property segments (Graph 3.12).

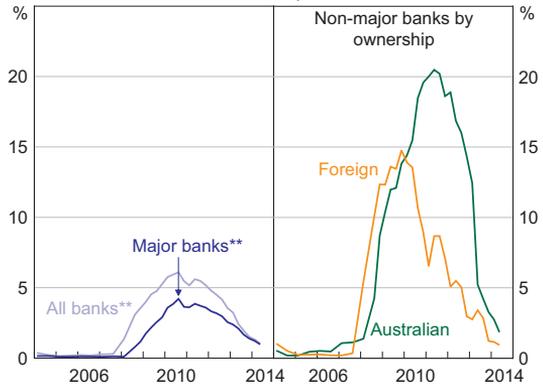
**Graph 3.12**  
**Banks' Commercial Property Exposures\***  
Consolidated operations\*\*



\* Quarterly from September quarter 2008; some banks report only on a semiannual basis  
 \*\* Exposures in the June quarter 2014 boosted by bridging loans, some of which should be unwound in the September quarter 2014  
 \*\*\* Excludes overseas exposures  
 Sources: APRA; RBA

While a deterioration in future loan performance of commercial property cannot be ruled out, banks have been successful in recent years in reducing their non-performing commercial property loans. The impairment rate on banks' commercial property loans continued to decline over the past six months, and is now at its lowest level since 2007 (Graph 3.13). Part of the improvement in loan performance over recent years was likely to have been due to the

**Graph 3.13**  
**Commercial Property Impairment Rate\***  
Consolidated operations



\* Quarterly from September quarter 2008; some banks report only on a semiannual basis  
 \*\* Excludes overseas exposures  
 Sources: APRA; RBA

write-off or disposal of impaired loans; the recent strong investor demand in the commercial property market may have facilitated some of those disposals. The fall has been broadly based across property types, though it has been most pronounced in retail and residential property, which had the highest peaks in impairment rates.

## Business Sector

### Funding and balance sheet position

Outside of commercial property, businesses' risk appetite generally remains subdued despite the low level of interest rates. In line with subdued non-mining investment, growth in intermediated business credit remains modest, though it has picked up over the past six months (Graph 3.14). Market-sourced funding also remains subdued (Graph 3.15). Net issuance of corporate bonds has been negative so far this year, while equity raisings have picked up a touch in recent quarters, due to an increase in initial public offerings.

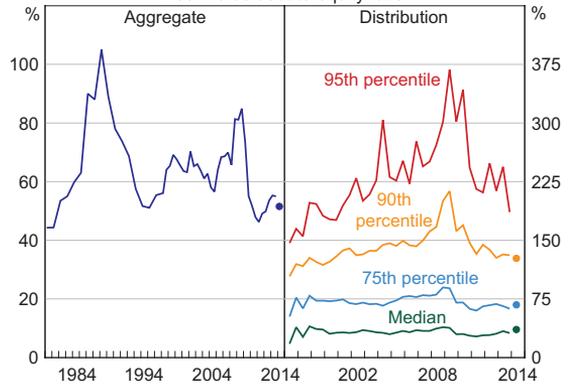
Corporate balance sheets appear to generally be in good shape following the sustained period of deleveraging after the financial crisis. The aggregate gearing ratio of listed corporations is near historical lows and, importantly, gearing ratios in the more

**Graph 3.14**  
**Business Credit Growth\***  
 Six-month-ended, annualised



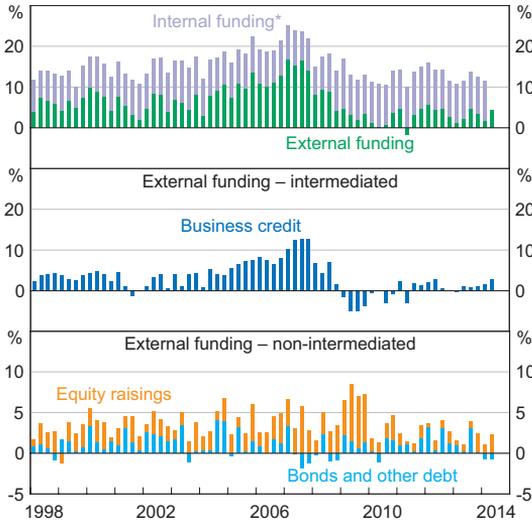
\* Excludes securitised loans and lending to financial corporations  
 \*\* Business credit extended during June 2014 was boosted by bridging loans, some of which were unwound in July 2014  
 Sources: APRA; RBA

**Graph 3.16**  
**Listed Corporations' Gearing\***  
 Book value debt-to-equity ratio



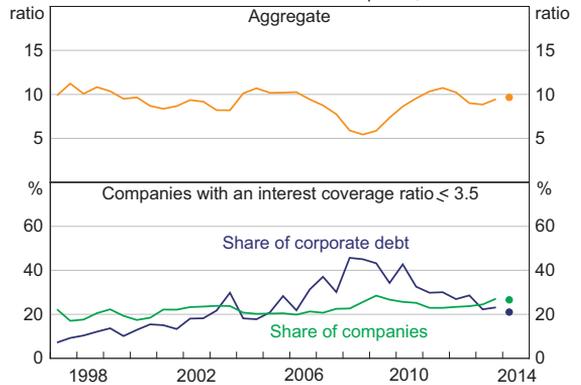
\* Excludes financial and foreign-domiciled companies; June 2014 observations are estimates based on companies that have reported to date  
 Sources: Bloomberg; Morningstar; RBA; Statex

**Graph 3.15**  
**Business Funding**  
 Net change as a per cent to GDP



\* March 2014 observation is the latest available  
 Sources: ABS; APRA; ASX; RBA

**Graph 3.17**  
**Listed Corporations' Interest Coverage\***  
 Ratio of EBITDA to net interest expense, annual



\* Excludes financial and foreign-domiciled companies; June 2014 observations are estimates based on companies that have reported to date  
 Sources: Bloomberg; Morningstar; RBA

vulnerable upper tail of the distribution have fallen significantly from their peak in June 2009 (Graph 3.16). The aggregate interest coverage ratio of listed corporations remains fairly high, with companies' profits able to cover their net interest expenses around 10 times (Graph 3.17). Despite this, the share of listed corporations with a reasonably low coverage ratio (assessed here as 3½ or less) exceeds

its pre-crisis average. At current levels of profitability, these companies could face some difficulty servicing their debts in a higher interest rate environment. Any risk to the Australian financial system is likely to be modest given the share of listed corporate debt owed by these companies has halved from its 2008 peak, to be currently around 20 per cent.

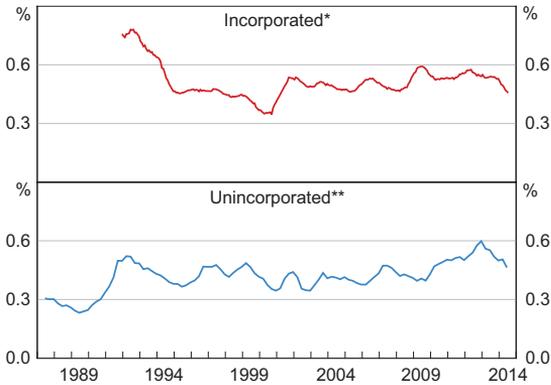
### Loan performance and other indicators of business stress

Indicators of business stress have continued to improve over the past six months (Graph 3.18). Failure

**Graph 3.18**

**Business Failures**

Share of businesses in each sector, annual



\* Companies entering external administration  
 \*\* Includes business-related personal bankruptcies and other administrations  
 Sources: ABS; AFSA; ASIC; RBA

rates for both incorporated and unincorporated businesses are well below their recent peaks in 2012. Among incorporated businesses the decline in the failure rate has been led by a fall in the number of failures in the services and construction industries.

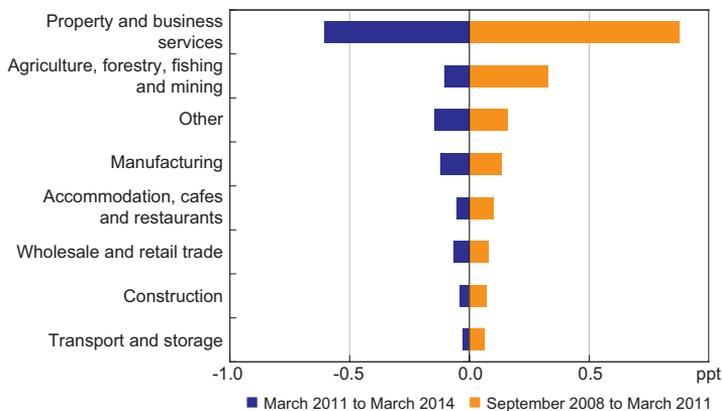
As discussed in the chapter 'The Australian Financial System', the share of banks' business loans that is non-performing continues to fall. Data for the major banks suggest the improvement in loan performance over recent years has been broadly based across industries, but has been especially marked in the property and business services (mostly commercial property), and manufacturing industries (Graph 3.19). The agriculture, forestry, fishing and mining category also contributed to the previous increase in non-performing loans, although less than half of the deterioration has currently been reversed.

One potential risk to future loan performance is that banks might compete for the limited demand from businesses for intermediated credit by easing lending standards. As discussed in the chapter 'The Australian Financial System', while pricing competition between banks in extending loans to large corporations has intensified, so far there has not been a broad relaxation in non-price terms for corporate loans. ✎

**Graph 3.19**

**Non-performing Loans by Industry\***

Contributions to changes in the business non-performing loan ratio



\* Major banks; consolidated global operations; December 2008, June 2011 and June 2014 for CBA  
 Sources: Banks' Pillar 3 Reports; RBA