2. Household and Business Finances in Australia

Households and business balance sheets are in strong shape overall. Strong employment growth has supported household incomes and the broader pick-up in economic activity has underpinned increases in business incomes across industries relative to the lows early in the COVID-19 pandemic. While increased consumption opportunities and higher interest payments have reduced the rate of saving, overall, households are continuing to save. Non-performing loans for households and businesses remain low.

Nonetheless, some households and businesses are already facing more challenging conditions and the combination of higher interest rates and inflation will further increase pressure on household budgets and business profitability over the period ahead (see 'Box B: The Impact of Rising Interest Rates and Inflation on Indebted Households' Cash Flows'). Although the labour market has tightened, household income growth has not kept pace with inflation. This has left households with less capacity to meet their rising housing costs (loan payments or rent) while maintaining their consumption and rate of saving. Reflecting this, as well as the strong recovery in household spending as pandemic restrictions eased, the household saving rate declined in the first half of 2022 from unusually high levels. To date, there have been limited signs of a pick-up in financial stress among household borrowers. This is in part due to strong employment conditions and the large liquidity and/or equity buffers established during the pandemic. It also reflects that higher policy rates feed through to higher mortgage payments with a lag. A small group of variable-rate borrowers with low incomes, small liquidity buffers and high debt are most vulnerable to payment difficulties – including those with relatively new loans and less housing equity. Fixed-rate borrowers will also face large increases in their minimum loan payments when their fixed terms expire. As such, housing loan arrears rates are likely to increase from low levels in the period ahead.

Most businesses have benefited from the recent economic recovery and are in a strong financial position. However, some firms have been particularly affected by rising costs, labour shortages and supply disruptions and their profit margins are under pressure. Strains are acute in parts of the construction industry given the prevalence of fixed-price contracts (see 'Box C: Financial Stress and Contagion Risks in the Residential Construction Industry'). More broadly, firms with low cash buffers and high levels of debt are finding it more difficult to absorb the increases in their expenses; smaller firms are at greater risk than large and listed companies in this regard. Overall, company insolvencies have picked up, although they remain slightly lower than pre-pandemic levels. The cash flows of office and retail commercial property landlords have been impacted by subdued rental demand. In the commercial property sector, smaller landlords with lower quality properties and low liquidity may find themselves more exposed to cash flow strains.

The outlook for financial stability over the coming years will hinge in large part on the ability of households and businesses to weather

challenging economic conditions both in Australia and internationally, including higher interest rates, high inflation and slower growth. The financial resilience of households will remain closely tied to labour market conditions, both in terms of employment outcomes and growth in real incomes. While most borrowers are expected to be able to continue to service their debts, growth in household consumption is expected to slow as households cut back their discretionary spending. The trajectory for household consumption – which is subject to considerable uncertainty – will in turn influence business profits. Another source of uncertainty relates to the magnitude of potential declines in asset prices, including for housing and commercial property, following the significant price increases of recent years in most markets. Debt-servicing challenges will become more difficult if labour market conditions turn out to be worse than expected. However, liquidity buffers and high levels of net wealth and capital among leveraged asset owners and banks, respectively, should help to cushion direct financial stability risks.

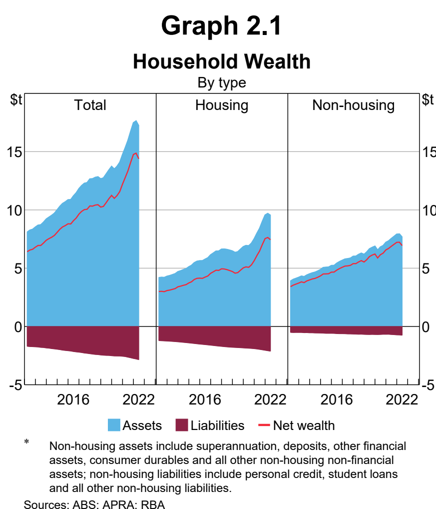
In aggregate, the household sector entered the interest rate tightening cycle in a strong financial position

Overall, households' financial positions were strong as at the end of June (the period for which the most recent comprehensive data are available). The aggregate value of household assets was around six times larger than the aggregate value of household debt, compared to 5½ times larger at the end of 2019 (Graph 2.1). Household net wealth has increased strongly over the past two years, including for the two-thirds of households that own their homes, notwithstanding recent declines in housing prices. Non-housing wealth has also increased since the start of the pandemic, reflecting increased saving; however, this will have been weighed down more recently by declining financial asset prices. Very low interest rates and strong growth in employment and income enabled households to continue to add to their already-large liquid saving buffers in the first half of 2022.

Financial stability risks from the large stock of household debt have been mitigated by a large increase in liquidity buffers since the start of the pandemic. Balances in offset and redraw accounts have increased by around $110 billion – or 7 per cent of household disposable income – since March 2020. Indebted households have continued to add to their already-large liquidity buffers in recent months despite the rise in minimum loan payments. Consistent with this, housing loan arrears rates remain very low (see 'Chapter 3: The Australian Financial System').

Rising interest rates and declining real incomes are beginning to put pressure on household budgets …

Increases in interest rates since May, together with high inflation, have reduced the amount of spare income available to households after meeting housing costs and basic living expenses. This has placed some strain on household budgets. For indebted households, the reductions in spare income have been

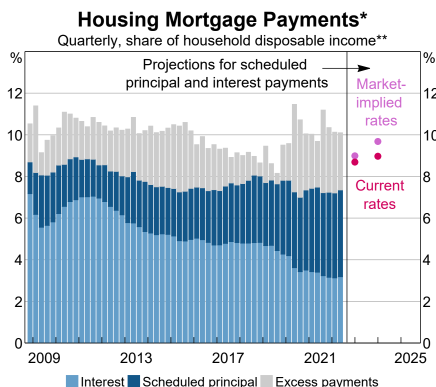


largest to date for the two-thirds of borrowers with variable-rate mortgage debt, although lags between changes in the cash rate and increases in payments mean the announced rate rises are yet to pass through completely.

Total scheduled payments on housing loans are projected to increase to around 9 per cent of household disposable income by the end of 2023 (based on interest rate increases announced between May and October flowing through to variable loan payments and as fixed-rate loans roll off) (Graph 2.2). If interest rates were to increase broadly in line with market expectations out to the end of 2023, aggregate scheduled interest and principal payments are projected to rise to a level that is roughly on par with the total payments households were making (including excess payments into offset and redraw accounts) prior to the commencement of the tightening cycle. This suggests that households in aggregate are reasonably well placed to adjust to a period of higher interest rates – however, as discussed below, the experience across individual households will vary considerably.

Scenario and sensitivity analysis indicates that the majority of owner-occupiers with variable-rate loans have the ability to adjust to a period of higher interest rates and inflation, in part due to their substantial savings buffers; however, a small share of these borrowers are vulnerable to debt-servicing difficulties and, ultimately, default (see 'Box B: The Impact of Rising Interest Rates and Inflation on Indebted Households' Cash Flows'). Borrowers with fixed-rate loans have experienced rising cost-of-living expenses in recent months, but will also face potentially large increases in mortgage payments as their fixed-rate terms expire in the period ahead. For housing investors, strong ongoing rental demand should support their housing income and therefore their loan payment capability over a period where debt-servicing costs increase. On the other hand, increases in rents and living costs more broadly have put pressure on renters' spare cash flows recently.

Overall, there have been limited signs in the official data of a pick-up in financial stress across Australian households to date, in part reflecting strong ongoing growth in employment and incomes. This is consistent with timely indicators that show household spending has held up in recent months and information from liaison with banks. However, the experience across households has been uneven, and some more timely (albeit indirect) sentiment-based measures of financial stress among households have started to turn. For example, household perceptions of their own financial situation have weakened considerably to be around levels reached early in the pandemic (Graph 2.3). Google searches on financial stress and negative sentiment in financial news articles, which have historically borne some relationship with loan arrears, have generally trended higher. Information from the Bank's liaison program also suggests that demand for a range of social and community services – including low-cost housing and food services – has increased of late. Increases in indicators of financial stress are likely in the period ahead.



* Dots show projections for the sum of interest and scheduled principal payments as a share of income. Based on OIS projections for the cash rate as end 2022 and end 2023. Assumes full pass-through to variable-rate mortgages and that fixed-rate loans roll onto variable-rate mortgages.

** Seasonally adjusted and break-adjusted.

Sources: ABS; APRA; RBA

… but most borrowers remain well placed to service their debt

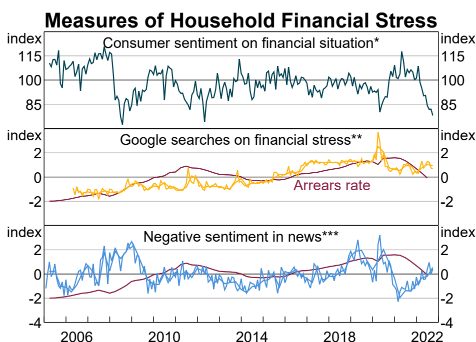
Most indebted households are well-placed to manage the recent increase in their housing and other living expenses as they have had sizeable spare income available after meeting their debt and basic living expenses and many have accumulated large savings buffers over recent years. When taking out a loan, a household's ability to service its debt is assessed based on higher interest rates than those prevailing at the time of origination. The Australian Prudential Regulation Authority requires lenders to apply minimum interest rate buffers when assessing the ability of new borrowers to service their debt; this minimum buffer is currently at least 3 percentage points above the loan interest rate. Further, only a small share of households borrow the maximum possible based on their lenders' assessment rate, and so most commence their loans with a larger effective cash flow buffer than required by their lender. Consistent with this, many indebted households have accumulated a sizeable stock of liquid savings that could be used to support their consumption and/or meet increased loan payments if necessary.

The Reserve Bank's Securitisation Dataset indicates that, as at August, a little over 35 per cent of all borrowers had prepayment buffers (in the form of offset and redraw account balances) equivalent to more than two years' worth of their minimum payments, while almost one-quarter had buffers of between three months and two years (Graph 2.4). For the median owner-occupier variable-rate borrower, mortgage prepayment balances in offset and redraw accounts were sufficient to cover 20 months' worth of required payments as at August. This is down from 22 months in April, reflecting the recent increase in interest rates and so larger required monthly payments.

By contrast, a little less than 40 per cent of borrowers have relatively low mortgage buffers (less than three months of payments). However, 40 per cent of these low-buffer borrowers have fixed-rate loans or are investors with loans originated before 2021. In general, fixed-rate borrowers and investors face contractual restrictions or disincentives to make excess payments. Accordingly, this subset of borrowers are likely to have liquid savings outside of their mortgage accounts, and so this metric could overstate their vulnerability. Indeed, survey data

Graph 2.3

Measures of Household Financial Stress



* Compared to a year ago, average since 1980 = 100.

** Tracks relative frequency of Google searches based on key words related to household financial stress; index normalised to have mean zero and standard deviation of one.

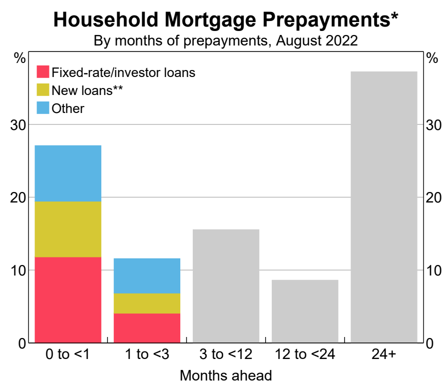
*** Tracks the relative negative sentiment within financial news articles published in Australia that are relevant to households; index normalised to have mean zero and standard deviation of one.

Sources: APRA; Dow Jones Factiva; Google; RBA; Westpac-Melbourne Institute

Graph 2.4

Household Mortgage Prepayments*

By months of prepayments, August 2022



* Months ahead expressed as number of months that prepayments (including offset and redraw balances) can cover minimum scheduled payments. Includes split loans. Only loans with less than 3 months of prepayments are broken down by loan type.

** New loans are those originated during 2021 and 2022. These are somewhat under-represented in the Securitisation data as new loans can take some time to be securitised.

Sources: RBA; Securitisation System

suggest that, although investors have smaller buffers in the form of prepayment facilities, they have historically tended to hold more liquid assets than owner-occupiers (data limitations make it difficult to obtain a timely read on the liquid asset holdings of investors and fixed-rate borrowers).[1] The remainder of low-buffer households (around 20 per cent of all borrowers) are more vulnerable to large shocks to their income or expenses, particularly if they entered the tightening cycle with little in the way of spare monthly cash flow.

In addition to large liquidity buffers, strong housing price growth over recent years has meant that most households have substantial equity buffers in their homes. Just 5 per cent of loans in the Bank's Securitisation Dataset were estimated to have an outstanding loan-to-valuation ratio (LVR) greater than 75 per cent as at August. Moreover, very few loans were in negative equity at that time and, as discussed below, very large further declines in housing prices would be required to materially increase the share of loans in negative equity.

Some recent borrowers and those with a combination of high debt and low liquidity buffers are vulnerable to rising expenses

Recent home buyers are more vulnerable to debt-servicing challenges and default in a rising interest rate environment, as they have had less time to accumulate liquidity and equity buffers. Information from the Securitisation Dataset shows that, as at August, around half of all home buyers who took out loans since the start of 2021 had prepayment buffers equivalent to less than three months of their scheduled payments; this compares to less than 40 per cent of total borrowers (Graph 2.5). Recent home buyers – and in particular first home buyers (FHBs) – are also over-represented among borrowers with low equity buffers; this cohort has a higher share of loans with current LVRs greater than 80 per cent.

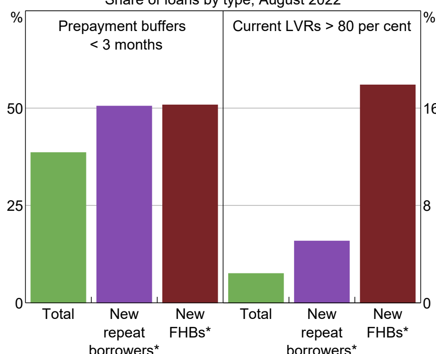
In addition, highly indebted borrowers are more vulnerable than others because their interest expenses are more sensitive to increases in interest rates. Home owners who borrowed in the past two years are more likely to be highly indebted. The share of new lending with a debt-to-income (DTI) ratio greater than six has risen sharply over the past couple of years and, notwithstanding recent declines, remains elevated (Graph 2.6). The interest rate used by lenders to assess borrowers' capacity to service their debts (serviceability assessment rate) has also been lower, on average, for recent cohorts of borrowers, in line with lower interest rates during the pandemic. As a result, in addition to being more indebted, more recent borrowers are also likely to have smaller buffers between their actual loan interest rates and the rate at which their loans were assessed and so may be closer to encountering constraints on their ability to service their debts than other borrowers.

The most vulnerable borrowers are those who are both highly indebted and have low prepayment buffers; overall, these borrowers make up only a small share of indebted

Graph 2.5

Loans with Low Liquidity or Equity Buffers

Share of loans by type, August 2022



* New loans are those originated during 2021 and 2022. These are somewhat under-represented in the Securitisation data as new loans can take some time to be securitised.

Sources: ABS; CoreLogic; RBA; Securitisation System

households. As at August, around 1 per cent of all variable-rate owner-occupier loans had a loan-to-income (LTI) ratio greater than six and prepayment buffers equivalent to less than one month of payments, with lower income households over-represented in this group (Graph 2.7). Based on a much broader and more conservative metric of 'high' debt, those with an LTI ratio greater than four and prepayment buffers of less than three months accounted for around 6 per cent of all owner-occupier variable-rate loans. Overall, the low share of borrowers with both high debt and low buffers is consistent with survey data showing that highly indebted households tend to have large liquidity buffers.[2]

Variable-rate borrowers face large increases in their minimum payments, but many have been making large excess payments and so are well equipped to manage

Variable-rate mortgages account for around 65 per cent of outstanding housing credit. Although higher interest rates are increasing variable-rate borrowers' minimum mortgage payments, many borrowers' regular payments will not increase by as much as the required minimum as they have been making sizeable excess payments into offset and redraw facilities.

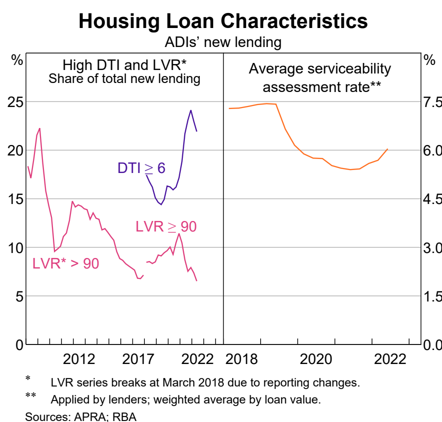
Once the 2½ percentage points of cash rate increases between May and October have been fully passed through to loan payments, estimates suggest:

- Around 40 per cent of variable-rate borrowers would not have to increase their payments at all, relative to their average payments (including excess payments) over the past year. A further 15 per cent would experience less than a 20 per cent increase in the dollar value of their monthly payments (relative to their average payments over the past year).
- Around 20 per cent of variable-rate borrowers will have their minimum loan payments increase to more than 30 per cent of their incomes (Graph 2.8).
  - Of this group, around one-third had been making payments that were larger than their new required minimums, suggesting they are relatively well equipped to manage.
  - However, others are more vulnerable because they have lower income and/or low saving buffers. Borrowers with projected debt-servicing ratios above 30 are much more likely to be in the lower half of the income distribution for

Graph 2.6

Housing Loan Characteristics

ADIs' new lending



* LVR series breaks at March 2018 due to reporting changes.

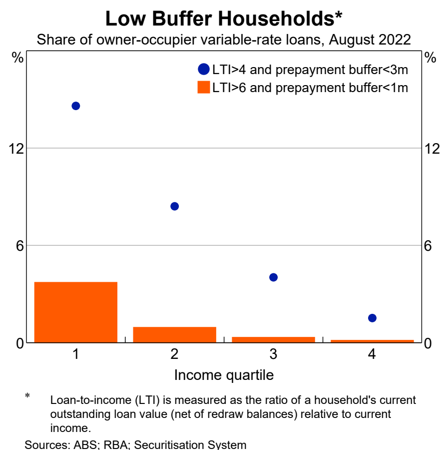
** Applied by lenders; weighted average by loan value.

Sources: APRA; RBA

Graph 2.7

Low Buffer Households*

Share of owner-occupier variable-rate loans, August 2022



* Loan-to-income (LTI) is measured as the ratio of a household's current outstanding loan value (net of redraw balances) relative to current income.

Sources: ABS; RBA; Securitisation System

variable-rate borrowers than other borrowers, while around one-third are estimated to have low prepayment buffers (equivalent to less than three months' of minimum payments).

If interest rates were to rise by a cumulative 3½ percentage points (broadly in line with current market expectations to the end of 2023) and incomes were to grow in line with forecast wages growth, the share of borrowers facing a minimum debt-servicing ratio greater than 30 would increase to around 25 per cent by the end of 2023. This figure would be higher if unemployment were higher and income growth did not increase as expected.

Many fixed-rate borrowers will face a large increase in their payments when their fixed terms expire

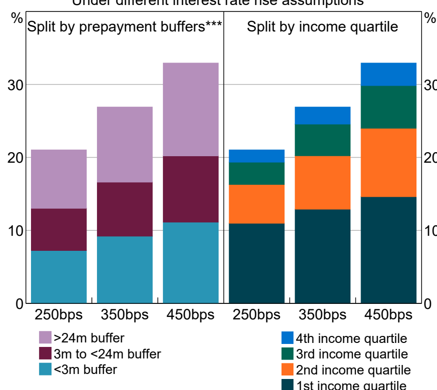
Around 35 per cent of outstanding housing credit is on fixed-rate terms (including the fixed component of split loans, which have become increasingly popular in recent years). Around two-thirds of these loans are due to expire by the end of 2023 (Graph 2.9). Based on current market pricing for the cash rate and assuming full pass-through to variable mortgage rates, most fixed-rate borrowers with loans expiring in 2023 will face discrete increases in their interest rates of 3–4 percentage points when they roll over to variable rates, depending on their current rate and the timing of their fixed loan term expiry.

If interest rates were to rise by a cumulative 3½ percentage points from the beginning of the current tightening cycle to the end of 2023, almost 60 per cent of borrowers with fixed-rate loans would face an increase in their minimum payments of at least 40 per cent when they expire (Graph 2.10). In this situation, just over one-third of fixed-rate borrowers will not experience any increases in their minimum payments by the end of 2023, mostly because they have loans that are due to expire in 2024 and beyond.

Only limited information is available to assess whether fixed-rate borrowers will experience difficulty with these increased minimum payments as these borrowers tend to accumulate savings outside of their mortgages (as contractual limitations restrict their ability to save via offset and redraw facilities). Given very low interest rates and the broad-based increase

Graph 2.8

Share of Variable-rate Loans with Loan-servicing Ratios Greater than 30 per cent*



* New minimum loan payment to income ratio. Income at origination grown forward to the September 2022 quarter using WPI (including forecasts). Excludes split loans.

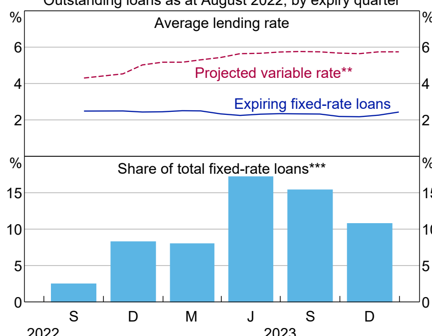
** Relative to the start of the monetary policy tightening cycle.

*** As at April 2022 (prior to tightening cycle).

Sources: ABS; RBA; Securitisation System

Graph 2.9

Projected Expiration of Fixed-rate Loans*



* Assumes fixed-rate loans are not repaid early or refinanced.

** Based on OIS market path for the cash rate as at 4 October and assuming full pass through to variable mortgage rates.

*** Another 38 per cent of fixed-rate loans will expire in 2024 and beyond.

Sources: Bloomberg; RBA; Securitisation System

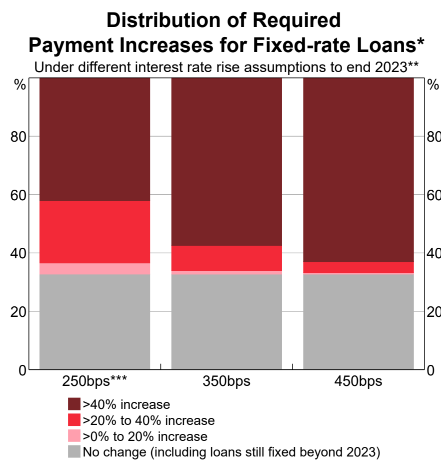
in household saving over recent years, many fixed-rate borrowers are likely to have accumulated liquidity buffers during the fixed loan term (particularly as many will have demonstrated a capacity to service higher interest rates prior to refinancing at lower fixed rates). However, some will be vulnerable. Information from the Bank's Securitisation Dataset indicates that the current (large) cohort of fixed-rate borrowers tend to have similar incomes to variable-rate borrowers, suggesting both groups are likely to have a similar capacity to save, on average. This is in contrast to less-timely survey data that indicate that fixed-rate owner-occupier borrowers have historically had lower liquid assets and disposable income than other borrowers. For split loans, borrowers are saving in the variable component of their loans, with the distribution of excess payments across split borrowers similar to that of borrowers with variable-rate loans.

The small share of borrowers who have recently moved to variable-rate loans at the expiry of their fixed-rate terms appear to have managed the transition so far. Among owner-occupier loans in the Securitisation Dataset that were observed to have rolled on to fully variable rates between February and June 2022, roughly 20 per cent increased their prepayment buffers by more than six months soon after transitioning to variable rates. This is suggestive of lump-sum transfers from other liquid asset holdings, and was 8 percentage points higher than the share of owner-occupier variable-rate loans that increased their buffers by six months or more over the same period. However, a little more than half did not adjust their prepayment buffers soon after they had transitioned to variable rates, indicating the practice was not particularly widespread.

Graph 2.10

Distribution of Required Payment Increases for Fixed-rate Loans*

Under different interest rate rise assumptions to end 2023**



* Fixed rate loans that expire in 2022 and 2023 are assumed to roll on to the average variable rate (which depends on the assumed change in rates); fixed rate loans that expire beyond 2023 are in the 'No change' category.

** Relative to the start of the monetary policy tightening cycle.

*** Changes announced as at October 2022 Board meeting.

Sources: RBA; Securitisation System

Recent first home buyers would be more exposed to a sizeable fall in housing prices than other borrowers

Most indebted households have accumulated a large equity buffer over recent years through strong price growth and large excess payments, which reduces the likelihood of lenders' losses in the event of a default. However, recent borrowers are at greater risk of entering negative equity should housing prices decline significantly. This risk is more material for FHBs, who tend to enter the housing market with relatively high initial LVRs (Graph 2.11). Newer loans, including those taken out by FHBs, are more likely to experience negative equity not only because borrowers tend to start with higher LVRs than repeat buyers and investors but also because they have had less time to accumulate excess payments and to benefit from housing price growth. Recent FHBs are also more likely to experience financial stress. Nevertheless, these loans do not pose a systemic risk to banks as they account for less than 10 per cent of all outstanding loan balances. Consistent with this, even very large future housing price declines would only result in a small share of all loans entering negative equity, although an environment in which there were a

large number of forced sales could further amplify the price cycle.

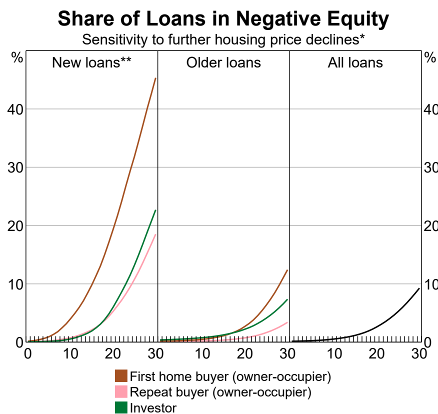
Renters are also facing heightened financial pressures

Strong growth in rents in response to low vacancy rates will support the cash flows of indebted housing investors and therefore their ability to service their debts. However, more renting households are likely to experience financial stress as cost pressures continue to increase. More than one in five renting households move home in a given year, and rents for newly advertised properties have risen sharply across the country (Graph 2.12). Compared to indebted households, renters tend to have lower spare incomes (after meeting their housing costs and basic living expenses) and lower savings buffers, making them more vulnerable to increases in rents and the cost of living more broadly. This is one reason why renters have historically been more likely to report experiencing financial stress than indebted owner-occupiers.

Graph 2.11

Share of Loans in Negative Equity

Sensitivity to further housing price declines*



* Each percentage decline is applied to the price levels that prevailed in each SA3 region during August 2022, separately for houses and apartments.

** New loans are those originated during 2021 and 2022. These are somewhat under-represented in the Securitisation data as new loans can take some time to be securitised.

Sources: ABS; CoreLogic; RBA; Securitisation System

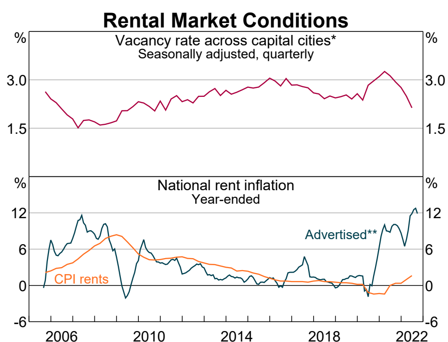
Many businesses are facing pressure on their profitability due to rising costs …

Firm-level data suggests that many businesses' net profit margins were yet to fully recover to pre-pandemic levels by March 2022 (the latest available data). For the median company, the net operating profit margin was around 2.5 percentage points lower than before the pandemic, albeit with considerable variation by industry (Graph 2.13). While profit margins were broadly around pre-pandemic levels for many firms in the retail and accommodation & food services industries by the March quarter, they remained relatively low for many firms in the construction, transport and education industries. There was also considerable variation in profitability across individual firms, with around one-third reporting negative quarterly operating cash flows in the March quarter, a slightly higher share than prior to the pandemic.

While demand has generally been strong for many businesses, inflation pressures, labour shortages and supply disruptions have presented challenges to profitability, particularly for businesses with limited ability to raise their prices to offset higher input costs. This has been especially evident in the residential construction industry due to the prevalence of fixed-price contracts, and has contributed to a pick-up in financial stress and insolvencies (see 'Box C:

Graph 2.12

Rental Market Conditions



* Excludes Adelaide from 2015 to 2018.

** Hedonic rolling three-month average.

Sources: ABS; CoreLogic; RBA; REIA

Financial Stress and Contagion Risks in the Residential Construction Industry').

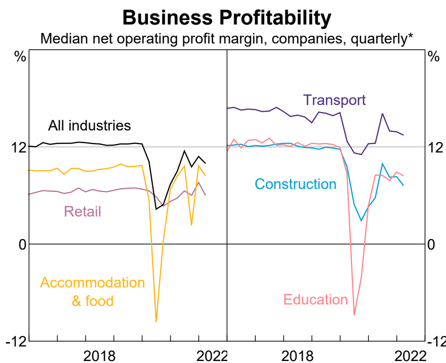
… which could pose challenges for those with high levels of debt and low cash buffers

Lower profitability reduces debt-servicing capacity, compounding the effect of recent increases in variable business lending rates for some indebted firms. Currently unprofitable small and medium enterprises (SMEs) appear particularly exposed, as they tend to be more indebted than profitable SMEs – and are therefore already more vulnerable to rising interest rates (Graph 2.14). Larger firms are typically more indebted than smaller firms, but they also tend to have a higher capacity to service debt because they have more diversified and stable incomes. Overall, large businesses tend to have similar leverage regardless of whether they are currently profitable or unprofitable.

Firms with weak or negative operating profits will also need to rely more heavily on cash reserves to support their operations or service debts. While aggregate cash holdings were around 25 per cent higher in the June quarter than before the pandemic, data on businesses' bank deposits indicate that this disproportionately reflects increased cash balances for larger businesses. Average cash balances for SMEs are typically lower relative to their size and have been declining over 2022, again suggesting these firms are more vulnerable to weak profit outcomes in the period ahead.

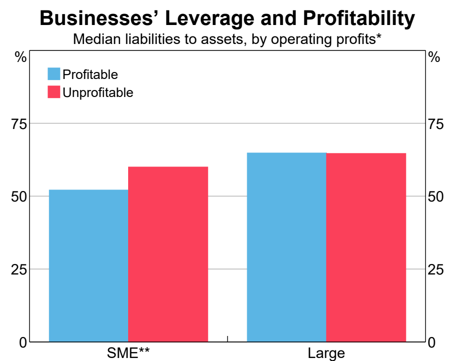
Large listed companies nevertheless remain healthy …

The financial positions of most listed companies remained strong over the first six months of 2022. Profitability was broadly stable, and liquidity ratios remained substantially higher than in pre-pandemic years (Graph 2.15). Gearing ratios have also been little changed over the past couple of years and, as at June 2022, the majority of companies had an interest coverage ratio (ICR) above two (i.e. annual profits were at least twice as large as interest expenses). Historically, firms with an ICR below two have tended to be at higher risk of insolvency. The share of leveraged listed companies that appear vulnerable to debt-servicing difficulties is reasonably low, with only around 15 per cent having both an ICR below two and a liquidity ratio (the ratio of short-term assets to short-term liabilities) of less than one. Financial market



* Net profits measured as operating revenue less operating costs and wages; not including government support payments (e.g. JobKeeper); includes all GST-remitting companies (~500,000); seasonally adjusted.

Sources: ABS; RBA



* Liabilities and assets as reported in June 2020; profits are operating revenue less operating costs and wages in the March quarter 2022; includes indebted GST-remitting companies (~150,000).

** Firms with annual turnover below $50 million.

Sources: ABS; RBA

pricing of risk (which measures a company's risk of technical default) remains low.

… and most remain well placed to service higher interest expenses

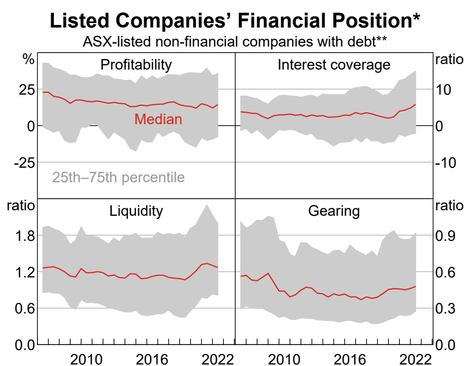
The average variable rate on large businesses' outstanding bank loans has increased since the end of April. However, many listed companies source some of their borrowing through fixed rates and/or use interest-rate swaps that moderate the short-term effect of increases in interest rates. Indeed, as at the most recent data (to the end of June), listed companies' interest expenses had so far been little changed. While increases in corporate bond yields have been somewhat larger, nearly all bonds outstanding for ASX-listed companies are issued on fixed-rate terms, and only around 10 per cent of bonds are due to expire in the next 12 months (equivalent to only a couple of per cent of ASX-listed company debt, excluding hybrid securities). Given these considerations, for most listed companies the pace of increases in debt-servicing costs is likely to be gradual.

Higher lending rates will more fully pass through to listed companies' debt-servicing costs over the medium term as fixed-rate loan terms expire and hedges roll off; however, most leveraged firms are well placed to absorb higher interest expenses. Estimates based on current profits suggest that for each 100 basis point increase in the average variable business lending rate, relative to the start of the current tightening cycle, the debt-weighted share of listed companies with a low ICR would increase by between 2 and 5 percentage points (Graph 2.16). This may be a high estimate, as historically profits have typically increased alongside rising interest rates (this analysis assumes constant profits). A scenario where profits instead decline noticeably – assuming a simple 10 per cent decline for illustrative purposes – suggests the share of businesses with a low ICR would be somewhat, but not markedly, higher.

Company insolvencies have increased further, but remain low

Policy support and cash buffers accumulated early in the pandemic helped build resilience for many businesses, and over recent quarters most firms benefited from the strong economic recovery. Accordingly, the non-performing share of banks' business loans has remained very low. Trade credit payment times, which can be an

Graph 2.15

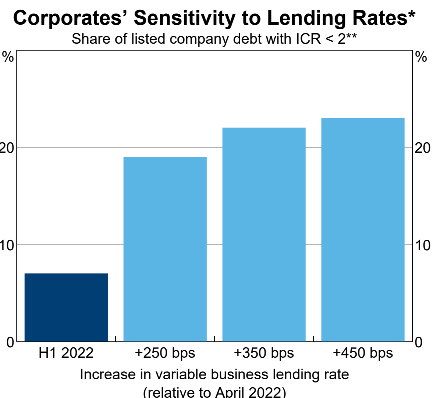


* Profitability measured by profits over equity, liquidity by current assets over current liabilities, gearing by debt over equity, and interest coverage by profits over gross interest expenses. There is a gradual structural break in gearing ratios over 2019 and 2020 due to an accounting change. Data are bi-annual; latest observation is as at June 2022.

** Excludes companies with a ratio of debt to assets less than 10 per cent.

Sources: Morningstar; RBA

Graph 2.16



* Leveraged ASX-listed non-financial companies. Full pass-through assumes all debts are variable rate.

** ICR is calculated as profits (EBITDA) over gross interest expenses.

Sources: Morningstar; RBA

early indicator of potential financial stress, also remain lower than prior to the pandemic and within the ranges of recent quarters.

Insolvencies have risen further but remain slightly below pre-pandemic levels. The recent increase has been driven largely by developments in the construction industry, though insolvencies in a range of other industries have also drifted higher since September 2021 (Graph 2.17). Further increases in insolvencies are likely in the period ahead as economic activity slows and vulnerable businesses draw down further on cash buffers. The resumption of Australian Taxation Office enforcement activities on unpaid tax is also likely to continue to prompt some businesses that are unable to pay their debts to commence formal insolvency procedures, contributing to higher insolvencies. Nonetheless, broader financial stability risks from rising insolvencies appear low; a material deterioration in economic conditions would likely be required for this assessment to change.

Retail and office property market conditions remain weak but do not pose material financial stability risks at present

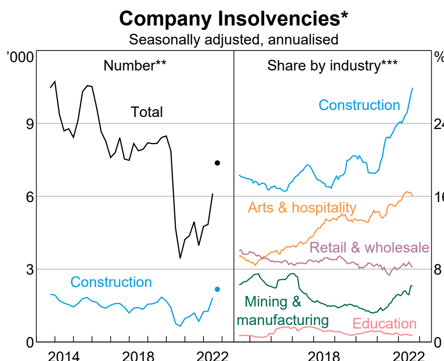
Underlying tenant demand for retail and central business district (CBD) office property remains weak. As at June 2022, market rents in both segments were around 10 per cent lower than pre-pandemic levels. Retail shopping centre vacancy rates remain elevated, particularly in the CBDs of major capital cities where the pandemic has had a persistent dampening effect on economic activity (Graph 2.18). Consistent with this, CBD office vacancy rates have also remained high over the past year. While demand for prime office space has increased modestly, this has been broadly matched by additions to the office stock. Conditions in secondary-grade office markets are weaker, in part because some tenant demand has moved to discounted higher grade properties. By contrast, demand for industrial property remains strong and vacancy rates are low.

Financial stability risks from weak leasing conditions in the retail and office sectors remain low, but would be expected to increase if economic conditions were to deteriorate substantially. The non-performing share of banks' commercial property lending remains

Graph 2.17

Company Insolvencies*

Seasonally adjusted, annualised



* New external administrations and controller appointments.

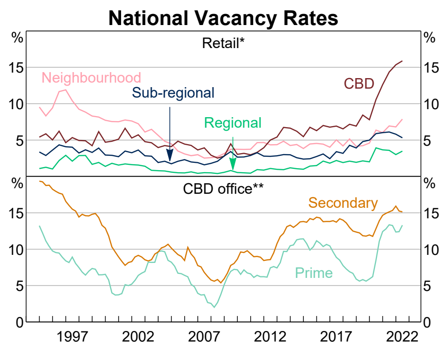
** The dots are September quarter estimates based on monthly observations for July and August 2022.

*** 12-month rolling basis; selected industries.

Sources: ASIC; RBA

Graph 2.18

National Vacancy Rates



* Speciality store vacancy rates. Regional centres are anchored by department stores, sub-regional by discount department stores, and neighbourhood by supermarkets; CBD includes a variety of retail formats.

** Central business districts in mainland state capital cities and Canberra.

Sources: JLL Research; RBA

negligible and banks' overall exposures remain low, at around 6 per cent of assets. Moreover, large listed Australian real estate investment trusts (A-REITs), which directly own around 60 per cent of retail shopping centre space and roughly 10 per cent of total office space, maintained healthy financial positions over the first half of 2022. Near-term increases in financing costs for A-REITs are likely to be manageable, as most have either fixed-rate debt or use interest-rate swaps to hedge interest rate exposure and only a small share of debt funding is due to roll off over the next year. While information on the financial health of smaller landlords is limited, liaison with banks suggests the vast majority of these borrowers will be able to meet higher debt payments, though some could struggle if their earnings were to decline significantly. Comprehensive information on the commercial property exposures of non-bank lenders is also not readily available, and so it is possible that impairment rates are higher in that part of the market.

Although declines in commercial property valuations are possible, risks to banks are contained

Commercial property valuations are likely to decline in coming quarters given recent and prospective increases in interest rates; ongoing weakness in tenant demand in some segments could amplify the magnitude of falls. In this event, some leveraged investors in commercial property could realise sizeable losses. Some could be in breach of LVR covenants on their debt and, if they are unable to contribute more equity or renegotiate loan payment terms, could be forced to sell their properties. However, direct risks to the banking sector presently appear low. The banking sector has significant protection against declining commercial property valuations, owing to their conservative credit policies. Commercial property loans typically have relatively low LVRs (less than 65 per cent) and impose a range of minimum requirements on borrowers' debt-servicing capabilities (such as minimum ICRs and maximum debt-to-assets ratios). Moreover, banks' direct exposures to commercial property are considerably lower than a few decades ago, when higher interest rates and an economic downturn last precipitated a large decline in the value of commercial property assets.

Endnotes

[1] See Wang L (2022), 'Household Liquidity Buffers and Financial Stress', RBA *Bulletin*, June.

[2] See RBA (2022), 'Box B: How Risky is High-DTI and High-LVR Lending?', *Financial Stability Review*, April.