Household and Business Balance Sheets

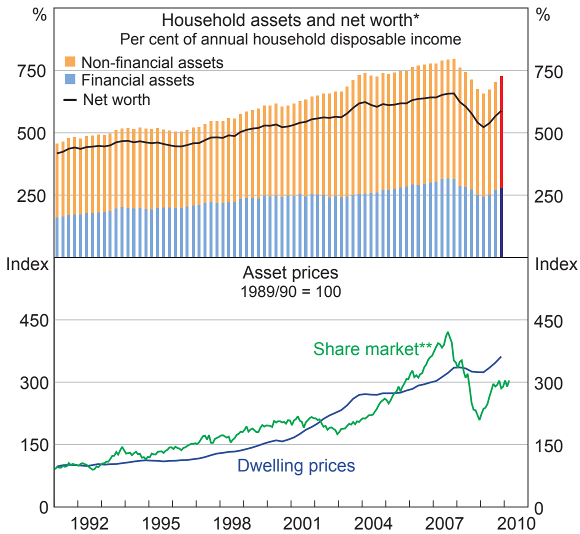
Households and businesses have weathered the recent downturn relatively well. The economic recovery is supporting incomes, surveys of household and business finances indicate a positive outlook, and arrears rates and other measures of financial stress remain at much lower levels than were seen in the early 1990s. The household sector directly benefited from the boost to incomes from government payments and sharply lower interest rates, as well as the support these measures have given to the economy more generally; these measures are now being unwound as the economy strengthens. Households have been showing some inclination to strengthen their financial position by increasing saving and reducing the pace of borrowing, though gearing remains at historically high levels. Businesses have been deleveraging over the past year, reflecting both a more cautious approach to finances and more stringent terms and pricing for credit, although there are signs that access to debt funding has become a little easier in recent months.

Household Sector

The past year has seen a substantial improvement in the aggregate financial position of the household sector. Reflecting the recovery in asset values from their earlier falls, net worth per household increased by an estimated 11 per cent in the year to December 2009, with the March quarter 2010 likely seeing further increases. Prices of dwellings, which account for around 60 per cent of household assets, rose by around 10 per cent over the year to December (Graph 60). The value of households' financial assets also increased, due mainly to higher equity prices, which were up by around 30 per cent in the year to end December. As at the end of 2009, average net worth stood at a little below six times annual household disposable income. Although this is below its pre-crisis multiple, this is mainly a reflection of ongoing growth in household incomes; in dollar terms, net worth was around $610 000 per household in December, only a little below its 2007 peak.

Pressure on household incomes from the economic downturn is also abating. Unemployment looks to have peaked at a lower rate than had been expected earlier, with strong growth in both full-time and part-time employment since mid 2009; surveys

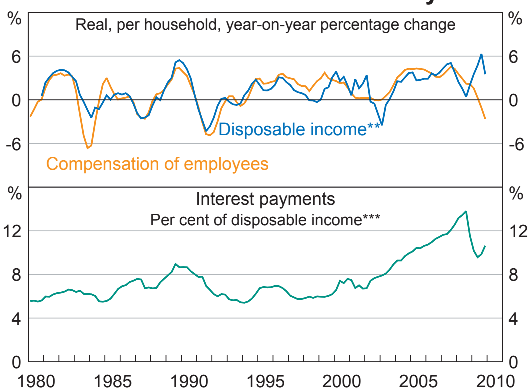
Graph 60
Household Assets and Asset Prices



* Income is before the deduction of interest payments; includes income and financial assets of unincorporated enterprises. Estimates for December quarter 2009.
** All Ordinaries Index to March 2000, then ASX 200
Sources: ABS; APM; RBA; REIA; Thomson Reuters

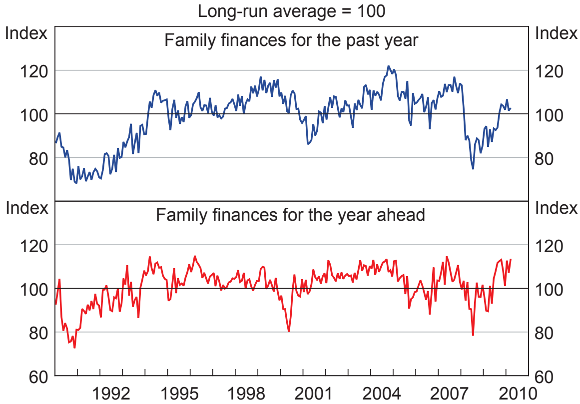
of employers' hiring intentions signal continuing good prospects. Earlier softness in the labour market had led to a fall in aggregate compensation of employees (which typically comprises around three quarters of the household sector's disposable income): it declined by 2.6 per cent in real terms for the year to December 2009 when compared with the previous year (Graph 61). Through the downturn, however, disposable incomes were boosted by accommodative fiscal and monetary policy settings. As a result, total disposable income per household increased by 3.5 per cent in real terms, and 6.6 per cent in nominal terms, over the same period.

Graph 61
Household Incomes and Interest Payments*



* Household sector excludes unincorporated enterprises
** After the deduction of interest payments
*** Before the deduction of interest payments
Sources: ABS; RBA

Graph 62
Consumer Sentiment
Long-run average = 100

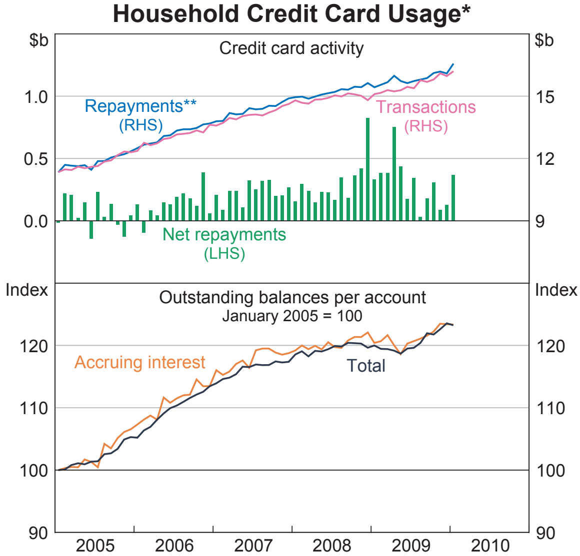


Source: Melbourne Institute and Westpac

Household interest payments have increased a little as a share of disposable income since mid 2009; this ratio stood at 10.6 per cent in the December quarter 2009, after having previously declined by 4 percentage points from its earlier peak. While household incomes have, in aggregate, been boosted by the decline in interest rates over late 2008 and early 2009, lower rates would have put downward pressure on the incomes of those households holding more interest-bearing assets than liabilities.

Reflecting the combination of increasing asset prices, supportive policy measures, and an improving labour market, households have become increasingly optimistic about their financial situation. Since the release of the previous *Financial Stability Review*, survey measures of households' perceptions of current financial circumstances have continued to improve, following a period when confidence had been weakened by the financial crisis (Graph 62). Credit card usage patterns have reflected this evolution: in recent months both transactions and outstanding balances picked up, after having been broadly unchanged over 2008 and the first half of 2009 (Graph 63). The pattern of net credit card

Graph 63
Household Credit Card Usage*



* Personal credit cards; seasonal and calendar adjustment with X-12-ARIMA
** Repayments of outstanding balances, interest and other charges
Source: RBA

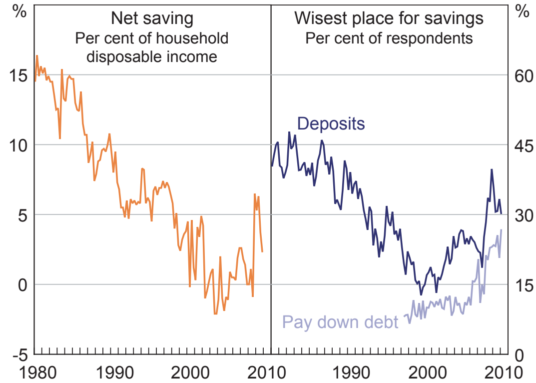
repayments is consistent with some households having used government stimulus payments to repay outstanding balances, particularly those accruing interest.

Despite the recent pick-up in credit card usage, households still seem to be taking a fairly conservative overall approach to finances. Over the past year they have, in aggregate, been saving around 4 per cent of disposable income, compared with little net saving over much of the past decade, though this has declined more recently (Graph 64). When asked about the wisest place for savings, survey respondents continue to nominate deposits or debt repayment ahead of other less conservative investments; in part, though, the relative appeal of deposits is likely to have reflected the high deposit interest rates that have been on offer.

Total outstanding household debt has been growing at a much slower pace than in the previous decade. After slowing to an annualised rate of 4.7 per cent in the six months to January 2009, the pace of growth in borrowings has strengthened to 8.3 per cent over the six months to January 2010 (Graph 65). Within this, borrowings for owner-occupier housing increased at an annualised rate of 10 per cent. The past six months have seen the share of first-home buyer activity fall back towards its longer-run average, after having earlier increased strongly in response to government grants and lower interest rates. With the phasing out of the various first-home buyer incentive schemes, the first-home buyer share of the number of loan approvals has fallen to 28 per cent, down from a peak of 39 per cent in May 2009 (Graph 66). The relative size of first-home buyer loans has also recently declined, after briefly rising well above that of other owner-occupiers during the peak of activity in early 2009.

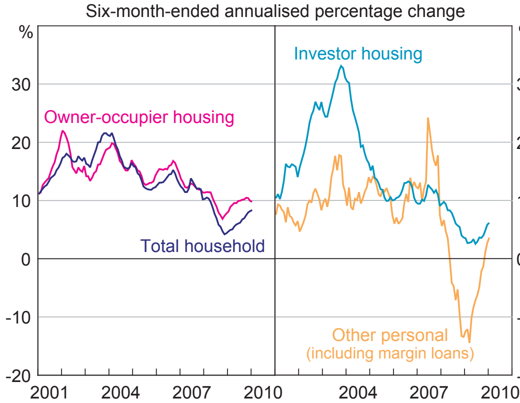
Household borrowing for investment purposes – which had slowed the most during the crisis – has shown some signs of turning around in recent months. As the share market strengthened and

Graph 64
Household Saving Indicators



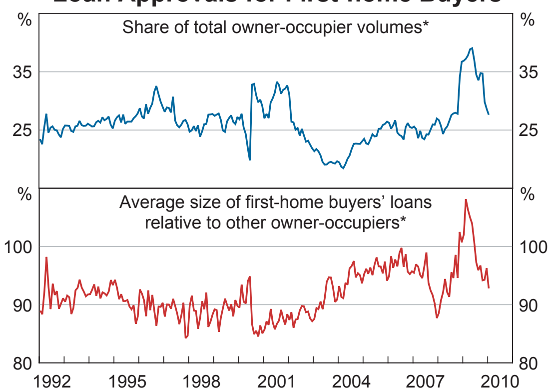
Sources: ABS; Melbourne Institute and Westpac

Graph 65
Household Debt Components
Six-month-ended annualised percentage change



Source: RBA

Graph 66
Loan Approvals for First-home Buyers



* Owner-occupier loan approvals net of refinancing
Sources: ABS; RBA

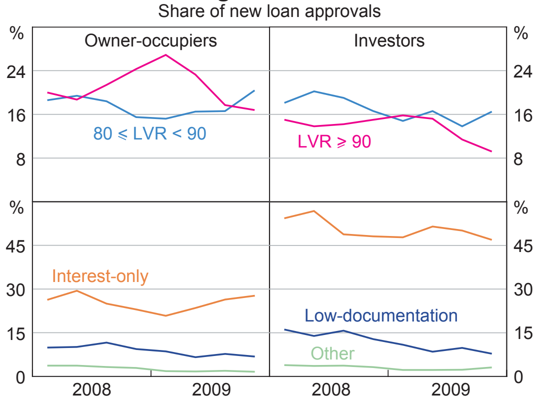
became less volatile in the second half of 2009, outstanding margin debt began to recover a little of the sharp decline seen in the previous 18 months. Despite this, gearing levels on margin loans are currently low by historical standards, suggesting that both lenders and borrowers are approaching margin lending more cautiously than before the crisis.

Investor housing credit growth has also picked up recently, reaching an annualised rate of 6.2 per cent in the six months to January 2010. This is consistent with investors becoming more confident about the outlook as housing prices have strengthened. Lending standards for new investor loans have

Graph 67

Banks' Housing Loan Characteristics*

Share of new loan approvals



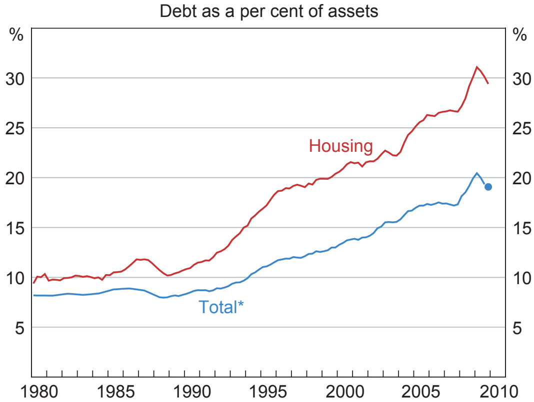
* LVR = loan-to-valuation ratio; 'Other' includes loans approved outside each bank's standard serviceability policy, and other non-standard loans; 'Interest-only' includes mortgages with 100 per cent offset acounts

Source: APRA

Graph 68

Household Gearing Measures

Debt as a per cent of assets



* Includes financial assets of unincorporated enterprises. Estimate for December quarter 2009.

Sources: ABS; RBA

tightened over the past two years; relatively fewer investor loans are now being written with higher loan-to-valuation ratios (LVRs) or lower documentation standards (Graph 67). There has also been a decline in the share of interest-only loans, though it is still the case that close to one half of all new investor housing borrowers have the option of making no principal repayments, reflecting the tax advantages of this funding strategy.

Lenders have also been adjusting their criteria for new loans to owner-occupiers. While the strong response to first-home buyer incentive schemes initially saw some lower-quality loans approved – including an increase in the share of housing loans with deposits of less than 10 per cent – banks have since tightened maximum LVRs and other elements of their underwriting standards. Together with a fall in the proportion of first-home buyer loan approvals, this has seen a decline in the share of new owner-occupier housing loans with an LVR above 90 per cent, from a peak of 27 per cent in the March quarter 2009 to 17 per cent by the end of the year. Partial credit bureau data suggest that the creditworthiness of recent first-home buyers has been broadly similar to earlier cohorts of first-time borrowers.

Ongoing growth in household debt has further increased the gearing of household balance sheets. Households' aggregate debt is equivalent to around 20 per cent of aggregate assets, having increased by a couple of percentage points in recent years; this ratio is well above the average of the period since financial deregulation (Graph 68). Outstanding housing-related debt is currently equivalent to 29 per cent of housing assets, with this measure having also increased in recent years.

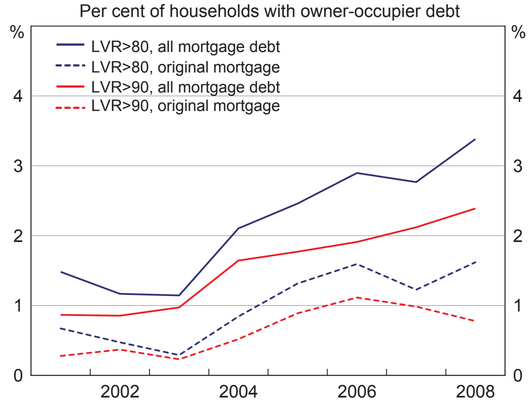
Increased indebtedness raises households' exposure to shocks to their incomes and financial circumstances. Yet although the Australian household sector as a whole has become more indebted, it remains the case that there is only a small share of very highly geared borrowers.

In general, households appear well placed to meet their debt repayments. Based on the most recent HILDA Survey data, in late 2008 – a period when housing loan interest rates were at their highest in more than a decade – around 2 per cent of households with owner-occupier mortgages fulfilled two criteria indicating possible increased vulnerability: they spent more than 50 per cent of their disposable incomes on mortgage repayments; and they had an LVR of 90 per cent or more (Graph 69). There has been an increase in loans with lower deposits and second or refinanced mortgages, but most of these borrowers were generally only facing a moderate repayment burden. Although the share of households fulfilling at least one of these criteria has risen in recent years, it was still the case that more than 90 per cent of owner-occupier households with mortgages had an LVR below 80 per cent and/or a debt-servicing ratio below 30 per cent of income.

The share of households with negative equity is estimated to be very low, with HILDA data suggesting that these households have historically been no more likely to be behind in repayments than other indebted households. Indebted owner-occupier households only comprise around one third of all households, and within this group only a very small share have been behind schedule in their repayments in recent years (Graph 70). Moreover, more than one half of owner-occupiers whose original mortgage is still outstanding have been ahead of schedule on their repayments in recent years; this buffer suggests that households' aggregate debt-servicing capacity was quite strong heading into the recent economic downturn.

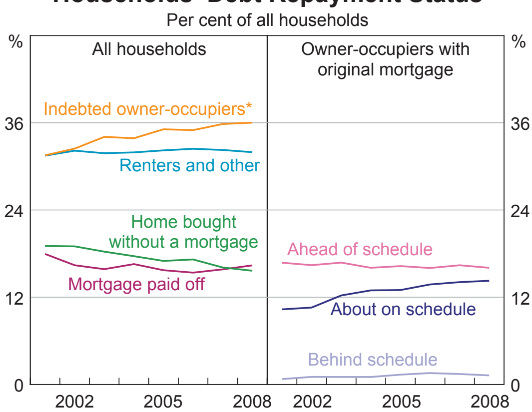
Reflecting the generally sound financial position of the majority of households, and the improvement in the economic environment, indicators of household financial stress have been showing signs of stabilising over recent months. While delinquency rates on mortgage payments remain higher than the longer-run average, they have levelled out recently, and are low relative to international experience. By loan value, the share of non-performing housing loans on banks' balance sheets was around 0.6 per cent as at December 2009, little changed over the second half of the year, and around 7 basis points higher than a year earlier; most of these loans remain well covered by collateral (Graph 71).

Graph 69
Households with Low Equity and High Repayments*



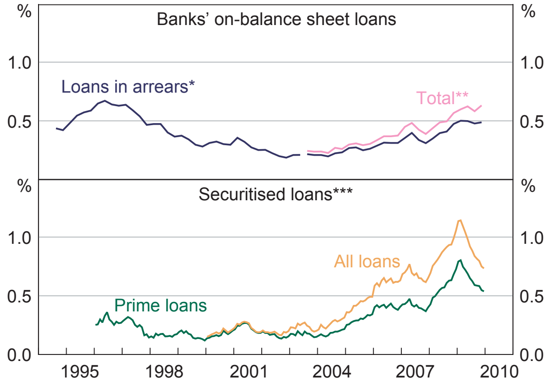
* Repayments on corresponding debt greater than 50 per cent of household disposable income
Source: HILDA Release 8.0

Graph 70
Households' Debt Repayment Status



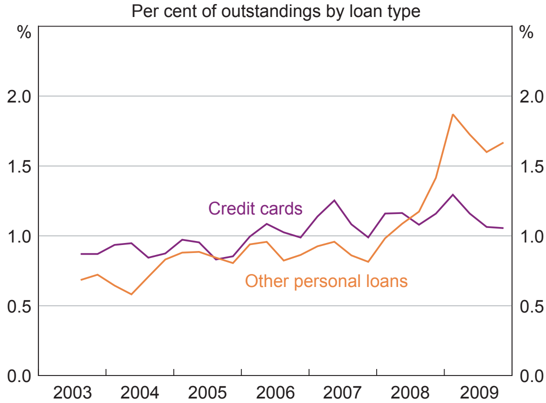
* Owner-occupiers with any mortgage debt
Source: HILDA Release 8.0

Graph 71
Non-performing Housing Loans
Per cent of outstandings



* Loans that are 90+ days past-due but otherwise well secured by collateral
** Includes 'impaired' loans that are in arrears (or are otherwise doubtful) and not well secured by collateral
*** Loans securitised by all lenders, 90+ days past-due
Sources: APRA; Perpetual; RBA; Standard & Poor's

Graph 72
Banks' Non-performing Personal Loans*
Per cent of outstandings by loan type



* Includes 'impaired' loans and 90+ days past-due items that are well secured
Source: APRA

The interpretation of recent movements in securitised loan arrears rates has been complicated by the decline in the amount of outstanding securitised loans.[5] As at December 2009, the share of prime securitised loans in arrears for 90 or more days was a little above the equivalent measure for banks' on-balance sheet loans, while the arrears rate across all types of securitised housing loans was higher, at around 0.75 per cent. The difference mainly arises because the securitised loan pool includes non-ADI loans (of which a larger share have lower documentation), as well as non-conforming loans. The latter are made to borrowers with impaired credit histories or borrowers who do not otherwise meet traditional lenders' credit standards; they do not make up any part of ADI lending, and only comprise less than 1 per cent of outstanding domestic loans.

This low, and shrinking, share of lower-quality loans has been an important factor in Australian housing loan delinquencies remaining at a relatively low level. The recent levelling out in housing loan arrears rates also reflects the improved economic and financial conditions discussed above, including lower household interest payments; arrears rates on (securitised) variable-rate loans fell by 31 basis points over the year to December 2009, in contrast to a 2 basis point increase for fixed-rate loan arrears over the same period (variable-rate mortgages make up around 80 per cent of all mortgages). Although interest rates have been rising more recently, at least part of the effect of this on arrears rates should be cushioned by the improving labour market. The recovery in housing prices is also likely to have been supportive lately, since higher prices increase the equity on which borrowers are able to draw, increasing the potential for them to resolve their overdue payments by refinancing or selling the property.

According to securitised loan data, housing arrears rates have trended downwards across all states, with New South Wales experiencing the largest improvement. Nationwide, it is estimated that currently around 27 000 households are 90 or more days in arrears on their housing loans, compared with an estimate of 23 000 at the end of 2008.

Arrears rates on other household loans have also improved over the past year. After peaking at 1.3 per cent in the March quarter 2009, the arrears rate for credit cards has recently declined by around 25 basis points (Graph 72). The rate on other

5 The value of outstanding securitised loans has declined from $204 billion in June 2007 to $116 billion in January 2010, due to the amortisation and refinancing of existing securitised loans, and the almost total cessation of new RMBS issuance over much of this period. This has greatly changed the characteristics of the securitised loan pool; in particular, since only mortgages currently not in arrears are securitised, earlier strong growth in securitisations initially put downward pressure on the arrears rate.

personal loans has fallen by a similar amount, in part due to an improvement in arrears on margin loans, reflecting the stronger share market performance.

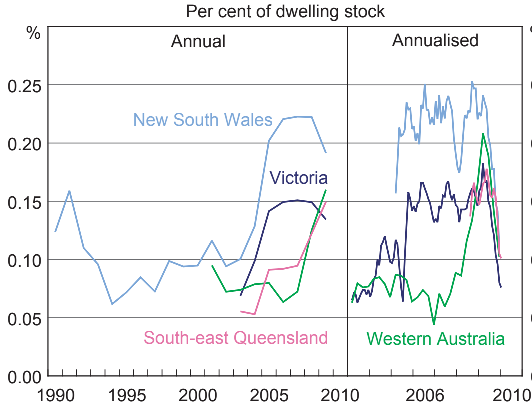
Indicators of more severe household financial distress are also showing signs of improvement. The rate of mortgagees' court applications for property possession declined substantially over the second half of 2009 (Graph 73). For New South Wales and Victoria, the rate of possession applications has fallen to 2005 levels, after a number of years where it had been higher than average. Queensland and Western Australia have also seen a substantial falling off in possession activity. The decline in mortgagees' court applications is likely to have reflected both improved financial circumstances that have enabled some delinquent borrowers to catch up on repayments, and a pick-up in the housing market, allowing other households in arrears to sell properties to repay debt. Another contributing factor has been the declining share of outstanding loans made by non-traditional lenders, which in the past have tended to act more quickly than other lenders in obtaining and executing possession judgments. In recent months there has also been a levelling out in the rate of bankruptcies and other personal administrations, after it rose between 2005 and 2009, and it remains the case that only a very small proportion of households have reached such an extreme of financial distress.

Business Sector

Relatively favourable economic conditions, strong profits and overall moderate gearing preceding the downturn meant that businesses were, in aggregate, well placed to handle the difficulties of the recent period. A small number of companies had employed highly geared business models, however, leaving them particularly exposed to the slowdown in the real economy and the disruption in debt finance availability; within this group, property and infrastructure managers were also exposed to asset price declines. While economic conditions are now improving, firms continue to report above-average difficulty in obtaining finance, though this too appears to be easing.

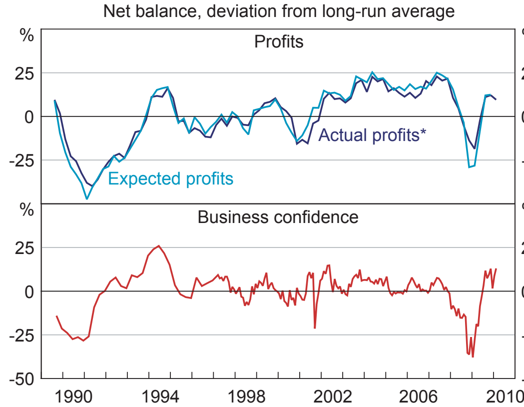
Although business profits weakened in the recent challenging economic environment, indications are that there has been some recovery since mid 2009. Signs of an improving outlook have been reflected in survey measures of actual and expected profits, which have been well above their long-run averages in recent months, while business confidence has also rebounded strongly (Graph 74). While aggregate business profits

Graph 73
Applications for Property Possession*
Per cent of dwelling stock



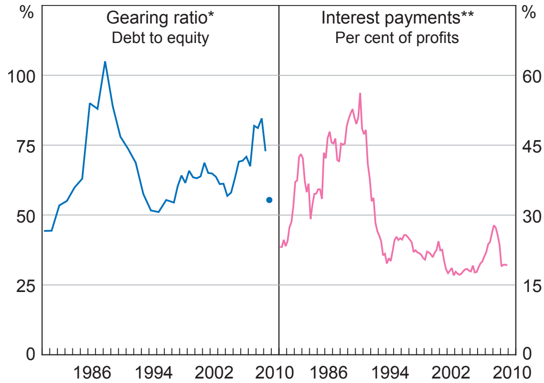
* Includes applications for possession of some commercial, as well as residential, properties
Sources: ABS; state Supreme Courts

Graph 74
Business Conditions Surveys
Net balance, deviation from long-run average



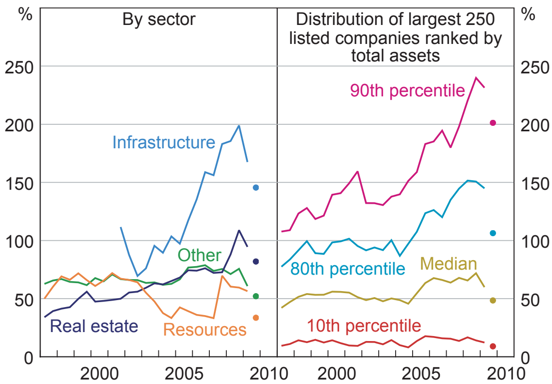
* Latest observation is for February 2010
Source: NAB

Graph 75
Corporate Sector Finances



* Listed non-financial companies' gross debt/shareholders' equity at book value; excludes foreign companies, includes real estate companies. Latest observation includes only companies that have reported to December 2009.
** ABS data prior to 1994, RBA data thereafter. Profits are measured as non-financial corporations' gross operating surplus.
Sources: ABS; Morningstar; RBA; Statex

Graph 76
Listed Companies' Gearing Ratios*



* Listed non-financial companies' gross debt/shareholders' equity at book value; excludes foreign companies, includes real estate companies. Latest observation includes only companies that have reported to December 2009.
Sources: Morningstar; RBA

declined by 2½ per cent in the year to December 2009 (according to the national accounts measure), they increased by 4½ per cent in the December quarter. An improvement was also evident in financial results announced during the latest corporate reporting season: on a matched sample basis, underlying profits for listed non-financial ASX 200 companies were around 20 per cent higher in the December 2009 half compared with the six months to June, though they were around 15 per cent weaker than the December 2008 half.

Reflecting these improving prospects, share market analysts' earnings forecasts for listed companies have been revised upwards over recent months, with less variation among analysts, indicating both an optimistic and less uncertain profits outlook. Resource companies' earnings are expected to recover strongly in the 2010/11 financial year, with an expected increase of around 45 per cent over forecast profits for the current financial year, due to improved commodity prices and production volumes; earnings for other non-financial firms are expected to increase by around 15 per cent over the same period.

The improving economic environment suggests that businesses remain well placed to service debts, even as interest rates rise from recent lows. A further boost to business finances has come from declining debt levels and equity raisings over the past year, which together have reduced the listed corporate sector's aggregate gearing ratio to around 55 per cent at December 2009, down from around 85 per cent at the end of 2008, and well below the peaks of the late 1980s (Graph 75).

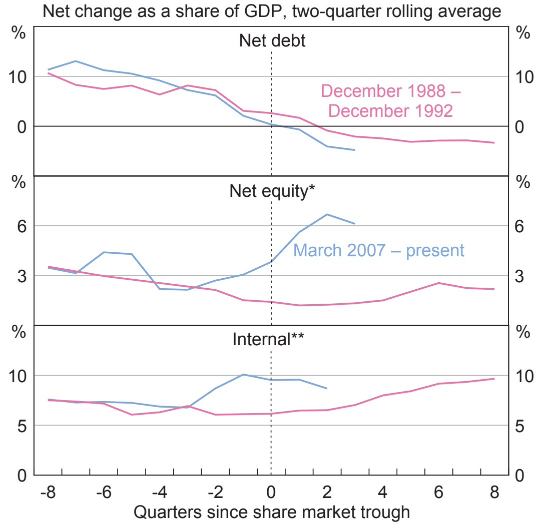
Pre-crisis, gearing ratios among resource and other non-financial companies had remained fairly steady at below 80 per cent (Graph 76). In the real estate and infrastructure sectors, though, highly geared business models became more prevalent and overall gearing increased significantly, to more than 100 per cent for both sectors. This minority of highly geared firms was particularly vulnerable to the recent constriction in debt finance availability; for firms with short-term refinancing needs, it led variously to asset sales, write-downs, and equity raisings. As more highly geared firms took advantage of improved market conditions to access equity finance and pay down debt, the distribution of listed companies' gearing ratios narrowed appreciably over the second half of 2009.

More recently, there have been indications that the business sector is entering a new phase of balance sheet adjustment, with an increasing number of equity raisings being announced to fund investments (including acquisitions) rather than as recapitalisations. There has also been a pick-up in initial public offerings, in line with improved share market conditions. As a source of external funds, the net amount of equity raised in the six months to December 2009 was equivalent to around 6 per cent of GDP, up from an average of 2½ per cent over the previous ten years (Graph 77). This is a notable contrast to the early 1990s slowdown, when equity was a more limited support for business finances. Internal funding sources have continued to hold up well in the recent episode, with retained earnings equivalent to around 8 per cent of GDP, a couple of percentage points higher than in the early 1990s. Improving profitability suggests that firms will continue to have good internal sources of finance to fund investment expenditure.

In contrast, external debt financing has slowed substantially. The recent period has seen a noticeable contraction in business credit (Graph 78). In the past couple of months, however, there have been signs of stabilisation: liaison with lenders and businesses suggests an increasing preparedness of lenders to extend credit, and there are early signs of an uptick in commercial loan approvals.

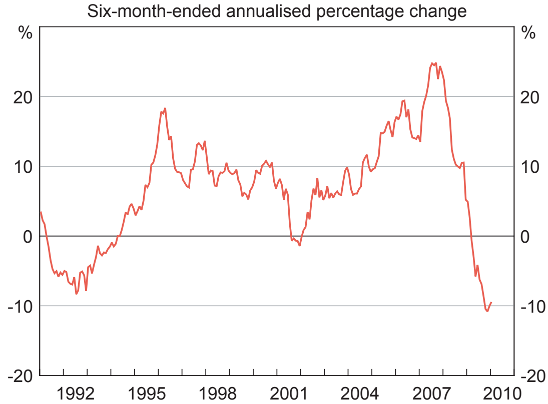
Partly driving the recent slowdown in credit growth was subdued demand from business borrowers in the face of the uncertain economic environment. Banks had also tightened lending standards, both as a response to the higher risk arising from the economic and financial environment (and the associated increase in loan impairments), and as an upward correction of standards following a period when, at least for some lenders, risk was arguably being priced inadequately (see *The Australian Financial System* chapter for further discussion). Over the course of 2008, average interest spreads over the cash rate increased by a little under 200 basis points for new variable-rate loans for both large and small businesses; since mid 2009 spreads have declined a little for large businesses, though spreads on new small business loans are yet to see much change. Banks have also been enforcing more stringent non-price refinancing terms, including tighter loan covenants, collateral requirements, and one-off refinancing fees.

Graph 77
Business Funding



* Annual average prior to June 1990
** Excludes unincorporated enterprises, includes public non-financial corporations
Sources: ABS; ASX; Austraclear Limited; RBA

Graph 78
Business Credit*

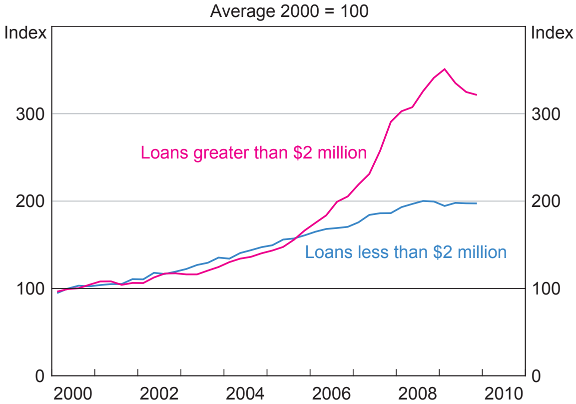


* Includes securitised loans
Source: RBA

Graph 79

Banks' Business Lending by Loan Size

Average 2000 = 100

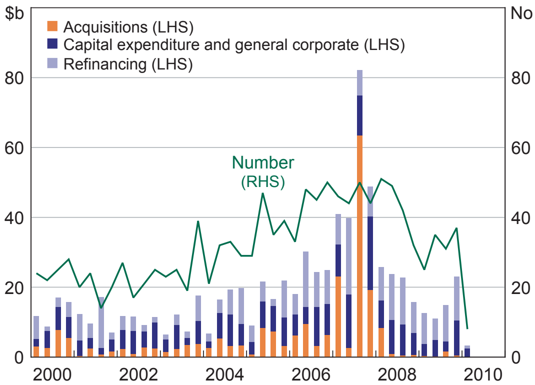


Source: APRA

Graph 80

Syndicated Loan Approvals*

Loans to Australian-domiciled companies



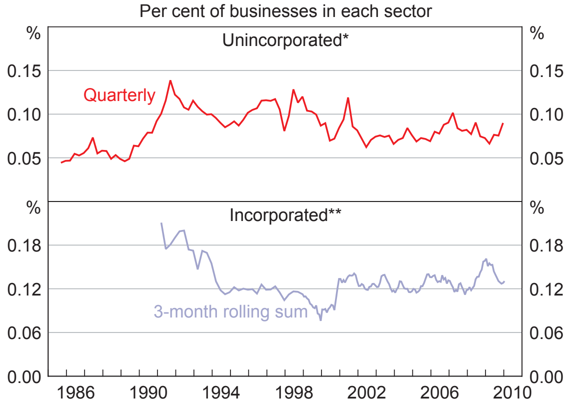
* Latest observation is to end February 2010

Sources: RBA; Thomson Reuters

Graph 81

Business Failures

Per cent of businesses in each sector



* Business bankruptcies

** Corporate receiverships and liquidations; pre-1999 data quarterly only

Sources: ABS; ASIC; ITSA; RBA

Across business types, the decline in outstanding debt was concentrated in lending to larger corporations, particularly by foreign banks, while credit outstanding to smaller businesses (which rely more heavily on bank funding) was little changed in net terms, remaining around mid-2008 levels (Graph 79). Borrowing conditions for larger firms have recently been improving, though, and activity in the syndicated loan market has picked up a little, with $23 billion of new facilities approved in the December quarter – around the quarterly average over the past decade – though to date in the March quarter activity has been subdued (Graph 80). Notably, whereas the bulk of loan approvals over 2008 and 2009 were purely for refinancing of existing debt, the December quarter saw an increase in loans approved for general corporate purposes such as capital expenditure; this is further indicative of a turning point in businesses' balance sheet adjustments. Corporate bond issuance also picked up in 2009, totalling $30 billion (up from around $12 billion in 2008), although only $4 billion of this was issued domestically.

The overall strength of the business sector's financial position ahead of and into the downturn is demonstrated in ongoing low business failure rates, which remain around the levels of recent years, and well below the highs of the early 1990s (Graph 81). As discussed in *The Australian Financial System* chapter, non-performing business loans have increased, reaching 4.1 per cent of banks' total business loans in December 2009. This was led by the commercial property sector, where around 5.1 per cent of exposures were impaired as at December 2009, although as discussed below, underlying conditions in the commercial property sector have now begun to improve.

Commercial Property

The improvement in the economic environment since mid 2009 has underpinned a stabilisation of conditions in the commercial property market. Rents and capital values for office and industrial premises, while still well below their mid-2008 peaks, are no longer rapidly declining, reflecting a modest increase in white-collar employment and a pick-up in overall business activity (Graph 82). The relative strength of the retail sector over the past couple of years has seen rents and prices in this market segment remain broadly unchanged.

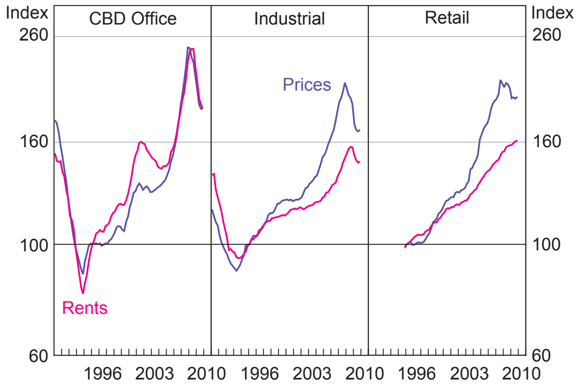
The Australian commercial property market has also been supported by a relatively low level of excess supply in the current episode. Whereas the commercial property boom of the late 1980s saw construction work done average close to 3 per cent of GDP in the three years to June 1990, work done in the three years to December 2008 averaged a more moderate 2 per cent of GDP (Graph 83). Another reason for the more benign outcome was the timing of the financial sector turmoil, with many planned projects being interrupted by lenders withdrawing finance before construction was underway. This supply experience contrasts with that of the late 1980s, when a much larger share of building projects were completed, exacerbating the effect on rents and prices of slowing underlying demand from tenants. Although a large aggregate supply overhang was avoided in the current episode, there are some market segments where new stock additions have been contributing to higher vacancy rates, which are continuing to weigh on rental earnings. In particular, the very low vacancy rates in Perth and Brisbane CBD office property markets in 2006 and 2007 prompted a relatively strong supply response, while additions to suburban and regional districts have weighed on rents in other states.

Reasons why the availability of funding for commercial property development contracted more than for other business purposes include that banks reacted promptly to the early deterioration in the loan quality of a small number of large commercial property exposures; they

Graph 82

Commercial Property

March 1995 = 100, log scale

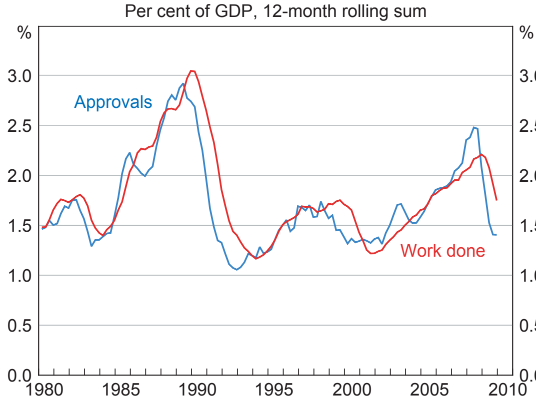


Sources: Jones Lang LaSalle; RBA

Graph 83

Commercial Property Construction

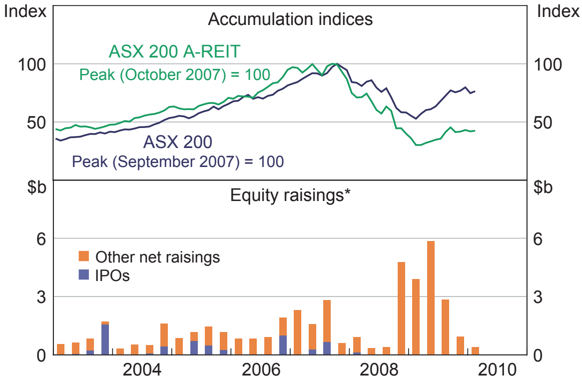
Per cent of GDP, 12-month rolling sum



Sources: ABS; RBA

were also concerned that asset valuations had become stretched. A reduced appetite for lending is still apparent, although liaison with lenders and commercial property borrowers has indicated that this has eased slightly in recent months. Although some larger commercial property firms have issued bonds over the past year, they have done so at elevated spreads, while issuance of other forms of debt securities – such as commercial mortgage-backed securities or debentures – remains subdued.

Graph 84
Listed Real Estate Investment Trusts



* March quarter 2010 is quarter to date
Sources: ASX; Thomson Reuters

The reduction in the availability of debt finance, together with downward asset revaluations, induced substantial equity raisings by listed real estate investment trusts (REITs), with $13.5 billion of net raisings over the course of 2009 (Graph 84). Over this period equity-raising activity was supported by a turnaround in investor sentiment: after falling much further than the market as whole over 2008, since March 2009 share prices for listed REITs have improved in line with the broader market, though they remain more than 50 per cent below their October 2007 peaks. Reflecting still-soft commercial property prices, listed REITs' balance sheets have continued to be affected by downward asset revaluations, which were equivalent to around 5 per cent of assets in the second half of 2009, after declines equivalent to 10 per cent of assets were seen in the previous two half-years. However, the slowing pace of these, combined with continuing net debt repayments and equity raisings, has seen the aggregate debt-to-equity ratio of listed REITs decline from 91 per cent in June 2009 to 81 per cent in December, though this is still high when compared to the longer-run average of around 60 per cent.