2. Resilience of Australian Households and Businesses

Summary

Most Australian households and businesses remain well placed to manage the impact of high inflation and higher interest rates given the strength of the labour market and sizeable savings buffers. Nevertheless, pressure on household budgets and business profitability has increased over the past six months.

- **The vast majority of Australian borrowers have continued to service their debts in the face of higher inflation and interest rates.** In part, this is because some households have gained additional work, reduced discretionary consumption and/or drawn on savings buffers. The income and savings positions of borrowers have allowed most to continue to meet their essential expenses and mortgage payments; very few have fallen behind on their loan payments or sought temporary loan modifications. In the event that more borrowers became unable to service their loans, only a very small number would be in negative equity on their mortgage. As a result, losses to lenders are expected to remain low and manageable.
- **The business sector remains resilient overall, as strong demand and high cash buffers have supported business profitability and balance sheets.** However, ongoing cost pressures coupled with a softening in demand is putting pressure on some businesses' profitability and liquid reserves. Company insolvencies have increased from the very low levels seen during the COVID-19 pandemic, but as these companies have tended to be small and have little debt, risks to banks and the broader financial system remain low.
- **There are few signs of financial stress among owners of Australian commercial real estate (CRE)**, despite pressures on profitability and valuations from reduced leasing demand and higher interest rates. It is possible that stresses, including among non-bank CRE lenders, could emerge if higher interest rates and a severe economic downturn were to lead to a sharp fall in rental income, or stress in foreign CRE markets escalated and spilled over to the Australian market (see Chapter 1: The Global and Macro-financial

Environment). However, systemic risks from CRE are limited in Australia due to domestic banks' low exposures and conservative lending practices.

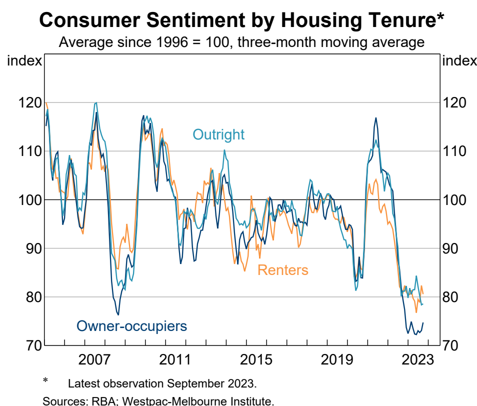
2.1 Households

Higher inflation and interest rates continue to put pressure on household budgets …

Many households continue to face a squeeze on their budgets as high inflation and the increase in interest rates over the past 18 months have reduced available income after essential expenses and housing costs. Consistent with this, consumer sentiment remains near historically low levels, particularly for owner-occupier mortgagors (Graph 2.1).

Budget pressures differ across households depending on income levels and whether they have debt (see 5.3 Focus Topic: Indicators of Household Financial Stress):

- **Lower income households**, including many renters and some mortgagors, spend a larger share of their income on housing costs and other essential items. They have therefore been impacted more by inflation than households on higher incomes. These households had little in the way of spare income even before the sharp increase in inflation.



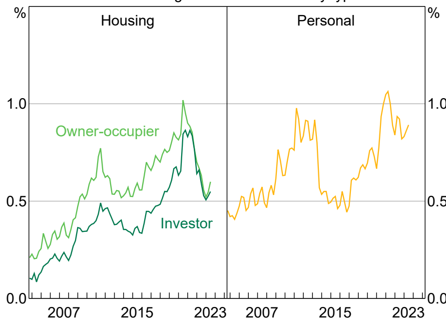
- **Variable-rate borrowers** (accounting for around three-quarters of housing credit) have seen their scheduled mortgage payments increase sharply since the first increase in the cash rate in May 2022. For most, payments have increased by between 30 per cent and 50 per cent, depending on when the loan was originated. Borrowers with high debt relative to their income – including some new mortgagors and first home buyers – have been particularly affected as their scheduled loan payments relative to income have increased by a greater amount than those of other borrowers.
- **Borrowers who fixed their interest rates** during the COVID-19 pandemic and are yet to roll off those rates (accounting for around one-fifth of housing credit) will see similar increases in scheduled mortgage payments, with the bulk rolling off over the rest of this year and in early 2024. However, they do not appear to be more at risk than similar borrowers on variable rates and in fact have benefited from having fixed their interest rates at very low levels for an extended period (see 5.2 Focus Topic: An Update on Fixed-rate Borrowers).
- **Housing investors** (accounting for around 30 per cent of housing credit) have experienced increases in their mortgage costs, similar to owner-occupiers on the same type of loan (i.e. variable or fixed rate). At the same time, rental incomes have increased strongly in the tight rental market, offsetting some of the effects on investor cash flows from higher costs.

… but the vast majority of household borrowers have continued to service their debts.

While budget pressures have led to an uptick in arrears and personal insolvencies, the vast majority of households continue to service their debts (Graph 2.2). Lenders in the Bank's liaison program have reported that borrowers have been more resilient than expected in their ability to service their debt, given the sharp rise in interest rates.

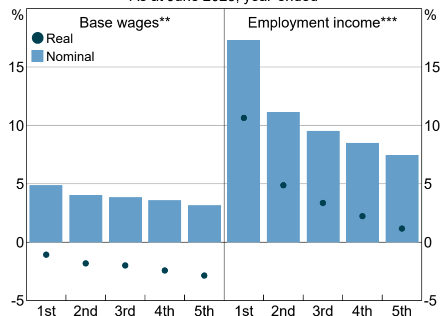
Households' ability to manage higher expenses and interest rates has mostly relied on three factors:

1. *The strong labour market has supported household incomes.* More Australians than ever are in paid work (as a share of the population), and some have increased their hours of work. Together with job-switching, promotions and additional payments such as overtime or cost-of-living bonuses, this has led to strong growth in nominal employment income (Graph 2.3, right panel). This is especially true for those on lower incomes, with many having experienced a lift in real incomes that has outpaced growth in their base hourly wage rate.
2. *Many households have curtailed their spending, particularly for discretionary goods and services.* Consistent with high inflation and the resulting tightening in monetary policy, growth in household consumption has slowed materially since mid-2022. Liaison with retailers also suggests that households are increasingly looking for value, including on essential items. Looking ahead, some households may find it increasingly difficult to cut back further on consumption as they have already reduced their discretionary expenditure substantially.
3. *Some households have been able to draw on the large savings buffers they accumulated during the pandemic.* Most households entered the period of high inflation and rising rates in a strong financial position because of substantial fiscal and monetary policy support and reduced consumption opportunities during the pandemic. Low interest rates had also supported borrowers, including borrowers on fixed rates, to increase their savings over this time (Graph 2.4). More recently, however, the flow of new savings has slowed, including excess payments into offset accounts and redraw facilities.[1] In addition, a larger share of variable-rate owner-occupier borrowers



* Well-secured loans prior to March 2022; both well-secured and not well-secured loans thereafter. Latest observation June 2023.

Sources: APRA; RBA.



* Inflation quintiles constructed by income levels.

** Total hourly rates of pay, excluding bonuses and commissions; quintiles constructed using hourly wage rates in the previous period.

*** Single Touch Payroll employment income per worker for those with a 2019/20 tax return; percentiles constructed using employment income in the current period; estimates are based on the percentile at the mid-point of each group; administrative data on incomes are not necessarily directly comparable to published aggregate estimates.

Sources: ABS; ATO; RBA.

have persistently drawn on their buffers this year (Graph 2.5). The share of small withdrawals (relative to income) has also picked up, possibly indicating that these withdrawals are used to finance regular spending rather than large, discretionary expenses such as holidays.

A small but rising share of borrowers are on the cusp, or in the early stages, of financial stress …

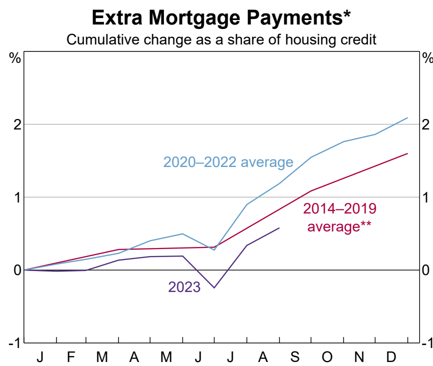
While almost all borrowers have been able to make adjustments that have allowed them to continue servicing their debts and cover essential spending**,** the share falling behind on their mortgage payments has begun to pick up from a low level. Before reaching this stage, households often contact their lender to enquire about options to restructure their loan or apply for temporary hardship, turn to alternative sources of finance or seek other forms of help. A growing share of households have sought financial counselling; the National Debt Helpline (NDH), for instance, has seen demand for its services increase by around one-quarter from the low level experienced during the COVID-19 pandemic (see 5.3 Focus Topic: Indicators of Household Financial Stress). Some households contacting the NDH have been using 'buy now, pay later' products to finance their regular consumption. However, in contrast with some countries, there is little evidence that Australian households are turning to other forms of personal credit (such as credit cards or personal loans) to sustain their spending (Graph 2.6).

Further insights into how the share of borrowers in mortgage stress is likely to be evolving can be derived using the loan level data from the Bank's Securitisation System and the Melbourne Institute's Household Expenditure Measure (HEM) of essential expenses (see Box: Assumptions underlying estimates of borrowers' essential expenses and income).

Graph 2.4

Extra Mortgage Payments*

Cumulative change as a share of housing credit



* Data are not seasonally adjusted. Series are calculated as the cumulative sum of extra payments divided by the June figure for total housing credit in that year.

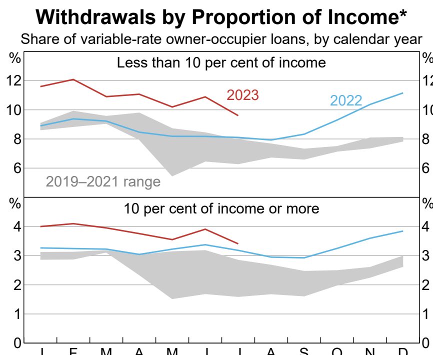
** Available data prior to 2020 are quarterly.

Sources: APRA; RBA.

Graph 2.5

Withdrawals by Proportion of Income*

Share of variable-rate owner-occupier loans, by calendar year

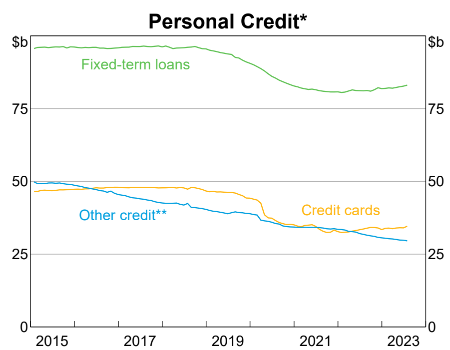


* Includes borrowers who reduced their mortgage savings (in offset and redraw accounts) for all of the preceding three months. Total withdrawals over the three months are compared to gross annual income grown by WPI from loan origination.

Sources: ABS; RBA; Securitisation System.

Graph 2.6

Personal Credit*



* Seasonally adjusted and break-adjusted. Includes off-balance sheet securitisation. Latest observation July 2023.

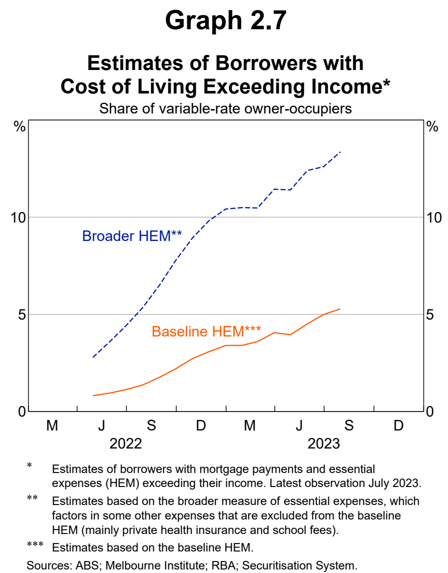
** Other credit includes margin loans, finance leases and other revolving credit.

Sources: APRA; RBA.

Using the baseline HEM measure of essential expenses, the share of variable-rate owner-occupiers whose essential expenses and mortgage costs exceeded their income in July 2023 is estimated to be around 5 per cent, up from around 1 per cent in April 2022.[2] These households are likely to have little capacity to cut back on spending (Graph 2.7).

Using a broader HEM measure of expenses – which includes items that are more discretionary in nature but can be difficult to adjust (such as private health insurance and private school fees) – the share of variable-rate owner-occupiers whose expenses and mortgage costs exceeded their income in July 2023 is estimated to be around 13 per cent, up from around 3 per cent in April 2022 (Graph 2.7). These borrowers, however, are likely to have some capacity to reduce spending over time.

These estimates show that a small but rising share of borrowers are likely to have seen their essential expenses and mortgage costs exceed their income as interest rates have increased since May 2022. However, they do not necessarily indicate that these borrowers are in mortgage stress. Rather, these estimates indicate that a share of borrowers need to make adjustments beyond significantly reducing consumption – such as drawing on their savings buffers (discussed below) or assessing other options like restructuring their loan. The analysis below focuses on the share of borrowers whose expenses exceed their income based on the baseline HEM measure of expenses, given these borrowers are likely to be facing particularly challenging financial decisions and are at greater risk of defaulting on their housing loan.

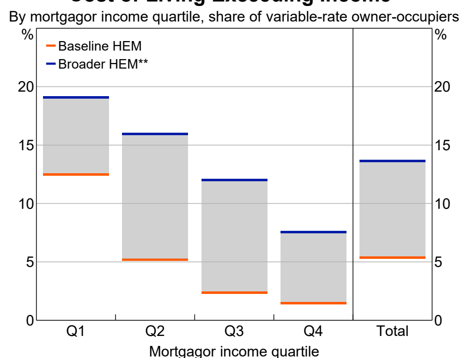


Lower income borrowers – defined as those in the bottom quartile of *mortgagor* incomes, with up to around $78,000 in household disposable income – tend to be more affected by higher interest rates as they already had less spare income before interest rates began to increase in May 2022. Consistent with this, lower income borrowers make up a larger share of borrowers with insufficient income compared with their essential costs and scheduled mortgage payments (Graph 2.8).

Graph 2.8

Estimates of Borrowers with Cost of Living Exceeding Income*

By mortgagor income quartile, share of variable-rate owner-occupiers



* Estimates of borrowers with mortgage payments and essential expenses (HEM) exceeding their income as at July 2023.

** This factors in some other expenses that are excluded from the baseline HEM (mainly private health insurance and private school fees).

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

… but most borrowers are well placed to service their debts even if interest rates were to increase further.

As noted above, most owner-occupier borrowers are currently estimated to have sufficient income to allow them to meet their essential expenses and loan payments. By contrast, the estimated 5 per cent of borrowers with insufficient income (using the baseline HEM) will need to draw down on available savings buffers or find other margins of adjustment, such as additional work, to meet their essential expenses and scheduled mortgage payments.[4] About 70 per cent of these borrowers have sufficient savings in their offset and redraw accounts to finance their cash

Box: Assumptions underlying estimates of borrowers' essential expenses and income

The share of borrowers whose essential expenses and mortgage costs exceed their income cannot be observed in the loan level data from the Bank's Securitisation System[3] (or by lenders themselves). Therefore, it must be estimated. The range of estimates presented here depend on the following assumptions for income and expenses.

Baseline HEM: Essential expenses are proxied using the Melbourne Institute's Household Expenditure Measure (HEM), the minimum living expenses measure used by Australian banks when assessing loan serviceability. The HEM is defined as the median spend on a basket of absolute basics (such as most food items, utilities and transport costs) plus the 25th percentile spend on discretionary basics (e.g. take-away food, restaurants and entertainment) for different household types and income levels. Rents and mortgage payments are not included.

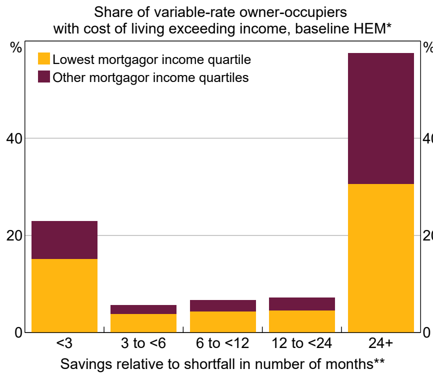
Broader HEM: Additional expenses that are less likely to be adjusted in the near term (mainly private health insurance and private school fees) are added to the baseline HEM, which may better capture the near-term financial pressure borrowers face. However, households estimated to be unable to meet these additional expenses may be able to adjust to their budget constraints before defaulting on their loan. As such, the baseline HEM is likely to better capture borrowers' ultimate essential living costs and their ability to service their current loan.

For both measures, borrowers' income growth is assumed to align with the Wage Price Index (WPI) since their loan was originated. This is a very conservative estimate of incomes: growth in the WPI, by design, cannot factor in other sources of income growth, such as promotions and job switching, that may occur over time. These step-increases in income are likely to be particularly relevant for younger mortgagors. In addition, some borrowers do not disclose all their income when applying for a loan, but rather only what is needed to be approved for a loan. This results in a potential upward bias in the estimated share of borrowers with a cost of living that is exceeding their income.

flow shortfalls for at least six months, assuming interest rates remain around current levels (Graph 2.9). However, the remaining 30 per cent of these borrowers (or around 1½ per cent of all variable-rate owner-occupier borrowers) are at risk of depleting their buffers within six months – and so are at higher risk of falling into arrears on their housing loan. Lower income borrowers are over-represented in these groups as they are more likely to have difficulties covering their essential costs and mortgage payments; furthermore, those who cannot cover these costs tend to have smaller savings buffers.

Graph 2.9

Mortgage Buffers Relative to Cash Flow Shortfalls



* Includes variable-rate owner-occupier borrowers who are estimated to be in cash flow shortfalls as at July 2023 under assumptions using the baseline HEM and income growth in line with WPI growth since loan origination.

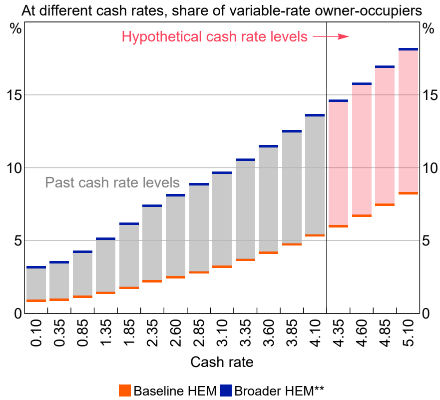
** Number of months that mortgage prepayments (offset and redraw balances) can cover cash flow shortfalls.

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Most borrowers are also expected to be well placed in the event of a further increase in interest rates. The direct effect of a hypothetical 50 basis point increase in the cash rate to 4.6 per cent increases the estimated share of variable-rate owner-occupier borrowers who are unable to cover their expenses (using the baseline HEM) from around 5 per cent to around 7 per cent (Graph 2.10). Of these borrowers, about 30 per cent are at risk of depleting their buffers within six months (equivalent to 2 per cent of all variable-rate owner-occupier borrowers).

Graph 2.10

Estimates of Borrowers with Cost of Living Exceeding Income*



* Estimated shares of variable-rate owner-occupier borrowers with mortgage payments and essential expenses (HEM) exceeding their income as at July 2023 under assumptions using the Household Expenditure Measure and income growth in line with WPI growth since loan origination. Assumes no changes in expenses or incomes if the cash rate were to change.

** This factors in some other expenses that are excluded from the baseline HEM (mainly private health insurance and private school fees).

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Employment remains an important factor in households' resilience.

While most borrowers appear well placed to service their debt and cover essential costs during an extended period of higher interest rates, this would change if they became unemployed for a sustained period. Around one-third of all variable-rate owner-occupier borrowers would have enough buffers in their offset or redraw accounts to sustain their scheduled mortgage payments and essential expenditures for at least one year if they were to lose all their household's income – an extreme scenario, as discussed below (Graph 2.11). On the other hand, a little over 40 per cent are estimated to have buffers to sustain them for less than three months.

Relative to their costs of living, the buffers held by lower income borrowers are similar to those of borrowers on higher incomes. However, they are more at risk of becoming unemployed and having to draw down on these buffers during an economic downturn.[5] Highly leveraged borrowers represent another group at higher risk

as they have fewer savings and tend to spend more of their income on servicing their mortgage (see 5.3 Focus Topic: Indicators of Household Financial Stress).

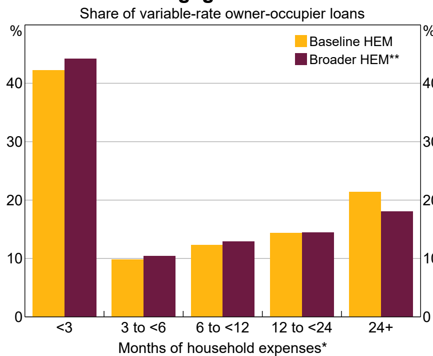
While a substantial economic downturn poses a considerable risk for individual borrowers if they become unemployed, it is unlikely to have material implications for system-wide financial stability. Even in the case of a substantial increase in unemployment of 2 percentage points, based on the estimates in Graph 2.11, only around 1¼ per cent of variable-rate owner-occupier borrowers would become at risk of depleting their buffers within one year (where expenses are taken from the baseline HEM). Furthermore, several factors are likely to mitigate this risk for individual borrowers and, hence, the broader financial system, including:

- Mortgagors have historically been around 40 per cent less likely to lose work during downturns than non-mortgagors. Around 60 per cent of mortgagor households have multiple income earners and are therefore likely to retain a share of their income if one income earner loses their job.[6]

Graph 2.11

Household Cost-of-living-adjusted Mortgage Buffers*

Share of variable-rate owner-occupier loans



* Number of months that mortgage prepayments (offset and redraw balances) can cover minimum scheduled payments and HEM expenses for variable-rate owner-occupier borrowers if they were to lose their entire household income as at July 2023.

** This factors in some other expenses that are excluded from the baseline HEM (mainly private health insurance and private school fees).

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

- Borrowers affected by income losses can apply for hardship arrangements from their lenders. If approved, this could include temporary mortgage payment deferrals, interest-only periods or other forbearance arrangements. If borrowers perceived their income losses as permanent, most could repay their loan in full by selling their property as the vast majority have sufficient equity in their homes.
- A large increase in the unemployment rate – all else equal – could lead to a monetary (and/or fiscal) policy response. While this is unlikely to materially change the circumstances of many households that lose a job in the near term, it will ease financial pressures across households more broadly.

Overall, and supported by conservative lending standards, the risks to the broader financial system from housing lending remain low.

This assessment is informed by two considerations:

- *While arrears rates are likely to increase, they are expected to remain very low.* About 1½ per cent of borrowers are estimated to have their essential expenses and mortgage costs exceed their income *and* be at high risk of depleting any available buffers. Even if the unemployment rate were to increase by 2 percentage points (around twice as sharply as projected in the August 2023 *Statement on Monetary Policy*), the share of existing borrowers at risk of running out of buffers over the next year or so would likely remain at low single-digit levels. Similarly, most borrowers would be well placed to service their housing loans if interest rates were to increase further.
- *Only a small share of borrowers are at risk of becoming unable to service their loan and very few of these are likely to result in losses for lenders.* Supported by prudent lending

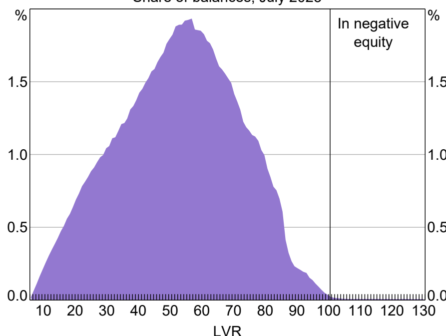
standards and the general increase in housing prices over a number of years, the vast majority of borrowers have substantial equity in their properties. While very disruptive for affected households, this does allow them to sell and repay their loan before defaulting (Graph 2.12). Only around 0.1 per cent of loans (0.15 per cent of loan balances) are in negative equity at current housing prices. These shares would increase to around ½ a per cent if housing prices were to fall by 10 per cent from their July levels (Graph 2.13).

As a result – and consistent with banks' expectations – losses incurred by lenders are likely to remain manageable even in adverse circumstances. As such, banks – supported by their strong profits and capital positions – can withstand such losses while continuing to lend to households and businesses (see Chapter 3: Resilience of the Australian Financial System).

Graph 2.12

Outstanding LVR Distribution*

Share of balances, July 2023



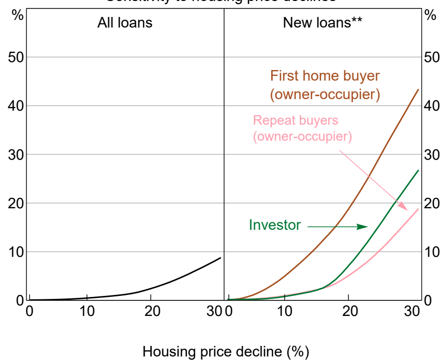
* Loan balances adjusted for redraw and offset account balances; property prices estimated using GCCSA price indices.

Sources: ABS; CoreLogic; RBA; Securitisation System.

Graph 2.13

Share of Loans in Negative Equity

Sensitivity to housing price declines*



* Each percentage decline is applied to the price levels that prevailed in each GCCSA region during July 2023, separately for houses and apartments.

** New loans are those originated since January 2021. 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.

2.2 Businesses

The strong recovery from the pandemic supported business profitability, but pressures have emerged more recently from higher input costs, higher interest rates and slowing demand.

Strong demand over much of the past couple of years has enabled most businesses to pass on higher input costs. However, ongoing cost pressures coupled with a softening in demand has more recently put pressure on some businesses' profits. Firm-level data suggest that operating profit margins as at March 2023 are around their pre-pandemic levels in most industries, outside of the mining sector. However, profit margins have begun to decline a little in the accommodation and food industry (Graph 2.14).

Higher interest rates have directly affected businesses' interest expenses, especially for smaller businesses (Graph 2.15). Indebted smaller businesses have seen significant increases in their interest expenses, as many have variable-rate loans. While some smaller businesses have fixed-rate loans, these tend to be for smaller amounts and with shorter

maturities. By contrast, larger ASX-listed companies have used interest rate hedges for variable-rate debt and issued longer term fixed-rate debt when interest rates were low, which has slowed the impact of higher interest rates on their cash flow positions. As a result, the (debt-weighted) share of listed companies with earnings less than double their interest expenses – equivalent to an interest coverage ratio (ICR) less than 2 – has mostly stayed the same over the past couple of years (Graph 2.16, left panel). These businesses will face higher interest rates once hedges expire or debt matures, though this is likely still some time away. For most large ASX-listed issuers, only a small share of bonds is due to expire in the next year.

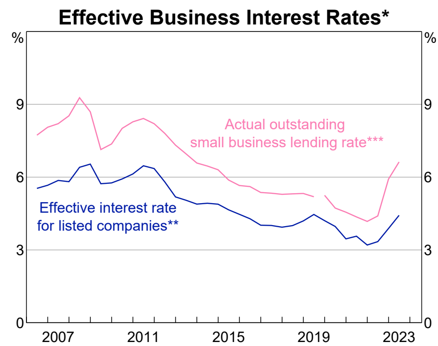
Businesses facing profitability challenges are drawing down on cash buffers to support their operations or service debts. Despite this, these cash buffers relative to expenses remain generally high, having increased over the past couple of decades and particularly sharply during the pandemic (Graph 2.17). Similarly, information from listed companies supports the observation that many have substantial cash buffers. The (debt-weighted) share without sufficient short-term assets on hand to cover their short-term liabilities – equivalent to a liquidity ratio less than 1 – has increased a little from the pandemic lows but it remains below its 10-year average (Graph 2.16, right panel). Even among unprofitable listed companies, 60 per cent have enough cash on hand to cover their total liabilities, which reflects that these companies tend to have little debt.

Company insolvencies have increased to pre-pandemic levels …

The number of company insolvencies has increased to around pre-pandemic levels (Graph 2.18). While most are small companies, the number of medium and large companies

Graph 2.15

Effective Business Interest Rates*



* Latest observation June 2023.

** Effective median interest rate for ASX-listed non-financial companies. Calculated as annual interest expenses over interest-bearing liabilities. Excludes companies with a ratio of debt to assets less than 10 per cent.

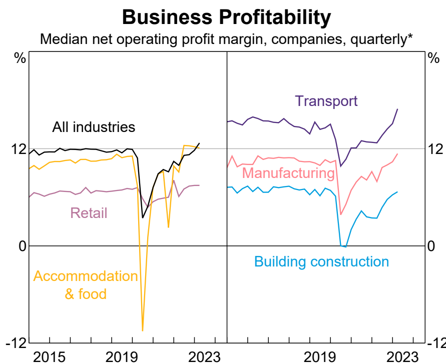
*** Six-month average. Series break in 2019 due to a change in the definition of a small business loan.

Sources: APRA; Morningstar; RBA.

Graph 2.14

Business Profitability

Median net operating profit margin, companies, quarterly*



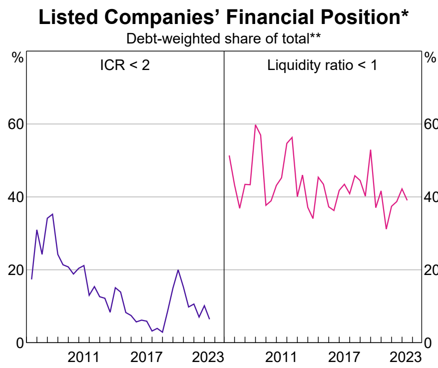
* Selected industries; net profits as operating revenue less operating costs and wages; not including government payments (e.g. JobKeeper); includes ~250,000 GST-remitting companies; seasonally adjusted. Latest observation March 2023.

Sources: ABS; RBA.

Graph 2.16

Listed Companies' Financial Position*

Debt-weighted share of total**

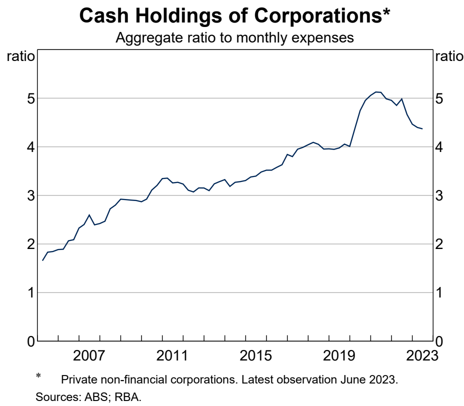


* Interest coverage ratio (ICR) measured by profits over gross interest expenses, liquidity ratio measured by current assets over current liabilities. Latest observation June 2023.

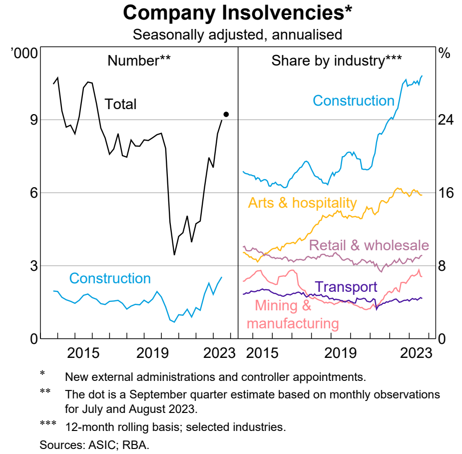
** Excludes companies with a ratio of debt to assets less than 10 per cent.

Sources: Morningstar; RBA.

becoming insolvent has increased of late. Insolvencies of larger businesses are more likely to transmit stress to households and other businesses, as they have more employees, larger debts, and more interlinkages with other businesses via trade credit. Over the past year, a number of large residential construction firms have entered insolvency. Rising insolvencies in the construction industry have accounted for one-third of the increase in insolvencies of late, albeit this upswing has occurred from the very low levels recorded during the pandemic (see Box: Risks in the residential construction industry).



* Private non-financial corporations. Latest observation June 2023.
Sources: ABS; RBA.

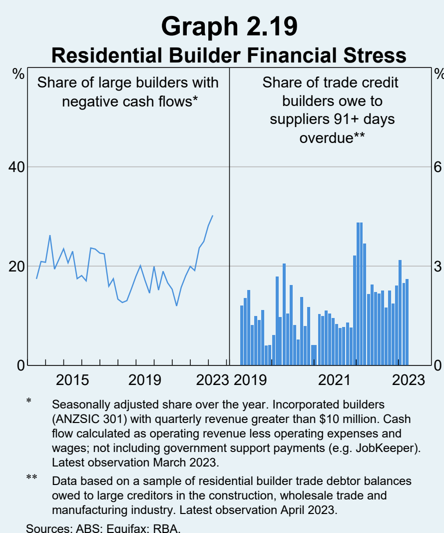


* New external administrations and controller appointments.
** The dot is a September quarter estimate based on monthly observations for July and August 2023.
*** 12-month rolling basis; selected industries.
Sources: ASIC; RBA.

Box: Risks in the residential construction industry

The construction industry – in particular, residential builders locked in to fixed-priced contracts – continues to experience challenges.

A sharp rise in construction input costs, compounded by costly delays arising from labour and materials shortages as well as bad weather, has eroded profit margins on existing fixed-price contracts for many residential builders. Some builders are still working through these contracts, which are now loss-making for many. As such, the share of large residential builders with negative cash flows has increased sharply over the past couple of years (Graph 2.19, left panel). Higher interest rates have also raised debt-servicing costs for many firms. Reflecting these financial pressures, residential builders' overdue trade credit balances to major suppliers have increased (Graph 2.19, right panel).



Graph 2.19
Residential Builder Financial Stress

* Seasonally adjusted share over the year. Incorporated builders (ANZSIC 301) with quarterly revenue greater than $10 million. Cash flow calculated as operating revenue less operating expenses and wages; not including government support payments (e.g. JobKeeper). Latest observation March 2023.

** Data based on a sample of residential builder trade debtor balances owed to large creditors in the construction, wholesale trade and manufacturing industry. Latest observation April 2023.

Sources: ABS; Equifax; RBA.

The risk of transmission of financial stress from builders to their sub-contractors remains elevated.

Some sub-contractors have also faced higher input costs, but many have been able to pass these on due to strong demand for their services arising from the large pipeline of work yet to be done. Profit margins among construction services companies have improved but remain below pre-pandemic levels. Builders facing cash flow challenges can quickly transmit stress to sub-contractors through delayed trade payments; while most sub-contractors appear to be managing these challenges, some have been impacted by builders defaulting on outstanding invoices.

Signs of severe financial stress among households owning and operating small construction businesses also remain low; personal insolvencies related to business failures are near historical lows, including in the construction sector (Graph 2.20). However, new residential construction

activity is slowing, which will put further pressure on builders and construction services firms, particularly those relying on cash flows from new projects to offset losses on others.

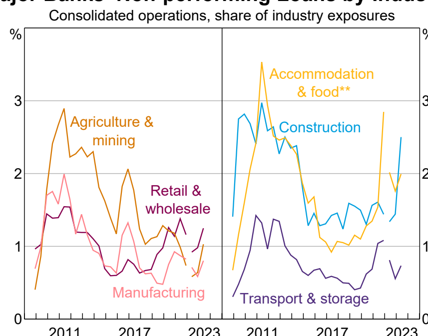
* New personal insolvencies of business owners/operators (e.g. sole traders or directors of proprietary companies). Latest observation June 2023.

Sources: AFSA; RBA.

… but there are limited direct risks to the banking sector.

Banks appear to have limited exposures to companies that have entered insolvency. This is consistent with low rates of non-performing business loans at banks; non-performing loans have increased in the construction sector but these account for only a small share of banks' business lending (Graph 2.21). Banks' exposures to insolvent businesses are likely to increase should more medium and large businesses become insolvent.

Most insolvent firms tend to have unsecured debt, likely with non-bank lenders and other businesses, as well as debts to the Australian Taxation Office (ATO) (Graph 2.22).[7] Systemic risks posed by non-bank lenders remain small, as non-banks account for a small share of total credit in the Australian economy (less than 10 per cent of business lending and 5 per cent of housing lending) and banks have relatively limited exposures to non-bank lenders (see Chapter 3: Resilience of the Australian Financial System). Defaults on debts to other businesses via trade credit could transmit financial stress between businesses; however, there is no widespread evidence of this at present. The increase in insolvencies has partly reflected the resumption of ATO enforcement activities on unpaid taxes following the end of the pandemic. This is likely to continue to prompt some businesses that are unable to pay their debts to commence formal insolvency procedures.

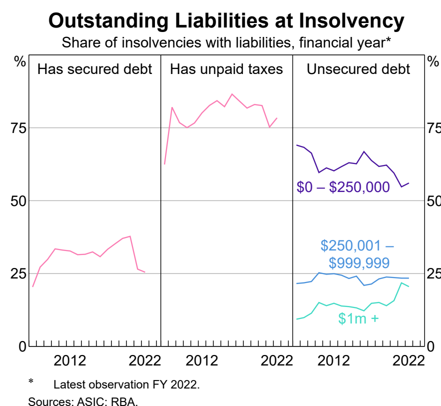


* Selected industries; series break in June 2022 due to changes in reporting methodology. Latest observation June 2023.

** One major bank does not report data for this industry.

Sources: Major banks' Pilar III disclosures; RBA.

Graph 2.22



Overall, the risks to the broader financial system stemming from the business sector remain low.

This assessment is based on two factors:

1. *Strong demand has meant that most businesses have been able to pass on higher input costs.* In addition, cash buffers remain high, although the distribution of these across businesses is likely to be highly uneven.
2. *The increase in company insolvencies has had a limited impact on banks.* Although the level of business insolvencies has increased to pre-pandemic levels, those businesses entering insolvency tend to be small and have little debt, and of this only a limited amount is owed to banks.

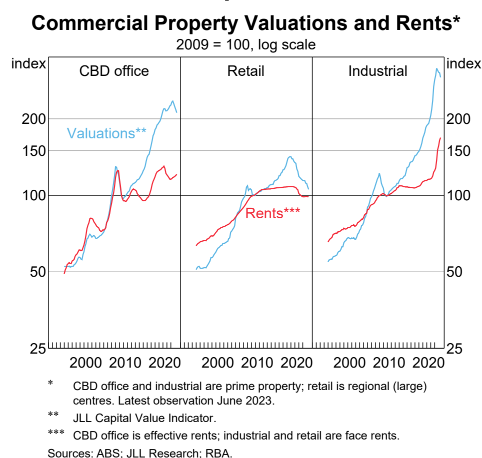
However, a decline in demand associated with a slowdown in the economy is a key risk for businesses' profits and ability to service their debts. Businesses that are exposed to discretionary consumer spending or that cannot reduce costs quickly when revenues fall (such as those in the arts and recreation, and business services industries) would face a significant decline in profits.[8] Pressures on profits will be most challenging for highly indebted businesses that are already drawing down on their cash buffers. Businesses affected by significant declines in profits and low cash buffers are more likely to reduce their number of employees, and therefore transmit financial stress to households.[9]

2.3 Commercial real estate

There is pressure on profitability and asset valuations in office and retail CRE …

Weak leasing demand (reflected in higher vacancy rates and weak rental growth) coupled with higher interest rates is weighing on some office and retail owners' ability to service their loans (Graph 2.23). At the same time, these factors are leading to declines in the values of the assets they hold, and further falls appear to be likely. Conditions are most challenging in the office sector, particularly for secondary grade offices, as many employers prefer higher quality office space to encourage workers back to the office and meet sustainability targets. By contrast, industrial properties continue to perform strongly due to increased demand for distribution and warehouse facilities.

Graph 2.23



… but there are limited signs of financial stress among owners of Australian CRE.

Recent Bank analysis of the CRE market in Australia finds little evidence of financial stress among owners of Australian CRE, despite pressures on profitability and valuations.[10] Australian Real Estate Investment Trusts (A-REITs) have generally reduced their risks since the global financial crisis (GFC), with balance sheets that continue to have relatively low levels of leverage and ICRs of more than three times earnings.

Information from liaison suggests that Australian unlisted trusts (excluding superfund-related products) have higher leverage than A-REITs. While some unlisted trusts have experienced an increase in redemption requests from unit holders, they appear to be effectively managing liquidity pressures – including by limiting redemptions and/or distributions of returns, which has likely occurred after drawing down buffers of liquid asset holdings. While some trusts have indicated a desire to sell assets, there is no evidence of Australian unlisted trusts being forced to rapidly sell assets at steep discounts.

Liaison also suggests that while some landlords with funding from banks are struggling to meet ICR requirements as part of their covenant agreements, lenders have been working with existing borrowers who can demonstrate a path back to meeting minimum requirements. The current level of loan-to-value (LVR) ratios of many of these borrowers could accommodate further declines in valuations. However, should owners' profits and/or prices decline sharply – and the owners are unable to increase income and/or contribute more equity – these limits could become binding, and a forced property sale could be triggered, potentially at a steep discount. Consistent with financial pressures being managed to date, non-performing rates on Australian banks' commercial property lending remain negligible across all bank types and segments (Graph 2.24).

Overall, while risks in Australian CRE markets are elevated, the risks to the broader financial system from CRE lending remain low.

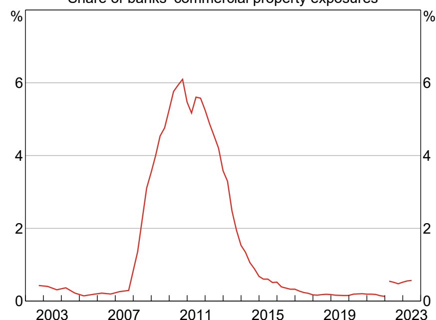
The risks to the broader financial system stemming from the CRE sector remain low, notwithstanding the ongoing headwinds and an increased risk of foreign stress being transmitted to Australian CRE markets through common ownership and funding sources (see Chapter 1: The Global and Macro-financial Environment, and recent Bank analysis[11]). This assessment arises from two factors:

1. *There is limited evidence of a withdrawal of foreign investors from the Australian CRE market, and A-REITs continue to access offshore funding markets and are well placed to manage temporary dislocations in global CRE debt markets due to having ample liquidity.* However, widespread financial stress among owners of CRE overseas could increase the risk of a disorderly fall in valuations in Australia, should losses on foreign assets force owners to sell and lead lenders to reduce lending to Australian CRE. This risk has increased, as foreign investors have become more active in Australian CRE markets.
2. *Banks operating in Australia have conservative lending practices and small exposures to CRE.*

Graph 2.24

Commercial Property Non-performing Rate*

Share of banks' commercial property exposures



* Excludes overseas exposures. Prior to 2022, data reported as impairment rates.

Sources: APRA; RBA.

Lending practices have improved since the GFC. Over recent years, most commercial property bank loans have been written with an LVR of less than 65 per cent and have requirements that borrowers have earnings that cover twice their interest expenses. Banks' aggregate exposures to commercial property markets have declined since the GFC and are now around 6 per cent of total assets. Consistent with this and as noted above, rates of banks' non-performing CRE loans remain low. While foreign bank branches have a higher concentration of CRE exposures, reflecting the specialised nature of their Australian banking operations, lending standards are broadly in line with those at domestic banks and non-performing loans remain similarly low at these institutions.

Endnotes

[1] While some renters were also able to build substantial savings over the COVID-19 pandemic and entered the inflationary environment in a relatively strong position, many have since reduced their savings. Moreover, renters have had substantially lower savings than mortgagors to begin with and are therefore more at risk of entering financial stress if they experience a shock to their incomes or expenses (see 5.3 Focus Topic: Indicators of Household Financial Stress).

[2] Under the same set of assumptions for essential expenses and income, our estimates are broadly in line with estimates from lenders, with the Commonwealth Bank estimating that around 3½ per cent of their recent loans belong to households whose income was below essential expenses and scheduled mortgage payments in June 2023.

[3] RBA (2022), 'Securitisation System – RBA Securitisations Industry Forum'.

[4] The additional 8 percentage points of variable-rate owner-occupier borrowers estimated to have insufficient income to cover their necessary costs (based on the broader HEM) are less likely to enter arrears or default on their home loan as they have more capacity to reduce expenditure.

[5] RBA (2023), 'Box B: Scenario Analysis on Indebted Households' Spare Cash Flows and Prepayment Buffers', *Financial Stability Review*, April.

[6] Lower income borrowers are more likely to lose work and are therefore more at risk (see RBA, n 4). However, these borrowers also tend to have smaller debts (in absolute terms), which reduces losses to the financial system.

[7] Banks typically lend on a secured basis, with relatively small amounts lent unsecured, such as for working capital.

[8] See RBA (2023), *Financial Stability Review*, April.

[9] See Grozinger P (2023), 'Financial Health and Employment in the Business Sector: A Non-linear Relationship', RBA *Bulletin*, September.

[10] See Lim J, M McCormick, S Roche and E Smith (2023), 'Financial Stability Risks from Commercial Real Estate', RBA *Bulletin*, September.

[11] See Lim *et al*, n 10.