

2. Household and Business Finances

Over the past year the household sector has faced continued low income growth and a decline in wealth due to falls in housing prices. Given high household debt, these developments had the potential to diminish the financial resilience of households. There have been some signs of increased financial stress, especially in regions experiencing more difficult economic conditions. Arrears rates on housing loans have continued to rise, particularly in Western Australia and the Northern Territory, but overall remain low in absolute terms and by international standards. Strong employment growth, very low interest rates and improvements in lending standards over recent years have supported these outcomes. The incidence of negative equity on housing loans has increased in Western Australia and the Northern Territory, but remains low in aggregate.

Looking ahead, increased uncertainty regarding the global and domestic macroeconomic outlook increases the risks faced by households. Acting in the opposite direction, the recent improvement in housing market conditions in Sydney and Melbourne has reduced the risks for leveraged households and from declining household wealth. Overall, households remain well placed to service their debt: the most indebted households are those with the highest incomes, and many have sizeable prepayments. The recent reductions in interest rates will also support borrowers' ability to service their debts by reducing their interest payments. Improvements in bank lending standards over recent years reduce the risk that lower interest

rates will see an unsustainable increase in household indebtedness.

The financial health of businesses generally remains good, though there are risks in some industries. These include residential construction firms, retailers of discretionary goods and businesses affected by the drought in the eastern states. Consistent with the challenging conditions for retailers, valuations for retail properties have declined and vacancy rates in sub-regional shopping centres are rising. In contrast, the office and industrial property markets remain buoyant in Sydney and Melbourne, with valuations continuing to rise and office vacancy rates falling. Yields for office property continue to fall, although they remain attractive relative to other asset classes.

Risks related to the housing market have receded somewhat over the past six months

The housing market is a key source of potential systemic risk that needs to be monitored closely, with housing accounting for 40–50 per cent of household and bank assets. Overall, risks related to the housing market have receded somewhat as housing market conditions in Sydney and Melbourne have improved. After declining for more than a year, housing prices in Sydney and Melbourne increased over the four months to September and auction clearance rates have picked up noticeably (Graph 2.1). There are tentative signs that turnover may be near its trough. The stabilisation of housing market conditions in these cities has coincided with the

lower cash rate, the Australian Prudential Regulation Authority's (APRA) changes to the interest rates used in loan serviceability assessments (discussed below) and the resolution of some policy uncertainty following the Federal election. In addition, the magnitude of the earlier declines in prices may have been sufficient to rekindle some demand.

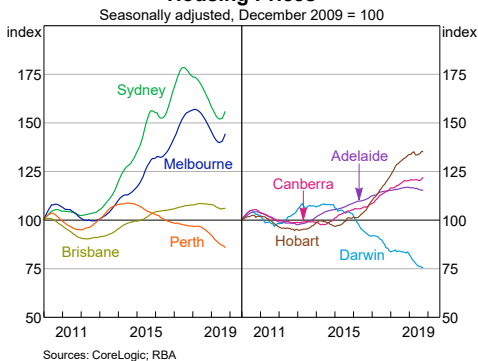
In contrast to Sydney and Melbourne, housing prices in Western Australia and the Northern Territory have continued their prolonged decline. In Perth, housing prices are around 20 per cent lower than their 2014 peak and in some parts of regional Western Australia, housing prices have fallen by more than 10 per cent over the past six months. Housing demand in Western Australia has been weighed down by low population growth and ongoing weakness in macroeconomic conditions. Conditions in most other capital cities and regional areas are generally subdued. Overall, these housing markets did not experience the earlier price declines seen in Sydney and Melbourne, and prices are generally close to their 2018 peaks.

New apartment completions in Sydney and Melbourne remain high, but are past their peak

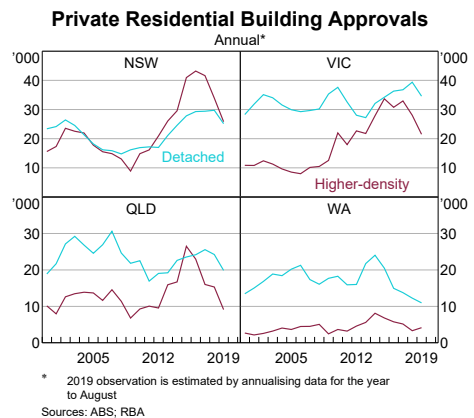
Higher density dwellings have been a growing share of new additions to the housing stock. High density developments take a long time to plan and develop and therefore their supply cannot respond quickly to changes in demand. Private residential building approvals have declined significantly since late 2017, and indicators of future construction activity suggest that some further modest declines in building approvals are likely in the near term (Graph 2.2). New apartment completions in Sydney and Melbourne remain high, but are also past their peak (Graph 2.3). The decline in activity has reflected the combined effects of weaker demand from buyers and tighter credit availability for both developers and buyers. For developers, meeting the banks' financing conditions of minimum pre-sales has been more difficult to achieve, and a greater share of development has been financed by non-bank lenders.

The large volume of apartments being delivered in Sydney has been associated with an increase in the rental vacancy rate and has placed downward pressure on rents (Graph 2.4). In Melbourne, new supply has been well absorbed

Graph 2.1
Housing Prices



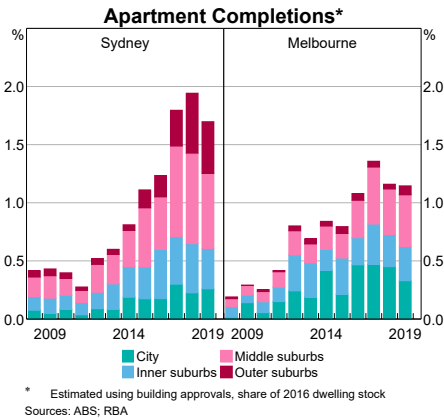
Graph 2.2



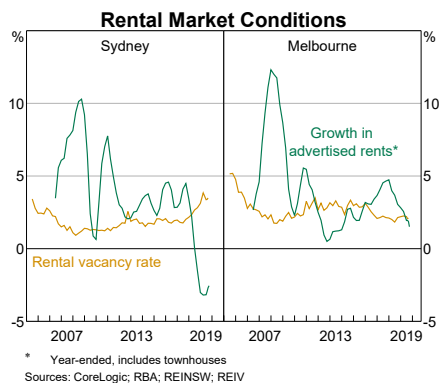
and the rental vacancy rate has been little changed.

In Melbourne, ongoing strong population growth and weak indicators of future construction activity suggest that the medium-term risks of oversupply are limited. This is also broadly the case in Sydney, although the rise in the vacancy rate suggests there is a chance of near-term oversupply, at least in some areas. However, taking into account lags in development and planning, there is a risk that an undersupply will emerge in a few years' time should new additions to the housing stock be sustained at volumes lower than household formation.^[1]

Graph 2.3



Graph 2.4

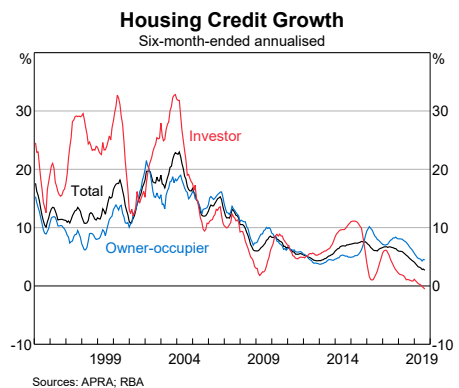


Housing credit growth remains low, but there are signs of a pick-up in loan demand

Housing credit growth has slowed since mid 2017. In six-month-ended annualised terms, growth in both investor and owner-occupier housing credit is around multi-decade lows, with investor credit growth especially weak (Graph 2.5). The slowdown has been most pronounced for the major banks. Liaison with lenders and mortgage brokers indicates that housing loan applications have decreased over the past couple of years with little change in the rate of loan approvals. There have been signs of a pick-up in the number of both loan applications and approvals more recently, but with housing market turnover remaining low, credit growth has also remained low.

Lenders have passed through most of the recent reductions in the cash rate to housing interest rates. However, non-price conditions remain tighter than in recent years, despite a modest easing in serviceability standards over the past six months. In July, APRA changed its guidance on the interest rate floors and buffers that banks use to assess a borrower's ability to repay a residential mortgage. The change was introduced because a prolonged period of record low interest rates meant that a floor of 7 per cent was high, particularly for lower risk

Graph 2.5



lending. Lenders were previously required to apply the higher of an interest rate floor of at least 7 per cent or the interest rate on the loan plus a buffer of at least 2 percentage points. APRA's new guidance replaces the interest rate floor of 7 per cent with a requirement for banks to set their own floor rates, while the minimum interest rate buffer was increased to at least 2.5 percentage points.

Lenders initially announced new floor rates around 1½–2 percentage points lower than previously and buffers in line with the minimum of 2.5 per cent. The net effect has been to increase the maximum loan size available to most prospective borrowers. For loans with relatively low interest rates (such as principal-and-interest loans to owner-occupiers), maximum loan sizes have increased by more than for loans with higher interest rates (such as interest-only loans to investors). In practice, however, only a small share of borrowers take out loans that are close to the maximum available to them, suggesting the overall impact on credit growth is small.

Working in the opposite direction, other earlier changes to lending standards were still being implemented over the past six months. These include an increased focus on verifying expenses (such as by examining transaction accounts more closely) and implementing the 2018 changes to the Household Expenditure Measure benchmark (which has resulted in higher expense benchmarks for higher income households relative to lower income households). Banks have also introduced policies limiting high debt-to-income lending and increased the repayment rates used to assess prospective borrowers' existing credit card obligations. The progressive expansion of Comprehensive Credit Reporting to cover mortgages, as well as credit cards, is unlikely to meaningfully reduce credit supply. Very few prospective borrowers are expected to have

other mortgage debts that have been overlooked in existing application processes.

ASIC is undertaking a consultation process with stakeholders to update its guidance on the Responsible Lending obligation. In August, the Federal Court handed down its decision in the Australian Securities and Investments Commission's (ASIC) case against Westpac on how responsible lending laws should be applied. ASIC is appealing the judgement.

Falls in housing prices have increased negative equity, but the overall incidence remains low

The estimated share of outstanding mortgage balances in negative equity has increased to around 3¾ per cent (Graph 2.6). Over half of all loan balances in negative equity are in Western Australia and the Northern Territory. If housing prices in Western Australia and the Northern Territory were to fall further, the share of loan balances in these states that are in negative equity would increase substantially. A further 10 per cent decline in housing prices in Western Australia and the Northern Territory is estimated to result in the share of loan balances in negative equity in these regions increasing from a little under one-fifth to over one-third. While this would lead to heightened financial stress for these borrowers and higher potential losses for lenders with exposures to these areas, these loans would still account for less than 4 per cent of the stock of outstanding mortgage balances in Australia. There have also been some small increases in the share of loan balances in negative equity in New South Wales and Victoria. However, these shares remain very low in absolute terms and housing markets in these states have stabilised.

Negative equity poses limited costs for financial institutions if borrowers continue making repayments. But if borrowers encounter problems servicing their loans, they are unable to resolve their situation by selling their

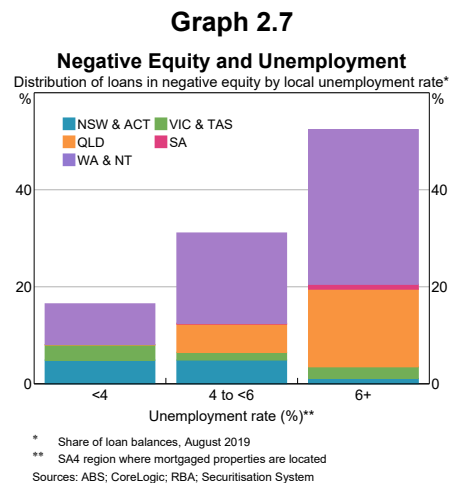
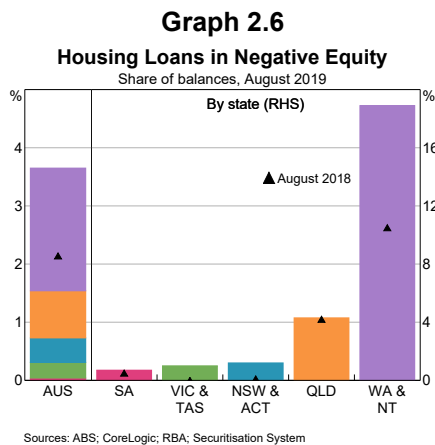
property. These borrowers are likely to experience greater levels of financial stress than borrowers with positive equity. This could in turn have larger negative spillovers on local economies as financially stressed borrowers with negative equity are more likely to need to reduce their consumption than those with positive equity. Moreover, lenders will bear credit losses if borrowers in negative equity default on their loans.

Declines in income have historically been a key reason for households defaulting on their loans. Although the Bank’s central forecast is for the unemployment rate to remain broadly unchanged for some time, if the unemployment rate were to rise, the risks associated with negative equity would increase. About one-half of all mortgages currently in negative equity (1.3 per cent of all mortgages by number) are estimated to be in areas where the unemployment rate has risen over recent years and currently exceeds 6 per cent (Graph 2.7). A disproportionately large share of these riskier loans belong to borrowers from Western Australia and regional areas in Queensland and the Northern Territory, suggesting lenders with exposures to these areas will incur larger losses.

The strengthening of lending standards has increased the resilience of households

The reduced share of lending at high loan-to-valuation ratios (LVRs) and on interest-only (IO) terms over recent years has limited the share of mortgages in negative equity. High LVR loans have only a small equity buffer against housing price declines, while IO loans do not require borrowers to accumulate equity through principal repayments (although many choose to make voluntary prepayments). The shares of loans approved with LVRs above 90 per cent and on IO terms remain near their lowest levels in at least 10 years, at around 7 per cent and 15 per cent respectively (Graph 2.8). The value of IO loans outstanding has continued to decline as the rate at which IO loans have switched to principal-and-interest repayments has continued to exceed the rate of approvals.

Improvements in lending standards also help to reduce the risk that the low interest rate environment could lead to an unsustainable increase in household indebtedness. The cumulative effect of measures to strengthen lending standards has been to reduce maximum available loan sizes, which means borrowers will have larger buffers to use in the event of future increases in their expenses or declines in



income. Accordingly, the share of loans written at very high debt-to-income ratios has declined over recent years (Graph 2.9). Many of these loans are likely to be to investors, given the tax benefit they receive from gearing.

Household debt remains high, but indebted households tend to have high incomes and large repayment buffers

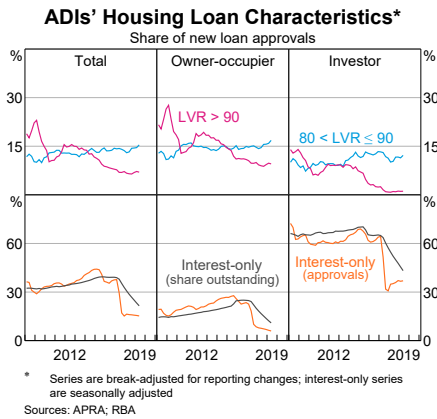
The household debt-to-income ratio remains high relative to history and by international standards. However, financial stability risks associated with household debt are determined not only by its level, but also by factors affecting borrowers' ability to repay it. Improvements in

lending standards have significantly increased the capacity of borrowers who have taken out loans in recent years to service their debts relative to previous cohorts. And while there is still a sizeable share of loans originated under weaker serviceability criteria prior to 2015, the risks associated with these borrowers are mitigated by the amortisation of their loans and the accumulation of savings. For the majority of these borrowers, the value of their homes have increased since taking out their loan and their income has grown, albeit at a moderate pace.

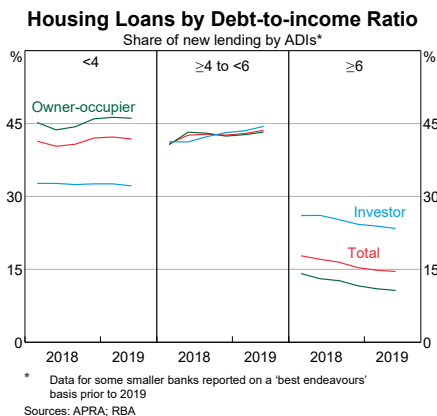
Most household debt is held by households in relatively strong financial positions. In particular, the Australian Bureau of Statistics' 2017/18 Survey of Income and Housing confirms that around 75 per cent of the value of all household debt is held by households in the top 40 per cent of the income distribution. Higher income borrowers have more capacity to maintain their loan repayments by adjusting their expenditure if their circumstances change. This reduces the risk of bank losses (but could nevertheless pose downside risks to household consumption and economic growth). Meanwhile households in the bottom 40 per cent of the distribution account for only around 10 per cent of all household debt (Graph 2.10). Moreover, the median debt-to-income ratio for households in the top 20 per cent of the income distribution is more than three times that of households in the lowest 20 per cent.

Overall, households continue to have a sizeable stock of mortgage prepayments that could be used if they encounter difficulties servicing their loans. The total stock of prepayments (the sum of balances in offset accounts and redraw facilities) is around 16 per cent of gross housing credit, or 2½ years of required mortgage repayments at current interest rates (Graph 2.11). However, the distribution of prepayment buffers across borrowers is uneven and around 30 per cent of borrowers have less than one

Graph 2.8



Graph 2.9



months' worth of prepayments. Of these, around half have disincentives to prepay (such as investor and/or fixed rate loans). The remainder are borrowers with minimal prepayments, who could be relatively vulnerable to shocks to their ability to service their loans (unless they are accumulating savings elsewhere).

Nevertheless, housing loan arrears continue to trend higher

Housing loan arrears rates have risen steadily over recent years, albeit from very low levels (Graph 2.12). The largest increase in housing loan arrears has occurred in Western Australia

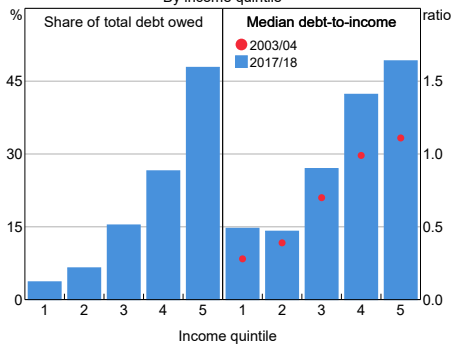
and the Northern Territory (see 'Box B: Housing Loan Arrears – Insights from Western Australia'). Arrears rates have also risen in New South Wales and other states, but are at low levels. Higher unemployment rates and weak income growth in Western Australia and the Northern Territory have reduced some households' ability to repay their debt. More generally, weak housing market conditions make it more difficult for households to repay their debt by selling their property. Nationally, around 15 per cent of loans in arrears are also in negative equity, although this is equivalent to just 0.1 per cent of all loans.

In all states, increases in the share of housing loans that are 90+ days in arrears have been driven to a greater extent by loans remaining in arrears for longer than by increases in loans entering arrears (Graph 2.13). This suggests households are finding it harder to resolve their situation than previously and is consistent with the softer housing market conditions. Liaison with banks also suggests that more lenient forbearance and foreclosure policies have contributed to the increase in longer-term arrears rates.

With the rise in housing loan arrears, lenders need to have appropriate processes in place to identify financially stressed households and, where feasible, help them return to a regular repayment schedule (such as in cases of

Graph 2.10

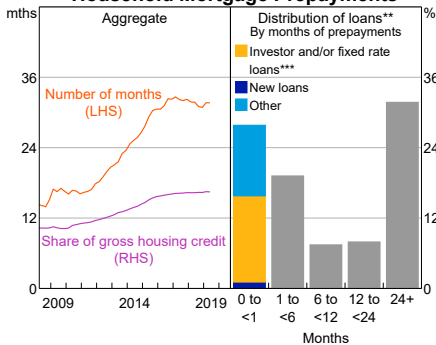
Distribution of Household Debt*
By income quintile



* Only includes households with debt
Source: ABS

Graph 2.11

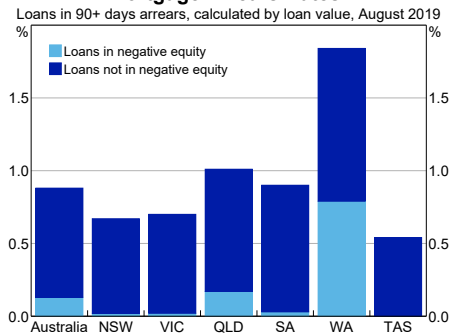
Household Mortgage Prepayments*



* Available redraw plus offset account balances
** As a share of the total number of loans as at June 2019
*** These loans have features that discourage prepayments
Sources: APRA; RBA; Securitisation System

Graph 2.12

Mortgage Arrears Rates*



* Representative selection of loans from the Securitisation System
Sources: RBA; Securitisation System

temporary financial stress). Lenders should ensure these processes are fair and well resourced. Where housing prices are falling, situations where borrowers are behind in their repayments should be resolved in a timely way, so that the financial position of the borrower and lender does not deteriorate further.

If economic conditions weaken or housing prices and turnover fall further, there is a risk that housing loan arrears rates could rise from their current levels. However, the recent reductions in the cash rate should help to offset this somewhat by reducing the interest burden on indebted households.

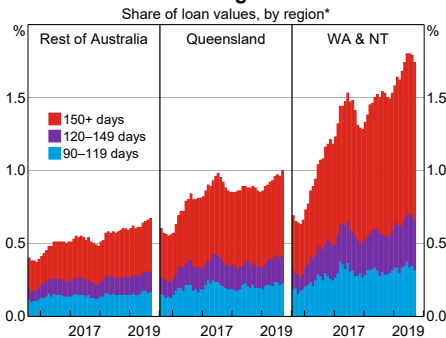
More generally, other indicators of household financial stress remain low. The rate of personal administrations, which historically have mainly been associated with unsecured personal loans and credit card debt, has trended lower over the past year or so to around its lowest level in two decades (Graph 2.14). The decline has been broadly based across states, although personal administrations in Western Australia remain high. Data from the 2017/18 Survey of Income and Housing also suggest the share of households experiencing at least one form of financial stress (such as being unable to raise emergency money) continues to drift lower. Around 30 per cent of households indicated they had experienced at least one type of

financial stress in 2017/18, which is a noticeable decline in the 45 per cent share reported 15 years ago.

Personal debt, which includes personal loans, credit card debt and other revolving credit such as margin loans, accounts for a small and declining share of household credit (Graph 2.15).^[2] In recent decades, homeowners have increasingly been able to use housing-secured financing in place of personal debt. In part, this reflects the increased availability and use of redraw facilities and offset accounts linked to residential mortgage loans. More recently, the increased use of buy-now-pay-later services may be contributing to a decline in credit card balances accruing interest. Buy-now-pay-later products are attractive to consumers because they offer the ability to smooth consumption at limited or no cost: these obligations do not incur interest, although late fees are charged if payments are missed and some providers charge regular account keeping or payment processing fees. While these products are not subject to responsible lending laws, the providers do employ some varying methods of managing risk, for example, by setting low purchase limits for new customers or requiring full repayments of previous purchases before funding new purchases. However, there are currently few safeguards that would prevent

Graph 2.13

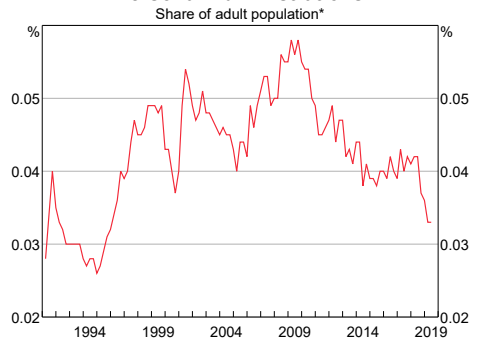
Extent of Housing Loan Arrears



Sources: RBA; Securitisation System

Graph 2.14

Personal Administrations



* Includes both business and non-business related personal administrations; seasonally adjusted
Sources: AFSA; RBA

vulnerable consumers from entering into multiple arrangements with different providers. This could contribute to an increase in financial stress for some households, with lower income and/or younger households potentially more at risk.

On the assets side of the balance sheet, households' holdings of superannuation have increased significantly over time. While this has mitigated the impact of declining housing prices on household net wealth over recent years, superannuation assets are illiquid for most households. Looking ahead, there is a risk that heightened global financial market uncertainty could leave some households exposed to falls in the value of their financial asset holdings, including superannuation. While this could cause households that are reliant on income streams from these financial assets to reduce their consumption, the aggregate effect is likely to be smaller than that associated with a decline in housing wealth as superannuation wealth is more unevenly distributed than housing wealth and returns on financial assets are typically more volatile than returns on housing. Moreover, downward revaluations to superannuation

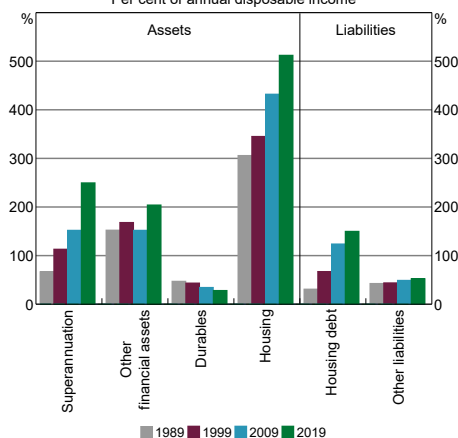
holdings are unlikely to pose broader financial stability risks as these positions are typically not leveraged.

The financial health of the business sector remains sound overall

Business balance sheets remain in good shape overall. Mining sector profitability has been boosted by increased revenue, as well as an ongoing focus on reducing costs, including by paying down debt to reduce interest expenses (Graph 2.16). Outside of the mining sector, profitability and gearing remain around their historical averages and debt-servicing ratios are close to decade lows.

Nevertheless, some businesses are facing challenging conditions. Smaller businesses continue to face relatively tight credit conditions. Lending to small businesses has hardly grown over the past year, compared with a 5 per cent increase in lending to large businesses. Small businesses also report that tighter credit conditions have made it harder to fund their operations or refinance debt. However, this does not currently appear to be having a widespread impact on asset quality. While the share of loans to private unincorporated businesses that are non-performing has risen slightly, it remains

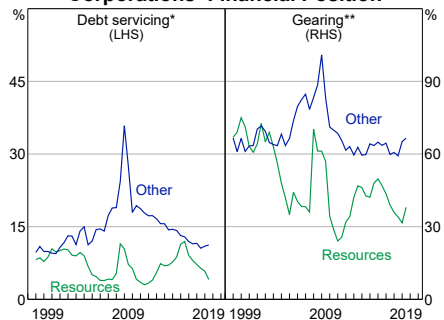
Graph 2.15
Household Balance Sheet
Per cent of annual disposable income



* Other financial assets include financial assets held outside of superannuation; other liabilities include personal credit, student loans and other household liabilities

Sources: ABS; RBA

Graph 2.16
Listed Non-financial Corporations' Financial Position



* Ratio of net interest expenses to Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA)

** Ratio of debt to equity

Sources: Morningstar; RBA

historically low and only marginally higher than that of incorporated businesses (Graph 2.17). Rates of business failure (insolvency and administration) have declined further and are below historical averages.

Drought conditions across eastern Australia continue to weigh on the farm sector and other businesses in affected regions. The direct risks to the financial system from the farm sector are low, with agricultural firms estimated to account for just 7 per cent of total private non-financial sector debt. The quality of banks' loans to the sector does not appear to have deteriorated to date, with information from liaison with banks suggesting borrowers so far have generally been able to stay within their existing facility limits (Graph 2.18). Moreover, these firms appear well placed to service their short-term debts, with deposits held by primary producers under the farm management deposits scheme remaining at a high level. Other businesses in drought-affected regions are also experiencing difficult conditions as drought-affected farmers reduce their spending. If these businesses find it more difficult to service their loans as a result of reduced incomes, banks are likely to experience a deterioration in asset quality.

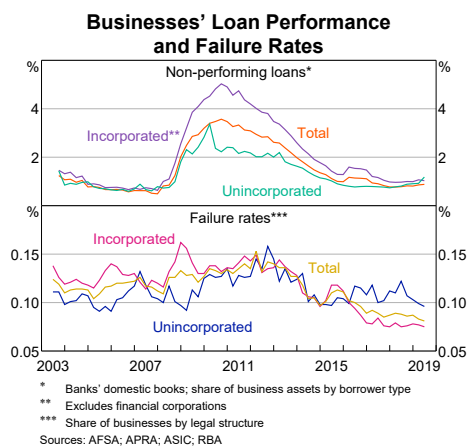
The operating environment for firms in the residential construction sector has become

more challenging as construction activity has declined. This has occurred against a backdrop of declining profitability in recent years as competition increased alongside the earlier strength in demand. While ongoing weakness in residential construction activity is likely to test the resilience of some firms, to date there has been little evidence of widespread stress. Non-performing loans to the sector remain within the narrow range seen in recent years and are historically low. Increases in residential construction firms' gearing have been constrained by banks' tighter lending standards in recent years, and low interest rates have supported the ability of firms to repay their debt. Construction sector debt accounts for only around 1 per cent of banks' assets.

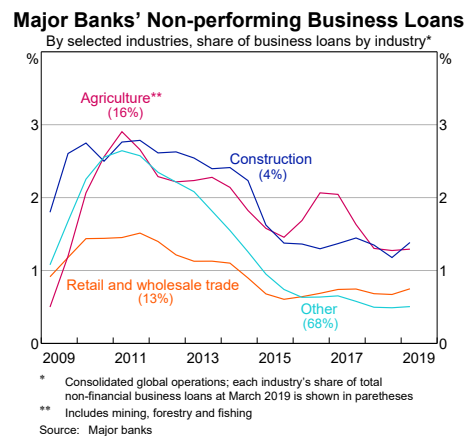
Risk appetite remains elevated in commercial property markets, but challenging trading conditions are reducing demand for retail property

Asset valuations for commercial property remain high following a number of years of strong growth (Graph 2.19). Rental yields have continued to decline as rental growth across all segments has remained relatively modest. However, yields on commercial property remain higher than many other asset classes and

Graph 2.17



Graph 2.18



spreads relative to sovereign yields have increased recently, largely reflecting a decline in yields on Australian Government bonds. Increases in commercial property valuations have also been evident overseas, given low interest rates globally and sustained economic growth over recent years. However, if investor risk aversion was to rise, for example in response to a global shock or lower domestic economic growth, this could trigger a portfolio allocation away from commercial property towards safer asset classes and valuations could fall sharply. If this was to occur, highly leveraged investors would be vulnerable to breaching LVR covenants on bank debt, though the potential scale of this is unclear given data limitations. A worst case scenario would see this trigger property fire sales and further large price falls. Heightened competition, changing consumer preferences and ongoing subdued growth in household income are creating a challenging environment for some retailers. Indicators of the financial health of retailers in the consumer discretionary industry suggest that, while profitability has declined, to date retailers seem to be meeting their financial obligations. Some retailers have responded to the headwinds by reducing their physical footprint

and, as a result, retail property valuations have declined over the past six months. The vacancy rate at sub-regional shopping centres (those with discount department stores as anchor tenants) is at its highest level in at least 25 years and rents have declined slightly for these centres over the past year (Graph 2.20). The vacancy rate for large regional shopping centres has also been drifting higher, with very little growth in rents.

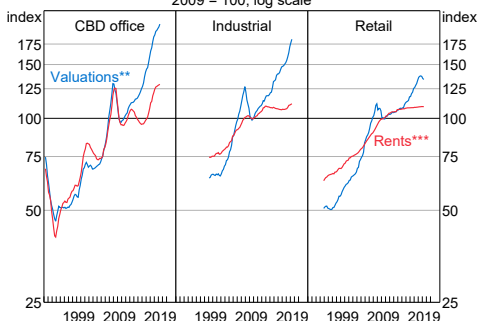
Retail development activity has increased considerably since 2016. Much of this has been refurbishing large regional centres to reorientate them towards services, as well as constructing smaller neighbourhood centres, particularly in areas with many new dwellings. Accordingly, there is a risk that older and less favourably located centres will find it harder to attract and keep tenants, which would weigh on rents and valuations and may lead to debt servicing challenges for the owners of some centres. The risks to banks from the retail property market appear low, given these exposures account for less than 2 per cent of total bank assets.

In contrast to the retail market, the office market appears less vulnerable to a sharp decline in valuations. Favourable economic conditions in Sydney and Melbourne have supported strong tenant demand for office space in recent years.

Graph 2.19

Commercial Property*

2009 = 100, log scale

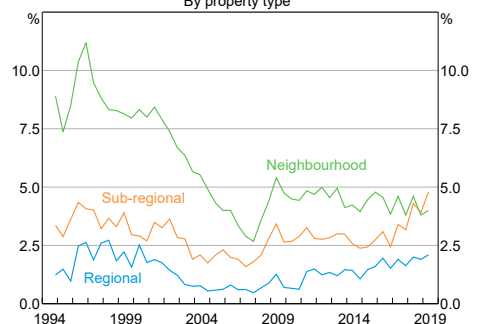


* CBD office and industrial are prime property; retail is regional (non-CBD) centres
 ** JLL Capital Value Indicator
 *** CBD office is effective rents; industrial and retail are face rents
 Sources: ABS; JLL Research; RBA

Graph 2.20

Retail Vacancy Rates

By property type*



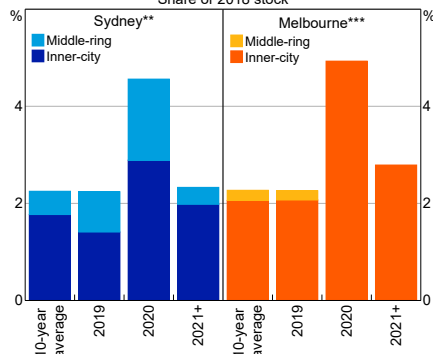
* Regional centres are major centres based around department stores (David Jones, Myer); sub-regional centres are discount department store based (Big W, Kmart, Target); neighbourhood centres are based around supermarkets
 Sources: JLL Research; RBA

Vacancy rates have declined to decade lows in both cities, to around or below 4 per cent. Withdrawals from the office stock in the Sydney CBD have also contributed to the low vacancy rates. Nevertheless there are risks. Tight office market conditions have encouraged a supply response in these cities, and the volume of new supply is expected to be well above average over the next year or two (Graph 2.21). While many new buildings have high rates of tenancy precommitments, older and less well located buildings may lose tenants. The low vacancy rates observed currently and attractive yields relative to other assets might encourage excessive new supply. The long planning and development processes can mean that macroeconomic and office market conditions can differ between when a building is completed and when it was proposed.

Banks' commercial property exposures as a share of total assets are around 5 per cent, and have increased steadily over the past five years or so.

Foreign banks have accounted for nearly all of the increase in banks' lending for office property while foreign and domestic banks have accounted for the increase in retail property lending. Impairment rates for commercial property remain very low. ❖

Graph 2.21
Future Office Supply*
 Share of 2018 stock



* Completed projects and projects under construction
 ** Inner-city is Sydney CBD and North Sydney; Middle-ring is Bondi Junction, Chatswood, Macquarie Park, Parramatta and St Leonards
 *** Inner-city is Docklands and Melbourne CBD; Middle-ring is East Melbourne, Southbank and St Kilda Road
 Sources: Property Council of Australia; RBA

Endnotes

[1] RBA (2019), 'Box C: Risks in High-density Apartment Markets', *Financial Stability Review*, April, pp 38–41.

[2] RBA (2018), 'Box B: Recent Trends in Personal Credit', *Financial Stability Review*, November, pp 29–32.