INFORMATION PAPER

Countercyclical capital buffer

December 2020
Disclaimer Text

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Executive summary

The countercyclical capital buffer (‘CCyB’) is an additional amount of capital that APRA can require authorised deposit-taking institutions (ADIs) to hold at certain points in the economic and financial cycle. The primary purpose of the countercyclical capital buffer is to increase the resilience of the ADI sector during periods of heightened systemic risk. This extra resilience, in the form of more capital, can then be used by banks during a severe downturn to absorb losses while continuing to lend. The buffer was set at zero per cent of risk-weighted assets upon its introduction in 2016, and retained at that level since then.

In the first half of 2020, APRA decided to maintain the countercyclical capital buffer at zero per cent until at least March 2021. This was the appropriate response to the historically large economic downturn underway in Australia due to COVID-19. It was also consistent with APRA’s decision in March to relax expectations that banks maintain ‘unquestionably strong’ levels of capital during the current downturn. This relaxation in capital expectations was intended to assist banks to absorb losses while continuing to lend to support households, businesses and the broader economy.

Current conditions suggest a zero CCyB setting is still appropriate and that this is likely to remain the case until at least the end of 2021. Whilst a recovery is underway in the Australian economy, the scale of the downturn earlier in the year, and ongoing weakness in some parts of the economy, indicate that a long period of recovery remains. Financial stress amongst borrowers, and the resulting impacts on banks, are likely to increase further next year, as a range of support measures are tapered. On the downside, there remain large risks to the economic outlook, including that of further large COVID-19 outbreaks. At present, there are no signs of a significant easing of lending standards and financial exuberance causing a need for macroprudential action. However, there are upside scenarios, where this is plausible in the medium term. Even in these upside scenarios, the recovery is likely to be uneven and targeted macroprudential tools may be more appropriate than an increase in the CCyB which could slow lending more broadly. Allowing banks to use their large capital buffers to support lending is likely to remain the best course of action for some time.

APRA’s recently released consultation on the reform of the ADI capital framework has proposed some changes to the countercyclical capital buffer framework in Australia. These include a 100 basis point default level of the buffer, and a new maximum level of 350 basis points. Establishing a non-zero default level of the buffer will increase APRA’s flexibility to respond to sudden unexpected shocks like COVID-19, and is being introduced with a range of other changes to the capital framework designed to ensure that overall capital levels in the banking system are not increased beyond the ‘unquestionably strong’ benchmarks that the banking system currently meets. The indicators and key considerations APRA will use to set the level of the CCyB from 2023 onward will be developed over the coming year.
## Glossary

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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</thead>
<tbody>
<tr>
<td>ABS</td>
<td>Australian Bureau of Statistics</td>
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<tr>
<td>ADIs</td>
<td>Authorised deposit-taking institutions, which includes banks, building societies and credit unions.</td>
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<tr>
<td>APRA</td>
<td>Australian Prudential Regulation Authority</td>
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<tr>
<td>APS110</td>
<td>Prudential Standard APS 110 Capital Adequacy</td>
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<tr>
<td>Capital conservation buffer</td>
<td>An additional layer of Common Equity Tier 1 Capital above the minimum regulatory requirement that can be utilised in times of stress to absorb losses, subject to constraints on dividends and other distributions. See APS 110 for further information.</td>
</tr>
<tr>
<td>Countercyclical capital buffer</td>
<td>An extension of the capital conservation buffer that can be imposed by APRA to protect the banking sector from systemic risk.</td>
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<tr>
<td>Credit</td>
<td>Credit provided by financial institutions operating domestically.</td>
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<tr>
<td>Credit-to-GDP gap</td>
<td>The difference between the credit-to-GDP ratio and its long term trend.</td>
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<tr>
<td>GDP</td>
<td>Gross domestic product</td>
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<td>LVR</td>
<td>Loan-to-value ratio</td>
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<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
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<tr>
<td>SME</td>
<td>Small and medium enterprise</td>
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APRA requires banks to hold capital to ensure that they can absorb losses, maintain the confidence of their creditors, and continue to lend, even during a severe downturn. Capital protects bank creditors, including depositors, and ensures that the banking system can continue providing its essential payment and lending functions. Most capital requirements for authorised deposit-taking institutions (ADIs) are not varied by APRA over the economic cycle.

The countercyclical capital buffer ('CCyB'), which has been part of APRA’s capital adequacy framework since 2016, is different. This buffer is an additional amount of capital – equivalent to between 0 and 2.5 per cent of risk-weighted assets – that APRA can require ADIs to hold at certain points in the economic and financial cycle. APRA’s primary objective when adjusting the countercyclical capital buffer is to proactively build the resilience of the banking sector during periods of increasing systemic risk. The additional buffer can then be reduced or removed during subsequent periods of stress to reduce the risk of the supply of credit being impacted by regulatory capital requirements. APRA set the level of the countercyclical capital buffer applying to ADIs at zero per cent upon its introduction on 1 January 2016.

In the first half of 2020, APRA decided to maintain the countercyclical capital buffer at zero per cent until at least March 2021. This was the appropriate course of action, given the historically large economic downturn underway in Australia due to COVID-19. It was also consistent with APRA’s decision in March to relax expectations that banks maintain ‘unquestionably strong’ levels of capital during the current downturn. This relaxation in capital expectations was intended to assist banks to absorb losses while continuing to lend to support households and businesses. The practical effects of this relaxation are the same as would have been achieved by lowering a positive CCyB rate to zero – a move that was undertaken by most of the advanced economies that had positive CCyB rates at the start of 2020. Giving banks the ability to support the economy in this way was a key objective of APRA’s long-running program of work to raise bank capital levels.

Current conditions suggest a zero CCyB setting is appropriate and that this is likely to remain the case until at least the end of 2021. While the economic recovery is underway, the scale of the downturn earlier in the year was such that the economy remains significantly weaker than in 2019. The baseline scenario released by the Reserve Bank in November indicated Australian GDP would be unlikely to return to its pre-pandemic level until the end of 2021, and that the unemployment rate would be a bit above six per cent at the end of 2022. Financial stress may well rise further next year, as a range of programs supporting

1 See Media Release: APRA announces countercyclical capital buffer rate for ADIs, 17 December 2015.
4 See Reserve Bank of Australia: Statement on Monetary Policy, November 2020.
household and business finances expire. Downside risks to the economic recovery also remain, including the risk of further large COVID-19 outbreaks. Given this assessment, continuing to allow banks to use their large capital buffers to support lending is likely to remain the best course of action for some time.

There have been no major signs of increased systemic risk and financial exuberance in the extension of household and business credit by ADIs during 2020. Housing credit growth was near historically low levels early in the pandemic, as containment measures prevented some housing transactions. More recently, housing credit growth has been increasing as housing turnover has recovered. Business credit grew quickly in March and April as business sought to bolster their liquidity, but has contracted in recent months. Further declines are likely in the near term as investment intentions are weak and unlikely to pick up much until demand conditions have improved.

Bank lending standards have been tightened somewhat over 2020. This includes ADIs taking into account reductions in income, or increases in the variability of income, that have been experienced by some businesses and households during the pandemic. Recently, the share of new mortgages that have higher loan-to-valuation ratios has risen moderately, likely as a result of increased first-home buyer activity.

National housing prices declined by a small amount between April and September 2020, but have risen modestly over recent months. Larger price falls have been seen in Melbourne and Sydney, consistent with the more severe impact of the current downturn on these areas. Shifts towards working from home and online retail have contributed to falls in the valuations of offices and retail property, and large rises in overall vacancy rates. Some of these behavioural changes may persist and lead to further negative developments in these markets. This will be monitored closely given that a large share of bank losses have been accounted for by commercial real estate lending in past downturns.

Increases in some measures of financial stress, including non-performing loans, have so far been limited. One major reason for this is the significant support being provided to households and businesses by fiscal and monetary policy. Widespread loan deferrals provided by the banks, and supported by regulatory concessions offered by APRA, are another factor. Financial stress is likely to rise next year as some of these programs end. Banks have raised significant provisions against future credit losses likely to arise from this financial stress. While this has lowered their profitability considerably below that of recent years, they remain profitable.

Worse-than-expected rises in financial stress, or downside economic scenarios, could lead to significantly more provisions being required next year, and thus lower bank profitability further. However, stress tests conducted this year by APRA indicate the banking system should remain above its minimum capital requirement even in very severe downside scenarios. The high levels of capital banks entered 2020 with – due to the `unquestionably strong’ capital expectations APRA set out in 2017 – are a key driver of this result.

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There are upside scenarios under which a fast economic recovery could lead to financial exuberance and a need for macroprudential action. Current very low levels of interest rates – necessary to support economies through this period – may create incentives for greater leverage and risky lending over coming years. As always, APRA will carefully monitor these risks. However, even in an upside scenario, the recovery is likely to be uneven. The negative effects of the COVID-19 episode are likely to linger in parts of the economy for an extended period of time, even after health risks diminish. In these upside scenarios, an increase in higher risk lending – to the extent it occurs – is more likely to occur in specific portfolios than to increase across the board. If this were to occur, macroprudential tools which target only the type of lending where risk is increasing may be the better policy choice. Increases in the CCyB increase capital requirements applicable to all types of lending and may slow lending more broadly.

APRA’s recently released consultation on the reform of the ADI capital framework proposes significant changes to the countercyclical capital buffer framework. These changes include a default level of the buffer of 100 basis points. Under the proposed changes, the buffer could be raised above this level in an environment of heightened systemic risk, up to the proposed new maximum level of 350 basis points. Equally, the buffer could be reduced below this default level, including to zero, during future downturns. The indicators and key considerations that APRA will rely on to set the buffer from 2023 onward will be developed over the coming year. One change that may be made is the inclusion of economic forecasts in the indicator set.

Further information on this, including the appropriate level of the CCyB to apply from the commencement of the new capital framework in 2023, are likely to be announced in late 2021.

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7 See Media Release: APRA seeks to enhance flexibility and resilience of ADI capital framework, 8 December 2020
Chapter 2 - Systemic risk assessment

The following section summarises APRA’s current assessment of the systemic risk environment, focusing on developments that have driven countercyclical capital buffer decisions. A key tool in this assessment is a set of core indicators that form part of APRA’s current framework for the countercyclical capital buffer (listed in the table below).

There is no mechanical link between any indicator and the level at which APRA sets the buffer. Buffer decisions are based primarily on judgement, taking into account all available information. Changes in these indicators do not always reflect changes in systemic risk. Other considerations, including the wider prudential context and the macroeconomic outlook are also important, and particularly so this year. This flexible approach is in line with that used by most of the countries that have a countercyclical capital buffer as part of their bank capital framework. When analysing the systemic risk environment, APRA also seeks input from other agencies on the Council of Financial Regulators, particularly the Reserve Bank of Australia.

<table>
<thead>
<tr>
<th>Risk Area</th>
<th>Core Indicators</th>
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<td>Credit-to-GDP gap</td>
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<td>Housing credit growth</td>
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<td>Investor housing credit growth</td>
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<td>Business credit growth</td>
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<td>Commercial property exposures growth</td>
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<td>Household debt-to-income annual change</td>
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<td>Asset prices</td>
<td>Commercial property price growth</td>
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<td>Housing price growth</td>
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<td>Lending indicators</td>
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<td>Financial stress</td>
<td>Non-performing loans</td>
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<td>Return on equity</td>
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Credit growth

Private sector credit grew by two per cent over the 12 months to October, with both housing and business credit growing slowly. In the current environment, credit growth is an important indicator of whether the banking system is continuing to perform its primary function of lending to support investment and other economic activity. There are a range of factors affecting credit growth at present – including weak demand from borrowers facing significant economic uncertainty – that must also be considered. Some credit growth dynamics during 2020 have been driven by actions and measures intended to combat
financial pressures arising from COVID-19, and to support the liquidity position of businesses. Increases in credit growth driven by these dynamics should not be interpreted as indicating an increase in prudential risk.

The credit-to-GDP gap was unchanged over the year to June quarter 2020 at -11 percentage points. The credit-to-GDP gap is the difference between the credit-to-GDP ratio and its long-run trend. Nominal GDP fell by 8 per cent in the June quarter, causing annual GDP growth to slow significantly compared to the prior year. At the same time, broad credit growth slowed to its lowest levels since the GFC. There is likely to be some upward pressure on this ratio over coming quarters, as pre-COVID quarters are removed from the annual GDP denominator. Increases for this reason do not represent the same increase in risk as those driven by faster credit growth. This current dynamic adds to the ever-present need to carefully interpret the signal provided by the credit-to-GDP gap.

Housing credit grew by three per cent over the 12 months to October. All of the growth over the past 12 months was in lending to owner-occupiers, as lending to investors did not grow over this period. The fall in the share of housing lending that is to investors appears to be part of a long run cycle, though this was likely given extra impetus by the weakness in the demand for rental housing during 2020.

Housing Credit Growth

A number of other factors have weighed on housing credit growth during 2020. In the early stages of the pandemic there was a fall in new housing loans, due to a decline in housing turnover when containment restrictions were in place. Furthermore, household savings have increased to historically high levels contributing to an increase in excess repayments. Savings were boosted as households reduced their spending in line with limited consumption opportunities due to lockdown restrictions and precautionary financial behaviour. Notably, there has been a large increase in offset account balances, which are not accounted for in

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8 The long-run trend is calculated using a one-sided Hodrick-Prescott filter, a tool used in macroeconomics to establish the trend of a variable over time. For more information see Basel Committee, Guidance for national authorities operating the countercyclical capital buffer, December 2010.
credit growth. Doing so would reduce housing credit growth to just two per cent over the 12 months to October. In addition, mortgage repayment deferrals have contributed to higher housing credit growth, given deferrals involve the capitalisation of interest into loan balances.

More recently, housing loan commitments have strengthened, indicating housing credit growth is likely to increase in coming months. This primarily reflects a large increase in owner-occupier loan commitments in all states and territories except Victoria over recent months, which includes the increase in first home buyer activity. Some increase in housing turnover and borrowing is consistent with a ‘catch-up’ due to some activity having been delayed by containment measures and restrictions earlier in the year. The Government’s Homebuilder and First Home Loan Deposit schemes have also likely been supporting housing turnover and loan commitments. The Homebuilder scheme is likely to have brought forward some sales due to the requirement that a contract is signed by the end of the year to qualify for the initial scheme.
Business credit grew by around one per cent over the year to October. The onset of COVID-19 contributed to a sharp increase in business credit in March and April, with businesses increasing their liquidity due to concerns over reduced revenues and future access to credit. In subsequent months, as some uncertainty subsided, many businesses sought to reduce their credit outstanding, particularly through revolving credit facilities. Fiscal policy measures (including the JobKeeper and Boosting Cashflow for Employers programs) also increased the liquidity position of businesses, reducing the need for businesses to borrow. In addition, demand for new loans from businesses has declined. This increased caution is unsurprising given continuing high levels of uncertainty about the economic outlook. Loan repayment deferrals for small and medium enterprises boosted credit outstanding to this segment, but the impact of this on total business credit growth is small.

![Business Credit Growth](image)

**Business Credit Growth**

Annual

Source: RBA

**Asset prices**

House prices have been fairly resilient so far during the pandemic. At a national level, prices fell from April to September, but have risen in recent months. This national outcome reflects uneven changes across the country and in different segments of the market. The largest falls were in Sydney and Melbourne, where prices declined by two and four per cent respectively from April to November. All other capital cities and many regional areas had positive growth over this period. More recently, detached housing has outpaced apartments, with continued declines in some apartment markets.

These price dynamics represent the diverse range of current influences on the housing market. Lower migration and falls in income for some parts of the population are lowering demand in some areas. In contrast, record-low mortgage rates and demand for extra space, given the additional time spent in homes, are likely raising demand across the country. Strong policy measures supporting household incomes, as well as mortgage deferrals, have supported prices, including by preventing forced sales.

These opposing factors present both upside and downside risks to house prices in 2021. The end of many policy measures, including mortgage deferrals, in the first half of 2021 is a key downside risk. An increase in forced sales could place downward pressure on prices,
although this may be offset by factors such as record low mortgage rates. Some forward-looking housing indicators, such as auction clearance rates, have strengthened over recent months.

COVID-19 has led to changes in some of the dynamics that have driven property prices over recent years, such as population growth. Overall, larger house price falls during 2020 tended to be concentrated in areas that experienced rising prices over preceding years. Prices in Melbourne, for example, rose by 30 per cent over the five years to the end of 2019. Prices in Perth, which experienced a price fall of around 20 per cent over the five years to the end of 2019, have risen slightly during the COVID period. This negative correlation between pre-COVID and during COVID developments has likely supported the housing equity position of Australian households. This can be seen by looking at the share of areas where prices are 20 per cent or more below their post 2010 peak. So far, this share has fallen slightly during 2020.
Around 7 per cent of bank lending is used to invest in commercial real estate, or is secured by this asset class. Different parts of the commercial real estate market have had different outcomes so far during the pandemic. Rents and valuations for industrial properties, such as warehousing and distribution assets, have risen due to the shift towards online shopping. Valuations in this segment have risen by around 8 per cent over the year to September 2020. The flipside of this dynamic has been falling valuations and rents for retail properties. Vacancy rates for retail properties have risen sharply this year, especially in CBDs. This follows an upward trend that had already been underway prior to COVID-19. Retail property valuations have fallen by around 9 per cent over the last year.

The office property market has been affected by the economic downturn and the shift towards remote working. This, together with increased office supply, has contributed to an increase in office vacancy rates, particularly in Sydney and Melbourne. Valuations of offices have started to fall, declining by around 4 per cent in September in six-month annualised terms. Low transaction volumes during the pandemic increase the uncertainty present in valuation estimates. A major question for this market is the extent to which the increase in remote working will persist in the longer term.

**Lending indicators**

Lending standards tightened somewhat for both residential mortgage and business lending during the pandemic. However, most of the tightening of lending standards reflects a tighter application of existing standards given the uncertain economic situation. This includes accounting for reductions in income, or increases in the variability of income, that have been experienced by some businesses and households during the pandemic.

The share of new housing lending undertaken at a loan-to-value ratio (LVR) of 90 per cent or more was broadly unchanged over the year and remains significantly lower than levels prevailing in 2014. The share lent at an LVR between 80 and 90 per cent increased moderately over the year. This is likely in part due to first home buyers, who tend to borrow at a higher LVRs, accounting for an increased share of new borrowing during the pandemic. The Government’s First Home Loan Deposit Scheme, policies encouraging the purchase of newly built dwellings, and lower mortgage rates, are likely supporting demand from first home buyers.
Higher-risk Housing Lending
Share of new lending*

Source: APRA
* The series break is due to the introduction of a new data collection in June 2019. The previous collection shows share of new loan approvals and the new collection shows share of new loans funded.

APRA’s credit conditions and lending survey suggests ADIs expect to ease some housing lending standards over the next 12 months as a reversion of initial tightening measures at the onset of COVID-19. This is in line with the reopening of the economy and better-than-expected housing market conditions.

Discussions with lenders suggest that most of the slowing in business credit growth appears to be due to weak demand for credit, rather than any notable reduction in the supply of credit. Weak business demand for credit is understandable, given the high level of economic uncertainty and the weak outlook for business investment. It is also consistent with the pattern of weak business credit growth in a period when interest rates for loans to small, medium and large businesses are very low. Consistent with the outlook for parts of this sector, standards have also been tightened for lending to parts of the Commercial Real Estate sector.

Financial stress

The aggregate non-performing loan ratio for banks increased over the year to September, with both business and housing non-performing loans (NPLs) rising during the year. Despite this, NPLs remain low compared to past downturns, with a range of factors likely keeping NPLs low at present. Fiscal programs supporting household and business incomes, the early release of superannuation and low interest rates are likely having a large effect on reducing financial stress. Banks’ deferral programs for housing and SME loans, and APRA’s actions to allow banks to not treat deferred loans as non-performing, are also very important factors. It is reasonable to expect a rise in NPLs as these programs end in 2021.
Housing loan repayment deferrals peaked at 11.3 per cent of loans in May. By the end of October they had fallen to 3.9 per cent of loans. Importantly, less than 2 per cent of the housing loans exiting deferral over this period have moved to non-performing. Similarly, the share of SME deferrals peaked at 18.1 per cent in May and has since fallen very sharply to 4.5 per cent in October. Around 1 per cent of SME loans exiting deferral over this period became non-performing. Better-than-expected economic outcomes over 2020, as well as strong fiscal support, have likely assisted this large transition back to normal financial arrangements. The borrowers who have had their financial situations most severely affected by the COVID-19 downturn are likely among those who remain on deferrals.

Consistent with the impact of the pandemic on the economy, banks have raised their provisions for future credit losses during 2020, and this has lowered their profitability. The banking system’s return on equity was around 6 per cent over the year to September 2020, down from an average of 12 per cent over 2017-19.
Other considerations

The economic environment and outlook, existing levels of banking system resilience, and the broader operating environment, are also important when assessing the overall level of systemic risk and setting the countercyclical capital buffer.

The Australian and global economies remain in the midst of a historically large downturn driven by the economic impacts of the COVID-19 pandemic. While health and economic outcomes have been better in Australia than in many other advanced economies, the economic impact has been very large compared to past downturns. Many current baseline forecasts, including those from the Reserve Bank, predict Australian GDP will not reach its pre-COVID levels until the end of 2021 and that unemployment will remain elevated in coming years. Economic outcomes in the near term will continue to be heavily influenced by Australia’s level of success in containing COVID-19, and domestic and international experience has shown this can change rapidly.

Consistent with its mandate, APRA has run internally modelled stress tests that assess the resilience of the banking system including to a severe downside scenario. This scenario is premised on much worse COVID-19 outcomes than have been seen so far in Australia, together with much tighter containment restrictions. Overall, this stress testing indicates the banking system can withstand even this severe downside scenario.

Capital ratios rose for many banks over 2020, as banks reduced dividend payments based on the high degree of economic uncertainty and guidance from APRA. The system aggregate CET1 level rose from 11.0 per cent in September 2019 to 11.8 per cent in September 2020. This is comfortably above the aggregate level of capital likely to be required when the changes to the ADI capital framework come into force at the end of 2023. As noted, these changes, which are still subject to consultation and so may change, are likely to include a

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non-zero default level of the CCyB. The recently released consultation proposed that the default level would be 100 basis points. A positive default level of the CCyB would provide APRA with flexibility to respond quickly to future economic and financial shocks.

See Media Release: APRA seeks to enhance flexibility and resilience of ADI capital framework, 8 December 2020
## Table of indicators

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<th>Core indicators</th>
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<th>Sep 16</th>
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<td>-1</td>
<td>-1</td>
<td>-3</td>
<td>Not yet available</td>
</tr>
<tr>
<td>Asset prices</td>
<td>Housing price growth*</td>
<td>-1%</td>
<td>0%</td>
<td>6%</td>
<td>11%</td>
<td>11%</td>
<td>9%</td>
<td>5%</td>
<td>0%</td>
<td>-2%</td>
<td>-2%</td>
<td>-4%</td>
<td>-8%</td>
<td>-10%</td>
<td>-6%</td>
<td>3%</td>
<td>11%</td>
<td>12%</td>
<td>4%</td>
<td>-2%</td>
</tr>
<tr>
<td>Lending conditions</td>
<td>LVR≥90 share of new housing lending</td>
<td>11%</td>
<td>11%</td>
<td>11%</td>
<td>10%</td>
<td>10%</td>
<td>9%</td>
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</tr>
<tr>
<td>Financial Stress</td>
<td>Aggregate NPL ratio</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
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<td>0.9%</td>
<td>0.9%</td>
<td>1.0%</td>
<td>1.1%</td>
<td>1.1%</td>
</tr>
<tr>
<td></td>
<td>Return on Equity - quarterly</td>
<td>5%</td>
<td>12%</td>
<td>11%</td>
<td>13%</td>
<td>11%</td>
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<td>11%</td>
<td>1%</td>
<td>9%</td>
<td>4%</td>
<td></td>
</tr>
</tbody>
</table>

* Six-month-ended annualised growth; expressed in per cent

** Expressed in percentage points

Source: APRA, RBA, ABS, Corelogic

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