



Financial Industry Monitoring Service

In-depth analysis of developments in the Canadian and U.S. financial services industries

The rise of Household Inc.

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Derek Holt
Assistant Chief Economist
(416) 974-6192
mailto:derek.holt@rbc.com

Ivana Rupcic
Economist
(416) 974-6525
mailto:ivana.rupcic@rbc.com

Executive summary

This paper argues that a growing reliance on lines of credit, interest-only credit products, zero interest deferred principal loans, and hybrid flexible financing options is often misread as a sign that a cross-section of households are grossly mismanaging their finances with speculative behaviour being driven by a low interest rate environment.

Instead, while there are potential pitfalls associated with such financing options, their introduction and adoption are more appropriately interpreted as a healthy reaction to three key developments affecting the management of household finances that open up more room for financial innovation while shifting the composition of risks. Because of these developments, households are only now seeing the emergence of the kind of financing flexibility that has long been available to corporations and governments.

Those three main drivers include: an overall decline in inflation expectations that changes how people borrow by extending their planning horizons; increased financial innovation by the financial sector leading to a host of new products for increasingly sophisticated consumers; and fundamental changes in the nature of the workforce that require more payments flexibility.

Because of these drivers, households are gaining the *potential* to manage their finances just like corporations. For example, they are using interest-only lines of credit that are very similar in nature to a plain-vanilla corporate coupon bond. A 0% consumer loan with deferred principal repayment is like a sovereign strip bond. A 0% car loan with amortized principal repayment is like a coupon-only corporate bond stripped of principal repayment. Households are increasingly matching their financing needs with opportunities as they arise, taking advantage of a growing array of financing options to smooth income and consumption over their entire lifetimes.

The very essence of the argument is that overall borrowing patterns are not excessive. Far from it, since *despite* generational lows on interest rates, the annual pace of household debt growth today is significantly lower than it was in the 1970s and 1980s, whether inflation-adjusted or not. Instead, households are just changing the *way* in which they are borrowing for the better with growth in lines of credit restraining growth in credit cards, fixed and variable rate installment loans, and even mortgages, while becoming the preferred form of borrowing and liquidity management. While there will always be cyclical variations that will cause some shifting in and out of floating versus fixed rate products, we're probably still in the early stages of a long-lived preference shift towards credit lines even if rates go up more than expected.

There are four principal implications. First, there is room for more innovation in serving household borrowing and liquidity management needs. Second, a proper understanding of what is driving household finances shifts the focus towards prepayment risk and away from credit quality. Third, along with the benefits of financial innovation and greater flexibility is a greater need for individual

prudence to be guided by sound advice from financial institutions. While households may be managing their finances more like corporations today, financial institutions must play the kind of role in guiding this change that is akin to the competent independent CFO of a small business in motivating sound choices. Fourth, just as a total change in how households manage their finances has led to greater lifetime smoothing of incomes, housing demand and consumption, by corollary it also means that the classic wealth management model based on accumulators, wealth preservers and decumulators may itself be in the process of a full rewriting. This may help to explain why predictions based upon demographic theories for spending, borrowing, and saving behaviour over the past decade have been so wrong.

1. The drivers of change

Three key drivers of change are behind how households are reshaping the management of their finances by leaning towards more flexible financing options like lines of credit.

1.(a) Low and stable inflation

There are two competing effects at work in determining the role of inflation expectations. For starters, during periods of unanticipated, volatile and high inflation like the 1970s and parts of the 1980s, borrowers were wise to feed faster debt growth than today and repay depreciated principal. In contrast, during periods of low, stable and more anticipated rates of inflation, like today, this incentive is not there. This may explain why debt growth today — whether inflation-adjusted or not — is not breaking any records since inflation is low and more stable than in the past as central banks across the world have moved to explicit or tacit inflation targeting.

More importantly, low and stable inflation has substantially altered the way households are borrowing. Low and stable inflation rates enhance the ability to plan over longer horizons with greater certainty than in environments with huge swings in inflation and borrowing rates. This opens the door to debt products that focus more on interest-only payments that allow for principal payment to be postponed until a time when one's financial position is more suitable.

1.(b) Financial innovation

In recent years, financial institutions have introduced a variety of financial management products to both lead and respond to changing demands. This has not only led to greater flexibility and more accessible debt markets, but has also addressed the changing pattern of compensation for many consumers. Together with a higher comfort level of using debt in general as well as rising financial sophistication of households, this increase in borrowing alternatives has appreciably altered how households manage their finances.

The current generation is following the classic marketer's product adoption cycle. Early adopters of household debt products were constrained by relatively underdeveloped markets, a lack of familiarity with the product, and a higher cost in less efficient markets. Improvements on all three fronts have led to a debt-savvy generation that treats mortgages, credit cards and lines of credit with the same level of comfort as MP3 players. Essentially, this reflects a shift away from the more traditional view of debt being something that is best avoided toward the attitude that debt can be used rationally and effectively to smooth consumption patterns within a framework of total expected lifetime consumption and earnings.

Understanding the various ways that debt can be used has also altered the way consumers view their assets and expenses. Basic business accounting dictates that current expenses should be matched with current cash flows and this entails charging off the cost of goods roughly as they are consumed. New products, such as lines of credit, allow consumers to implement similar cash flow matching techniques by borrowing to finance investments or goods that are consumed, then paying off a commensurate portion of interest and principal as the good is used up. In this way consumers avoid the mistake of treating expenses as if they were assets. This works both ways, however, in that they must avoid the pitfall of postponing debts to beyond the economic, depreciated life of the asset.

The corporate analogy can be taken further by relating lines of credit to corporate bonds. While households are not generally permitted to issue bonds, they are using personal lines of credit to achieve the same ends. A bond as issued by a corporation or government involves receiving principal through the issue, making coupon payments at either fixed or floating interest rates, and repaying principal after a specified term that can extend over many years.

A personal line of credit, by comparison, entails drawing on a line up to a pre-specified maximum, having the option to pay interest and principal, or just interest at floating rates, and then paying off all or the remainder of the principal amount owing after a certain period of time. In that sense, a personal line of credit is very much tantamount to bond issuance by households. Also, a 0%, no money down deferred payment loan is like a strip bond.

1.(c) Workforce changes

A large proportion of today's workforce earns cash flows that are irregular and/or difficult to predict in terms of their timing. The rise of self-employment and professionals earning bonuses and commissions are two such examples. The rise of this portion of the workforce is one reason why a growing portion of the population is unsuited to traditional corporate pension plans, but it also carries implications for

credit and liquidity management products since if one is unable to perfectly plan cash flows, then fixed amortization loan plans may not be suitable. Having the ability to tailor amortization schedules to individual circumstances is a major advantage offered by such products as lines of credit and home equity loans. They give the debtor the ability to service interest payments and make lump sum principal repayments when doing so suits their cash flows.

2. Overall debt growth is not excessive

Having addressed the drivers behind changes in the way households borrow, the next task is to back this up by looking more carefully at the evidence concerning overall levels and patterns of growth in debt products. At annual rates of growth that have been in double-digit territory for years, the rapid increase in the popularity of lines of credit has led to the false perception that today's pace of growth in household debt is breaking historical records.

This is simply not true *despite generational lows on interest rates*. Today's pace of growth in household debt is actually significantly lower than it was during the latter half of the 1980s in Canada and the mid-1980s in the United States and is running more slowly than during most of the 1970s (chart 1). Similar observations hold in inflation-adjusted terms (charts 2, 3 and 4). For example, total household debt growth peaked at 10-15% per year in inflation-adjusted terms in the early- and late-1970s, plus the late 1980s, but is running in the 8-9% range today.

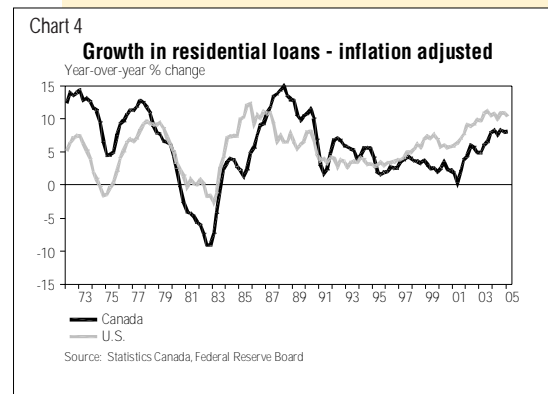
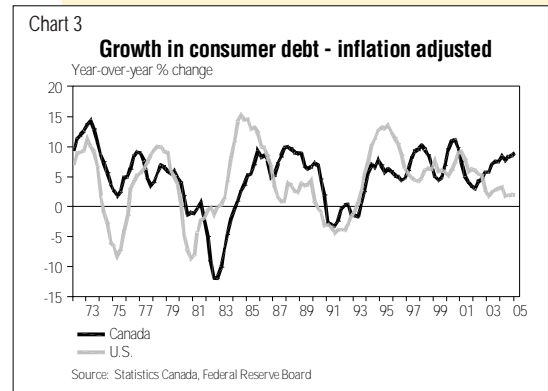
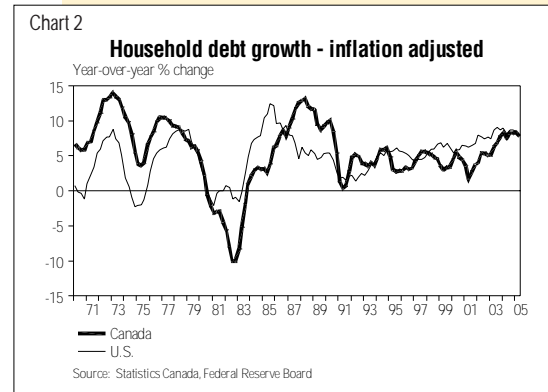
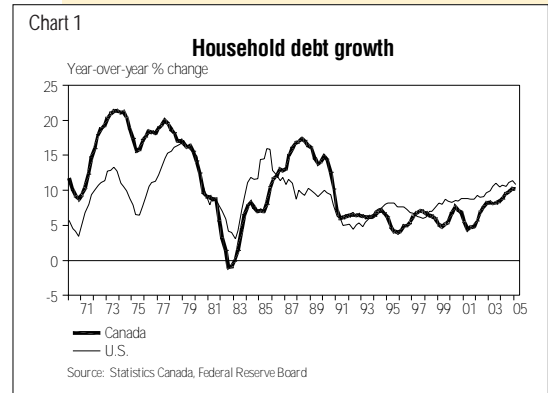
Part of this false alarmism stems from the hype surrounding the fact that debt is growing faster than incomes. Although true, it is a little late in the game to make such an observation. Annual debt growth has been running ahead of income growth for decades, pushing the debt-to-income ratio steadily higher in both Canada and the United States.

A rising debt-to-income ratio over many years, however, does not signal a record debt load since it is a false comparison. A rising debt-to-income ratio is not something to be worried about and says much more about capital market development than household credit quality. The problem lies in the very comparison of total household debt, financed over much of one's lifetime, to a single year's income. No one takes out a mortgage — which represents about 70% of total household debt — with the expectation that they will have to pay it all back out of one year's income.

Rather, a rising debt-to-income ratio is simply a reflection of the benefits of capital market developments, which allow households to use new instruments to better smooth their income and consumption over their lifetimes. This viewpoint is elaborated upon alongside the presentation of superior measures like debt service, leverage, and liquidity in our paper, *Seven Myths about Household Finances* (www.rbc.com/economics/market/pdf/myths05.pdf).

3. Lines of credit a preferred debt product

Now for the evidence on how headline-catching growth in certain debt products like credit lines is occurring *despite* the fact that records are not being broken on



total debt growth. Instead of driving record rates of overall debt growth, households are fundamentally changing the way in which they borrow. Personal lines of credit have made dramatic inroads into the total household debt market that can be decomposed into consumer debt versus mortgage debt products.

In terms of consumer debt, installment loan growth has fallen off sharply during the past five years, while lines of credit have been rising. This trend is even more apparent in the United States, where it has been bolstered by the tax advantage of using home equity-backed debt versus unsecured consumer loans. It is unlikely that installment credit will rebound materially over the long-run.

Another example of this development is that the strong growth in lines of credit is even displacing a portion of the traditional reliance on credit card debt. This is particularly true in the United States where, despite healthy growth in overall household debt, credit card debt is running at a meagre pace compared to past cycles.

It is also true in Canada, where today's 8% annual rate of growth in card debt, although still running ahead of overall economic growth (chart 5), is low compared to the 1980s when lines of credit were not as prevalent. This means that concerns about consumers borrowing on lines of credit and only paying interest must take into account the fact that they used to do the same thing with credit cards and have simply switched product preferences towards credit lines. Credit cards, however, are still the reigning champs in terms of payments intermediation. By eating into the growth of credit cards, as well as installment credit, drawn balances on lines of credit now represent about 35% of total non-mortgage debt in Canada (chart 6). The fact that this ratio has been on an upward trend for many years, and not just in the post-2001 environment of abnormally low short-term interest rates, is itself indicative of the fact that there is more than just the cycle at play here.

Apart from consumer debt, lines of credit also appear to be growing partially at the expense of growth in residential mortgages, which themselves would otherwise be growing faster (chart 7). It used to be that households may have taken bigger mortgages than they needed in order to fund other related needs at a low cost, such as renovations. Now, these are more likely to be done through a flexible line of credit.

5. The future of household finances

The central thrust of this paper is that there are sound reasons why personal lines of credit will continue to grow market share at the expense of installment loans, credit cards and residential mortgages without unduly swinging the overall debt picture or compromising household credit quality. For financial institutions, enabling the postponement of principal repayment is a sound lending practice as long as a borrower is paying the user cost of capital over time and constraints on the ability of financial institutions to raise capital are minimal.

There are several key implications that stem from the opinions expressed in this paper. The first major one is that it may be reasonable to expect growth prospects in installment credit products, residential mortgages and credit cards to be consistently lower

Chart 5

Canadian consumer credit growth

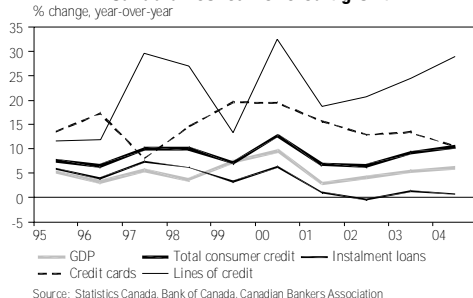


Chart 6

Personal credit line products

As a % of total consumer borrowing (excluding mortgage debt)

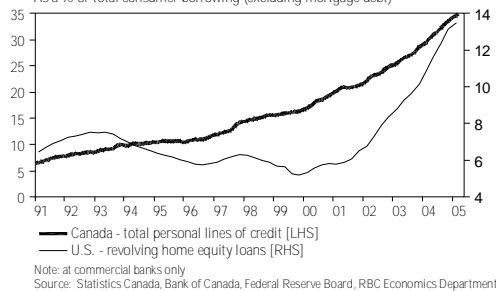
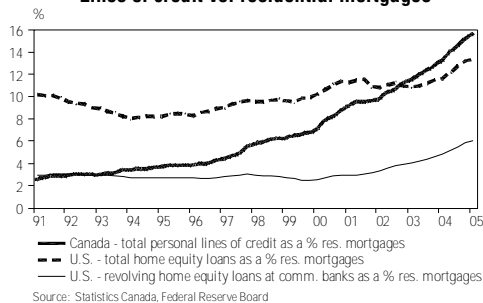


Chart 7

Lines of credit vs. residential mortgages



throughout future cycles than during past cycles, with cards becoming more transactions fee driven and less driven by extender rates.

Second, there is room for more financial innovation through the introduction of a greater variety of structured household lending products.

As a third implication, the composition of risks is changing. There are still important cyclical risks to be managed, such as not over-extending in relation to the ability to service debt, while managing current liquidity needs and long-run cash flow positions. What sets the household sector apart from corporations, however, is that it lends itself more readily to modern portfolio risk management practices. The law of large numbers offers high diversification of individual risks, unlike the lumpy risks associated with corporate credits, particularly in relatively small markets.

Fourth, innovation in any field raises a mixture of opportunities and risks for all affected parties. More options and greater flexibility entail the need for individual prudence to be guided by sound advice from financial institutions about the suitability of different choices. While households may be managing their finances more like corporations today, financial institutions must play a greater role in guiding this change in a manner that is akin to a good, independent CFO of a small business in motivating sound choices.

While anecdotal evidence so far suggests that this may not be true for everyone, the evidence from a broad loan portfolio perspective would appear to suggest that households on balance seem to be using lines of credit prudently. For instance, according to Clayton Research and Ipsos Reid, the fastest growth segment in home equity lines of credit (HELOCs) are clients who fully own their homes and have no mortgage. Also, roughly 80% of borrowers using non-line of credit consumer lending products still pay off those loans within one year such that they are not taking out lines and then acting

irresponsibly with their other credit products. This confirms the view that lines are being used, in part, to pursue debt consolidation by paying down other credit products.

A key consideration, however, is that as revolving credit grows in market share, this raises principal repayment risks since without an amortization schedule, the effective amortization period is uncertain.

Some other risks may actually be improving, at least for a sizable portion of the population. Through substituting away from higher cost credit card debt, households on both sides of the border are lowering their average cost of debt. Further, through a rise in financial sophistication towards more actively using debt products to smooth consumption and income over many years, households may be becoming *less* susceptible to medium-term interest rate volatility and thereby creating more stable consumer sector conditions than previously. Also, by showing greater sophistication in the use of credit and liquidity management products, households are in a better position to respond to cyclical developments in short-term and long-term interest rates by switching between different products.

The implications stretch further, however, than just household debt markets. If households are using credit products to smooth their spending, borrowing and saving requirements on a matched-needs basis throughout their lives, then by corollary this may well also smooth the lifetime distribution of wealth. Instead of a gradual run-up in wealth to peak levels prior to retirement in a classic model that has wealth accumulators giving way to wealth preservers and decumulators, the shifting of future earning power to the present through debt markets and postponement of liabilities may well mean that the pace of wealth accumulation is faster sooner in life and slower later on. This smoothing of wealth over one's lifetime also echoes modern business models based on companies with infinite lives; instead of waiting for retirement to draw on wealth, such decisions can be made regardless of age.