

Household sector balance sheet – if it ain't broke, it don't need fixin'

20 May 2009

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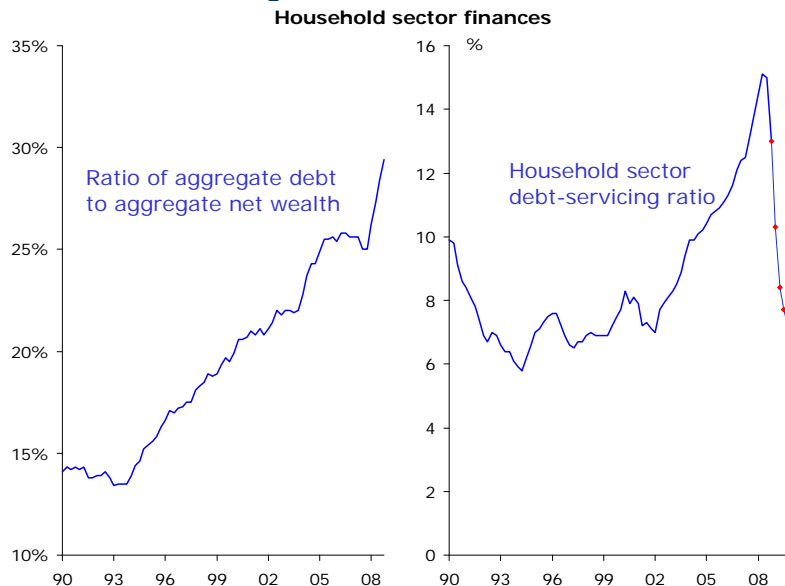
Key points

- Aggregate debt ratios tell us very little about vulnerability of the household sector balance sheet. Australian gearing does not necessarily have to fall to recalibrate the economy onto a sustainable path. The slowdown in credit growth to date has had more to do with the cycle, driven by a sharp drop in new finance approvals than any behavioural shift reflecting increased debt-aversion.
- Higher saving recently *has* been working hard to improve the household sector's *net* financial position. The aggregate 'balance sheet' is still expanding while this happens.
- While equity market collapses and continued debt accumulation have reduced net household wealth significantly since the global financial crisis, there have been some notable offsetting positive contributions from deposits, superannuation and housing values.
- Mortgage delinquencies will rise but write-offs will remain low.

What's in a ratio?

We have been arguing for a long while that standard 'debt ratios' have been leaned on excessively in a macroeconomic context to draw inferences about the vulnerability of the household sector's balance sheet. At the *individual* household level, measures such as gearing, debt-servicing ratio, uncommitted monthly income are critical to thorough credit risk assessment. Within the suite of standard measures, some are more instructive than others. For example 'household debt to income' is interesting but only in so far as what it implies for debt-servicing through the interest rate cycle. "Debt to assets" is useful in 'full recourse' jurisdictions but less so in non-recourse situations. 'Loan-to-valuation' ratios are critical in the context of determining responsible limits on secured lending and 'debt-servicing' ratios represent the drag on income at any point in time from one's total loan exposure.

Figure 1: What's in a ratio?



Source: RBA, ABS, ANZ Economics & Markets Research

Most of these measures lose a considerable deal of significance when they are presented in *aggregate* form, but especially so if used in a 'credit quality' context or in the context of assessing the sustainability of a *nation's* household debt levels. The reasons are simple but worth stating: we have circa 8 million householders that operate in the economy as largely independent agents. The wealth, debt, income and expenditure of each household are 'fire-walled' legally. Risk is generally not socialised. No household's income will service another household's debt. Yet we present the debt ratios as though this can happen.

Household sector gearing has been on a rising trend since the early 1990s and has spiked since the global financial crisis, by and large as consequence of falling equity values. The aggregate debt-servicing ratio has tumbled to low levels, reflecting substantial falls in interest rates. The left panel in the chart above offers very little analytically. The right hand panel offers considerably more, even in an aggregate context, but only as an indicator of the leverage monetary policy is having over aggregate disposable incomes. It tells us very little about the absolute (c.f relative) vulnerability of the household sector balance sheet.

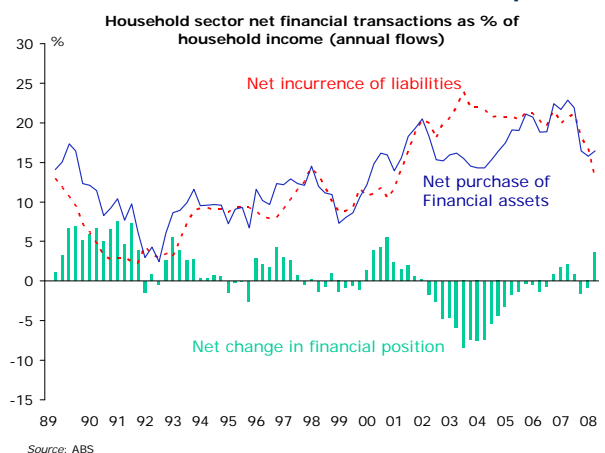
The significance of any aggregate 'gearing' or 'debt-service ratio' is therefore hidden in the anatomy of the measure. Decomposing Australia's household sector reveals that majority of households still have little or no debt¹. These households can ride through the interest rate cycle with virtual indifference. Analysing a narrower set of debt-holders alone (that is ignoring the income of households with *no* debt) moves us in the right direction, but we're still not close to achieving a meaningful measure as even within the 'householders with debt' sector, there is a full spectrum of individual gearing and debt-servicing levels – from households who are holding more than most lenders would now be prepared to lend, to those who could comfortably borrow multiples of their current debt levels with no debt-stress. We're back to the fire-wall issue again. Despite the attraction and widespread application of such measures in macro-risk analysis, their use as analytical tools in this context are, at best, limited.

Is the household sector deleveraging?

If we take a fairly narrow perspective, where deleveraging is simply *debt levels falling*, then the answer is 'no'. If deleveraging is measured by comparing movements in debt to movements in asset values (i.e. *change in the gearing ratio*), then the answer again is 'no'. If we take a broader perspective and represent deleveraging as an transactions-based *process* that works to improve the net financial position of the household sector, then the answer is 'yes'. This broader perspective encapsulates more than just debt movements. It looks at transactions on

both sides of household sector's balance sheet (ignoring valuation effects). Having answered 'yes' to this question however, does not necessarily imply that what we are seeing is anything new or representative of a shift in household behaviour. The chart below reveals we could have answered 'yes' to the same question about 60% of the time over the last 19 years. Most of these years coincided with the periods of solid rises in gearing levels: while some householders are borrowing to invest and/or consume, other households are investing in financial assets without borrowing. Overall, such investment decisions by individual households, when summed, worked to improve the net financial position of the sector. The same is happening now, although to date, the performance has not been extraordinary.

Household sector restores financial position



Taking a closer look

The improvement in the household sector's net financial position has accelerated in the past two quarters, coinciding with an improved saving performance. Having said that, the gross saving rate and the extent of financial position improvement as % of income is not unprecedented.

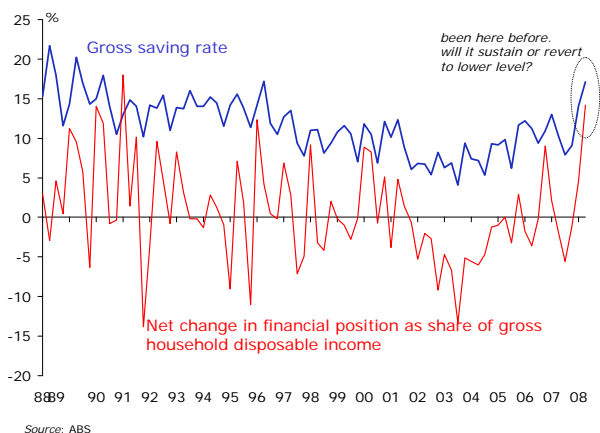
Many have interpreted this trend as evidence that the household sector is paying down debt to restore some sustainability to the household balance sheet. Whilst this may be happening at the micro level as it always does to varying degrees, it is not happening at the aggregate level.

Contrary to perceptions, the household sector continues to actively expand its balance sheet. While there has been a slowing in the rate of accumulation in both loans and financial assets during the financial crisis, flows are still strong, adding to balances on both the asset and liabilities side. Interestingly the chart above shows that, but for a very brief period between 2003 and 2005 when debt growth was out-pacing growth in investment in financial assets, the household sector in aggregate has been largely self-

¹ See "Who's Vulnerable in the Household Sector", Economics@ANZ, 2005; "Household Debt: Safe as Houses", Economics@ANZ, 2004.

funding on a net flows basis for the most of the past two decades².

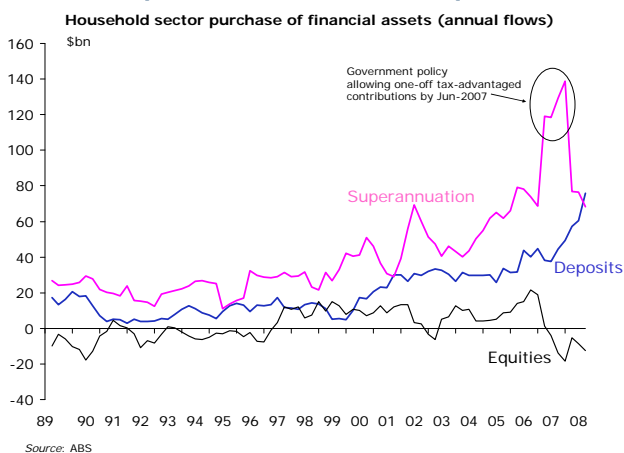
Extra saving is a big part of this



Where is the household sector investing?

Deposit flows have benefited considerably from a general flight to safety and more specifically from the government guarantee on bank deposits which most probably strengthened householder perceptions of relative safety. The 'biggest loser' since the crisis has been direct equities and unit trusts. Very substantial falls in unit values combined with little evidence of price discovery in these markets has deterred flows. A settling in credit markets and greater hope for economic recovery, however, should see net flows into equity markets improve over 2009/10. Re-capitalisation in the non-finance corporate sector via equity raisings should facilitate this process but will only come forth in any 'market moving' scale when growth prospects, confidence and the cost of capital improve significantly.

Deposits favoured over equities



Net flows into *superannuation* have remained healthy through the global financial crisis, remaining at levels reached prior to the tax-driven spike in 2007. While a

² Note: the conceptually identical measure of net lending to households shows a broadly similar pattern with the exception of the 1998 to 2001 period which also showed a moderate deterioration in net lending by households.

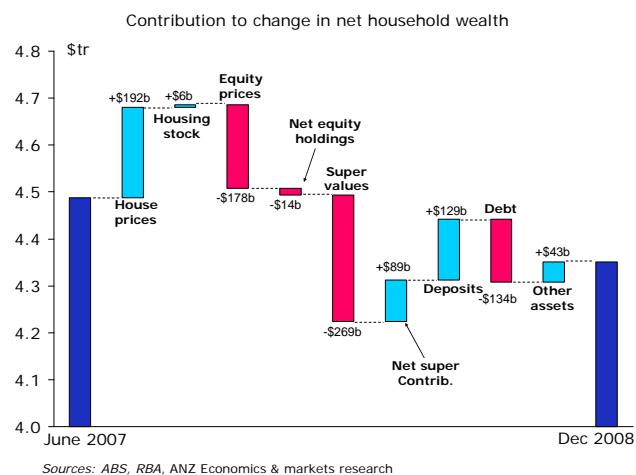
considerable share of total contributions is compulsory, the resilience in total flows may reflect some attempt to 'refill the coffers' following negative returns experienced by most super funds recently. Surprisingly, longer-term net flows into superannuation have consistently surpassed flows into other financial saving vehicles for the past two decades. Tax advantages, demographics and greater awareness of the need to self-provide have been powerful drivers towards this form of saving.

Introducing valuation impacts.....

Valuation effects have played havoc with the household sector balance sheet over the past 18 months. While considerable media emphasis is often placed on the 'drag' from big market movements, not enough emphasis is given to transactions-based developments impacting on net wealth.

The chart below decomposes the contributions to the change in the household sectors net wealth position between June 2007 (just before the onset of the global financial crisis) and December 2008. Net household wealth has fallen moderately from just under \$4.5 trillion to around \$4.35 trillion over this period. The direct and indirect fallout from equity price falls has detracted substantially from wealth (-\$450bn) as has continued debt accumulation (-\$130bn). Offsetting these wealth declines to a large extent have been the continued investment in deposits (+\$129bn), net contributions to superannuation (+\$89bn) and house values (+192bn)³.

Decomposing changes in household net wealth



What is driving slower household debt growth?

The threat of recession or joblessness may be prompting some householders at an individual level to reassess what is an optimal level of debt. Action depends in large part upon how immediate or real is the threat. That interest rates are presently at historically low levels will also be an influence on

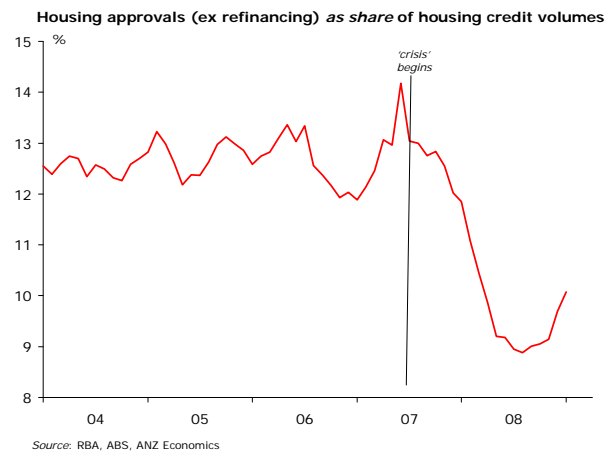
³ Median prices in December 2008 were still above June 2007 levels. In March 2009, gross dwelling wealth was still up \$150bn on June 2007 levels

desired levels of debt. More specifically, the holding cost of debt is as low as it has been for many decades with the incentive to reduce household debt falling sharply. These two high level drivers are counter-acting. The third influence is the flow of new finance. What plays out in a macroeconomic context is an empirical question.

...lower approvals- Yes

So far the evidence suggests household debt is behaving pretty much as expected given the state of the economy with most of the deceleration so far being explained by a substantial weakening in new finance approvals. Housing finance as a share of credit volumes has tumbled from around 13% in mid-2007 to under 9% a year later (see chart below). This has been inflicting a significant drag upon credit volumes over 2008/09. We do expect household finance approvals to pick up over 2009/10 with signs in some markets already emerging. This will minimise further deceleration in credit growth over this period.

Less debt coming in through the 'front door'



...margin calls – Yes

Notwithstanding the 'forced repair' of those holding margin lending accounts, for the vast bulk of debt holders, active debt reduction or run-off becomes a matter of choice that can be affected either through asset sales and/or new saving to net off obligations.

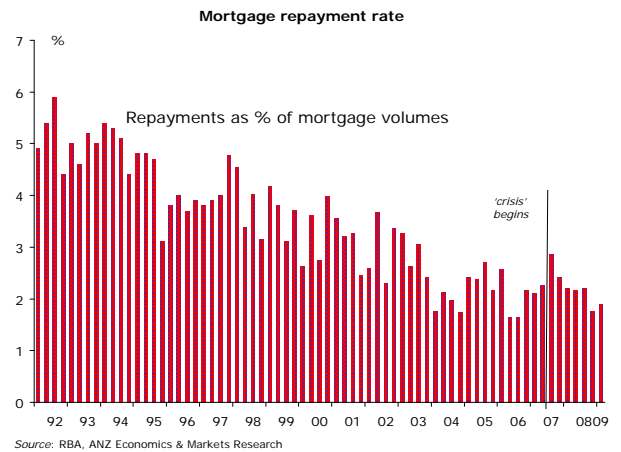
...higher mortgage repayments - No

In the housing market, credit is still expanding and the mortgage "repayment rate" has not stirred.

The repayment rate has been on a structural decline for most of the past decade, reflecting greater debt-acquisitiveness of the household sector, facilitated by the advent of home equity lines of credit, interest-only loans and redraw facilities and 'justified' by permanently lower interest rates. There does *not* appear to have been any noticeable shift in aggregate repayment behaviour since the financial crisis, although some flattening in the trend has been evident since 2004 (possibly reflecting a settling in the adjustment to lower structural interest rates and/or in customer penetration limits of the less 'principle-hungry' mortgage products. Whether the

household sector is undergoing a long-term behavioural or attitudinal shift that prompts a *structural* winding back of debt levels (over and above the pure cyclical impact described above), only time will tell. The financial crisis will have prompted some householders to adopt a debt reduction strategy, but this should be strongly counter-weighted (at some point in the near future) by the cyclical boost from historically low debt-holding costs and a lift in new finance demand.

No more going out the 'back door'



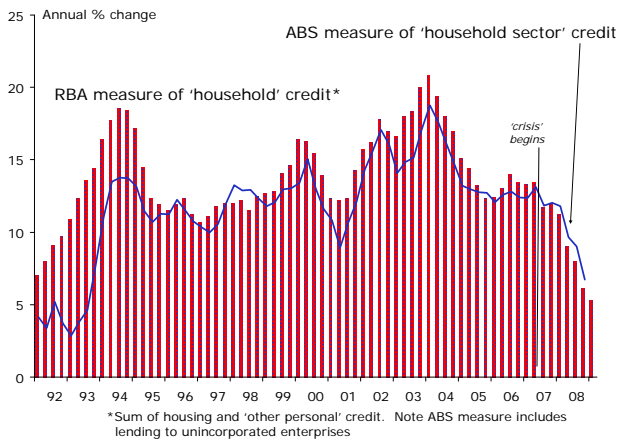
... financial asset liquidation - No

As shown in chart on the previous page ('Deposits favoured over equities'), *total* investment in financial assets has continued to expand despite slowing in recent quarters. Negative net new investment in equities reflects portfolio shifts to safety and to a lesser extent, forced repair on margin calls. Reticence to invest new money into equity markets remains strong, yet with values at significantly low levels (vis a vis year ago levels) and superannuation savings 'locked-in', there is limited incentive and choice respectively to utilise existing asset portfolios to reduce debt levels. Asset liquidation by those forced to repair individual balance sheets is unlikely to be of sufficient scale to 'move' aggregates.

Given debt stress in Australia's household sector has been relatively benign compared to many other countries and the servicing burden is easing significantly ahead of any substantial labour market deterioration, we are more likely to avoid the development of a lasting 'anti-debt' movement in this country.

Household credit slows

'Household' sector credit growth



Won't lower interest rates automatically reduce debt levels?

Significant falls in interest rates in the past six months to their lowest level in 4 decades offer households a direct mechanism for facilitating a debt reduction strategy. According to ABA data, approximately two-thirds of the mortgage book can be described as the traditional credit-foncier type, having, as a default, a fixed **total** repayment component (except when rates rise and the customer is not ahead of schedule). When rates are falling as is the case now, the 'principle' component plays the swing variable, constituting a rising share of total payments. This has the potential to weigh down credit growth compared to what would have been had interest rates not fallen.

We have estimated interest rate cuts so far since August 2008 and in prospect will have detracted \$21bn in the year to September 2009 and \$30bn in the year to September 2010 from housing credit volumes (compared to what would have been if interest rates had not moved). In isolation, this detracts about 2% from annual housing credit growth in 2009 and about 3% in 2010. The negative contribution to credit is purely cyclical. It is, however, not observable in aggregate repayment rate measures as it is ordinarily swamped by the demand effects of lower interest rates on *new* finance (cyclical) and also, through the 1990s, by the adjustment to lower structural interest rates (not cyclical).

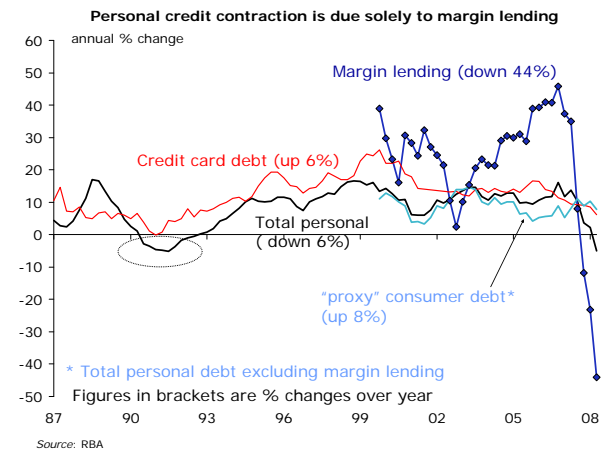
What about trends in non-housing personal?

Margin lending volumes have dropped 44% over the year to December. Credit card volumes on the other hand are still up 5.0% over the year February 2009 and our proxy for "consumer debt" is up by 8% over the same period. The deceleration in personal lending volumes growth, as is the case in the housing market, also reflects sharp falls in personal finance approvals. Since the global financial crisis, margin calls have been a significant drag on volumes. **Further, the shorter average duration of most parts of the non-housing personal loan book implies an**

inherently more rapid run off of volumes (compared to the housing book) if not countered by new demand for finance.

An apparent bottoming in personal finance approvals and stabilisation in equity markets should see some positive reads on lending volumes in the next few quarters. A subdued retail environment however, suggests recovery will remain soft.

Personal debt contraction so far not consumer-driven



The downside risks...

There are downside risks to credit growth. On the *demand* side, sharper than expected downturn in the economy is likely to delay the front-end support to credit growth, by keeping demand for *new* finance at low levels. While grant-assisted first-home buyer finance is growing rapidly, there are only tentative signs of a bottoming in broader measures of household finance. The phase out of first-home buyer boost by year's end and labour market weakness over 2009/10 suggest there are already notable headwinds presenting against the very substantial monetary and fiscal stimulus which should be starting to bolster finance demand. While we believe such stimulus will win out at the end of the day, recovery in lending could be delayed should the global environment falter once again.

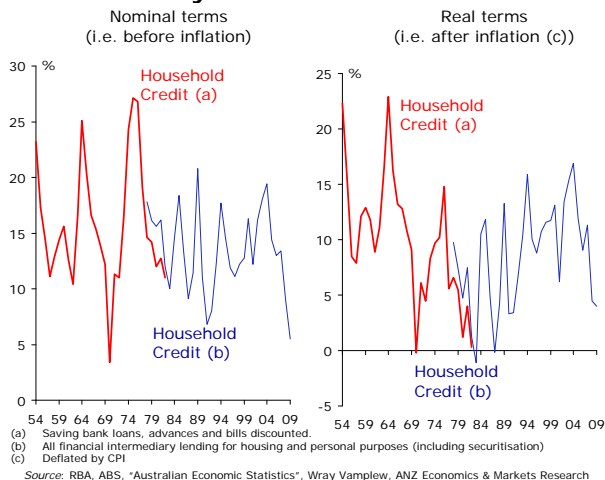
The *supply* side also presents a risk to credit growth once demand picks up⁴. With little liquidity in securitisation markets, the task of expanding credit relies increasingly upon the intermediary sector. If capital and funding constraints linger or intensify for this sector for an extended period, credit rationing, the imposition of quantitative lending caps or tightening eligibility criteria by some lenders may begin imposing a constraint on lending growth.

The emergence of a deeper than forecast economic downturn and/or a further tightening in the supply of credit therefore does threaten to take household credit growth into uncharted territory. While we are

⁴ Note. The demand and supply risks are complementary, not additive i.e. if demand does not recover; the supply side constraint is less relevant.

approaching growth recorded in the 1969 credit 'crunch' in nominal terms, we are still a way off from historic lows in *real* terms.

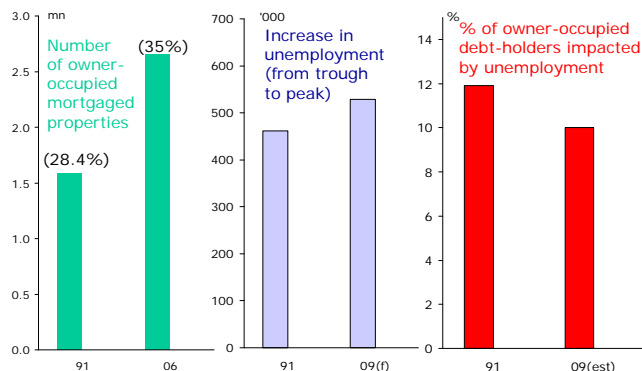
Still a way off from 1969 credit 'crunch'



The combined influences suggest delinquencies on home lending will rise over 2009/10 but write-offs should remain low.

Direct incidence of joblessness on debt-holders

Direct impact of job loss on system owner-occupied mortgage customers



Delinquencies to rise

The economic slowdown introduces us to the next phase of the credit quality cycle. As unemployment levels rise and incomes growth becomes more subdued, lender losses will also rise. Importantly, default rates are more heavily influenced by shocks to the 'income' account (e.g. joblessness) than the condition of the balance sheet, average debt or gearing levels. Whilst data is scant, it is generally recognised the household sector balance sheet came through the previous recession with considerably less adjustment than the corporate sector. This is reflected in the composition of bank write-offs and the continuation in solid housing credit growth over that time.

With the unemployment level expected to rise by over 500,000 (trough to peak), the percentage of debt-holders hit by joblessness will also rise. Top-down analysis reveals despite more joblessness in absolute levels compared to the last recession, the impact as a share of owner-occupied mortgage customers will be slightly smaller (see chart below). The small net fall in the percentage of customers directly impacted by unemployment masks two offsetting influences: a greater percentage of "working householders with debt" and a smaller expected increase in the unemployment rate compared to the early 1990s recession.

Loss-given-default is very much affected by gearing levels and associated loan-to-valuation ratios. Here, the outlook for house prices holds the key. We believe house prices will be well supported over the cycle, protecting security coverage, despite strong downside pressure from labour market weakness. In any case, any write-offs to the housing book are unlikely to move credit aggregates sufficiently. These are microeconomic events, albeit very important for lenders.



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