

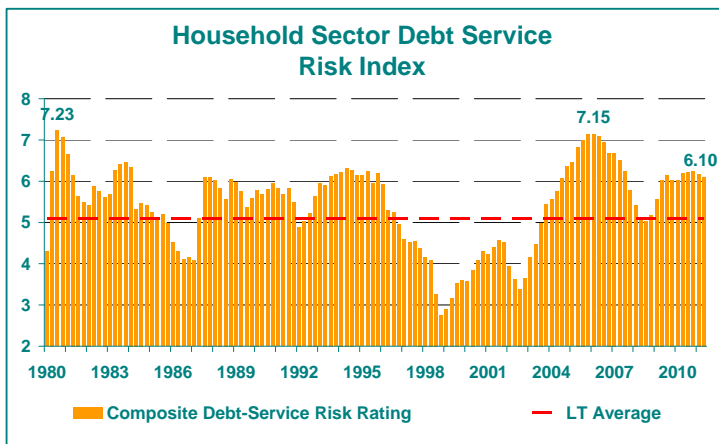
HOUSEHOLD, CONSUMER AND RETAIL- “HOUSEHOLD SECTOR DEBT-SERVICE RISK”

Further mild improvement in households’ “breathing space” as indebtedness declines further in the 2nd quarter

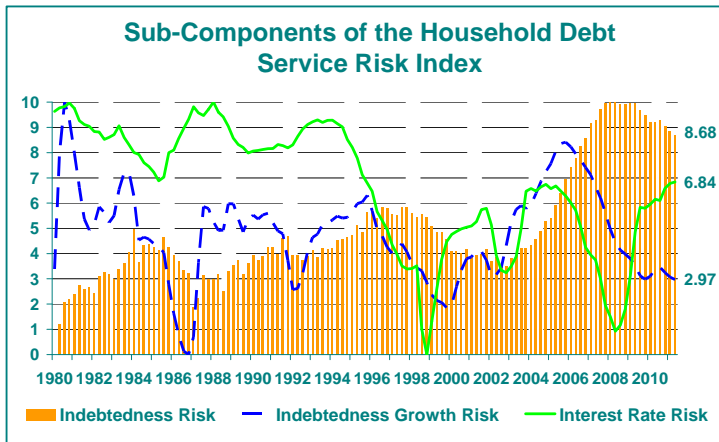
13 September 2011

HOUSEHOLD DEBT-SERVICE RISK DECLINES MILDLY FURTHER IN THE 2ND QUARTER

Our FNB Household Sector Debt-Service Risk Index declined for the 2nd successive quarter during the 2nd quarter of 2011, due to further downward progress in the household sector’s debt-to-disposable income ratio. This decline implies a decline in the household sector’s vulnerability to any unwanted events such as interest rate hiking of economic growth slowdown, which may impair its ability to service its debt at some future stage.



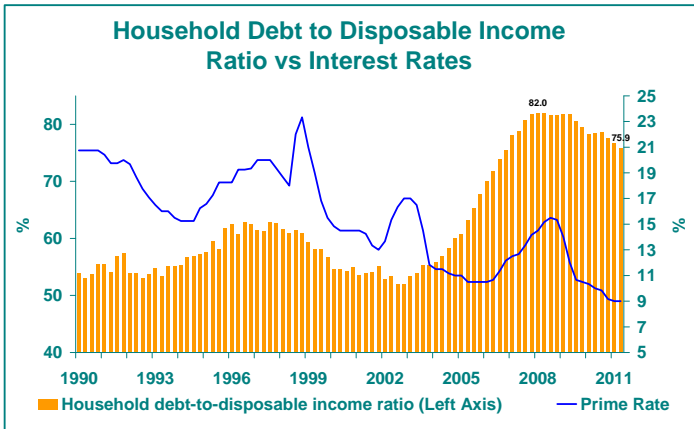
The index takes into account the level of household indebtedness, as expressed by the household debt-to-disposable income ratio, the direction in which this ratio is moving (currently downward), and the level of interest rates (prime rate) relative to long term consumer price inflation (5-year average inflation). The lower the debt-to-disposable income ratio goes, the lower the risk, and downward momentum in the debt ratio thus also exerts downward pressure on the overall Debt-Service Risk Index. On the other hand, the lower interest rates get relative to long term average inflation, the higher the risk for the household sector becomes, because this implies a diminishing probability of further interest rate cuts and an increasing probability that future interest rate moves could be up.



Therefore, a slight rise in the 5-year average inflation rate in the 2nd quarter, brought about by a recent rise in consumer price inflation, exerted slight upward pressure on the overall index. However, against this, a further decline in the household sector debt-to-disposable income ratio, from the previous quarter’s 76.8%, to 75.9% in the 2nd quarter, offset increased interest rate risk and caused the Household Sector Debt-Service Risk Index to decline further from 6.18 to 6.10 in the 2nd quarter.

This level of debt-service risk, however, remains high by historic standards, with the long term average since 1970 being 5.1. Further significant reduction in the debt-to-disposable income ratio would thus appear essential. The lowest level of 2.74 was achieved in the final quarter of 1998, and it was this low level that preceded the start of one of the country’s great consumer and home buying booms.

EXAMINING THE HOUSEHOLD INDEBTEDNESS TREND – FURTHER POSITIVE PROGRESS MADE IN REDUCING THE DEBT-TO-DISPOSABLE INCOME RATIO

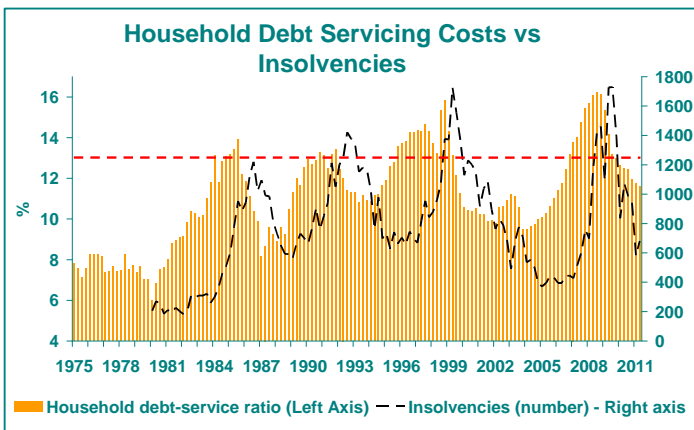


The September SARB Quarterly Bulletin brought about further positive news with regard to the improving household sector indebtedness situation. In the 2nd quarter of 2011, the declining trend in the household sector debt-to-disposable income ratio continued, with the ratio declining from 76.8% in the previous quarter to 75.9%.

This declining trend started back in 2008, where the ratio hit an all time peak at 82% in the 1st quarter of that year. The decline in the ratio has been brought about by slow single-digit growth in the value of household sector credit in recent years, enabling nominal disposable income growth to outgrow the pace of credit growth.

The pace of decline has been slow going, however, as disposable income growth since the recession in 2008 has also remained slow compared to the pre-recession boom years. Nevertheless, the 2nd quarter did show some further rise in year-on-year disposable income growth from 8.9% in the 1st quarter to 9.9%. This, along with a slowing household credit growth from 6.8% in the 1st quarter to 6.4% in the 2nd quarter, resulted in further reduction in the debt-to-disposable income ratio.

Reducing the debt-to-disposable income ratio further looks set to continue to be challenging, because the renewed economic slowdown of late looks set to see slowing disposable income growth in coming quarters. However, we believe that the downward trend will continue at a gradual pace due to simultaneous slowing in household credit growth, reaching a level below 70% during 2013.

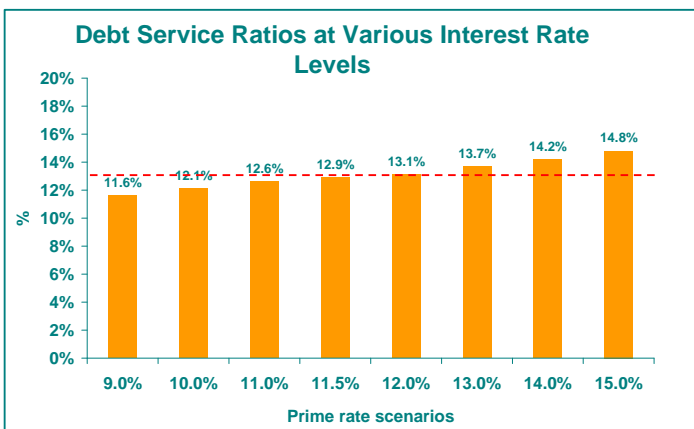


A lower debt-to-disposable income ratio, accompanied by no movement in interest rates, implies a further mild reduction in the debt-service ratio, i.e. the cost of servicing the household sector debt burden (interest+capital) expressed as a percentage of disposable income.

The debt-service ratio declined to 11.6% in the 2nd quarter, slightly down from 11.7% in the previous quarter. This ratio correlates well to household sector-related bad debt trends, as one can see in the trend in the number of insolvencies recorded.

The debt-service ratio is now well down from the 16.2% peak reached in the 2nd quarter of 2008, and

a resultant sharp decline in insolvencies is evident. However, important to bear in mind is that much of this reduction has been achieved through a huge reduction in interest rates to the lowest levels in a few decades, and less so by reduction in indebtedness. As interest rates always go up at some point, it is important that indebtedness be sufficiently low so as to provide some scope to absorb any future increase in the debt-service ratio as a result of such future interest rate hikes.



What magnitude of interest rate hiking do we believe that the household sector can absorb? The answer is subjective, based on one's view of what is a manageable peak level in the debt-service ratio. Our subjective "acceptable peak" is 13%. Above this, it would appear that the level of bad debt becomes "painful" for both the financial sector as well as the household sector. The ratio breached the 13% level

in 1996–99 and again in 2006–9, and both periods could be regarded as periods of severe financial pressure for the household sector.

At the 2nd quarter debt-to-disposable income ratio level of 75.9%, an 11.5% prime rate peak would keep the household sector below the 13% level. That implies that a maximum interest rate rise of 2.5 percentage points is manageable for the household sector at the current debt-to-disposable income ratio level. Given the magnitude of previous interest rate hiking cycles, which are more in the region of 4–5 percentage points, 2.5 percentage points leeway is still perhaps on the risky side.

So what level of debt-to-disposable income ratio would be acceptable as to give the household sector sufficient breathing space? Once again the answer is subjective, but a 67% debt-to-disposable income ratio would allow the debt-service ratio to peak at 13% with a prime rate reaching 15%.

We would thus suggest that a debt-to-disposable income ratio at least below 70% would be appropriate for South Africa, given that our economy can have wild swings in inflation, meaning that interest rates well-into double-digits are never out of the question. At present, slowing household sector credit growth is encouraging, and we anticipate a debt-to-disposable income ratio below 70% to be reached during 2013.

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