HOUSEHOLD SECTOR DEBT-SERVICE RISK

- The household sector, with its high indebtedness and very low savings rate, remains highly vulnerable to interest rate hiking

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1. SUMMARY – HOUSEHOLD SECTOR FINANCIAL VULNERABILITY REMAINS HIGH

Household sector credit quality has improved in recent years. However, this improvement has very little to do with any real improvement in the household sector's "balance sheet". Rather, it has mostly to do with massive interest rate cuts since late-2008, from a prime rate of 15.5% to the current 9%. This would be fine if we could guarantee that interest rates wouldn't ever rise again, but that is not the real world. Just yesterday, the Reserve Bank Governor, in her Monetary Policy Committee statement, while not moving interest rates was at great pain to emphasis that ""the risks to the outlook for inflation are on the upside". This implies "upside" risk for interest rates too, and many analysts including ourselves hold the expectation that the next move in interest rates will be up and that it will start late this year.

This is not particularly good news, because the household sector's vulnerability to interest rate hikes remains very high for the simple reason that its level of indebtedness remains very high. The SARB Quarterly Bulletin released this week told us that the household debt-to-disposable income ratio measured 77.6%, down from the previous quarter's 78.7%. While the decline was good news from a vulnerability point of view, the ratio remains extremely high by SA's historic standards, and has declined only moderately from the 82% high reached 3 years ago in the 1st quarter of 2008.

The still high level of indebtedness is accompanied by rising interest rate risk, as rates have moved lower, and therefore nearer and nearer to their bottom turning point of the cycle. These 2 factors have kept our Household Sector Debt Service Risk Index at a relatively high level of 6.25 (on a scale of 1 to 10) in recent quarters. While not quite as high as the level of risk reached in 2006, where the index peaked at 6.72, the current level is well above the long term average of near to 5. This suggests that the next interest rate hiking cycle will have to be very mild if we are to avoid another round of very severe financial pain, short of any further significant reduction in household sector indebtedness prior to that event.

What would we regard as a mild interest rate hiking cycle? Well, the household sector debt-service ratio, i.e. the cost of servicing the household debt burden (interest + capital) expressed as a percentage of household sector disposable income, was at 11.9% by the 4th quarter of 2010. This is significantly down from the all-time high of 16.2% reached in the 3rd quarter of 2008. With the debt-service ratio being such a good predictor of default rates on our home loan book, as well as being a good predictor of many other forms of household debt default rates, the 2008 peak meant almost unprecedented financial pain for the household sector. Another peak of 15.5% prime rate would take the debt-service ratio back to levels not far below that previous peak, because the level of indebtedness remains not far short of 2008 levels, and this scenario we would term as "painful".

So how much interest rate hiking would the household sector be able to manage without experiencing "severe pain" once again? Our subjective view is that the debt-service ratio needs to stay below 13% for relative comfort, and for this to happen we would be able to absorb only 2 percentage points' worth of interest rate increases at the current level of household debt-to-disposable income. While our current expectation is indeed for a more moderate interest rate hiking cycle than last time around, ultimately it will be economic and inflationary forces which will have a large say in what the Reserve Bank does. Given that history tells us that SA interest rate hiking magnitudes of 4-5 percentage points are quite possible, the household sector with its high level of indebtedness remains vulnerable. There is also a lack of building of financial buffers. This is reflected in a very weak savings rate, which the SARB reported at -0.3% of disposable income in net terms when adjusted for depreciation in fixed assets owned by households, further increasing that vulnerability.

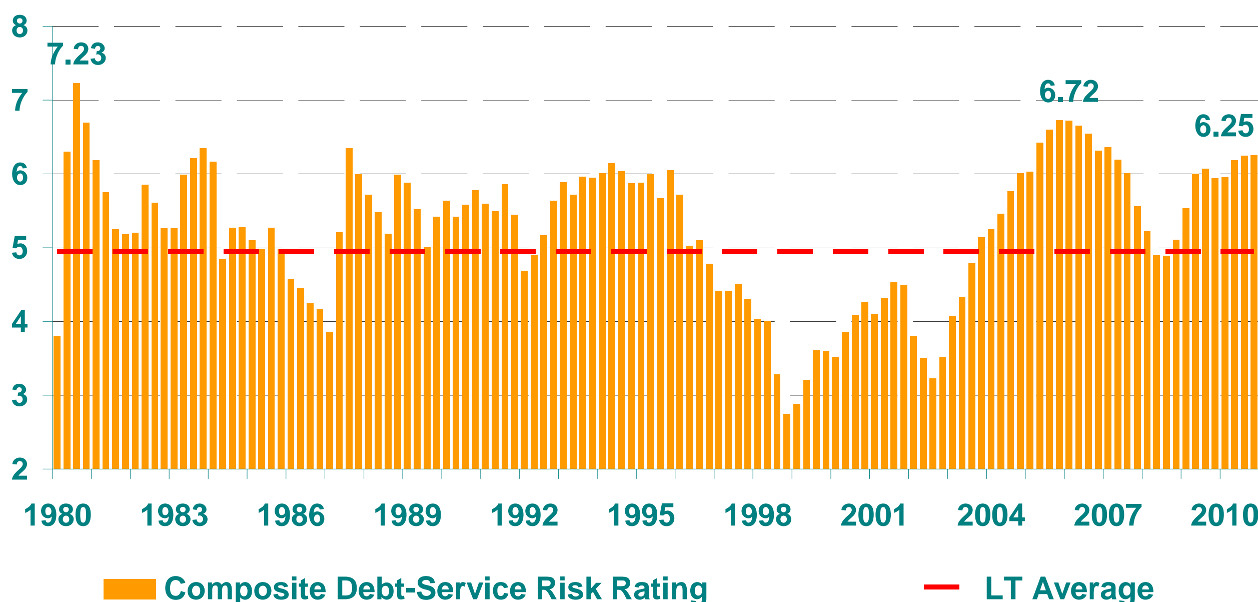
2. HOUSEHOLD SECTOR VULNERABILITY – AS TALK OF INTEREST RATE HIKES MOUNTS, HOW MUCH INTEREST RATE HIKING WOULD BE COMFORTABLE?

The 4th Quarter 2010 Household Sector Debt Service Risk Index remains virtually unchanged on the previous quarter, and remains high (high risk level) on the back of rising interest rate risk.

The Governor has spoken, and the Reserve Bank's repo rate remains "unchanged for the time being". However, she emphasized in her statement that the inflation risks lie to the upside. Recent upward pressure on global oil and food prices currently stand out as potential key upward drivers of our domestic inflation. The general talk therefore appears to be around the timing and magnitude of interest rate hikes, no longer of cuts, and late-2011 is penciled in as "D-Day" by many analysts including ourselves. The general expectation appears to be for a more mild interest rate hiking cycle than last time around, but then last time around the expectation was also for a more mild interest rate hiking cycle. Such is the hazardous nature of forecasts. In the end, economic and inflationary conditions will largely determine how far the Reserve Bank goes, and we have little control over that. What households do have control over, however, is how much they borrow, and their levels of indebtedness will be the key determinant as to how vulnerable the household sector is to interest rate hikes, and how much interest rate hiking they can absorb.

So how vulnerable is the household sector at present"? The FNB Household Sector Debt Service Risk Index is an attempt to demonstrate this vulnerability to future events that may influence its ability to service its debt. The Index is made up of three variables, namely the levels of indebtedness (as represented by the household debt-to-disposable income ratio), the direction that indebtedness is moving in (i.e. a smoothed time series of the quarter-on-quarter rate of change in the debt-to-disposable income ratio), and at what level interest rates are relative to "structural inflation" (for which we take prime rate as a multiple of a 5-year moving average inflation rate of the private consumption expenditure deflator).

In the 4th quarter of 2010, the index measured 6.25, which remains high by historic standards, and virtually unchanged from the previous quarter (implying a high level of risk/vulnerability). Recent levels have only been noticeably exceeded in the early-1980s and around 2006 at the height of the household credit boom, and both of those risky periods were followed by severe household sector financial pain.



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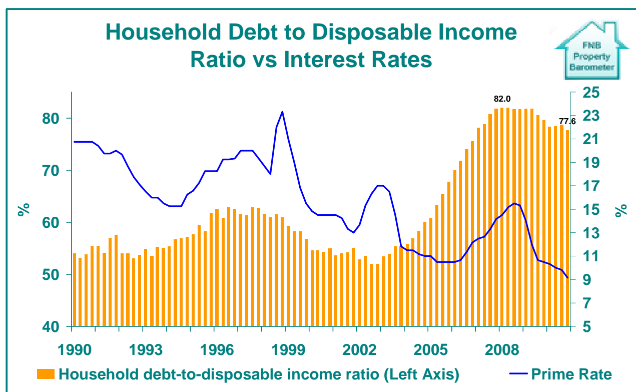
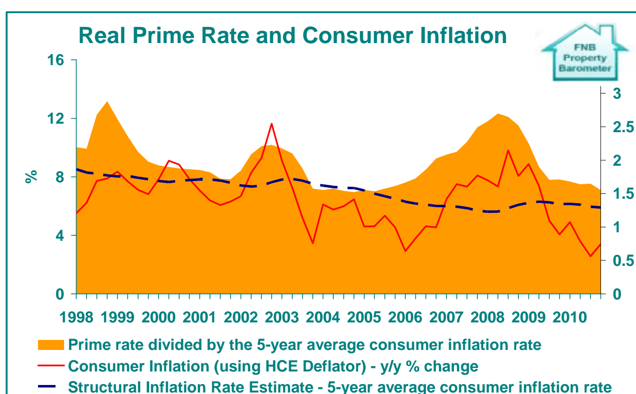
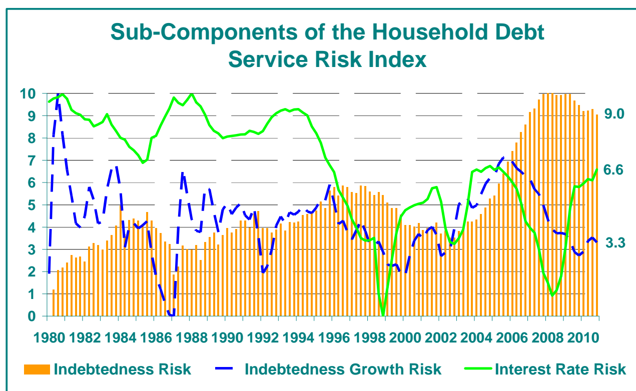
What keeps the level of household debt-service risk so high? First and foremost is the still very high level at which the debt-to-disposable income ratio hovers. The latest SARB numbers showed a return to decline in the household sector debt-to-disposable income ratio, from a previous quarter's 78.7% to a 4th quarter 77.6%. This came despite an acceleration in 4th quarter household credit growth from 7.9% in the 3rd quarter to 8.9%, and was due to an acceleration in nominal household disposable income growth on the back of a faster 4th quarter economic growth rate.







*The decline in the debt-to-disposable income ratio is a positive development in light of the fact that the ratio still remains very high by our historic standards. The 77.6% recorded remains only moderately down from the all-time high of 82%, reached almost 3 years prior at the beginning of 2008. **It is this high debt ratio that is instrumental in keeping the Household Debt Service Risk Index at relatively high levels.***

Nevertheless, the slight improvement in the debt ratio, coupled to the fact that momentum in this ratio has turned downward, are two slightly positive factors for the level Debt Service Risk Index.

These slight improvements, however, were negated by rising interest rate risk. The index doesn't take current inflation pressures into account. Rather, it looks at how low interest rates have fallen relative to "structural" or longer term inflation rates. The reasoning is that the nearer interest rates get to the structural inflation rate, the higher the risk that we may be at or near the end of interest rate cuts and that the next rate moves will be up. In other words, periods of very low interest rates are seen as higher risk periods, because borrowing/lending is done based largely on whether the borrower can afford to service the debt at current interest rate levels. Rate hikes after periods of low inflation, therefore, spell trouble for a group of borrowers who haven't built up buffers for this inevitable event, and there are a significant amount of these households. The converse is that a relatively high interest rate period is a lower risk period because lending/borrowing is done more conservatively, based on those high interest rates..

By the 4th quarter of 2010, our real prime estimate, taking prime rate as a multiple of the 5-year average consumer inflation rate, was 1.55%, the lowest real prime rate using the structural inflation estimate since the 2nd quarter of 2005.

Examining the 3 sub-indices that make up the Household Sector Debt-Service Risk Index, therefore, the Indebtedness Risk Index declined from a previous quarter's 9.3 to 9 in the 4th quarter of 2010, and the Indebtedness Growth Risk Index declined from 3.5 to 3.3 over the same period. However, Interest Rate Risk rose from 6.1 to 6.6, due to further rate reductions in September and November, nullifying the mild improvement in the former 2 sub-indices.

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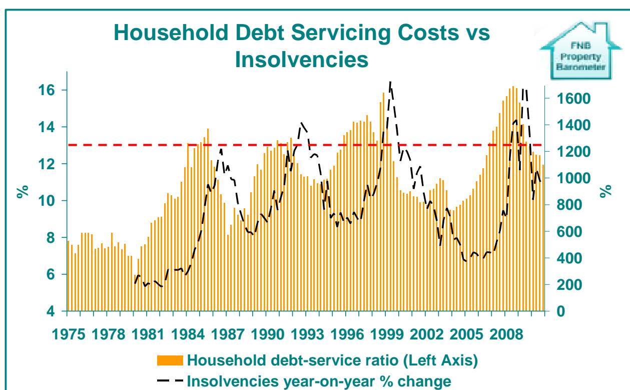
The debt-service ratio is still at a high level for a cyclical trough, compared to previous cyclical troughs

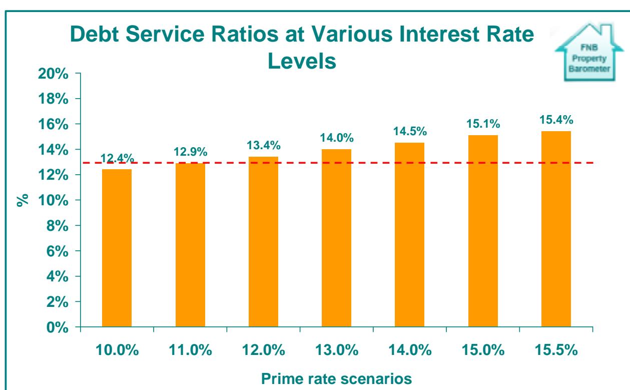
The answer to the question as to how much rate hiking the household sector could comfortably take is a very subjective one. Here, the level of the household debt-service ratio is very important, as it is arguably the best single variable with which to predict default rates on home loans, and possibly for household debt overall.



The debt-service ratio is the cost of servicing the household sector debt burden (interest + capital payments) expressed as a percentage of total household sector disposable income. The debt-service ratio rose to its highest level ever of 16.2% as at the 3rd quarter of 2008, and there is little doubt that this was a period of severe pain for lending institutions and a significant portion of households alike, and neither have fully recovered to date. The only similar period was that of late-1998, when the debt-service ratio peaked at 15.9%, also a very painful period which most would not want repeated. So what is a good "target" limit? Our admittedly subjective view is that 13% would be a good level. This was the level reached in the final quarter of 2006, and it was very shortly thereafter that credit quality began to deteriorate rapidly, as reflected in the dramatic acceleration in insolvencies growth from 2007.

At present, thanks to big interest rate cutting by the SARB since late-2008, the debt-service ratio has dropped significantly, reaching 11.9% by the final quarter of 2010. This is seemingly well-below the "point of pain" and the levels of default have improved significantly. However, despite prime rate, at 9%, being at a multi-decade low level, the level of indebtedness has kept the debt-service ratio well-above the previous cyclical bottom points of 8.1% in 1987, 10.8% in 1993, 9.8% in 2002, and 9.5% in 2004. Therefore, in the current cycle, we are nearer to the "point of pain" than we were at the bottom of any of the other cycles on record, implying a less room to absorb rate increases.

So how much interest rate hiking would the household sector be able to manage without experiencing "severe financial pain"?

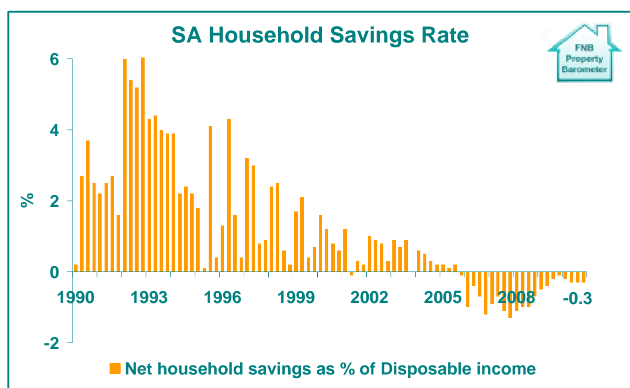


Given that we suggest a 13% debt-service ratio as our (admittedly subjective) acceptable limit, how much rate hiking would we be able to accommodate while still keeping the ratio below that 13% level? The accompanying graph suggests that, using the 4th quarter 2010 debt-service ratio, a rise in prime rate to 11% would take the ratio to 12.9%, while anything more than that would take it to above the 13% level.

If prime rate were to go all the way back to 15.5%, it would give us a very high ratio of 15.4%. That would be only slightly lower than the 1998 and 2008 peaks, and reflects the very limited progress in lowering the household debt-to-disposable income to date.

While we admit that an appropriate debt-service ratio peak is open to debate, the 1998 and 2008 peaks were extremely painful, and the current levels of household indebtedness suggest that the household sector may experience very significant financial pain again should we be subjected to a "normal" South African interest rate hiking cycle, normal being perhaps 4-5 percentage points if the last 2 cycles are a good benchmark.

The general perception appears to be that the SARB currently will behave moderately, and expectations for the next interest rate cycle tend more towards 2-3 percentage points' worth of rate hikes. However, the future remains an uncertain place, and this is a fragile assumption to work on, remembering that a "more moderate" interest rate hiking cycle was a widespread expectation before the last interest rate hiking cycle too. ***What is thus still needed currently, we believe, is a more significant decline in the household debt-to-disposable income ratio prior to the next interest rate hiking cycle, in order that the household sector create an ability to handle more than just perhaps 2 percentage points' worth of interest rate hikes.***



In addition, it is important that the household sector builds up financial buffers, many of which have been run down over the past few years. The SARB Quarterly Bulletin continues to paint a woeful picture of household savings, currently running at "net dis-saving of -0.3% of disposable income. While the level of savings doesn't feature directly in our Debt-Service Risk Index, its low rate does continue to add to the vulnerability of the household sector to any unwanted financial "shocks".