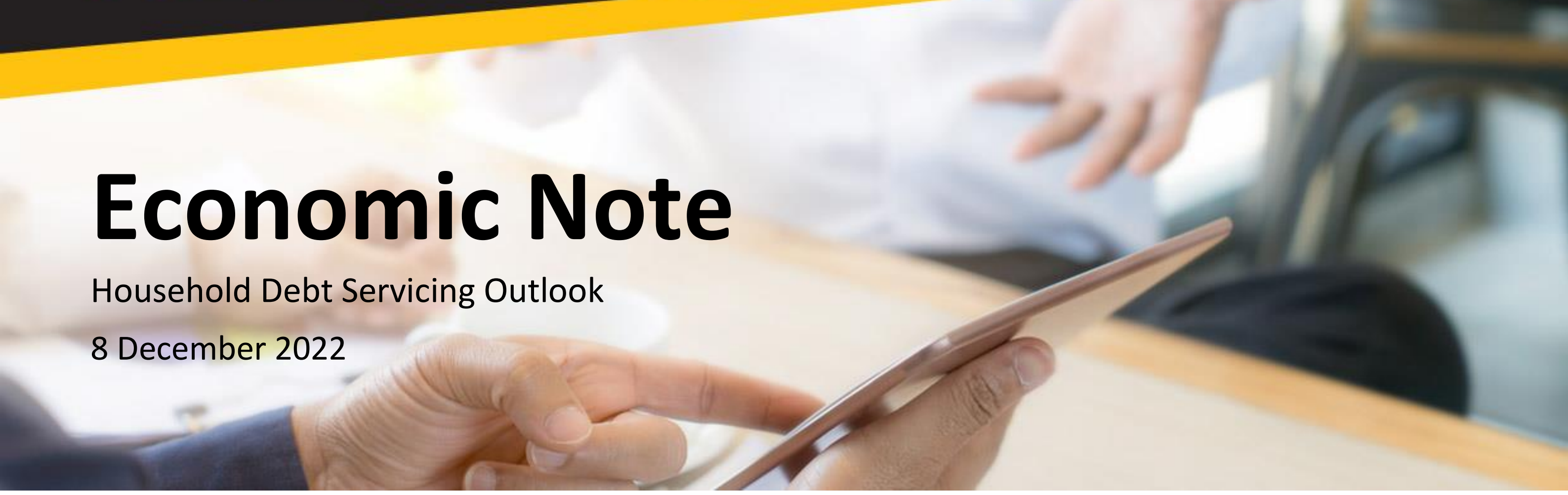

Economic Note

Household Debt Servicing Outlook

8 December 2022

This is going to hurt

- Higher debt servicing costs are expected to add roughly $80 per week to the average household budget by the end of next year.
- The impacts are uneven with highly indebted households to face considerably higher costs.
- Discretionary spending will be hard hit and we foresee recessionary conditions for the household sector in 2023.

Summary

Updating our earlier work suggests that households will continue to face sharply increased costs, putting budgets under pressure. Rising debt servicing costs alone amount to an extra $80 per week for each household by the end of next year (an extra $8bn on household debt servicing), rising to an extra $100 per week in total by the end of 2024 (approaching $12bn). The debt servicing impacts will be highly uneven across the household sector. Not all households have debt, whereas others will have large outstanding mortgages. As such there will be marked distributional cash flow impacts from higher retail interest rates.

Our concern is that the households who have built up savings post-COVID may not be the ones who need to find additional funds to cover higher debt servicing costs and have enough to get by. For many borrowers, increases in debt servicing costs will be sizeable, running into the hundreds of dollars per week. Discretionary spending will be hard hit and we foresee recessionary conditions for the overall household sector in 2023. This could see the RBNZ pivot to a slower pace of hikes, but not just yet given the need to drive (elevated) inflation lower.

Recap

The economy is transitioning away from a period of considerable policy support during the COVID hit to one in which monetary policy settings have been aggressively tightened to combat elevated inflation. The return to a lower inflation environment will eventually make life much easier for households. But in the interim, sizeable OCR hikes will mean higher debt servicing costs that will place some household budgets under considerable pressure. **In this note we update our analysis on household living costs** by taking a more in-depth look to ascertain the impact on households at the pointy end of the debt distribution. It focuses on the serviceability impacts of higher mortgage interest rates.

This analysis largely steers clear of looking into the impacts of lower house prices on housing equity and household balance sheets, which will reinforce the downdrafts to consumer spending. House prices are currently more than 10% down on their late 2021 peak and are set to fall another 5% or so. Household assets are sizeable in relation to debt, but homeowners who have bought at the late 2021 peak will be feeling the balance sheet hit.

Household borrowing costs are rising

Interest rates are now rising from multi-decade lows, with RBNZ figures showing that the average carded rate for mortgage borrowing troughed at 2.83% in September 2021. As the new mortgage rates on offer are significantly higher than they were back then and as borrowers refix onto much higher rates, the average mortgage rate should continue to steadily climb. Our forecasts suggest it should move above **4.5% by the end of 2022, and peak at around 6.75% by mid-2024.** Even if the OCR is cut in 2024, average borrowing costs are unlikely to move lower until 2025.

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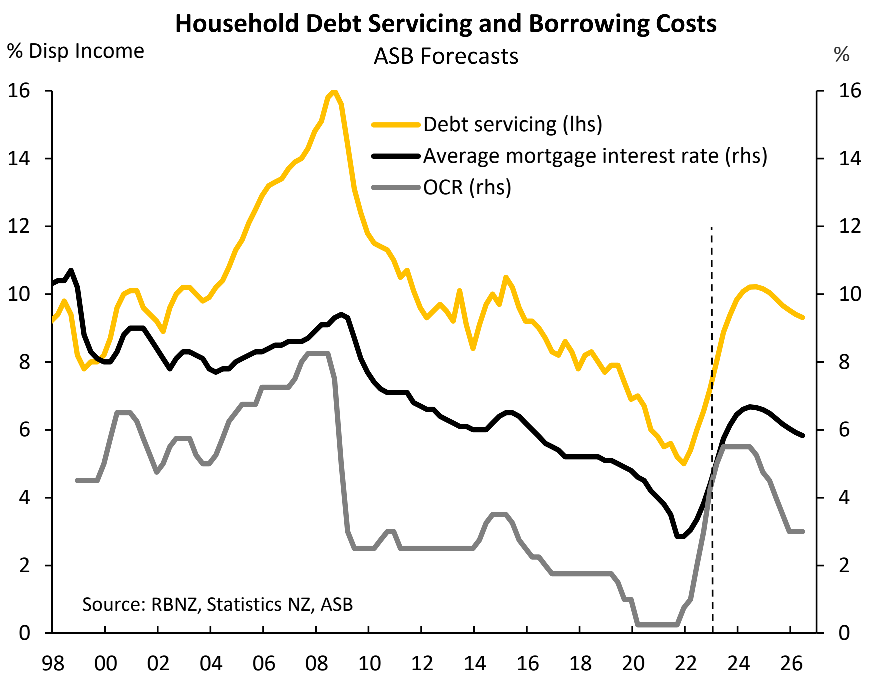
Please refer to the important disclosures at the end of this document.

Household debt is sizeable. RBNZ figures place the stock of household debt in the region of $340bn or just under 175% of household disposable incomes and slightly more than 90% of nominal GDP. This equates to about $180k for each private dwelling. Of late household debt has plateaued in relation to incomes as the growth in household debt has slowed. **However, movements in borrowing costs are the primary driver in movements of debt servicing costs.**



Viewing the household debt servicing relative to incomes (see chart) shows a roughly 400bps increase in debt servicing costs relative to incomes from mid-2022 to mid-2024. **That would lift household debt servicing slightly above 10% of disposable incomes, back towards historical averages from low shares of household incomes.**

Our estimates suggest this would add roughly $8bn to annual total household debt servicing costs by the end of next year, approximately $11bn by mid-2024 (2024Q3) and close to $12bn in total by the end of 2024. This equates to just under an extra $80 per household per week by the end of 2023 compared to mid-22 levels or closer to $100 per week by late 2024. **This is getting up there and will allocate much of the increase in weekly household after-tax incomes that we expect over the next few years.** Furthermore, a high inflation environment means that prices for other goods and services will also be climbing, squeezing household budgets. Moreover, averages can hide a lot. Households at the pointy end of the debt distribution will clearly be under significant pressure, and this is where our analysis now turns.

Looking under the hood

The RBNZ figures also provides some breakdowns of overall housing debt holdings. Of the $340bn of mortgage borrowing about $250bn is secured on owner-occupier properties ($200k per owner-occupier dwelling), with $90bn secured on residential investment lending ($145k per private rental dwelling) and with $5bn or so of business loans secured on residential property. Household debt growth is slowing but has increased by about 30% since late 2018, with the growth in owner-occupier debt (+33%), outpacing the growth on investor (+28%) and business loans (+0.2%).

Even within these broad categories, mortgage debt is not distributed evenly. There is a sizeable chunk of homeowners who do have an existing mortgage, whereas the size of household mortgage tends to be inversely related to the years of tenure, particularly for owner occupiers**. All else equal, a borrower with higher debt to income (DTI) would have a smaller buffer to withstand adverse shocks to serviceability (including falls to incomes or higher interest rates).**

<u>Influences on household debt and debt servicing</u>

Interest rates

This is the key driver. Falls in mortgage interest rates to around records lows last year have coincided with a pick-up in household debt as borrowers bought forward the pace of activity. That's how monetary policy works.

Kiwis tend to fix their mortgages, typically on the lowest rate available, with RBNZ figures confirming that about 11% of the value of mortgage debt is secured on variable rate loans, about 60% is on terms for less than one year with 85% less than two years. The average duration for mortgage loans is around 13 months with about half of all loans likely to be repriced over the next 12 months. Now with debt serving costs sharply on the rise, borrowers who have racked up a considerable amount of debt face an unpleasant surprise.

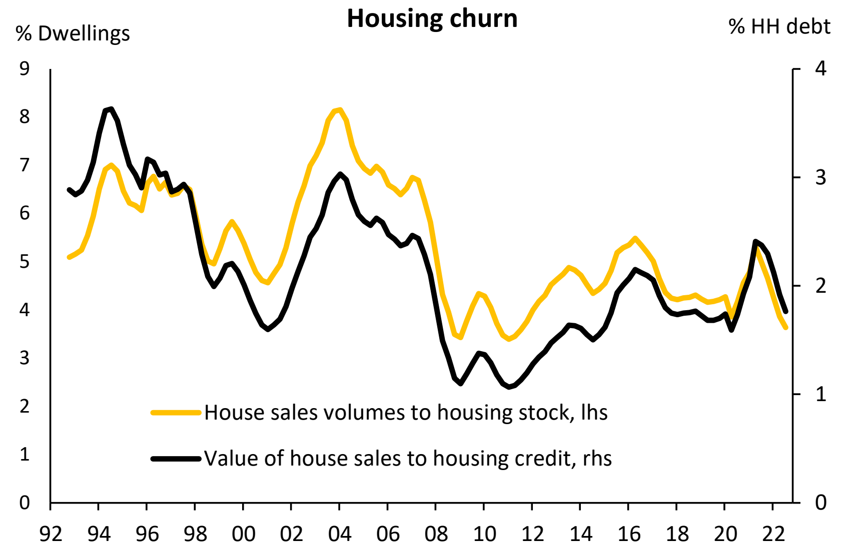
The accompanying table suggests that borrowers who fixed for two years back in December 2020 at 2.59% are now looking at an equivalent rate close to 6.75%. For someone with a $500k mortgage this equates to an extra $300 per week. Ouch.

Maturing mortgages Today's rates	Variable 7.99	6 m 6.50	1 y 6.54	2 y 6.74	3 y 6.84	4 y 6.99	5 y 6.99
6 months ago	5.85	**4.95**	4.85	5.35	5.65	6.35	6.45
1 year ago	4.45	4.19	**3.65**	4.36	4.69	4.95	5.19
2 years ago	4.45	3.39	2.49	**2.59**	2.65	2.99	2.99
3 years ago	5.20	3.89	3.39	3.55	**3.89**	4.19	4.29
4 years ago	5.80	4.95	3.95	4.29	4.49	**4.95**	5.09
5 years ago	5.80	4.95	4.39	4.69	4.99	5.49	**5.69**

Source: ASB

Readers are referred to our home loan reports for up to date advice on home loan choices.

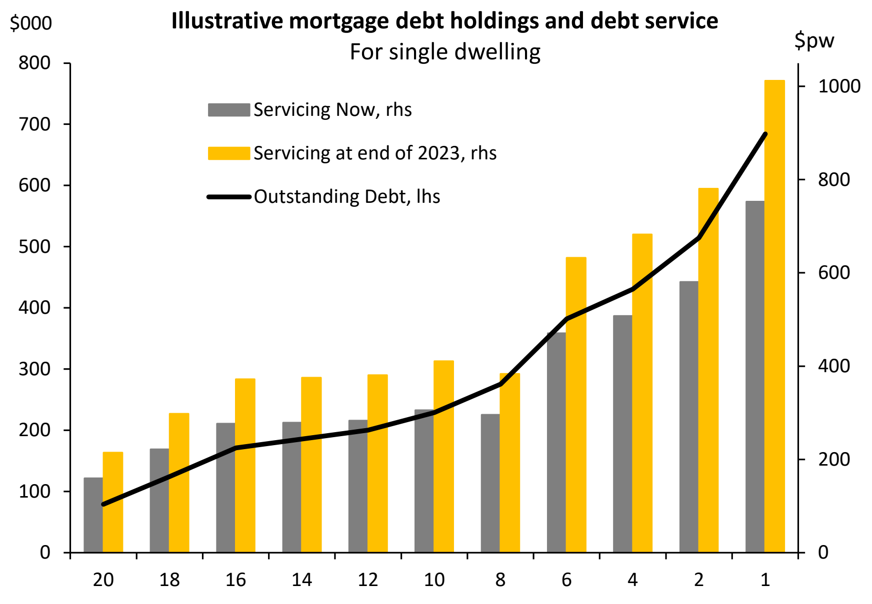
House prices and housing churn.
That the rise in household debt has coincided with rising house prices should come as no surprise to anyone. Increases in debt tend to be positively correlated with the housing cycle. Typically, the more trading activity in the housing market, the larger the pick-up in debt reflecting the different LVR positions of buyer (higher) and seller (lower).



Source: RBNZ, REINZ, Statistics NZ, ASB

Period of tenure
Another key determinant is how long the homeowner has owned the property. The longer the property has been owned, the lower the price the vendor would have paid for it and the longer the period in which principal repayments have been made. To illustrate this, we look at a hypothetical example where we compare debt servicing costs for a selection of homeowners who have purchased a dwelling at the REINZ nationwide median sales price from 20 years ago to one year ago, with a 20% deposit and 30-year mortgage. It makes the simplifying assumption that the homeowner stays in the property but does not trade up or down nor finance large renovations on the property.

The chart shows that, courtesy of forking out for less for a home and having also paid principal repayments, outstanding debt and debt servicing is likely to be lower the longer the period of tenure. **Increasing mortgage interest rates would be felt more acutely for borrowers who have just got on the housing ladder and typically will have larger debt levels.** Our stylised example shows that the increase in debt service costs ranges from an extra $50 weekly to just over $250 per week by the end of next year. Debt levels (and servicing) will likely be higher for more expensive property purchases. Debt levels may also be higher for households with longer tenures than this example given they are likely to have changed dwellings over their lifetime or funded substantial renovations on their existing property. Actual purchase prices and mortgage arrangements will also vary considerably. Still, you get the general idea.

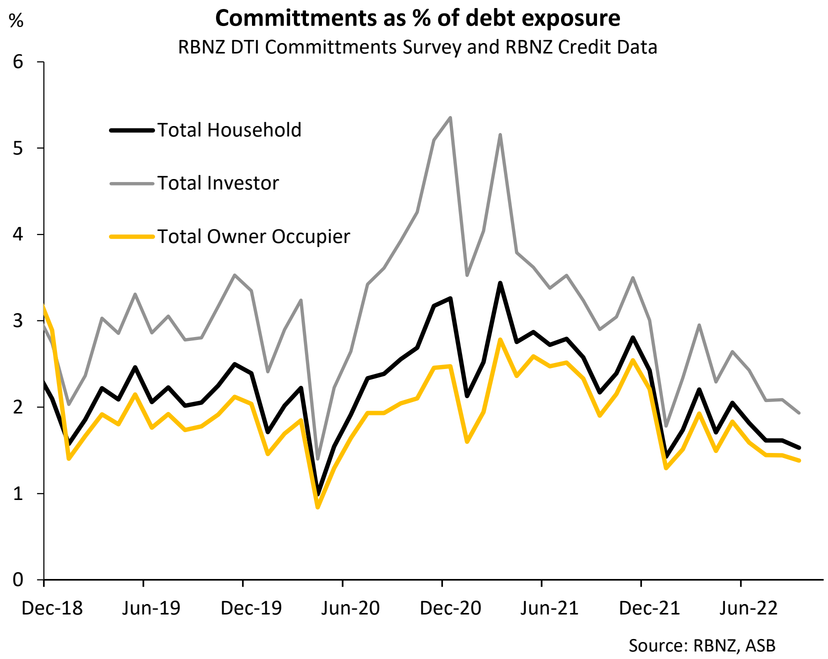


Source: RBNZ, REINZ, ASB

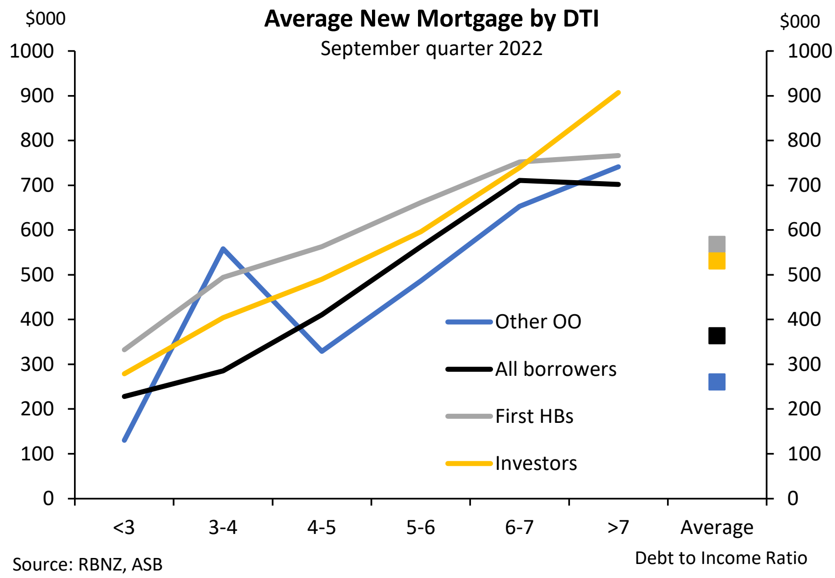
Insights from the RBNZ commitments survey

Finding distributional household debt data is tricky so as a proxy we use RBNZ figures from the monthly 'DTI new commitments survey'. This data goes back to early 2017 and collects data from banks on household debt and gross income for new mortgage borrowing made by households. The commitments are categorised by the status of borrower, and includes first home buyers, other owner occupiers or those with investment property collateral. There are also some regional splits with some Auckland information provided. **This survey focuses on new lending and captures only a subset of the debt distribution, but its advantage is that it provides useful information on exposures of borrowers who are likely to be the most adversely impacted by rising debt servicing.** The appendix has a selection of additional charts.

New commitments are only a modest portion of total mortgage lending, but they are at the pointy end of the debt distribution and are likely to represent the borrowers most vulnerable to sharply rising debt servicing costs. Viewing new commitments shows a surge in investor borrowing as the LVR restrictions were relaxed in 2020. Commitments for all forms of borrowing have tailed off as the housing market has slowed and the RBNZ has tapped the monetary policy brakes. Our suspicion is that new borrowing is unlikely to recover until the factors supporting the housing market – population, interest rates and real incomes – turn around, which looks to be later in 2023 at the earliest.



The commitments data also categorise lending according to the income of the borrowers. Viewing from a debt to income (DTI) lens (see charts in Appendix) shows that the average loan tends to rise with DTI and that commitments tend to be highest for borrowers with a DTI in the 4-6 range. The average loan size has increased by DTI bracket and has increased noticeably since late 2018, with the average increase in the region of 60% (to roughly $360,000), with house prices and mortgage debt up around 40% since then.



Breaking down new borrowing by tenure (see chart) shows that **first-home buyers tend to have the highest mortgages relative to their incomes, on average, closely followed by investors.** The average new mortgage for a first-home buyer is around $600k versus under $300k for owner-occupiers changing dwellings and $530k for investors.

The RBNZ data on gross incomes for household borrowers is not provided for housing investors, but for owner occupiers it reveals a shift of the income distribution to the right, with higher income borrowers gaining an increasing proportion of new lending. For example, borrowers with a gross income less than $140,000 now account for around one-third of loan commitments compared to 60% back in 2017. More than half of new commitments were for borrowers with an annual gross income exceeding $165,000 per annum as opposed to less than 30% back in 2017. This likely reflects a combination of higher house prices (and corresponding mortgage debt) as well as rising household incomes. For first-home buyers, average gross incomes tend to be higher for lower DTI borrowing. **This suggests that increasing debt servicing costs could really squeeze discretionary spending for higher DTI borrowers who have just got on the housing ladder.** For other owner-occupiers, average gross incomes tend to be higher for higher DTI loans, suggesting they could have more leeway to cope with higher debt servicing costs.

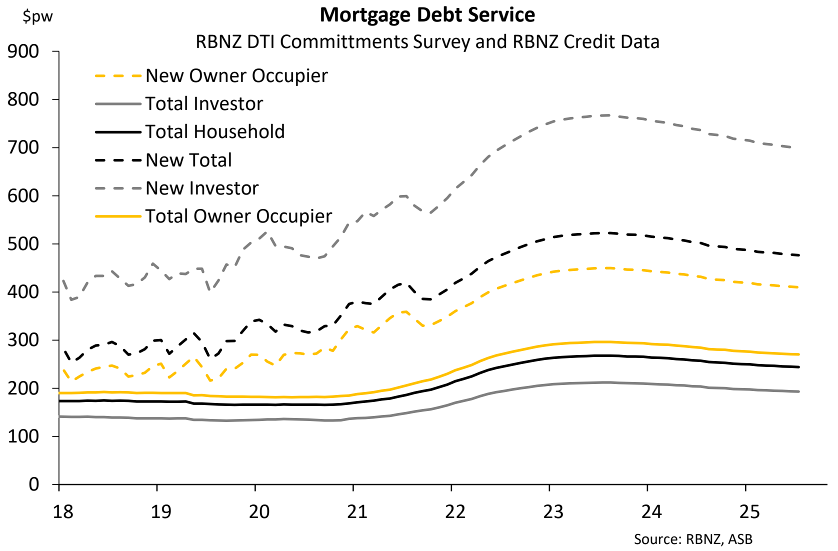
New versus average impacts

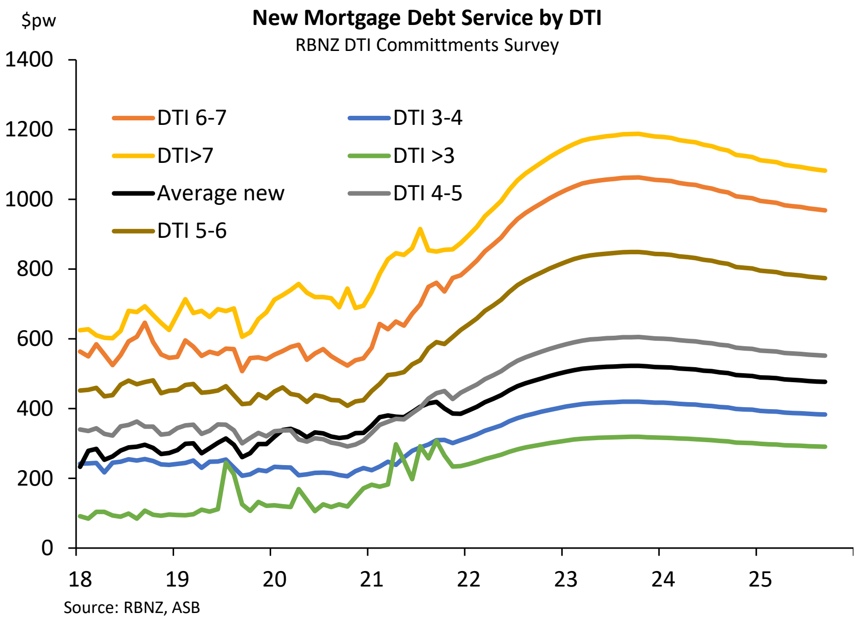
To illustrate the differences for new versus existing borrowers we simulate the impacts of higher mortgage interest rates on debt servicing costs (see charts). For new borrowers we use the commitments data and simulate what will happen to debt servicing given the outlook for mortgage interest rates and household incomes. For the stock of existing borrowers we use RBNZ figures that provide broad category breakdowns.

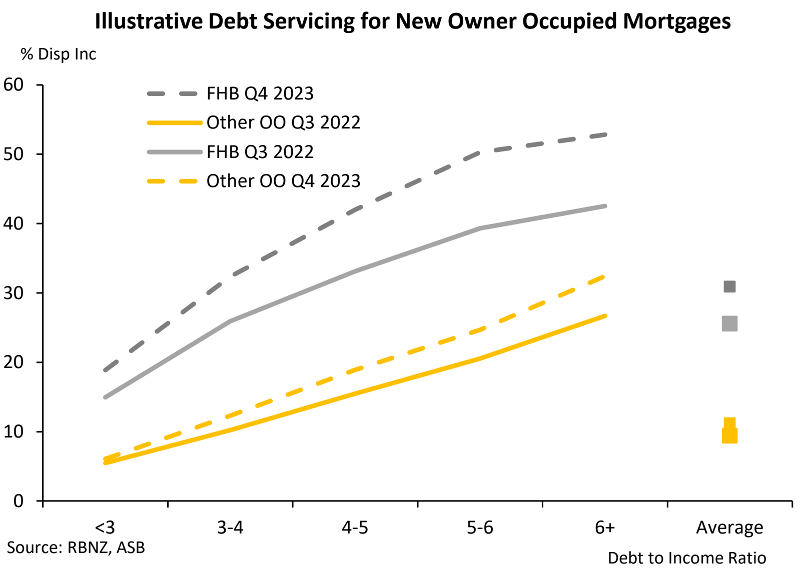
The top chart shows average debt service for new lending (dotted lines) versus average debt servicing costs for existing borrowers (solid lines). **According to the figures the average debt servicing cost will increase by roughly $80 per week by the end of 2023. For new borrowers, however, the increase is much larger, coming in at $130 per week.** Investors who have just taken up a loan face an increase of around $190 per week, whereas increases for new owner-occupiers are around $110 per week.

The middle chart summarises the pending increases in debt servicing costs for newer borrowers by DTI bracket**. It shows an average $80 to $300 weekly increase, with larger increases for more indebted borrowers.** These figures are averages, with some borrowers within each category facing much higher increases.

Translating this into debt servicing relative to incomes (bottom chart) shows a sharper climb for first-home buyers, with those just on the housing ladder likely to see an approximate 4 to 10 percentage-point increase in debt servicing ratios.



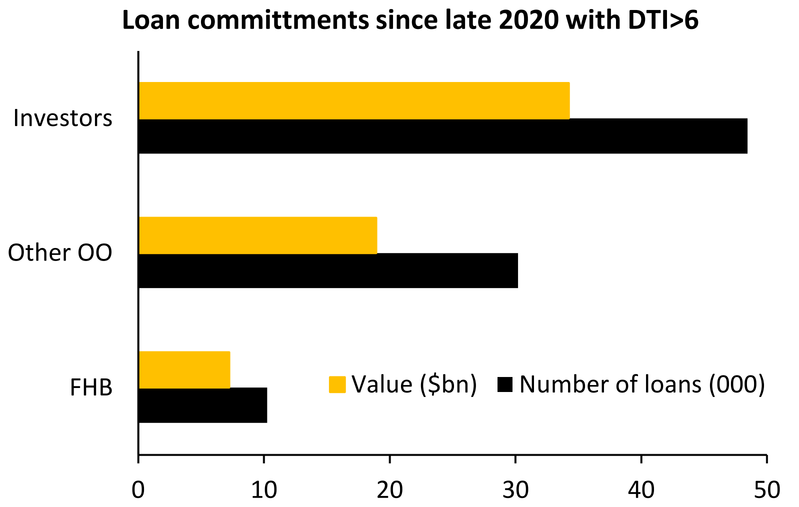




New first home buyers with a DTI above six, for example, would have to shell out more than 50% of their

disposable incomes on debt servicing. Increases in debt servicing relative to incomes would be smaller for other owner-occupiers (one to six percentage points), with debt servicing a correspondingly lower share of incomes than for first home buyers.

How many borrowers will be significantly impacted? This is the $64,000 question. As an illustration the accompanying chart summarises the value of loans with a DTI ratio above 6 times income that have been taken out from late 2020, when mortgage interest rates were falling to historic lows and the housing market was boiling over. It shows close to 90,000 home loans have been taken out since, half of which were by investors. **These numbers are comparatively low (about 5% of the housing stock) and we are confident that the stringent loan assessments carried out by banks will mean that the pool of distressed sales will be extremely small.** Numbers of first-home buyers who have recently purchased appear to be comparatively low and investors will likely be able to pass on the extra costs to their tenants.



Source: RBNZ, ASB

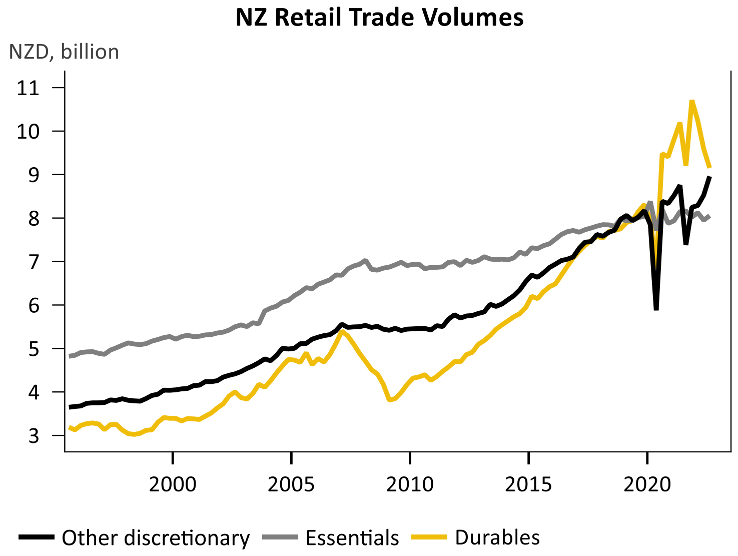
However, there will also be a pool of existing borrowers with high debt levels that will also have to refinance at correspondingly higher interest rates. This refinancing pool will be large (anywhere from 50%-60% of total household debt rolls over in the next 12 months) and the numbers will not be pretty for many households refinancing.

Household spending outlook and what might the RBNZ do?

Costs facing households have surged this year and the narrative next year is for more of the same. On top of the average $80 weekly gain in debt servicing costs by the end of next year, higher prices for other goods and services see total outgoings go up another $70 per week or so. This is if households don't change their spending patterns. However, we suspect they will.

The message looks to be sinking in. The mood amongst consumers is downbeat, with consumers decidedly gun shy over committing to major purchases. There will also be repercussions for broader economic act household spending. With household spending making up the bulk of economic activity, with a sizeable chunk of employment and consumer spending leveraged to the consumer spending outlook there will be repercussions for economy-wide economic activity and employment.

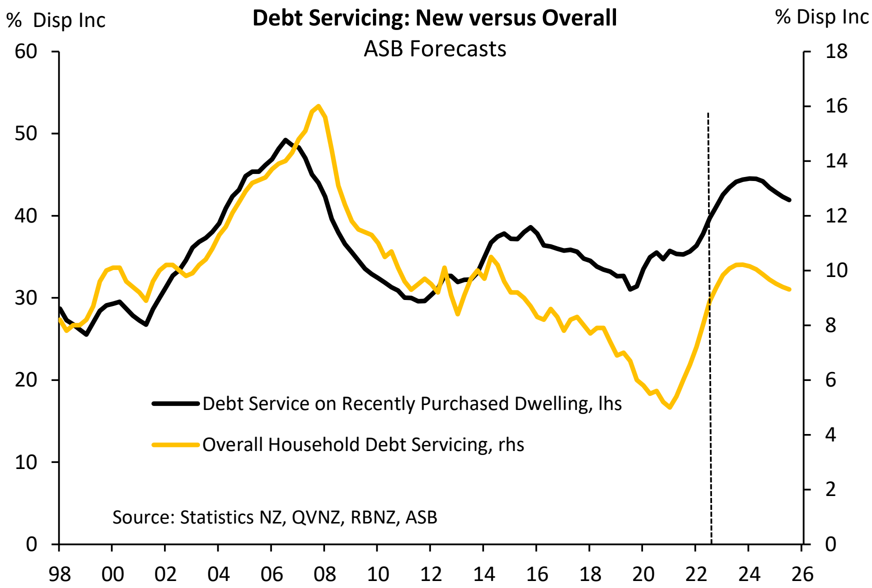
The strong starting point for the household sector should help cushion some of the impacts. Household incomes have also been on the rise and Kiwi households have built up a nest egg of savings during the COVID-19 pandemic: $30bn according to RBNZ estimates. Moreover, RBNZ [figures] show that payment deficiencies are still very relatively low with kiwis still making excess repayments on their mortgages ($16bn in the September 2022 year).



Source: Macrobond, ASB

However, the concern is that the households who have built up the savings will not be the ones who need to find additional funds to cover higher debt servicing costs. It will mean considerably reduced funds available for households after paying down the mortgage, with discretionary spending likely to be hard hit. Aligned with this should be the further retrenchment in durable spending that was on rocket boosters when the housing market was smouldering, interest rates were historically low and spending options were limited due to mobility restrictions. **The Christmas mood should be downbeat this year and we envisage 2023 will be a year in which household spending volumes retrench.**

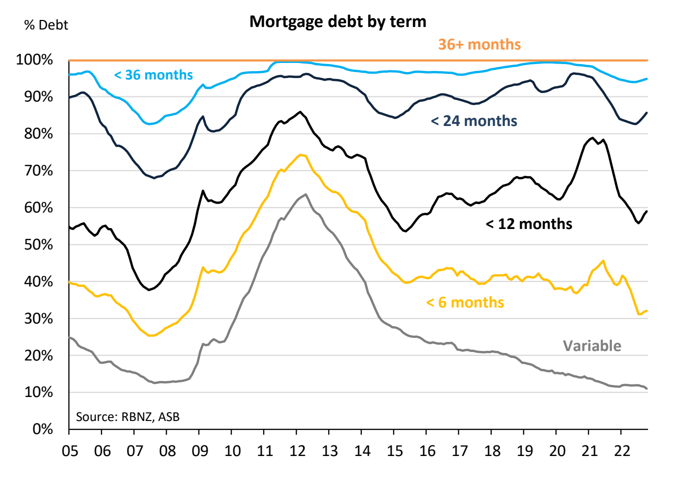
In light of the mounting debt headwinds facing households and other headwinds, we don't see an imminent turn around in the housing market. Mortgage commitments data have shown a significant tailing back of new lending of late, with falls in commitments more acute falls for higher DTI borrowers (see appendix).

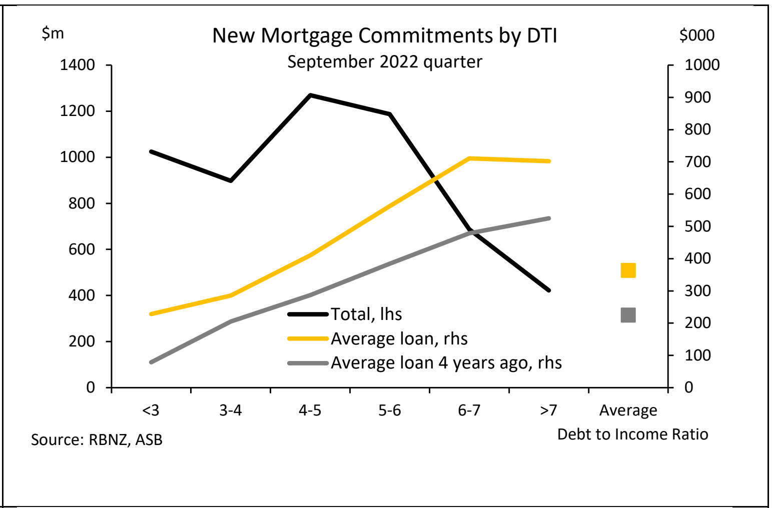


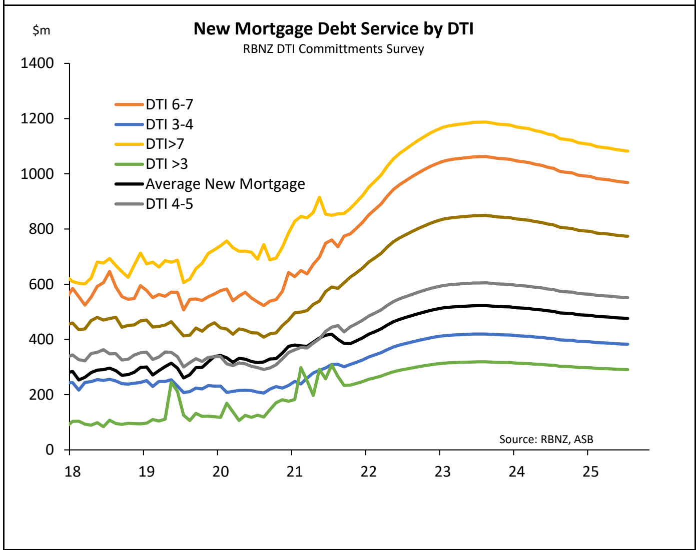
What are the monetary policy implications? With the RBNZ focused on getting inflation down quickly, weaker household spending won't initially phase the RBNZ. In fact, they have suggested that domestic spending needs to slow to get inflation down. Our earlier work on inflation persistence has flagged the labour market as being the key driver in core inflation**.** **It is possible that a much weaker household spending outlook could significantly dampen inflationary pressure via impacting the labour market.** This in turn, could encourage the RBNZ to 'pivot' sooner rather than later on the pace of hikes, culminating in a lower OCR peak**. It is still early days, however, and lowering inflation is still likely to be 1,2 and 3 on the RBNZ's must-do list.**

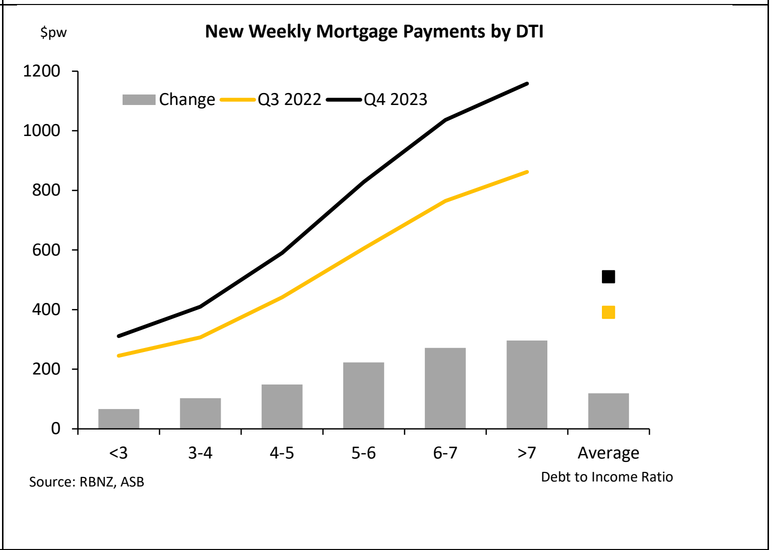
Still, the message is not all doom and gloom. The housing market will eventually recover as it always does. **Debt servicing for the purchase of a typical dwelling is expected to peak at a lower share of income than leading up to the GFC.** Debt servicing could then move lower providing house prices do not respond to the prospect of lower mortgage interest rates.

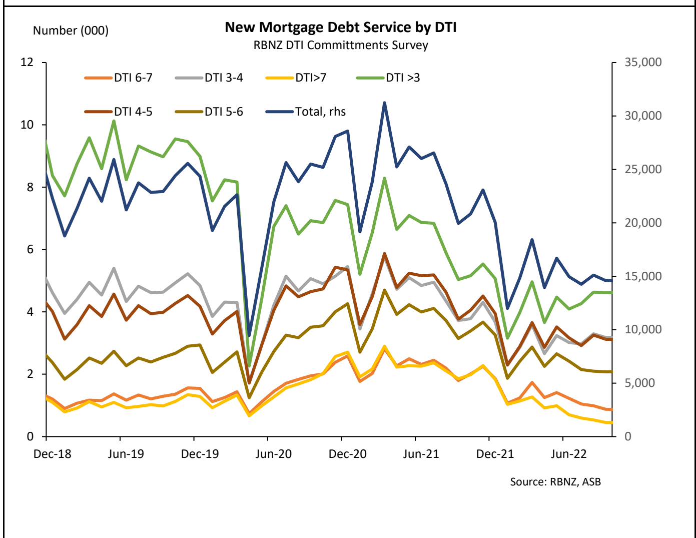
Graphical appendix

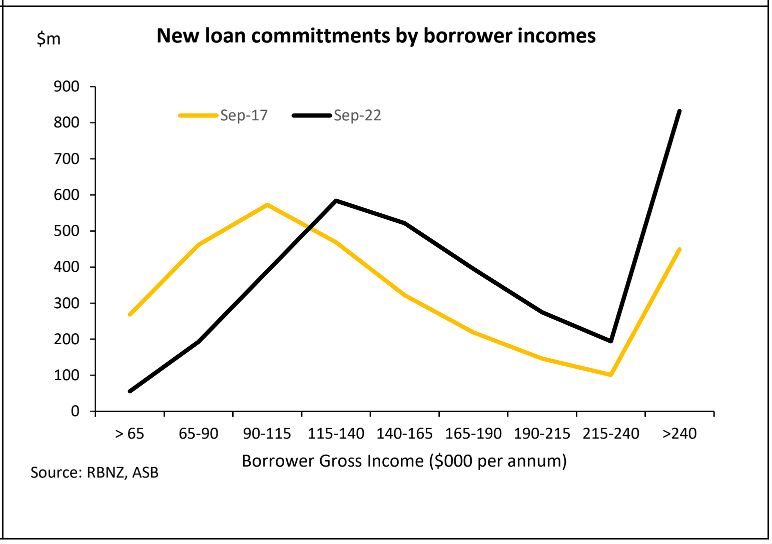












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