5.3 Focus Topic: Indicators of Household Financial Stress

There is no universally accepted definition of the concept 'household financial stress', so the Reserve Bank monitors a broad range of indicators of the health of household finances in Australia. This Focus Topic provides an assessment of households' financial health and the incidence of financial stress across different types of households. The main findings are:

- **Early indicators show that financial pressures have increased.** Many households are facing a squeeze on their budgets and have had to make (in some cases, substantial) adjustments to their spending or saving patterns in light of the increase in inflation and interest rates over the past 18 months.
- **The incidence of severe financial stress has increased but remains low.** The vast majority of households have had scope to make adjustments to their personal situation, including increasing hours worked, reducing their discretionary spending, saving less or reducing their stock of savings.
- **The group of borrowers at higher risk of falling into arrears on their mortgage remains small.** Borrowers with low incomes, large loans relative to their income or property value, and low savings are particularly at risk.

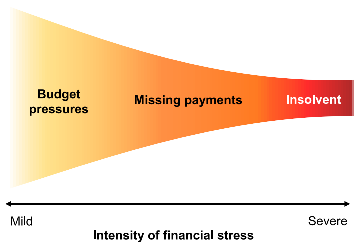
The Bank monitors a broad range of indicators to assess household financial stress.

Definitions of financial stress vary, which reflects that different households can be in different stages along the spectrum of stress (Figure 5.3.1):[1]

- *Rising budget pressures* can be an early indicator of stress. Budget pressures may cause households to worry about being able to pay their bills or build savings going forward, and force some to cut back on discretionary expenditures or look to increase hours worked.
- *Under severe financial stress* is the more extreme end of the spectrum. Insolvent households are unable to service their debts or pay their essential bills out of their income and savings.

Some life events, such as illness or job loss, may push households into severe financial stress immediately, independent of the state of the economy. In other cases, financial stress can build gradually from milder to more severe forms as a household exhausts its options to respond to budgetary pressures. Some households may be able to 'self-cure' and exit financial stress – for instance, through hardship assistance from lenders or by selling assets to reduce their debts – however, this may involve substantial financial and personal costs (e.g. in the sale of the family home).

Figure 5.3.1: Spectrum of Financial Stress



Financial stress first and foremost impacts people's wellbeing but there can also be spillovers to the broader economy and financial system. Households in early stages of financial stress might sharply reduce their non-essential spending, which can contribute to or exacerbate an economic downturn. In extreme cases, financial stress can have implications for financial stability. Households in severe financial stress are unable to service their debts, which could lead to losses for lenders and – if sufficiently large and widespread – could cause them to reduce lending or to become financially stressed themselves.

The Bank therefore closely monitors a range of indicators for signs of financial stress. These range from early indicators of building financial pressures (such as households' perception of their financial situation) to measures of more severe stress (such as loan arrears and other late debt payments). In addition to these directly observable indicators, the Bank analyses a range of surveys – such as the Survey of Income and Housing (SIH) by the ABS and the Melbourne Institute's Household, Income and Labour Dynamics in Australia (HILDA) Survey – for a comprehensive assessment of households' experiences with financial stress and their financial wellbeing. As these surveys tend to be available only with a substantial lag, the Bank complements this information with loan level data from the Securitisation System. We then estimate indebted households' evolving financial positions in terms of:

- *spare cash flows* – households' income available after meeting housing costs and other essential expenditures
- *savings buffers* – savings that can be drawn on when household income is not sufficient to meet housing costs and other essential expenditures.

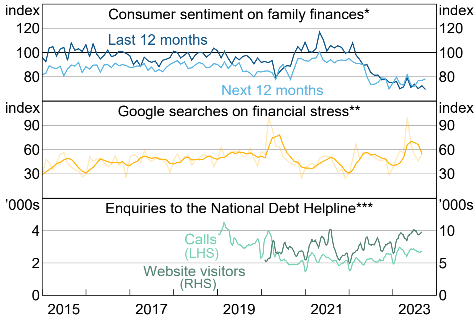
A growing number of households are in early stages of financial stress, but a very small share are currently unable to service their debts.

High inflation and higher interest rates have reduced most households' spare cash flow. In turn, a small but increasing share of households is likely to have to spend more than their incomes (see Chapter 2: Resilience of Australian Households and Businesses). Consistent with these broad-based budget pressures:

- many households are making adjustments to their expenditure, as evidenced by slowing consumption growth
- households' sentiment of their current or future financial health has declined sharply since early 2022
- the frequency of Google searches of terms related to household financial stress increased earlier this year to its highest level since the start of the COVID-19 pandemic in early 2020
- financial counselling services such as the National Debt Helpline have seen increased demand for their services from the low levels seen during the pandemic (Graph 5.3.1).

Graph 5.3.1

Indicators of Household Financial Stress



* January 1996 = 100. Latest observation September 2023.

** Tracks relative frequency of Google searches based on key words related to household financial stress; March 2020 = 100, four-month rolling average. Latest observation September 2023.

*** Number of enquiries per week, four-week rolling average. Latest observation 31 August 2023.

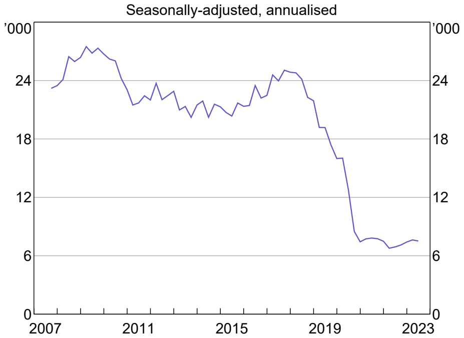
Sources: Financial Counselling Australia; Google Trends; RBA; Westpac-Melbourne Institute.

At the other end of the spectrum, indicators of severe financial stress have also begun to increase, but they have remained at very low levels as measured by mortgage arrears rates (see Graph 2.2 in Chapter 2: Resilience of Australian Households and Businesses) and personal insolvencies (Graph 5.3.2).

Graph 5.3.2

Personal Insolvencies*

Seasonally-adjusted, annualised



* Excludes business-related personal insolvencies. Latest observation June 2023.

Sources: AFSA; RBA.

Budget pressures and incidences of financial stress differ across households. Some households have been affected more by high inflation and higher interest rates and are therefore facing budget pressures more acutely.

Renters are generally more likely to experience financial stress but do not pose direct financial stability risks.

Timely, comprehensive and representative data on renters' financial situations is hard to come by. Yet, many renters are likely to have been particularly impacted by the recent period of high inflation for the following reasons:

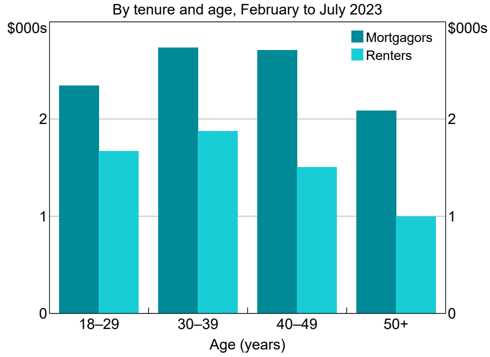
- *Renters tend to have lower incomes.* Private survey data covering the period from February to July 2023 show that renters have substantially lower incomes than mortgagors across all age groups (Graph 5.3.3).[2] Renters have also been particularly impacted by recent large rent increases.[3] That said, some renters – particularly those on low incomes – are likely to have experienced stronger-than-average income growth (see Graph 2.3 in Chapter 2: Resilience of Australian Households and Businesses).
- *Renters have substantially lower savings* than mortgagors irrespective of their age (Graph 5.3.4).

As a result, renters are much more likely to experience financial stress than other households. In 2021, renters were around twice as likely to face difficulties paying their bills and

Graph 5.3.3

Median Household Weekly Income*

By tenure and age, February to July 2023



* Survey respondents report gross (before tax) income. Medians are interpolated from survey response buckets.

Sources: RBA; RFI Global's DBM Atlas.

were around four to five times more likely to seek help from community services or family and friends (Graph 5.3.5).[4] Renters could also experience financial stress more severely if the labour market were to soften, as they tend to be more likely than mortgagors to lose work in economic downturns.[5]

Even though renters are more likely to experience financial stress, they do not pose direct financial stability risks as they do not have material debts. That said, if a large number of renters were to default on their rental payments, this could adversely impact the cash flow of investors, particularly those who financed their investment property with debt. And, if renters were to sharply reduce their spending, this could contribute to a more material economic downturn.

Mortgagors are facing much higher interest costs, but the vast majority appear well placed to continue to service their debts.

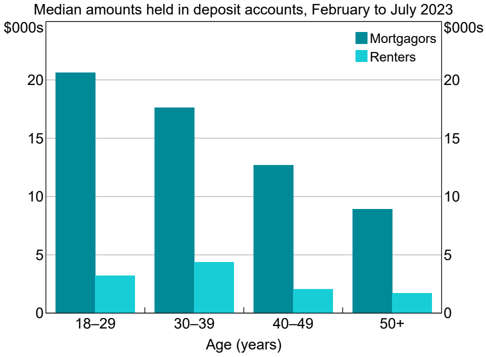
Mortgagors tend to have higher incomes than renters and have historically been less likely to experience financial stress. More recently, however, borrowers – except those still on low fixed rates – have faced substantial increases in their mortgage costs, with the majority having seen their payments increase between 30 and 50 per cent since April 2022 (Graph 5.3.6, all loans).

Mortgage payments represent an increasing share of borrowers' income. The share of variable-rate owner-occupier borrowers devoting at least one-third of their (reported) income to their mortgage payments has increased sharply, from around 4 per cent in April 2022 to around 20 per cent in July 2023 (Graph 5.3.7). This share is the highest among low-income mortgagors (defined as the bottom

Graph 5.3.4

Liquid Assets by Tenure and Age*

Median amounts held in deposit accounts, February to July 2023



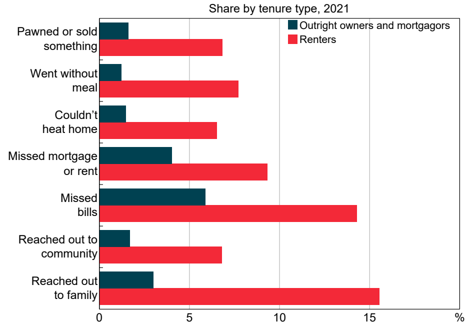
* Liquid assets include balances held in deposit accounts. Medians are interpolated from survey response buckets.

Sources: RBA; RFI Global's DBM Atlas.

Graph 5.3.5

Incidences of Financial Stress

Share by tenure type, 2021

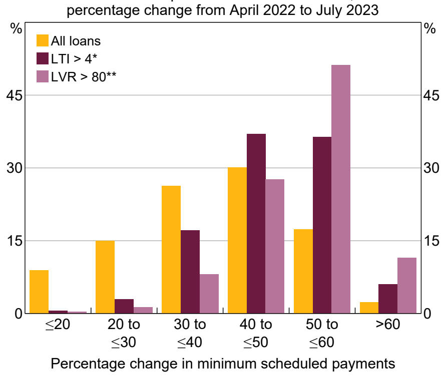


Sources: HILDA Survey Release 21.0; RBA.

Graph 5.3.6

Change in Minimum Scheduled Payments

Owner-occupier variable-rate borrowers, percentage change from April 2022 to July 2023



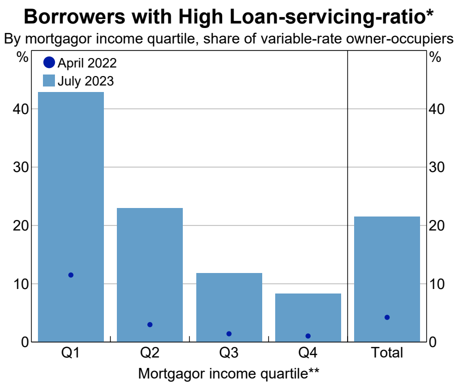
* LTI is current loan balance divided by estimated current household income. This is estimated by growing forward income reported at origination by WPI. Where original income is missing, borrower income is estimated using loan characteristics.

** LVR is offset and redraw adjusted loan balance divided by property price estimated using GCCSA price indices.

Sources: ABS; CoreLogic; RBA; Securitisation System.

quartile of mortgagor incomes – that is, borrowers with up to around $78,000 in household disposable income) at around 43 per cent.[6] By contrast, the share is around 8 per cent for borrowers in the highest mortgagor income quartile. Further, higher income borrowers can generally absorb the higher debt-servicing costs without becoming financially stressed because they tend to have significant income relative to essential spending needs (see Graph 2.8 in Chapter 2: Resilience of Australian Households and Businesses).

Graph 5.3.7



* Borrowers with loan-servicing-ratio exceeding 30 per cent.
** Based on the distribution of variable-rate owner-occupier borrower incomes.
Sources: ABS; RBA; Securitisation System.

Borrowers with larger loans relative to their income ('higher LTI') or relative to the value of their property ('high LVR') are more likely to face financial stress.[7] Since interest rates increased in May 2022, higher LTI loans and high-LVR loans tend to have seen larger increases to their scheduled minimum payments compared with other variable-rate owner-occupier loans (Graph 5.3.6).[8] As a result, these borrowers are much more likely to struggle to meet their essential spending needs. About 25–50 per cent of higher LTI borrowers and about 15–32 per cent of high-LVR borrowers are estimated to have an income level not sufficient to meet their housing costs and necessary expenses, compared with 5–13 per cent for all variable-rate owner-occupier borrowers, depending on assumptions about essential expenses (Graph 5.3.8).[9]

Higher LTI variable-rate owner-occupier borrowers whose essential expenses and housing costs exceed their income tend to have only slightly lower savings buffers than all borrowers in a similar financial position (irrespective of the Household Expenditure Measure (HEM) used to capture essential expenses). By contrast, high-LVR borrowers tend to have substantially lower savings buffers and are hence most at risk of entering mortgage stress (Graph 5.3.9).[10] Consistent with this, higher LTI and in particular high-LVR borrowers have higher arrears rates than other borrowers (see Graph 5.2.3 in 5.2 Focus Topic: An Update on Fixed-rate Borrowers).

By contrast, other groups of borrowers do not appear to be materially more at risk and have broadly similar or lower arrears rates to other borrowers (see Graphs 5.2.2 and 5.2.3 in 5.2 Focus Topic: An Update on Fixed-rate Borrowers). These include:

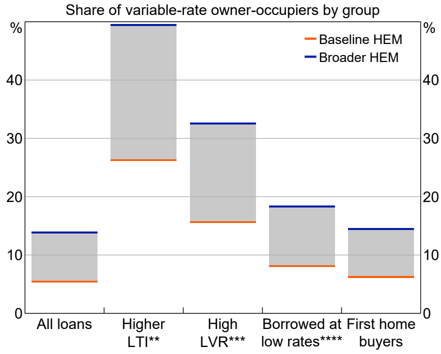
- *Those who borrowed at low fixed or variable rates during the COVID-19 pandemic* and are now on higher variable rates (accounting for 25 per cent of outstanding variable-rate owner-occupier loans by volume). The estimated share of borrowers in this group whose income does not meet their cost of living ranges between 8 and 18 per cent (depending on the measure of essential expenses used) – which is not significantly different to all other borrowers in a similar financial position. This is despite these borrowers having had less time to repay the principal on their loan and therefore often having larger loan sizes, and the fact that their borrowing capacity at loan origination was assessed at an interest rate below their current rate. Moreover, these borrowers have broadly similar savings buffers to other borrowers.

- *First home buyers*. These borrowers tend to take out loans with high LVRs as saving for a deposit can be difficult; by contrast, previous home buyers tend to have accumulated equity in their properties.[11] Despite some recent first home buyers having higher LVRs (and hence lower equity in case of needing to sell if in stress), between about 6 and 14 per cent are estimated to have living costs that exceed their income, which is similar to all variable-rate owner-occupiers. This group also has similar savings buffers to other comparable borrowers.
- *Investors*. While investors have seen similarly large increases in their interest payments compared with owner-occupier borrowers on the same interest-rate type, most are likely well placed to service their debts. This is because investors tend to have higher incomes and savings than other households and have seen their rental income increase strongly over the past year or so (albeit generally not sufficient to offset the increase in mortgage costs). Moreover, investors are more likely than owner-occupiers to sell their properties to avoid financial stress.

Graph 5.3.8

Estimates of Borrowers with Cost of Living Exceeding Income*

Share of variable-rate owner-occupiers by group

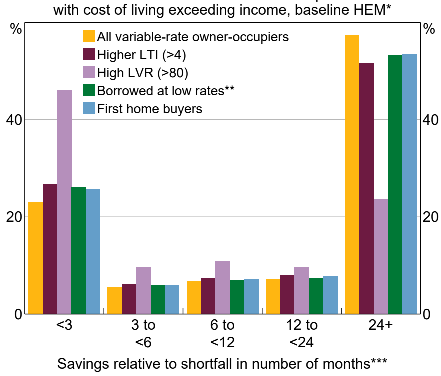


* Estimates of borrowers with mortgage payments and essential expenses (HEM) in excess of their income as at July 2023.
** Borrowers with loan-to-income ratio exceeding 4.
*** Borrowers with loan-to-valuation ratio exceeding 80.
**** Borrowers who borrowed between March 2020 and April 2022.
Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Graph 5.3.9

Mortgage Buffers Relative to Cash Flow Shortfalls

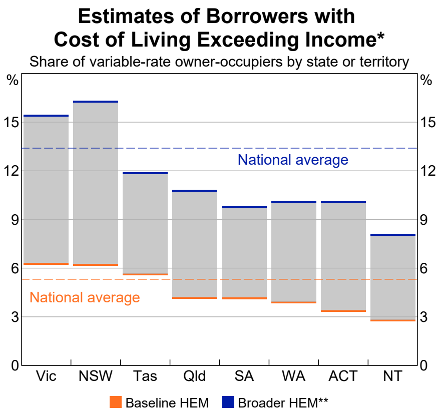
Share of variable-rate owner-occupiers with cost of living exceeding income, baseline HEM*



* Includes variable-rate owner-occupier borrowers who are estimated to be in cash flow shortfalls as at July 2023 under assumptions using the baseline HEM and income growth in line with WPI growth since loan origination.
** Borrowed between March 2020 and April 2022.
*** Number of months that mortgage prepayments (offset and redraw balances) can cover cash flow shortfalls.
Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Financial stress does not vary much across Australia. This is despite borrowers in some regions having seen larger increases in their loan payments (relative to their incomes) – for example, New South Wales and Victoria have the highest shares of borrowers devoting at least one-third of their incomes to their mortgage expenses. Housing prices (and thereby loan sizes) largely drive these differences. While the share of borrowers estimated to have their cost of living exceed their income is higher in these states, it is not significantly so, with the shares ranging between 6 and 16 per cent depending on HEM assumptions (Graph 5.3.10). In turn – and supported by the tight labour market across most of Australia – loan arrears remain relatively low, at less than 1 per cent across all states and territories (Graph 5.3.11).

Graph 5.3.10

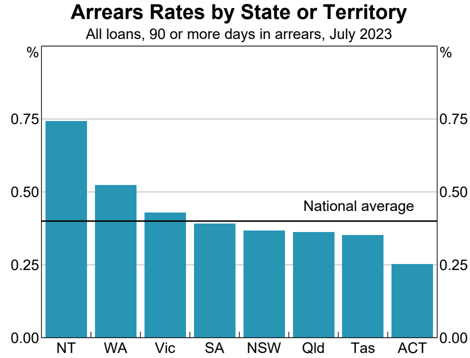


* Estimates of borrowers with mortgage payments and essential expenses (HEM) in excess of their income as at July 2023 under assumptions using the Household Expenditure Measure and income growth in line with WPI growth since loan origination.

** This factors in some other expenses that are excluded from the baseline HEM (mainly private health insurance and private school fees).

Sources: ABS; Melbourne Institute; RBA; Securitisation System.

Graph 5.3.11



Sources: RBA; Securitisation System.

Endnotes

[1] Adapted from Bullock M (2018), 'Household Indebtedness and Mortgage Stress', Address to the Responsible Lending and Borrowing Summit, Sydney, 20 February.

[2] Data are from RFI Global's DBM Atlas that collects information on the financial position of around 26,000 Australian consumers through a variety of methods.

[3] Hanmer F and M Marquardt (2023), 'New Insights into the Rental Market', RBA *Bulletin*, June.

[4] Based on data from the HILDA Survey.

[5] RBA (2023), 'Box B: Scenario Analysis on Indebted Households' Spare Cash Flows and Prepayment Buffers', *Financial Stability Review*, April.

[6] By comparison, the bottom quartile of all household incomes extends to around $50,000 (based on data from Wave 21 of the HILDA Survey, grown forward by WPI growth), reflecting that mortgagors tend to have higher incomes than other households.

[7] RBA (2021), 'Chapter 5: Mortgage Macroprudential Policies', *Financial Stability Review*, October.

[8] Higher LTI loans are defined as LTI greater than 4, which accounts for around 14 per cent of variable-rate owner-occupier loans. APRA considers loans with a total debt-to-income (DTI) ratio of 6 as higher risk loans. This is not directly comparable to our threshold choice of an LTI greater than 4 because it relates only to the size of the loan, not all debt a borrower holds. Using a threshold of 6 as a definition of high-LTI loans captures around 2 per cent of loans outstanding.

These borrowers tend to have seen even larger increases in their scheduled minimum payments and are much more likely to not have enough cash flow (around 70 per cent). While this group is therefore much more likely to be in financial stress, focusing on this group risks missing a larger group of borrowers that are also at risk of entering financial stress as interest rates increase. High-LVR loans are defined as LVR greater than 80 per cent, which accounts for around 3 per cent of variable-rate owner-occupier loans.

[9] See 'Box: Assumptions underlying estimates of borrowers' essential expenses and income' in Chapter 2: Resilience of Australian Households and Businesses.

[10] Previous work has found that borrowers with higher debt-to-income ratios (which captures a borrower's total debt, including loans on other properties such as investment properties) tend to have larger savings buffers. This is mostly driven by investors who are more likely to have larger debts and larger liquidity buffers than owner-occupier borrowers considered here. Consistent with evidence presented here, previous work also found that high-LVR borrowers continue to have noticeably lower liquidity buffers many years after they take out their mortgages (RBA, n 7).

[11] See RBA, n 7.