

CURRENT ANALYSIS

September 2015

A new indicator...and still carrying (heavy) debt loads

- **New light was shed on Canada’s relatively benign environment of low debt servicing costs with Statistics Canada yesterday releasing a new metric that helps to fill a gap in monitoring household financial stress.**
- **The more complete debt service ratio indicates only a moderate degree of stress on household finances despite elevated debt levels, although a greater amount than the interest-only metric alone would suggest.**

Despite the weak economic performance in Canada as evidenced by a negative print for real GDP growth in Q1/15 and again in Q2/15, Canadian households continued to ramp up their reliance on borrowing with outstanding debt balances reaching \$1.84 trillion in June, a 4.9% rise from a year ago to represent the quickest pace of accumulation in more than two years.

The persistence of historically low interest rates, and to a lesser extent, sustained income gains have kept the relative costs of servicing these debt balances at a record low; thus, helping to contain the financial stability risks posed by elevated household indebtedness. A new and more complete debt service metric released yesterday by Statistics Canada, however, indicates that the total costs of servicing outstanding balances (taking into account both principal and interest payments) is elevated on a historical basis (14.1%) (Chart 1).

Do servicing ratios appropriately reflect burden on existing balances?

The share of personal disposable income that is required to cover the interest-only expenses related to outstanding debt balances—the previous debt service ratio—eased to 6.4% in the second quarter of 2015 (i.e. 6.4 cents of every \$1 of disposable income is directed to interest payments). This represented the lowest level since records began in 1990 and continued the firmly entrenched downward trend that has been evident in the past number of years (Chart 1).

As with other household debt metrics, the debt service ratio depends upon aggregate levels in its determination—the total level of outstanding household debt payments and aggregate disposable incomes (ie. including incomes of the debt-free households, which account for roughly one-third of all households)¹. Resultantly, the ratio does not represent what a typical household in Canada actually pays with respect to the costs of servicing their debts. (This is particularly the case given that the Bank of Canada noted that 40% of outstanding debt balances are held by only 12% of households)². As well, this ratio takes into account only the interest payments associated with debt levels. Principal payments on outstanding debt balances—which have grown substantially over time—are also a factor in determining how much of a household’s disposable income is taken up by servicing record debt levels.

Chart 1

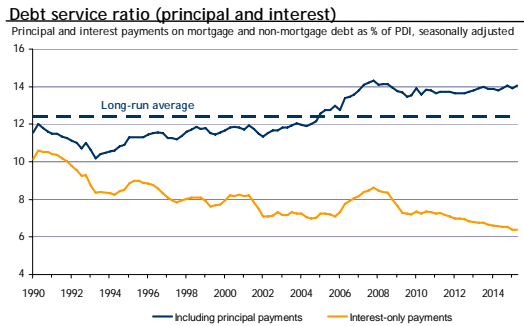
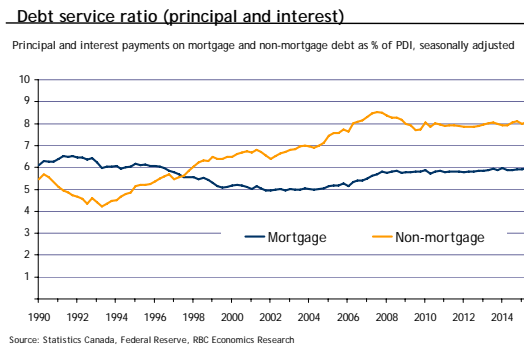
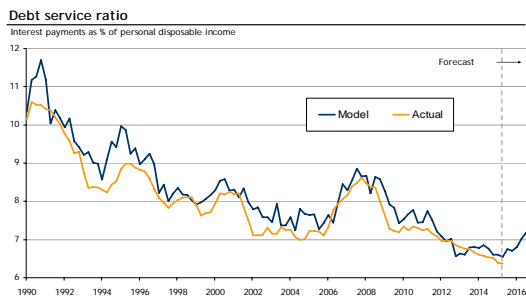


Chart 2



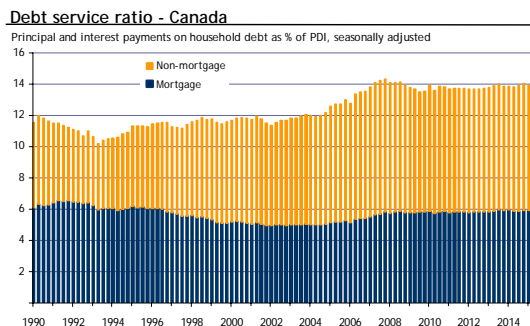
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Chart 3



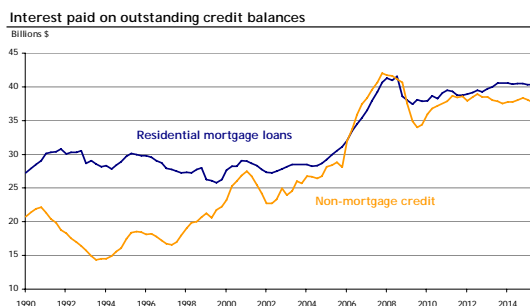
Source: Statistics Canada, RBC Economics Research

Chart 4



Source: Statistics Canada, RBC Economics Research

Chart 5



Source: Statistics Canada, RBC Economics Research

How does the inclusion of principal payments alter the overall payment ratio?

Statistics Canada released a total debt service ratio series to gauge the share of household disposable income that is devoted to overall debt servicing costs including principal payments (Chart 1). This measure is calculated from aggregate debt levels and aggregate incomes (and therefore underestimates the debt burdens faced by highly indebted households similar to the debt service ratio referred to above). The total debt service ratio incorporates interest payments on both mortgage loans and non-mortgage credit, akin to the interest-only debt service ratio. It also takes into account estimates for principal repayments on both types of loans³ (Chart 2).

Household debt service burdens have been restrained by the low interest rate environment with some Canadian mortgage holders able to reduce their regular payments when renewing their fixed-rate mortgages⁴. (At current market rates, homeowners renewing their mortgages, based on a five-year fixed term, are typically refinancing at lower borrowing rates). This has resulted in a sustained decline in the interest-only debt service ratio (Chart 1). The inclusion of the required principal repayments, however, indicates that the share of disposable income allocated to debt payments has not declined despite the low interest rate environment.

This expanded debt service ratio indicates that Canadian households, in aggregate, devote close to 14% of their disposable incomes to costs associated with servicing outstanding debt balances. The measure remained relatively steady over the past several years as rising debt levels offset the decline in financing costs due to exceptionally low interest rates (e.g. Canadians “spent” their interest savings on mortgage debt not consumption). The measure is elevated on a historical basis, however, and highlights the risk that sharply higher interest rates would generate as the adjustment to higher debt obligations would be greater than is indicated by the interest-only ratio alone.

In the future, as an expected improvement in economic conditions eventually prompt the beginning of a monetary policy tightening cycle, a measured pace of increase in interest rates would keep the interest servicing costs of current debt levels historically low, albeit rising modestly (Chart 3). With that said, even in the case where interest rates rise gradually, as is our baseline view, upward pressure on households’ total financial obligations is likely inevitable given current elevated levels of outstanding debt balances.

Are the risk from debt servicing costs associated with consumer credit rising?

The potential challenges posed by household indebtedness are further evident with the servicing share of non-mortgages, credit that is typically associated with variable rates plus a spread, accounting for more than half of the servicing costs (at 8.1%) (Chart 4). According to Statistics Canada, this could be attributed to the emergence of home equity lines of credit, which are “increasingly used as a substitute for more traditional mortgages”⁵. Moreover, underlying this measure, the interest paid on consumer credit and non-mortgage loans (consisting of lines of credit, credit cards and personal loans) has risen sharply despite the existence of the historically low interest rate environment (Chart 5). As of Q2/15, total interest payments for non-mortgage household debt equalled \$37.7 billion. This was only modestly below the \$40.3 billion in servicing interest payments for mortgage loans despite consumer credit balances amounting to only half of outstanding residential

mortgage loans. The effective borrowing rates for consumer credit products are higher than for mortgages and the typical exposure of this debt to variable rates highlights the risks facing indebted households when interest rates begin to rise.

Calm waters persists, but underlying developments are worth monitoring

Record levels of residential mortgage debt and consumer loans do make households, particularly those with high total debt service ratios and increased exposure to variable rates, sensitive to higher-than-expected costs should economic conditions deteriorate further and the labour market takes a sharp turn, or if rates eventually rise more sharply than anticipated. In consecutive releases of its *Financial System Review*, the Bank of Canada has cautioned that elevated debt balances present a risk to the stability of the financial system should an unforeseen macroeconomic shock materialize. Even in the absence of a shock, Canadian households will have to adjust to higher debt payments when economic conditions permit interest rates to drift upwards. A more complete debt service ratio indicates only a moderate degree of stress on household finances despite elevated debt levels, although a greater amount than the interest-only metric alone would suggest. While we are not sounding the alarm bells for household debt at this juncture, the debt-to-income ratio is expected to rise to a new record high in Q2/15. Moreover, there exist pockets of stress that are not captured in headline ratios and are worth monitoring; notably, households with high debt obligations and lower incomes, an increased exposure to variable borrowing rates and elevated interest payments on non-mortgage outstanding balances

Notes

1. Based on Ipsos Reid's *Canadian Financial Monitor 2014*.
2. *Financial System Review—December 2014*. Bank of Canada.
3. For more details see: <http://www.statcan.gc.ca/pub/13-605-x/2015006/article/14219-eng.htm>
4. *Financial System Review—June 2014*. Bank of Canada.
5. Statistics Canada "Household debt service ratio—Interest and principal". September 2015.
In its December 2014 *Financial System Review*, the Bank of Canada noted that there has been "little growth" in HELOCs given borrowers increased preference for mortgages, although HELOCs still account for 40% of total outstanding consumer credit balances.

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