2. Household and Business Finances in Australia

The large contraction in economic activity caused by the COVID-19 pandemic is testing the resilience of some Australian households and businesses. A broad range of income support policies are softening the effect of the economic downturn. However, there is a high level of uncertainty about how big and how long the downturn will be. It is likely that many businesses will not fully recover. Financial stress will rise for some households to the extent that the unemployment rate increases in the near term and as short-term policy support tapers off. However, an overwhelming majority of households remain well placed to service their debt. Many have increased their financial resilience through higher mortgage prepayments, paying down personal credit balances, and increasing their savings. Overall, businesses entered 2020 in good financial shape, but have since experienced sharp falls in revenue. Most have withstood the economic contraction so far, with the support of government initiatives and private lenders. As the downturn persists and the support starts to unwind, however, it is likely that business failures will rise. Vacancy rates for office and retail commercial properties have already risen, particularly for shopping centres. A prolonged loss of rental income would weaken the financial position of landlords, including their ability to repay their debts. An increase in business sector weakness would affect workers and therefore households.

While households generally also started the year in a good financial position, many workers have lost their jobs or had their hours reduced. The income support policies have helped considerably, though there are signs of growing financial stress. The share of households behind on loan repayments has risen and is expected to increase further. Borrowers who have deferred loan repayments will, at some point, need to resume repayments. While housing prices have declined only modestly to date, they could fall further given weak population growth and the potential that some mortgage holders in financial difficulties sell their properties. Price falls would erode homeowners' equity and increase losses to banks in some cases, though the vast majority of loans are very well collateralised.

Income support policies have helped to maintain the cash flow of most businesses, despite sharp falls in revenue

Many businesses have faced enormous disruptions to their trading. In aggregate, small business revenue has fallen by 15 per cent since March, with larger declines for businesses operating in Victoria (Graph 2.1). However, aided by the support policies, small business cash flow – measured by bank deposit inflows – has been little changed in aggregate. While deposit inflows for small businesses have declined significantly in some hard-hit industries, including arts and recreation services and accommodation and food services, they have increased in others.

The support policies have increased cash flow through either direct government subsidies or by significantly reducing expenses, including labour costs and loan repayments. About 11 per cent of small business loans were deferred as of August, with four-month extensions available on a case-by-case basis. These measures, along with temporary insolvency relief policies, have contributed substantially to the decline in business failures observed since the start of the year (see 'Box B: Business Failure Risk in the COVID-19 Pandemic').

Business cash buffers have increased amid greater uncertainty …

Business cash buffers have increased markedly since the start of the year. Before the pandemic, around half of Australian businesses had enough cash on hand to pay their expenses for less than one month (Graph 2.2). By June 2020, more than 40 per cent of businesses reported they had sufficient savings to cover their current expenses for more than six months, partly due to the level of income support. Large corporates appear particularly well placed in terms of cash buffers, having significantly increased their cash holdings during the pandemic, including through reducing expenses and drawing down credit lines.

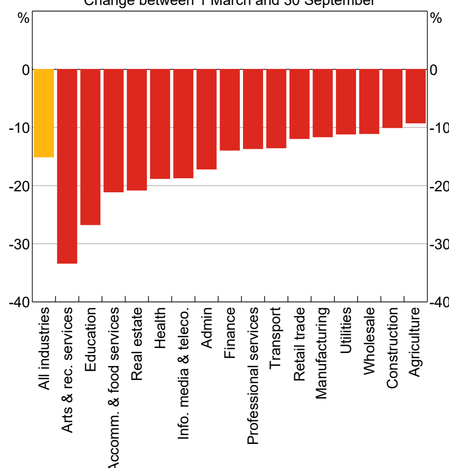
The majority of businesses are well placed to service their debts given the extent of income support, as well as low levels of gearing and falls in interest rates over recent years (Graph 2.3). Fiscal measures that allow companies making losses up to June 2022 to claim back taxes paid in years up to June 2019 will further support cash flow for many businesses. Despite the policy support, some businesses are facing more challenging circumstances. The capacity to service debt appears to have fallen in recent years for companies least able to pay (as shown by the gradual decline in the interest coverage ratio for the firm at the 25th percentile).

At least 10–15 per cent of small businesses in the hardest-hit industries still do not have enough cash on hand to meet their monthly expenses. These businesses are in a tenuous position and are particularly vulnerable to a further deterioration in trading conditions or the removal of support measures. Survey evidence indicates that about one-quarter of small businesses currently receiving income support would close if the support measures were

Graph 2.1

Small Business Sales*

Change between 1 March and 30 September



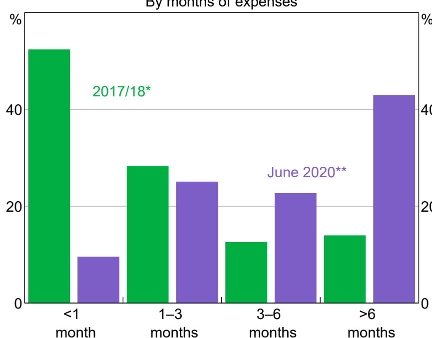
* Underlying data are weekly

Sources: MYOB; RBA

Graph 2.2

Distribution of Business Cash Buffers

By months of expenses



* Firm-level estimates drawn from BLADE

** Estimates from ABS business survey and are not fully comparable with the firm-level estimates due to differences in definitions and coverage

Sources: ABS; RBA

removed now, before an improvement in trading conditions.

… though business failures are expected to increase

Business failures will increase, although there is a high degree of uncertainty about the magnitude and timing. It will depend on the strength of the economic recovery, which will be influenced by the duration and severity of future COVID-19 related disruptions, and the timing and extent of the unwinding of the various support measures (see 'Box B: Business Failure Risk in the COVID-19 Pandemic'). Bankruptcies and insolvencies are currently very low because of the income support, loan repayment deferrals and temporary insolvency relief (Graph 2.4).

Tenant demand for commercial property is falling, especially in retail

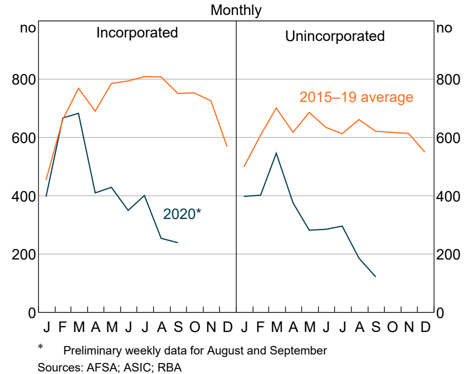
Vacancy rates for commercial property are rising, putting pressure on commercial landlords. This has been particularly pronounced in the retail sector which was experiencing challenges before the pandemic. Retail vacancies rose sharply over the first half of 2020. The biggest increase has been in central business districts (CBDs), where vacancy rates have risen to over 10 per cent (Graph 2.5). Further increases in vacancy rates are likely and department stores have accelerated planned closures. In contrast, conditions in the industrial property market are more favourable, with liaison suggesting increased demand for warehouses and distribution centres since March, driven by the accelerated shift towards online retailing and strength in food sales.

Office vacancy rates have risen in most capital cities, and from near-record lows in Sydney and Melbourne (Graph 2.6). Demand for office space is expected to decline in the near term given staff working from home and reduced economic activity, and potentially in the longer term as

Graph 2.4

Business Failures

Monthly



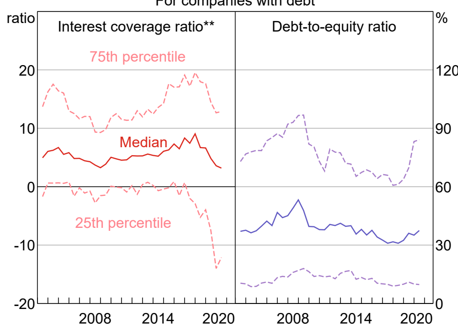
* Preliminary weekly data for August and September

Sources: AFSA; ASIC; RBA

Graph 2.3

Corporate Debt Servicing Indicators*

For companies with debt



* Excludes all companies in the resource and financial sectors

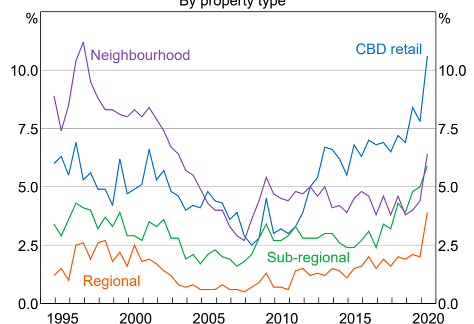
** Interest coverage measured as the ratio of earnings before interest, tax, depreciation and amortisation (EBITDA) to gross interest payments

Sources: Morningstar; RBA

Graph 2.5

Retail Vacancy Rates*

By property type**



* Vacancy rates for specialty stores

** Regional centres are anchored by department stores, sub-regional by discount department stores and neighbourhood by supermarkets

Sources: JLL Research; RBA

businesses reconfigure how they work. Secondary-grade offices appear particularly vulnerable to falling demand, as tenants are often enticed by lower rents during downturns to upgrade to better premises. At the same time, an above average volume of new office buildings will have been completed in Sydney and Melbourne in 2020, increasing supply. While most of these new buildings have pre-committed tenants, it will put further pressure on vacancy rates in second-grade buildings.

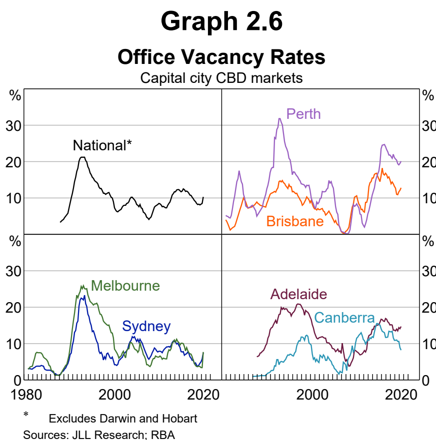
Commercial property investors would incur losses if prices fell sharply

Given the deterioration in rental conditions already underway, office and retail property prices could fall sharply. Investors could substantially re-evaluate risks and pull back demand, which had contributed to strong office price growth over the past decade, particularly in Melbourne and Sydney (Graph 2.7). Similarly, the economic downturn is likely to accelerate the contraction in retail property prices, which had already declined by around 10 per cent on average between late 2018 and the middle of this year. This raises the potential for leveraged investors to breach loan covenants, requiring a review of their situation with their lenders. With commercial property valuations being so uncertain APRA released guidance that authorised deposit-taking institutions (ADIs) may defer revaluations for existing commercial property collateral until 31 March 2021.

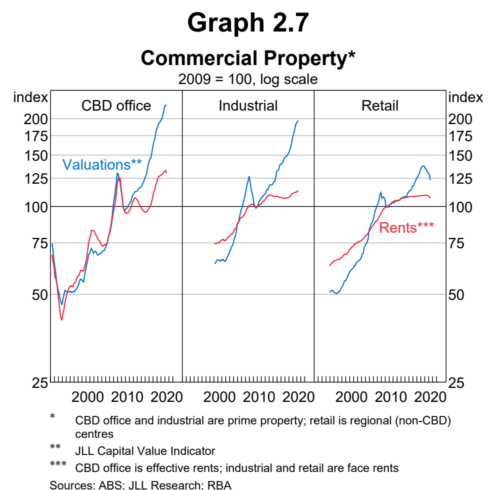
The outlook for commercial property means banks' impairment rates are likely to increase from their current low levels. Some indebted landlords will find it difficult to meet their debt repayments, given rising vacancies and declining rents. Risks appear highest for retail commercial property. However, banks are better placed than in the downturns in the 1990s and 2007/08 as prudent lending standards have been maintained over the past few years. Banks' direct exposures to commercial property as a share of assets are only 6 per cent, around 2 percentage points lower than before the GFC. Banks' effective exposures to commercial property are somewhat higher than this as some business loans are secured by commercial property.

Some households have experienced significant falls in income, but many have been able to save and most are continuing to repay their debt

Some households have experienced significant falls in income due to job losses, reduced working hours and lower wages. For those



* Excludes Darwin and Hobart
Sources: JLL Research; RBA



* 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

affected, cash flow has been underpinned by government income support policies, loan repayment deferrals, and low interest rates. As at July 2020, around 30 per cent of Australia's working age population was receiving JobKeeper, JobSeeker or equivalent payments. Around 3 million requests for early access to superannuation have been processed, equivalent to 10 per cent of quarterly household income. A considerable portion of the superannuation withdrawals has been saved through either paying down debt or building deposits. Household saving rates increased sharply in the June quarter for each of renters, mortgagors and outright homeowners (Graph 2.8). A key uncertainty is the extent to which those households that have strengthened their financial position by saving extensively will run down these savings to support consumption in the coming period. However, fiscal measures to support low and middle income households, including income tax cuts, will help to support households' financial position and spending going forward.

Despite unprecedented income support, some households have experienced significant falls in income due to job losses, lower wages or reduced working hours. Others face heightened income uncertainty and job insecurity. To date, job losses and reduced working hours have been most pronounced for younger workers. Individuals with mortgages have historically had lower rates of unemployment than renters, although both groups have experienced increasing unemployment over 2020 (Graph 2.9). With further increases in unemployment expected, more households will experience financial stress.

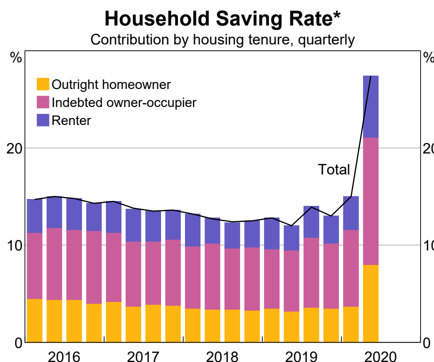
In response to the difficult economic conditions, repayments were deferred on around 7 per cent of housing loans by number at the end of August 2020. This share is down from a peak of 8 per cent in June, partly reflecting the recovery underway in many parts of the country. Bank liaison suggests that some borrowers deferred repayments for precautionary reasons. APRA data suggest that around one in ten loans recorded full repayments while deferred. This may understate the share of borrowers who have not changed the amount they are putting toward their mortgage to the extent that it does not include payments into offset accounts.

The shares of deferred loans have been similar across the states and territories, although they are slightly higher in Victoria reflecting the extended lockdown measures. Deferral rates have been highest for borrowers working in industries most affected by the pandemic such

Graph 2.8

Household Saving Rate*

Contribution by housing tenure, quarterly

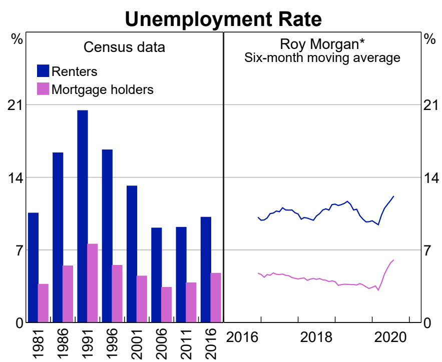


* Average saving estimated as the difference between net household income and expenses; average saving of each group weighted by 2016 Census housing tenure shares

Sources: ABS; RBA; Roy Morgan

Graph 2.9

Unemployment Rate



* Respondent is considered to be 'unemployed' if they indicate they are looking for work (broader than ABS definition); benchmarked against 2016 Census

Sources: ABS; RBA; Roy Morgan

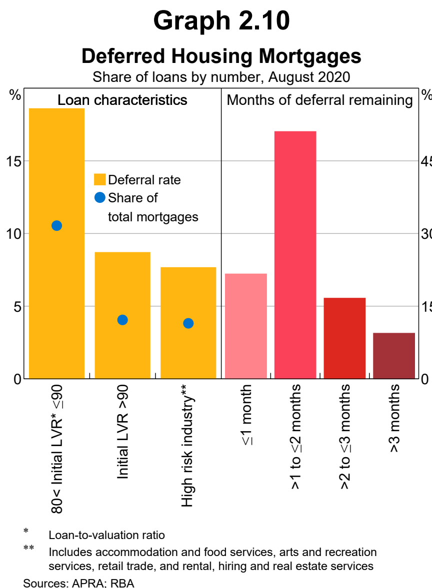
as tourism and retail trade, and in regions where a higher share of employees have received JobKeeper payments (Graph 2.10). Deferred loans tend to have higher current loan-to-valuation ratios and lower prepayments. About three-quarters of deferred loans have prepayments of less than three months' worth of repayments. This is a larger share than for all loans, for which around half have less than three months' worth of repayments.

The share of non-performing loans to households will increase over coming months

Deferrals started expiring in late September with most due to expire before the end of October. A four-month extension is possible on a case-by-case basis for borrowers that are not yet able to resume repayments but have good prospects of doing so. APRA has received loan deferral plans from ADIs and will monitor implementation closely. The vast majority of loans moving out of deferrals to date have not had trouble resuming repayments, but because this has been voluntary, borrowers choosing to resume repayments will be those in the strongest financial position. It is likely the share of loans exiting from deferrals and then beginning to miss payments will increase over coming months. Banks have assessed that about 15 per cent of deferred loans are at greatest risk of not being able to resume repayments when the deferral period ends. Some borrowers may be able to restructure their debt (such as by extending the term or temporarily switching to interest-only payments) and lower their repayments. However, some borrowers may need to sell their property to repay their debt. Accordingly, banks' asset quality is expected to deteriorate further (Graph 2.11). Estimates based on the recent relationship between unemployment and housing loan arrears, while imprecise, suggest that the share of borrowers in arrears could reach around 2 per cent if the unemployment rate reaches 10 per cent. This would double the current rate of housing arrears.

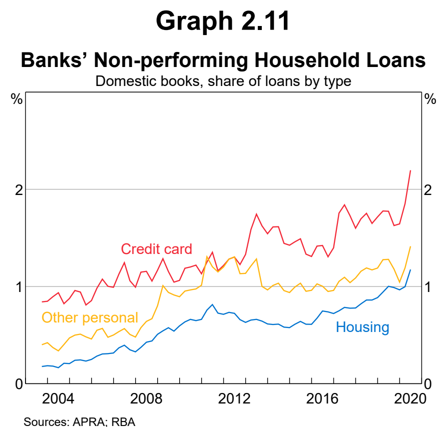
The vast majority of housing loans are in positive equity, which should limit the extent of losses to banks

If a borrower with positive equity in their home has trouble making repayments, there is the option to sell the property and repay the debt without losses for the lender or ongoing debt for the borrower. If many borrowers were to attempt to sell because they are unable to meet



Graph 2.10
Deferred Housing Mortgages
Share of loans by number, August 2020

* Loan-to-valuation ratio
** Includes accommodation and food services, arts and recreation services, retail trade, and rental, hiring and real estate services
Sources: APRA; RBA

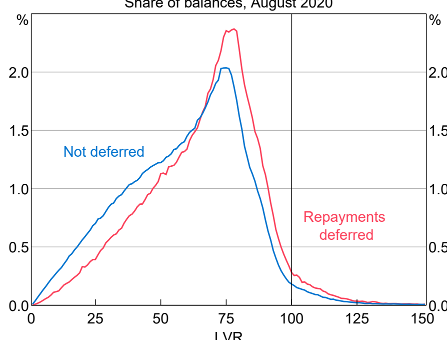


Graph 2.11
Banks' Non-performing Household Loans
Domestic books, share of loans by type

Sources: APRA; RBA

their repayments, and demand is weak, housing prices could fall. Large and sustained price falls could lead to losses for borrowers and lenders. The share of loans currently in negative equity is estimated to be around 3 per cent, although the share among loans with deferred repayments is larger as they tend to have higher LVRs (Graph 2.12). The share of all loans in negative equity would roughly double if prices were to fall by a further 10 per cent, and for a 20 per cent decline, the share would increase seven-fold. Loans currently in negative equity are mostly in Queensland, Western Australia and the Northern Territory, where some regions had large housing price falls during the unwinding of the mining investment boom.

More generally, almost all households with a mortgage remain well positioned to service their debt, and many have responded to the increased uncertainty and any boost to their cash flow by increasing their prepayments. In aggregate, households have also been paying down balances on credit cards. Further, the strengthening in lending standards over recent years has meant the share of housing loans with riskier characteristics is lower than in the past. This will help protect both borrowers and banks' asset quality in the difficult period ahead, and banks have already provisioned against expected losses on this lending.



Demand for housing has held up, though conditions may weaken if low population growth is prolonged or if there is a significant increase in forced sales

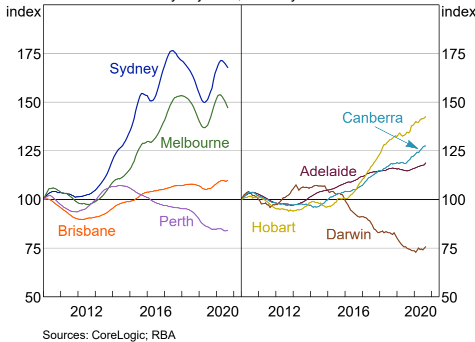
National housing prices are 1½ per cent below their April 2020 peak, led by declines in Melbourne and Sydney (Graph 2.13). After a period of low transactions and listings during the initial national lockdown, new property listings are at a broadly similar level to this time last year (with the exception of Melbourne). Government grants for home building and renovating appear to have provided support to the market for detached dwellings (as described in the Bank's August 2020 *Statement on Monetary Policy*). Owner-occupiers are driving much of the housing market activity, consistent with low interest rates that are attractive to buyers in secure employment. Housing credit to owner-occupiers is growing at a similar pace to the beginning of the year, and recent strength in new loan commitments is consistent with many households not being affected financially (Graph 2.14). Investor housing credit has been contracting amid weaker rental market conditions (particularly in Sydney and Melbourne where the pullback in demand from international students has had the largest impact).

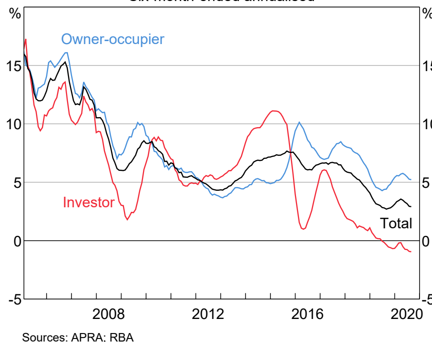
Banks have begun reversing some of the moderate tightening in lending standards they had earlier put in place in response to COVID-19 amid heightened uncertainty about the economic outlook. Since the earlier tightening affected only a small share of borrowers, and typically only resulted in lenders offering lower maximum loan sizes, the recent unwinding is likely to have a limited effect. The loosening includes returning LVRs and the discounts applied to less reliable income such as rent,

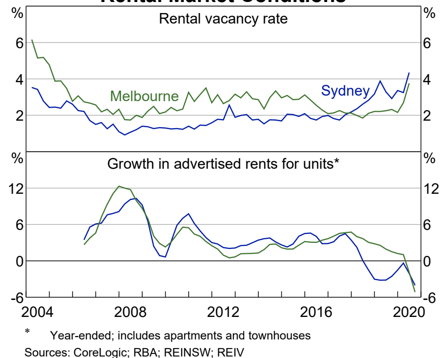
bonuses and overtime to their previous levels. The Government has proposed changes to responsible lending obligations to simplify the loan application process.

Rental vacancy rates have increased considerably in Sydney and Melbourne, partly due to the impact of travel restrictions on demand from international students (Graph 2.15). There is also less demand from international tourists and domestic business travellers for short-term rental properties. Extended periods of vacancies could lead to mortgaged investors struggling to afford repayments, and deciding to sell their properties. This has the potential to exacerbate housing price falls, particularly in areas with more investor properties. A sizeable portion of small-to-medium-sized business loans are also secured by residential property and so difficulties experienced by these businesses could also lead to more forced sales and downward pressure on housing prices.

Apartment prices have softened over recent months, especially in inner city areas. For newly completed apartments, sales are now being settled in very different economic conditions. While there is little evidence of higher settlement failures to date, risks are elevated given the economic uncertainty and potential for further price declines. However, risks to banks appear reasonably low. Banks' lending for off-the-plan apartments over the past couple of years has been at conservative LVRs, and their exposures to residential construction are less than 1 per cent of total assets. Risks from financing apartment construction are higher for non-bank lenders, reflecting greater exposures as a share of assets (around 10 per cent on average according to available data), and lower pre-sale requirements.[1] ✠







Endnotes

[1] See https://www.rba.gov.au/publications/fsr/2019/apr/box-d.html