2. Household and Business Finances

In Australia, vulnerabilities related to household debt and the housing market more generally have increased, though the nature of the risks differs across the states. Household indebtedness has continued to rise and in Sydney and Melbourne, investor activity and housing price growth have picked up strongly. In inner areas of Brisbane and some other locations, there are ongoing concerns about a future oversupply of apartments given the large volume of apartments still to be completed. In Western Australia and other regions exposed to the mining sector, economic conditions remain challenging and both detached house and apartment prices have fallen as income and population growth have slowed.

There has been some tightening of lending standards since 2014, which is evident in the ongoing decline in the share of loans with high loan-to-valuation ratios (LVRs). However, some types of higher-risk housing lending such as interest-only (IO) loans, particularly to investors, have increased of late. Though household indebtedness has continued to rise, low interest rates and improved lending standards in recent years are helping to keep the household debt-servicing burden contained. In this environment, the risks are primarily macroeconomic in nature rather than direct risks to the stability of financial institutions.

The Council of Financial Regulators (CFR) has been monitoring and evaluating the risks to household balance sheets. In an environment of heightened risks, the Australian Prudential Regulation Authority (APRA) announced further measures in March 2017 to reinforce sound housing lending practices. Authorised deposit-taking institutions (ADIs) will be expected to limit new IO lending to 30 per cent of total new residential mortgage lending, and within that to tightly manage new IO loans extended at high LVRs. APRA also reinforced the importance of: banks managing their lending so as to comfortably meet the existing investor credit growth benchmark of 10 per cent; loan serviceability assessments being appropriate to the current environment of heightened risks, including the size of net income buffers; and banks continuing to exercise restraint on lending growth in higher risk segments such as high loan-to-income loans, high LVR loans and loans for very long terms. In addition, APRA highlighted the need to contain growth in warehousing facilities to non-ADI housing lenders, and to ensure appropriate lending standards are maintained.[1]

In addition, the Australian Securities and Investments Commission (ASIC) has stressed the importance of lenders and brokers ensuring that consumers are not provided with unsuitable IO loans, and announced a targeted industry surveillance to examine the practices of lenders and mortgage brokers in this respect. ASIC also announced that eight major lenders can provide remediation to consumers who suffer financial difficulty as a result of shortcomings in past lending practices.[2]

1 APRA (2017), 'APRA Announces Further Measures to Reinforce Sound Residential Mortgage Lending Practices', Media Release No 17.11, 31 March.

2 ASIC (2017), 'ASIC Announces Further Measures to Promote Responsible Lending in the Home Loan Sector', Media Release, No 17-095MR, 3 April.

Conditions in the non-residential commercial property sector also vary across the country. Conditions are strongest in Sydney and Melbourne, consistent with their stronger economies, while in Perth and Brisbane elevated vacancy rates and falling rents remain a challenge. Overall, yields on Australian commercial property assets are at historically low levels but remain higher than in many overseas markets and for other asset classes. As such, Australian commercial property continues to attract foreign investors. If these investors were to reassess their desired yield, it could put downward pressure on commercial property prices. This could occur if global interest rates rose more quickly than investors currently expect, for example in response to higher than anticipated global inflation.

Businesses generally remain in good financial health, with listed corporations' profits in line with their average over the past few years. Low interest rates are providing ongoing support to businesses and indicators of stress among businesses are generally low, with the exception of businesses exposed to resources or operating in mining regions. Even for these latter companies, higher commodity prices over the past six months have contributed to higher profits at resource-related companies, though the outlook for commodity prices remains uncertain.

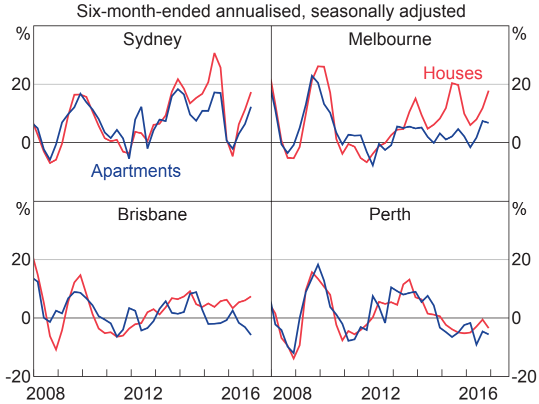
Household Sector

Housing and mortgage markets

Risks to household balance sheets and housing markets more generally have increased. In Sydney and Melbourne, housing prices are rising at a rapid pace and auction clearance rates are at high levels (Graph 2.1). At the same time, there continue to be concerns about an oversupply of apartments in pockets of Melbourne and in parts of Brisbane, where apartment prices have declined in recent months, rental growth has been soft and the vacancy rate has trended higher (Graph 2.2). In Western Australia and other regions with large exposures to the mining sector, overall housing market conditions remain weak.

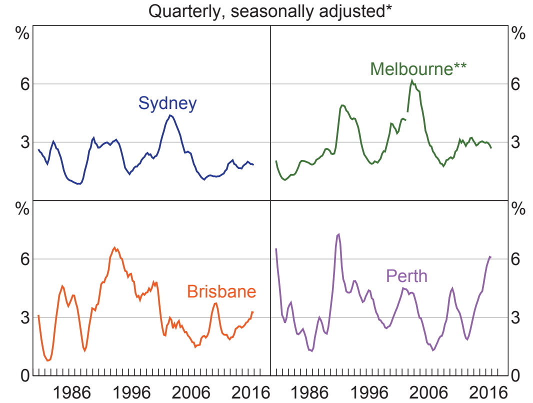
Investor credit has also risen noticeably over the past six months, with investor demand particularly strong in Sydney and Melbourne (Graph 2.3). Overall household indebtedness has increased while income growth has remained weak. Some types of higher-risk

Graph 2.1
Housing Price Growth by Dwelling Type
Six-month-ended annualised, seasonally adjusted



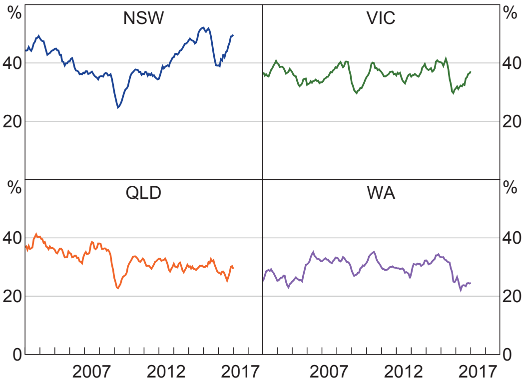
Sources: APM; RBA

Graph 2.2
Rental Vacancy Rates
Quarterly, seasonally adjusted*



* 12-month moving average
** Series break December quarter 2002
Sources: RBA; REIA; REIVA

Graph 2.3
Investor Housing Loan Approvals
Share of total loan approvals by state, excludes refinancing*



* Seasonally adjusted three-month moving average; investor refinancing based on RBA estimates

Sources: ABS; APRA; RBA

mortgage lending, such as IO loans, also remain prevalent and have increased of late (see 'Box B: Interest-only Mortgage Lending'). As noted above, APRA has recently taken measures to contain new IO lending.

The risks associated with strong investor credit growth and increased household indebtedness are primarily macroeconomic in nature rather than direct risks to the stability of financial institutions. Indeed, some evidence suggests that investor housing debt has historically performed better than owner-occupier housing debt in Australia, though this has not been tested in a severe downturn. Rather, the concern is that investors are likely to contribute to the amplification of the cycles in borrowing and housing prices, generating additional risks to the future health of the economy. Periods of rapidly rising prices can create the expectation of further price rises, drawing more households into the market, increasing the willingness to pay more for a given property, and leading to an overall increase in household indebtedness. While it is not possible to know what level of overall household indebtedness is sustainable, a highly indebted household sector is likely to be more sensitive to declines in income and wealth and may respond by reducing consumption sharply.

A further risk during periods of strong price growth is that it may be accompanied by an increase in construction that could result in a future overhang of supply for some types of properties or in some locations. In this environment, as well as amplifying the upswing for such properties, any subsequent downswing is likely to be larger and more likely to see prices and rents fall if the vacancy rate rises. This poses risks to the whole housing market and household sector, not just to the recent investors.

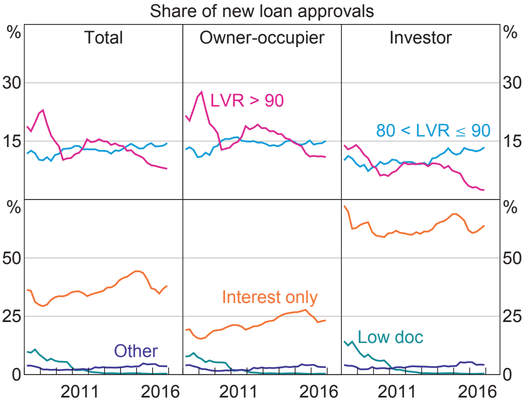
Prudent mortgage lending standards help to offset these risks. Over the past six months, lenders have further tightened lending terms, in part to keep investor credit growth within the 10 per cent benchmark set by APRA at the end of 2014.[3] Recent non-price measures introduced by banks include tighter serviceability and maximum LVR restrictions on new residential projects or postcodes considered to be riskier. Overall, the share of new lending with LVRs greater than 90 per cent has fallen (Graph 2.4). In addition, the price of mortgage finance has increased of late, and loan pricing is becoming more granular. For example, the major banks' advertised margin between investor and owner-occupier lending rates has risen to around 50–60 basis points after narrowing during 2016. Furthermore, all of the major banks will have introduced higher IO pricing by April, resulting in an average IO premium of 18 basis points for owner-occupier loans and 15 basis points for investor loans.

Regulators continue to scrutinise lender compliance with broader regulatory expectations. ASIC's 2015 review of IO home loans uncovered a range of weak practices

3 APRA (2014), 'Reinforcing Sound Residential Mortgage Lending Practices', Letter to all ADIs, 9 December.

Graph 2.4
ADIs' Housing Loan Characteristics*

Share of new loan approvals



* Series are break-adjusted for reporting changes; 'Other' includes loans approved outside normal debt-serviceability policies and other non-standard loans; interest-only data are seasonally adjusted

Sources: APRA; RBA

that led to a subsequent tightening of industry standards.[4] In this regard, ASIC recently lodged a case with the Federal Court alleging contraventions of the *National Consumer Credit Protection Act 2009* by one lender over a three-year period to early 2015.[5] In March 2017, ASIC completed a review of the mortgage broker market, which outlined conflicts of interest and other unsound practices such as lax assessment of consumer expenses and a propensity to direct consumers towards some higher-risk types of loans. ASIC's review recommended improvements to commission payment models, greater disclosure requirements for brokers, and improved governance and oversight of brokers by lenders and aggregators.[6] As noted earlier, APRA and ASIC have also recently announced a range of measures that are designed to strengthen mortgage lending practices.

4 See ASIC (2015), 'Review of Interest-only Home Loans', Final Report, August.

5 See ASIC (2017), 'ASIC Commences Civil Penalty Proceedings against Westpac for Breaching Home-loan Responsible Lending Laws', Media Release No 7-048MR, 1 March.

6 See ASIC (2017), 'Review of Mortgage Broker Remuneration', Final Report, March.

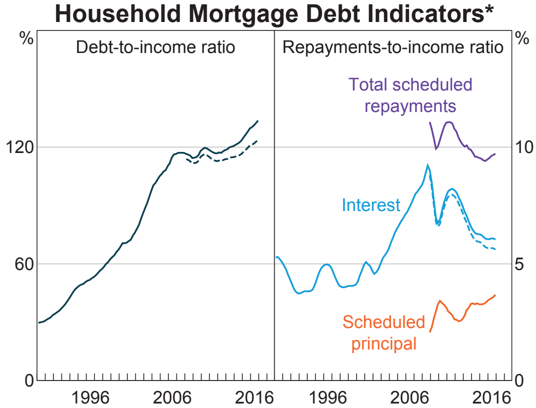
Financial position and indicators of stress

While the financial position of households has been fairly resilient, vulnerabilities persist for some highly indebted households, especially those located in the resource-rich states. Household indebtedness (as measured by the ratio of debt to disposable income) has increased further, primarily due to rising levels of housing debt, although weak income growth is also contributing. Rising indebtedness can make households more vulnerable to potential income declines and higher interest rates. This is of most concern for households that have very high levels of debt (see 'Box C: Characteristics of Highly Indebted Households').

Low interest rates are helping to offset the cost of servicing larger amounts of debt and hence total mortgage servicing costs remain around their recent lows (Graph 2.5). In this regard, lenders have tightened mortgage serviceability assessments in recent years to include larger interest rate buffers, which should provide some protection against the potential effects of higher interest rates.

Prepayments on mortgages increase the resilience of household balance sheets. Aggregate mortgage buffers – balances in

Graph 2.5
Household Mortgage Debt Indicators*



* Excludes non-housing debt; dotted lines are calculations based on debt balances net of offset accounts; income is household disposable income before housing interest costs

Sources: ABS; APRA; RBA

offset accounts and redraw facilities – are high, at around 17 per cent of outstanding loan balances or around 2½ years of scheduled repayments at current interest rates. However, these aggregate figures mask significant variation across borrowers, with available data suggesting that around one-third of borrowers have either no accrued buffer or a buffer of less than one month's repayments. Those with minimal buffers tend to have newer mortgages, or to be lower-income or lower-wealth households.

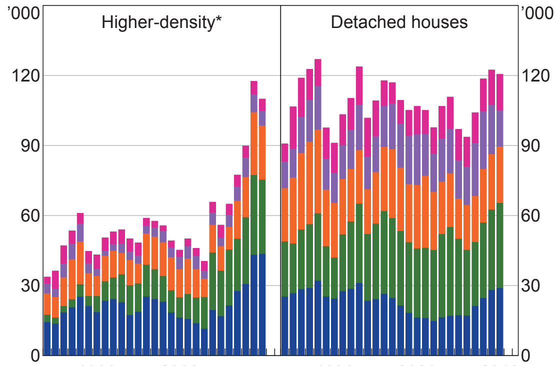
Weak economic conditions, and declining housing prices, continue to present challenges to the financial health of households in regions with large exposures to the mining sector. For example, the rate of personal administrations in Western Australia increased further over the second half of 2016. While commodity prices have increased, this seems unlikely to translate into significantly improved labour market outcomes in these regions in the near term. If housing prices continue to decline in these locations, then banks may face additional losses on their mortgage portfolios.

Commercial Property

Residential development

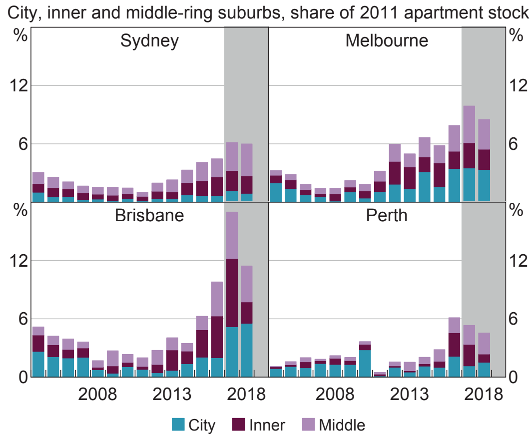
The construction of new apartments and other higher-density housing has increased substantially over recent years, reaching historically high levels. In 2016, higher-density dwellings accounted for around half of all residential building approvals (Graph 2.6). As would be expected, much of this activity has occurred in the most populous cities of Sydney, Melbourne and Brisbane. In Sydney, construction activity has been spread across the inner and middle suburbs, and the increase in new supply relative to the existing stock of apartments is relatively modest (Graph 2.7). However, in Melbourne and Brisbane, where apartments have historically accounted for a much smaller share of the dwelling stock, activity has been concentrated within the central business districts and in a few surrounding inner suburbs. Moreover, in Brisbane the overall increase in the supply of apartments in inner to middle-ring suburbs is much larger than that of Sydney and Melbourne as a share of the current stock, and population growth in Queensland has slowed in recent years.[7] This large number of new apartments recently completed

Graph 2.6
Dwelling Approvals



* All other non-detached dwellings
Source: ABS

Graph 2.7
Estimated Apartment Completions*



* Estimated completions are derived from ABS building approvals data based on a two-year construction period
Sources: ABS; RBA

7 Shoory M (2016), 'The Growth of Apartment Construction in Australia,' RBA *Bulletin*, June, pp 19–26.

and currently under construction raises the risk of localised pockets of oversupply. As discussed earlier, apartment prices have fallen in Brisbane. In Perth, reduced growth in demand for new dwellings has created challenging conditions for builders and developers.

In these circumstances, developers may have trouble finding buyers for their new apartments in some areas. While liaison with industry suggests that settlement failure rates remain low, developers are continuing to report delays in settlement for some purchasers. One reported contributor to settlement delays is tighter access to finance, particularly for buyers relying on foreign income. Liaison also indicates that valuations at settlement are sometimes coming in below what buyers had anticipated and, in some cases, below contracted purchase prices, reducing the amount banks will lend. For investors buying these new apartments, declines in apartment prices raise the likelihood that they fall into negative equity at settlement. The potential for rents to fall and vacancy rates to rise also raises the risk that investors may find it more difficult to subsequently service their mortgages.

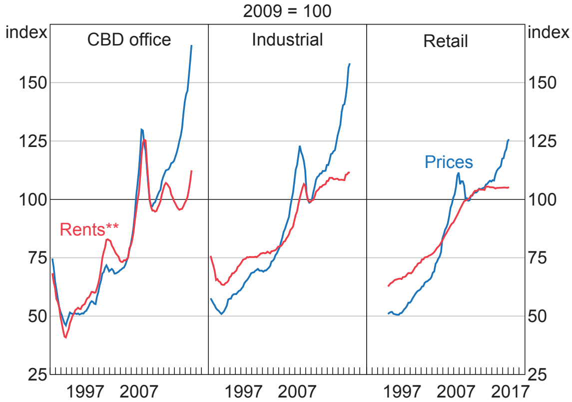
In view of these concerns, developers' access to bank finance has tightened further, particularly in geographic regions at risk of oversupply. Banks tightened finance for residential developers over the course of 2016, with measures such as stricter pre-sales requirements, lower maximum LVRs and stricter geographic concentration limits. Liaison with industry suggests that the use of non-bank lenders, such as mezzanine financiers and private equity, has consequently increased, and that the pricing of finance from these sources is generally higher. Liaison also reports that the use of intermediaries who connect borrowers with non-bank lenders has increased. Overall, however, it is difficult to fully gauge the scale of this type of lending.

Other commercial property

Commercial property prices have continued to rise by more than rents, and yields have now reached historically low levels (Graph 2.8). Nonetheless, yields on Australian commercial property remain higher than in many overseas property markets and other asset classes, which has attracted investors, including foreign buyers. The current heightened commercial property valuations may leave some leveraged investors vulnerable to subsequent price declines. In particular, if global interest rates were to increase more quickly than investors currently anticipate or demand from foreign or domestic investors were to decline, a consequent price decline may lead leveraged property investors to breach loan-to-valuation covenants on bank debt. They would then be required to inject additional equity to support their loan facilities, which may prompt further sales and price declines if they were unable to do so.

Like residential property markets, conditions in commercial property markets vary significantly by state and type of asset. Investor demand is strongest in Sydney and Melbourne, and

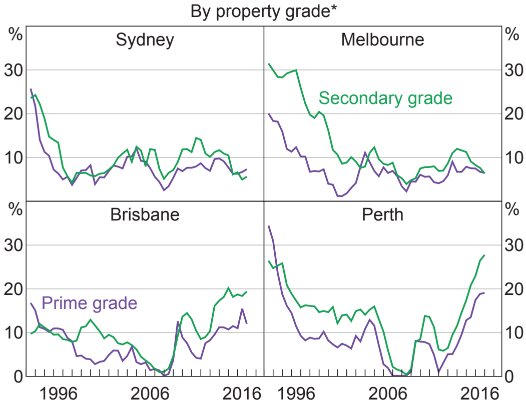
Graph 2.8
Commercial Property*
2009 = 100



* CBD office and industrial are prime property, retail is regional (non-CBD) centres
** CBD office is effective rents, industrial and retail are face rents
Sources: ABS; JLL Research; RBA

for office and industrial properties. In Sydney and Melbourne, prices for office property are rising, and growth in rents has increased in recent months due to strong tenant demand. In Brisbane, office prices are rising at a much slower rate, while prices in Perth are flat. Office vacancy rates are elevated in Brisbane and Perth (Graph 2.9).

Graph 2.9
CBD Office Vacancy Rates
By property grade*



* Prime grade includes premium and A grade stock weighted by floor space; secondary grade includes B grade, C grade and D grade stock weighted by floor space

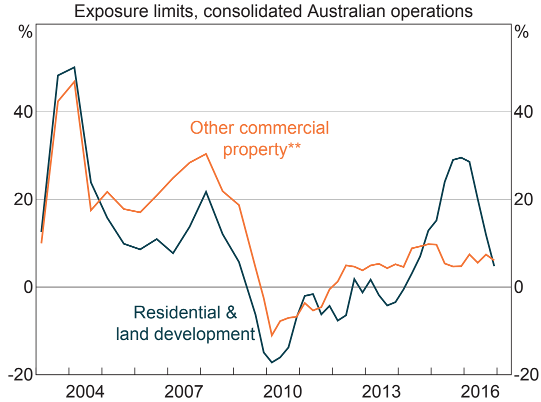
Sources: Property Council of Australia; RBA

There is some evidence that conditions in the prime-grade Brisbane and Perth office markets may be stabilising, though this appears to have come at the expense of secondary-grade markets where the outlook remains weak. Falling rents and increasing vacancy rates have motivated tenants to relocate into better quality office spaces. Accordingly, prime-grade tenant demand picked up in Brisbane over the past six months, while in Perth analysts generally expect the vacancy rate in prime-grade office property to stabilise, with little new supply forecast to come on line over the next couple of years.

Conditions in industrial and retail commercial property markets also vary by city. Stronger local economic conditions and infrastructure investment have supported tenant demand in the Sydney and Melbourne industrial markets, and rent growth has picked up noticeably in Sydney. Conditions in Brisbane may be stabilising, while rents in Perth continue to fall. In retail property markets, tenant demand has been soft nationally.

In 2016, APRA reviewed banks' commercial property lending practices, including lending for residential development.[8] The review examined banks' underwriting standards and portfolio controls. Among other things, the review found evidence at some ADIs of weak underwriting standards and that the ability of lenders' boards to monitor the risk profile of lending was hampered by inadequate information systems. Over the past six months, banks have tightened their commercial property lending standards and growth in banks' commercial property exposures has slowed, due primarily to slower growth in lending for residential and land development (Graph 2.10). A decline in Australian banks' commercial property exposures has been offset by an increase in Asian banks' commercial property exposures (Graph 2.11).

Graph 2.10
Commercial Property Exposures Growth*
Exposure limits, consolidated Australian operations



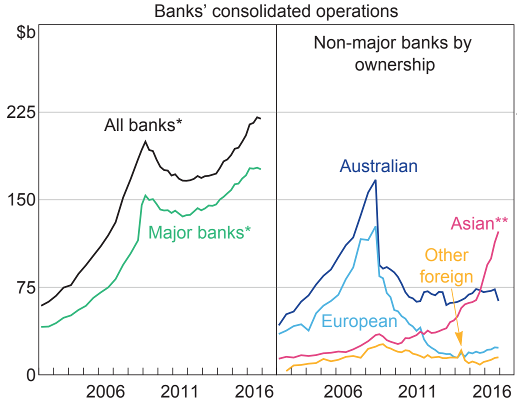
* Year-ended growth

** Includes industrial, office, retail, tourism & leisure and other

Sources: APRA; RBA

8 APRA (2017), 'Commercial Property Lending – Thematic Review Observations', Letter to all ADIs, 7 March.

Graph 2.11
Commercial Property Exposures
Banks' consolidated operations



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

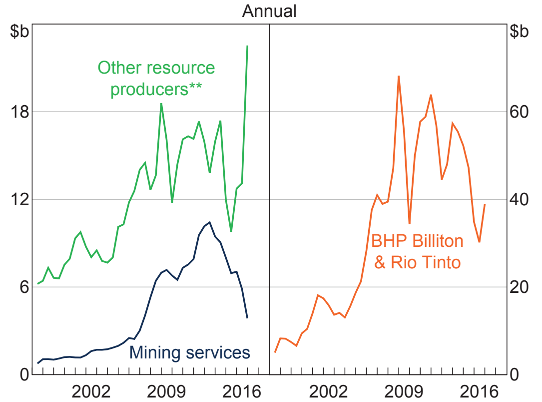
Business Sector

Conditions have generally improved over the past six months for businesses in the resource-related sector. The rise in commodity prices since the beginning of 2016, particularly for iron ore, and the ongoing efforts of these businesses to cut costs and reduce debt, have led to a substantial increase in the aggregate earnings of listed resource-related corporations (Graph 2.12). Many listed resource-related corporations have used some of their increased profits to pay down debts, resulting in a decline in the sector's gearing and debt servicing ratios. In line with these positive developments, resource-related corporations' distance-to-default measures have increased over the past year (Graph 2.13).[9] Nevertheless, earnings have continued to weaken for mining services corporations as resource producers have focused on cost reduction.

As noted in previous *Reviews*, banks' direct exposures to the mining sector have declined in recent years and now constitute only a little over 1 per cent of their total lending, though this figure excludes banks' exposures to non-resource-related businesses operating in mining regions (Graph 2.14). Conditions remain challenging for these businesses, given mining firms' continued focus on cost containment, and some indicators of financial distress have picked up. For instance, unincorporated business failure rates are elevated in Queensland and Western

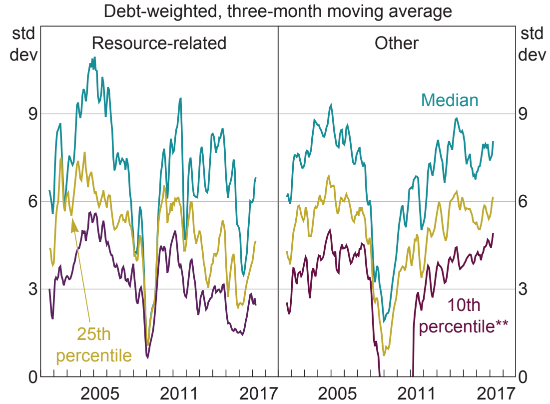
9 Distance-to-default is a forward-looking, market-based measure of default risk using equity prices and book-value liabilities. See Robson M (2015), 'Default Risk Among Australian Listed Corporations', RBA *Bulletin*, September, pp 47–54.

Graph 2.12
Listed Resource-related Corporations' Earnings*
Annual



* Listed corporations' EBITDA; excludes foreign-domiciled corporations
** Includes listed junior explorers
Sources: Bloomberg; Morningstar; RBA

Graph 2.13
Listed Corporations' Distance-to-default*
Debt-weighted, three-month moving average

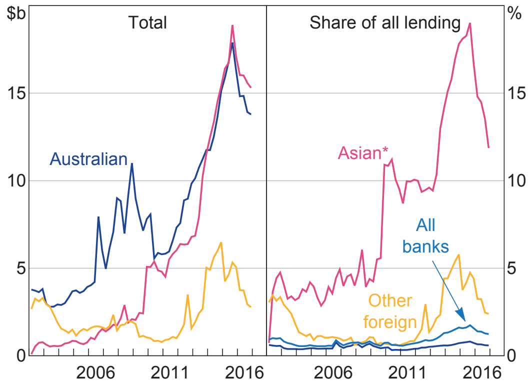


* Calculated up to 31 March 2017 using a sample of the largest 300 corporations listed on the ASX by debt; excludes financial and foreign-domiciled corporations
** Between 2008 and 2011, distance-to-default measures turned negative for around 100 non-resource-related companies, implying a high probability of default; of these, around one-third went on to default
Sources: Bloomberg; Morningstar; RBA

Australia (Graph 2.15). If higher commodity prices were to fall or not translate into improved economic conditions in mining-exposed regions, business failure rates may pick up further.

Outside the mining-exposed states, businesses' finances generally appear sound and indicators of stress are low. Survey measures of business conditions are well above their historical averages; listed corporations' distance-to-default measures have continued their trend improvement and earnings have been in line with previous years; failure rates are low; gearing remains around its historical average; and many businesses continue to benefit from the depreciation of the Australian dollar since 2013 (Graph 2.16). The low interest rate environment has also made it easier for companies to meet their debt obligations by reducing debt-servicing costs (Graph 2.17).

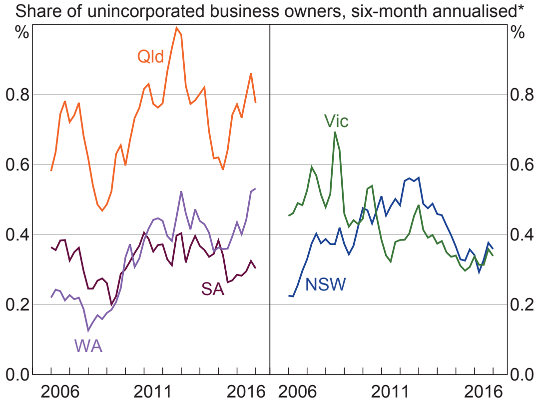
Graph 2.14
Banks' Lending to the Mining Sector
Domestic books



* Includes HSBC

Sources: APRA; RBA

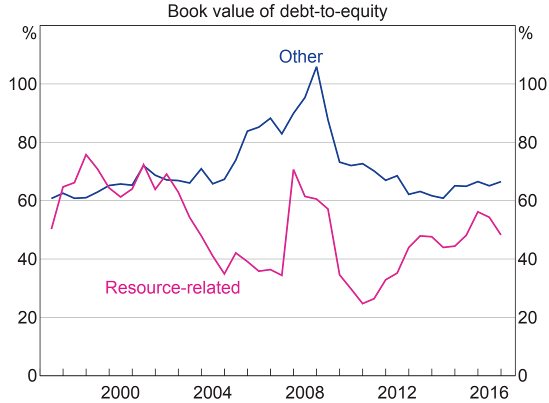
Graph 2.15
Unincorporated Business Failures by State
Share of unincorporated business owners, six-month annualised*



* Number of unincorporated business owners by state estimated from September quarter 2015

Sources: ABS; AFSA; RBA

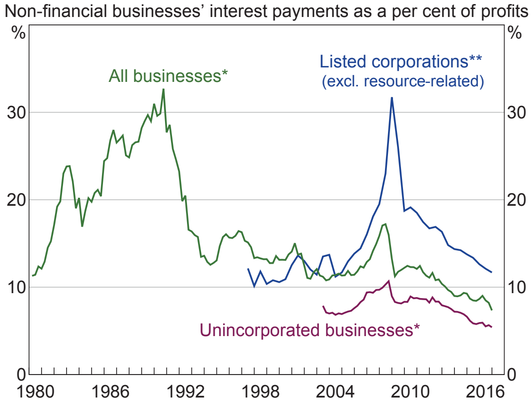
Graph 2.16
Listed Corporations' Gearing Ratios*
Book value of debt-to-equity



* Excludes financial and foreign-domiciled corporations

Sources: Bloomberg; Morningstar; RBA

Graph 2.17
Debt-servicing Ratios
Non-financial businesses' interest payments as a per cent of profits



* Gross interest paid on intermediated debt from Australian-located financial institutions

** Net interest paid on all debt as a per cent to EBITDA; excludes foreign-domiciled corporations

Sources: ABS; APRA; Bloomberg; Morningstar; RBA