Chapter 4

Household debt in Australia

I suspect that a significant number of households have taken on a debt level which makes sense in the good times, but does not take into account the fact that bad times will inevitably occur at some time or the other.[1]

Introduction

4.1 A significant cultural change seems to have taken place in the attitude of many Australians towards debt. Twenty years ago Australian households averaged about $50 in debt for every $100 of income. That figure has now risen to about $150 in debt for every $100 of income.

4.2 Similar rises in debt to income ratios have occurred in other countries, particularly in the last decade, although the rise in Australia has been more rapid than in most other countries. In line with this increase in the household debt to income ratio, the total amount lent to persons by banks has also risen dramatically, from $92.4 billion in 1990, to $579.1 billion in 2005.[2]

4.3 From having one of the most conservative approaches to debt in the OECD, Australians are now amongst the heaviest borrowers and seem to have accepted much higher debt levels as part of life in the new millennium.

4.4 The large rises in household debt in this country have aroused concern and provoked comment both nationally and internationally, for example in the internationally renowned *The Economist*:

> The profligacy of American and British households is legendary, but Australians have been even more reckless…there are now concerns that unsustainable rates of borrowing will sooner or later end in tears.[3]

4.5 Many of the statistics and graphs used in this chapter are drawn from material provided to the Committee by the Treasury and by the ANZ Bank. Other material was derived from statistics compiled by the Department of Parliamentary Services Parliamentary Library Statistics Group or published by the Reserve Bank of Australia (RBA) and the Australian Bureau of Statistics (ABS). The Committee records its thanks for the assistance provided.

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1 RBA, *Do Australian households borrow too much?,* p. 7.

2 RBA, *Bank lending by sector*, Table D05 http://www.rba.gov.au/Statistics/Bulletin/D05hist.xls

3 'Living in never-never land', *The Economist*, 9 January 2003.

The growth of household debt

4.6 Table 4.1 shows the size of household debt or liabilities in Australia and how it has grown.

Table 4.1: Household liabilities and assets, $ billion

Quarter	Liabilities $ b	Assets $b			Liabilities as % of assets %	Liabilities as % of GDP %	Liabilities as % of gross household disposable income, %
		Non-Financial	Financial	Total			
Jun-90	187	873	500	1373	13.6	48.6	70.6
Jun-95	267	1114	705	1819	14.7	56.8	82.4
Jun-00	473	1642	1117	2759	17.1	75.8	114.6
Jun-01	515	1793	1219	3012	17.1	77.1	114.1
Jun-02	596	2106	1269	3375	17.7	83.6	126.5
Jun-03	685	2400	1315	3715	18.4	90.4	140.9
Jun-04	796	2767	1477	4244	18.8	98.0	153.7
Mar-05	861	2912	1631	4543	18.9	99.7	157.7

Source: RBA Bulletin, Table B.20, based on ABS, *Financial Accounts* (Cat. No. 5232.0) - for household liabilities; and ABS, *National Income Expenditure and Product* (Cat. No. 5206.0) - for gross household disposable income.

Note: 'Non-financial assets' comprise consumer durables and dwellings – dwellings represented 95% of total non-financial assets for the March 2005 quarter; 'Financial assets' include both households and unincorporated enterprises and cover bank deposits, shares and superannuation.

4.7 Bank lending to households over the last fifteen years has grown a faster rate than the economy. Total bank lending to households grew from 24 per cent of GDP in 1990 to 67 per cent in 2005. It should be noted that this statistic understates total lending as it does not include non-bank sources of finance such as credit unions and non-conforming lenders.

4.8 Based on bank lending statistics, the major part of debt held by Australian households, 85 per cent, is made up of mortgages for housing. Fixed term loans make up a further 6 per cent, and revolving loans (which include credit and charge card debt and lines of credit) the remaining 9 per cent.

4.9 Housing mortgages may be further broken down between owner-occupiers and investors. Borrowing for investment purposes currently comprises 34 per cent of borrowings for housing.

4.10 Credit card debt totalled $31.4 billion as at June 2005, representing 58.5 per cent of revolving loans and 5.4 per cent of total household debt. Credit card debt has risen from $4.1 billion (June 1990) to $31.4 billion (June 2005). 4

4.11 Growth in fixed term loans (for example, unsecured personal loans) has been more modest however, increasing from $19 billion to $33.5 billion between 1990 and 2005. The ANZ submission points out that the rate of growth of personal borrowing has almost halved, from an annualised rate of 22% in the December 2003 quarter to 12% in the December 2004 quarter.[5]

4.12 The Reserve Bank of Australia has published the following figures for bank lending (Table 4.2) which show that while borrowing has continued to grow, the rate of growth has slowed in the last year.

Table 4.2: Bank lending to persons, June 1999 to 2005, $billion[6]

Month/Year	Housing		Other Personal		Total $billion (and change over previous year)
	Owner-occupiers	Investors	Fixed loans	Revolving loans	
June 1999	153.1	60.7	21.2	21.4	256.3
June 2000	169.7	75.7	22.5	26.7	294.6 (+15%)
June 2001	194.0	86.1	19.6	27.2	326.9 (+11%)
June 2002	220.5	96.9	26.7	31.4	375.5 (+15%)
June 2003	254.2	123.3	28.8	37.9	444.3 (+18%)
June 2004	288.6	151.9	31.6	45.4	517.4 (+17%)
June 2005	324.0	167.9	33.5	53.7	579.1 (+12%)

Source: RBA Bulletin, August 2005, Table D.5.

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4 Derived from Reserve Bank of Australia, *Credit and Charge Card Statistics*, Table C1, http://www.rba.gov.au/Statistics/AlphaListing/alpha_listing_c.html

5 ANZ, *Submission 17*, p. 7.

6 This table shows bank lending only and does not include lending by non-bank lending institutions.

Factors contributing to the rise in household debt

4.13 Most of the evidence available to the Committee focussed on housing related debt and credit card debt. Contributors to the inquiry and other commentators broadly agree on the main causes of the rise in household debt, although opinions differ about significance of the various contributing factors. The primary factors that have resulted in much higher household debt levels include:

- Freeing up of the financial markets, which meant credit became much more readily available;
- A prolonged period of low inflation and low interest rates gave consumers a feeling of confidence in the economy;
- Increased competition in lending, more advertising and promotion;
- A much wider range of products from lenders, including lines of credit and interest-only loans;
- The stockmarket boom in the mid-to-late 1990's followed by the real estate boom and the ability of consumers to borrow for investment purposes;
- The growing acceptance of the concept of debt used for investment as 'good debt', actively promoted by financial advisers promoting wealth creation strategies based on investment in equities and property;
- Increasing financial literacy and the realisation of the baby boomer generation that it would have to take more responsibility for funding a comfortable retirement;
- Rising asset values, especially in residential real estate, which gave home owners a feeling of increased wealth (so-called 'wealth effect'), and the ability to unlock that wealth through new financial products such as loans based on home equity;
- A sustained period of economic growth, low inflation, low interest rates, and falling unemployment.

4.14 A detailed discussion of these various influences is contained in Appendix 5.

Distribution of debt across households

4.15 Debt is distributed unevenly across households. Treasury pointed out that only a third of households have a mortgage, and that the debt to income ratios in these households will be higher than the average figure.[7]

4.16 A study conducted by University of Melbourne researchers[8] found that debt levels do vary significantly. The study revealed that about a third of households have

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7 The Treasury, *Submission 13*, p. 7.

no debt, and almost a quarter have debts equivalent to less than half a year's income. However, for 9 per cent of households, liabilities exceed four times annual income.

4.17 Treasury suggested that there is a strong relationship between income and debt, those with higher incomes holding most of the debt and being well placed to repay it. The University of Melbourne study confirms this relationship, showing that most household debt is held by income rich and asset rich households.

4.18 Using assets as a measure of wealth, 72 per cent of all debt is held by the wealthiest 30 per cent of households, and 42 per cent of debt by the wealthiest 10 per cent. The 20 per cent of households that are the least wealthy in terms of the assets they have account for just 6 per cent of household debt. The survey found similar results when income is used as the measure of wealth. Table 4.3 shows the distribution of assets and debt among the Australian population. This table is divided according to net worth (i.e.: the value of all assets and savings) and net income.

Table 4.3: The distribution of household wealth and income by percentile

Percentile	Sorted by net worth		Sorted by net income	
	Assets	Debts	Assets	Debts
1-10	0	0	5	2
11-20	1	0	5	2
21-30	2	1	5	3
31-40	4	3	7	5
41-50	5	5	7	7
51-60	7	7	9	8
61-70	9	9	10	11
71-80	12	13	13	16
81-90	18	18	15	17
91-100	42	45	25	27
TOTAL	100	100	100	100

Source: Table is an extract from Table 5, p14 of *Income, wealth and joblessness: insights from the HILDA survey*, a paper by B. Headey and M. Wooden of the University of Melbourne presented to the 2005 Melbourne Institute Economic and Social Outlook Conference, 31 March – 1 April 2005.

[8] *Income, wealth and joblessness: insights from the HILDA survey*, a paper by B. Headey and M Wooden of the University of Melbourne, presented to the 2005 Melbourne Institute Economic and Social Outlook Conference, 31 March – 1 April 2005.

4.19 An analysis of the same HILDA data used in the University of Melbourne study conducted by the Economic Group of the RBA somewhat unsurprisingly confirmed these findings.[9] This study showed that households that are most highly leveraged (i.e.: have the highest debts-to-assets ratio) are those most able to bear the debt - mid-life households with high income.

4.20 This study also found that those households living in areas described as 'least vulnerable to reversals in housing prices, the outer suburbs and non-metropolitan regions that have experienced relatively smaller gains in recent years' and households that are negatively geared on investment property tend to be more highly leveraged.

4.21 The study found that while young households in general are less likely to be homeowners, those who do have mortgages are likely to have particularly high leverage.

4.22 However, the study does appear to confirm that relatively few households are leveraged at a level considered to be 'high'. The study estimated that 11.4 per cent of households with housing loans (less than 4 per cent of all households) had a ratio that was 'high' – that is, exceeded 80 per cent - and less than 3 per cent had negative equity in their homes.[10]

Household debt indicators

4.23 How are households coping with increases in debt levels? A number of ratios provide a picture of the impact of debt on households. They include: household saving ratio; debt to income ratio; interest-to-income ratio; and the household gearing ratio.

Household savings ratio

4.24 The household savings ratio is calculated as a percentage of household savings to household income. The trend for Australian households over the last 20 years has been one of a diminishing rate of savings and rising consumption, to the extent that Australian households have now entered a period of dis-saving as shown in Figure 4.1.

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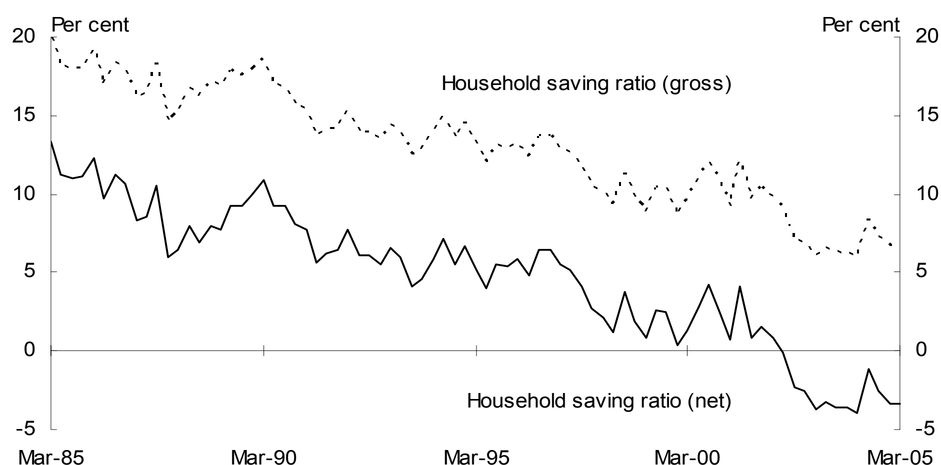
9 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003.

10 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003, p. 8.

Figure 4.1: Savings ratio of Australian households

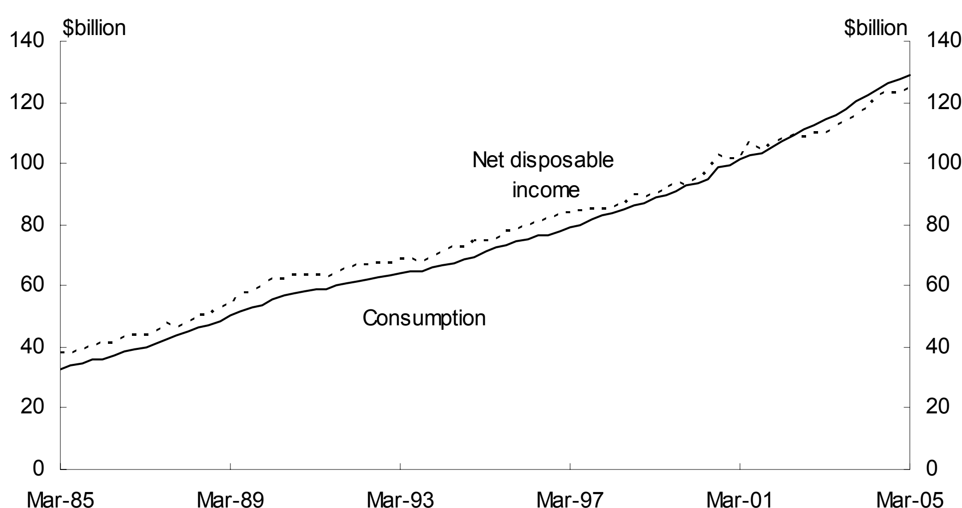


Source: Australian Bureau of Statistics cat. no. 5206.0

4.25 Treasury advised the Committee that although the household savings ratio has a number of limitations 'the broad conclusion that households are saving proportionately less of income now than in the past is likely to be correct'. [11]

4.26 This trend is also clear when consumption and income are compared, as shown in Figure 4.2:

Figure 4.2: Household consumption and income



Debt-to-income ratio

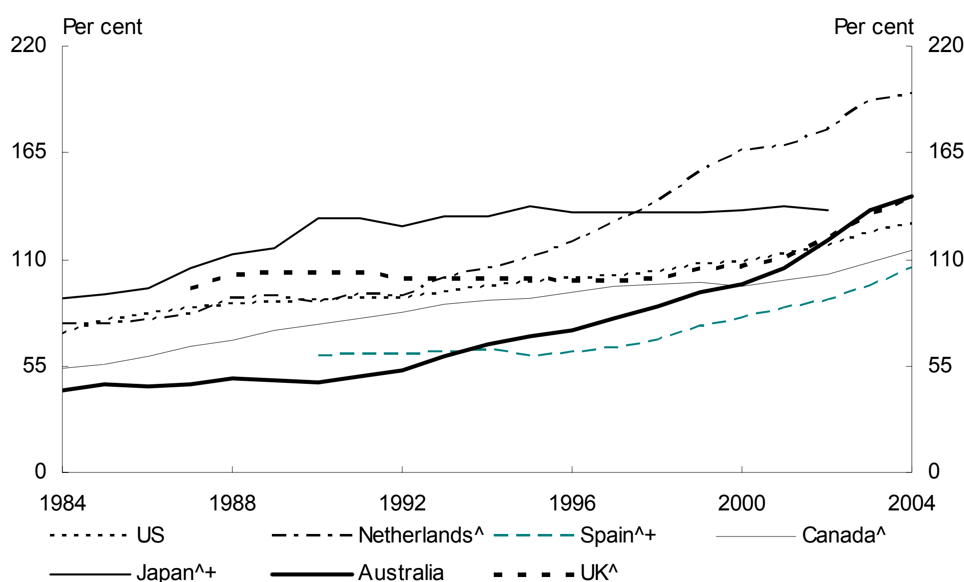
4.27 The debt to income ratio measures the size of debt as a percentage of disposable income. However, not all commentators agree that this statistic is useful.

11 The Treasury, *Submission 13*, p. 7.

The ANZ, for example, submitted that the gross debt to income ratios 'offer no reliable guide for assessing the vulnerability of the household sector and if used alone can provide a misleading view of fundamental conditions'. The ANZ submitted that to fully understand the issue of household debt, the level of debt must be examined in the context of a household's accumulated assets and current income.[12]

4.28 Historically, Australian households were debt adverse by international standards but in common with many other developed countries, they now carry much more debt, as shown in Figure 4.3.

Figure 4.3: Household debt-to-income ratio, selected countries



^ Includes unincorporated enterprises
+ Income is after tax and after the deduction of interest payments
All data is based on calendar years, except for Spain, which is based on financial years

Source: RBA.

Interest-to-income ratio

4.29 A useful indicator of debt serviceability is the interest payments to income ratio. This measure shows what percentage of a household's disposable income is required to meet interest payments on their debt.

4.30 Treasury advised the Committee that despite a fall in interest rates, increased levels of debt means that interest payments now take up a higher proportion of income compared with the last decade. Figure 4.4 shows how average interest payments-to-income are now above the peaks of the 1980s and early 1990s.

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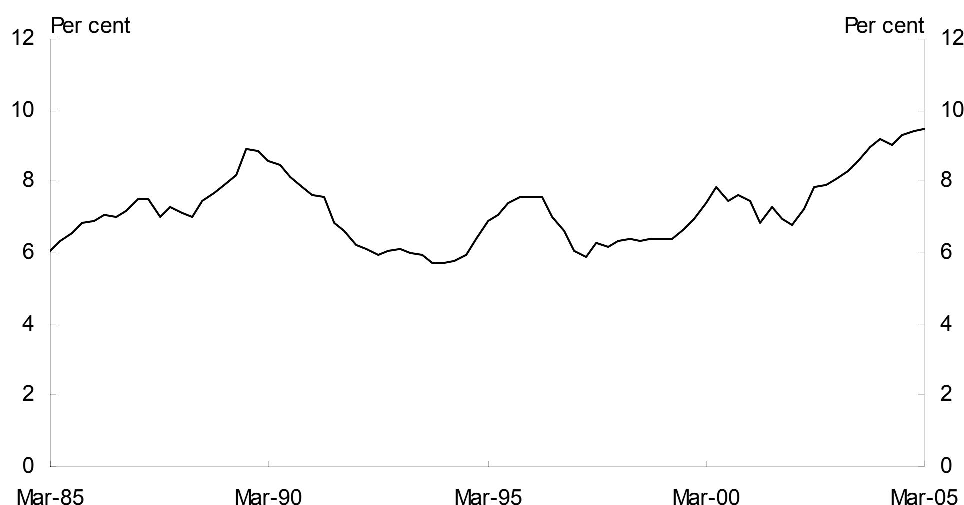
12 ANZ, *Submission 17*, p. 3.

Figure 4.4: Interest payments-to-income ratio of Australian households



Source: Australian Bureau of Statistics cat. no. 5206.0.

Household-gearing ratio

4.31 The household-gearing ratio shows the percentage of assets encumbered by debt, that is, the amount of debt the household has as a percentage of total assets. The ANZ advised the Committee that while the gearing ratio is rising, it remains well below international benchmarks.

4.32 Figure 4.5 shows the gearing ratio in Australia compared to a number of selected countries. Although the gearing ratio of Australian households is now higher than many OECD countries, including the USA and UK, because of the substantial increase in house prices in recent years Australia's household gearing ratio (household debt to assets) remains relatively low by international standards.[13]

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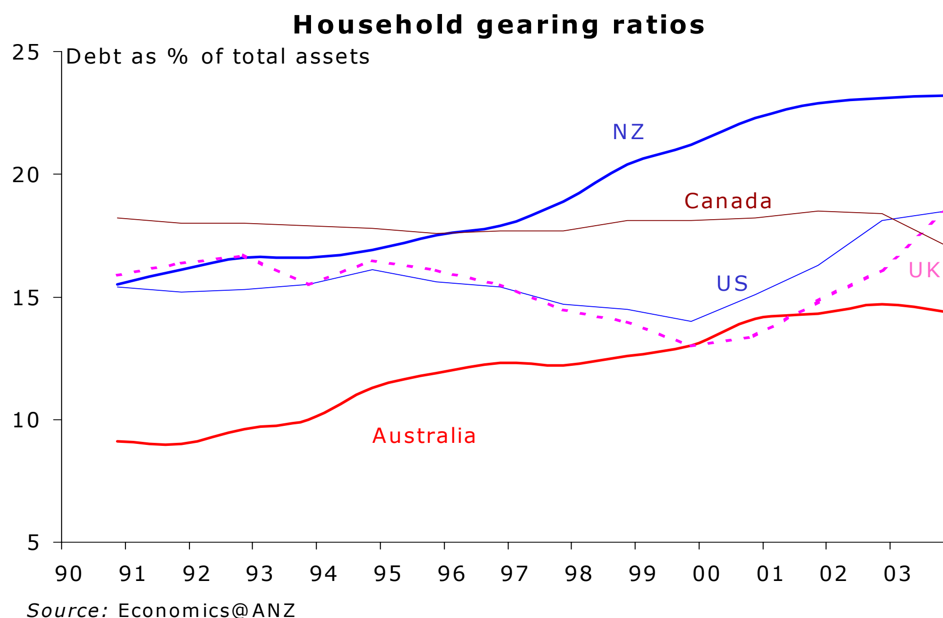
[13] ANZ, *Submission 17*, p. 4.

Figure 4.5 – Household gearing ratio (Debt as a % of total assets)



Source: Economics@ANZ

4.33 The Australian Bankers' Association (ABA) told the Committee that while debt is high, it is 'still reasonably small compared to household assets'. The Association advised that debt is equivalent to twenty per cent of assets, and that this ratio has been stable for a number of years. The ABA acknowledged that this ratio is around twice what it was in the 1980s, meaning that households are now more highly geared.

4.34 Again, the RBA considers that this statistic understates the true figure for those households who hold housing debt. In July 2003, the RBA estimated that when the figure is adjusted to take account of those households who have no housing debt, the average gearing ratio for those that do have housing debt rises to about 43 per cent.[14] A subsequent study conducted by the RBA and released in July 2003 estimated the ratio to be 48 per cent.[15]

4.35 As pointed out by the Treasury in its submission, all of these measures have limitations. Perhaps the major limitation is that they present an average picture, where in reality large variations in debt and circumstances will be evident between individual Australian households.

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14 RBA, *Do Australian households borrow too much?*, speech by Mr I J Macfarlane, Governor, to the Sydney Institute, 3 April 2003, p. 5.

15 RBA Economic Group, *Housing Leverage in Australia*, Luci Ellis, Jeremy Lawson and Laura Roberts-Thomson, July 2003, p. 8.

How are households coping?

4.36 The household sector's debt levels are now at historically high levels, and this is reflected in most measures of debt serviceability. In its most recent report, the RBA reported that:

> Both as a result of higher debt levels, and the increase in mortgage rates earlier this year, the ratio of aggregate household interest payments to disposable income has increased further to 9.8 per cent, the highest level on record. The total repayment burden, allowing for principal repayments, is higher again relative to past experience, given the increase in average loan size.[16]

4.37 However, the available evidence indicates that most of those households that are carrying heavy levels of debt are well-placed to meet their repayments. As both the Treasury and RBA have observed, there are few signs of financial distress, and default rates on all forms of credit are very low. The exception is a very small number of households (compared to the size of the population that has debt) who are undoubtedly in difficult situations, usually as a result of inadequate income levels.

4.38 Financial counselling organisations agree that most Australians seem to have little difficulty managing their household debt. For example, the Care Financial Counselling Service (CFCS) told the Committee that 'Most consumers do not appear to have any problems managing their increased levels of debt.' However, the CFCS went on to say that it had experienced a marked increase in demand for its services:

> …the disparity between those coping well and those on the brink or already in crisis is becoming more marked. For example, CARE noted a dramatic increase in demand for its services in the first 6 months of 2004. [The number of] clients over 50 seeking assistance has risen from 12% to 24% in 3-4 years.[17]

4.39 The CCLC questioned the validity of relying on default rates as an indicator of financial stress, arguing that there are three reasons why this may mask the true situation:

> The first is fairly obvious - that is, we have had fairly solid economic conditions for some time now so if default rates are going to be low then now is the time that they will be and any form of economic downturn might have an effect on that.
>
> The second one is that we see clients making very creative use of the availability of other credit in order to mask potential default situations. We have clients who refinance their credit over and again…roll their credit card debts over into their home loan…and, at the extreme, use one credit card to

16 RBA, *Financial Stability Review*, p. 11.

17 CFCS, *Submission 2*, p. 3.

> pay another. … They really have no capacity to make the payment at all; they are using it as a mechanism to mask their situation.
>
> The final thing, which we think is perhaps the biggest problem when looking at the default rate, is that in the last 10 or 20 years we have moved to a completely new scenario whereby, instead of paying off loans, people are making minimum payments. This is not something which happened in the past…What we have now are credit cards and store cards - the most obvious example of continuing credit facilities - whereby people will sit for many years with their balance fully drawn. …When we look at defaults, we are not measuring people's ability to meet that debt; what we are measuring is their ability to meet the minimum payment only.[18]

4.40 The Australian Bankers Association (ABA) agreed that default rates do not necessarily provide the most reliable indicator of financial stress, but noted that determining financial stress levels was difficult:

> Finding the right indicator of households' financial stress is a very difficult exercise, and it is something that we have given thought to. We never make the claim that because defaults are at record lows there is no financial stress out there at all. It is a good indicator that overall things are looking pretty good for the economy and for households in general. But when you move away from defaults and look for some other measure, you then get into a debate about judgement and that is an awkward debate, something which we have not seen any definitive research on or answer to. It is something we are engaged in and we are looking at it and we are interested in seeing whether there is something useful we can do.[19]

4.41 People whose financial difficulties force them to seek the assistance of the many financial counselling groups in the community may be considered as experiencing financial stress, but it is difficult to obtain a reliable estimate of the number of people who avail themselves of these services. The following statistics provide some indication of the number of people who get to the point that they need external assistance.

- a survey conducted by members of the Financial Counsellors' Association of NSW (FCAN) indicated that 2 322 clients presented for counselling in NSW during 2003;[20]
- CARE Inc Financial Counselling Service (CARE) reported that it responded to over 2 200 new requests for assistance in the ACT during 2004;[21]

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18 *Official Committee Hansard*, 16 May 2005, p. E22-23.

19 *Official Committee Hansard*, 16 May 2005, p. E73.

20 FCAN, *Submission 1*, iii.

21 CFCS, *Submission 2*, p. 2.

- the Credit and Debit hotline operated by the Consumer Credit Legal Centre (NSW) Inc (CCLC) took 2 512 calls from the public and financial counsellors in the first 5 months of operation;[22]
- the CCLC received between 4 500 and 5 000 calls in the period Sept 2004 – May 2005[23];
- Anglicare Tasmania assisted 1 200 individuals and families during the 2003-04 financial year; [24]
- in 2002-03, financial counsellors under the Commonwealth Financial Counselling Program assisted approximately 16 000 clients; 25 and
- during 2003-04, one financial counsellor in Brisbane assisted 679 new clients and 399 existing clients. In Queensland, demand for financial counselling is increasing, and waiting periods to see a counsellor can be a few weeks.[26]

4.42 These statistics almost certainly under-report the number of people who are in financial distress or are approaching that state. As the Centre for Credit and Consumer Law, Griffith University (CCCL) noted in its submission:

> Other households, who are currently managing their credit commitments, may be at risk of default or financial hardship if their financial circumstances or other factors change. Unemployment, family breakdown, and ill health all feature as significant causes of financial difficulty.[27]

4.43 The CCLC told the Committee that many consumers in financial difficulties resort to bankruptcy and other insolvency arrangements, noting that in 2003-04, there were 16 441 non-business bankruptcies across Australia, and 5 482 Debt Agreements under Part IX of the Bankruptcy Act. Excessive use of credit was the second most common cause of non-business bankruptcies, after unemployment.[28]

4.44 A number of studies show that lower income households are the most likely to encounter difficulties. A report prepared for the FCAN found that 76 per cent of the associations' clients have incomes of less than $30 000 per annum. The primary causes of credit and other debt problems reported by clients in order of importance were unemployment (27 per cent), excessive use of credit (19 per cent), domestic discord (15 per cent) and ill health (14 per cent). Of those who reported excessive use of credit, credit cards are the principal source of difficulty.

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22 CCLC (NSW) Inc, *Submission 6*, p. 3.

23 *Official Committee Hansard*, 16 May 2005, p. E21.

24 Anglicare Tasmania Inc, *Submission 10*.

25 CCCL Griffith University, *Submission 11*, p. 3

26 CCCL Griffith University, *Submission 11*, p. 3.

27 CCCL Griffith University, *Submission 11*, p. 4.

28 CCCL Griffith University, *Submission 11*, p. 4.

4.45 While excessive use of credit is listed as a less significant reason for financial problems than might be expected, it appears to be the issue that causes the most problems when people encounter personal problems which reduce their earning capacity. The authors of the study observed:

> The typically low income of the majority of the clients…makes them vulnerable to uncontrollable factors such as loss of employment, domestic discord and ill-health.[29]

4.46 MasterCard confirmed that this is the case:

> One of the major reasons for debt defaults, as has been reported by a lot of research, is catastrophic life events such as ill health, divorce or the death of the primary breadwinner in a family. Almost always these life events are unforeseeable and, unfortunately, they are also usually totally unavoidable.[30]

4.47 On the basis of the evidence received by the Committee, it is difficult to sustain an argument that a significant proportion of the community are in financial distress as a result of excessive levels of household debt. It cannot be disputed however that there is evidence of a significant minority who are in distress, and a further group of indeterminate size who are not currently in financial distress but would have difficulty coping with a change in personal circumstances. As the CCLC observed:

> Probably not the majority of us but a very significant minority are using credit to mask an imbalance between income and expenditure. There are probably people who are using that credit proportion to buy luxury or imported goods and some who are using it to increase their capital wealth by investing in their own house, but we see a lot of people who are using credit just to live - people on fairly low incomes who are using credit facilities to purchase necessaries such as groceries, electricity, car registration and those sorts of things.[31]

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29 FCAN, *Submission 1*, attachment, p. 48.

30 *Official Committee Hansard*, 16 May 2005, p.55. (Mr Naffah)

31 *Official Committee Hansard*, 16 May 2005, p. E21-22.

What are the future risks to households?

4.48 The RBA has been warning for some time about the risks associated with what it sees as unsustainably rapid increases in household debt. The major risk for many households is that they may have difficulty meeting repayments if the economic climate deteriorates or their personal circumstances change. As the Governor of the RBA warned:

> I suspect that a significant number of households have taken on a debt level which makes sense in the good times, but does not take into account the fact that bad times will inevitably occur at some time or the other.[32]

4.49 MasterCard was also among those who warned of the possible consequences of an economic downturn:

> …the existing issues with managing household debt will blow out significantly when the inevitable economic downturn eventuates.[33]

4.50 Despite the fact that there are few signs of financial distress among the household sector at present, the RBA has continued to warn that the household sector, through its excessive levels of borrowing and record levels of debt, is vulnerable:

> …the high levels of household debt make the household sector vulnerable to change in the generally favourable economic and financial climate. Given this, developments in household sector finances and the housing market will bear close watching in the period ahead.[34]

4.51 External factors appear to pose the greatest risk to the economic climate, for example, a general slow-down of the world economy. While remaining fairly optimistic about the prospects of the household sector, the RBA has previously laid out what it sees to be the major threat posed by continuing rapid rises in household debt:

> …the combination that would be most damaging to the Australian economy would be if the household sector were to continue putting itself into a more exposed position at the rate it has over the past few years, while at the same time a further weakening of the world economy was starting to feed through to activity and incomes. That would be a recipe for ensuring that, when the house price correction came, as it inevitably would if the world economy was weak enough, it would be bigger and more disruptive than otherwise. I am not saying that this is the most likely outcome, only that it is a risk we have to take into account.[35]

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32 RBA, *Do Australian households borrow too much?,* p. 7.

33 MasterCard, *Submission 15*, p. 3.

34 RBA, *Financial Stability Review*, September 2005, p. 16.

35 RBA, Opening Statement to the House of Representatives Standing Committee on Economics, Finance and Public Administration, 6 June 2003, p. 3. (from RBA website)

4.52 The RBA currently appears to be of the view that risks have abated somewhat due to an apparent slowing of the rate at which household debt is increasing. This slowing appears to be largely because the housing market has stabilised and some corrections are emerging as prices fall in some cities. There has been a marked change in the housing market over the last 18 months, and 'cooling is evident in conditions in all capital cities, although it is most pronounced in Sydney'.

4.53 The RBA has also commented that households appeared to be going through a period of consolidation.

4.54 While the overall picture is not alarming at present, some risks to households remain and in its recently released *Financial Stability Review* the RBA has warned that 'there remains a possibility that the adjustment could turn out to be much larger than currently anticipated'.[36]

4.55 However, the RBA notes that the correction to the housing market has, to date, proceeded smoothly, and this has helped alleviate concerns about a potentially more damaging adjustment at some point in the future.[37]

Interest rate rises

4.56 The Treasury has warned that the household sector is now more sensitive to shocks such as higher interest rates or lower income and identified highly geared investors as being particularly at risk:

> The increased debt of the household sector is likely to make their consumption more sensitive to changes in (actual and expected) interest rates. The extent of the increase in sensitivity will depend on the distribution of the debt. For example, investors, some of whom are more highly geared, account for an increasing proportion of the housing market, and may react differently to owner-occupiers.[38]

4.57 However, the RBA is of the view that this is a somewhat over-stated risk, pointing out that interest rate rises are less likely in the more stable economic environment which now prevails:

> For a given rise in interest rates, it [households] will be more affected because the rise will apply to a larger loan. But it is probably not right to make the assumption about 'a given rise in interest rates'. That is because in the low inflation/low interest rate environment we have today, interest rates do not move about as much as before. In the late 1980s, on one occasion the

36 *Financial Stability Review*, September 2005, p. 2.

37 *Financial Stability Review*, September 2005, p. 8.

38 The Treasury, *Submission 13*, p. 10.

> mortgage rate rose by 3½ percentage points in a year, in the 1990s we have had nothing like that (the largest rise in a year was 1¾ percentage points).[39]

Recent borrowers and low income earners

4.58 People who have recently taken out a mortgage tend to be more at risk in times of economic downturns or if their personal circumstances change, as their exposure to debt is at its maximum. However, this has always been the case, as the Governor of the RBA has pointed out:

> Of that 30 per cent of households, a lot have had the mortgage for a reasonable period and, during that period, their incomes have gone up or they have paid off part of their mortgage. The vulnerable group is the people who have just taken out a mortgage, and it was ever thus. The one time in your life when you are vulnerable, when you have a high amount of debt relative to your income, is when you first take out a mortgage.[40]

4.59 The RBA also acknowledged the nature of this risk for recent borrowers and also for lower income earners in its recent *Financial Stability Review*:

> Among borrowers with housing debt, those with the highest debt-servicing burdens, or the smallest buffers on which to fall back in adverse circumstances, are often those that have taken out loans only recently as well as lower-income households and investors.[41]

4.60 The Consumer Credit Legal Centre (Griffith University) advised the Committee that it thought that there were many households who were only just managing:

> High household debt levels pose significant risks for many households and individuals… many households are likely to be 'only just' managing their consumer credit obligations, and are vulnerable to changes in individual financial circumstances and/or economic conditions. [42]

Home equity loans and redraw facilities

4.61 These products have been identified by the RBA on a number of occasions as a source of possible risk to households that use them. The RBA has observed that an increasing number of households have taken advantage of these facilities to top up their mortgages. While this does allow households to tap into their wealth, it does

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39 RBA, *Do Australian households borrow too much?*, p. 3.

40 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 12 August 2005, p. 34.

41 *Financial Stability Review*, September 2005, p. 11.

42 CCLC Griffith University, *Submission 11*, p. 3.

have the effect that their debt levels stay higher for longer, leaving them exposed to changes in circumstances for longer periods.[43]

Investor housing

4.62 The RBA has issued a number of warnings about the rapid rise of investor housing. This sector's activity has risen dramatically in the last decade, and investors are often highly geared. The RBA has been particularly concerned that many new investors do not fully understand the nature of the risks they face, which are considerably greater than for owner-occupied housing. As the Governor told the House of Representatives Standing Committee on Economics, Finance and Public Administration in June 2004, investors are vulnerable to a drop in property prices:

> I think there are a lot of people out there who thought they were going to get rich but they have this asset which is costing a lot of money to service and is not going up in price; rather it is going down, and it is hard to find tenants.[44]

Marginal borrowers

4.63 The other group of households who are identified as being at risk if circumstances change are those who are described as 'marginal borrowers', who borrow outside of the normal lending limits imposed by the banks from non conforming lenders. The RBA notes that 'if economic conditions were to change, however, marginal borrowers are likely to be more vulnerable and one might expect them to quickly become distressed sellers in adverse circumstances'.[45]

Committee views

4.64 The rise of household debt in Australia has been spectacular, but should be kept in perspective. A similar phenomenon has been observed in many other OECD countries, and in some, the rises have been even larger than in Australia. The rises have almost certainly had similar causes, low interest rates in most countries being a common feature. Persistent low interest rates in the USA have also had effects worldwide.

4.65 Household debt of itself is neither a good nor a bad thing. For many people, debt has provided a way to build wealth. It also allows people to smooth out their expenditure over their lifetimes. Debt only becomes a problem if it leads to unacceptable risks for those households who have substantial debt or to significant misallocation of resources within the economy.

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43 See for example RBA, *Do Australian households borrow too much?*, pp. 3-4.

44 House of Representatives Standing Committee on Economics, Finance and Public Administration, *Official Hansard*, 4 June 2004, p. 15.

45 RBA, *Financial System Stability – some current observations*, speech by John F. Laker, Assistant Governor (Financial System), 16 May 2003, p. 13.

4.66 The rises in debt that have occurred have been unsustainable, as the RBA has been warning for some time. They have also had some unfortunate outcomes, not the least of which is that housing has become very expensive and is now unaffordable for all but those who appear to hold most of the debt, that is, well established, mid-life high-income households. Low income households and younger people are severely disadvantaged in such an overpriced market.

4.67 Fortunately, the rate of increase has moderated, although there are no guarantees that it will not resume where it left off.

4.68 Could the rises have been prevented? The answer is almost certainly no, although some fiscal policy settings such as the changes to the capital gains tax (CGT) in 1999 may have contributed to the rises that took place. The coincident factors of readily available finance resulting from deregulation and major reductions in interest rates meant that demand in the housing market would inevitably intensify, with increases in house prices an inevitable result. When the other pro-cyclical factors of rising incomes, rising employment, increased numbers of people seeking housing for investment purposes and wealth effects are added to the equation, a 'perfect storm' was an inevitable result, as could be seen in the very rapid increases in house prices that occurred.

4.69 Should government policy be changed to slow future rises? The Committee considers that there is a case for removing some of the pro-cyclical factors from the housing market, although caution is required to ensure that over-reaction does not result. The Committee notes that the Productivity Commission has recommended that the Australian Government establish a review of those aspects of the personal tax regime that have recently contributed to excessive investment in rental housing, with a focus on the capital gains provisions.[46] The Committee also notes that the Government has rejected this recommendation. Nonetheless, the Committee considers the recommendation to have merit, as reviewing the CGT provisions offers one of the few realistic alternatives available for moderating the excessive demand for investment housing, a significant distortion in the housing market.

4.70 The Committee does not consider that it is practical or desirable to wind back the clock on financial sector deregulation, which despite having had a number of possibly unforeseen unexpected effects, has overall been beneficial for both the household sector and the economy. It has led to many efficiencies and made finance more readily, on a more equitable basis. Re-imposing limits on lending would not gain any community support.

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46 Productivity Commission Inquiry Report, *First Home Ownership*, No. 28, 31 March 2004, pXXV.

4.71 However, there is a case for ensuring lending is conducted responsibly, as discussed in the previous section, where the Committee welcomed a number of initiatives to address unsound lending practices. The Committee believes that it is essential that the non-conforming lending sector be subject to more stringent scrutiny of how it conducts its business, particularly as it is in direct competition with the deposit-taking sector which is subject to stringent prudential requirements and supervision by APRA. The Committee considers that there is a strong case for ensuring that conforming and non-conforming sectors face the same regulator framework, particularly in relation to consumer protection requirements.

4.72 The Committee noted with interest a comment in the AMWU submission that the European Central Bank sets a target for the growth of credit in the economy equal to the product of the desired growth in GDP and inflation, giving a rate of growth of between 4 and 5 per cent per annum, and that this target is an objective of monetary policy. The sole objective of monetary policy in Australia is to keep inflation within the target range.[47] The Committee has not taken any evidence on the EU approach and is well aware that it would, if adopted in Australia, represent a major change to what overall has been a successful policy approach. While the Committee is not advocating that such an approach is necessarily appropriate for Australia, it suggests that the RBA should consider whether setting a target is desirable, and how it might be achieved.

Recommendation 4

The Committee recommends that the Government reassess its decision to reject the recommendation of the Productivity Commission for a review of those aspects of the personal tax regime that have recently contributed to excessive investment in rental housing.

4.73 The Committee is encouraged by the RBA's assessment that risks to households from rising household debt levels do not appear to be high at present. However, there are few grounds for complacency, and the risks, while not yet pressing, require close monitoring and in some cases, action.

4.74 The Committee is of the view that much more should be done to educate borrowers of the risks associated with investing in real estate; of borrowing against equity; and of borrowing at debt-to equity ratios in excess of 80 per cent.

4.75 Furthermore, the Committee notes and supports the findings and recommendations in the report of the Parliamentary Joint Committee on Corporations and Financial Services titled 'Property investment advice – safe as houses?', dated June 2005.

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47 AMWU, *Submission 4*, p. 4.

Recommendation 5

The Committee recommends that through the Ministerial Council on Consumer Affairs, the State and Territory Governments develop and pass uniform legislation for the development of educational material focussed on the risks associated with investing in real estate, borrowing against home equity, and of borrowing at debt-to-equity ratios in excess of 80 per cent; and that real estate agents be required to provide copies of this material to prospective buyers at the point of first enquiry.