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HOUSEHOLD SECTOR FINANCIAL VULNERABILITY

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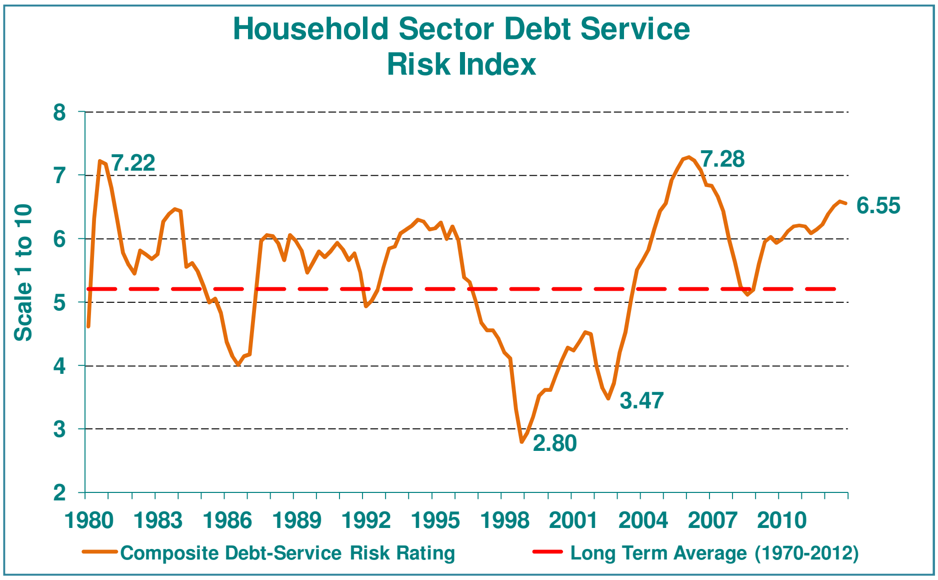
Household debt service risk turns for the better late in 2012, but remains high.

OUR HOUSEHOLD SECTOR DEBT-SERVICE RISK INDEX DECLINED SLIGHTLY IN THE 4TH QUARTER OF 2012

According to our FNB 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 declined (improved) slightly in the 4th quarter of 2012. From a 3rd quarter 2012 index level of 6.59 (on a scale of 1 to 10), the 4th quarter saw a slight decline to 6.55. This comes after a rising trend spanning 5 consecutive quarters prior to the 4th quarter.

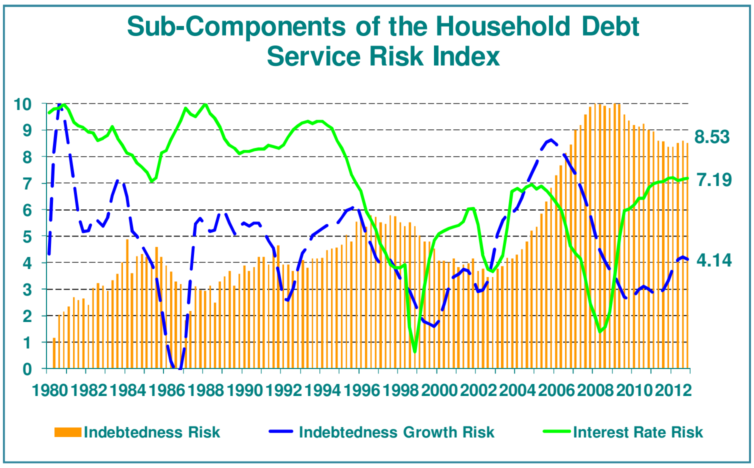
However, it must be said that the level of the Household Sector Debt-Service Risk Index remains high, well-above the long term (33 year) average level of 5.2, and at current high levels it would be preferable to be seeing further declines in the coming quarters.



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

THE HIGH LEVEL OF HOSUEHOLD INDEBTEDNBESS STILL KEEPS THE OVERALL RISK RATING HIGH, BUT ITS 4TH QUARTER DECLINE CAUSED THE SLIGHT IMPROVEMENT (DECLINE)



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 mild increase in the debt-to-disposable income ratio earlier in 2012, the 4th quarter saw the ratio recede mildly once more on the back of a rise in quarter-on-quarter household disposable income growth in that quarter, driven by some economic growth revival late in the year.

However, at 75.8%, the Debt-to-Disposable Income Ratio remains extremely high by SA's historic standards, and still of concern is that in 2012 the figures have shown renewed "resistance" to decline, and I believe that further decline is crucial prior to the next interest rate hiking cycle..

Therefore, in 2012 we started to see the "Indebtedness Growth Risk Index" make an increasing contribution to the overall Debt-Service Risk Index. However, this sub-index has turned down in the 4th quarter of 2012, and remains relatively low at 4.14, indicating no strong direction in indebtedness growth.

The third component is the Interest Rate Risk Index, which was at a relatively high level of 7.19 as at the 4th quarter of 2012 and up slightly from the previous quarter. The reason for its negative contribution to the overall Risk Index in the 4th quarter was a further decline in average prime rate in the 4th quarter, after a further interest rate cut in the 3rd quarter of 2012, lowering prime rate still nearer to the long term average inflation rate.

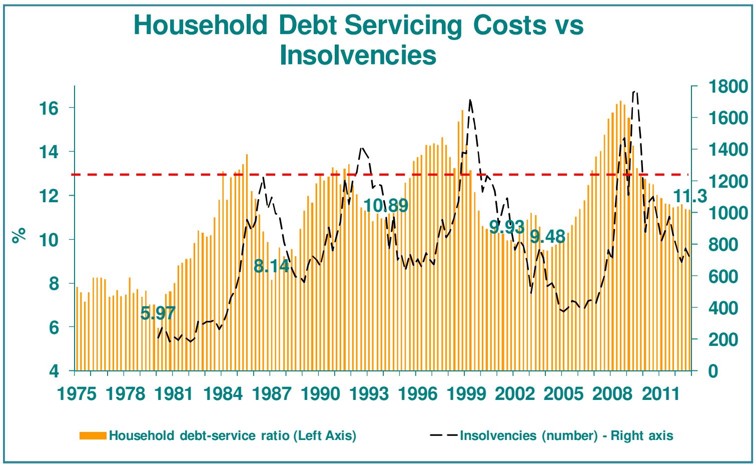
This sub-index's contribution to the overall Debt-Service Risk Index is high, due to the sharp decline in interest rates since 2008, from 15.5% prime at mid-2008 to the current 8.5%. In recent years, interest rates have moved to abnormally low levels by SA's historic standards, given that "structural 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.

ALTHOUGH THE 4TH QUARTER DECLINE IS WELCOME, OUR SIMPLE MEASURE OF DEBT-SERVICE RISK REMAINS CONCERNINGLY HIGH, AND REQUIRES SIGNIFICANT FURTHER REDUCTION FOR COMFORT

Despite a slight decline in the Debt Service Risk Index in the final quarter of 2012, its levels remain high by historic standards. The household sector's financial situation is still 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.

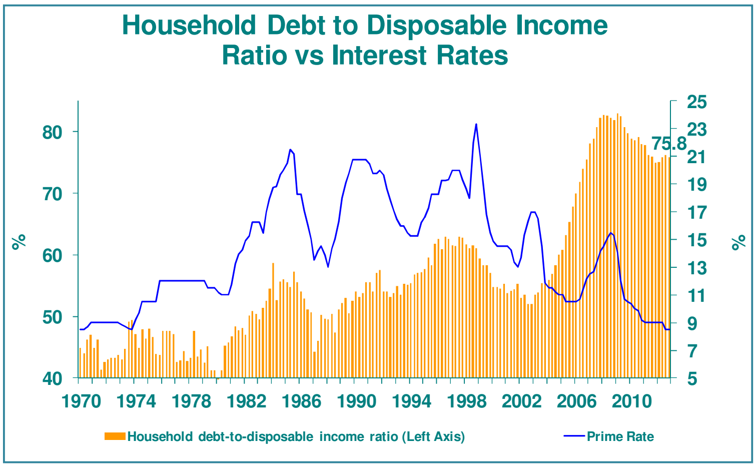
This may seem a strange statement to make, as payment performance on debt by the household sector has improved significantly in recent years, and this is seen in publicly available numbers such as insolvencies, which have fallen dramatically.

However, for this improved credit performance, the household sector has been relying heavily on the Reserve Bank (SARB) to maintain interest 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 2012 4th quarter's 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 2012 as a result.*

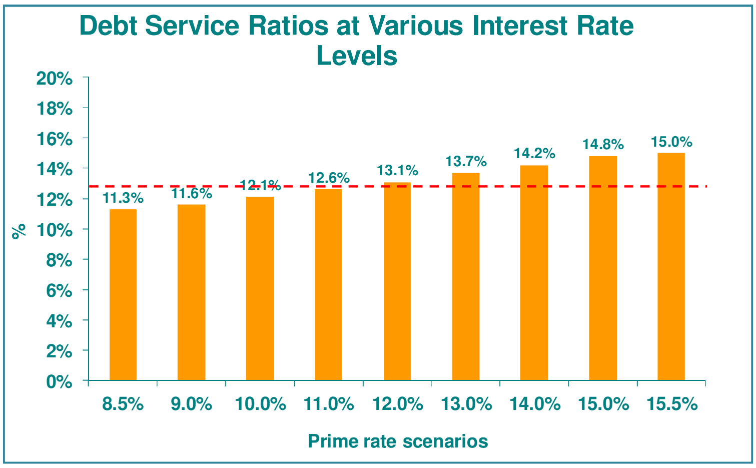
The "low risk" way of reducing the debt-service ratio, and thus the more desirable way, would be through lowering the debt-to-disposable income ratio of the household sector. The 4th quarter decline in the debt-to-disposable income ratio, from 76.2% to 75.8% is thus a welcome change in direction.



However, crucial to further decline will be for household credit growth, which recorded 10.2% year-on-year in the 4th quarter of 2012 (up from a previous quarter's 9.44%), not to accelerate too much further, because it is doubtful whether our currently mediocre economy can keep disposable income growth growing faster than household credit at such a growth rate (a requirement for a decline in the debt-to-disposable income ratio).

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 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"?

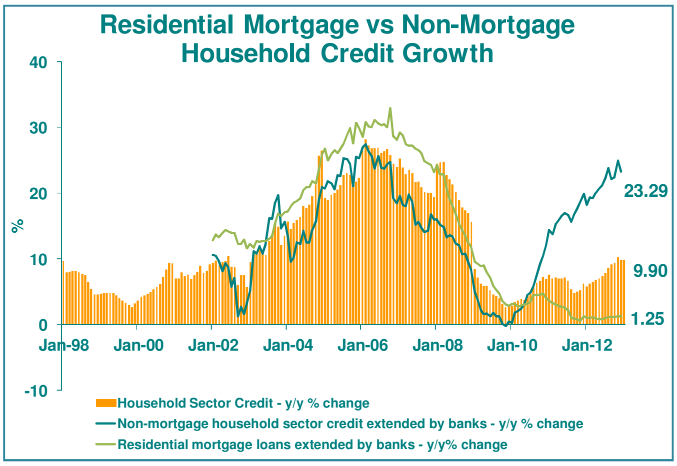


The accompanying graph shows the debt-service ratio at the current debt-to-disposable income ratio, for different hypothetical interest rate scenarios. According to these, a prime rate of 12% would cause the household debt-service ratio to go beyond the 13% "threshold" at a 4th quarter household debt-to-disposable income ratio of 75.8%.

That means that the household sector probably still only has room for what would be a mild interest rate hiking cycle 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 some quarters of it being more mild than normal****.*

IN CONCLUSION – FURTHER DECLINE IN THE DEBT-TO-DISPOSABLE INCOME RATIO IS NEEDED, BUT HOUSEHOLD CREDIT GROWTH MAY NEED TO SLOW SOMEWHAT TO GUARANTEE THAT.

In the 4^TH quarter of 2012, our Household Sector Debt-Service Risk Index declined mildly after 5 preceding quarters of increase. This is a welcome move in the Index, but it is important to stress that it 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, nominal household disposable income growth had been showing year-on-year growth rates between 9% and 10%, and given our modest expectations for economic growth in 2013, it is not expected to be much different this year.

Therefore, monthly household credit growth of 9.9% year-on-year as at January 2013 appears unlikely to be meaningfully below household disposable income growth, and this would mean that a declining trend in the debt-to-disposable income ratio for households in the near term is not guaranteed.

The question is whether a slower household sector credit growth rate can be "engineered" without hiking interest rates. Non-mortgage household credit growth still remains very strong at 23.3% in December, 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.

However, late in 2012, we saw increasing concern being expressed by the Minister of Finance as well as the Credit Regulator, around strong growth in unsecured credit. A few months' worth of data will be required to see whether these "verbal interventions" towards lenders will begin to have the desired impact in terms of slowing certain lending components' growth rates down. Such a potential impact could be just "what the doctor ordered" in terms of being able to get to a lower level of household indebtedness, and therefore debt-service risk, prior to the next interest rate hiking cycle.