PERSPECTIVE

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WHAT RISING PERSONAL DEBT-TO-INCOME TELLS US

For several years, TD Economics has been warning about the risk to consumer finances from a low-for-longer interest rate environment. The history of economics tells us that if you provide an abnormally generous incentive for an extended period of time, an imbalance will inevitably develop. And, the recent level of interest rates has been anything but normal. By our estimation, interest rates are at least two percentage points lower than what would be considered a non-stimulative (i.e. neutral) level. So, it comes as no surprise that household borrowing has ballooned, lifting the level of personal debt relative to after-tax income to 151% in the third quarter of 2011. This is a record high and stands above the similar ratio in the United States. In terms of the outlook, the ratio is likely to keep climbing – a prospect highlighted by the Bank of Canada in its latest interest rate announcement. The TD projection is that if interest rates remain stable and there is no further tightening of mortgage rules, the debt-to-income ratio could reach 160% in the second half of 2013, a ratio that marks the peak reached in the United States and the United Kingdom before their real estate markets plunged.

While this sounds very ominous, one needs to acknowledge that the debt-to-income ratio is an imperfect measure of financial stress. In economic jargon, the problem is that you are comparing a stock (the amount of debt) to a flow (the annual increase in personal after-tax income). If you have family with an annual income of $100,000 and a mortgage of $160,000, it is not evident that the household is exposed to major financial risk.

What truly matters is the quality of the assets acquired with the debt and even more importantly the ability of the household to meet their financial commitments. A superior assessment of financial risk is total debt service costs relative to income. However, Canada does not have a strong measure of this. Statistics Canada does produce a measure of debt interest payments, but this does not include principal payments. Given the lack of an official statistic, the Bank of Canada and private sector economists use an Ipsos Reid poll of 4,000 households that provides a rough estimate for total personal debt service costs. By this measure, personal debt obligations are manageable, with debt service costs at historically low levels. However, this is a reflection of the current interest rate environment. And, the Ipsos Reid survey does provide some evidence that Canadian households have become more sensitive to interest rates. In particular, the share of income that households have to devote to debt payments started to creep up in 2011, despite the fact that average interest rates on consumer loans have remained relatively steady. If interest rates were to rise two percentage points, our estimation is that roughly 10% of Canadian households with debt would have difficulty meeting their financial commitments, because more than 40% of their after-tax income would be going to service their debts. This is not the bulk of Canadians and it does not suggest a U.S.-style problem, but it does represent close to 2 million households. And, as debt continues to rise in the coming quarters, the vulnerability will increase further.

So, the debt-to-income metric is imperfect. There is also no fixed ceiling as to how high it can rise because the distribution of the debt across age groups matters. Historically, debt growth has been dominated by younger Canadians and we worry about their financial situation because they have accumulated less other assets to draw upon in the case of financial difficulty. However, it is evident that older Canadians are now carrying more debt later in life, but they face less risk of default when interest rates rise because they have more of a financial cushion. The greater impact of the higher debt in this case is likely a lower standard of living in retirement. So, the debt-to-income ratio could climb further, even exceeding 160%, and still be financially manageable if older Canadians are the debtors. The problem is that this raises questions about inadequate saving for retirement.

The conclusion is that Canadians are being incented by low interest rates to borrow, and that incentive will remain in pace over the coming year. Odds are that debt growth will rise at probably half the pace observed over the last five years, but even that slower pace will exceed income growth. The steady climb in the debt-to-income ratio will draw a lot of attention and fretting by economists. However, the actual level of the ratio does not provide a great deal of insight into the extent of financial risk associated with household debt. The rising trend in the ratio does, however, flag the fact that Canadians are becoming more leveraged and are more vulnerable to an economic shock than they were heading into to the 2008/2009 recession. Personal finances are also more exposed to swings in real estate valuations, as the bulk of debt accumulated in recent years has been mortgage related. To be clear, there is good reason to believe that Canada has avoided the imprudent borrowing and lending decisions in the United States, but this does not rule out the possibility – the likelihood in fact – that Canada will experience a housing correction when interest rates do eventually return to more normal levels.

Given the fact that Canadians are increasingly viewing the prevailing level of interest rates as normal, there is an extremely high probability that it will be very unsettling to Canadians when interest rates do rise, even if they do so gradually. For the majority of households, it will be similar to when gasoline prices unexpectedly increase materially – finances generally remain in tact but there is less money in your wallet to make other purchases, which can lead to significantly lower spending growth by consumers that make up roughly 60% of the economy.

The increasing financial and economic vulnerability suggests that the federal government might want to consider taking regulatory action to temper personal debt growth. A possible action would be a further tightening of the mortgage insurance rules, such as lowering the maximum amortization to 25 years. A case could also be made of income testing all mortgage loans at the 5-year posted rate – at the moment if you take out a 5-year fixed rate mortgage you are income tested at the transaction rate. However, these are just two options from a suite of policy responses. Make no mistake, the economy will take a hit when it has to be weaned off the drug of exceedingly low interest rates. The goal should be to limit the effects of withdrawal as much as possible.

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