Debt Dashboard: Digging beyond the household debt headlines

June 2017

Scorching housing activity and rising household debt have garnered a fair share of negative headlines in Canada. We acknowledge that some of the concerns are valid, especially given that households continue to take on debt and the debt-to-income ratio clocks in at record highs nearly every quarter. The increases have been supported by healthy labour markets and low interest rates, but the bigger risk is what happens when rates rise.

This brief note takes a look at a few of the hot spots we are watching as well as some of the mitigating factors.

Key hot spots to watch:

Of concern...

- Interest payments on non-mortgage debt are equal to the total interest costs associated with mortgages, despite total non-mortgage debt balances being lower
- Auto loans make up ~15% of consumer debt, and delinquency rates have been rising
- The aggregate value of home equity in Canada is lower once home equity lines of credit are taken into account
- 1 in 10 older age households had debt in excess of $100K in 2016, posing potential challenges for future retirement security
- If rates were to rise 100 basis points over the next year, households, in aggregate, would have to allocate an additional 2 cents of every $1 of income to servicing debt

But on the bright side...

- One-third of households in Canada are debt free and 25% owed less than $25K in 2016
- Mortgage delinquency rates remain low at only 0.3%
- Household assets exceed outstanding debt balances by a measure of nearly 6 to 1
- Ongoing hiring gains are expected drive the unemployment rate modestly lower through the forecast horizon and help to contain household risks

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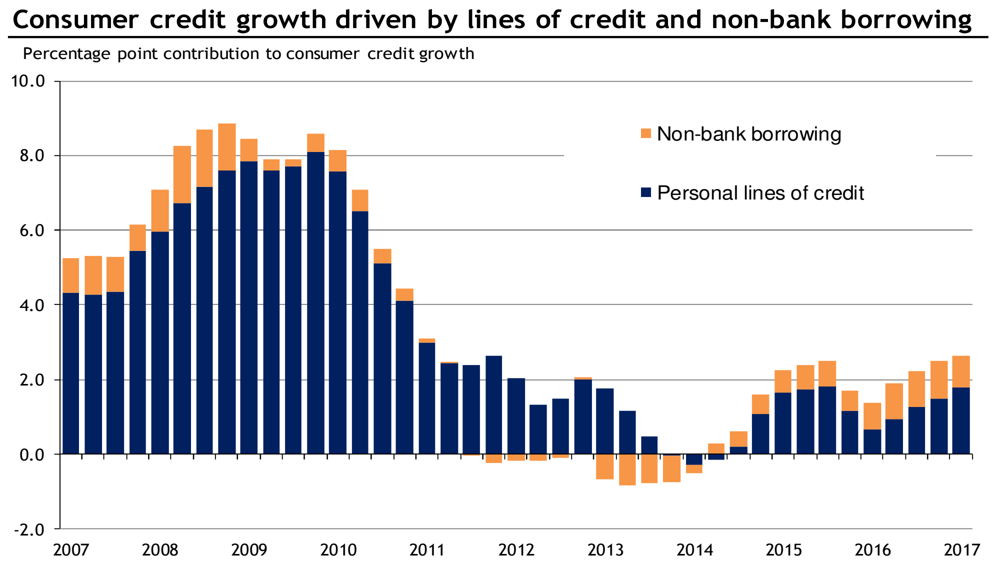
Our Watch List—

#1—Accelerating consumer credit growth

Consumer credit ramped up over the past year to reach the quickest pace since late 2011. Growth remains low when compared to the rates seen leading up to the 2008/09 recession, but there are risks alongside the uptrend given exposure to rate increases.

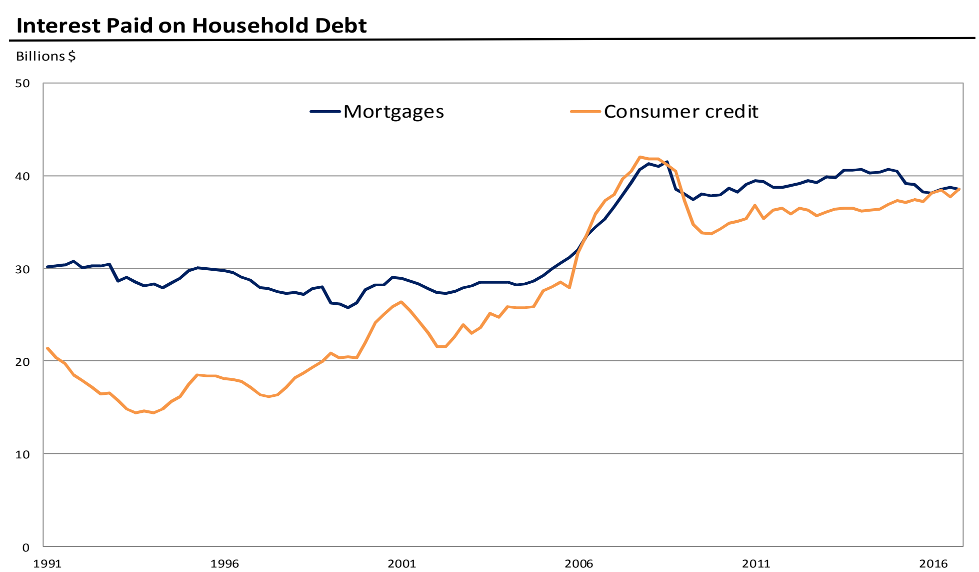
Personal lines of credit are driving consumer credit growth higher



Source: Bank of Canada, RBC Economics Research

Interest payments for consumer credit—which accounts for ~30% of household debt—are equal to the total interest paid on mortgages. This debt tends to be tied to variable rates, so the ramp-up increasingly leaves households exposed to higher interest rates.

The effective interest rate on non-mortgage debt is twice that of mortgage loans

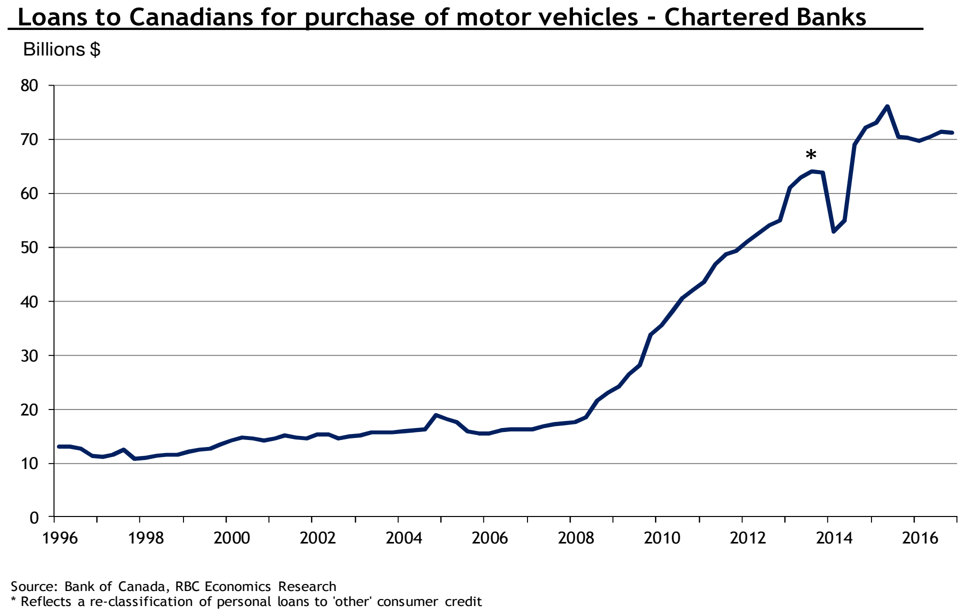


Source: Statistics Canada, RBC Economics Research

#2—Auto loans—Four years of record pace

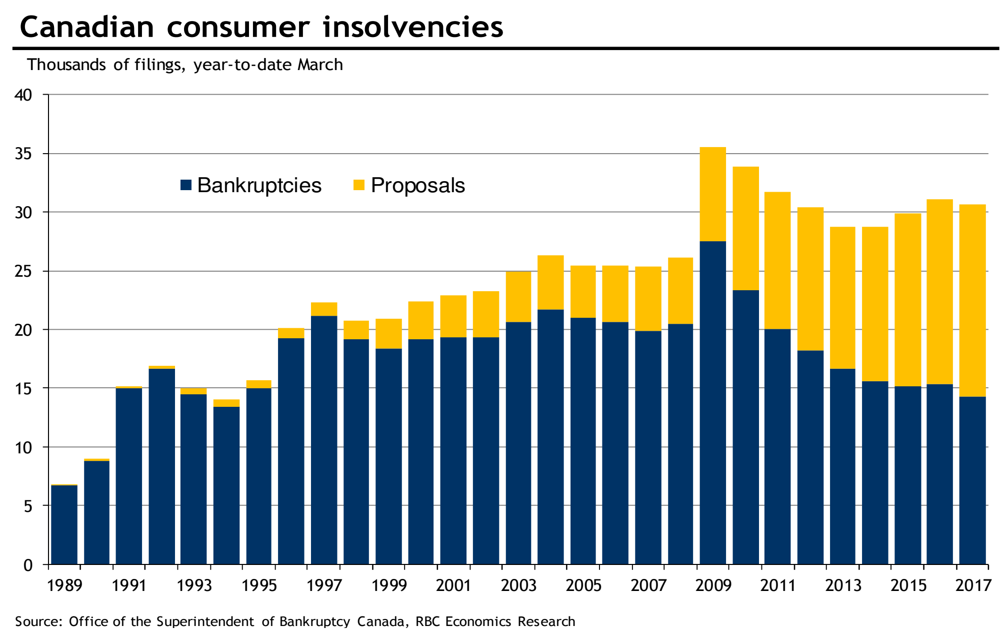
Car sales set records in each of the past 4 years and there has been a 4-fold rise in auto loans over the past decade. Taking into account all lenders, non-prime borrowers are taking on car loans at a higher rate than prime borrowers. With these riskier loans at 25% of the market*, a rise in delinquencies remains a risk.

Rapid growth in car loans



The number of households filing for bankruptcy has been falling in Canada since changes came into effect in 2009 that made filing for bankruptcy more difficult**. But more households are filing proposals to re-negotiate the terms of their debts. These include paying creditors a share of the debt owed, or extending the time to pay debt.

Upswing in number of households wanting to settle debts under conditions other than existing terms



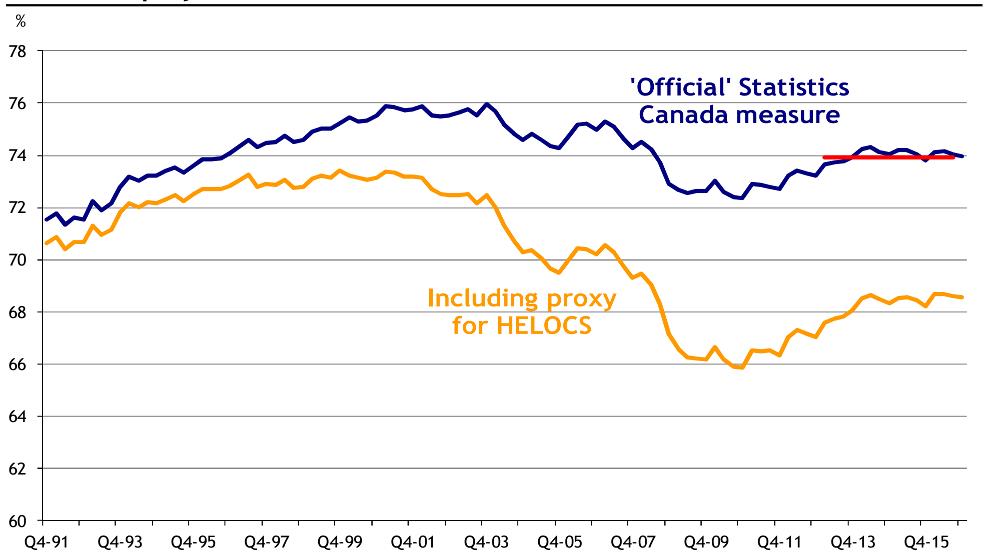
*Bank of Canada *Financial System Review,* June 2015.
** Summary of changes—http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01782.html

#3—Borrowing against home values lowers the equity stake in real estate

The aggregate value of home equity in Canada is lower once balances on home equity lines of credit are taken into account. The headline 74% real estate equity is lower when a proxy for these lines of credit is incorporated.

Aggregate home equity overstates the cushion provided to homeowners should home values decline

Owners' equity as a % of real estate



Source: Statistics Canada, Bank of Canada, RBC Economics Research

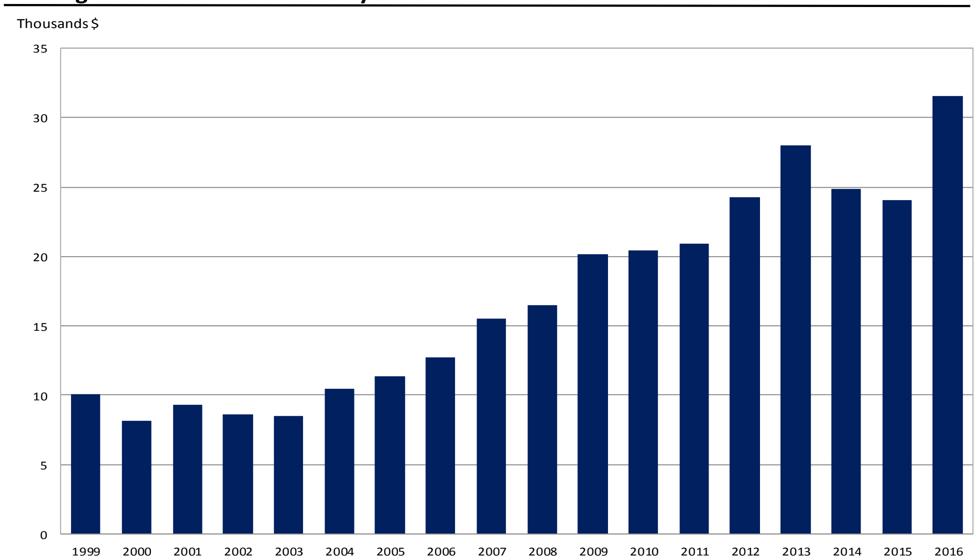
#4—Rising debt loads of older age cohort

1 in 10 households over the age of 65 had debt in excess of $100K in 2016. Lines of credit accounted for most of the increase amongst this age cohort over the past decade.

More than half of these credit lines are at variable rates, leaving this group exposed to interest rate increases at a time when incomes tend to fall due to retirement.

Close to 25% of 65+ households have a secured line of credit, up from only 4% in 1999

Average Debt of Households 65 years and older

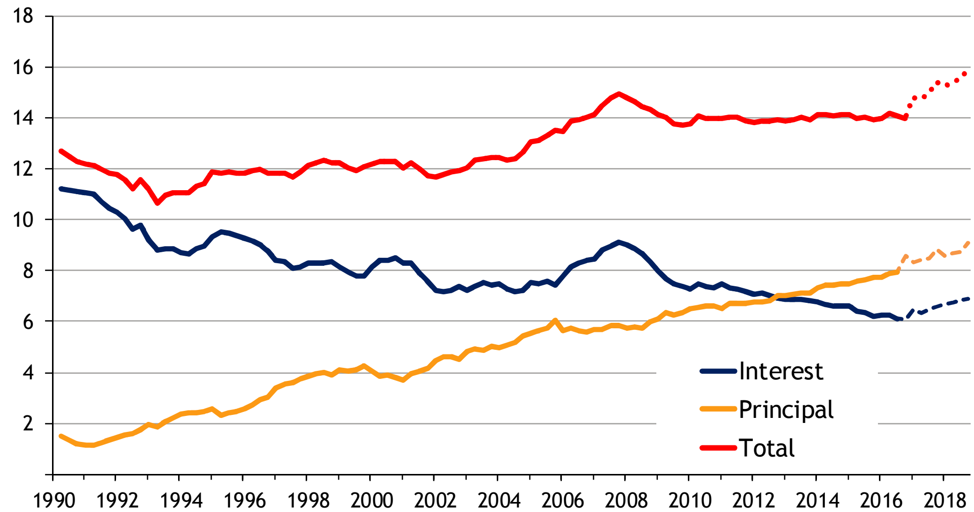


Source: Ipsos Reid Canadian Financial Monitor, RBC Economics Research

#5—Upward pressure on debt-servicing costs

A 100bp rise in interest rates over the next year would cost households an additional 2 cents of every $1 of income to service debt loads

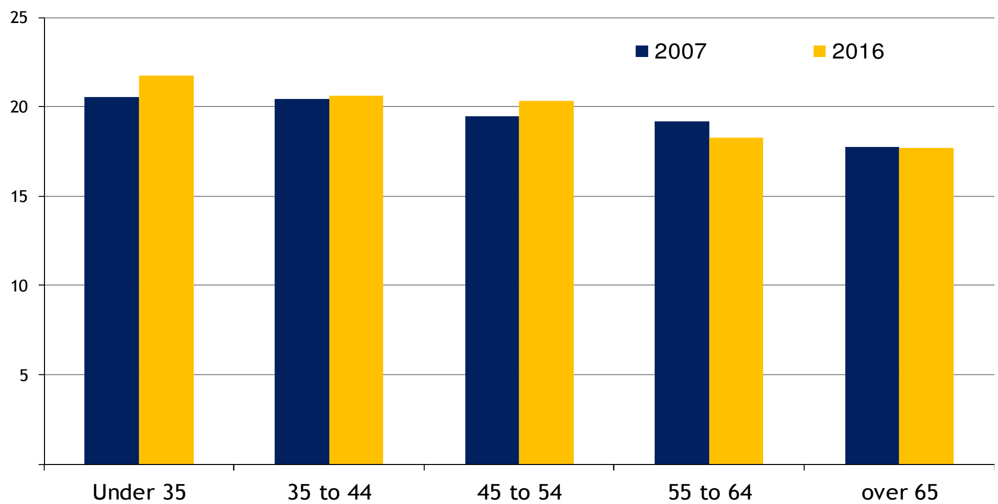
The share of income needed to service household debt in Canada has remained stable over the past several years. This has occurred despite interest rates declining, which suggests households used savings from lower interest payments to borrow more.



Source: Statistics Canada, RBC Economics Research

Debt-servicing costs rose for the average household under the age of 35 over the past decade as higher debt levels offset savings from lower borrowing rates. Most other cohorts saw stable to lower costs despite outstanding balances rising across age groups. Higher interest rates will intensify pressure on all households going forward.

Average debt servicing costs are highest for households under the age of 35



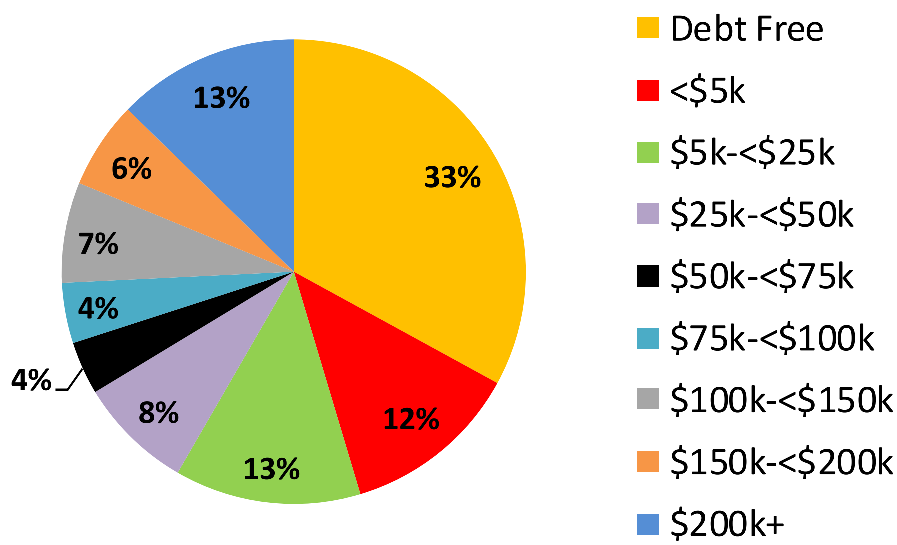
Source: Ipsos Reid Canadian Financial Monitor, RBC Economics Research

Monitoring, but not necessarily hot spots...

#1—One-third of household in Canada are debt-free

One-third of households in Canada were debt free and 25% owed less than $25K in 2016. Only one-third of households have a mortgage while homeownership rates are close to 70%.

The majority of households in Canada have little to no debt



Source: Ipsos Reid Canadian Financial Monitor, RBC Economics Research

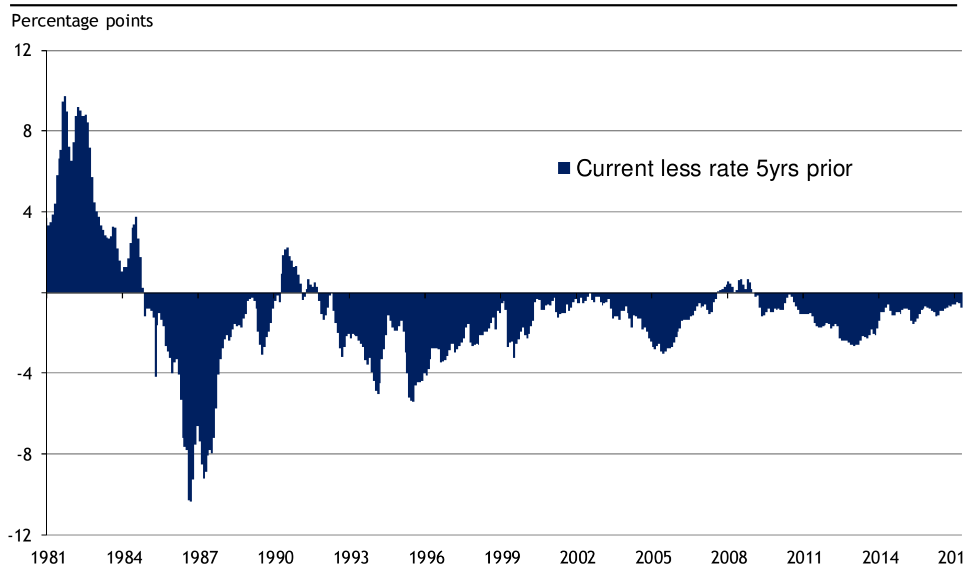
#2—Households have some insulation to higher rates in the short-term

The majority of mortgages in Canada are fixed-rate, which suggests that households will be exposed to higher interest rates gradually as they refinance at different times.

Households refinancing in the near term will face lower rates than they are currently paying—current 5-year posted mortgage rates are below the rates recorded 5 years ago. This provides some cushion to absorb higher borrowing rates over time.

Close to 60% of mortgages in Canada have 5-year terms and 75% of mortgages are locked in at a fixed rate

5yr conventional mortgage rate (5-year difference)

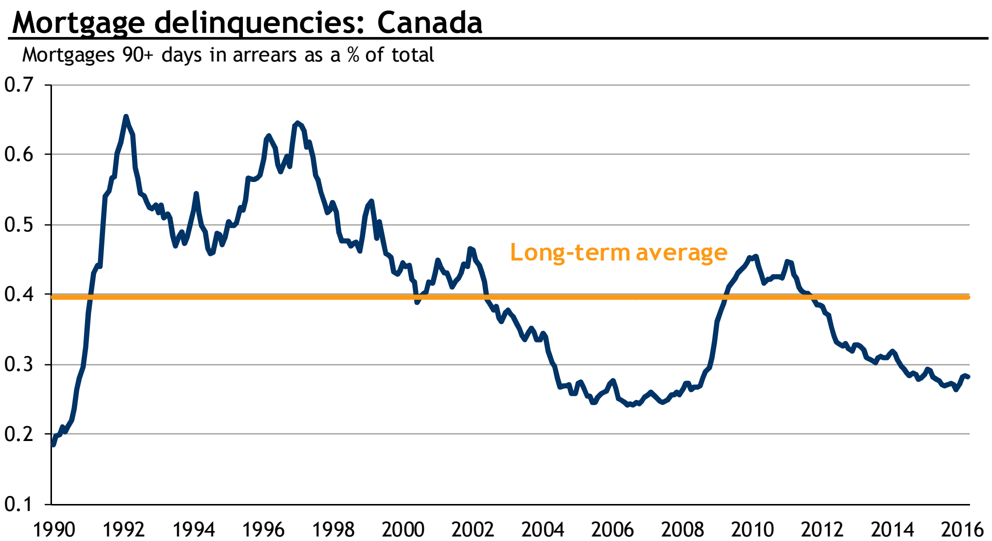


Source: Canada Mortgage and Housing Corporation, RBC Economics Research

#3—Mortgage delinquency rates remain low

Only 0.28% of mortgages are more than 90 days in arrears

Mortgage delinquency rates remain low in Canada. A rise in unemployment tends to coincide with delinquency rates. But ongoing hiring gains are expected to drive the unemployment rate modestly lower through the forecast horizon, containing defaults.

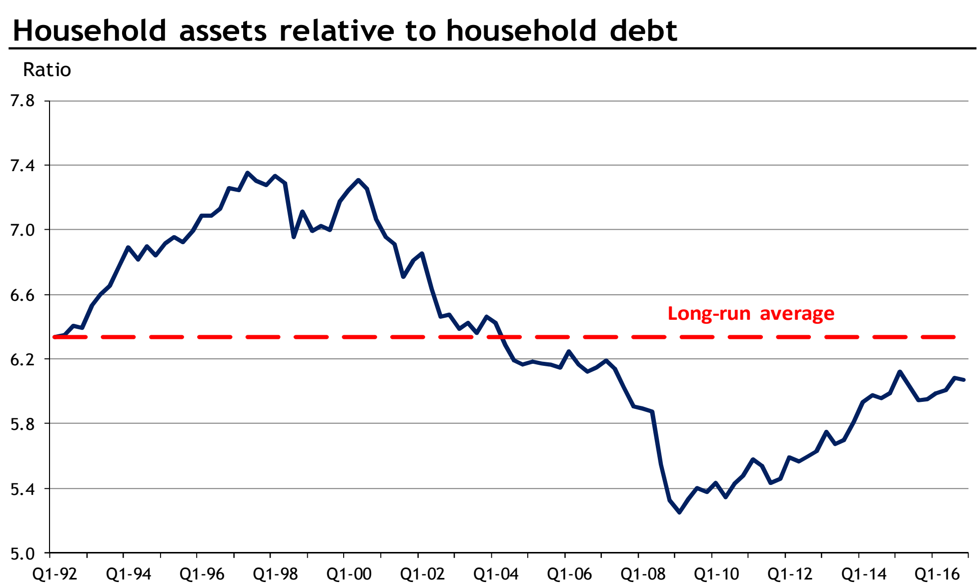


Source: Canadian Bankers' Association, RBC Economics Research

#4—Household asset gains reflect more than home price increases

The mix of household assets exceed outstanding debt by a measure of nearly 6 to 1

Rising household asset values capture more than home price increases with the mix of financial market and real estate assets on household balance sheets in line with its historical average. Financial and non-financial assets each exceed household debt by a measure of ~3 to 1.



Source: Statistics Canada, RBC Economics Research

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