HOME LOANS DIVISION

HOUSEHOLD SECTOR CREDIT RISK

– While household sector conditions may be improving, risks remain high

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HOUSEHOLDS' FORTUNES IMPROVE ON THE BACK OF INTEREST RATE CUTS, BUT RISKS TO FUTURE ABILITY TO SERVICE DEBT REMAIN HIGH

Recently, the news for the household/consumer sector has become mildly better, with interest rates and inflation having declined significantly. Insolvencies growth has slowed sharply from near 109% in the 3rd quarter of 2008 to 10% by the 1st quarter of this year, and decline (negative growth) in both this figure as well as banks' non-performing loans may not be far off.

FNB Property Barometer survey respondents tell us that demand activity levels have risen mildly in recent quarters, and the FNBBER Consumer Confidence Index has started to rise moderately over the past 2 quarters, and so it should because reduced interest rates have made it slightly easier for many to service (repay) debt.

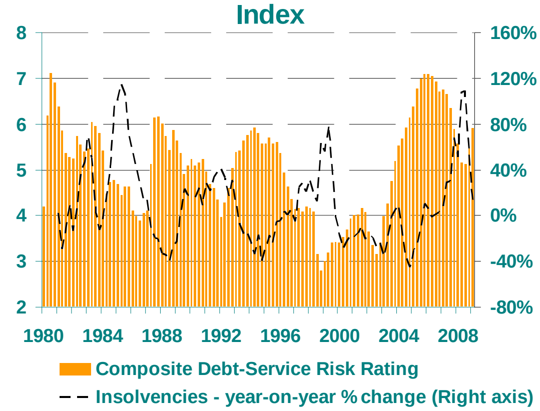
This mild recovery in households' ability to service debt, however, remains something of a "high risk" recovery, because it depends solely on interest rate cuts while the overall level of indebtedness remains near historically highs. After 2 quarters of decline in the household debt-to-disposable income last year, the positive (downward) trend was halted "prematurely" by the rapid weakening in the economy and its negative impact on disposable income. Disposable income growth has plummeted sharply, overtaking the declining in growth in outstanding household debt, and as a result the past 2 quarters have shown debt-to-disposable income ratio increases.

Now, while an improvement in default rates on home loans and other household debt is always welcome, one needs to take a closer look at the reasons for the improvement. The household sector debt-service ratio (the cost of total instalments on household debt per period expressed as a percentage of disposable income for that period) is indeed coming down, and there is a good correlation between debt-service ratio and household default rates. But the problem is that the recent decline in the debt-service ratio is almost solely due to aggressive interest rate cuts by the SARB, and not due to any decline in the level of household indebtedness.

Now household indebtedness is a cyclical phenomenon, so last year's peak was not a crisis. What would be troublesome, though, would be if we get to the next phase of interest rate hiking and there had been no meaningful drop in the household sector indebtedness, something that looks increasingly possible now that it appears that interest rate cutting is at or near the bottom of the cycle, and the speculation is starting to turn to when the next interest rate hiking cycle will be.

Interest rate hiking may still be some way off, but these things can creep up on us unexpectedly at times. It is important that, by the time of such an event, the household debt-to-disposable income ratio has declined significantly, which depends much on an improvement in the fortunes of the global and domestic economy so as to raise disposable income growth. Otherwise, the country could fairly quickly find itself in another troublesome period of high levels of bad debt before substantial improvement has taken place.

Household Debt Service Risk Index



KEY HOUSHOLD SECTOR AND RELATED INDICATORS

	Most Recent	Prev.	Year ago
Real Disposable Income – q/q annualized chge. (Q1)	*-4.5%*	*-1.9%*	*3.1%*
Real GDP – q/q annualized % change (Q1)	*-6.4%*	*-1.8%*	*1.7%*
SARB Leading Indicator – Indicator Value (Apr)	*106.0*	*104.6*	*122.6*
SARB Leading Indicator – y/y % change (Apr)	*-13.5%*	*-15.6%*	*-3.2%*
Prime Overdraft Rate – monthly avg. -% (June)	*11%*	*12%*	*15.3%*
Consumer Price Inflation – y/y % change (May)	*8.0*	*8.4*	*11.7%*
Debt-to-disposable Income Ratio - % (Q1)	*76.7%*	*76.3%*	*78.2%*
Debt-service Ratio - % (Q1)	*14.4%*	*15.0%*	*14.8%*
Net Saving to disposable income ratio - % (Q1)	*-0.1%*	*-0.2%*	*-0.5%*

Our "Debt-Service Risk Index" therefore remains at high levels as a result of ongoing high level of overall indebtedness, and has actually started to rise again over the past 2 quarters due to renewed rise in the household debt ratio as well as due to the approaching end to interest rate cuts. The most recent 1st quarter reading of 5.9 is still lower than the 7.1 risk peak reached in early-2006, but that's still on the high side, given a multi-decade average of near 5. So, interest rate cuts may be starting to help have helped improve the household financial and debt situation somewhat, but it is a moderate and "HIGH RISK" recovery, and the risks have already begun to show some short term increase again.

DESPITE MORE "GREEN ON THE SCREEN", THE HOUSEHOLD SECTOR FINANCIAL AND DEBT POSITION REMAINS FRAGILE AND RISKY AT BEST

While more green appears on the screen, suggesting a mildly more positive environment from a household sector financial and credit quality point of view, much is the result of a sharp drop in interest rates since December 2008, while the real "household sector fundamentals" remain extremely weak. This raises serious questions as to the sustainability of any improvements that we may be starting to see in terms of consumer confidence and prospects for improved household sector credit quality.

Household Sector Financial Conditions and Determinants Thereof	Q1-2008	Q2-2008	Q3-2008	Q4-2008	Q1-2009	Q2-2009 to date
Real Disposable Income Growth (q/q ann.)	Declining positive growth	Declining positive growth	Negative Growth	Declining negative growth	Declining negative growth	N/A
Employment Growth	Rising positive growth	Declining positive growth	Declining positive growth	Negative growth	N/A	N/A
Average Real Wage Growth	Rising positive growth	Negative Growth	Zero growth	Positive growth	N/A	N/A
SARB Leading Economic Indicator Growth - qtly avg. (q/q ann.)	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Diminishing Negative Growth	Positive m/m growth in April
Real Economic Growth (q/q ann.)	Decline in positive growth	Rise in positive growth	Decline in positive growth	Negative Growth	Declining negative growth	N/A
Debt servicing costs and main drivers thereof						
Interest Rates on debt (quarterly average)	Rising	Rising	Rising	Declining	Declining	Declining
Consumer Price Inflation	Rising	Rising	Rising	Declining	Declining	Declining
Household debt-to-disposable income ratio	Rising	Declining	Declining	Rising	Rising	N/A
Household debt-service ratio	Rising	Rising	Rising	Rising	Declining	N/A
Drivers of household wealth						
Household Net Saving-to-GDP Ratio	Increased dissaving	Slightly less dis-saving	Slightly less dis-saving	Slightly less dis-saving	Slightly less dis-saving	N/A
Real house prices (y/y%)	Declining positive growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth	Accelerating negative growth
Real Interest rate earned on fixed deposits	Declining positive real rate	Negative real rate	Declining negative real rate	Positive real rate	Rising positive real rate	Declining positive real rate
JSE All Share Index monthly average	Negative Growth	Positive growth	Negative Growth	Deterioration in Neg. Growth	Less negative growth	Positive growth
Indicators of household confidence						
Consumer Confidence Index (FNBBER)	Declining	Declining	Declining	Declining	Rising	Rising
% of total residential property sellers selling to emigrate	Rising	Rising	Rising	Declining	Declining	Declining

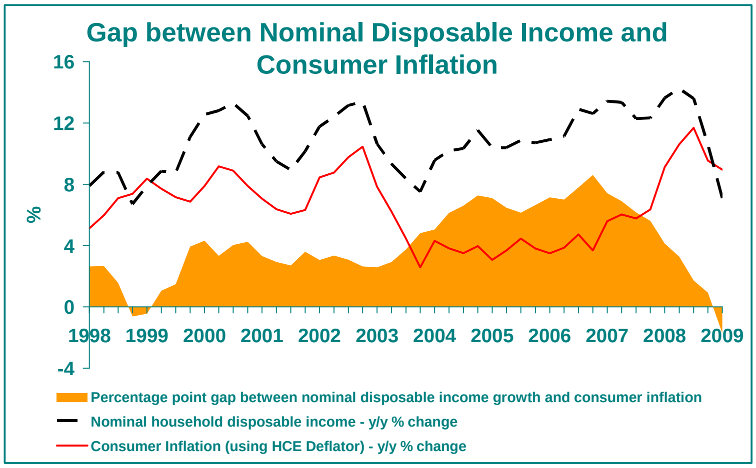
Improvement

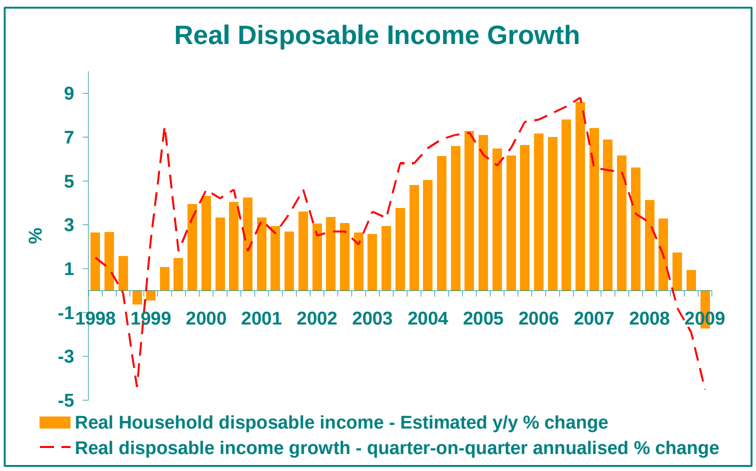
No change or "less deterioration"

Deterioration

HOUSEHOLD SECTOR DISPOSABLE INCOME GROWTH SLOWS DRAMATICALLY IN 1ST QUARTER 2009

Firstly, lets examine real household disposable income growth, or lack thereof. Real disposable income growth is the combined result of nominal disposable income growth and consumer price inflation trends. From late-2008, the household sector has had some relief from the latter, with the inflation rate in the household consumption expenditure deflator declining from a quarterly year-on-peak of 11.7% in the 3rd quarter of 2008 to 8.9% in the 1st quarter of 2009. However, this decline has been insufficient to keep pace with the very sharp decline in nominal disposable income growth, from a 14.3% year-on-year growth peak in the 2nd quarter of last year to 7.1% in the 1st quarter of this year.





This massive decline in nominal disposable income growth, despite some support from rising wage inflation, as labour tries to play lagged catch-up to last year's high consumer price inflation, reflects the severity of the global and domestic recession.

Nominal disposable income growth has been hit from two sides. Firstly, total wage bill growth has been hit by mounting job loss, as many sectors go into retrenchment mode, along with the discretionary component of remuneration having in all probability been reduced significantly. Secondly, as company profitability is hit, growth in the investment income portion of overall household sector income has also come under pressure.

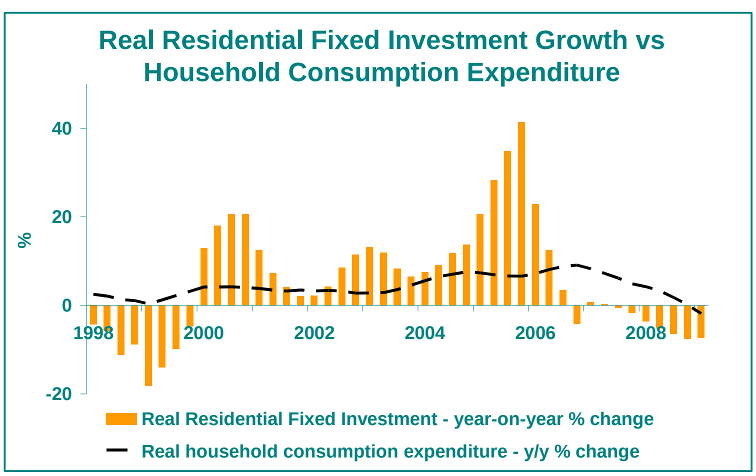
The result has been a continuation of the ongoing decline in real disposable income growth into even deeper negative growth territory. The declining growth trend started as far back as early-2007, caused initially by rising consumer price inflation and sustained by the sharp weakening in the economy in more recent times.

On a quarter-on-quarter annualised basis, real disposable income has already been in "negative growth" territory for 3 consecutive quarter, recording -4.5% in the 1st quarter of 2009, while on a year-on-year basis it dipped into negative territory for the first time in the 1st quarter of this year

THE HOUSEHOLD SECTOR'S RESPONSE TO DISPOSABLE INCOME PRESSURE

- Residential Fixed Investment is a victim

What has the response of the household sector been to this setback in terms of real disposable income level? Firstly, It Is noticeable that residential fixed investment, largely driven by the household sector, gives way long before household consumption expenditure. In the absence of significant household savings, residential fixed investment is highly credit-driven, and so, similar to vehicles sales, it plummets in interest rate hiking periods or periods of heightened financial stress.



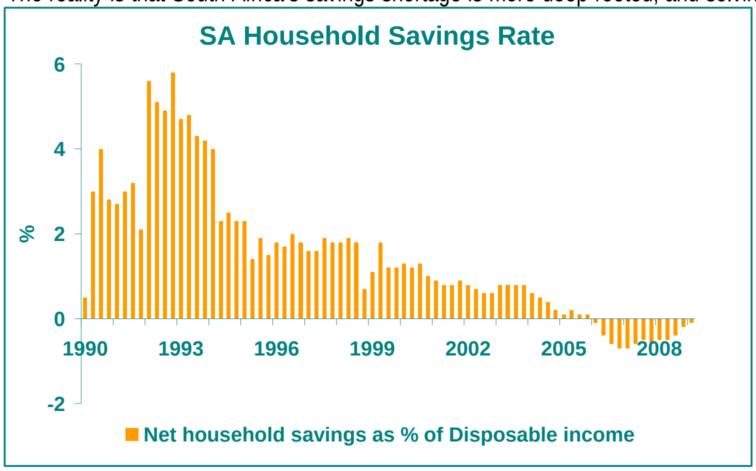
Real residential fixed investment fell into negative growth territory late in 2007, and by the 1st quarter of 2009 was running at a year-on-year rate of decline of -7.3%. In contrast, real household consumption expenditure, which still remains just above 100% of total household sector disposable income, only hit negative year-on-year growth territory in the 1st quarter of this year to the tune of -1.8%, which was in response to real disposable income growth finally turning to negative year-on-year growth.

- Early signs of a savings improvement are there, but the savings rate remains dismal

The second response is the start of a move to a better rate of saving, albeit a rate that is still dismal. South Africa's household sector has been in a situation of "net dissaving" since 2006, which implies that the rate of gross saving is insufficient to even cover the depreciation on fixed assets owned by the sector. Some would argue that low returns make the incentive to save weak, implying that savings accounts with financial institutions are the only way to save. This would be to ignore the fantastic returns which were to be had on other asset classes, notably property and equities, earlier in the decade, but which failed to stem the tide of decline in the savings rate

Some would suggest that the financial pressure under which the household sector currently finds itself makes it very difficult to save. It is ironic, though, that we are starting to see some small improvement in the savings rate in these difficult times, while in the boom times a few years ago the savings rate continued its long term deterioration.

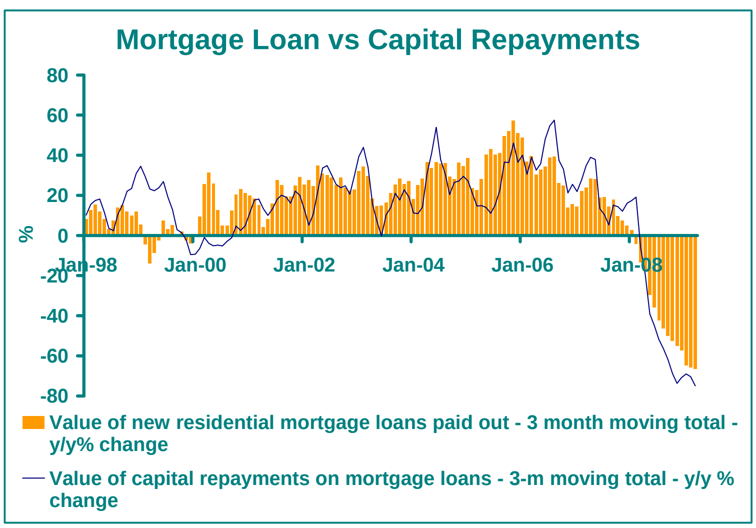
The reality is that South Africa's savings shortage is more deep-rooted, and solving it is complex. But its existence creates something of a roller-coaster ride for credit-driven sectors such as residential property, because it means that residential investment is hugely dependent on credit. And so, when interest rates rise, or banks return to deposit requirements on new mortgage loans (due to the falling value of the loan security, i.e. the house being purchased), the household sector's ability to invest in housing is greatly impaired.



The dis-savings rate has improved marginally from -0.7% of household sector disposable income at the beginning of 2007 to -0.1% by the 1st quarter of 2009, but that is hardly a rate to get excited about yet, and points to ongoing difficulty for many buyers to obtain mortgage loans while deposit requirement remain in place.

- New borrowing cut back sharply, but indebtedness level nevertheless rises, remaining near historic highs

The third response from the household sector as a whole to deteriorating economic times, starting back in 2007, has been to start cutting back on new borrowing, although much of this has been with the imposed by banks through tighter lending criteria and not all a voluntary process. In the 1st quarter of 2009, the value of new residential mortgage loans and re-advances granted fell by -57.5% year-on-year, while the value of total mortgage loans paid out (this series include commercial property loans but residential is traditionally dominant) fell even more dramatically by -66.4% over the same period. While the SARB does not publish new loans data for other categories of loans, it is believable that new lending in certain other credit categories has declined, similar to the mortgage lending case.

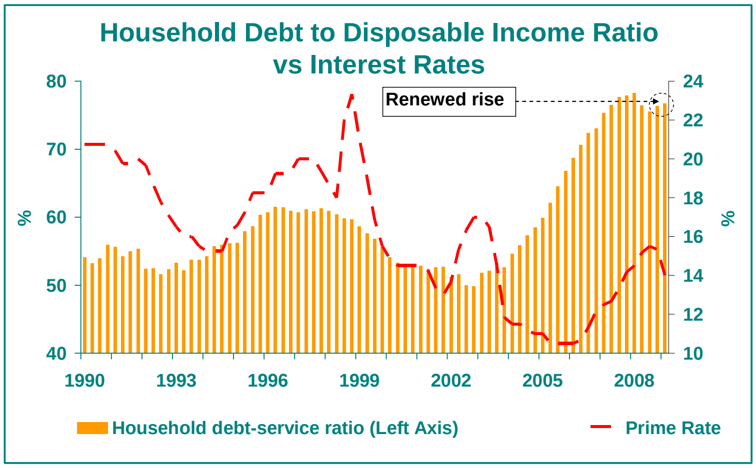


But to assume that this has led to the levels of household sector debt becoming more manageable would be misplaced. As fast as new mortgage loan payouts have fallen, so too has the value of capital repayments on mortgage loans. In the first quarter, the value of capital repayments fell by -74.9%.

Declines in new loans granted in many instances mean not only that a household doesn't buy a particular house, but also that another household can't sell its own house and settle its outstanding bond before re-locating and taking out a new loan itself. Declines in capital repayments are partly due to less movement in the housing market, too, and therefore less loans being settled prematurely.

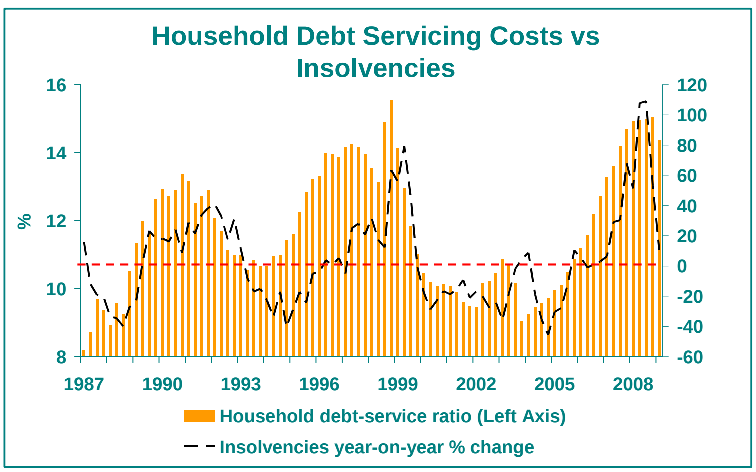
So one must not be fooled by the massive declines in new lending. They don't necessarily mean a corresponding drop in the value or number of outstanding loans.

To the contrary, the value of both mortgage loans outstanding as well as total household debt outstanding continue to grow positively, albeit slower, at a time when new lending has been cut so dramatically. This may partly dispel one theory that households may use the extra cash in hand, emanating from lower interest rates, to settle debt. As at the first quarter, on a macro level we hadn't seen much sign of this, and the monthly household debt estimate by the SARB shows total household debt still growing at +5.3% year-on-year as recently as May. Recent low household credit growth numbers are indeed an improvement (from a sustainability point of view at least) on the near-30% household credit growth rate back early in 2006, but in this recessionary environment of ours these rates are still not low enough to have put the high household debt-to-disposable income ratio on a sustainable downward path.



The sharp decline in nominal disposable income growth has not only caught up with the consumer price inflation decline in recent times, but also with declining credit growth, translating into a renewed increase in the household sector debt-to-disposable income ratio. After reaching an all-time peak of 78.2% in the 1st quarter of 2008, the household debt-to-disposable income ratio did decline for 2 quarters to 75.5%. Those were slightly better economic growth times, however, and over the past 2 quarters we have once again seen the ratio rise mildly to 76.7%.

And so, for all the rumblings about extremely tight lending policies of banks, as yet they have failed to make any significant dent in the overall indebtedness level of the South African household sector.



In the absence of decline in the household debt-to-disposable income ratio, it has therefore been up to the Reserve Bank (SARB) to improve the strained household sector's ability to service its debt burden by cutting interest rates sharply. The debt-service ratio is possibly the best single macro-indicator to predict the future path of home loan default rates, and possibly of household credit quality in general. The debt-service ratio has started to decline in 2009, down to 14.4% in the 1st quarter from a peak of 15% late last year. Plotting insolvencies on the same graph, it would appear that declining insolvencies growth could turn to negative growth one quarter later, and the value of non-performing home loans value may also be near to the start of a declining trend.

Household sector credit quality may thus not be far from some improvement.

But a credit quality improvement that relies almost solely on interest rate cuts, as opposed to getting the indebtedness level back down to more manageable levels (essential given the magnitude of global and local economic weakness and uncertainty) is a "high risk" credit quality improvement, because as fast as interest rates go down they can go up again, depending on the global and local inflation picture. Household indebtedness levels run in cycles, not unrelated to interest rate cycles, and the high level of the household debt-to-disposable income ratio as a cyclical peak has not proved to be a crisis to date ("crisis" implying bank collapses and the like). And if the economy was still growing at a respectable rate, the most recent interest rate hiking cycle would have by now probably have set debt-to-disposable income on a lengthy downward trend, setting the household sector up for increased borrowing growth during the next period of low interest rates (which is already upon us). The dramatic slowdown in the economy, and therefore disposable income growth, has halted the downward progress in debt-to-disposable income almost before it has started, and the risk now is that we could be sitting near to the indebtedness peak when the next rising interest rate cycle begins, which would imply a speedy return to the currently high levels of bad debt.

In short, therefore, don't be fooled by the relief granted by the SARB in terms of significant interest rate cuts. Even should this lead to declining rates of default, and it probably will, it is important to understand that we have made little progress to date in improving the "true household sector fundamentals". Savings remains almost non-existent, although there are some early signs of improvement starting, and the debt-to-disposable income ratio remains sticky near its all-time peak. Until this situation has improved significantly, we have to hope that a re-start of global inflation doesn't lead us into another interest rate hiking cycle in the near future.

BRINGING IT ALL TOGETHER – THE HOUSEHOLD DEBT SERVICE RISK INDEX

The graph below represents my rating of risks to the household sector's future ability to service debt, which has seen the Household Debt Service Risk Index rising over the past 2 quarters back up to level of 5.9 after some decline since its 2006 high. The last strong rising trend in risk, to high level by historic standards, was indeed followed by a sharp lagged deterioration in credit quality. There are 2 reasons for this recent increase in the Debt Service Risk Index. Firstly, the direction of the household debt-to-disposable income ratio, along with its level are key determinants in determining the level of risk, with the other driver being the level of real interest rates.

The Household Debt-Service Risk Index (expressed on a scale of 1 to 10 with 10 being the highest level of risk) is an attempt at measuring the vulnerability of households when it comes to the future ability to service their debt. 3 variables play a role in its level:

- The level of the household debt-to-disposable income ratio (higher debt-to-disposable income ratio implies higher risk)
- The direction of the household debt-to-disposable income ratio (rising debt-to-disposable income ratio points to higher risk than declining trend), and
- The level of real interest rates. This measure of real interest rates is the difference between prime rate and the 5-year average consumer price inflation rate. The reason for using a 5-year average inflation rate is to get to more of a "structural level" of inflation, because periodically we will have extremely low levels of inflation which will could temporarily lead to low interest rate levels, but which could be "unrealistic" and could imply steep hiking and pain once inflation "normalises". As prime rate moves nearer to the 5-year average inflation rate (i.e. declining in real terms), the lower the scope for further rate cuts and the greater the chance that the next rate move is up. Should the SARB pursue with negative real rates al la US Federal Reserve, this too creates risks in terms of stimulating unsustainable credit growth. Either way, periods of low real interest rates are seen as ones where the risks to the household sector's debt serviceability rise.

The Household Debt Service Risk Index has begun to rise over the past 2 quarters due to the combination of household debt-to-disposable income resuming its rise, along with interest rate cuts seemingly nearing their bottom as they move lower in real terms. The decline in the index from the second quarter of 2006 was due to the pace of growth in household debt-to-disposable income starting to lose momentum, although still growing, and then later due to rising interest rates taking the country further away from low real interest rate levels that could drive us into an unsustainable debt situation. Early-2006 saw us reach a level of debt-service risk last seen in 1980. By last year, with the debt-to-disposable income ratio initially starting to decline, things looked promising for a decline to far lower levels of household debt-service risk. This improvement has however, at least temporarily, been halted by a recession that has slowed income growth dramatically.

So for now the levels of debt service risk remain far higher than the late-1998 low, at which stage real interest rates were intolerably high and set for a huge reduction, and household indebtedness was significantly lower and on its way down. Those were the solid fundamentals (1998) which preceded the greatest property boom in history. The current time by comparison remains a "proceed with caution period" for responsible borrowers/lenders.