2. Household and Business Finances in Australia

Concerns of widespread financial stress in the household and business sectors have eased as economic outcomes have exceeded expectations. Improving economic conditions and temporary policy measures have supported households' and businesses' cash flows, allowing almost all to make debt repayments and most to maintain or even grow their liquidity buffers. This has in turn reduced the risks of large scale defaults on housing and business debt.

The vast majority of households and businesses who had deferred loan repayments have now resumed full repayments. However, some increase in household and business financial stress is likely as temporary support measures progressively end and borrowers deplete financial buffers. Households and businesses that derive their incomes from sectors most heavily affected by the pandemic face an elevated risk of repayment difficulties if their buffers prove to be insufficient. Overall though, the share of heavily indebted households and businesses in this position is small. As a result, lenders' non-performing loan ratios are expected to rise modestly from low levels.

The nature of risks in housing markets has changed over the past six months. The economic recovery and policy stimulus have underpinned strong demand for housing, particularly from first home buyers. Housing prices in the largest cities have risen to be around 2017–18 levels. However, the price increases have not been uniform by region or dwelling type. Demand for inner city apartments fell over 2020 and is likely to be constrained in the near term given changes in housing preferences and reduced immigration. The short-term risks of oversupply of apartments are limited by the relatively low volume of expected apartment completions in 2021.

Conditions in the office property market remain weak, with vacancy rates having increased considerably over the past year, particularly in Sydney and Melbourne. Risks from the retail property sector are elevated, given weak rental market conditions. However, the financial positions of the largest owners of retail property remain sound, and they appear well placed to cope with the ongoing structural change towards online retailing. In contrast, some smaller landlords might have greater difficulties in managing declines in earnings, and insolvencies are likely to rise (see 'Box B: Risks in Retail Commercial Property').

Overall, household finances have improved …

Household disposable income increased by 5 per cent over 2020, boosted by temporary government income support. Improving labour market conditions contributed to income growth in the second half of the year. The program to allow households to access their superannuation early also provided a notable boost to household cash flow, with 3.5 million withdrawals totalling $36 billion (3 per cent of aggregate annual household disposable income) until the program's conclusion at the end of 2020. The combination of higher household disposable income and a sharp decline in household consumption saw the household saving ratio double to 12 per cent over 2020. This additional saving was used to pay down debt and/or build liquidity buffers, with the aggregate household mortgage debt-to-income ratio declining over 2020, and household deposit balances rising relative to household disposable income. (Graph 2.1). Part of the increase in household deposits has been in the mortgage offset accounts of indebted households.

Survey data suggest that the increase in liquidity buffers (the ratio of bank deposits to expenses) has been evident for both renters and indebted homeowners (Graph 2.2). Households with members employed in a range of industries – including those that have been relatively heavily affected by the pandemic – have also increased their buffers. In contrast, outright homeowners – who are typically less likely to encounter financial stress than other types of households – have reduced their buffers, though they remain high relative to other households, who are potentially more vulnerable.

… but a small share of households are vulnerable

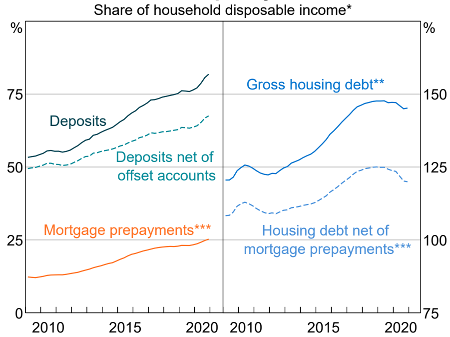
Most households remain in a good position to service their debt given low interest rates and have the additional safety net of large mortgage prepayment buffers. Around half of all mortgages have prepayment buffers equivalent to more than 3 months' worth of repayments and, for more than one-quarter of loans, the buffer exceeds 2 years' worth of repayments (Graph 2.3). The share of loans with prepayment buffers of only one month or less fell very slightly over 2020 and remains close to its pre-pandemic level of 40 per cent. Most loans with low prepayments do not present large risks to lenders. Data from the Reserve Bank's Securitisation System suggest that just under two-thirds of these loans are held by investors and/or fixed-rate borrowers who have incentives to hold savings outside their mortgages. Of the remaining loans with low prepayments, some are new loans that have not yet built buffers, while others belong to borrowers with persistently small prepayment buffers. This latter group of relatively 'risky' borrowers has declined to around 10 per cent of all loans from around 15 per cent a year ago.

Timely survey data indicate that households who rented or had a mortgage were much more likely to access some form of (government or private) financial assistance in 2020 compared to outright owner-occupiers (Graph 2.4). Households with at least one member working

Graph 2.1

Household Liquidity and Debt

Share of household disposable income*

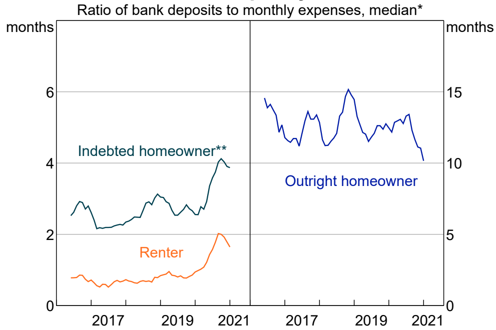


* Before housing interest costs
** Gross of redraw and offset account balances
*** Sum of redraw and offset account balances
Sources: ABS; APRA; RBA

Graph 2.2

Household Liquidity Buffers

Ratio of bank deposits to monthly expenses, median*



* Monthly expenses include living expenses, loan, and rental payments; six-month moving average
** Includes households with investor and owner-occupier debt
Sources: RBA; Roy Morgan Single Source

in industries that remain heavily affected by the pandemic (the recreation and personal, transport and storage, and retail sectors) were slightly overrepresented among those seeking assistance. Looking ahead, some of these households may need to draw on their prepayment buffers as support is unwound.

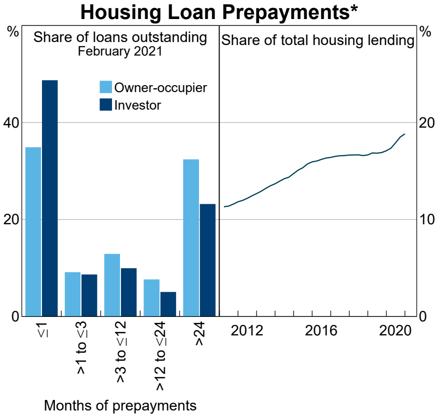
The share of housing loans (by value) on repayment deferrals at the end of February 2021 had declined to 0.7 per cent, from a peak of 11 per cent in May 2020. Almost all borrowers whose repayment deferral has come to an end – including many who chose to resume payments early – have resumed full repayments and are up to date with their loan schedule. The small number of loans still on deferred payments are slightly skewed towards borrowers with riskier characteristics, such as those with high loan-to-valuation ratios (LVRs) at origination and with prepayment buffers of less than 3 months' worth of repayments (Graph 2.5). Loans remaining on deferral are at greater risk of entering arrears than those that have already exited repayment deferral arrangements. A disproportionate share is in Victoria, where the recovery had been delayed. However, any rise in housing loan arrears rates over coming months is likely to be more modest than previously expected given better-than-expected economic conditions (see 'Chapter 3: The Australian Financial System').

Housing market strength has reduced near-term risks to household balance sheets

Housing market conditions have strengthened as the economic recovery has continued (Graph 2.6). Accommodative monetary policy has supported the prices of housing and other

Graph 2.3

Housing Loan Prepayments*



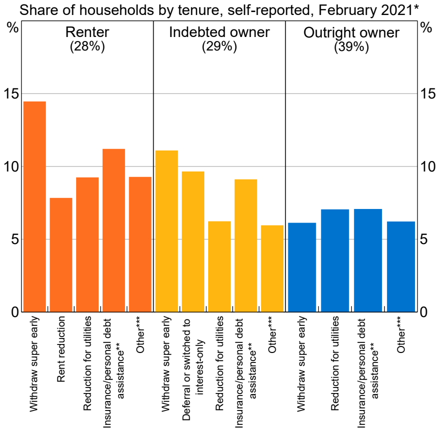
* Available redraw plus offset account balances

Sources: APRA; RBA

Graph 2.4

Selected Financial Assistance during COVID-19

Share of households by tenure, self-reported, February 2021*



* The share of respondents by housing tenure is shown in parentheses

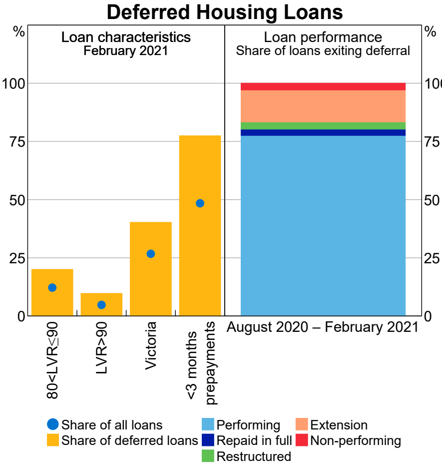
** Reduced or put on hold insurance or personal loan payments

*** The survey asks if respondents receive any other types of financial assistance; JobKeeper is self-reported under this question

Sources: RBA; Roy Morgan Single Source

Graph 2.5

Deferred Housing Loans



Sources: APRA; RBA

assets. After falling by almost 2 per cent between April and September 2020, nationwide housing prices have since more than recovered. In Perth and Darwin, prices have been increasing for the first time in several years, although they remain around 20 per cent below their peaks of 6–8 years ago. In Sydney and Melbourne, prices are now a little above the historical peaks they reached in 2017/18. Housing demand has been supported by low interest rates, stimulus payments boosting household income, temporary additional support for first home buyers and the HomeBuilder program. If housing prices continue to rise as the end of stimulus payments slows household income growth, this will present renewed challenges for housing affordability for lower income households.

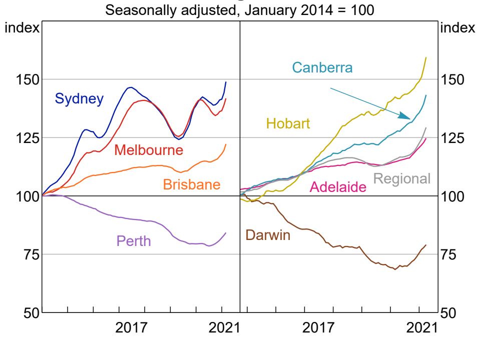
While prices have been rising nationally, there have been important compositional differences. These differences reflect changes in preferences, and the composition of demand, in response to the pandemic. Prices in regional areas have increased by 11 per cent over the past year, compared to 5 per cent in the capital cities. Price growth has also been stronger for detached houses than for units. Rental conditions have also been weak, particularly in Melbourne and in the inner and middle suburbs of Sydney where vacancy rates have increased sharply and rents for units have fallen (Graph 2.7). The closure of Australia's international borders is expected to cause population growth in 2021 to be around 1¼ percentage points lower than previously expected and has reduced demand for inner city rental housing by international students. A shift in preferences towards detached houses has also been weighing on demand for inner city apartments. However, near-term risks of oversupply – and therefore sharp price declines – are mitigated by the considerably smaller volume of higher-density inner city apartments due for completion in 2021 relative to previous years.

Rising housing prices have reduced the incidence of negative equity. The share of loans for which the value of the loan exceeds the value of the property has fallen to around 1¼ per cent, down from over 3 per cent a year ago (Graph 2.8). As a result, a larger share of borrowers could sell their property and extinguish their debt if they experienced repayment difficulties, reducing potential losses for lenders. The share of loans in negative equity has fallen in all states, but the incidence remains greater in Western Australia, the Northern Territory and Queensland. Loans that remain on repayment deferrals are no more likely to be in negative equity than those making full repayments.

Graph 2.6

Housing Prices

Seasonally adjusted, January 2014 = 100

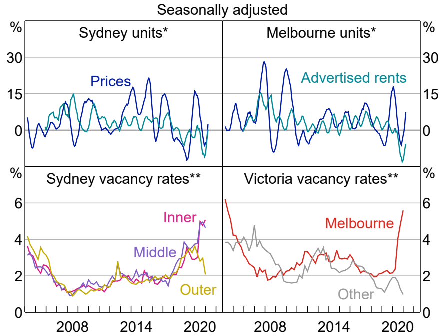


Sources: CoreLogic; RBA

Graph 2.7

Housing Market Conditions

Seasonally adjusted



* Apartments and townhouses; six-month annualised growth

** Rental market vacancy rate for all dwelling types; quarterly

Sources: CoreLogic; RBA; REINSW; REIV

Lending standards are largely unchanged and remain robust

The strengthening in lending standards since the mid 2010s has ensured that indebted households generally had sufficient income and equity buffers to cope with the COVID-19 economic downturn. Lending standards were initially tightened further at the onset of the pandemic in anticipation of deteriorating economic conditions, but with the subsequent improvement in the economic outlook, this has since been unwound. The share of high LVR lending increased over the second half of 2020 but remains low by historical standards, while the share of interest-only lending has been little changed at low levels (Graph 2.9). The share of lending at high debt-to-income ratios also increased over the second half of 2020 following earlier declines (Graph 2.10).

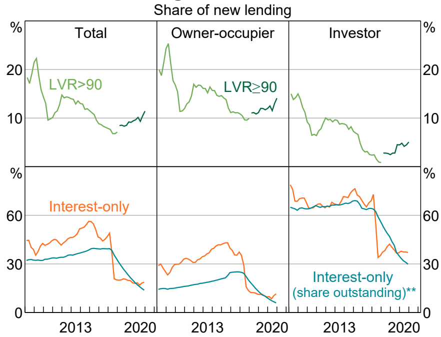
Some of the increase in high LVR lending to owner-occupiers reflects the greater share of first home buyers who have responded to government incentives and lower interest rates, which make purchasing housing more attractive relative to renting. Despite typically having higher initial LVRs than other borrowers, prior to the pandemic first home buyers tended to pay down their debt relatively quickly. In addition, Securitisation System data suggest that for loans less than 5 years old, first home buyer and other loans have similar prepayment buffers and arrears rates. While new loans are generally at higher risk of facing repayment difficulties in the event of a shock to household income than older loans, there is little evidence to suggest that lending to first home buyers has been an especially risky form of lending.

Credit growth has increased but remains modest and has mostly been driven by lending to owner-occupiers (Graph 2.11). Some of the increase in owner-occupier loan commitments has been related to a pull-forward of demand for construction loans, which may ease with the expiry of the government's HomeBuilder program. Investor credit growth has increased in recent months but remains very low by

Graph 2.9

ADIs' Housing Loan Characteristics*

Share of new lending



* LVR series break at March 2018 due to reporting changes; interest-only series are break-adjusted and seasonally adjusted

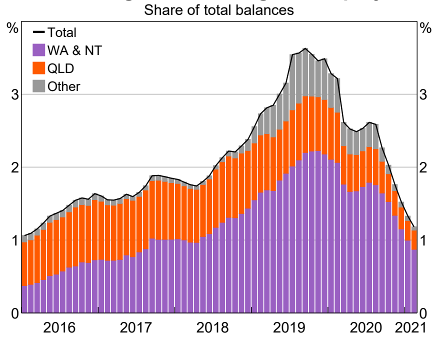
** Share of outstanding interest-only loans to housing credit

Sources: APRA; RBA

Graph 2.8

Housing Loans in Negative Equity

Share of total balances

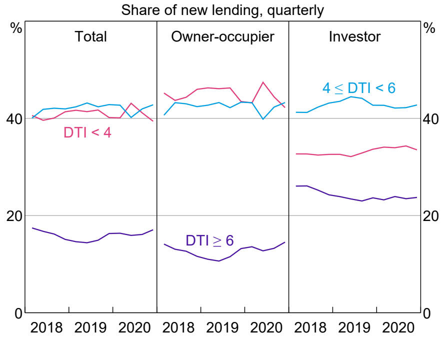


Sources: ABS; CoreLogic; RBA; Securitisation System

Graph 2.10

Debt-to-income Ratios

Share of new lending, quarterly



Sources: APRA; RBA

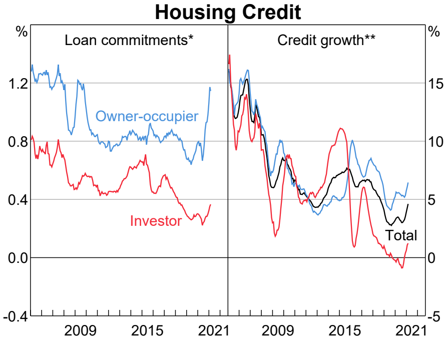
historical standards. Investor loan commitments, which are a leading indicator of investor credit growth, have started to rise, and lenders have reported renewed investor interest, particularly for detached houses.

Business profitability has improved as the economy has started to recover

In aggregate, business profitability has recovered strongly following the significant trading disruptions that occurred at the height of the pandemic, with temporary policy measures providing significant support (Graph 2.12). Aggregate business revenue remains weaker than a year ago, but this has been more than matched by reductions in operating expenses.

Graph 2.11

Housing Credit



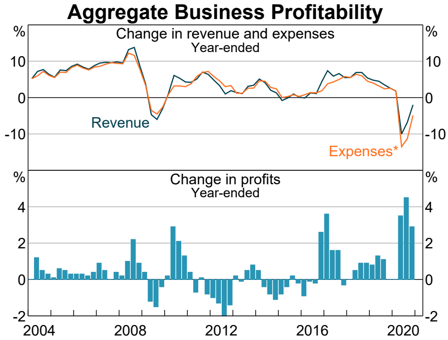
* As a share of total housing credit; excludes refinancing

** Six-month-ended annualised terms

Sources: ABS; APRA; RBA

Graph 2.12

Aggregate Business Profitability



* Estimated as the difference between revenue and gross operating profits

Sources: ABS; RBA

Improved trading conditions and policy support have helped businesses maintain the large cash buffers they accumulated in 2020 (Graph 2.13). By late 2020, companies' holdings of cash and deposits covered more than 5 months' worth of expenses on average, while unincorporated businesses had over 2 months' worth of buffers. While this partly represents firms reducing expenses, it is mostly accounted for by increased cash holdings. In addition, some businesses hold committed lending facilities with banks that they could draw on if needed. These savings are expected to support businesses through the recovery.

Despite improvements in the outlook, some businesses are vulnerable in the near term

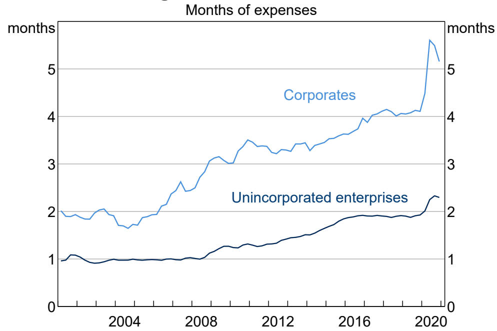
Businesses in the arts and recreation, accommodation and food, and transport sectors have experienced relatively large declines in revenue over the past year (Graph 2.14). Activity in these sectors remained at a low level in late 2020 even as aggregate economic conditions improved. A sizeable share of firms in these sectors have continued to receive a significant boost from temporary support measures in early 2021.

Some firms will find it challenging to continue to meet their existing expenses as the policy

Graph 2.13

Cash Holdings of Non-financial Businesses

Months of expenses



Sources: ABS; RBA

support measures are withdrawn if their trading conditions do not improve. As at February 2021, the share of businesses still receiving JobKeeper payments was highest in Melbourne and in areas with a relatively high share of businesses operating in sectors more affected by the pandemic (Graph 2.15). Firms in these sectors also tend to be more highly geared and have lower levels of liquidity than those in other sectors, suggesting they face a higher risk of future difficulties in servicing their debts. Without a sustained pick-up in revenue, some businesses will be forced to reduce their current levels of employment. In turn, this will diminish the ability of some households to service their own debts.

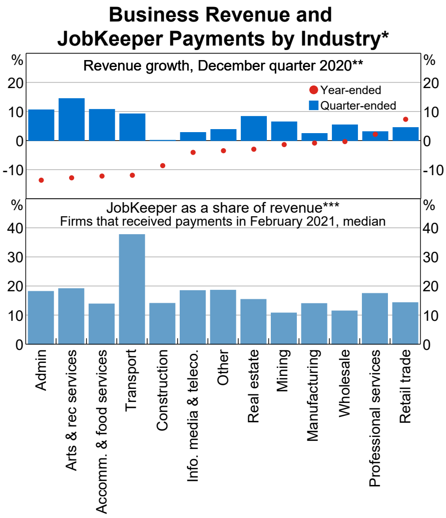
In addition, many businesses provide, or rely on, trade credit (where a business purchases goods or services on account and pays the supplier at a later date). If some businesses have trouble making their payments, this would spill over to other businesses through trade credit networks. To date, these contagion risks remain contained, with average trade credit payment times – an indicator of firms' difficulty in making payments – slightly below pre-pandemic levels. The failure of trade finance investor Greensill Capital in March does not appear to reflect broader problems with the provision of trade credit in Australia or internationally.

Overall, the risks of insolvency appear largest for SMEs operating in high risk industries, given they tend to have smaller cash buffers and have been more reliant on temporary support measures than larger firms. The share of SME loans with deferred repayments has fallen to just over one per cent (by number), from around 13 per cent in June 2020. The share of major banks' SME lending with a relatively high probability of default has increased, suggesting that banks expect the performance of some SME loans to deteriorate.

Business insolvencies have begun to rise

Business insolvencies have risen from their mid-2020 lows, with the increase at the very end of the year coinciding with the end of the moratorium on director liability for insolvent trading (Graph 2.16). Looking ahead, it is likely that insolvencies will rise further for some months, notwithstanding the expected

Graph 2.14



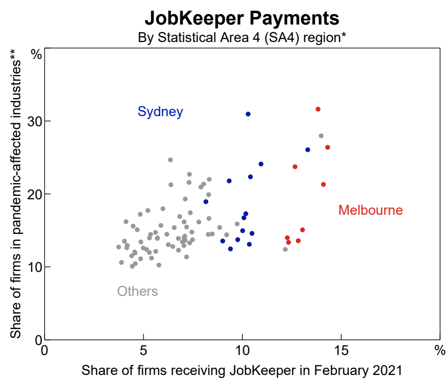
* Non-financial businesses in industries from the ABS Quarterly Business Indicators Survey

** Industry aggregates; quarter-ended growth rates are seasonally adjusted

*** Annualised JobKeeper payments in Feburary 2021 as a share of FY 2019/20 total revenues

Sources: ABS; RBA

Graph 2.15



* There are around 100 SA4 regions in Australia, each comprising between 100,000 and 500,000 residents; a small number of regions are excluded from this graph due to small sample sizes

** Pandemic-affected industries include accommodation & food services, arts & recreation services, education, and transport

Sources: ABS; RBA

improvement in aggregate economic conditions. Vulnerable businesses may find it difficult to continue to operate and/or to meet their debt repayments if their revenues do not increase sufficiently to cover the withdrawal of government support.

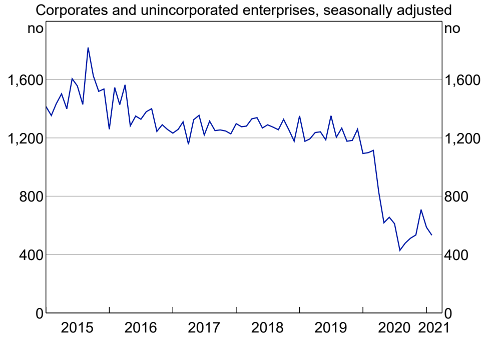
There are a couple of factors that are likely to help moderate the rise in insolvencies following the end of the moratorium period. Support measures have prevented business insolvencies not only through cash support, but also by giving businesses more time to wind down operations without entering into insolvency. This suggests that a larger-than-usual share of firms ceased trading without becoming insolvent and so creditors incurring losses. Further, changes to the insolvency framework and the recently announced SME Recovery Loan Scheme are expected to provide better outcomes for some small business owners and their creditors (discussed further in 'Chapter 4: Domestic Regulatory Developments'). Businesses now have more options for debt restructuring and, in the case of insolvencies, new expedited processes will help to reduce costs.

Business insolvencies will have flow-on effects to households, both by reducing employment and because just under 30 per cent of loans to SMEs are secured by (most likely the business owners') housing. Residentially secured loans benefit SMEs by allowing them to borrow larger amounts and at lower interest rates, but they also increase the probability that business insolvencies will result in defaults on loans secured by housing. While this risk of default on housing debt amplifies the financial stress experienced by small business owners and would negatively affect housing markets, it is unlikely to cause significant issues for banks, as most borrowers hold positive equity in their homes, and SME loans account for only 15 per cent of total outstanding credit. Moreover, around one-third of businesses that were still receiving JobKeeper payments at the beginning of 2021 were sole traders, suggesting that for these firms at least, the flow-on effects of any business insolvencies for households through a reduction in employment are likely to be fairly small.

Graph 2.16

Business Insolvencies

Corporates and unincorporated enterprises, seasonally adjusted



Sources: AFSA; ASIC; RBA

Commercial property risks are greatest for retail and also offices

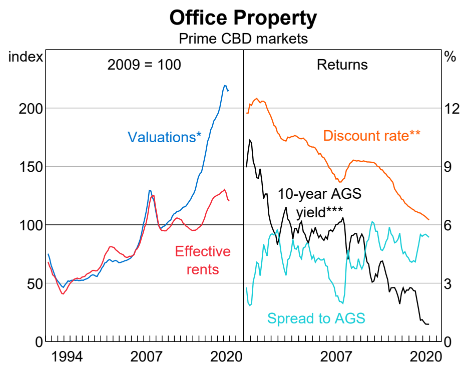
Banks are closely monitoring their commercial property exposures that have been most affected by the pandemic, in particular the office and retail property markets (see 'Box B: Risks in Retail Commercial Property'). Impairment rates on commercial property lending remain low, consistent with relatively low LVRs and strong debt covenants leading into pandemic, but are expected to rise. While banks' direct commercial property exposures account for only about 6 per cent of their total assets in aggregate, there is considerable variation across banks (for Australian-owned banks, the range is 0–16 per cent). Moreover, banks' effective exposures are higher than their direct exposures because, as noted above, some business lending is secured by commercial property. Non-bank lenders remain active in the sector and they can influence conditions for banks by competing on lending standards, and by financing deals which also involve banks.

Vacancy rates continued to rise across most CBD office markets in the December quarter 2020, and in Sydney and Melbourne are currently around their highest levels in about 20 years (Graph 2.17). About one-quarter of reported CBD office vacancies in these cities are due to existing tenants seeking to sublet some space, which means owners have still been receiving at least some rent. The increase in vacancy rates has been similar across property grades to date, but secondary-grade office buildings tend to be more vulnerable when demand is falling as tenants take advantage of incentives to move to higher-quality premises.

Tenant demand for offices is expected to remain weak in the early stages of the economic recovery, with some staff at many businesses continuing to work at least partly from home. Office supply will expand further this year as new office buildings are completed, albeit by less than last year, and most new office space has pre-committed tenants. Measures of office rents and valuations have declined only slightly since the pandemic, although the low number of sales transactions in 2020 increases the uncertainty about recent price trends (Graph 2.18).

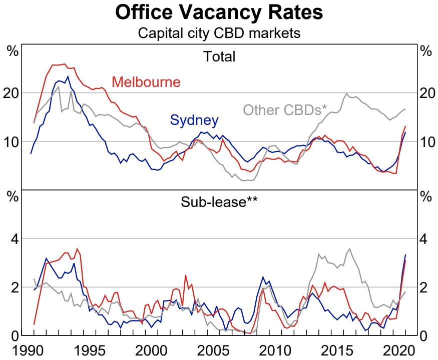
Valuations and rents for industrial property have continued to grow, reflecting strong demand for logistics and warehousing facilities partly due to the accelerated shift towards online retailing (Graph 2.19). Unlike in other sectors, sales transactions in the industrial property market did not decline in 2020. For diversified commercial property investors, strong conditions in the industrial property market are expected to cushion the impact of declining valuations and rental income in the retail and office sectors. Transactions data from 2015–19 suggest that about one-third of large office and retail property investors had also purchased industrial property. ✠

Graph 2.18



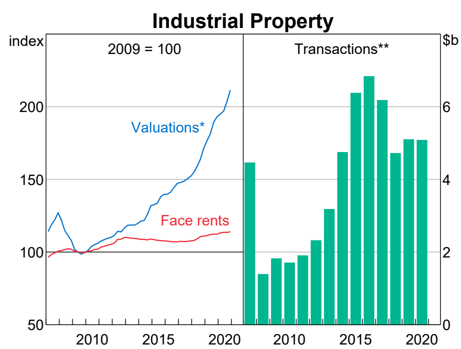
* JLL Capital Value Indicator
** The rate applied to properties' projected cash flows to estimate their present value
*** Australian Government Securities; spread to AGS in percentage points
Sources: JLL Research; MSCI; RBA

Graph 2.17



* Brisbane, Perth and Adelaide
** Share of total office space offered for sub-lease
Sources: JLL Research; RBA

Graph 2.19



* JLL Capital Value Indicator; prime grade
** Total value of transactions over $5 million
Sources: JLL Research; RBA