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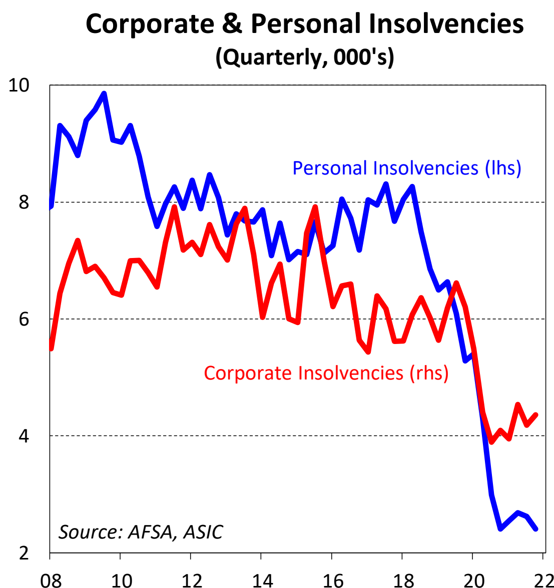
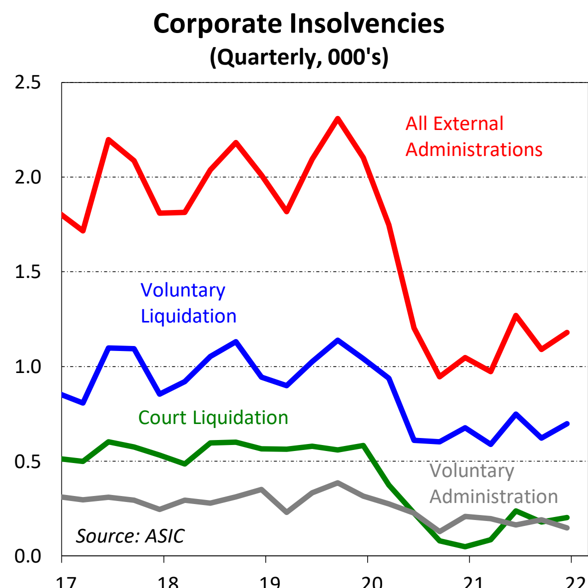
# The Insolvency Tsunami That Never Hit

- **It has been just over a year since temporary COVID-19 insolvency relief expired, yet both corporate and personal insolvency rates remain low. In fact, as of December 2021 corporate insolvencies are 43.9% below pre-pandemic levels, while personal insolvencies are 54.4% lower.**
- **When the policy measures were lifted at the end of 2020, analysts were concerned that insolvencies would soar. Indeed, Treasury estimates suggested that insolvencies would be so high that the industry would struggle to cope with the surge in appointments.**
- **Creditors turned to alternative collection methods while the temporary relief made recovering debt through formal insolvencies more difficult. But even after the expiration of the relief measures, creditors have continued to rely on alternative collection methods.**
- **Creditors have also opted not to pursue so called 'zombie companies', as they are unlikely to recover sufficient debt to offset the costs. This has further contributed to the low level of insolvencies, as these businesses would have ordinarily been wound-up had the temporary measures not been introduced.**
- **The structural change in creditor collection means it is unlikely that insolvency rates will rapidly return to pre-pandemic levels. However, there may be a gradual pick up over the next 18 months, as the tax office recommences collection action and government stimulus unwinds.**
- **Omicron has added a new element of uncertainty and there may be an up-tick in insolvencies caused by the resulting 'shadow lockdown'. Although, this will likely be limited to the hardest hit industries of retail and hospitality and among already struggling businesses.**



**Insolvencies and the Pandemic**

Early in the pandemic, when the economy plunged into lockdown, there were widespread concerns that insolvencies would spike sharply.

However, as a result of temporary relief measures introduced in March 2020, both personal and corporate insolvencies fell to record lows. This is despite Australia experiencing the sharpest contraction in GDP in the history of the series, going back to 1959.

GDP growth tipped into negative territory over the March quarter of 2020 and the economy experienced a technical recession in the June quarter, after GDP plunged a whopping 6.8%. Over the same period, insolvencies dropped 25.5%. Personal insolvencies fell by 18.5%, while corporate insolvencies almost halved, plummeting by 42.8%. Then insolvencies continued to fall to record lows over the second half of 2020, as the economy recovered alongside easing restrictions.

Changes to regulation played a crucial role in preventing a surge in insolvencies, alongside other government support measures such as JobKeeper.

The below table summarises the temporary changes made to insolvency legislation:

| Policy Measure | Regime | Period |
| --- | --- | --- |
| Increasing the time to comply with a creditors statutory demand from 21 days to 6 months | Corporate Insolvency | 20 March 2020 to 31 December 2020 |
| Increasing the minimum debt threshold for creditors to issue a creditors statutory demand from $2,000 to $20,000 | | |
| Relief for directors from any personal liability for debts incurred whilst trading insolvent | | |
| Increasing the time to comply with a Bankruptcy Notice from 21 days to 6 months | Personal Insolvency | |
| Increasing the minimum debt threshold for creditors to issue a Bankruptcy Notice from $5,000 to $20,000 | | |
| Increasing temporary debt protection period. Individuals could apply for 6 months relief from creditors collecting debts. Increased from 21 days | | |

The brunt of the policy changes was aimed at preventing liquidations and bankruptcies. A liquidation, or winding up, involves the sale of all realisable assets of a company and ultimately the deregistration of the company. A bankruptcy similarly involves the sale of an individual's assets and lasts for at least 3 years, during which the debtor is subject to several financial and travel restrictions. Both liquidations and bankruptcies can be creditor initiated (court-ordered) or debtor initiated (voluntary) and make up the bulk of insolvency appointments.

There are various other types of personal and corporate insolvency appointments including, restructuring appointments such as voluntary administrations and personal insolvency agreements. However, these types of appointments generally represent a smaller proportion of the total number of insolvencies.

**Corporate Insolvencies**

Voluntary and court ordered liquidations represented most of the fall in corporate insolvencies, plunging 91.8% and 35.0%, respectively, between March and December 2020 while the temporary policies were in place. Restructuring appointments (voluntary administrations) declined 33.9%.

The sharp decline in court liquidations was driven solely by the temporary changes to insolvency laws. Specifically, the increase in the time to comply with a creditors statutory demand, from 21 days to 6 months. This undermined the normal collection process, significantly reducing the rate of court liquidations.

Effectively, after March 2020 there was no benefit to creditors in attempting to wind up a company to recover their debt, as they would now need to wait at least 6 months before commencing any action. However, if creditors were to wait until the temporary measures expired on 31 December 2020, they could take action to wind up a company within 21 days. As a result, winding up applications were largely put on hold, translating to much fewer court liquidations.

Another measure introduced was to increase the debt threshold for a creditors' statutory demand. However, this likely had a less significant impact on the rate of court appointed insolvencies.

In the case of voluntary liquidations, the fall in appointments was a product of director insolvent trading relief, which temporarily removed any personal liability for debts incurred while a company was trading while insolvent. This excised any pressure on directors to place their companies into liquidation if they became temporarily insolvent. The temporary relief lasted from 20 March 2020 to 31 December 2020 and meant directors could weather short term cash-flow concerns by increasing leverage, without the risk of personal liability. This is partly reflected in the spike in business lending as lockdowns hit, as businesses sought to shore up their cash flow positions.

The temporary protections for directors also contributed to the fall in voluntary administrations, by providing directors flexibility to restructure outside of the formal regime, without the risk of personal liability. The protection from personal liability also meant directors were not forced to restructure due to lockdown induced, short-lived solvency issues.

**Personal Insolvencies**

The temporary policy measures introduced in the personal insolvency framework broadly mirrored the corporate policy changes. Accordingly, a similar dynamic was observed wherein the normal collection process was impaired, significantly reducing the rate of bankruptcies. Indeed, by the end of 2020, when the temporary measures had run their course, personal insolvency appointments were down 54.4% on a year earlier. The drop was led by court ordered and voluntary bankruptcies, which tumbled 80.2% and 53.9%, respectively.

**One Year On**

Now, just over a year since the temporary insolvency policies expired, both corporate and personal insolvency rates remain low. In fact, as of December 2021, corporate insolvencies are 43.9% below pre-pandemic levels, as of December 2019. While personal insolvencies are 54.4% below pre-pandemic levels.

So how is it that insolvencies did not spike when the measures were lifted, considering the policy changes made such a huge contribution to the initial fall. And further, can we expect insolvency rates to accelerate rapidly towards their previous levels over the coming years?

The biggest change to come from the temporary insolvency measures was a change in the approach to credit collection. Creditors and debt collectors were required to find more efficient ways to collect debt, in an environment where the standard collection framework (insolvencies) was no longer viable. This saw a shift towards cooperation with debtors to reach payment arrangements, compromises, or interest holidays, which supported the long-term prospects of recovery at a time where defaults would have otherwise soared.

So, when the temporary measures lifted there was only a modest increase in insolvencies. The

overall rate of insolvencies remained low because of the structural change in collection strategies. And even during the Delta lockdowns in 2021, insolvencies remained around historically low levels.

The increased adoption of alternative collection methods means it is unlikely that insolvency rates will jump back to their pre-pandemic levels. However, there will likely be a gradual pick up as the Australian Taxation Office (ATO) – who historically initiates a large proportion of court appointed insolvencies – recommences more aggressive collection action. The ATO previously recommenced wind ups at the end of 2021 after an 18-month hiatus, however, have since paused again following Omicron. The unwinding of government stimulus is also expected to contribute to the pick-up in insolvencies as cash flow deficiencies hit underperforming businesses.

**Zombie Companies**

The temporary measures introduced in 2020 were effective in preventing insolvencies during extreme economic circumstances. However, they bought with them one major side effect. Insolvent companies which would have otherwise been wound up, regardless of the implications of the pandemic, did not enter liquidation. Instead, these companies continued to incur additional liabilities without consequence, or where simply abandoned. Creditors were unable to pursue these businesses, referred to as 'zombie companies'.

The small spike in insolvencies shortly following the expiry of the temporary policies in part reflects the winding up of these 'zombie companies'. However, there has been no material surge in court ordered liquidations suggesting that creditors have opted not to pursue so called 'zombie companies' as they are unlikely to recover sufficient debt to offset the costs. Instead, these companies will likely be struck off by the Australian Securities and Investments Commission, without investigation.

**Outlook**

The economic recovery is well underway, and many businesses experienced bumper sales through the end of 2021. However, the Omicron wave has added an element of uncertainty and there may be an up-tick in insolvencies caused by the resulting 'shadow lockdown'. Although, this will likely be limited to the hardest hit industries of retail and hospitality and among already struggling businesses.

Looking forward, we expect strong growth in consumer spending, despite the temporary disruptions from Omicron, supported by large household saving buffers. Plus, the unemployment rate is at its lowest level in more than a decade and set to head lower. This is welcome news for businesses, particularly those hard hit by the pandemic, like hospitality and tourism. In addition, the balance sheets of businesses are in good shape and interest rates remain low. In this supportive environment, it is difficult to foresee a spike in insolvencies. However, risks do remain. The emergence of new variants remains a key uncertainty and could hamper economic growth if lockdowns are reintroduced.

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