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HOUSEHOLD SECTOR FINANCIAL VULNERABILITY

The topic of household debt will likely be a major theme in 2013.

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SUMMARY

Expect the topic of household sector indebtedness to be a key theme in 2013. Over the years, perhaps fueled by the consumer boom of last decade, we have seen a seemingly increasing obsession amongst many households over consumption and credit. This seems to be a common phenomenon in societies where things have gone well for long periods of time, and it can be argued that middle and upper income South Africa has "had it good" for a very long time, with no major wars, recessions or depressions (the 2008/9 recession being relatively short-lived when one compares it to for instance the early-1990s recession of over 2 years).

But even the relatively recent 2008/9 3-quarter long recession, and the interest rate peak of 15.5% prime rate in 2008, is fading in the memory of many. A long period of "abnormally low" interest rates by South Africa's standards has led to a major improvement in household debt repayment performance, and this can be seen in large declines in numbers such as total insolvencies. Home loans bankers, for one, sleep a lot easier at night these days, with non-performing loans well down from the highs of 2008/9. And in the area of non-mortgage household sector credit, the growth in borrowing has steadily accelerated since early-2010 in response to renewed happier economic and interest rate times.

But "all is not well". If low interest rates lead to improved repayment performance this does not mean that the underlying household financial frailties no longer exist. Increasingly, certain commentators are expressing alarm at the huge growth rates in certain categories of household credit. Total household sector credit growth moved to above 10% as at November, the 1st month of double-digit year-on-year growth since late-2008.

But the discussion broadened late last year. Whereas the debate had typically focused on what the level of bad debt could become should household indebtedness get too high, allegations emerged that high levels of indebtedness maybe linked in part to social unrest.

While links between indebtedness and social unrest may be tough to prove, there is little doubt that over-indebtedness can do a lot of harm to households, and should be kept in check. Certain studies in the UK have even started to draw a link between levels of indebtedness and mental illnesses such as stress and depression. How at risk is SA's household sector? Relative to what, is the question, I guess.

At least by our own historic standards, though, I would say that the answer is "very high", given that the household sector debt-to-disposable income ratio is at 76%, not far lower than the 2008 historic high of 82.7% which caused much pain when interest rates hit their peak in that year. Furthermore, 2012 saw some renewed rise in the debt-to-disposable income ratio, after a few prior years of mild decline, and further household credit growth acceleration in the 4th quarter makes it likely that further increase took place in the debt-to-disposable income ratio as 2013 approached.

Our Household Debt Service Risk Index, rose for the 5th consecutive quarter in the 3rd quarter of 2012, to a level of 6.68 (scale of 1 to 10), a very high level compared to the long run average of 5.3. This, therefore, suggests that SA's household sector is still at a relatively high level of vulnerability by our own historic standards.

Driving the Index higher was a higher debt-to-disposable income ratio of 76% in the 2^{nd} and 3^{rd} quarter, up from late-2011, while abnormally low interest rate levels have also helped to sustain high risk levels (very low real interest rates being viewed as a greater risk than high ones, the reasoning being that rate hiking risk is higher at the lower real levels, as well as because households tend more towards "over-borrowing" the lower the interest rates are)

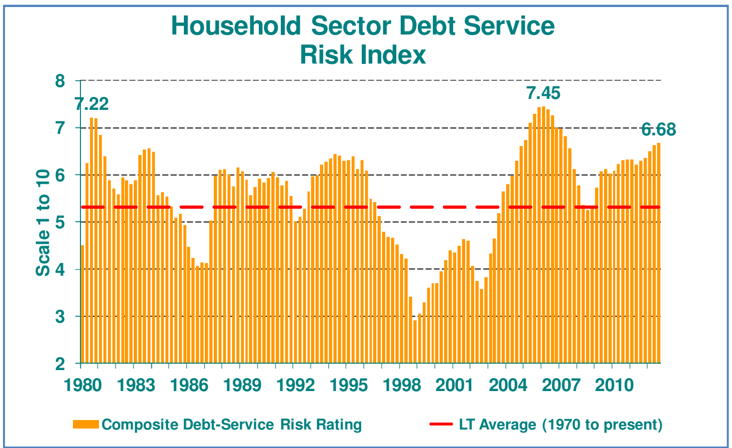
The high level of household vulnerability has introduced a key policy dilemma. Arguably the most effective way to curb overall household borrowing growth is to hike interest rates. However, given the high level of household indebtedness, the initial effect of rising interest rates is to exert severe pressure on many of those households with high levels of debt, not an attractive policy option in a time when the economy is battling and unemployment is a real problem.

A key challenge is thus to find a way to reduce the household sector's propensity to borrow, and increase its desire to save, preferably without having to have painfully high interest rates such as those experienced at certain times in the 1990s. Expect this debate, and increasing focus on the "how to achieve it" to be a key theme in 2013.

HOUSEHOLD SECTOR DEBT-SERVICE RISK ROSE FURTHER IN THE 3^{rd} QUARTER OF 2012

According to our Household Debt-Service Risk Index, the vulnerability of the country's household sector when it comes to being able to service its debt in future still appears to be rising. From a 2^{nd} quarter 2012 index level of 6.63 (on a scale of 1 to 10), the 3^{rd} quarter saw a further increase to a level of 6.68. This represents the 5^{th} consecutive quarter of increase in our simple measure of household debt-service risk.

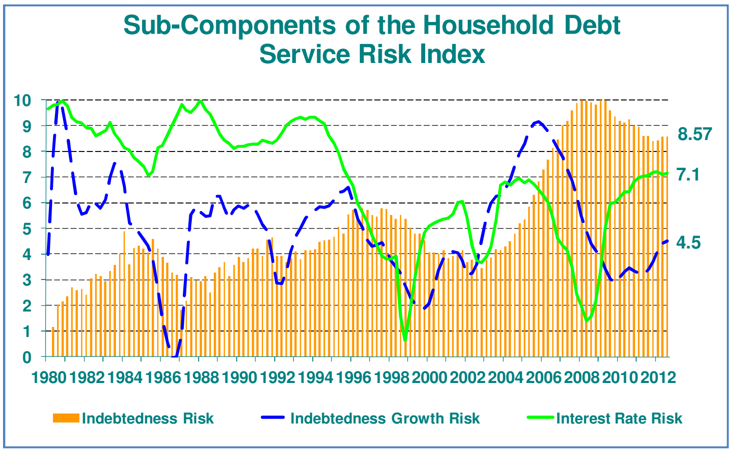
Of concern is that the Household Sector Debt-Service Risk Index remains well-above the long term (32 year) average level of 5.3, and at current high levels it would be preferable to be seeing a declining trend.



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 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 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 higher risk ones, especially when rates are "abnormally low" by a country's standards, as is currently the case.

EXAMINING THE 3 COMPONENTS, THE HIGH LEVEL OF INDEBTEDNBESS STILL KEEPS THE OVERALL RISK RATING HIGH, ALONG WITH A HIGH INTEREST RATE RISK RATING



Examining the 3 sub-indices of the overall Household Debt-Service Risk Index, the Indebtedness Risk Index remains the highest at 8.57, despite having declined moderately from a level of 10 as at the 1st quarter of 2008, the quarter in which the debt-to-disposable income ratio reached its all-time high.

Although the debt-to-disposable income ratio receded mildly to 75.2% by the 4th quarter of 2011, this level still remains extremely high by SA's historic standards, and more of concern is that in 2012 the figures have shown mild renewed increase to 76% as at the 2nd and 3rd quarters.

Therefore, in 2012 we started to see the "Indebtedness Growth Risk Index" make an increasing contribution to the overall Debt-Service Risk Index, although still relatively low at this stage with a Risk rating of 4.5, the upward move having just begun and the trend not yet being a strong one.

The third component is the Interest Rate Risk Index, which was at a relatively high level of 7.1 as at the 3rd quarter of 2012. The reason for its rise since 2008 has been the sharp decline in interest rates since then, from 15.5% prime at mid-2008 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.

The reasoning behind lower real interest rates pointing to greater household vulnerability is that certain households that borrow during low interest rate times tend to be more vulnerable, due often to a lack of forward thinking and planning for the inevitable interest rate hiking cycles. Vulnerability of borrowers who qualify for loans at the peak of the interest rate cycle should thus on average be less than many of those who can only qualify at the low points in the cycle.

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

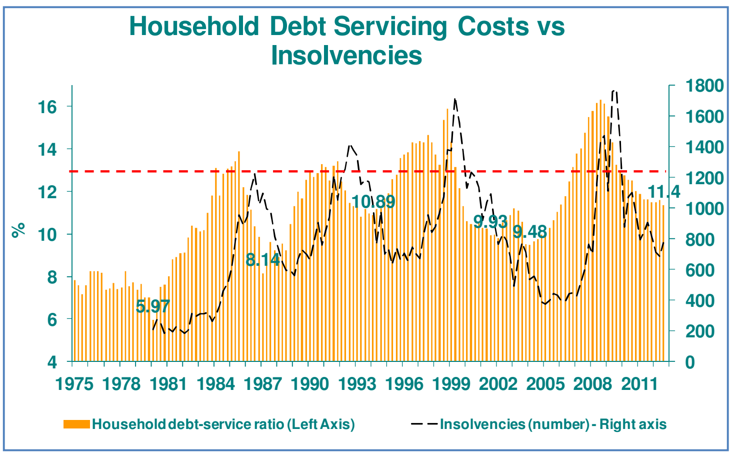
The fact that the Debt Service Risk Index is on a rising trend, at a time when its levels are high by historic standards, should arguably be a cause for concern. The household sector's financial situation is far from healthy, and significant pain could be felt were we to go into the next interest rate hiking cycle at current levels of household sector vulnerability.

This may seem a strange statement to make, as payment 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.

However, for this improved credit performance, the household sector has been relying heavily on the Reserve Bank (SARB) to maintain interest rate levels that are very low by SA's standards, instead of building more significant financial buffers.

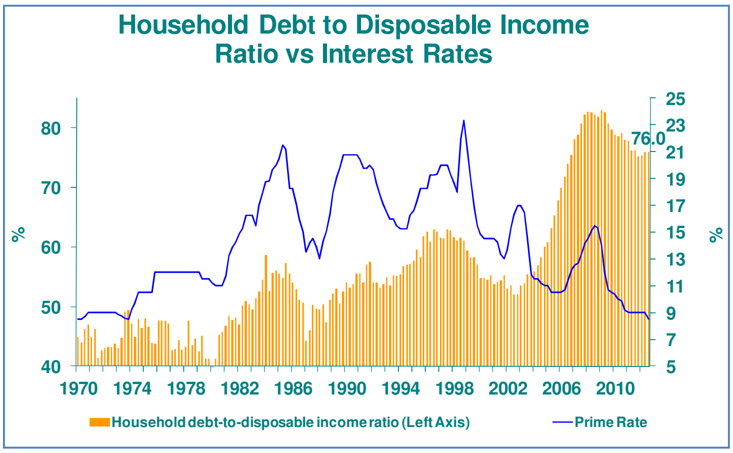
With a rising debt-to-disposable income ratio, the debt-service ratio will also start to move higher should interest rates not decline further.

Indeed, it has been the SARB's huge reduction in interest rates from 15.5% prime as at late-2008 to the 3rd quarter's 8.5% in 2012 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 11.4%. This, in turn, significantly improved household credit performance, and the right hand graph below shows insolvencies having dropped dramatically from 2009 to 2012.



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. Some mild decline of this ratio did contribute to the lower debt-service ratio up until the end of 2011, but the resumption of a rise in the debt-to-disposable income ratio in 2012 required a further half-of-a-percentage-point interest rate cut by the SARB in the 3rd quarter to prevent the debt-service ratio from rising.

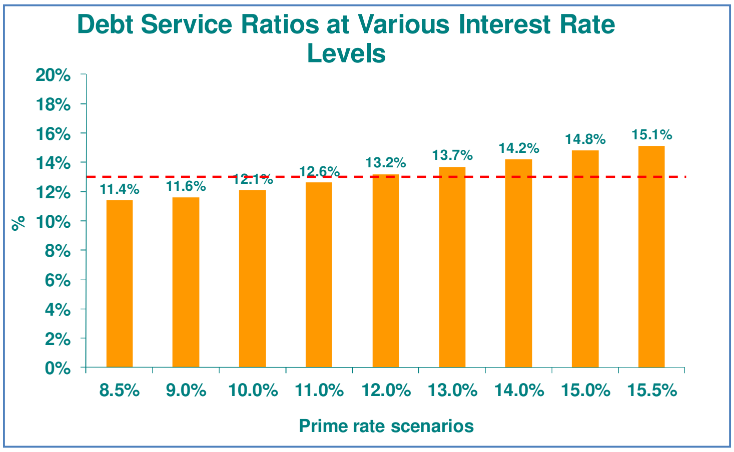
Should interest rates not decline further, and currently accelerating household sector credit growth does push the debt-to-disposable income and debt-service ratios higher, this recent level of debt-service ratio could represent the bottom turning point of the current cycle. Should this be the case, it would be the highest bottom turning point in recorded history. Given that the debt-service ratio is a fairly good predictor of household credit performance, that is a cause for concern.



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

Looking at it another way, I am of the admittedly subjective opinion that a 13% debt-service ratio represents an acceptable maximum at the peak of the 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 3rd quarter household debt-to-disposable income ratio of 76%.

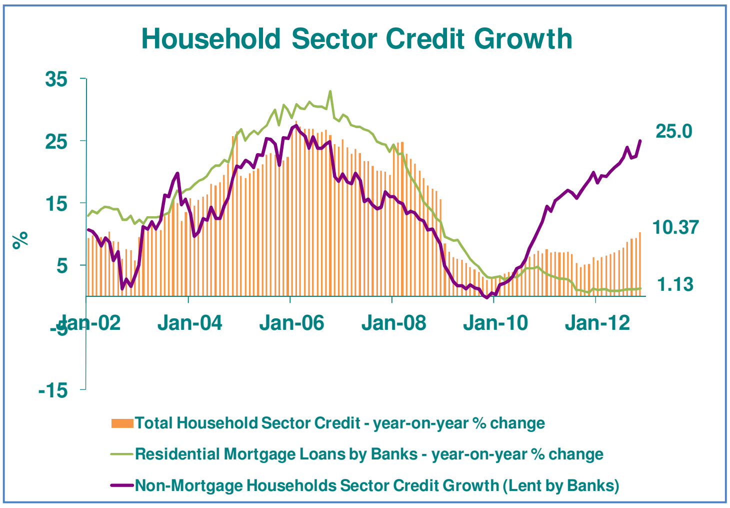


That means that the household sector probably only has room for what would be a mild interest rate hiking cycle of 3.5 percentage points. This may sound like a comfortable margin, but it is important to bear in mind that interest rate levels are at currently abnormal (low) levels, and that "normalization 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 some quarters of it being more mild than normal.***

IN CONCLUSION – FURTHER RISE IN THE DEBT-TO-DISPOSABLE INCOME RATIO SEEMS LIKELY, INCREASING HOUSEHOLD SECTOR VULNERABILITY.

In the 3rd quarter of 2012, our Household Sector Debt-Service Risk Index increased (deteriorated) further, implying a further increase in the already-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, nominal household disposable income growth had indeed been slowing. Simultaneously, growth in household sector credit continued to steadily accelerate, and by November had reached double-digit growth of 10.4%, which in all likelihood exceeded the growth rate in nominal disposable income growth (which was down to 9.2% year-on-year by the 3rd quarter of 2012 according to SARB data).



At present, the SARB is not expected to raise interest rates any time soon, and the danger exists that the long period of low and stable interest rates causes households to become increasingly forgetful of previous periods of higher interest rates, and propensity for borrowing rises. Certainly this appears to be the case if one looks at total bank sector non-mortgage household sector credit, which by November 2012 had reached year-on-year growth of 25%. Only very low growth in the mortgage credit component to households has kept something of a lid on overall household sector credit growth, but insufficient to prevent total household credit growth from accelerating nonetheless.

In 2012, we saw increasing concern being expressed by the Minister of Finance as well as a growing number of economic commentators. Where do household debt levels become "unacceptably high"? That is debatable. However, South Africa's household sector with its low savings rate, and high levels of indebtedness at least relative to its own historic standards, appears highly vulnerable to any external economic shocks. This is likely to see the country's high and strongly growing household debt level being a major topic of debate amongst economists and policymakers alike in 2013.