TREASURY MINISTERIAL BRIEF

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Treasurer

TREASURER INFORMATION NOTE: HOUSEHOLD DEBT

Timing: For information

Key points

- Although Australian household debt has risen in recent years, low interest rates, growing asset holdings, and debt concentration amongst high income households provide some comfort to policy makers that the majority of households can meet their obligations.
- But there are risks. While Australia's household debt currently appears manageable, there is a concern that high household debt will compound the adjustment to any downturn.
  - For example, a large increase in unemployment could quickly see an increase in loan defaults, which leads banks to slow the flow of credit to the economy. The situation would likely be compounded by weaker consumption as other households make efforts to repair their balance sheets.
  - Moreover, given residential mortgages comprise around 80 per cent of Australian household debt and around 60 per cent of bank assets, falling house prices increase this vulnerability as they erode borrower equity and potentially expose financial institutions to losses in instances of default.
- Increased bank capital since the financial crisis has improved the resilience of the financial system. In addition, and notwithstanding the range of issues that have been raised about banks' lending standards by the Royal Commission, at a high level it appears that prudential policies, such as minimum serviceability buffers introduced in late 2014, have been restricting lending to marginal borrowers. While these policies present some risks in transition, it should also increase the resilience of bank balance sheets and the financial system in the long run.
- The bottom line is that households will likely continue to service debt unless unemployment prevents them from doing so. As such, low unemployment and a growing economy are important for the sustainability of household debt.

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ADDITIONAL INFORMATION

Thinking about whole of economy debt

- Economists commonly think about an economy as having four main sectors – the household sector; the business sector; the government sector; and an external sector (i.e. 'the rest of the world'). A fifth sector, the financial sector, is often considered separately as an intermediary that transfers financial capital from those groups with savings to those that would like to borrow, either to finance consumption or investment.
  - This intermediation role might suggest financial sector debt being a passive feature of an economy, but this is seldom the case. The impact of financial conditions on intermediaries' liabilities is very important for their ability to support economic activity.
- Within Australia, it is the household sector that typically has savings, and the government and business sectors that are in need of them. That is, the household sector is typically the creditor sector, while the business sector and the government sector are debtors.
  - While individual households may be net debtors (i.e. they owe more than they own), the household sector as a whole is a net creditor (i.e. they own more than they owe), with the total assets of the household sector a multiple of their debts.
- In Australia, the financing needs of the business and government sectors have historically exceeded the level of household savings. The additional demand for finance has been met by the rest of the world, leaving Australia with net foreign debt of around 56 per cent of GDP.

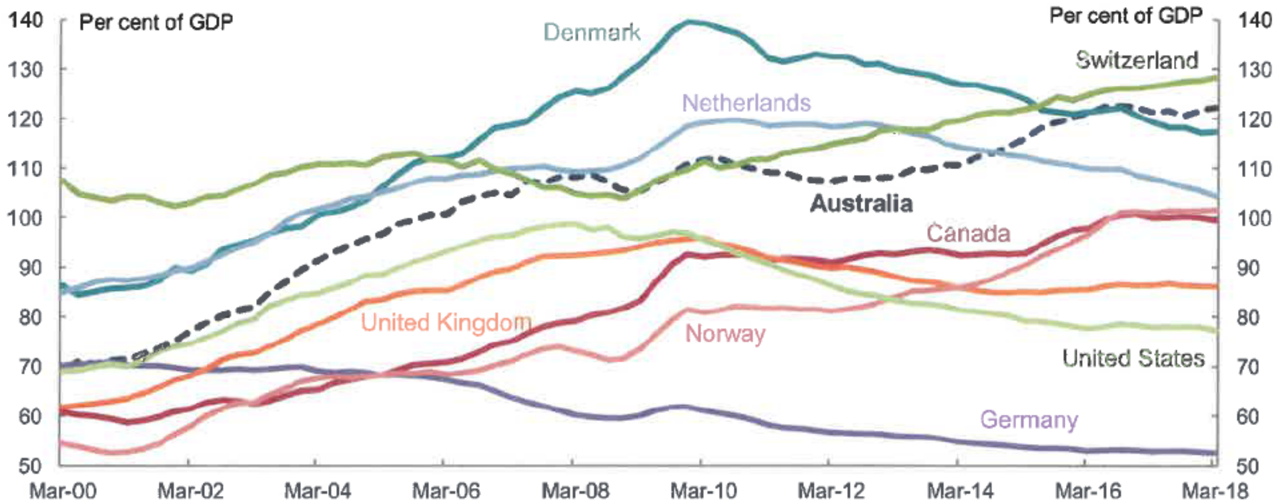
Household sector debt

- Notwithstanding the net asset position of the household sector, Australian households hold a relatively high level of debt by international standards.
  - According to the OECD, as a proportion of *net disposable income*[1], Australian households are the fifth most indebted in the OECD – behind only Denmark, the Netherlands, Norway and Switzerland.
  - According to data from the Bank for International Settlements, as a *proportion* of GDP, Australian households are the second most indebted among a group of 43 advanced and large emerging market economies, behind only Switzerland (Chart 1).
- Australian household debt is greater than government (both State and Commonwealth) and private non-financial business debt combined, and has risen to 122 per cent of nominal GDP from 108 per cent of nominal GDP a decade ago (Chart 2). Over the same period the household debt-to-disposable income ratio has increased from 163 per cent to 191 per cent.
- Mortgages increasingly dominate Australian household debt, currently accounting for around 79 per cent of outstanding household debt. Owner-occupier mortgages account for 53 per cent of household debt, while investor mortgages account for 26 per cent. Other debt categories include personal loans, credit card debt, and HECS debt.

[1] The difference between the household debt-to-income ratio and the household debt-to-disposable income ratio is that disposable income is measured after income tax, the Medicare levy and the Medicare levy surcharge are deducted.

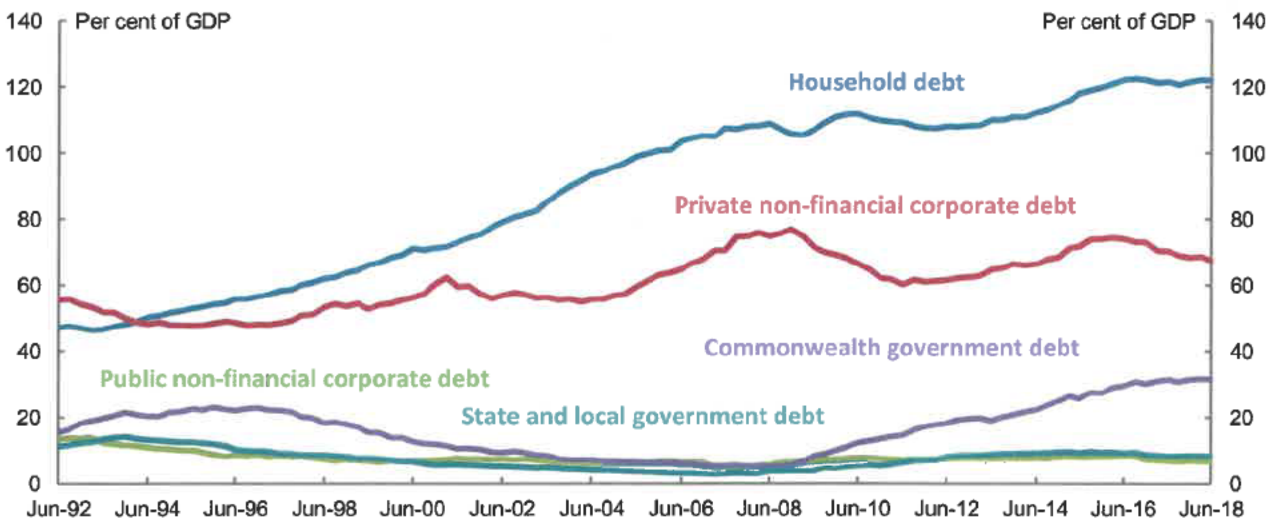
- Household debt has increased over the last five years alongside low and stable mortgage interest rates, and relatively rapid population growth underpinning strong demand in the housing market. This may cease as the housing market reaches the end of the current cycle and activity slows.

Chart 1: Household debt-to-GDP of selected countries



Source: Bank for International Settlements

Chart 2: Australian debt by sector



Source: ABS 5232.0; ABS 5206.0; Treasury calculations

- Aside from cyclical drivers increasing household debt in recent years, there are structural reasons that Australian household debt is high by international standards. These include:
  - The fact that house prices are high in Australia relative to income compared with other countries and our household debt largely funds residential real estate ownership;
  - The Australian economy has experienced relatively consistent economic growth since the early 1990s recession, with relatively less income volatility supporting borrowing; and

- Australian households own more of the rental housing stock (and its associated debt) than is the case in other countries.

  : Were debt associated with the rental housing stock to instead rest on corporate balances sheets, as it does in many other countries, reported household debt would be lower. But domestic households would likely be significant owners of those corporations. As such, households would still have a significant exposure to changes in the value of the rental housing stock, though admittedly limited liability would lessen the extent of household losses in instances of corporate insolvency.

- International institutions like the IMF have previously warned that Australia's level of household debt is above 'sustainable' levels, but defining sustainability is difficult.

Thinking about debt sustainability

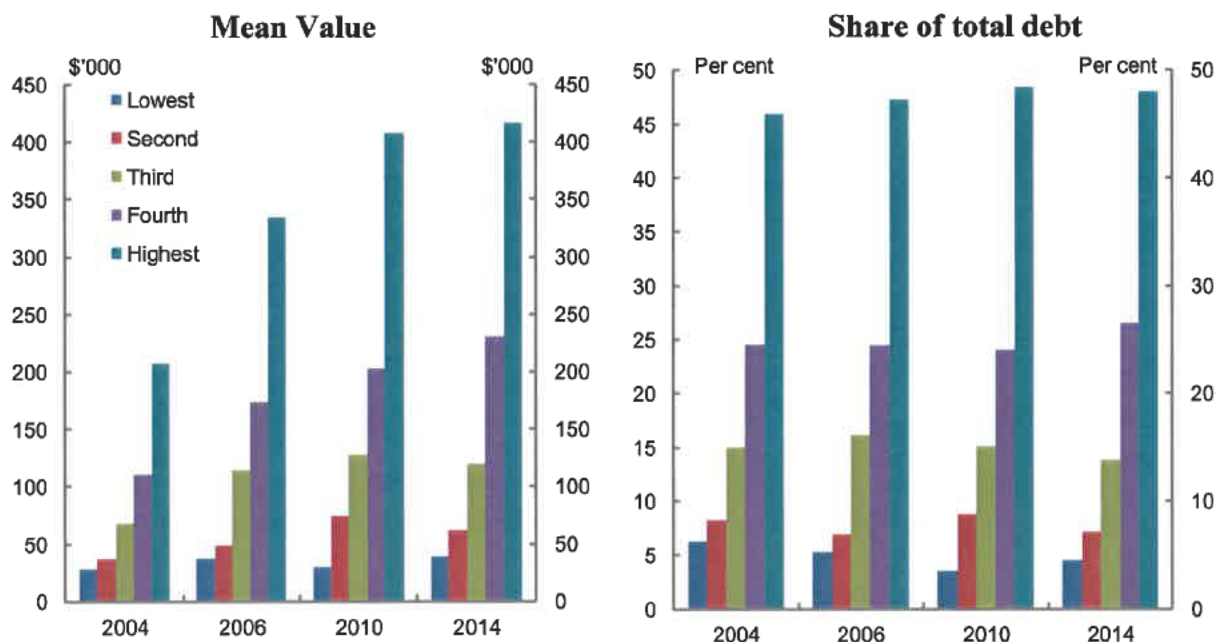
- It can be misleading to think about household debt in aggregate, gross terms, in which it is commonly reported – statements that household debt is now around $2.2 trillion or is over 122 per cent of nominal GDP say nothing about whether these obligations can be met.

- Gross debt to GDP is useful for making comparisons across countries and over time, but to fully assess risks it's better to consider more refined measures that account for the distribution of debt across households, offsetting asset positions and the burden of servicing debt.

Who holds the debt

- Australian household debt is not distributed equally across income groups, with the distribution of debt skewed towards high income households. According to data from the Melbourne Institute's Household, Income and Labour Dynamics in Australia (HILDA) survey, households in the top two income quintiles hold around 68 per cent of Australian household debt (Chart 3).

Chart 3: Distribution of household debt by income quintile



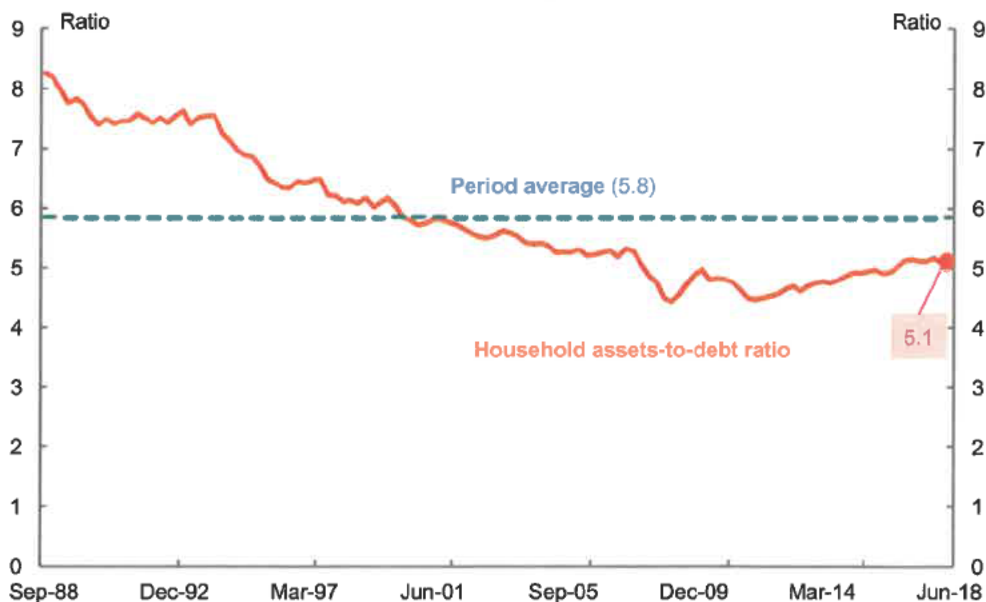
Source: RBA.

- Higher income households are more likely to comprise high skill workers that are less vulnerable to unemployment, which could enhance debt sustainability.
  - Moreover, high income households have the highest mortgage offset balances, allowing ongoing debt servicing to be maintained for a period in circumstances of unemployment.
  - However, the distribution of household debt is not without its challenges. While absolute debt levels may be skewed towards the highest income quintiles, households in the lowest income quintile still face elevated debt-to-income ratios.

Asset values

- The value of assets that sit as collateral against debt and the liquidity of those assets are both factors that need to be taken into consideration when drawing conclusions about the sustainability of household debt.
- While the level of household debt in Australia is substantial, the asset holdings of Australian households are even more so. In fact, the assets-to-debt ratio of Australian households is currently around five – that is, the aggregate asset holdings of the household sector are around five times greater than the debts of the household sector (Chart 4).

Chart 4: Household assets-to-debt



Source: RBA

- The assets-to-debt ratio was significantly higher in previous decades, but this needs to be considered in light of the effects of financial deregulation since the early 1980s. Financial deregulation removed constraints on the quantity (and in many cases the price) of credit the financial system could provide to the economy. By removing constraints on the quantity of credit, households and businesses that had previously been denied credit were increasingly able to access it and those that already had access were able to do so more intensively.
- Financial deregulation was a significant structural change, but its impact on the economy has taken several decades to feed through because many members of the community have significant interactions with the financial system only infrequently, such as when they choose to buy a house.

- Financial deregulation is unlikely to continue to extend the perimeter of the financial system much farther into the economy. But strictly speaking, it is impossible to know exactly when these changes will be fully reflected in the choices of households and businesses for a particular level of credit relative to their incomes, their assets and the interest rates they expect to face over the life of their loans.

- The household assets-to-debt ratio reached its lowest point at around four and a half times debt during the financial crisis in the March quarter of 2009, but has mostly increased since that time, reflecting both increases in asset prices and also saving by the household sector.

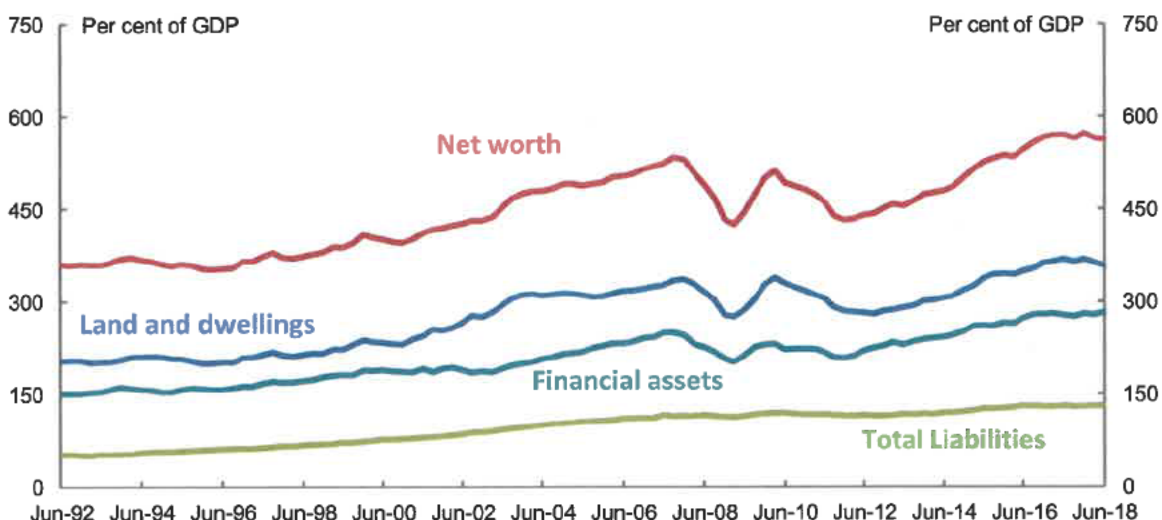
- The net worth of the household sector has risen by around 80 per cent (around 40 per cent of nominal GDP) over the past decade, led by increases in housing and land values as well as superannuation holdings, though both are somewhat less liquid assets (Chart 5).

  – Although house prices have fallen in Sydney and Melbourne over the last year, in aggregate they remain significantly higher than at the start of the current housing cycle in 2012. But given the concentration of household debt in mortgages, a significant decline in house prices would clearly have implications for the strength of household balance sheets and these risks should not be ignored.

    : Where around two-thirds of housing investors are negatively geared, these investments are implicitly predicated on expectations of capital gain in the future. Should these expectations be reconsidered in light of the recent declines in house prices or increased difficulty in rolling over financing, such as under the interest-only mortgages preferred by housing investors, investor sales may put additional downward pressure on prices.

    : Falling house prices may lead to an increase in non-performing loans, notwithstanding that they currently comprise only 0.8 per cent of housing loans. In a rising price environment, a borrower who experiences a change in their employment or financial circumstances that threatens their ability to service their loan will typically be able to sell the property and walk away with positive equity. This may not be the case should price declines erode borrower equity.

Chart 5: Household Sector Balance Sheet



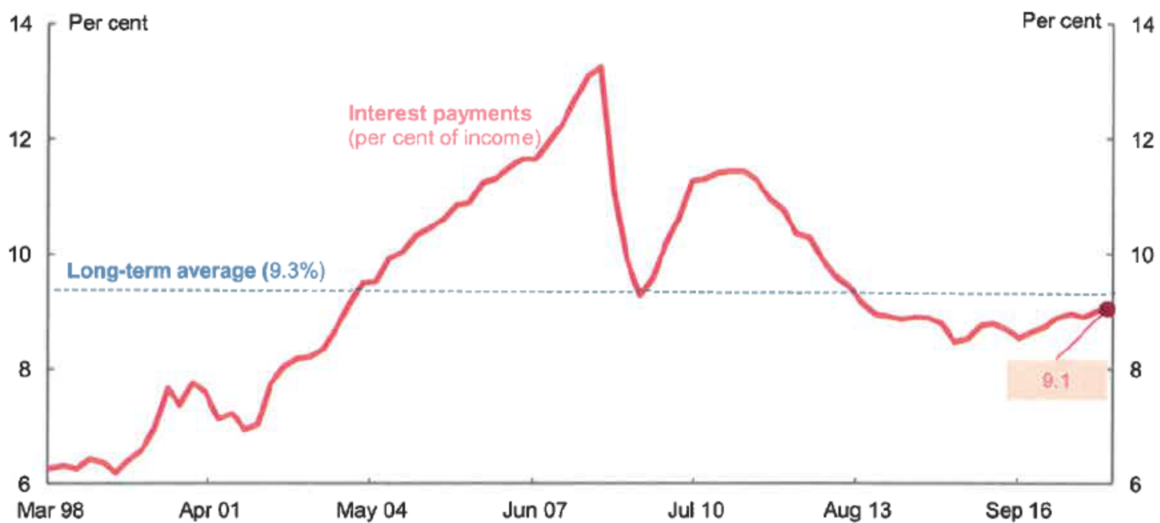
Source: ABS 5232.0

- However, as noted below, so long as households can service their mortgages, they are likely to continue to do so irrespective of the level of house prices, given the full recourse nature of borrowing in Australia. As such, low unemployment and a growing economy are important for the sustainability of mortgage debt.

Servicing costs

- In recent years, interest rates have fallen faster than debt has increased. As a result, the proportion of household income going to servicing debt has fallen from 11 to 9 per cent over the past decade to be around its long term average (Chart 6).

Chart 6: Interest payments as a percentage of income



Source: RBA

- Falling interest rates have allowed households to get ahead of their scheduled mortgage payments. Excess payments in offset accounts and available under redraw facilities are equivalent to around two and half years of mortgage payments at current interest rates.
- While there will always be risks that increases to interest rates will challenge household debt servicing ability in the future, the Reserve Bank has acknowledged that high levels of household debt are an important consideration for current and future monetary policy settings.
- Although in aggregate the amount of household income going to servicing debt is around its long-term average, the experience for particular households and particular regions may differ. Disaggregated data on the extent of mortgage stress can only be obtained from sources that provide information on the distribution of incomes and housing costs, such as the Census or Survey of Income and Housing, and these are prepared only every few years and at a lag.
  - According to Census data, mortgage stress amongst mortgage payers peaked in 2011 and had declined somewhat by 2016 but it remained higher than in earlier decades. This measure of mortgage stress applies the standard definition whereby a household is considered to be in mortgage stress when more than 30 per cent of their total household income is spent on mortgage repayments.
  - More high frequency sources, such as the national accounts cannot be used to assess the extent of mortgage stress. Nonetheless, the increase in aggregate household debt since

the Census suggests it is unlikely that mortgage stress indicators would have materially improved.

- In extreme stress, households fall into arrears in their mortgage payments. Evidence from bank annual reports and other sources indicates that the downturn in mining-related areas in the past few years has seen a pick-up in non-performing mortgage loans, particularly in Western Australia, though in aggregate and even in the more exposed states non-performing loans remain below the levels observed in many other advanced economies.

- We will provide you with additional briefing on mortgage and rental stress in Australia separately.

Bottom line: households will likely continue to service debt unless unemployment prevents them from doing so

- Periods of financial instability are commonly associated with a fall in asset values, an increase in non-performing loans and loan defaults, and a subsequent decrease in the flow of credit to the real economy as banks move to repair their balance sheets. The situation can be compounded by household and business efforts to rebuild balance sheet strength by paying down debt. Weaker credit growth and deleveraging can reduce economic activity.

- This dynamic is particularly pronounced in the case of business debt. A marked fall in asset prices could quickly see the value of a firm's assets fall below that of its debt, in which case the firm is insolvent. When that occurs, the firm's assets are liquidated, and the firm's creditors suffer (at least partial) losses on their loans.

- However, this dynamic need not operate to the same degree in the household sector. Unlike businesses, households can operate with negative equity – in part because (legally) full recourse lending requires them to. As a result, a fall in asset prices does not automatically lead to forced sales of assets and repayment of debt. Banks will only foreclose when a household no longer services its debt.
  - In such circumstances, many household assets may prove somewhat illiquid (housing and superannuation), but it is important to note that potential default on owner-occupied housing debt is one of the few reasons individuals can access their superannuation before retirement.

- It follows that policy makers should be more immediately concerned about events that have the potential to drive a marked increase in unemployment, preventing households from continuing to service their debts, rather than falling asset values per se.

- Nevertheless, a marked fall in asset values would still be problematic insofar as they would increase any post-foreclosure impact on bank balance sheets. Importantly, increased capital requirements, including in APRA's response to the Financial System Inquiry's recommendation that bank capital be 'unquestionably strong', have improved bank resilience since the financial crisis.