2. Household and Business Finances

Household and business balance sheets have in aggregate strengthened over the past six months, aided by the resilience of the Australian economy to further waves of COVID-19. Business revenue has increased and household incomes have been supported by strong employment growth as fiscal assistance has tapered off. Most indebted households have benefited from strong growth in housing prices over the past year and, coupled with higher mortgage payments in excess of scheduled requirements, the vast majority have accumulated substantial additional equity in their homes. The low interest rate environment has also helped many households and businesses to add to their already-substantial buffers and the incidence of financial stress remains very low. In addition, there continue to be few signs of financial stress for commercial property landlords, despite challenging conditions in some retail and office markets.

Near-term financial stability risks stemming from the COVID-19 pandemic have eased, but a small share of borrowers remain vulnerable to declines in their cash flows. For households, this includes those that are both highly indebted and have low excess payment buffers to draw on if required. For businesses, it is those with relatively low cash buffers, and those facing ongoing weak revenue growth and/or rising cost pressures. Increases in interest rates – which are anticipated by market participants over the next couple of years – would result in higher debt repayments for many households and businesses, but most are well placed to absorb these. However, there are some risks around borrowers' capacity to pay if rising inflation is not accompanied by faster household income growth and rising business profitability.

Looking further ahead, medium-term systemic risks remain elevated and so it is critical that lending standards remain strong. Although the vast majority of households are well placed to repay their debt, the aggregate household debt-to-income (DTI) ratio has edged higher, and the increased share of new housing loans with a high DTI ratio indicates that some new loans could be relatively risky (see 'Box B: 'How Risky is High-DTI and High-LVR Lending?'). Against this backdrop, the recent increase in the interest rate buffer that the Australian Prudential Regulation Authority (APRA) expects lenders to use in their loan serviceability assessments will have reduced the supply of credit to new borrowers who are most susceptible to finding difficulty in making repayments. It is important that lending standards do not slip and that borrowing and lending decisions are resilient to higher interest rates and the potential for falls in housing prices and/or real incomes.

Strength in household balance sheets has been underpinned by high savings, the strong labour market and rising housing prices

The financial resilience of the household sector as a whole has improved since the start of the pandemic. Growth in aggregate household assets has exceeded that in household debt since mid-2020 (Graph 2.1). This reflects broad-based growth in housing prices and high saving rates. Moreover, with unemployment and underemployment rates at low levels, households are less vulnerable than previously to a sustained fall in labour income.

Increases in equity and liquidity buffers have not only been evident in aggregate, but also for most individual households, including those that hold debt. The broad-based strength in housing prices has resulted in substantial increases in home equity for almost all indebted homeowners. Estimates using the Reserve Bank's Securitisation dataset indicate that only around 5 per cent of loans have an outstanding loan-to-valuation ratio (LVR) greater than 75 per cent, compared with almost one-quarter at the beginning of 2020. The share of loans in negative equity is also estimated to be exceptionally low, at less than ¼ of a per cent, down from 2¼ per cent in January 2020 (Graph 2.2).

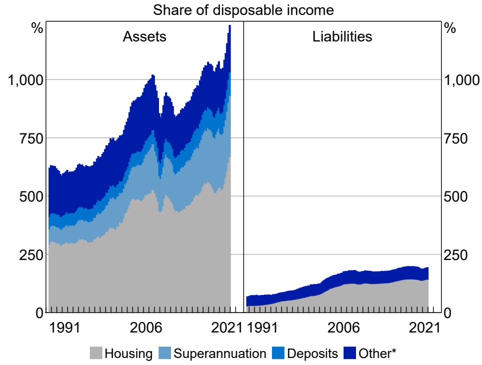
Increases in savings have also been evident for most households over the past couple of years. This largely reflects a combination of reduced consumption opportunities due to the pandemic, low interest payments on existing debt and significant fiscal policy support for household incomes. Although dated, survey data for 2020 indicate that real household disposable income and household saving increased across the income distribution over the first year of the pandemic. That said, around 10 per cent of households surveyed reported that they had needed to draw on their savings due to the impact of the pandemic.

Indebted owner-occupier household saving is largely in the form of payments into mortgage offset and redraw accounts. The flow of these payments in excess of scheduled requirements was equivalent to around 2.5 per cent of household disposable income in the December quarter of 2021, compared with an average of around 1 per cent in the two years preceding the pandemic. Securitisation data suggest that the median excess payment buffer for owner-occupiers with a variable-rate loan was equivalent to around 21 months' worth of scheduled payments in February 2022, up from around 10 months' worth at the start of the pandemic (Graph 2.3). However, for those with lower initial payment balances, the increase has been much smaller. The increase in payment buffers partly reflects the impact of lower interest rates on minimum repayments. If interest rates were to increase by 200 basis points, current excess payments would be equivalent to just under 19 months of scheduled payments.

Graph 2.1

Household Balance Sheet

Share of disposable income



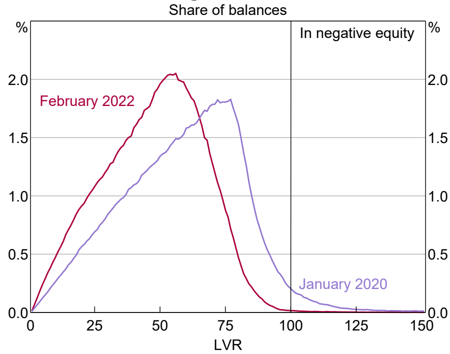
* Other assets include financial assets held outside of superannuation or deposits, consumer durables and all other non-housing non-financial assets; other liabilities include personal credit, student loans and all other non-housing liabilities.

Sources: ABS; APRA; RBA

Graph 2.2

Outstanding LVR Distribution*

Share of balances



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

Sources: ABS; CoreLogic; RBA; Securitisation System

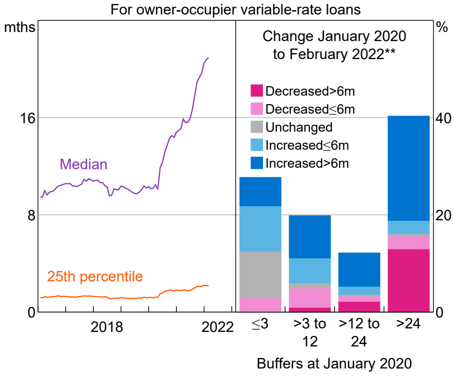
Increases in payment buffers for owner-occupier variable-rate loans have been broad based, with almost two-thirds of these loans recording higher buffers since the start of 2020. Of these, around 70 per cent have increased the stock of their buffers by six months or more. More broadly, around three-quarters of owner-occupier variable-rate loans currently have excess payment buffers of at least three months, compared with around two-thirds at the start of the pandemic.

It is more difficult with available data to gauge the size of liquidity buffers for households with investment or only fixed-rate loans. These borrowers face disincentives to prepay their mortgages and so are more likely to hold their savings in other forms. While there has been an increase in the share of fixed-rate lending over the past couple of years, some fixed-rate borrowers have a split loan and have accumulated large payment buffers in the variable-rate component of their loan.

Graph 2.3

Mortgage Excess Payment Buffers*

For owner-occupier variable-rate loans



* Offset plus redraw balances; measured in months of minimum repayments; excludes split loans.

** Expressed as a share of owner-occupier variable-rate loans.

Sources: RBA; Securitisation System

The incidence of household financial stress is low and declining, but a small share of households are vulnerable to cash flow shocks …

Consistent with the broad-based strength in aggregate household balance sheets, the incidence of household financial stress remains very low. The share of APRA-regulated lenders' non-performing housing loans was just 0.9 per cent at the end of 2021 – lower than before the pandemic (see 'Chapter 3: The Australian Financial System'). Almost all borrowers who have exited loan payment deferral arrangements available earlier in the pandemic are now up to date with their repayments. The recent strength in employment is likely to have offset the unwinding in fiscal policy support for most indebted households. For the small number of borrowers who are currently experiencing repayment difficulties, liaison with banks indicates that the vast majority had been experiencing problems prior to the pandemic, and that early indicators of financial stress in other borrowers (such as households reducing their prepayments) remain very low.

Households in flood-affected areas of New South Wales and Queensland are facing significant challenges. To alleviate near-term financial challenges, government disaster-relief payments and hardship assistance from lenders have been made available. Recent estimates suggest that the number of insurance claims is higher than following the 2011 Queensland floods and Cyclone Yasi; although, to date, the total value of claims has been lower as fewer homes require rebuilding. Banks direct exposures to the most heavily affected households are small relative to total lending.

More broadly, the small share of borrowers with low liquidity buffers are more likely than other borrowers to have their financial resilience tested if they experience an adverse shock to their incomes or expenses, including through higher inflation. The risks for households with low liquidity buffers are likely to be even higher for those whose payment buffers have been declining (as opposed to low and stable) and for those who also have high levels of debt. The Securitisation data indicate that, for owner-occupiers with variable-rate loans, the overall share of borrowers with a loan six or more times their income and a buffer of less than one month of minimum repayments has declined since the beginning of the pandemic, to just below 1 per cent (Graph 2.4). The share of owner-occupier variable-rate borrowers with low and declining buffers has decreased to around 2 per cent over the same period. Declines in the shares of both groups of vulnerable borrowers are partly due to lower interest rates.

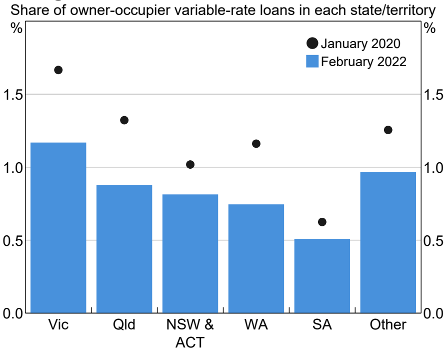
Historically, renters have been more likely to experience financial stress than indebted owner-occupiers. According to the Household, Income and Labour Dynamics in Australia (HILDA) survey, around one-third of renters reported at least one instance of financial stress (such as being unable to pay a bill on time or heat their home) in 2020, compared to one-sixth of owner-occupiers (Graph 2.5). Although renters are unlikely to pose direct risks to the stability of the financial system (as they have less debt), financial stress for renters could translate to repayment difficulties for indebted landlords or pose indirect risks by constraining household consumption and so economic activity. Renters with a combination of low liquidity buffers prior to the pandemic (equivalent to less than one month of disposable income) and high housing cost burdens (rental payments equivalent to more than 30 per cent of disposable income) were much more likely to report financial stress than other households. Around 15 per cent of renters were vulnerable based on this metric in 2020.

Although the value of consumer debt has declined over recent years, there has been strong growth in households using buy now, pay later (BNPL) services. BNPL services are generally a form of short-term financing that allow consumers to pay for goods and services in instalments. It is estimated that the value of BNPL transactions increased by around 40 per cent over the year to the December quarter of 2021, and the total number of BNPL accounts was equivalent to around one-third of the adult population (although some people have more than one account). There have been some increases in the incidence of late payments on these products. However, the value of BNPL transactions remains relatively small compared to other forms of personal

Graph 2.4

High Debt and Low Buffer Households*

Share of owner-occupier variable-rate loans in each state/territory



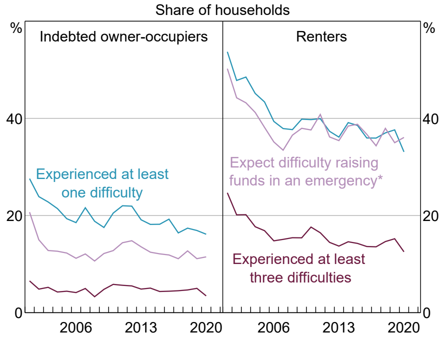
* Those with a loan-to-income ratio above six and less than one month of excess payment buffers (offset and redraw balances, measured in months of minimum repayments).

Sources: RBA; Securitisation System

Graph 2.5

Incidence of Financial Stress

Share of households



* $2,000 from 2001–2008; $3,000 from 2009–2019; $4,000 in 2020.

Sources: HILDA Survey Release 20.0; RBA

finance, with the value of domestic personal credit and charge card purchases on Australian-issued cards around 15 times larger than BNPL transactions in the December quarter of 2021.

… including a small share of borrowers who could struggle to service their debts as a result of higher interest rates and/or inflation

With economic activity continuing to recover and inflation picking up, market participants are expecting interest rates to increase from their current exceptionally low levels over the next couple of years. Overall, the majority of indebted households are well placed to manage higher minimum loan repayments. Sizeable interest rate buffers are built into loan serviceability assessments, which are designed to ensure that borrowers are able to service higher interest rates (based on their financial situation at the time they took out the loan). Moreover, interest payments have declined for most borrowers since they first took out their loans, with interest rates on new variable housing loans having fallen since 2011. In recent years, many borrowers have also actively refinanced to low fixed-rate loans.

Around 60 per cent of all borrowers currently have variable-rate loans, with around two-thirds of these being owner-occupiers. Scenario analysis using information in the Securitisation dataset indicates that if variable mortgage rates were to increase by 200 basis points:

- just over 40 per cent of these borrowers made average monthly payments over the past year that would be large enough to cover the increase in required repayments (Graph 2.6)
- a further 20 per cent would face an increase in their repayments of no more than 20 per cent
- around 25 per cent of variable-rate owner-occupiers would see their repayments increase by more than 30 per cent of their current repayments; however, around half of these borrowers have accumulated excess payment buffers equivalent to one year's worth of their current minimum repayments that could therefore help ease their transition to higher repayments
- the share of borrowers facing a debt servicing ratio greater than 30 per cent (a commonly used threshold for 'high' repayment burdens) would increase from around 10 per cent to just under 20 per cent.

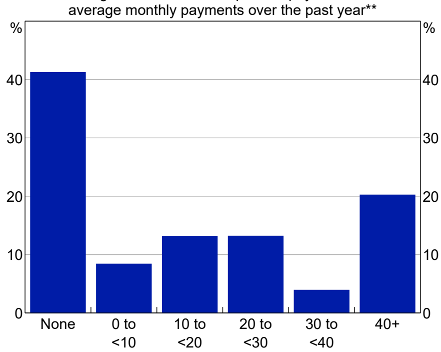
One caveat is that households' average monthly mortgage payments over the past year may have been larger than might reasonably be expected going forward, especially as previous spending patterns resume alongside the recovery in economic activity. It is difficult to draw inferences about the capacity of investors with variable-rate loans to make higher repayments, as they tend not to make excess mortgage payments (and other forms of saving are less visible in available data).

Most borrowers with fixed-rate loans are also likely to be able to handle the increases in their repayments when their fixed-rate terms expire.

Graph 2.6

Repayment Increases for Variable-rate Loans*

Changes between new required repayments and average monthly payments over the past year**



* Changes in repayments in response to a 200 basis point increase in interest rates.

** Share of variable-rate loans (excluding split loans) as at February 2022.

Sources: RBA; Securitisation System

Many borrowers have taken advantage of very low interest rates on fixed-rate products in recent years; in late 2021, almost 40 per cent of outstanding housing lending had fixed interest rates – roughly double the share at the start of 2020. Around three-quarters of currently outstanding fixed-rate loans will expire by the end of 2023.

Assuming all fixed-rate loans roll over to variable rates at the end of their fixed-rate period, and variable rates increase by around 200 basis points by the end of 2023, estimates from the Securitisation dataset suggest:

- over 90 per cent of those fixed-rate loans that are due to expire in the next two years will face an increase in repayments; for over half of borrowers, the increase would be in the range of 0–20 per cent (Graph 2.7)
- around one-quarter of fixed-rate borrowers have terms that expire beyond 2023, but could ultimately face larger shocks depending on how rates evolve over the next two years
- investors with interest-only loans are among the fixed-rate borrowers that would face the largest adjustment in repayments, reflecting the additional adjustment to principal and interest repayments when their fixed-rate periods expire.

Although the estimated increases in repayments are sizeable for some borrowers, it should be manageable for most. The risk of fixed-rate borrowers experiencing repayment difficulties would be partly mitigated by some splitting their mortgages between fixed and variable rates, which would result in smaller and more gradual increases in their total repayments than if they had only a fixed-rate loan. Moreover, given the broad-based increase in household saving rates over recent years, it is likely that many fixed-rate borrowers will 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).

These calculations assume household income after other expenses is unchanged (or in effect that any changes are perfectly offset). If rising inflation was to erode real household incomes, some borrowers may have to draw down their accumulated excess payment buffers much more quickly and/or cut back on other spending.

Macroprudential policy has reduced some riskier lending at the margin …

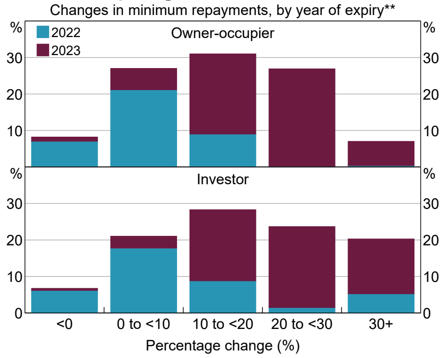
Growth in housing credit has picked up through the past year, alongside the strong growth in housing prices. As a result, the ratio of household credit to income has increased slightly from an already-high level, which contributes to elevated systemic risks (Graph 2.8).[1] Growth of housing credit to investors has also picked up but remains well below its 2015 peaks.

In response to the risks associated with rising household indebtedness, in October 2021 APRA increased the interest rate buffer that it expects prudentially regulated lenders to use to assess the ability of new borrowers to service their debt

Graph 2.7

Expiring Fixed-rate Loans*

Changes in minimum repayments, by year of expiry**



* Excludes fixed-rate loans that will expire beyond 2023; assumes future variable rates increase by approximately 200 basis points to 2023.

** Share of fixed-rate loans (excluding split loans) as at February 2022.

Sources: RBA; Securitisation System

by 50 basis points (to be at least 300 basis points above the prevailing loan interest rate). The increase works to reduce maximum loan sizes, and so reduces the amount of credit extended to riskier borrowers who seek to borrow very close to their maximum borrowing capacity (and as a result are more prone to repayment difficulties if they experience a fall in income or a rise in expenses).

The direct effect on aggregate credit growth is difficult to discern as the timing of the policy change broadly coincided with the end of lockdowns in Sydney and Melbourne, leading to unusual seasonality in the housing market. However, the impact on aggregate credit growth was expected to be modest given the majority of borrowers do not take out loans near their maximum. Further, some borrowers would have responded to the policy change by declaring more complex sources of income that were previously not required to support their desired loan amount, or by making other adjustments to their finances such as closing unused credit card facilities. Looking ahead, upcoming increases to the Household Expenditure Measure living expenses benchmarks to account for price increases could reduce maximum loan sizes further for some borrowers (maximum loan sizes are set at the amount of debt that a borrower can repay after factoring in their living expenses).

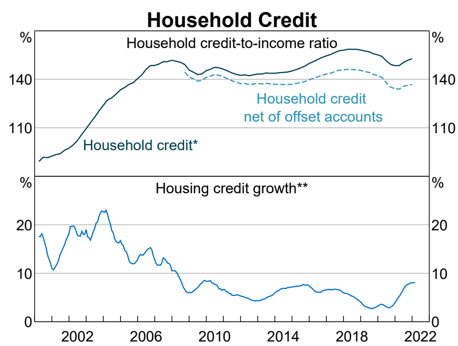
… but the share of new lending at high DTI ratios remains significant

While banks' loan underwriting policies remain sound overall, strong demand and some lenders' accommodative practices have pushed the share of high-DTI loans to very high levels. The share of new lending with a DTI≥6 is elevated, at around one-quarter of all new loans. This is noticeably higher than one year earlier; although, more timely monthly data indicate that the share of high-DTI lending moderated a little in early 2022 (Graph 2.9). The shares of new loans with high LVRs or interest-only terms remain low.

An increasing share of both investors and owner-occupiers have been taking out high-DTI loans. The increased share of high-DTI lending partly reflects low interest rates, as well as increased lending to investors who are more likely to have multiple housing loans and therefore higher DTIs. Around 60 per cent of the increase in high-DTI lending since early 2021 has been for loans with DTI ratios of between 6 and 7. There has also been a modest rise in the share of new owner-occupier loans with very high DTI ratios (≥10); however, almost all of this increase

Graph 2.8

Household Credit



* Sum of housing credit and personal credit; housing credit is net of redraw balances.

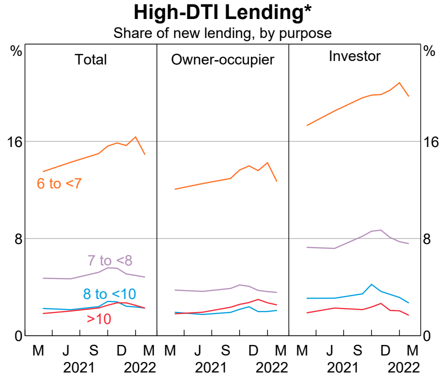
** Six-month-ended annualised terms.

Sources: ABS; APRA; RBA

Graph 2.9

High-DTI Lending*

Share of new lending, by purpose



* For the largest mortgage lenders; data provided on a 'best endeavours' basis.

Sources: APRA; RBA

reflects higher demand for temporary bridging loans.

All else equal, a higher DTI loan is riskier than a lower DTI loan as it is more likely that a fall in income or an increase in expenses will cause the borrower to have difficulties in meeting their repayments. However, household survey data suggest that individual borrower characteristics – such as the size of their liquidity buffers (cash, deposits and equities relative to disposable income), as well as levels of income and wealth – are also important determinants of self-reported mortgage stress (see 'Box B: How Risky is High-DTI and High-LVR Lending?'). Liaison with banks indicates that some high-DTI loans are originated with relatively large offset account balances.

To help mitigate potential financial stability risks associated with lending to highly indebted households, APRA has strengthened its prudential oversight of individual banks to ensure standards are being maintained and the risks associated with high-DTI portfolios are being properly scrutinised. APRA has also recently completed a consultation with lenders on its plans to require regulated lenders to be operationally ready to implement limits on high-DTI, high-LVR, investor or interest-only lending (or a combination of any two of these metrics).

The possibility of swings in housing price growth should be factored into borrowing and lending decisions

After nationwide housing prices increased by 22 per cent over 2021 (the strongest annual growth rate since the late 1980s), the pace of housing price growth moderated in most markets in early 2022. It is important that lenders and borrowers consider the potential for falls in housing prices, particularly for loans at high LVRs. Housing demand and the outlook for prices are uncertain due to a range of factors, including significant changes in population growth. Future increases in interest rates could also weigh on housing and other asset prices (see 'Chapter 3: The Australian Financial System'). Estimates using a model of the housing market that takes into account historical relationships between interest rates and both demand and supply factors suggest that a 200 basis point increase in interest rates from current levels would lower real housing prices by around 15 per cent over a two-year period, relative to the baseline model projection in the absence of an interest rate shock.[2]

Overall, business balance sheets have strengthened further …

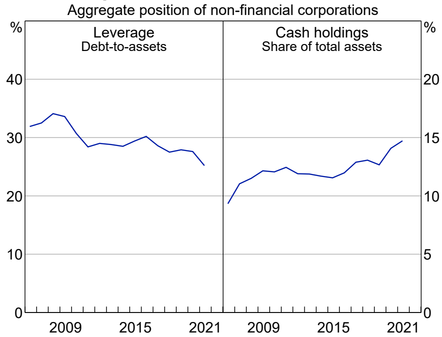
In aggregate, non-financial businesses have reduced their debt since the start of the pandemic, while the value of their assets has increased. In June 2021, the aggregate business debt-to-assets (leverage) ratio was about 25 per cent, down from 28 per cent two years prior (Graph 2.10). Overall, businesses have increased their resilience by building their liquidity buffers; at the end of June 2021 (the latest available annual data), total business cash holdings were about 30 per cent larger than their pre-pandemic level.

Most businesses have been easily meeting their debt repayment obligations, aided by low interest rates. Low loan arrears rates (see 'Chapter 3: The Australian Financial System') are

Graph 2.10

Corporate Balance Sheet Health

Aggregate position of non-financial corporations



Sources: ABS; RBA

consistent with detailed financial information available for listed companies, which suggests large businesses generally had little difficulty in servicing their debts at the end of 2021. In debt-weighted terms, only around 8 per cent of these firms had an interest coverage ratio (ICR) of below 2 (i.e. annual earnings that were less than twice their interest expenses) (Graph 2.11). An ICR below 2 has historically been associated with an increased risk of insolvency.

Most listed firms had adequate earnings at the end of 2021 to absorb a 200 basis point increase in average business lending rates, which is roughly equivalent to their level in late 2019. Estimates based on the recent short-term relationship between interest rate changes and firm-level interest expenses suggest that such an increase would not lead to a materially larger share of firms with low ICRs. Key reasons for this are that many of these businesses have fixed rates or use short-term interest rate swaps, both of which would moderate increases in interest expenses. In a scenario that assumes that increases in interest rates pass through fully to interest expenses (akin to a long-run outcome), the debt-weighted share of firms with low ICRs is estimated to increase to around 11 per cent; however, in practice, the share would likely be lower as rising interest rates typically accompany a stronger economy and business earnings.

… but around one-fifth of businesses have low cash buffers, partly because revenues remain low for some

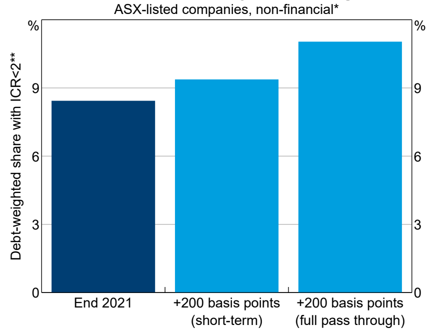
While aggregate business cash holdings remain high, a considerable share of businesses have very low cash buffers, leaving them more vulnerable to cash flow disruptions. Survey data up to January 2022 suggest around one-fifth of firms had very small buffers of less than one month's worth of expenses, up from around 10 per cent earlier in the pandemic (Graph 2.12). More than one-fifth of businesses with low cash buffers were in the construction sector, consistent with delays due to shortages of both building materials and labour, as well as a sharp rise in input costs. There was also a relatively high share of businesses with low cash buffers in the education, manufacturing and transport sectors.

Declining cash buffers in part reflect the slow recovery in some businesses' revenues. Although aggregate business revenue continued to grow in the second half of 2021 and is now 11 per cent higher than before the pandemic, some businesses continue to lag behind this broader recovery. As of the September quarter of 2021, around 7 per cent of

Graph 2.11

Corporates' Sensitivity to Lending Rates

ASX-listed companies, non-financial*



* Sensitivity based on debt and earnings at the end of 2021. Short-term based on empirical firm-level sensitivity over past three years; full pass through assumes all debts are variable rate.

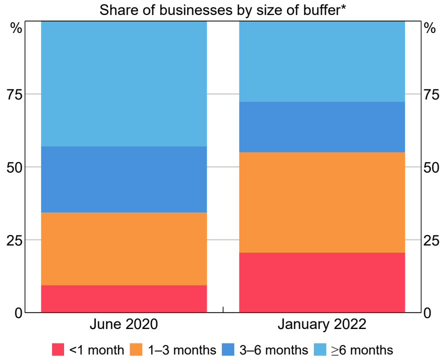
** ICR is calculated as earnings (EBITDA) over gross interest expenses.

Sources: Morningstar; RBA

Graph 2.12

Business Cash Buffers

Share of businesses by size of buffer*



* Number of months cash on hand could cover business operations.

Sources: ABS; RBA

businesses recorded revenues that had persistently been at least 40 per cent below their pre-pandemic average, up from around 3½ per cent at the end of 2019 (Graph 2.13). The increase in this share was generally greater in service-oriented industries where lockdowns and social distancing restrictions have weighed on demand.

Businesses with low cash buffers or already-weak revenues are more vulnerable to the current supply chain disruptions and staff shortages, which are weighing on revenues and raising costs. In March 2022, 16 per cent of businesses reported that supply chain disruptions were significantly affecting their revenues, up from around 11 per cent in April 2021. Governments and banks are providing support – including through grants and loan repayment deferrals – to smaller businesses affected by lockdowns, as well as to those affected by the recent flooding in New South Wales and Queensland.

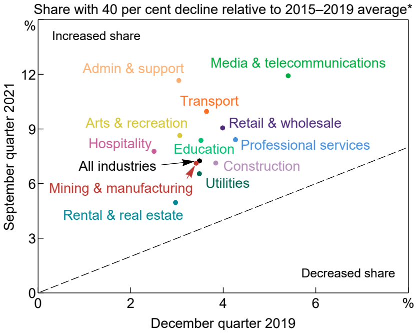
Insolvencies are rising, but from low levels

Policy support and cash buffers built earlier in the pandemic have helped many struggling businesses to weather ongoing disruptions or to successfully resolve their debts before winding down. Consistent with this, insolvencies and

Graph 2.13

Businesses with Low Revenues

Share with 40 per cent decline relative to 2015–2019 average*



* 40 per cent below firm-level average revenue in each of the previous four quarters, controlling for firm-specific quarterly seasonality; includes ~950,000 businesses; selected industries.

Sources: ABS; RBA

other financial stress indicators (such as the non-performing share of banks' business loans) remain very low. However, company insolvencies started to rise through last year.

Construction accounted for close to one-quarter of insolvencies over 2021. Some larger construction businesses have recently entered into administration, with the industry facing large increases in costs and thin margins on fixed price contracts (Graph 2.14). Looking ahead, contractors and suppliers to these firms are vulnerable to payment delays and defaults, particularly as contractors typically have unpaid receivables of around 1.25 times their monthly turnover, which is higher than most other industries. Some developers are also facing a higher-than-usual level of uncertainty about the timing of proposed apartment developments, unpredictability around demand as borders reopen, high pre-sale requirements from lenders, and the rise in construction costs. However, risks to banks are low overall as loans to construction businesses and developers account for only a very small share of assets for all domestic banks.

Further increases in insolvencies are also likely across a number of other industries, particularly as vulnerable businesses continue to draw down on cash buffers to cover lost revenue or higher costs.

Conditions in retail and office property markets remain challenging, but risks to banks remain low

Tenant demand for retail and office property remains weak. Vacancy rates in retail shopping centres remain elevated, with the impact of the pandemic amplifying longer-term structural challenges such as the shift to online retailing (Graph 2.15). Reflecting the weakness in tenant demand, retail rents and valuations have also continued to drift lower. While there are signs that demand for high-quality office space is starting to increase, conditions in secondary-grade office markets remain more challenging.

Financial stability risks from the commercial property sector remain low. Large listed Australian real estate investment trusts (A-REITs) directly own around 60 per cent of retail shopping centres by gross lettable area and roughly 10 per cent of total office space, mostly concentrated in prime grade assets. Overall, A-REITs have maintained healthy balance sheet positions since the onset of the pandemic, with steady profits and higher liquidity positions, slightly lower leverage and increasing ICRs (Graph 2.16). This suggests A-REITs' balance sheets are well positioned to handle ongoing earnings uncertainty and future increases in interest rates. Direct financial stability risks to banks are further mitigated by the fact that around three-quarters of A-REITs' outstanding debt has been sourced from capital markets, with the vast majority not due to mature until at least 2024.

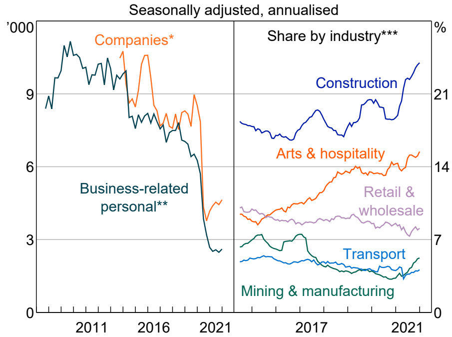
There is little information available on the financial health of smaller landlords. While some will have experienced declines in rents or rising vacancies during the pandemic, there is little evidence of indebted commercial property owners facing difficulties making loan repayments to banks. Impairment rates on banks' commercial property lending remain negligible, and banks' exposures to the sector remain low, at around 6 per cent of assets. Comprehensive information on the commercial property exposures of non-banks is not readily available and so it is possible that impairment rates are higher in that sector.

Looking ahead, increases in interest rates could be expected to weigh on commercial property valuations, but less so if the rate increases were to occur in an environment of rising rents. Large falls in property valuations could put some commercial property borrowers at risk of breaching their loan covenants unless they are

Graph 2.14

Business Insolvencies

Seasonally adjusted, annualised



* New external administrations and controller appointments.

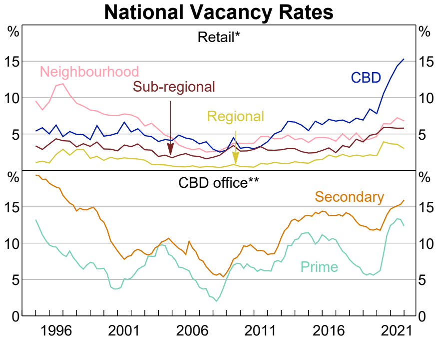
** New personal insolvencies of business owners/operators (e.g. sole traders or directors of proprietary companies).

*** Company insolvencies; four-quarter rolling basis; selected industries.

Sources: AFSA; ASIC; RBA

Graph 2.15

National Vacancy Rates



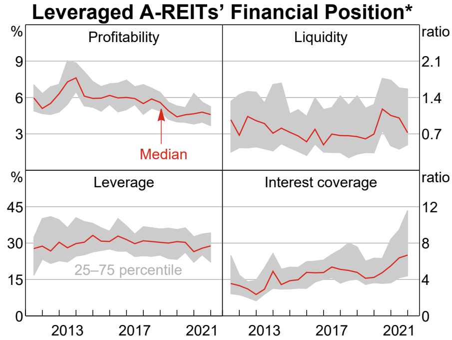
* Speciality store vacancy rates. Regional centres are anchored by department stores, sub-regional by discount department stores, and neighbourhood by supermarkets; CBD includes a variety of retail formats.

** Capital city central business districts and Canberra.

Sources: JLL Research; RBA

Graph 2.16

Leveraged A-REITs' Financial Position*



* Profitability measured by annual EBITDA over assets, liquidity by current assets over current liabilities, leverage by debt over assets, and interest coverage by annual EBITDA over annual interest expenses. There is a gradual structural break in ratios in late 2019 to early 2020 due to an accounting change.

Sources: Morningstar; RBA

able to contribute more equity to their loans. However, the incidence of negative equity is likely to remain very low, as commercial property loans tend to have relatively low LVRs.

Endnotes

[1] For background, see RBA (2021), 'Chapter 5: Mortgage Macroprudential Policies', *Financial Stability Review*, October.

[2] For further details on the model specification, see Saunders T and P Tulip (2019), 'A Model of the Australian Housing Market', RBA Research Discussion Paper No 2019-01.