2. Household and Business Finances

Risks to the household sector overall have lessened a little further since the previous *Review*. Housing lending standards remain considerably tighter than they were a year or two ago and while price growth has picked up a bit of late in the capital city housing markets, it remains below recent peaks. However, in areas reliant on mining there are clear signs of increasing financial stress among households, with non-performing loans rising, albeit from low levels. Housing price falls in mining regions have been substantial, making it more difficult for borrowers in financial stress to resolve their situation by selling their property. More broadly, while current debt-servicing ability is well supported by the low level of interest rates, household indebtedness continues to drift up and, with incomes growing more slowly than in the previous decade, households may not be able to rely on income growth to make their debt easier to service.

In residential property development, the risks in some apartment markets are closer to materialising, as the foreshadowed large and geographically concentrated increase in supply approaches. These risks appear greatest in inner-city Brisbane and Melbourne, where the new supply is largest relative to the existing dwelling stock. Developers face the risk that off-the-plan sales of apartments in these areas fail to settle due to tighter lending standards for buyers (particularly non-residents or those relying on foreign income) and valuations at settlement below the contract price. To date, settlement failure rates have remained low, although in some cases settlement has been delayed because the buyer has had difficulty accessing finance. While tighter lending standards have made accessing finance more challenging for some purchasers, it is nonetheless important that borrowers can afford to service their debt and that collateral is appropriately valued.

Banks have responded to these risks by tightening access to finance for new apartment developments. Together with greater difficulty achieving the required level of pre-sales, this has led some developers to delay their building projects. Given the significant volume of apartments expected to be completed in the next couple of years, some consequent slowing in construction in some areas could lessen the risk of oversupply.

Conditions in non-residential commercial property markets continue to vary across cities; Sydney and Melbourne are performing strongly, while Brisbane and Perth are facing difficult market conditions. The ongoing search for high-yielding assets in a global environment of low interest rates has been an important contributor to the strong price growth in Sydney and Melbourne. There is some uncertainty about the sustainability of demand at current yields, particularly if global interest rates were to increase or demand from Asia were to decline.

Businesses generally remain in good financial health, with aggregate levels of gearing around their historical averages and the earnings of listed corporations broadly in line with prior periods. Most businesses appear well placed to meet their debt obligations. An exception is companies in the resource-related sector, which continue to face much lower commodity prices than a few years ago, weighing on earnings. While many resource-related companies have been able to cut costs and reduce capital expenditure, it is becoming progressively more difficult to lower costs further. There are signs that these difficult conditions are affecting the financial health of other businesses in mining-reliant areas. In response, banks have reduced their exposures to the resource-related sector over the past six months and overall the stresses in that sector appear to pose little direct risk to the domestic financial system.

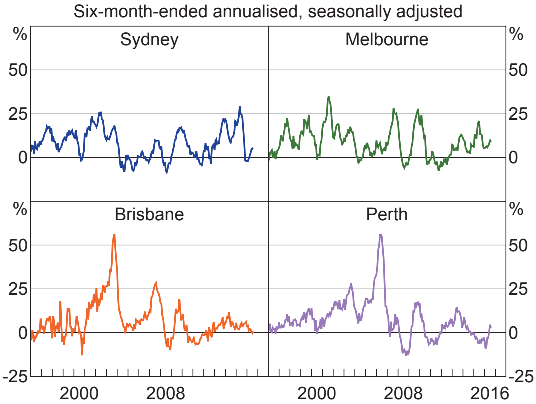
Household Sector

Housing and mortgage markets

Housing price growth over the past six months has remained below recent peaks, especially in Sydney, which was previously the most buoyant market (Graph 2.1). In the more mining-intensive states, housing prices have been broadly flat in Brisbane and Perth. Nonetheless, housing market activity in Sydney and Melbourne has shown signs of strengthening in recent months. In both cities, price growth has nudged higher of late and auction clearance rates have risen to high levels.

Since the previous *Review*, overall housing lending standards have tightened a little further. The substantial tightening that occurred in 2015 and early 2016 has remained in place, notably the stricter serviceability policies and reduction in the share of riskier lending. Banks also continue to apply tighter lending policies for apartments and to selected suburbs or regions deemed higher risk. One notable change to lending standards of late is the tighter restriction banks have placed on lending to non-resident borrowers and those reliant on foreign income, following some cases of fraud in loan applications. In liaison, the domestic banks have indicated that they expect this restriction to have relatively little influence on overall credit growth because few loan applicants have foreign income. Nonetheless, it could affect segments of the housing market where foreign buyers are most prevalent, such as inner-city apartment markets.

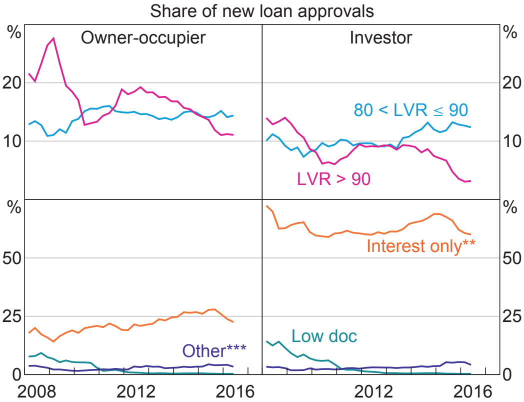
Graph 2.1
Housing Price Growth
Six-month-ended annualised, seasonally adjusted



Sources: APM; RBA

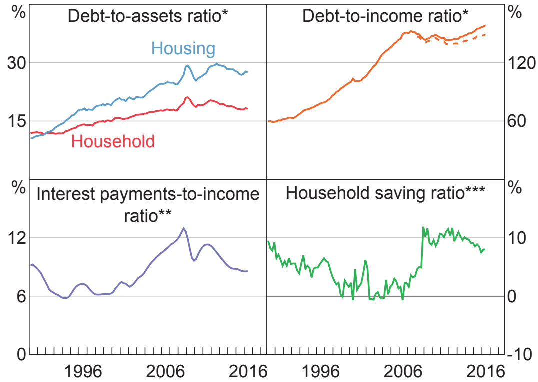
The cost of mortgage finance has declined, however, and lenders are competing for new customers. Competition for investor loans in particular has increased, and banks have recently narrowed the pricing differential between investor and owner-occupier loans. But the tightening of lending standards in recent years has meant that the profile of this new lending is lower risk than it was a year or so ago. For both owner-occupier and investment lending, the share of loans at high loan-to-valuation ratios (LVRs; those greater than 90 per cent) is now around its lowest level since the series began in 2008. Similarly, the share of interest-only lending has declined to its decade average level, although the share of interest-only lending to investors has flattened out in the most recent data (Graph 2.2). Historically, high-LVR lending has tended to be a bit more likely to default than other housing lending. High-LVR and interest-only lending also involve higher losses-given-default than other housing lending, all else equal, because borrowers' equity is lower at the point of default. Although the share of investor lending has picked up in recent months, it remains well below its high level of a year ago.

Graph 2.2
ADIs' Housing Loan Characteristics*
Share of new loan approvals



* Series are break-adjusted for reporting changes
** Investor series is seasonally adjusted
*** 'Other' includes loans approved outside normal debt-serviceability policies and other non-standard loans
Sources: APRA; RBA

Graph 2.3
Household Indicators



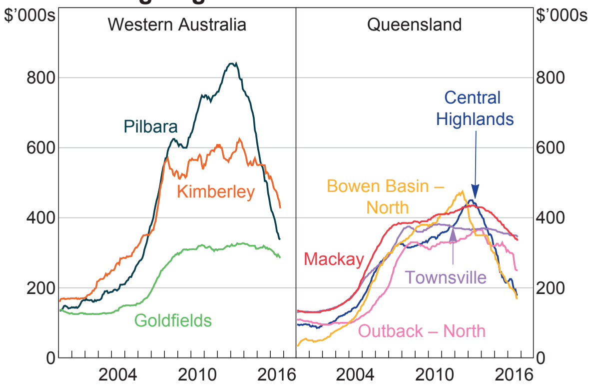
* Debt to the financial sector; dashed line is net of offset account balances
** Excludes unincorporated enterprises
*** Net of depreciation
Sources: ABS; APRA; RBA

Financial position and indicators of stress

In aggregate, the financial position of the household sector is broadly unchanged since the previous *Review*. The debt-to-income ratio continues to drift up from already high levels, as housing debt has increased and income growth remains low (Graph 2.3). However, households' debt-servicing ability remains well supported by the very low level of mortgage interest rates. Households are also less leveraged than in 2012, when debt-to-asset ratios peaked. Although the household saving ratio has declined a little over recent years, it remains higher than in the decade or so prior to the financial crisis. Aggregate mortgage buffers – balances in offset accounts and redraw facilities – also remain 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 differences across individual borrowers. Many borrowers have little or no buffer, especially the newest borrowers and those considered more at risk of experiencing financial stress, such as borrowers with lower wealth and income or higher leverage.

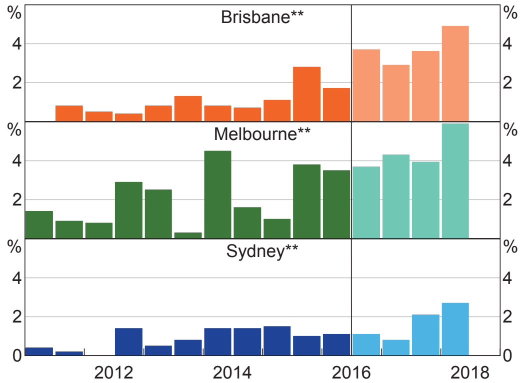
Although the household sector's aggregate financial position has remained broadly steady, households in some parts of the country are experiencing increased financial stress. Housing loan performance in Western Australia and Queensland in particular deteriorated further over the first half of 2016. Applications for property possession in Western Australia have edged higher over the past two years, although nationally they continue to decline as a share of the dwelling stock. In liaison, the banks attributed this deterioration largely to declining incomes in the mining states rather than to unemployment. For investors in the mining regions, elevated vacancy rates and sharply falling rents are reducing earnings. Housing price falls in mining regions have been substantial, and banks reported in liaison that in some towns it is difficult to sell properties, even with large price discounts (Graph 2.4). For borrowers having difficulty servicing their loan, this makes it challenging to resolve their situation through the sale of their property. However, mining companies own a large share of the properties in the most affected areas, reducing the number of households affected by these steep housing price falls. The rate of personal administrations has also increased over the past six months, particularly in Queensland and Western Australia, though nationally it remains close to 15-year lows.

Graph 2.4
Mining Regions' Median House Prices



Source: CoreLogic

Graph 2.5
Estimated Inner-city Apartment Completions
Share of the dwelling stock, six month blocks*



* Estimated completions from June 2016 onward are from CoreLogic, completions prior to this are based on ABS building approvals with a two-year construction lag; dwelling stocks estimated by RBA

** Inner-city areas of Brisbane (SA4), Melbourne (SA3) and Sydney (SA3)

Sources: ABS; CoreLogic; RBA

Commercial Property

Residential development

The foreshadowed risk of oversupply in some apartment markets is nearing as a large volume of new apartments has started to come on line, and many more completions are expected in the coming two years. Risks appear greatest in Brisbane and Melbourne's inner-city suburbs, where the pipeline of construction is large relative to the existing dwelling stock (Graph 2.5). Conditions in these inner-city markets are fairly subdued, especially in Brisbane where rents are now falling (see further discussion in 'Box B: Banks' Exposures to Inner-city Apartment Markets'). In contrast, new apartments in Sydney are more dispersed across the metropolitan area and account for a smaller share of the existing dwelling stock. In Perth, the expected flow of new dwellings is more modest relative to the stock and is geographically dispersed, but these dwellings are entering the market at a time when housing prices and rents are falling and population growth is slowing.

One risk associated with the large volume of construction underway is that off-the-plan purchases fail to settle. Liaison with the property industry points to some concern that this will become more common in Brisbane, Melbourne and Perth. These concerns arise from a combination of tighter financing conditions for purchasers (especially for non-residents and those reliant on foreign income) and valuations at settlement below the contracted price. Liaison with banks and industry suggests that in Melbourne, and increasingly in Brisbane, valuations for off-the-plan apartments are often a little below contract prices. However, the magnitude of the difference varies across individual projects and apartments.

Nonetheless, liaison suggests that settlement failure rates to date remain low, although settlement on some projects is taking longer as purchasers are having more difficulty arranging finance. While the tightening in lending standards has made accessing finance more challenging for some purchasers and made it harder for some purchasers to settle on time, it is prudent that financial institutions lend only to borrowers who can afford the repayments and hold adequate collateral. In weaker markets, such as Perth, there have been some instances of developers offering discounts to contracted prices to ensure that settlement occurs. In some cases, larger developers have also offered vendor finance to foreign buyers who could not access bank finance.

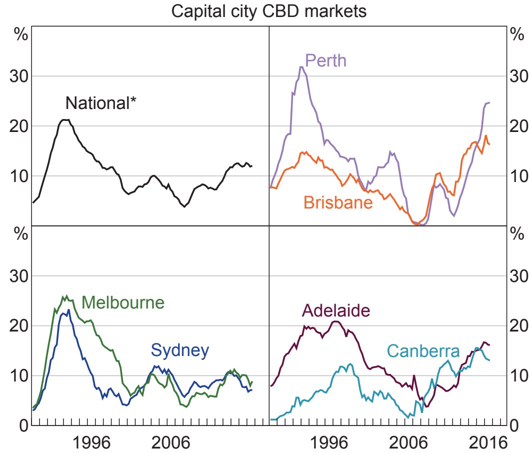
Assessing the overall financial health of developers is difficult due to the paucity of data available for unlisted developers, who account for a large share of the sector, and foreign developers, who are becoming increasingly active in Australia. The limited data available suggest that, in recent years, developers have funded new apartment projects largely through bank debt, increasing these developers' leverage and leaving them more vulnerable to a downturn in apartment markets. Banks have mitigated the risks on this lending by tightening financing conditions for new developments over the past six months or so, through stricter pre-sales requirements, lower maximum LVRs and stricter geographic concentration limits. Their lending to developers is generally well secured and, as yet, the additional costs to developers associated with settlement difficulties have not resulted in losses to the banks. Nonetheless, if apartment markets were to turn down and settlement difficulties become more widespread, banks would be more likely to incur some loan losses (see 'Box B: Banks' Exposures to Inner-city Apartment Markets').

Some developers have responded to the tightening of access to bank finance by accessing finance from non-bank sources. While this finance can sometimes be at much higher interest rates, it may not always have the same degree of security as bank finance, and it is important that the entities funding developers understand the risk and price it appropriately. Industry liaison also suggests that developers are having more difficulty securing pre-sales in some markets, leading to wider use of buyer incentives, project delays and, in more severe cases, sales of development sites. Given the significant volume of new apartments coming to completion in the next couple of years, a slowing in the commencement of new projects could lessen the general risks of an oversupply in some areas.

Non-residential property

Conditions in non-residential property markets continue to differ significantly across cities (Graph 2.6). Brisbane and Perth are experiencing challenging conditions, while the Sydney and Melbourne markets are performing strongly.

Graph 2.6
Office Vacancy Rates
Capital city CBD markets



* Excluding Darwin and Hobart
Source: JLL Research

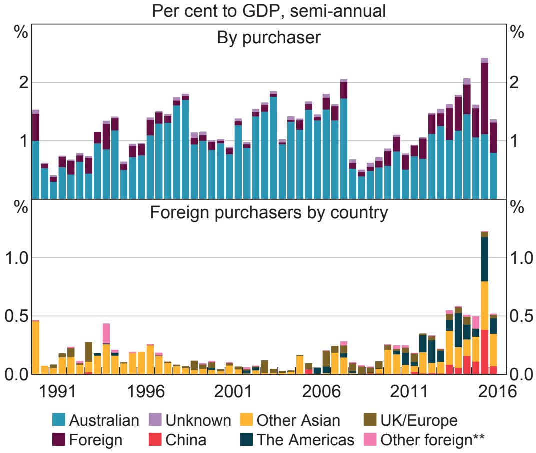
The slowing in mining investment and the fall in commodity prices are leading tenants to vacate offices in Perth and Brisbane, depressing rents in these cities. In Sydney, office rents are growing at their strongest rate in eight years, supported by local economic conditions and strong tenant demand from the technology and professional service sectors. The ongoing withdrawal of office space for infrastructure projects and residential conversion is likely to support the market over coming years. In Melbourne, rents have increased at a more moderate pace. Demand for smaller office spaces has been particularly strong in Sydney and Melbourne, in part due to the growth of start-ups.

Underlying conditions in industrial and retail property markets also vary by city. For industrial property, rental growth has been strongest in Sydney, underpinned by strong tenant demand and tight stock levels, and has recently picked up in Melbourne. In Brisbane and Perth, rents have been falling. In retail markets, rental growth has been soft nationally. Despite soft leasing conditions, retail redevelopment activity has been expanding, in part driven by international retailers entering the Australian market.

An ongoing dynamic in commercial property markets is a search for high-yielding assets in a global environment of low interest rates (as discussed in the previous chapter). Yields on Australian commercial property remain higher than in many overseas property markets and other asset classes, which has attracted new investors into the sector. In recent years, foreign buyers have become increasingly active in Australian commercial property markets (Graph 2.7). The increase in investor demand, particularly in Sydney and Melbourne, has pushed prices higher relative to rents (Graph 2.8). By definition, this has compressed yields, most obviously in office and industrial property markets.

Graph 2.7
Commercial Property Transactions*

Per cent to GDP, semi-annual



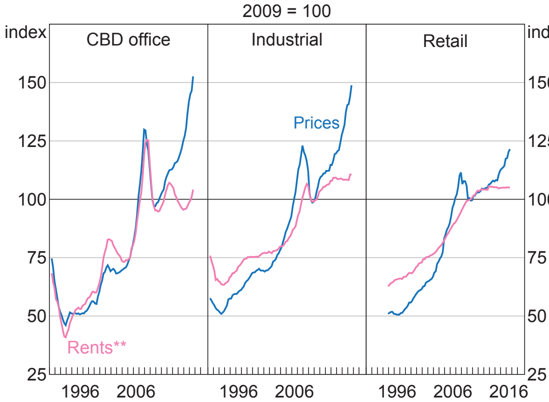
* Only includes transactions greater than $5 million

** Includes foreign purchasers of unknown origin

Sources: ABS; JLL Research; RBA; Savills

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

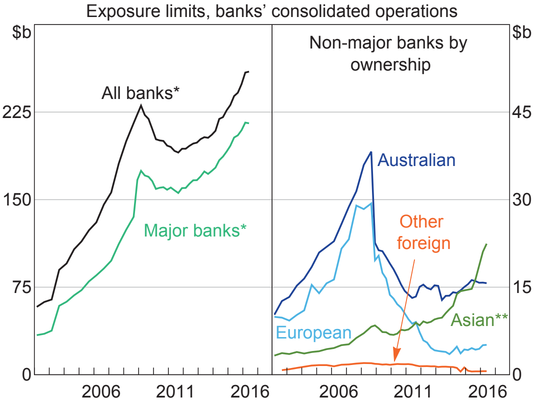
Sources: ABS; JLL Research; RBA

One concern is that the current low level of yields could prove unsustainable, particularly if global interest rates were to increase or demand from foreign buyers were to decline. If either of these occurred and valuations on properties declined, property investors could breach loan-to-valuation covenants on any bank debt. These investors would then be required to inject additional equity to support their loan facilities. A decline in valuations would therefore be more likely to affect highly leveraged investors, who are usually closer to their covenant thresholds. A related risk is that leasing conditions continue to weaken in the Perth and Brisbane office markets, which could reduce borrowers' ability to service their debts. Market analysts generally expect vacancy rates in these markets to stabilise over the next 12 months, aided by a shrinking supply pipeline.

Notwithstanding these risks, commercial property lending, including for residential development, has grown strongly over recent years. This growth has been broad based across office, retail, residential and land development and has been driven by the major banks and Asian banks (Graph 2.9). Asian banks have benefited from the entrance of foreign residential property developers into the Australian market, who have, in turn, been taking advantage of strong demand from Asian resident and new migrant buyers.

Graph 2.9
Commercial Property Exposures

Exposure limits, banks' consolidated operations



* Excludes overseas exposures

** Includes HSBC

Sources: APRA; RBA

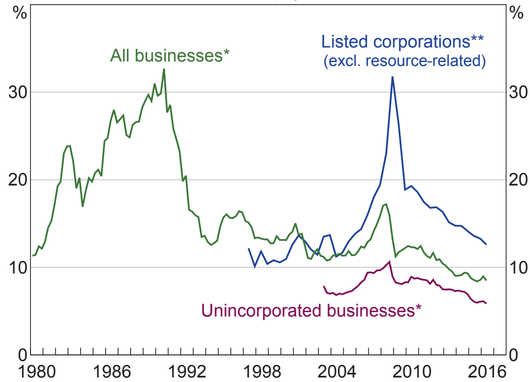
In recent months, APRA has commenced a review of banks' commercial property lending practices, including for residential development, with the aim of improving lending standards in this area.

Other Business Sectors

Outside commercial property and the resource-related sector, businesses generally are in good financial health. Survey measures of business conditions are above their long-run average levels; gearing ratios are around their historical averages; business failures remain low; and listed corporations' earnings have been broadly in line with the previous year (Graph 2.10). These positive indicators of financial health are occurring in an environment of low interest rates, reducing businesses' debt-servicing burdens. In addition, businesses in a range of industries continue to benefit from the depreciation of the Australian dollar and the decline in oil prices over the past few years.

Outside the resources sector, businesses generally appear to be in a strong position to meet their debt obligations. The aggregate debt-servicing ratio of listed corporations outside the resource-related sector has declined markedly in recent years, most recently driven by declining interest rates (Graph 2.11). The debt-servicing ratios of unlisted and unincorporated businesses have also fallen and are near historic lows.

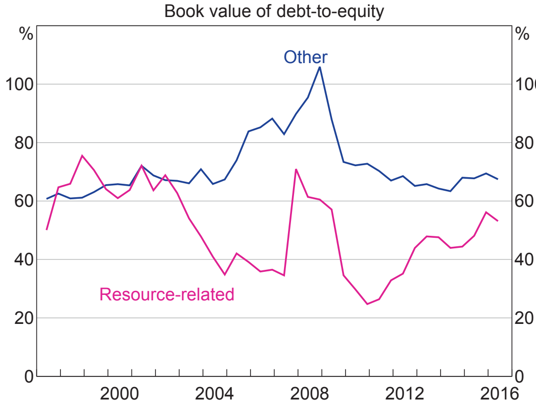
Graph 2.11
Debt-servicing Ratios
Non-financial businesses' interest payments as a per cent of profits



* 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

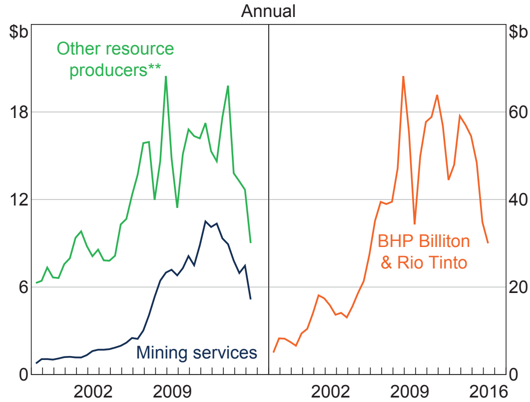
In contrast, conditions remain challenging for businesses in resource-related sectors and regions. The decline in commodity prices in recent years has weighed on the earnings of resource-related companies, including the large low-cost producers (Graph 2.12). Many smaller coal producers have struggled to cover costs, leading some to suspend operations at higher-cost mines. Some producers

Graph 2.10
Listed Corporations' Gearing Ratios*
Book value of debt-to-equity



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

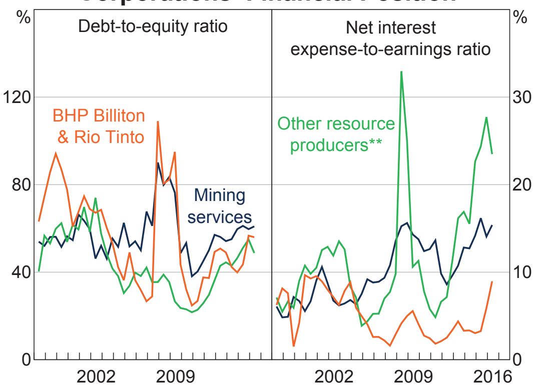
Graph 2.12
Listed Resource-related Corporations' Earnings*
Annual



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

have been able to partly offset the effect of lower prices by reducing capital expenditure and operating costs, but generating further significant cost savings is becoming progressively more difficult. The debt-servicing ratios of resource-related companies have increased over recent years, reflecting lower earnings as well as increases in gearing ratios, as these companies have taken on more debt even while they reduce investment (Graph 2.13).

Graph 2.13
Listed Resource-related Corporations' Financial Position*



* Excludes foreign-domiciled corporations; book value

** Includes listed junior explorers

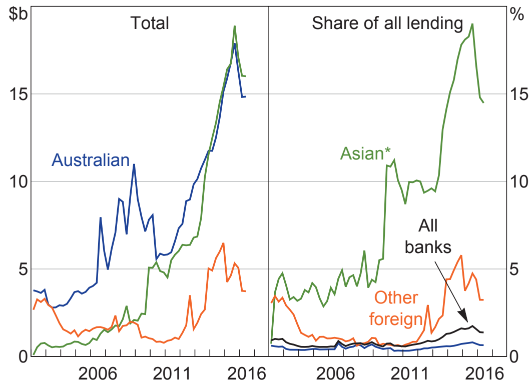
Sources: Bloomberg; Morningstar; RBA

Over the past few months, commodity prices have increased, although they remain substantially lower than their levels a few years ago. The recent uptick in prices has seen yields on resource-related companies' bonds decline and spreads narrow. This is consistent with improved market confidence in the ability of resource-related companies to meet their debt obligations and, if sustained, should make it easier for these companies to roll over their debt. Despite this improvement in the past few months, the more marginal resource-related companies remain vulnerable to further falls in commodity prices.

As emphasised in previous *Reviews*, stress in the resource-related sector poses little direct risk to the domestic financial system. Banks' mining-related lending has decreased over the past six months and is now only around 1½ per cent of their lending (Graph 2.14). However, this narrow measure of resource-related exposures excludes non-resource-related businesses operating in mining regions. Liaison with banks and industry suggests that the challenging conditions for the resource-related sector have weighed on other businesses in mining regions through second-round effects on household and business spending. Unincorporated business failures have increased in areas of regional Queensland exposed to coal and base metal mining, and smaller increases have been reported in Perth and regional Western Australia (Graph 2.15). ✠

Graph 2.14
Banks' Lending to the Mining Sector

Domestic books

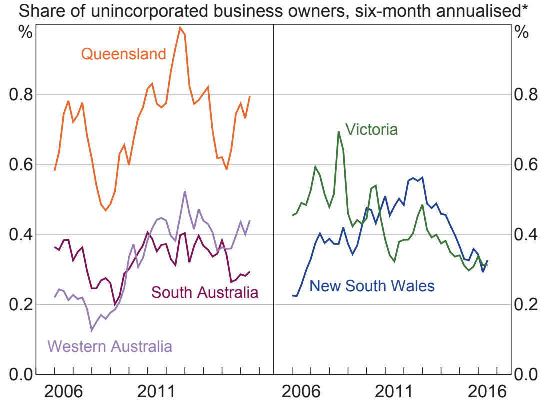


* Includes HSBC

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