



A Closer Look At The Canadian Debt Situation

by Benjamin Tal and Avery Shenfeld

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

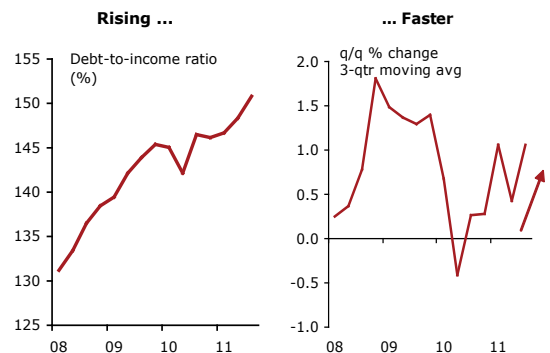
Emanuella Enenajor
(416) 956-6527
emanuella.enenajor@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

The rise in the debt-to-income ratio in Canada continues to receive a lot of attention. The record-high 151% as of the third quarter of 2011 is clearly a headline maker. But in order to have a serious discussion regarding the household debt situation in Canada we have to go much deeper than the headline number and try to assess what it really means. The following is a very brief discussion of some of our recent findings on this issue.

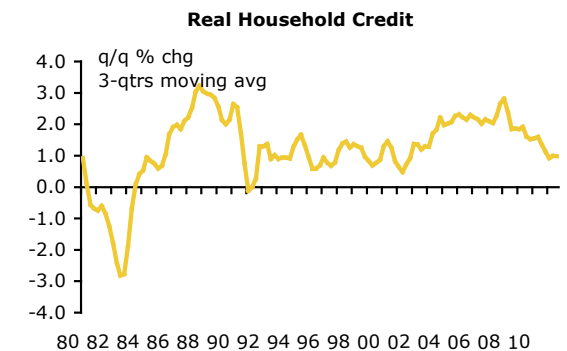
- As of the third quarter of 2011, the ratio of household debt to disposable income was 151%—a record high. The pace at which this ratio is rising has accelerated over the past three quarters and it is now rising by more than 1% per quarter on a three-quarter moving average basis (Chart 1).
- This acceleration is taking place despite a clear slowing in the pace of borrowing. As of 2011Q3, adjusted for inflation, the quarterly growth in personal (non-mortgage) credit is now flat on a three-quarter moving average basis—the slowest pace since the early 1990s. Quarterly growth in real mortgage outstandings is currently at just over 1% on a three quarter moving average basis, hovering around the slowest pace in a decade. As a result, overall real household credit is now expanding at a year-over-year rate of less than 4% and a quarterly rate of just under 1%—the slowest showings since 2001 (Chart 2).

Chart 1
Canadian Household Debt-to-Income Ratio



Source: Bank of Canada, CIBC

Chart 2
Real Household Credit is Rising at the Slowest Pace Since 2001

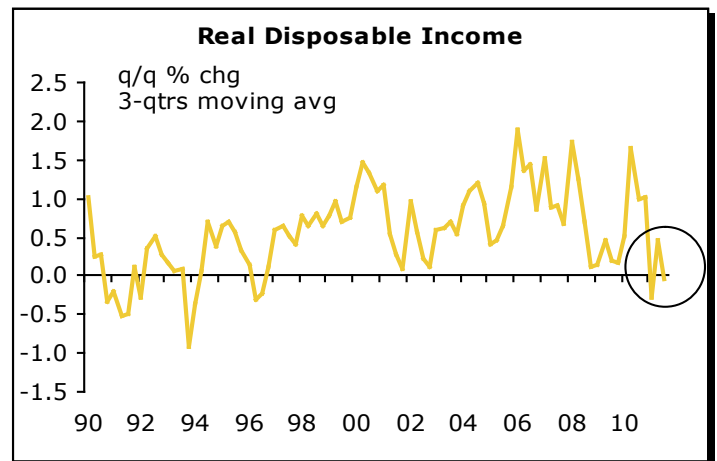


Source: Statistics Canada, CIBC

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

- The main reason for the acceleration in the pace of the increase in the debt-to-income ratio is the income part of that measure. Real disposable income in Canada is now flat on a three-quarter moving average basis—the weakest showing since 1996 (Chart 3). Even during the recent recession, real income was rising faster. So, at this point, it is not a debt problem. It is an income problem. Some of the recent weakness in real incomes reflected a spike in food and energy inflation that depleted the buying power of the average wage. We expect a levelling in food/energy prices to lead to some improvement on that front.

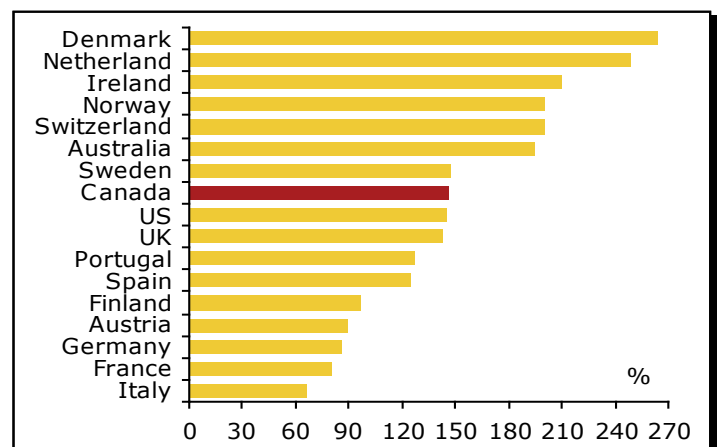
Chart 3 – Growth in Real Disposable Income is at a 15-year Low



Source: Statistics Canada, CIBC

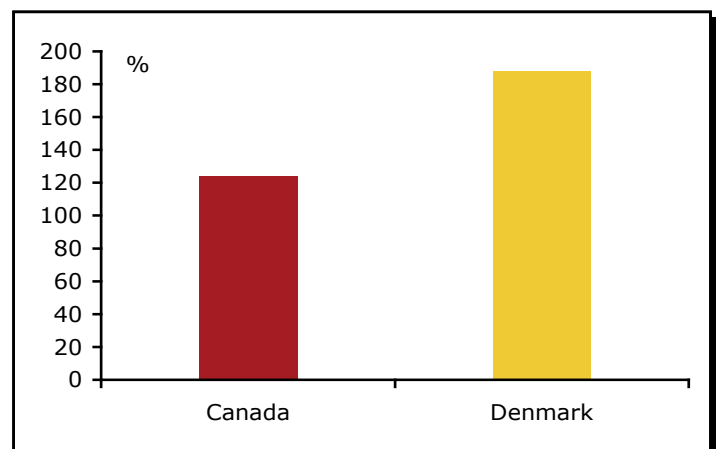
- But regardless what the source of the problem is, the debt-to-income ratio is elevated. Is there a critical threshold for this ratio that suggests an imminent derailing of the credit market as we know it? Well, focusing on other countries, we can see that in the developing world there are no less than seven countries with a debt-to-income ratio well higher than we see in Canada, most of which have not (yet) seen a credit crisis. Granted some of these countries are welfare-economies such as Denmark and Sweden where the debt-to-income ratios are well over 250% (Chart 4). A high level of taxation in those countries suggests a lower average disposable income and thus, an elevated debt-to-income ratio. But when we control for this factor by comparing the debt level to pretax income, we find that the level of household debt in these countries is still much higher than in Canada. For example, the ratio of debt-to-pretax income in Denmark is 188% vs. 122% in Canada (Chart 5).

Chart 4 – Debt-to-Income Ratio by Country (2011Q1)



Source: ECB, Bank of Canada, CIBC

Chart 5 – Debt-to-Gross Income Ratio (2010)



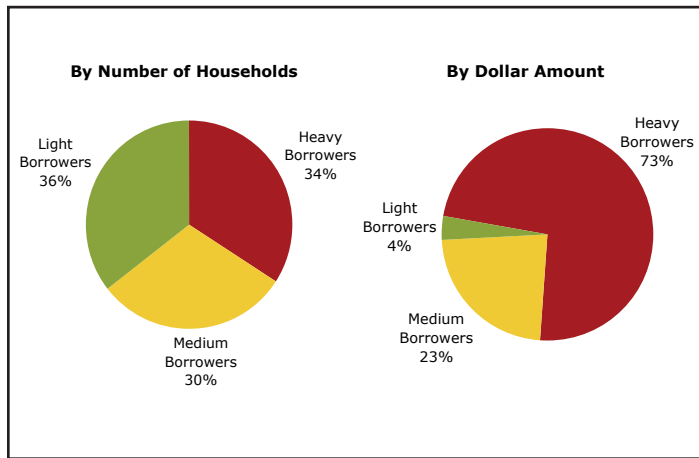
Source: IMF, CIBC

- All of this suggests that merely looking at a single measure, the debt-to-income ratio, does not tell the full story for either credit risks or the room for further growth in debt-financed activity.

- A deeper dissection of the data is therefore necessary. The headline debt-to-income ratio measures total household debt in the economy relative to total personal income (including the income of people with no debt). A much more meaningful measure will be the debt-to-income ratio of households *with* debt. And that’s exactly what we did in our micro, survey-based research. The following are some of the highlights:

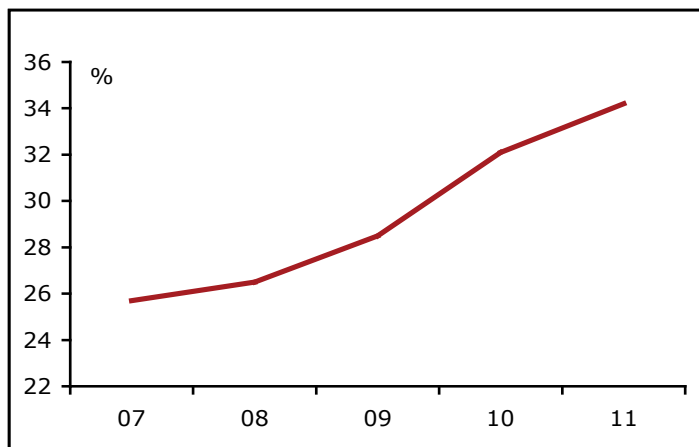
- We divided the pool of Canadian households with debt into three categories: heavy borrowers, medium borrowers and light borrowers. Heavy borrowers are defined by those with a debt-to-gross income ratio of more than 160%. This group accounts for one-third of total borrowers but for over 70% of total debt outstanding (Chart 6).
- The number of heavy borrowers is rising. In 2007, this group accounted for 26% of borrowers, today it accounts for 34% (Chart 7).
- BC and Alberta have the largest proportion of heavy borrowers (40% and 38% respectively). Atlantic Canada and Quebec have the lowest proportion of heavy borrowers (Chart 8).

Chart 6 – Composition of CDN Household Debt



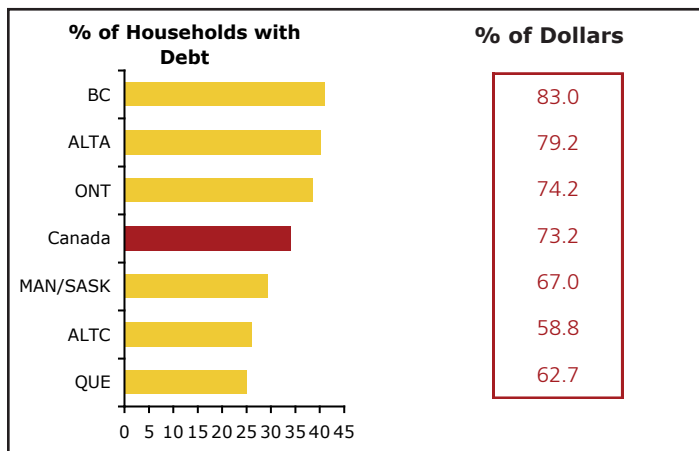
Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio.
Source: Canadian Financial Monitor, CIBC

Chart 7 – Number of Households with Heavy Debt Load on the Rise



Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio.
Source: Canadian Financial Monitor, CIBC

Chart 8 – Heavy Borrowers



Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio.
Source: Canadian Financial Monitor, CIBC

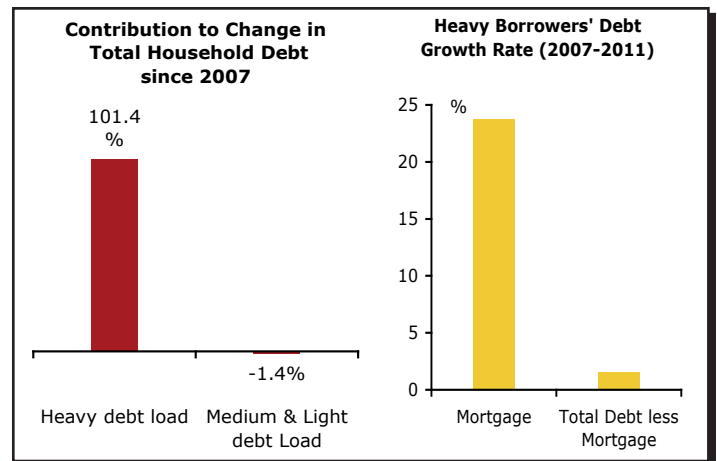
➤ Those households that are heavily in debt accounted for all the increase in debt since 2007, and most of the increase in their debt was mortgage debt (Chart 9). Rather than seeing growth in the use of debt from those with the most room to borrow, families deeper in debt are piling on more.

➤ Heavy borrowers are getting older. The share of heavy borrowers in the age group 45+ has risen from 36% in 2007 to 44% in 2011 (Chart 10). No less than 20% of heavy borrowers are over the age of 55. This is significant since it implies that as those heavy borrowers approach retirement, their focus will be on deleveraging. The rising number of this group suggests that the deleveraging force will be more significant in the future. We also see a clear upward trend in the number of personal bankruptcies among individuals over the age of 50.

➤ A look at net financial position of households also reveals a significant gap between the different groups. While the headline net financial wealth position was relatively stable over the past few years, it masks a situation in which the net financial position of heavy borrowers has worsened not only because of the increase in their debt position, but also due to the fact that the pace of appreciation of their financial assets has lagged the pace seen among light and medium borrowers (Chart 11).

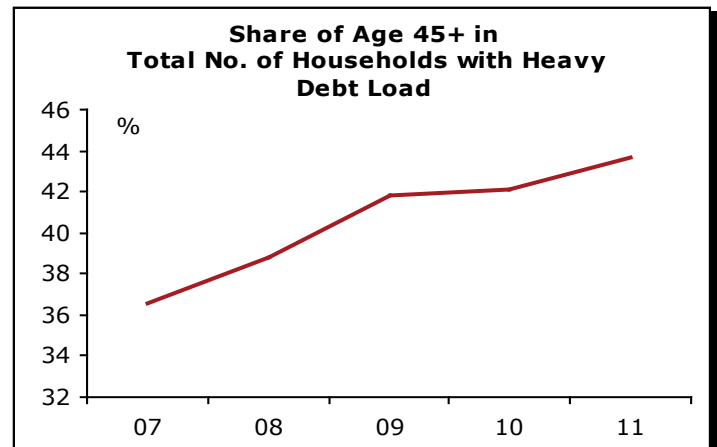
➤ Zooming in on the differences between the spending habits of heavy and non-heavy borrowers, and controlling for age and family compositions, we found that as a percentage of income, most of the debt service related expanses enjoyed by non-heavy borrowers is channeled towards savings, as we found no significant difference in their spending habit relative to heavy borrowers.

Chart 9 – Heavy Borrowers Accounted For All The Increase in Debt Since 2007



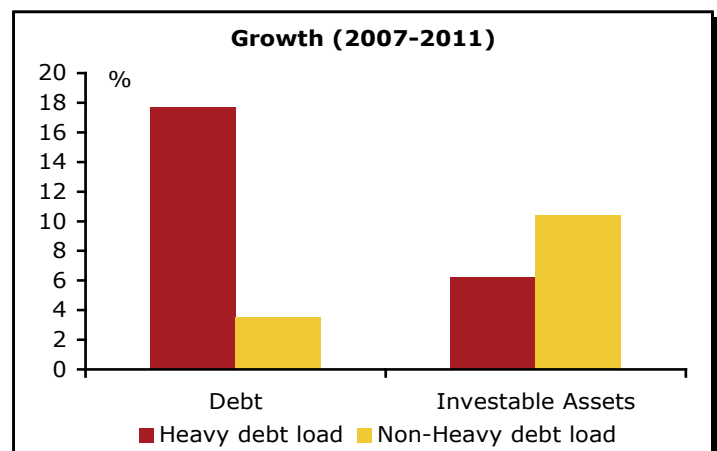
Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio. Source: Canadian Financial Monitor, CIBC

Chart 10 – Heavy Borrowers Are Getting Older



Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio. Source: Canadian Financial Monitor, CIBC

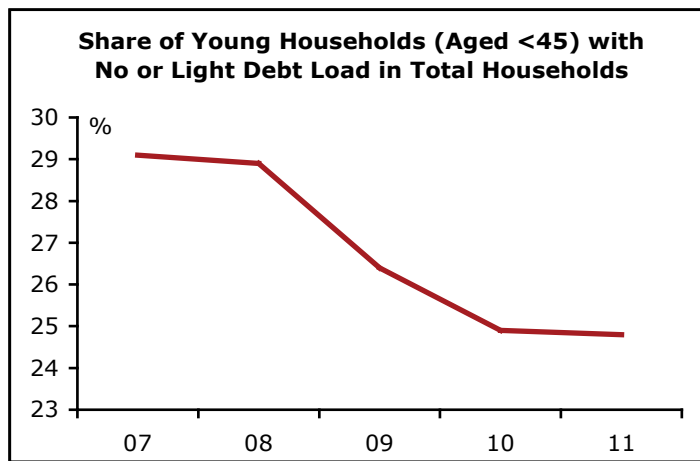
Chart 11 – Heavy Borrowers: More Debt, Less Capital Appreciation



Heavy Borrowers are those with ≥ 1.6 debt-to-gross income ratio. Source: Canadian Financial Monitor, CIBC

- The size of the potential borrowing pool (households age less than 45 with no or little debt) is shrinking, but it is still sizable—accounting for almost one in four households in the country (Chart 12). That represents a key target for future lending growth.

Chart 12 – The Target Group



Source: Canadian Financial Monitor, CIBC

Bottom line:

While the headline numbers can be misleading and do not imply an imminent derailing of the credit market any time soon, a close look at the micro data suggests that the composition of the debt situation in Canada is worsening—largely due to the fact that all the growth in debt over the past five years was among those heavily in debt. It also means that no less than two-thirds of households with debt have a reasonable or even too low debt load (given where interest rates are) suggesting some potential opportunities for growth. With interest rates remaining low for a while, the trajectory of heavy borrowing in the coming year or two will be an important variable to focus on. To the extent that a growing portion of future credit growth comes from those with a relatively light debt load, credit can continue to expand with a very limited increase in risk.

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