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HOUSEHOLD SECTOR FINANCIAL VULNERABILITY

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Slowing household income growth means that not enough has yet been done to reduce Household debt service risk significantly.

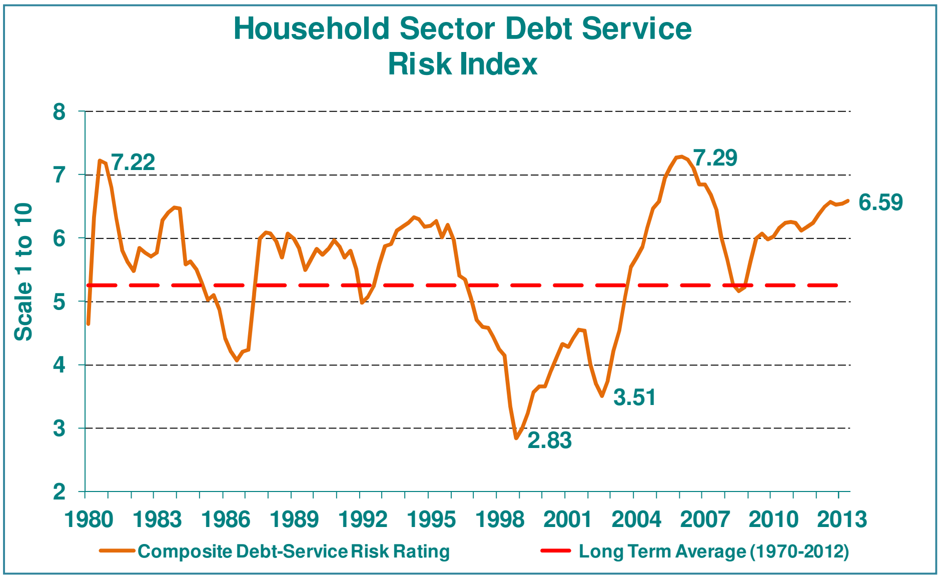
OUR HOUSEHOLD SECTOR DEBT-SERVICE RISK INDEX ROSE (DETERIORATED) SLIGHTLY IN THE 2nd QUARTER OF 2013

The release of the SARB (South African Reserve Bank) Quarterly Bulletin gave us the 2nd quarter picture of household sector income and indebtedness.

From this data, we calculate our FNB Household Debt-Service Risk Index, which indicates that the vulnerability of the country's household sector when it comes to being able to service its debt in future rose (deteriorated) slightly in the 2nd quarter of 2013.

From a revised 1st quarter 2013 index level of 6.54 (on a scale of 1 to 10), the 2nd quarter saw a slight rise to 6.59. This comes after a prior slight decline, which we had thought may have been the start of an improving trend, but it was not yet to be.

The level of the Household Sector Debt-Service Risk Index thus remains high, well-above the long term (33 year) average level of 5.2, and at current high levels it would be preferable to be seeing significant decline prior to the next interest rate hiking cycle.



The index is compiled from 3 variables, namely, the debt-to-disposable income ratio of the household sector, the trend in the debt-to-disposable income ratio, and the level of interest rates relative to long term average (5-year average) consumer price inflation.

The higher the debt-to-disposable income ratio, the more vulnerable the household sector becomes to unwanted "shocks" such as interest rate hikes or downward pressure on disposable income. An upward trend in the debt-to disposable income ratio contributes negatively to the overall risk index. Then, the nearer prime rate gets to the "structural" inflation rate (using a 5-year average consumer inflation rate as a proxy), i.e. the lower this estimate of real interest rates becomes, the more vulnerable the household sector becomes, the reasoning being that the nearer we may be getting to the bottom of the

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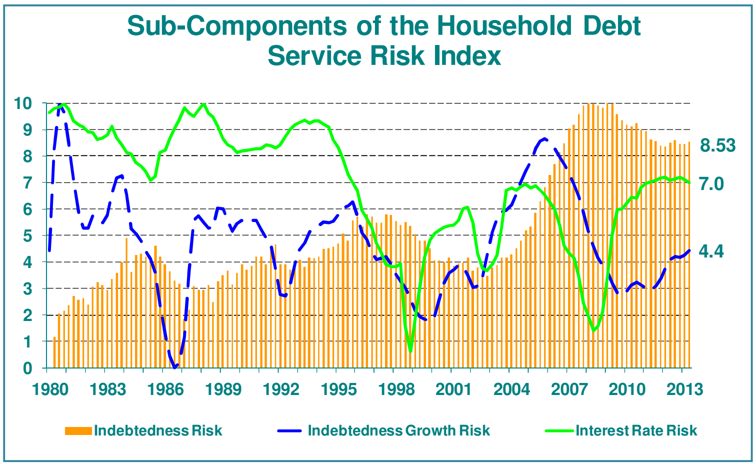
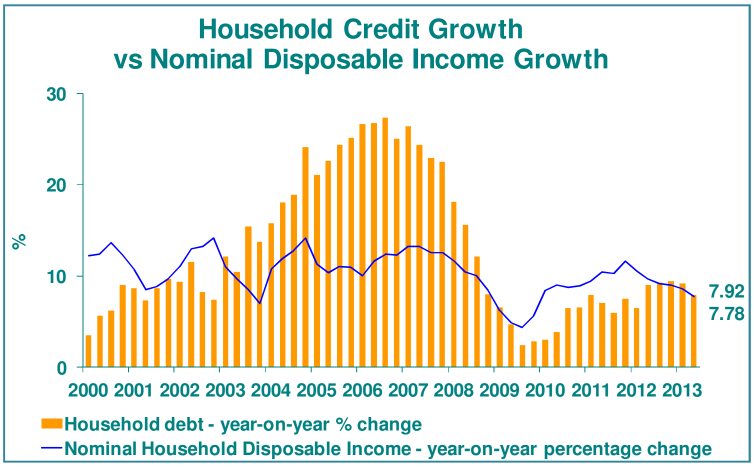
interest rate cycle and the end of rate cutting relief, and the more the risk of the next rate move being upward becomes, or at least the less the chance becomes of further cuts. In addition, households tend to make poorer borrowing decisions, on average, when money is cheap, and far better ones when interest rates are relatively high. That's a common human weakness, and hence an additional part of the logic of viewing low interest rate periods as ones where risk generally builds up, especially when rates are "abnormally low" by a country's standards, as is currently the case in SA.

A RISE IN THE LEVEL OF HOUSEHOLD INDEBTEDNBESS DROVE THE OVERALL RISK RATING SLIGHTLY HIGHER





Examining the 3 sub-indices of the overall Household Debt-Service Risk Index, the Indebtedness Risk Sub-Index remains the highest at 8.53, despite having broadly declined from a level of 10 as at the 1st quarter of 2008, the quarter in which the Household Debt-To-Disposable Income Ratio reached its all-time high.

After a brief 2 quarters of unchanged debt-to-disposable income ratio, the 2nd quarter of 2013 saw a resumed rise in the ratio.

This may come as a surprise to some, with lending institutions having pulled back on certain categories of household sector credit, and overall household sector credit growth having slowed in recent times.

*However, **the slowdown in household sector credit growth could not match the slowing pace of nominal disposable income growth, thus translating into a rise in this all-important indebtedness ratio.***

Whereas the SARB's quarterly measure of household sector credit growth slowed further from 9.2% year-on-year in the 1st quarter to 7.9% in the 2nd, nominal disposable income growth slowed from 8.6% to 7.8% over the same 2 quarters, a reflection of the weak economic times we find ourselves in.

The net result was a rise in the household debt-to-disposable income ratio from a 1st quarter's 75.4% to 75.8% in the 2nd quarter.

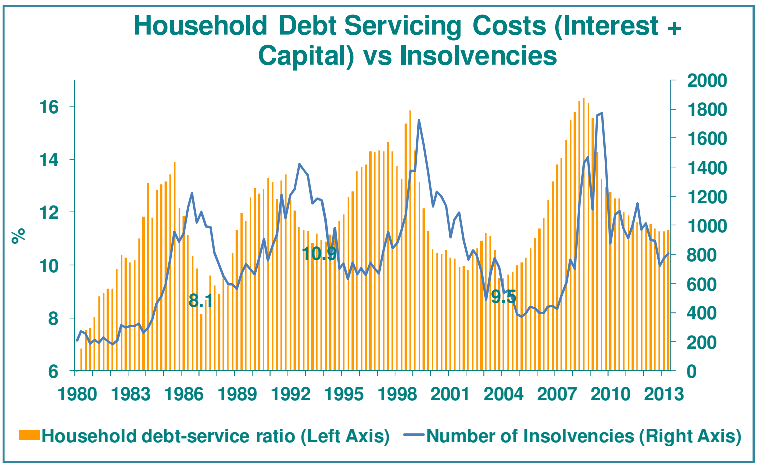
And at 75.8%, the Debt-to-Disposable Income Ratio remains extremely high by SA's historic standards, and still of concern is the fact that recent quarters' figures continue to show "resistance" to decline. And so, through 2012 and 2013 we have seen the "Indebtedness Growth Risk Index" rising, although admittedly this sub-index remains relatively low at 4.4, therefore not indicating very strong momentum in indebtedness growth.

The third component is the Interest Rate Risk Index, which remains relatively high level of 7 as at the 2nd quarter of 2013, although it hasn't risen in recent times, as the SARB has not lowered interest rates for over year now. The reason for its broadly negative contribution to the overall Risk Index is the fact that prime rate remains at low levels relative to SA's long term average inflation rate. This sub-index's contribution to the overall Debt-Service Risk Index has been high ever since the sharp decline in interest rates from late- 2008, from 15.5% prime to the current 8.5%. In recent years, interest rates have moved to abnormally low levels by SA's historic standards, given that "structural consumer inflation appears to be somewhere near to 6%. This decline is due to an abnormal global and domestic economic situation requiring significant monetary policy support.

OUR SIMPLE MEASURE OF DEBT-SERVICE RISK REMAINS CONCERNINGLY HIGH, AND REQUIRES SIGNIFICANT REDUCTION FOR COMFORT

The Debt Service Risk Index in the 2nd quarter of 2013 remains high by historic standards. The household sector's financial situation is still far from healthy, and significant pain could easily be felt were we to go into the next interest rate hiking cycle at current levels of household sector vulnerability.

This may seem a strange statement to make in the current times, as repayment performance on debt by the household sector has improved significantly in recent years, and this is seen in publicly available numbers such as insolvencies, which have fallen dramatically.

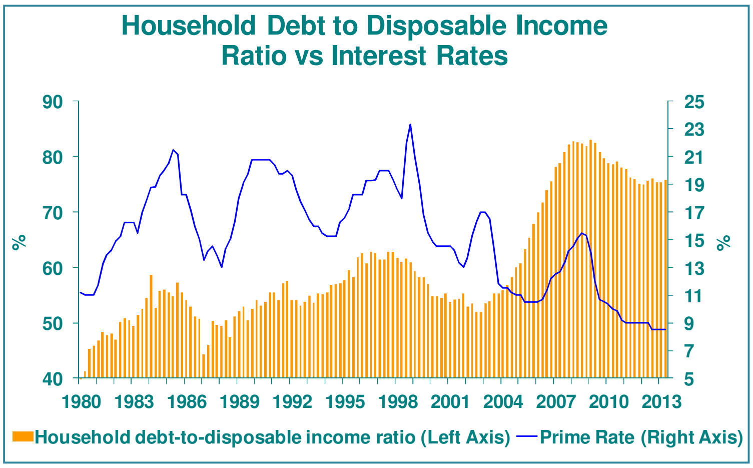

Household Debt Servicing Costs (Interest + Capital) vs Insolvencies

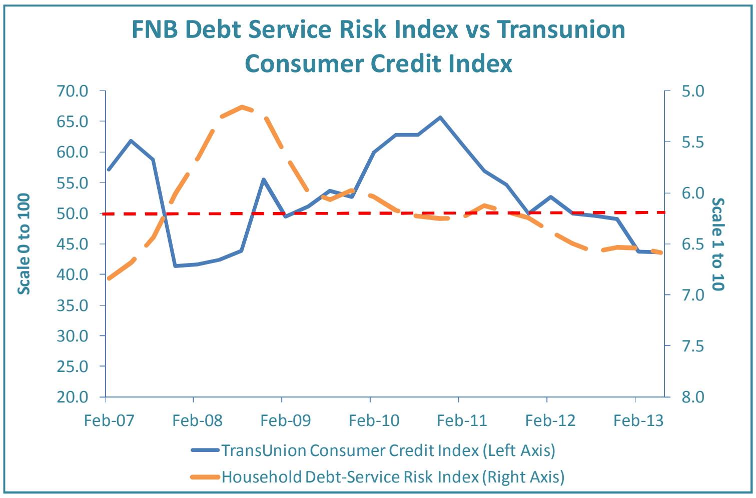
However, risk and current performance are 2 completely different things, and for this improved credit performance, the household sector has been relying heavily on the Reserve Bank (SARB) to maintain interest rates at very low levels, instead of building more significant financial buffers in the form of higher savings and lower indebtedness.

Indeed, it has been the SARB's huge reduction in interest rates from 15.5% prime as at late-2008 to the current 8.5% that has been the major contributor to bringing down the all-important debt-service ratio (cost of servicing the household debt, interest + capital, expressed as a percentage of household sector disposable income) from a painful all-time high of 16.3% to a far more comfortable level of 11.3%. This, in turn, significantly improved household credit performance, and the graph above shows insolvencies having dropped dramatically from 2009 to 2013 as a result.

But the "low risk" way of reducing the debt-service ratio, and thus the more desirable way, would be through lowering the debt-to-disposable income ratio of the household sector instead of relying on low interest rates (which never stay around for ever). The 2nd quarter rise in the debt-to-disposable income ratio, from 75.4% to 75.8% should thus be of some concern.

Crucial to any decline in the debt-to-disposable income ratio will be for household credit growth to still slow significantly further, in the absence of any meaningful improvement in economic and household disposable income growth.


Household Debt to Disposable Income Ratio vs Interest Rates


FNB Debt Service Risk Index vs Transunion Consumer Credit Index

Of concern, too, should be that the household sector credit cycle had turned for the worse a few quarters ago, according to the Transunion Consumer Credit Index, and indicator of overall "credit health". With a considerable lag, the Transunion Index has tracked the Household Debt Service Risk Index's deterioration.

Inverting the Debt-Service Risk Index and plotting it on a graph along with the Transunion Consumer Credit Index, we see that a low point (low risk point) in the Debt-Service Risk Index was reached in 2008, where-after a steady deterioration took place. With a lag, the Transunion Consumer Credit Index peaked (a peak in credit health) late in 2010. Thereafter, there was a steady slowing in the pace of improvement in consumer credit health until the 3rd quarter of 2012, where this index moved below the crucial level of 50, signaling the onset of a deterioration in consumer credit health.

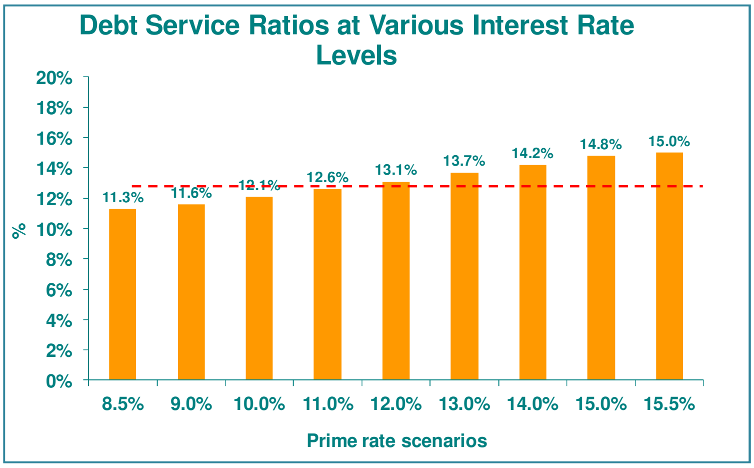
Such a deteriorating phase in the consumer credit cycle is undesirable at a time when interest rates still remain stable and at multi-decade lows.

Interest rate scenarios – still limited room for households to maneuver.

I am of the admittedly subjective opinion that a 13% debt-service ratio represents an acceptable maximum at the peak of the household debt-service ratio cycle. When this ratio rises higher than 13%, that would appear to be where matters become unacceptably painful for the household sector as well as lending institutions. That was the case around 2007/08 as well as in the late-1990s. At the current level of household indebtedness, what would it take for the debt-service ratio to reach a 13% "upper acceptable limit"?

The accompanying graph shows the debt-service ratio at the current debt-to-disposable income ratio, for different hypothetical interest rate scenarios. According to these, a prime rate of 12% would cause the household debt-service ratio to go beyond the 13% "threshold" at a 2nd quarter household debt-to-disposable income ratio of 75.8%.

That means that the household sector probably only has room for what would be a mild interest rate hiking cycle (by SA historic standards) of 3-3.5 percentage points before "severe" financial pain sets in. This may sound like a comfortable margin, but it is important to bear in mind that interest rate levels are at currently abnormal (low) levels by SA standards, and that "normalization" may be required at some future stage.

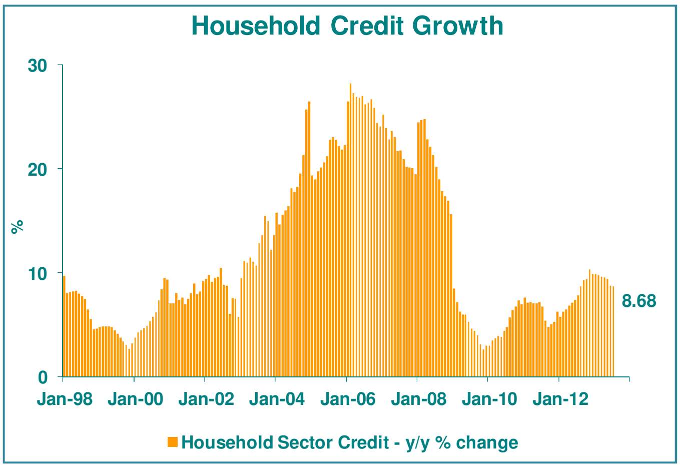


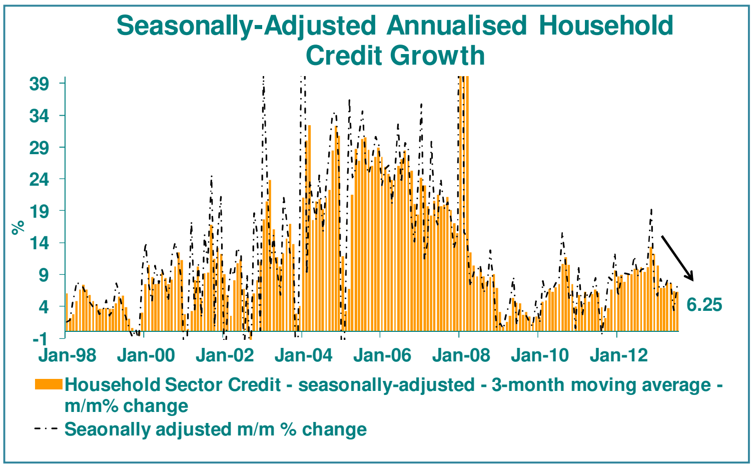
The risk is, therefore, that the next interest rate hiking cycle could be of a bigger than normal magnitude as opposed to expectations from many some quarters of it being more mild than normal.

IN CONCLUSION – FURTHER DECLINE IN THE DEBT-TO-DISPOSABLE INCOME RATIO IS NEEDED FOR SAFETY. GOOD NEWS IS THAT SLOWING HOUSEHOLD CREDIT GROWTH MAY SUPPORT SUCH A TREND.

In the 2ND quarter of 2013, our Household Sector Debt-Service Risk Index rose mildly once again. I regard this as an unwelcome move in the Index, which remains at high levels by historic standards. This implies a still-high level of household sector vulnerability to "unwanted shocks". Such shocks can either be in the form of rising inflation and/or interest rates, or through weaker economic growth which in turn can exert pressure on disposable income growth.

Through 2012 and the 1st half of 2013, nominal household disposable income growth has been slowing to a year-on-year growth rate recently below 8%, and given our modest expectations for economic growth in 2013, it is not expected to be too much different in the near future.





Therefore, monthly household credit growth of 8.7% year-on-year as at July 2013 would appear unlikely to be meaningfully below household disposable income growth. However, calculating a seasonally adjusted month-on-month annualised growth rate, we see that a recent loss of growth momentum in household credit to around 6.25% by July (3-month moving average,) and this would suggest that the year-on-year growth rate in household sector credit will soon be significantly lower.

This is positive news, suggesting that we may soon get it right to slowly "engineer" a decline in the debt-to-disposable income ratio to lower and safer levels without having to hike interest rates to do the job, provided disposable income growth does not dip too much lower. This slowing household credit growth is largely due to slowing non-mortgage components of household credit growth, which may be the result of successful "verbal intervention" by the authorities.

In late-2012, we saw increasing concern being expressed by the Minister of Finance as well as the Credit Regulator, around strong growth in unsecured credit, and it would appear that some lenders may have taken heed of these "verbal interventions", slowing certain lending components' growth rates down. Such measures are important in terms of being able to get to a lower level of household indebtedness, and therefore lower debt-service risk, prior to the next interest rate hiking cycle.

But slower household credit growth needs to continue for a prolonged period in order to reduce the debt-to-disposable income ratio, preferably before the next interest rate hiking cycle.