CURRENT ANALYSIS

June 2013

Chart 1

Household credit market debt

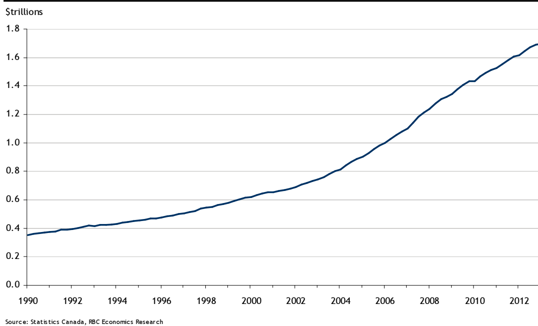


Chart 2

Household debt-to-income ratio

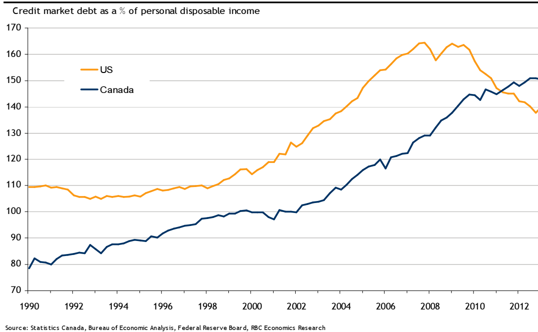
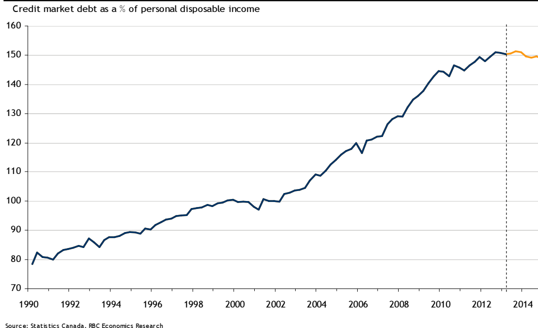


Chart 3

Household debt-to-income ratio



David Onyett-Jeffries, CFA
Economist
(416) 974-6525
david.onyett-jeffries@rbc.com

Assessing Canadian household indebtedness

The level of debt on Canadian household balance sheets set another record in the first quarter of 2013. The most recent release of the *National Balance Sheet Accounts* (NBSA) published by Statistics Canada indicated that Canadians held $1.7 trillion in outstanding mortgage and non-mortgage credit at the end of March (chart 1). A significant note, however, is that while the absolute level of debt is historically elevated, the important measures of household indebtedness actually declined at the start of 2013 relative to the end of last year. Moreover, this marks the second consecutive quarterly improvement in the key household financial metrics, providing an indication that Canadian households are in fact improving their financial positions despite growing debt balances. This note provides an overview of the measures of Canadian household indebtedness, highlighting their recent trends as well as our near-term outlook.

The debt-to-income ratio…

The debt-to-income ratio is one of the most cited indicators of household indebtedness and has typically been keyed on as evidence that Canadians' finances are in a tenuous state. This measure, which was reported by Statistics Canada as 161.8% in the first quarter of 2013, has approached the lofty levels that prevailed in the US just as the credit crisis came to a head in 2009 and as such, there is concern that it is only a matter of time until Canada suffers a similar fate. This comparison, however, is unjust given the definitional differences in the measures. Instead, using the methodology described by Statistics Canada, the internationally comparable measure for Canada was 150.5% in the first quarter of 2013 (chart 2).

While this comparison portrays Canadian household finances in a relatively better light in an international context, the debt-to-income ratio does still sit at a historically elevated level. Importantly, however, the measure has stopped rising in recent months. In fact, it has moderated in each of the last two quarters as household income growth has outpaced that of debt. As we have noted previously, timelier data point to a further moderation in household credit growth to multi-decade lows at the start of the second quarter and we anticipate that this downward trajectory will continue over the near-term. Combined with our expectation that personal income growth will pickup in conjunction with the ongoing improvement in labour market conditions, this suggests that the debt-to-income ratio will likely improve gradually through the remainder of this year and into 2014 (chart 3).

…and the other ratios…

As we have mentioned previously, the debt-to-income ratio is not our favourite measure for analyzing the financial position of households. Instead, we prefer to focus on the debt-to-asset ratio and the debt service ratio. The former ratio provides an indication of how debt is being used by consumers by indi-

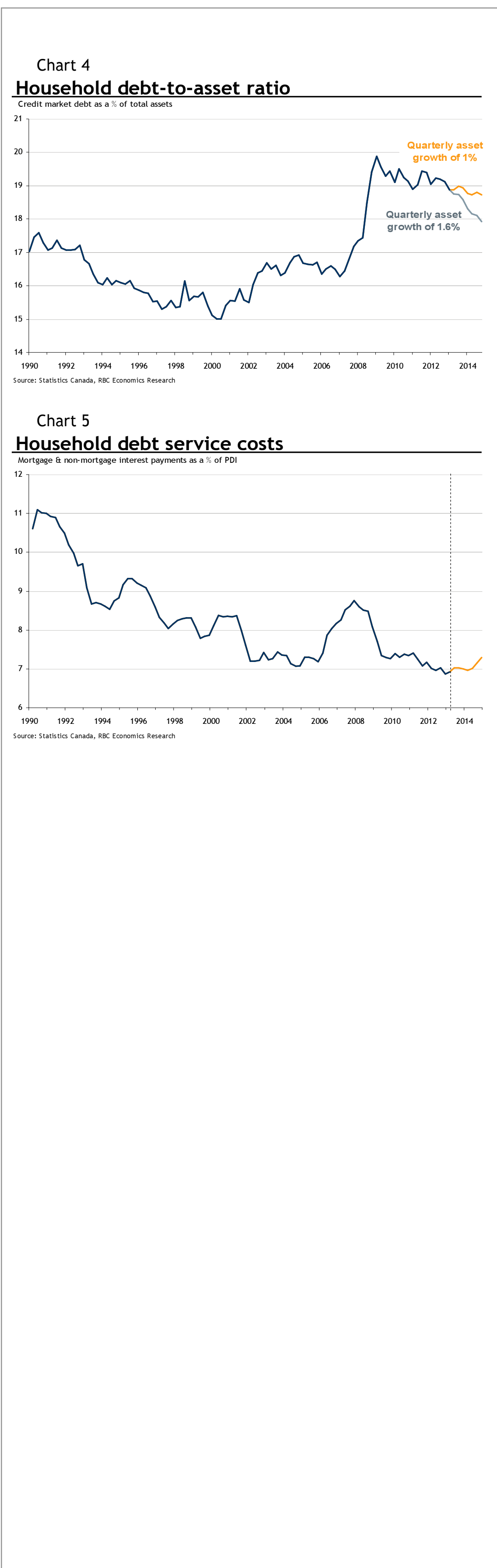


Chart 4
Household debt-to-asset ratio

Chart 5
Household debt service costs

cating what proportion of assets are funded by credit while the latter gives an idea of how easily households can meet their financial obligations.

After increasing sharply from 16.3% in Q1/07 to a peak of 19.9% in Q1/09 reflecting the 7.7% ($569 million) peak-to-trough decline in household asset values in this period, the debt-to-asset ratio has drifted lower to 18.9% as of the first quarter of 2013. The expected moderation in credit growth combined with even modest growth in household asset values should further reduce household asset leverage. For example, if we assume a quarterly growth rate in asset values of 1% (which is less than the average quarterly growth rate of 1.6% seen since 1990), the debt-to-asset ratio would drift lower by the end of 2014; if we assume asset growth consistent with historical averages, the ratio falls more precipitously to just below 18% (chart 4).

The debt service ratio[1] measures what share of personal disposable income is consumed by interest payments on household debt. Despite the record high levels of debt, the low interest rate environment has made it such that the costs associated with carrying the debt are historically low. Even with the expected continued expansion of household credit and forecast modest increases in market interest rates, debt servicing costs are likely to remain near generational lows throughout the forecast horizon (chart 5).

...confirm a "constructive evolution of imbalances in household finances"

The improvement in indicators of Canadians' financial position is a welcome development for policymakers and helps to mitigate what has long been highlighted as the largest risk to the financial system emanating from within our borders. As well, the ongoing moderation household debt growth, that in part reflects the impacts of government macro-prudential policy initiatives such as the tightening of mortgage insurance rules and enhanced mortgage underwriting guidelines[2], helps to reduce the pressure on the Bank of Canada to counteract the risks associated with excessive household leverage by raising rates. This in line with our view that the current level of monetary policy stimulus is likely to remain in place through the remainder of this year in an effort to support a faster pace of recovery for the Canadian economy against a backdrop of muted inflationary pressures.

Notes

1. The debt service ratio used in this analysis is slightly different from the rate published by Statistics Canada (found in CANSIM Table 380-0073) reflecting adjustments made to the personal disposable income measure that were used to make the debt-to-income ratio internationally comparable (see note 1 above)
2. For more information on these policies, please refer to RBC Economics (June 2012) *Canada's mortgage rules to tighten again*

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

®Registered trademark of Royal Bank of Canada.
©Royal Bank of Canada.