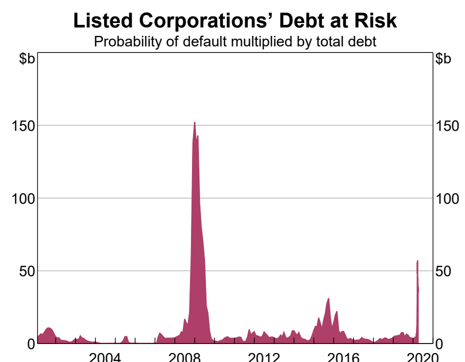
2. Household and Business Finances in Australia

Australian businesses and households are mostly well placed to face the large contraction in economic activity associated with the COVID-19 pandemic although it will test their financial resilience. As a result of the shock, many businesses have limited or no income, and many workers have been stood down, at least temporarily. But most businesses and households entered this difficult period in good financial health, with large cash and/or equity buffers to help withstand a temporary fall in income. Significant fiscal and monetary policy stimulus, as well as measures introduced to help affected households and businesses to manage their debt and rent obligations, will also support them. Preserving the financial positions of households and businesses will aid the ultimate economic recovery when the health crisis passes.

Most businesses were in good financial health before the pandemic. However, some pockets of vulnerability were evident in the retail trade, food and accommodation services, agricultural and construction sectors. Businesses in these industries typically have high levels of gearing and low levels of liquidity, making them especially vulnerable to significant declines in cash flow. The sharp decline in economic activity is placing additional stress on these already challenged sectors but will also test the resilience of some businesses that were previously in good health. There are signs of corporate vulnerability increasing, with financial market pricing of risk for publicly listed companies rising sharply (Graph 2.1).

Most households had sizeable cash and/or equity buffers going into the economic downturn. Many affected workers will have access to wage subsidies and superannuation balances to compensate for lost income, and repayment deferment will also provide a safety net for those households that would otherwise struggle to service their obligations. These factors will help households manage their debts during this difficult period. However, other households are not as well placed to withstand the downturn. To date, a large number of workers have been stood down, and many jobs have already been lost or are expected to be lost in the period ahead. The associated uncertainty is clearly weighing on household perceptions of their own financial situation (Graph 2.2).



* Calculated up to 6 April 2020, using a sample of the 300 largest (by debt) non-financial domestically-domiciled firms listed on the ASX

Sources: Bloomberg; Morningstar; RBA

Business sector conditions are deteriorating

Business balance sheets were generally in a good state before the economic downturn driven by the temporary health crisis. Liquidity and profitability were at high levels, gearing ratios were low, and the ability to service debts had risen significantly alongside reductions in interest rates. However, the adverse shock to business conditions is already large and expected to grow substantially. Fiscal and banking support will help businesses, but many will struggle. Revenues for many firms servicing the household sector – including those in the retail trade, food and accommodation services, and tourism industries – have dried up. Some firms have already closed, at least temporarily. Many have stood down workers. Economic activity across a wider range of industries has subsequently fallen, as flow-on effects work though manufacturing supply chains and business services.

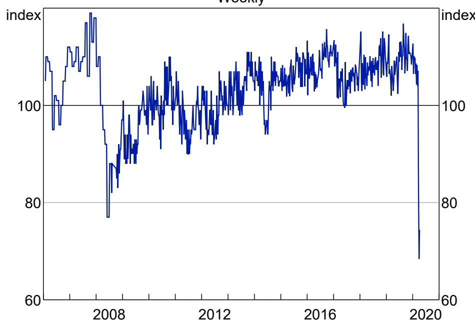
The impact of the COVID-19 pandemic in Australia was initially most pronounced for tourism and education-related industries. Demand had dropped, starting with restrictions on travel from mainland China at the start of February. Widespread restrictions in the domestic economy have progressively resulted in a broader and more pronounced impact through March. Some retailers, such as supermarkets, have experienced high levels of demand, and this has raised their short-term cash flow. But many other businesses in industries such as cafes, restaurants and accommodation services, and arts and recreational services, have been severely affected, in many cases temporarily closing. Alongside the unexpected decline in cash flow, these businesses tend to be more geared and more illiquid than those in other industries (Graph 2.3). The challenges faced by businesses in regional communities are compounded by the effects of the drought and the recent bushfires.

Despite the healthy state of listed corporates' balance sheets ahead of the pandemic and substantial government support, the size of the shock will still test the financial resilience of many businesses. About one-quarter of businesses typically do not have enough liquid assets to cover one month of expenses (including wages) and closer to half could not pay for three months of expenses. Valuations for listed corporates have declined sharply from late

Graph 2.2

Households' Financial Position Compared with a Year Ago

Weekly

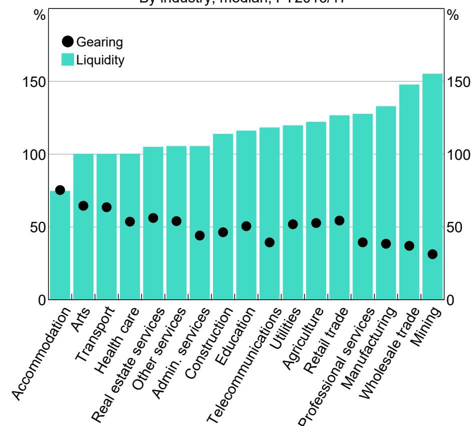


Source: ANZ-Roy Morgan

Graph 2.3

Businesses' Liquidity and Gearing Ratios

By industry, median, FY2016/17*



* Liquidity is calculated as the ratio of current assets to current liabilities, gearing is calculated as the ratio of debt to total assets (excludes firms with no debt)

Sources: ABS; RBA

February, and a number of listed corporates have suspended forward earnings guidance due to the uncertainty around the outlook for economic activity.

Business failures had been at low levels (Graph 2.4). However, increases in business failures and loan arrears are likely over the coming months, even with the policy measures designed to minimise insolvencies and offset any tightening in credit availability and cost (see 'Annex: Selected Policy Responses to the COVID-19 Pandemic'). There is considerable uncertainty around the trajectory of the economic shock and subsequent recovery. Firm-level analysis suggests that a decline in annual sales of, for example, 20 per cent would lead to an increase in the annual business exit rate (failures as well as takeovers etc) from around 8 per cent to 9½ per cent. This would be an increase of around 35,000 business exits. However, this estimate is based on historical data and does not explicitly account for government policy measures designed to temporarily raise business cash flow.

Generally, a substantial rise in loan losses would be expected to result in a tightening in the supply of credit to businesses. There have therefore been significant policy measures implemented to avoid this effect. These measures will help to support businesses through the coming months in terms of both liquidity and credit availability, and this will better position them for the recovery that will follow.

Many households have enough liquid assets to manage temporary falls in income …

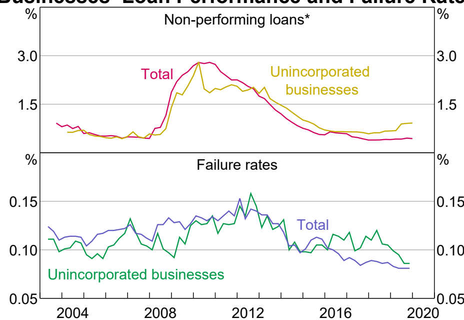
Most households entered this difficult period in good financial health. Surveys indicate that most households had enough liquid assets to cover basic living expenses and current obligations, such as mortgage and rent payments, for three months (Graph 2.5). Households with mortgage debt typically had sizeable liquidity and/or equity buffers. Among these borrowers, over half of these loans had enough prepayments to service their loan repayments for at least three months (Graph 2.6).

… but some households have little savings and are vulnerable to financial stress

There were some pockets of vulnerability prior to the pandemic, with some households having

Graph 2.4

Businesses' Loan Performance and Failure Rates



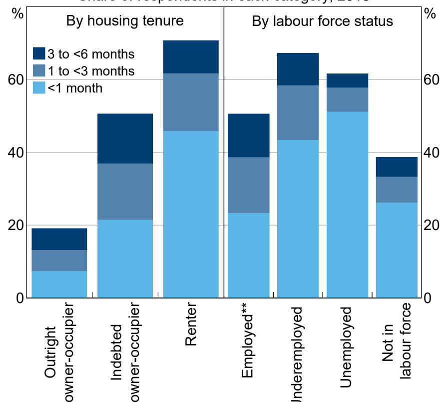
* Banks' domestic books, share of business assets

Sources: AFSA; APRA; ASIC; RBA

Graph 2.5

Household Liquidity Buffers*

Share of respondents in each category, 2018



* Buffers measured as a ratio of liquid assets to monthly living expenses. Liquid assets include bank accounts, cash investments, equity investments, and housing loan prepayments; monthly expenses include minimum repayments on owner-occupier debt, rental payments, and living expenses

** Does not include underemployed

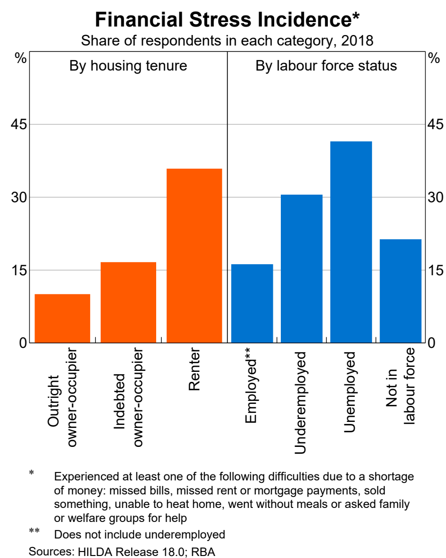
Sources: HILDA Release 18.0; RBA

less liquidity to manage declines in income. Surveys indicate that about one in five households only have enough liquid assets to get from one pay period to the next. These liquidity constrained households are typically young, twice as likely to be renting and twice as vulnerable to unemployment compared with other households. Amongst households with mortgage debt, just under one-third of mortgages have less than one month of prepayments, and about half of these appear particularly vulnerable to a sharp decline in income.

These households with small liquidity buffers are much more likely to report being in financial stress, regardless of their age, income or labour force status. More than one-third of renting households typically report in surveys that they have experienced financial stress in a given year (such as difficulty paying bills or having to go without meals) (Graph 2.7). The most vulnerable include those working in jobs more exposed to unemployment risk, such as casual workers, and those in industries most affected by the COVID-19 containment measures, such as accommodation and food services. Workers in these most exposed industries are both more likely to rent and more likely to be liquidity constrained (Graph 2.8). Additional income support and wage subsidies provided by the Australian Government will help many of these affected workers.

Increasing financial stress among renting households does not pose direct risks to the banking sector because these households typically hold little debt. But they pose indirect risks if they have trouble paying rent, and their landlords in turn have trouble making their own debt repayments. Mortgage repayment

Graph 2.7

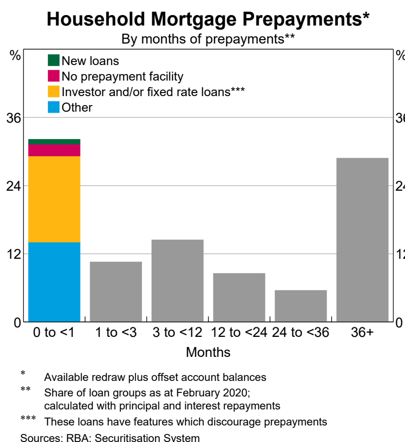


* Experienced at least one of the following difficulties due to a shortage of money: missed bills, missed rent or mortgage payments, sold something, unable to heat home, went without meals or asked family or welfare groups for help

** Does not include underemployed

Sources: HILDA Release 18.0; RBA

Graph 2.6



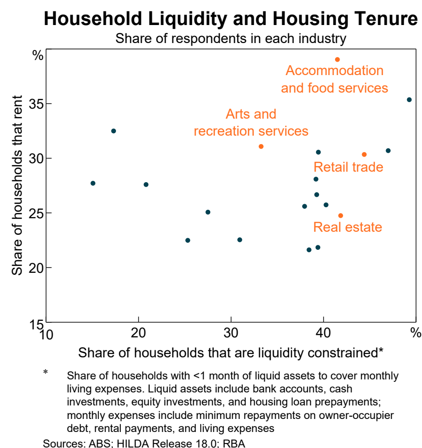
* Available redraw plus offset account balances

** Share of loan groups as at February 2020; calculated with principal and interest repayments

*** These loans have features which discourage prepayments

Sources: RBA; Securitisation System

Graph 2.8



* Share of households with <1 month of liquid assets to cover monthly living expenses. Liquid assets include bank accounts, cash investments, equity investments, and housing loan prepayments; monthly expenses include minimum repayments on owner-occupier debt, rental payments, and living expenses

Sources: ABS; HILDA Release 18.0; RBA

deferment by lenders should reduce these risks for now. To assist tenants, governments have also agreed to a moratorium on evictions for those tenants unable to pay rent due to a loss of income resulting from the COVID-19 pandemic.

For those with mortgage debt, a household member losing their job or having their working hours reduced is typically associated with greater financial stress. If labour market dislocations and associated debt serviceability problems persist, this could translate into more mortgage loans entering arrears. Analysis based on loan-level data and historical relationships indicates that, for every one percentage point increase in the unemployment rate, the mortgage arrears rate increases by about 0.8 percentage points. In response, the major banks have announced they will allow loan repayments to be deferred for up to six months to help homeowners having difficulty meeting repayments (see 'Annex: Selected Policy Responses to the COVID-19 Pandemic').

There are some risks from property markets

A key financial stability risk is the extent to which the weakness in economic activity spills over to the housing and commercial property markets. The prospect of large declines in property prices presents significant balance sheet risks for households, businesses and lenders.

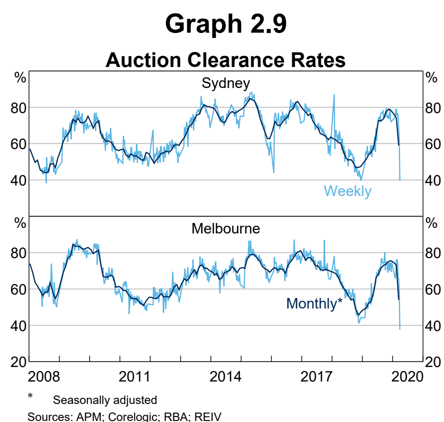
The shock to economic activity, and associated uncertainty, has caused a decline in demand in the residential property market, and this will increase the incidence of negative equity if prices decline. The containment measures, including government restrictions on auctions and open inspections, will lower housing turnover. In turn, the significant reduction in housing turnover will make it difficult to accurately assess changes in housing prices in the period ahead. Auction volumes and clearance rates have declined sharply in Sydney and Melbourne in recent weeks (Graph 2.9).

Consistent with this, liaison with banks suggests housing loan applications are falling and information from housing contacts in the Bank's liaison program also report much lower foot traffic through display homes.

For households behind on their repayments and with little equity in their homes, very low turnover and declines in housing prices will make it harder to resolve their situation by selling their properties. Scenario analysis based on loan-level data and historical relationships suggests that a decline in housing prices of 10 per cent would raise the share of loans in negative equity by 3½ percentage points, to 6½ per cent. This is shown by an increase in the share of loans with loan-to-valuation (LVR) ratios exceeding 100 per cent (Graph 2.10). The share of loans in negative equity would increase by proportionately more for larger price declines. A higher incidence of negative equity increases the risks of losses ultimately incurred by lenders in the event of foreclosure.

Conditions in commercial property markets are deteriorating

Prior to the pandemic, the retail commercial property market was facing challenging conditions due to weak consumer spending and heightened competition. The outlook for tenant demand for retail property has deteriorated



* Seasonally adjusted
Sources: APM; Corelogic; RBA; REIV

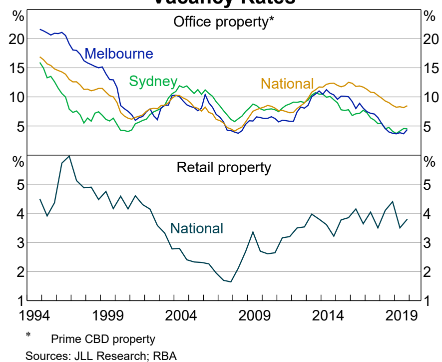
given the downturn in trading conditions, with declines in rents and increases in vacancy rates now likely (Graph 2.11). Conditions in office markets were previously strong, but these are also expected to deteriorate in the period ahead. Of note, an above-average volume of office supply is due to be delivered into the Sydney and Melbourne CBD markets this year and demand will be unlikely to keep pace with this stronger supply (Graph 2.12).

In light of the disruption to trading conditions in the commercial property market, and the potential impact on rental income flows, a mandatory Code of Conduct has been set up that outlines leasing principles for eligible tenants and landlords in the period ahead (see 'Annex: Selected Policy Responses to the COVID-19 Pandemic). Temporary measures include prohibiting the termination of leases for non-payment of rent, and introducing guidelines for rental waivers and deferrals (to be negotiated by landlords and tenants on a case-by case basis and based on the reduction of the tenant's trade). These measures will help support many small business tenants that will experience financial stress as a result of COVID-19.

Asset valuations in property markets had increased to very high levels over recent years, both in Australia and overseas (Graph 2.13). In the period ahead, declines in both sales volumes and valuations are likely, reflecting the weakness in the rental market and a repricing of risk by institutional investors. For some geared investors, falling valuations will see them breach loan covenants, which will need to be worked through with lenders. For developers with projects still under construction but with currently unsold properties, it could be difficult to finalise sales at a profitable price. Developers will then be left holding inventory – and debt – on their balance sheets with little or no revenue. This is a key risk for lenders. Banks have incurred substantial losses from construction loans in

Graph 2.11

Vacancy Rates



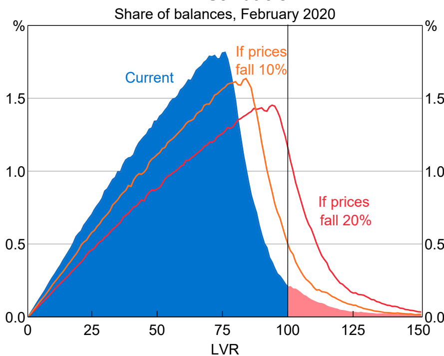
* Prime CBD property

Sources: JLL Research; RBA

Graph 2.10

LVR Distribution*

Share of balances, February 2020



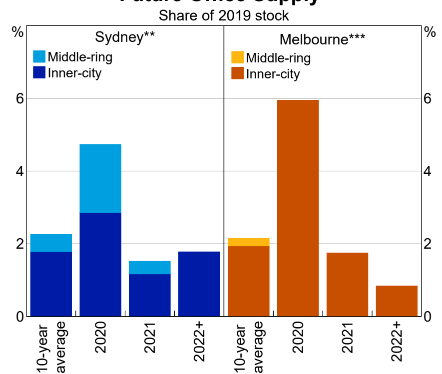
* Loan balances adjusted for redraw and offset account balances; property prices estimated using SA3 price indices

Sources: ABS; CoreLogic; RBA; Securitisation System

Graph 2.12

Future Office Supply*

Share of 2019 stock



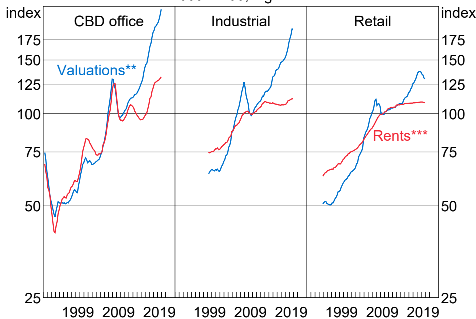
* Completed projects and projects under construction

** 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

past downturns, and while construction lending accounts for a small share of business lending, it has grown rapidly recently. Overall, banks' commercial property exposures as a share of total bank assets are around 6 per cent. Non-bank lenders are particularly active in lending for the construction of commercial property, including apartments.



* 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