CANADIAN CREDIT

August 2016

Checking the Pulse of Household Finances

Canadians have been accumulating debt at a steady clip of just over 5% for the past four quarters, as low interest rates, rising home prices and job growth fuel continued demand for credit. Canadian households owed a combined $1.94 trillion in the second quarter of this year. That was up 5.1% from the same period in 2015, only slightly slower than the first quarter's 5.2% pace. As the ongoing rise in outstanding debt balances leaves households increasingly vulnerable to an economic shock, this brief note looks at the current state of households' financial positions. In aggregate, rising asset values and low borrowing rates are underpinning the health of household balance sheets, although pockets of risks are emerging that warrant monitoring.

Signs of slowing for mortgages

Household credit growth continues to be driven by residential mortgage loans: they account for more than 70% of Canadians' outstanding debt balances. Mortgage growth clocked in at an annual pace of 6.2% in the second quarter, only slightly below the 6.3% rate seen the first quarter. Stimulative borrowing conditions and rising home prices in the hot housing markets of Toronto and Vancouver have underpinned demand for mortgages, which have increased both in number and in size[1].

There are signs that the tides for the residential mortgage market could be shifting. The recent slowdown in mortgage growth, though modest, followed two years of acceleration, and came amid evidence that national housing-market activity is beginning to cool. Rising home prices fuel mortgage growth and while tight supply conditions in the 'hot' markets may buoy home prices in the near term, an overall slowing in sales activity is likely to dampen mortgage accumulation in the coming quarters.

Uptick in consumer credit

As mortgage loan growth shows signs of stabilizing, the April to June 2016 period saw the first uptick in Canadians' appetite for consumer credit in a year and a half. The 2.6% annual increase in consumer credit balances (which consist of personal loans, lines of credit and credit cards) in Q2/16 marked a quicker pace of expansion than the 2.4% rate seen in the previous quarter (Chart 1).

Rising outstanding balances for personal lines of credit continue to be the predominant factor driving consumer credit accumulation (makes up nearly 50% of consumer credit); however, the 2.0% year-over-year increase in Q2/16 is well below the rates of increase recorded in this component over the 2008 to 2010 period (Chart 3). This slower rate of growth reflects a shifting preference of homeowners towards mortgages, in part, due to ongoing low mortgage rates (Home equity lines of credit make up the bulk of personal lines of credit and account for approximately 40% of overall consumer credit)[2].

Chart 1

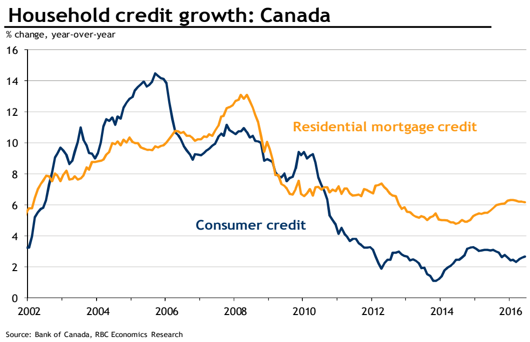


Chart 2

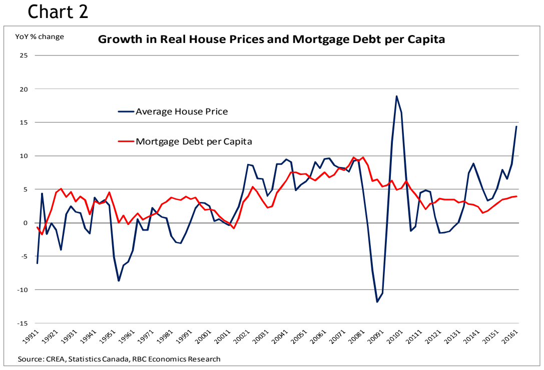
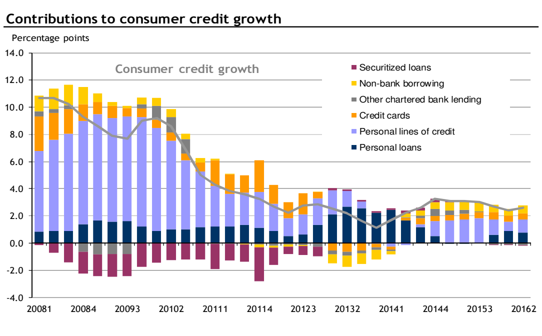


Chart 3



Laura Cooper
Economist
416-974-8593
laura.cooper@rbc.com

Chart 4

Loans to Canadians for purchase of motor vehicles - Chartered Banks

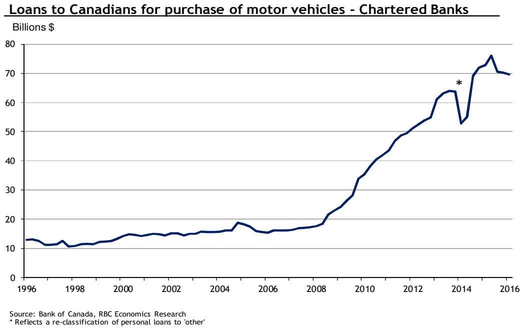


Chart 5

Household Asset Growth

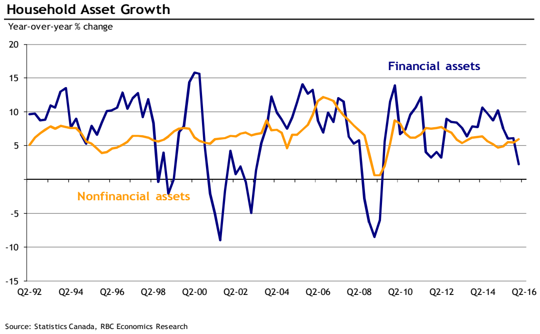
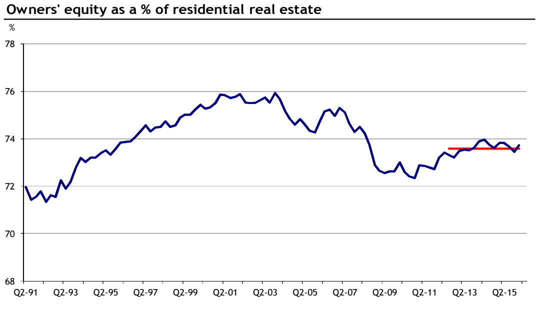


Chart 6

Owners' equity as a % of residential real estate



Driving up the balances

Strengthening demand for personal loans has also emerged in recent quarters against a backdrop of robust vehicle sales in Canada. Motor vehicle loans to households from Chartered banks have trended sharply higher since 2008 (Chart 4). Outstanding car loans still account for a relatively small share of total consumer credit; however, the rapid growth in this component has garnered more attention from the Bank of Canada who cite it as "another symptom of excessive borrowing"[3]. Longer loan amortizations (70% exceeding 72 months) and a tendency towards non-prime borrowers are contributing to the Bank's cautionary tone towards elevated household indebtedness[4].

Rising asset valuations accompanying debt accumulation

Household debt accumulation has been accompanied by increases on the asset side of households' balance sheets. Notably, rising home prices have buttressed ongoing gains in real estates assets (which accounted for a record 88% of households' non-financial assets in Q1/16). At the same time, five consecutive quarters of negative year-over-year growth for the S&P/TSX composite contributed to downward pressure on financial assets with growth in equity and investment fund shares turning negative for the first time in Q1/16 since 2012. Additionally, life insurance and pension asset valuations have slowed sharply, rising by the slowest pace in Q1/16 since the 2008/09 recession.

Despite the headwinds, household asset values outpaced debt accumulation in recent quarters to reduce household leverage (as indicated by declining debt-to-asset and debt-to-net worth ratios). Leverage is often a lagging indicator of fragility in the financial system, however[5]. Rising collateral values mask the underlying build-up in household vulnerabilities stemming from debt accumulation. Concurrent increases in house prices and financial assets mask households' increased exposure to a sharp correction in asset prices. The risk of a pronounced price downturn nationally remains low; however, it underpinned the Bank of Canada's recent assessment that financial vulnerabilities are "elevated and rising, particularly in the greater Vancouver and Toronto areas"[6].

Vulnerabilities are not distributed evenly

The equity in real estate assets held by Canadian households sat at 74% in Q1/16 (Chart 6). This suggests that households, in aggregate, likely have the capacity to sustain a hit to home values should a price downturn materialize. That said, the distribution of debt across households has become increasingly skewed to those who have less capacity to cope with a shock such as "highly indebted younger" households. Moreover, with outstanding balances amounting to nearly $400 billion, highly leveraged households (as measured by debt-to-income ratios above 350%) are accounting for an increasing share of household debt (21% up from 13% pre-recession)[7]. It is these households who are likely to bear the greatest burden in the event of an adverse shock such as a spike in unemployment.

Debt service costs remain low...for now

Low interest rates have kept household debt obligations manageable despite outstanding credit balances rising to all-time highs. Principal and interest payments for mortgage debt and non-mortgage debt amounted to 7.9% and 6.2% in Q1/16, respectively. These have remained broadly unchanged since 2008 as households have taken on higher debt loads with the "savings" arising from declining borrowing rates. Pressure on households' ability to service current debt levels will intensify, albeit gradually, as strengthening economic growth prompts a gradual increase in borrowing rates. By our estimates, a 100bp rise in mortgage rates would require a typical household, buying at current prices, to dedicate an additional 6.2 percentage points of their monthly incomes to service their mortgage.

Balancing risks

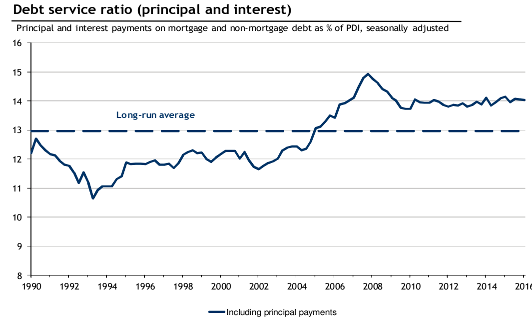
Household financial stress appears to be contained at this stage. The number of consumer bankruptcy filings year-to-date is broadly unchanged from a year-ago and sits at a level that is a multi-year low. Consumer proposals (a negotiation between a debtor and creditor to reduce the amount owing and/or to extend payment timelines) are edging higher; however, mortgage delinquency rates remain below their longer-run average in most provinces (the exceptions being the Atlantic region and to a lesser extent, Saskatchewan). Upward pressure on delinquency rates in oil-producing provinces is likely (given a typical 6-month lag between unemployment increases and delinquencies), although are increasing from still historically low levels.

Can the consumer continue to carry the (economic growth) load?

Robust increases in household asset values have coincided with firm consumer spending growth in Canada (Consumer expenditure has been the predominant driver of economic growth since the 2008/09 recession). That said, household net worth advanced at its slowest pace since 2009 in Q1/16. The persistence of this slowing trend and any attendant wealth effect could have implications for the sustainability of the consumer to continue to drive economic activity, even in the absence of an adverse macroeconomic shock. Should a shock materialize that leads to a housing market correction, the large run-up in household debt indicates a "more severe and longer-lasting" decline in household consumption than would otherwise have been the case[8]. The Bank of Canada assessed the risk of the latter materializing as low; however, the financial position of Canadian households suggests the cautionary tone evident in policy statements is unlikely to subside.

Chart 7

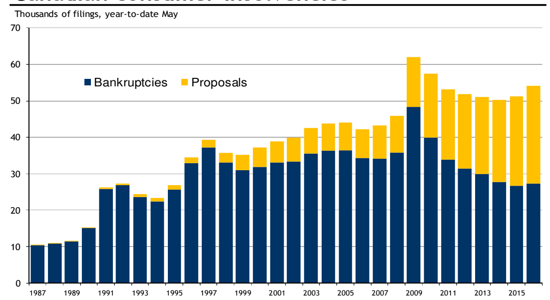
Debt service ratio (principal and interest)



Source: Statistics Canada, RBC Economics Research

Chart 8

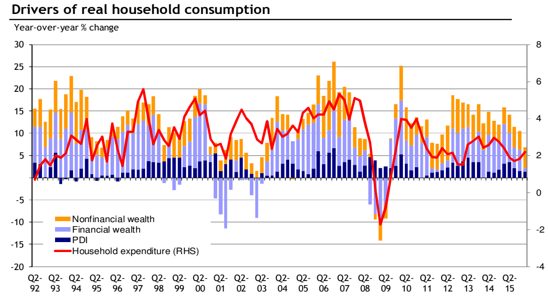
Canadian consumer insolvencies



Source: Office of the Superintendent of Bankruptcy Canada, RBC Economics Research

Chart 9

Drivers of real household consumption



Source: Statistics Canada, RBC Economics Research

Notes

1. Financial System Review: June 2016. Bank of Canada.
2. Financial System Review: December 2014. Bank of Canada
3. Financial System Review: June 2015. Bank of Canada.
4. Ibid
5. "Leverage? What Leverage? A Deep Dive into the U.S. Flow of Funds in Search of Clues to the Global Crisis". International Monetary Fund, June 2012.
6. Bank of Canada. Monetary Policy Statement. July 13, 2016.
7. Financial System Review: December 2015. Bank of Canada.
8. "World Economic Outlook. Chapter 3: Dealing with Household Debt". International Monetary Fund, April 2012.

Canada

As at the end of June, 2016	Outstandings (C$ billions)	Share of total %	m/m % change*	3-month % change*	y/y % change
Household markets					
Household credit	**1,948**	**100.0**	**7.7**	**6.0**	**5.1**
Consumer credit	**556**	**28.5**	**7.1**	**6.8**	**2.7**
Chartered banks	473	24.3	7.4	7.0	2.5
Personal loan plans	*97*	*5.0*	*7.0*	*4.3*	*3.9*
Personal lines of credit	*274*	*14.1*	*6.5*	*5.7*	*2.3*
Credit cards	*78*	*4.0*	*14.1*	*17.4*	*3.2*
Other	*19*	*1.0*	*2.0*	*8.1*	*-5.0*
Non-banks	70	3.6	6.8	6.1	4.3
Securitized loans	13	0.7	0.1	2.5	-0.6
Residential mortgages	**1,392**	**71.5**	**7.9**	**5.7**	**6.2**
Chartered banks	1,030	52.9	8.5	5.2	6.2
Non-banks	295	15.2	5.0	6.1	5.7
Securitized mortgages	66	3.4	12.7	11.1	8.0
NHA MBS	*56*	*2.9*	*15.1*	*-0.4*	*9.6*
Business markets					
Total business financing	**1,783**	**100.0**	**6.4**	**4.2**	**4.9**
Business loans	**669**	**37.5**	**7.1**	**5.3**	**7.5**
Non-mortgage loans	454	25.4	15.1	4.8	10.2
Chartered banks	331	18.5	21.2	6.9	12.1
Non-banks	121	6.8	-0.6	1.4	6.7
Securitized loans	2	0.1	-51.2	-50.1	-41.6
Commercial mortgage loans	**137**	**7.7**	**-0.1**	**0.7**	**3.5**
Chartered banks	58	3.3	5.5	6.6	9.7
Non-banks	75	4.2	-3.1	1.3	2.3
Securitized loans	4	0.2	-30.7	-30.9	-33.9
Bankers' acceptances	**79**	**4.4**	**-19.4**	**17.3**	**0.0**
Debt securities	**546**	**30.6**	**5.4**	**0.7**	**2.2**
Short-term (Commercial paper)	11	0.6	-65.0	-41.6	4.6
Long-term (Bonds)	535	30.0	7.9	1.9	2.1
Equities	**568**	**31.9**	**6.5**	**6.3**	**4.6**
Equities & warrants	533	29.9	6.2	6.4	4.7
Trust units	35	2.0	10.8	4.1	3.7

*Annualized growth rates

Source: Bank of Canada, Haver Analytics, RBC Economics Research