3. Business and Household Finances

The balance sheets of the domestic business and household sectors remain in good shape and there continue to be few signs of near-term risks to financial stability emanating from either of these sectors.

While conditions in the business sector are reported to be a little below average and business failure rates are higher than average, any potential risks that may arise from the sector are likely to be mitigated by the low level of gearing and limited appetite for taking on debt. This is also manifest in the continued, albeit gradual, improvement in banks' business loan performance. In the period ahead, market expectations are for profitability to pick up, while the depreciation of the Australian dollar since the beginning of the year should provide support to some trade-exposed sectors. Commercial property prices remain well supported by strong investor demand, although conditions appear to have softened in the commercial property leasing market.

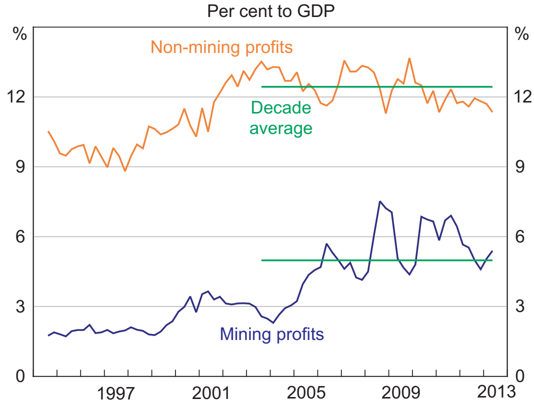
The household sector has continued to exhibit more prudence in managing its finances, with a higher rate of saving and slower credit growth having persisted for several years now. While household indebtedness and gearing remain around historically high levels, they look to have levelled out. In the low interest rate environment, many households have been paying down debt more quickly than required and indicators of financial stress are generally low. However, there are some signs that households are taking on more risk in their investment decisions, and the potential for a further increase in property gearing in self-managed superannuation funds (SMSFs) is a development that will be monitored closely by authorities for its implications both for risks to financial stability and consumer protection.

Business Sector

Business conditions and profitability

Overall conditions in the business sector have remained a little below average over the year to date, according to survey measures. Small improvements in conditions were, however, reported in some industries over this period including the business services and wholesale trade industries. The depreciation of the Australian dollar since the beginning of the year should also support some trade-exposed sectors in the period ahead. Aggregate profits of incorporated businesses increased by about 4½ per cent over the first half of 2013. This was largely driven by a 20 per cent increase in mining profits to a little above their decade average share of GDP, which was in line with rising commodity prices over the period (Graph 3.1). Despite this, mining profits remain 18 per cent below their recent peak in the

Graph 3.1
Business Profits*
Per cent to GDP



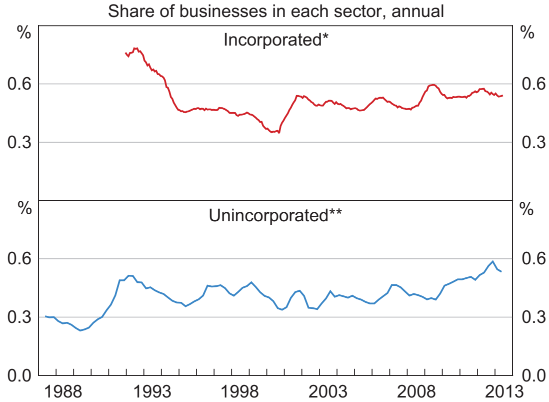
* Gross operating profits; inventory-valuation adjusted; excludes unincorporated businesses
Sources: ABS; RBA

September quarter 2011. Non-mining profits fell by around 1½ per cent over the six months to June, largely owing to lower profitability in the financial and business services, manufacturing and retail industries, which was only partly offset by an increase in profits in the construction, wholesale and property services industries. Analysts forecast that profitability will improve in 2013/14, with profits expected to grow by 14 per cent for the listed resources sector and 8 per cent for other listed non-financial companies.

Reported conditions for smaller businesses are weaker on average than for larger businesses. Smaller businesses have increasingly cited economic conditions and a lack of work or sales as their main concerns over the past few years. Consistent with this, ABS data indicate that the increase in profits of unincorporated businesses was more modest than the increase in profits for incorporated businesses, at about 3½ per cent over the six months to June 2013.

In line with below-average business conditions, business failure rates remain above their decade average, where again the performance differs between incorporated and unincorporated businesses (Graph 3.2). While the failure rate among unincorporated businesses has declined slightly since the start of the year, it remains higher than its peak in the early 1990s in annual terms. The incorporated business failure rate has been reasonably stable for a few years and is well below its 1990s peak. By industry, incorporated business failures have been concentrated in construction and services. By state, business failure rates (both incorporated and unincorporated) have been highest in Queensland and New South Wales.

Graph 3.2
Business Failures
Share of businesses in each sector, annual

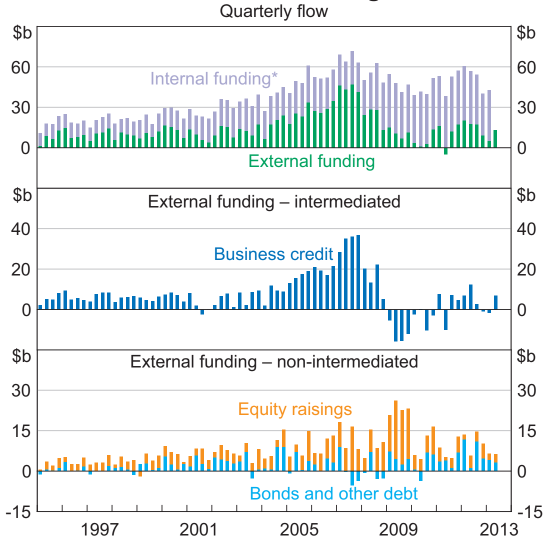


* Companies entering external administration
** Includes business-related personal bankruptcies and other administrations
Sources: ABS; AFSA; ASIC; RBA

Financing and balance sheet position

The flow of funding for businesses appears to have picked up a little since the end of last year, but is not as strong as at the beginning of 2012. There has been a small increase in external funding and some change in its composition over the past six months, although, overall, businesses still appear to have little appetite for taking on more debt (Graph 3.3). Bond funding has declined in the past half year after a period of stronger issuance in 2012. By contrast, business credit growth has picked up a little since the start of the year, to be 2½ per cent in annualised terms over the six months to July. Growth has been apparent for both incorporated and unincorporated businesses, consistent with a decline in average interest rates for large and small business lending (Graph 3.4). While part of the growth in business

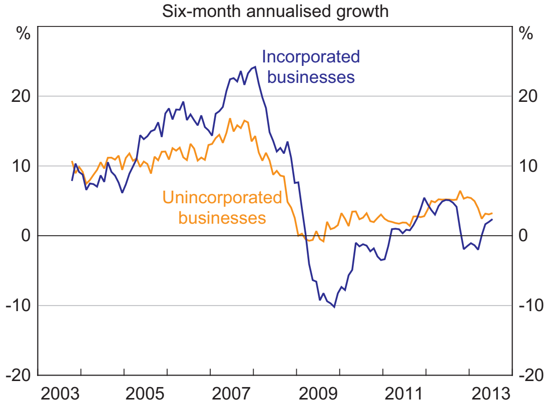
Graph 3.3
Business Funding
Quarterly flow



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

credit was a result of foreign currency valuation effects stemming from the depreciation of the Australian dollar over the period, the growth is also consistent with suggestions from liaison with businesses that access to credit has generally improved over the past year. Banks are, however, reportedly still cautious about lending to property construction and mining-related companies. Despite the pick-up, growth in business credit is still quite subdued compared with nominal GDP growth or past experience.

Graph 3.4
Business Credit*
Six-month annualised growth

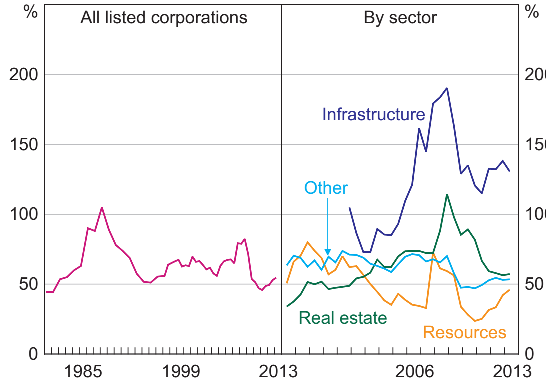


* Excludes securitised loans
Sources: APRA; RBA

Equity raising activity by listed companies generally remains subdued, despite increases in share prices across most sectors since the beginning of the year. An exception is that some real estate investment trusts have raised equity to fund expansions amid increased competition from foreign investors in Australian commercial property.

Despite some increase in debt funding and low equity raising activity, business gearing remains fairly low (Graph 3.5). Preliminary data indicate that the book value debt-to-equity ratio for listed non-financial corporations increased slightly over the six months to June 2013. The increase was largely driven by higher gearing in the resources sector, which was partially offset by a fall in gearing in the infrastructure sector. Methods of funding new infrastructure are currently receiving considerable

Graph 3.5
Listed Corporations' Gearing*
Book value debt-to-equity ratio



* Excludes foreign-domiciled companies; final observations are estimates based on a matched sample of companies that have reported to date
Sources: Bloomberg; Morningstar; RBA; Statex

attention, including from the G20.[1] Infrastructure funding involves some risks specific to the nature of the investment, partly due to the large scale of projects and potential uncertainty regarding the cash flow that new infrastructure assets will earn once completed. The typically high leverage of infrastructure corporations exacerbates these risks.

Preliminary data suggest that net interest payments as a per cent of profits for listed non-financial companies fell over the past six months, in line with recent falls in interest rates and higher profitability for some sectors. The fall was driven by the resources sector and, to a lesser extent, the real estate sector. While the distribution of the net interest payment ratio for listed companies remains wide, it has narrowed over the past two years. Many of the companies with the highest ratios are in the resources, real estate and manufacturing sectors, and are companies that generally have high gearing levels and below-average earnings.

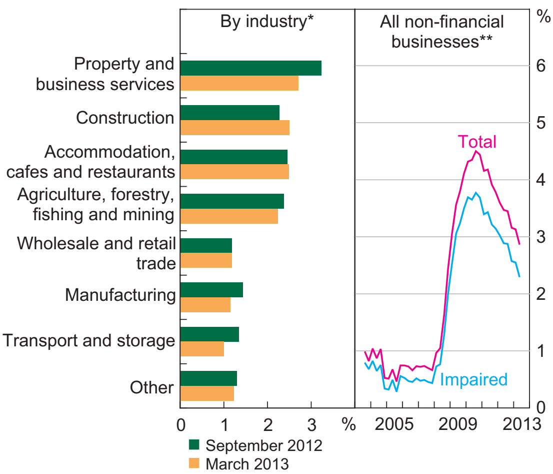
Loan performance

Although business conditions remain a little below average levels, banks' business loan performance has continued to improve. As discussed in 'The Australian Financial System' chapter, the share

1 For further details, see Chong S and E Poole (2013), 'Financing Infrastructure: A Spectrum of Country Approaches', RBA *Bulletin*, September, pp 65–76.

of banks' business loans that is non-performing has continued to decrease over the six months to June (Graph 3.6). Data from the major banks indicate that a decline in non-performing asset ratios was seen across a number of industries, with the largest declines for the property and business services (including commercial property, discussed in more detail below), transport and storage, and manufacturing industries. For some of these industries, the decline in non-performing assets was partly driven by write-offs that were previously provisioned for and for which the loss was therefore incurred in an earlier period.

Graph 3.6
Banks' Non-performing Business Assets



* Major banks; consolidated global operations; share of industry exposures; December 2012 and June 2013 for CBA
** All banks; domestic books; share of loans, bills and debt securities
Sources: APRA; RBA; banks' Pillar 3 reports

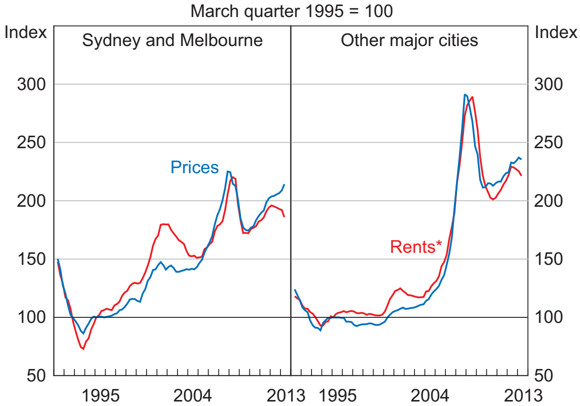
Commercial Property

The weaker than average operating environment experienced by some businesses is also observable in the commercial property sector, to which the banking system has considerable exposure. Commercial leasing markets continued to soften over early 2013 with CBD office and retail rents declining. The fall in CBD office rents reflected greater lease incentives, the average value of which is now higher, as a share of contractual rents, than its previous peak in late 2010. The CBD office vacancy rate has also continued to increase, driven by weaker demand for office space from resource companies and some state governments, as well as some earlier large supply additions, particularly in Brisbane and Perth. In the near term, only modest supply additions are expected as private non-residential building activity has remained subdued.

Despite the softening in leasing conditions, commercial property prices have continued to rise quite strongly. CBD office prices and rents typically move in line with each other, but over the past 18 months there has been some divergence, particularly in Sydney and Melbourne (Graph 3.7). This divergence may reflect increased demand for Australian commercial property from both foreign and domestic investors, possibly driven by a 'search for yield'. While yields on Australian office property have been trending down, they are nonetheless high compared with major overseas markets and also relative to domestic investments (Graph 3.8).

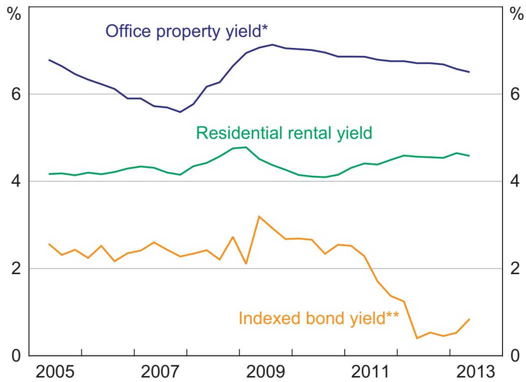
Over the past few years, the impairment rate on banks' commercial property exposures has declined substantially, driven by sales, write-offs and curings (improvements in loan quality). While the impairment rate remains above that for business lending in total, the spread between the two continues to narrow. Over the past two years,

Graph 3.7
CBD Office Property
March quarter 1995 = 100



* Effective rents
Sources: Jones Lang LaSalle Research; Property Council of Australia; RBA

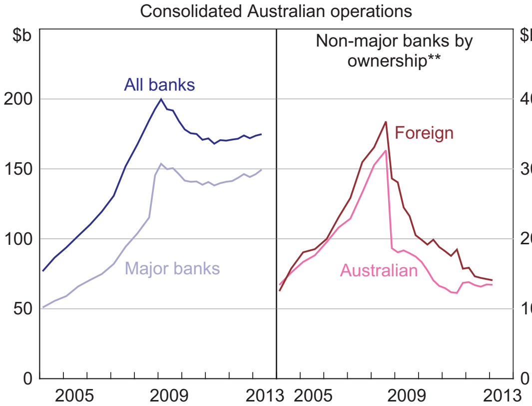
Graph 3.8
Property and Bond Yields



* Yields on premium office property
** 10-year inflation-indexed Treasury bond
Sources: Jones Lang LaSalle Research; Property Council of Australia; RBA

banks' exposures to commercial property have grown modestly, though they remain below their 2009 peak (Graph 3.9). Most of the growth has come from major banks. Within foreign banks, exposures of Asian-owned banks have also continued their increase since 2010, with bank liaison indicating they have been competing strongly in the syndicated loan market (which includes property-related loans). By contrast, exposures of European banks have fallen considerably since their peak in 2008, partly due to the sale and write-off of non-performing exposures.

Graph 3.9
Banks' Commercial Property Exposures*
Consolidated Australian operations



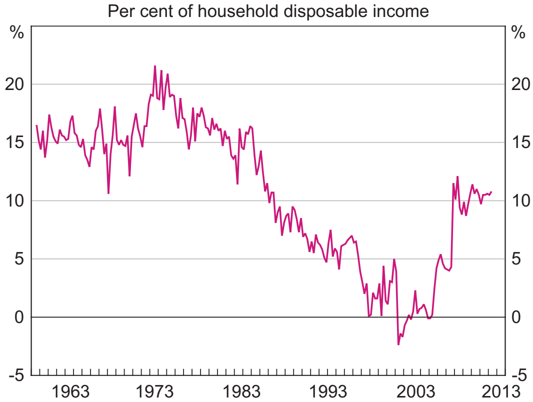
* Quarterly from September 2008; some banks report only on a semiannual basis
** Final observation is for March 2013
Source: APRA

Household Sector

Saving and borrowing behaviour

There has been little change in the financial position of the household sector throughout 2013 to date, with households continuing to exhibit more prudent management of their finances than a decade ago. Around the mid 2000s a marked shift commenced in households' attitudes, stemming from factors such as the end of the transition to a low inflation environment and a deregulated financial sector, as well as the subsequent reaction to the global financial crisis. This shift may have been reinforced more recently by concerns about the economic outlook, given that the unemployment rate has risen and economic growth is below trend. Consistent with this, the household saving ratio remains around 11 per cent, in contrast to the downward trend from the mid 1980s to mid 2000s (Graph 3.10).

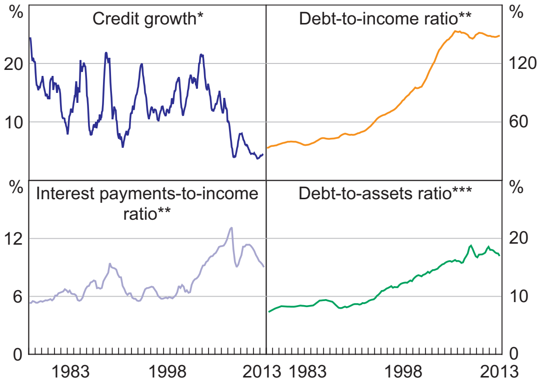
Graph 3.10
Household Saving*
Per cent of household disposable income



* Household sector includes unincorporated businesses; net of depreciation
Source: ABS

Households' more prudent approach to their finances has also been evident in their reduced appetite for debt. Household credit grew by around 4½ per cent over the six months to July in annualised terms (Graph 3.11). With household credit growth broadly matching the recent pace of income growth, the debt-to-income ratio has remained steady at slightly below 150 per cent.

Graph 3.11
Household Indebtedness

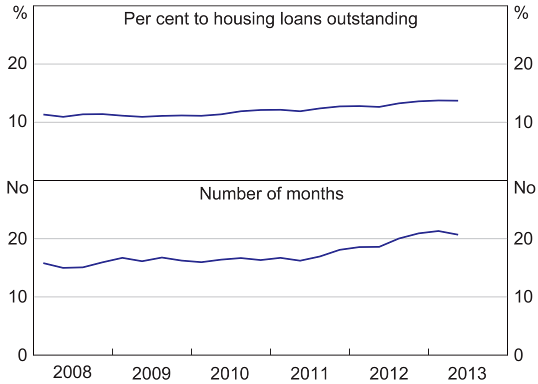


* Six-month annualised
** RBA estimates for September quarter 2013
*** RBA estimates for June and September quarters 2013
Sources: ABS; APRA; RBA; RP Data-Rismark

The further decline in interest rates over the past six months, particularly for housing loans, has reduced the proportion of disposable income required to meet household interest payments. It has also meant that many households have continued to pay down their mortgages more quickly than required, which has contributed to the slower pace of credit growth. For example, anecdotal evidence suggests that around half of households have not reduced their regular mortgage payments as interest rates have fallen.[2] Mortgage buffers – that is, balances in mortgage offset and redraw facilities – remain near their highs since the series began in 2008, at 14 per cent to outstanding mortgage balances, equivalent to around 21 months of total scheduled repayments at current interest rates (Graph 3.12). Together, these data suggest that many households have the resources to continue to meet their debt obligations even during a transitory period of unemployment or reduced income. Nevertheless, given that household indebtedness and gearing are still around historically high levels, continued prudent saving and borrowing behaviour would help support households' ongoing financial resilience.

2 For a more detailed discussion on mortgage prepayments, see Thurner M-O and A Dwyer (2013), 'Partial Mortgage Prepayments and Housing Credit Growth', RBA *Bulletin*, September, pp 31–38.

Graph 3.12
Mortgage Repayment Buffers*

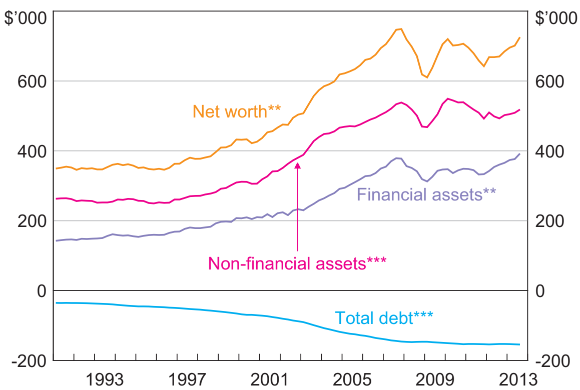


* Data are backcast before December 2010 to adjust for a reporting change by one bank
Sources: APRA; RBA

Wealth and investment preferences

Real net worth per household rose by an estimated 8½ per cent over the year to September 2013, though it remains 3 per cent below its 2007 peak (Graph 3.13). This recovery has largely been led by growth in households' financial assets, on the back of net inflows into superannuation and rising share prices. There has also been an increase in the value of dwelling assets, with the average (nominal) dwelling price rising by 7 per cent since its May 2012 trough.

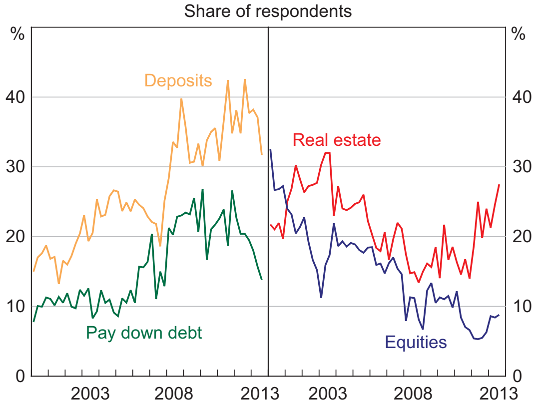
Graph 3.13
Real Household Wealth and Debt*
Per household



* In 2010/11 dollars; deflated using the household final consumption expenditure implicit price deflator; household debt excludes the debt of unincorporated businesses
** RBA estimates for June and September quarters 2013
*** RBA estimates for September quarter 2013
Sources: ABS; RBA; RP Data-Rismark

Some signs are emerging that the low interest rate environment and recovery in asset prices have encouraged a slight shift in household preferences towards riskier investments. Survey data suggest that over the past year or so, the share of households that believe that paying down debt is the 'wisest' use of their savings has decreased, while the share favouring equities has increased, though it still remains quite low at around 9 per cent (Graph 3.14). While increased financial risk-taking is an expected outcome of lower interest rates, it is important that households understand, and appropriately account for, the financial risks they take.

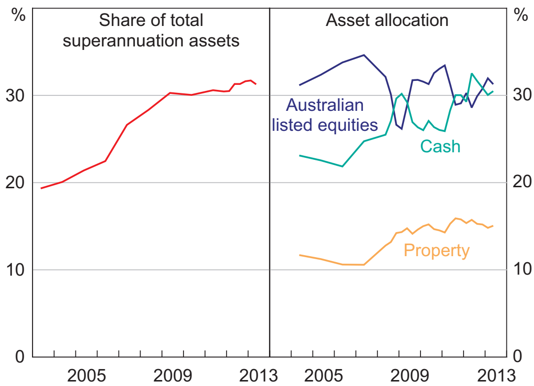
Graph 3.14
Wisest Place to Save
Share of respondents



Source: Melbourne Institute and Westpac

An avenue through which households may be taking more risk is in the management of their superannuation assets. Over the past decade, there has been a sizeable movement of assets into SMSFs from other fund types; the number of SMSFs has roughly doubled over this period and the sector now accounts for almost one-third of the $1.6 trillion in superannuation industry assets in Australia (Graph 3.15). SMSFs allocate a relatively large share of their assets (15 per cent) to direct property holdings (both commercial and residential); this share has increased over the past six years, partly driven by legislative changes that have allowed superannuation funds to borrow under limited recourse conditions (see 'Box D: Self-managed Superannuation Funds' for more details).

Graph 3.15
Self-managed Superannuation Assets*



* ATO estimates
Sources: APRA; ATO

One risk of the increase in property investment by SMSFs is that at least some of it is a new source of demand that could potentially exacerbate property price cycles. It also raises consumer protection concerns in the event SMSF members are exposed to greater financial risks than they envisage. An Australian Securities and Investments Commission (ASIC) report, released in April, identified that while most advice given to individuals about SMSFs was of good quality, there were pockets of poor advice, particularly related to geared residential property investment. In response, ASIC has expanded the information on its MoneySmart website to highlight the rules, costs and relevant considerations around SMSFs and residential property investment. It has also recently released a consultation paper that sets out proposals to impose disclosure requirements on advisers, including on matters that may influence an individual's decision about whether to set up an SMSF.[3] In addition, ASIC commissioned research to examine the minimum cost-effective balance for an individual to set up an SMSF and is also proposing to provide guidance that advisers inform individuals of the costs associated with having an SMSF.[4]

3 For further details, see ASIC (2013), 'Advice on Self-managed Superannuation Funds: Specific Disclosure Requirements and SMSF Costs', Consultation Paper 216, September.

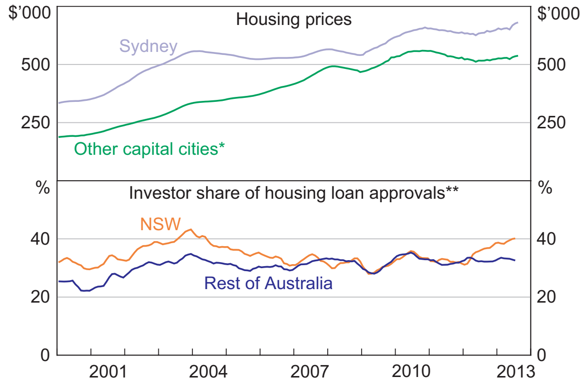
4 For further details, see Rice Warner (2013), 'Costs of Operating SMSFs', ASIC, May.

There is also evidence that SMSFs have been a large part of the recent demand by retail investors for the non-common equity capital being issued by banks, as well as hybrid securities more generally. These instruments attract a high yield as they combine features of debt and equity, and are also quite complex products that carry higher risk than more traditional debt securities. It is therefore important that these risks are adequately communicated to, and understood by, the purchasers of these products.

For the financial system, the direct near-term risks arising from lending to SMSFs are likely to be small. Despite overall lending to SMSFs having grown strongly for several years, it still accounts for a small share of overall bank lending. In addition, any increased risks to banks posed by limited recourse arrangements are largely offset by their frequent requirements for personal guarantees from SMSF members; minimum fund net asset requirements; and lower maximum loan-to-valuation ratios (LVRs) than often imposed on other property lending. In any case, the rapid growth of the sector warrants ongoing monitoring, and it is important that banks maintain sound lending standards and practices.

In addition to SMSFs, there has been a broader increase in residential property market activity over the past year or so. The increase in investor activity in New South Wales appears to have been particularly sharp; investor housing loan approvals now account for around 40 per cent of the value of loan approvals in the state, a share last recorded in 2004, although some of this no doubt reflects a decline in first home buyer activity (Graph 3.16). The increase in investor activity has been associated with a recent pick-up in Sydney housing price growth and reports of sale prices exceeding price guidance and valuations by wide margins. An increase in housing market activity more generally is not surprising given reductions in interest rates. However, it is important that those purchasing property maintain realistic expectations of future dwelling price growth; in contrast to the decades leading up to the crisis – when dwelling prices grew rapidly in response to disinflation and financial deregulation – long-run future growth in dwelling prices might be expected to be more in line with income growth.

Graph 3.16
Housing Market



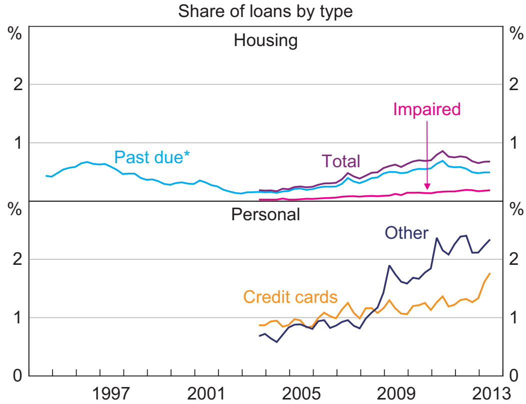
* Weighted by dwelling stock
** Three-month moving average; excludes construction, includes refinancing
Sources: ABS; RBA; RP Data-Rismark

Loan performance and other indicators of household financial stress

Despite somewhat subdued labour market conditions, with the unemployment rate continuing to gradually trend up over 2013 to date, aggregate indicators of household financial stress generally remain low. The non-performing share of banks' housing loans – loans that are past due or impaired – has been fairly steady since September 2012, at around 0.7 per cent (about 0.2 percentage points lower than its peak in mid 2011) (Graph 3.17). A number of banks indicated in liaison that housing loan performance is also likely to be broadly steady over the coming year. Any further improvement in housing loan performance is likely to depend on labour market performance: indicators of labour demand have continued to decline over recent months and are consistent with only modest employment growth in the near term.

The non-performance rates on banks' credit card and other personal loans, which are inherently more risky and less likely to be secured than housing loans, have broadly trended upwards, especially since 2008. While it cannot be ruled out that the increase in these non-performance rates signals an increase in household financial stress, there have also been some

Graph 3.17
Banks' Non-performing Household Assets
Share of loans by type

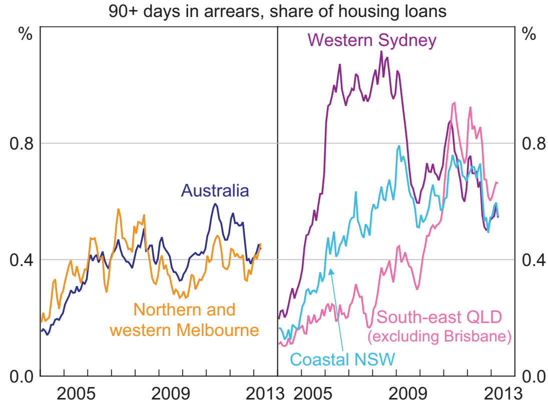


* 90+ days but well secured
Sources: APRA; RBA

changes in the composition of personal lending that may have contributed to the higher rates of non-performance. Regardless, these loan types account for a small share of total household credit.

At a more disaggregated level, data on securitised housing loans suggest that arrears rates have fallen in all mainland states since peaking in mid 2011, despite a small uptick in recent months. This fall has been driven by the regions that previously had quite high arrears, including parts of south-east Queensland and coastal New South Wales (which had experienced large dwelling price falls and weak economic conditions associated with the subdued tourism sector), as well as western Sydney (Graph 3.18). More recently, there have been some regions where arrears rates have increased. For example, as foreshadowed in the September 2012 *Review*, arrears rates in parts of Melbourne appear to have increased recently, albeit from low levels. Arrears rates also remain elevated in Hobart, reflecting weakness in both the labour and housing markets. More generally, loans that were originated during earlier periods of localised rapid dwelling price growth and above-average construction activity continue to account for a disproportionate share of loans currently in arrears. Encouragingly, the loan performance of more recent cohorts has tended to be better than that of earlier cohorts at the same loan age.

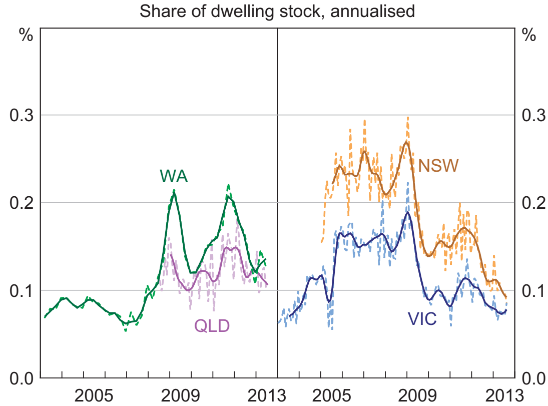
Graph 3.18
Securitised Housing Loan Arrears by Region*
90+ days in arrears, share of housing loans



* Prime loans securitised by all lenders; includes self-securitisations
Sources: ABS; Perpetual; RBA

Other indicators of household financial stress are broadly consistent with the generally low level of housing loan arrears rates. In the states for which data are available, the number of court applications for property possession has been lower in 2013 to date than in the corresponding period of 2012 (Graph 3.19). The number of non-business related personal administrations – bankruptcies, debt agreements and personal insolvency agreements – was also lower in the first half of 2013 than in the first half of 2012.

Graph 3.19
Applications for Property Possession*
Share of dwelling stock, annualised



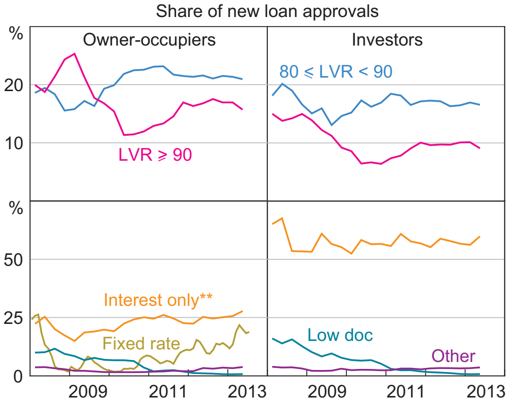
* Includes applications for some commercial properties; solid lines are 13-period Henderson trends, except for Western Australia, which is a 5-period trend
Sources: ABS; RBA; state supreme courts

Lending standards

Data on the characteristics of housing loan approvals suggest that banks have broadly maintained their lending standards since late 2011. The aggregate share of the value of banks' housing loan approvals with high LVRs (that is, above 90 per cent) increased throughout the second half of 2010 and 2011, but has been fairly steady since then (Graph 3.20). The distribution of the high-LVR share of loan approvals across individual banks also remains quite narrow and has shifted down since 2009, especially the upper end of the distribution (Graph 3.21). Looking across a wider range of financial institutions (that is, including credit unions and building societies) suggests that the share of high-LVR loan approvals may still be broadly trending upwards at some smaller institutions.

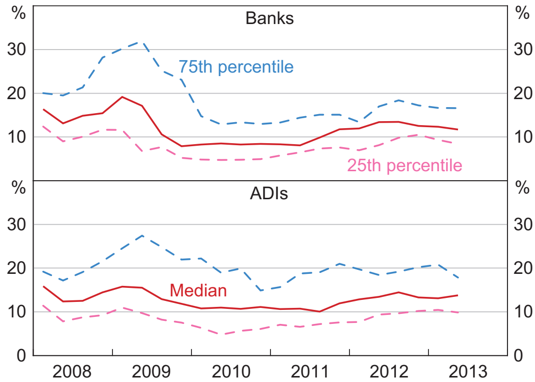
The interest-only share of housing loan approvals appears high at a little under 40 per cent, though these loans can include features that encourage the building of mortgage buffers, such as redraw and offset facilities. The share of housing loan approvals classified as low doc was unchanged in the first half of 2013 at less than 1 per cent of housing loan approvals.

Graph 3.20
Banks' Housing Loan Characteristics*
Share of new loan approvals



* LVR = loan-to-valuation ratio; 'Other' includes loans approved outside normal debt-serviceability policies, and other non-standard loans
** Series is backcast before December 2010 to adjust for a reporting change by one bank
Sources: ABS; APRA; RBA

Graph 3.21
Distribution of High-LVR Share of Housing Loan Approvals*



* Loans with LVR ≥ 90 per cent
Source: APRA

The low level of interest rates and the generally favourable pricing of fixed rates compared with variable rates have contributed to a sharp increase in the share of owner-occupier housing loans approved at fixed rates (from around 9 per cent, by value, in July 2012 to 19 per cent in July 2013). While fixed-rate loans insulate borrowers from interest rate increases during the fixed-rate period, they may be exposed to an increase in their mortgage payments when their fixed-rate period ends (especially if mortgage rates rise by more than expected). However, the risk to households may be limited by the practice of some banks increasing the interest rate add-ons they use to assess debt serviceability in the low interest rate environment. Another characteristic of fixed-rate loans is that, unlike most variable-rate loans, prepayments are often capped or discouraged; as a consequence, these loans may amortise more slowly than variable-rate loans. The increased tendency for owner-occupier borrowers to take out split loans (that is, with fixed- and variable-rate portions), which at least allow prepayment of the variable-rate portion, mitigates this.

Information on non-conforming housing loans – the closest Australian equivalent to US subprime loans – suggests that activity in this market has picked up a little over the past year. According to data from Standard & Poor's, the outstanding value of non-conforming securitised housing loans has roughly doubled since its trough in April 2012, though it remains a very small share of total housing lending (at an estimated 0.2 per cent of housing credit in July). Some non-ADIs have recently issued non-conforming residential mortgage-backed securities, while another non-ADI has announced plans to resume non-conforming lending after leaving this market in 2008. Financial stability risks posed by non-conforming lending remain limited so long as it remains a small share of total housing lending, consistent with the underlying narrow scope for prudent lending to households with blemished credit histories.