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Taking stock: Québec households' financial position Debt vs. household assets

Many studies have been published to date on Canadian households' financial position, primarily analyzing debt. An *Economic Viewpoint*¹ on Québec's situation was also published by Desjardins Group Economic Studies in the fall of 2010. Risk indicators were developed to shed light on the financial vulnerability of households if interest rates were to start climbing gradually. These indicators were designed to pinpoint the weight of debt carried by individuals vs. their income. To lay the groundwork for a more in-depth analysis of households' financial position, we have to look further and take the assets accumulated over time into account as well. In conducting its research, the Bank of Canada put forth a set of vulnerability criteria that simultaneously tracked the debt taken on by households vs. the assets accumulated (financial and non-financial).

This analysis will provide insight into many questions. Are rising debt levels among Québécois supported by increased assets? Is their overall financial position more at risk now than it was at the start of the last decade? Has the number of vulnerable households grown over the years? The compiled results of different indicators drawn from studies done in Québec using data gathered by Ipsos Reid provide a comprehensive picture of the situation. Furthermore, the debt-to-asset ratio (DAR) will be especially useful when diagnosing the financial health of Québec's households.

¹ "How vulnerable are Québec households to interest rate increases?", November 2, 2010.

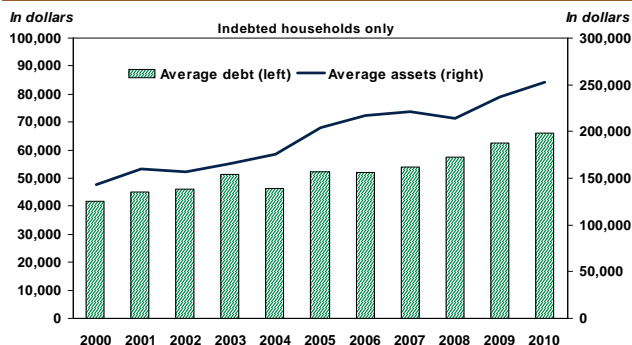
DEBT: THE VALUE OF ASSETS IS CRUCIAL

The studies carried out by the Bank of Canada on household debt go beyond the usual indicators. While the debt-to-income ratio and the weighting of the monthly payments required to service this debt are still closely examined, an approach has been developed to also take assets into account. The ratio of household borrowing (total debt) vs. total asset value (DAR) allows us to draw a line between the risk of payment defaults and personal bankruptcies. The DAR allows us to determine to what extent households can use assets to cover their debts. Households that contracted loans without having sufficient collateral could be more vulnerable from a financial standpoint. The ratio of loans (total debt) in insolvent households compared to the total value of assets held allows us to draw a connection to personal bankruptcies.

Generally speaking, if we compare changes in the loans contracted by households with the value of assets held, we end up with a comprehensive financial picture of household indebtedness. According to Ipsos Reid data, approximately 70% of Québec households resort to borrowing, whereas 30% have no debt. According to the data survey for Québec, ave-

rage household debt reached about \$65,000 in 2010, up from approximately \$40,000 in 2000; an increase of nearly 60% in 10 years. The assets cover financial and non-financial property: homes, automobiles, furniture, and personal items. Total assets per indebted household reached about \$145,000 on average at the beginning of the decade, and ballooned to about \$250,000 by last year (graph 1)—representing 70% jump. And

Graph 1 – For the past 10 years, household debt in Québec has almost increased in line with assets held



Sources: Ipsos Reid and Desjardins, Economic Studies

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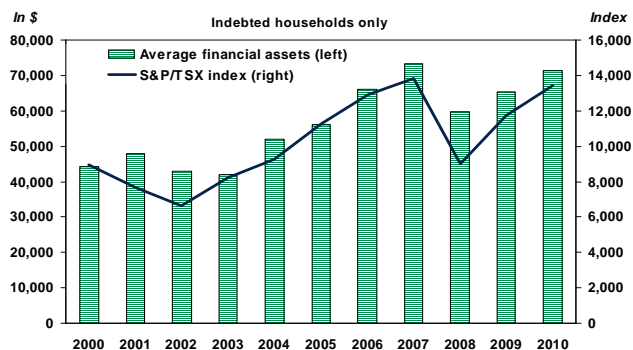
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yet the value of financial assets² held, i.e. chequing and savings accounts and, depending on the investments, bonds and other guaranteed investments, guaranteed investment certificates, mutual funds and equities, has risen only moderately—from an average of about \$45,000 at the start of the decade to above \$70,000 in 2010. The steep rise in home prices, with average prices jumping from about \$110,000 in 2000 to almost \$250,000 by 2010, is the main driver behind the increase in loans and the value of household non-financial assets. However, the average financial assets in indebted households took a major beating in 2008, in step with the financial markets (graph 2). Since only a portion of financial assets fluctuate in line with stock markets, market values have suffered from fewer sharp drops than stock markets in the past 10 years or so.

Graph 2 – Québec households' financial assets are closely tied to stock market performance



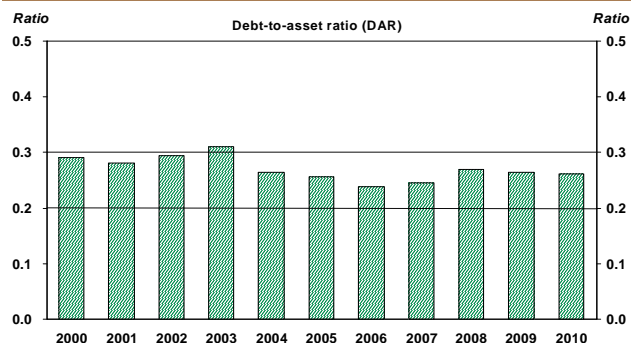
Sources: Ipsos Reid, Datastream and Desjardins, Economic Studies

According to Statistics Canada, “The debt-to-asset ratio shows the value of a household’s debts compared to the value of its assets. A high debt-to-asset ratio can indicate that debts are not adequately backed by assets. Moreover, should the value of the assets decrease because of fluctuations in the market, the ratio will increase.” According to a recent study from this federal organization³, a ratio of 0.8 or 80% is considered high. Anything above this threshold means that households are entering a discomfort zone. The DAR has been almost stable in Québec for the past 10 years or so. Based on this indicator, the financial position of indebted households did not deteriorate during this period, at least not overall. We have to conclude that the weight of household debt vs. assets has remained sustainable in Québec for the past 10 years or so, shifting within a range of 0.2 to 0.3 (graph 3). The drop in value of financial assets in 2008 with the unravelling of the financial crisis actually drove the DAR

² Pension plan assets were not taken into account since this asset type cannot be liquidated to settle debts during an employee’s working life.

³ HURST, Matt. “Debt and family type in Canada,” Statistics Canada, Canadian Social Trends, catalogue no. 11-008-X, April 21, 2011.

Graph 3 – The debt-to-asset ratio in Québec households has been fairly stable for the past 10 years



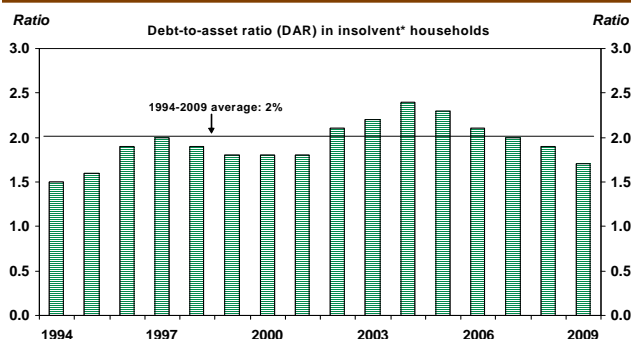
Sources: Ipsos Reid and Desjardins, Economic Studies

higher for a short period. For most households, however, the impact of the stock market correction was contained. As we will see further on, the most vulnerable households were hit the hardest.

DISCOMFORT ZONE AND CRITICAL THRESHOLD

What matters is defining a critical threshold for the DAR, or the debt level that usually leads to significant financial difficulties. According to insolvency statistics of the Office of the Superintendent of Bankruptcy Canada (OSB), Québec’s consumers who declare bankruptcy or who submit a proposal to their creditors to settle their debt usually have a 2-to-1 ratio of debts to assets (graph 4). This almost mirrors the results reached for Canada and matches the findings of a study made by the OSB⁴. Research conducted at the Bank of Canada⁵ shows that the critical threshold also points to a DAR in excess

Graph 4 – Insolvent Québecers usually have twice as many debts as assets



* Consumers who declare bankruptcy or submit a proposal to their creditors.
Sources: Office of the Superintendent of Bankruptcy Canada and Desjardins, Economic Studies

⁴ Office of the Superintendent of Bankruptcy Canada, “An Overview of Canadian Insolvency Statistics Up to 2006,” 2007.

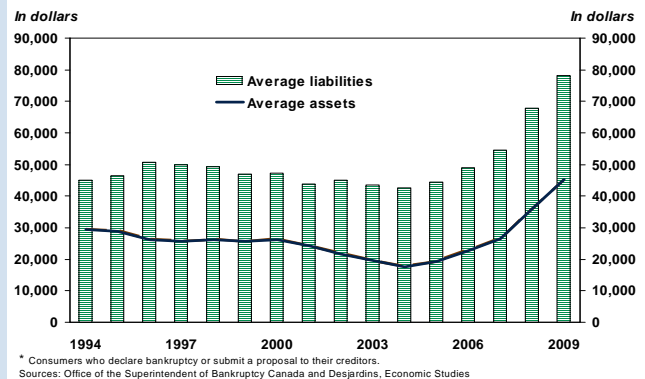
⁵ FARUQUI, Umar, LAI, Simon, and TRACLET, Virginie. “An Analysis of the Financial Position of the Household Sector Using Microdata,” Bank of Canada, Financial System Review, December 2006.

BOX 1: PERSONAL INSOLVENCIES IN QUÉBEC

According to the OSB, insolvency refers to consumers who declare bankruptcy or submit a proposal to their creditors to reimburse their debts over a longer period or to have the amount of debt reduced. Unlike personal bankruptcies, which usually entail a seizure of goods, submitting a proposal allows individuals to hang on to their property, but this is only available in cases where total debts are less than \$250,000.

The DAR of consumers forced into insolvency has hovered at around 2 for the past 15 years or so, meaning those who can no longer meet their financial obligations generally have twice as many debts vs. assets. Contrary to popular belief, those who are in a tight financial spot have often accumulated financial and non-financial assets. This category in Québec held on average \$45,000 in assets in 2009 (graph 5). Based on the OSB document, the types of assets held most often by insolvent consumers are, in order of importance: furniture, automobiles, personal items, securities, and a home (in fewer than 20% of bankruptcy cases). Among these categories, the residential property is usually associated with a higher asset value. The value of the mortgage also contributes to inflating the debt load carried by individuals.

Graph 5 – Profile of insolvent Québécois



Among the different liabilities recorded in insolvency cases, credit card balances are the most frequent, followed by personal loans from financial institutions. Outstanding income taxes with each level of government and unpaid amounts for utilities are the most common debts, followed by mortgage loans and student loans. The average debt of insolvent consumers in Québec reached almost \$80,000 in 2009, almost double the level recorded some 15 years ago.

of 2. While not all the households in this category are experiencing financial difficulties, those that become insolvent usually have twice as many debts compared to assets. For more details, see box 1.

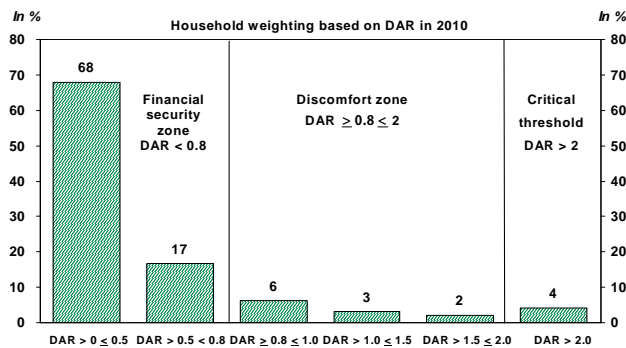
In short, the ratio that evaluates the extent to which households can use their assets to cover debt can either be related to a financial security zone (DAR < 0.8), a discomfort zone (DAR ≥ 0.8 and ≤ 2) or to an insolvency threshold (DAR > 2). Studies done by the Bank of Canada and Statistics Canada allow us to set barometers for the DAR to better assess the extent to which households are vulnerable. In essence, the heavier the household's debt load, the more sensitive that household will be to events that can affect the value of its assets. A sudden and persistent drop in the value of a household's assets, such as falling home prices or a severe stock market correction can have a devastating financial impact on some households. Other situations, like critical illness or a job loss, can also have an impact on household income and trigger the deterioration of an individual's balance sheet.

Lastly, a sudden increase in interest rates, yet another burden on the debt load, can also lead to financial difficulties. The *Economic Viewpoint* published last fall presented an assessment of the impact of rising borrowing costs on vulnerable households.

85% OF INDEBTED HOUSEHOLDS HOLD SUFFICIENT ASSETS

Other than the DAR's general trend, it's how this ratio is distributed that allows us to better target the proportion of households that could have trouble meeting their obligations. The vast majority of households in Québec—i.e. about 85%—fall into the financial security zone (DAR < 0.8), which is quite reassuring (graph 6 on page 4). Approximately 1.9 million households are in this situation. The portion of households in the discomfort zone (DAR ≥ 0.8 and ≤ 2) is quite considerable, at 11% and deserves closer attention. Those with a DAR equal to or greater than 2 are clearly in the minority. More specifically, in 2010, 4.2% of households exceeded this insolvency threshold vs. 7.6% in 2000. The proportion of at-

Graph 6 – Distribution of indebted households in Québec based on the debt-to-asset ratio (DAR)

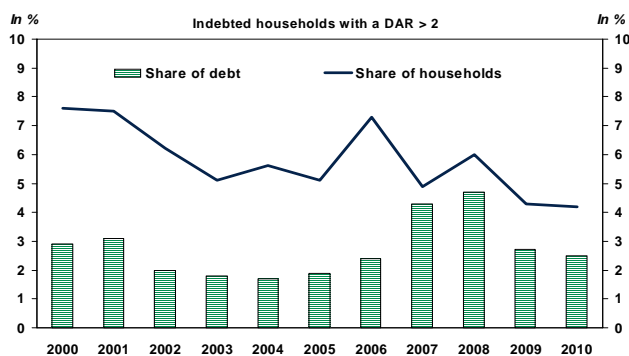


Sources: Ipsos Reid and Desjardins, Economic Studies

risk households is therefore less than it was 10 years ago. The perception that a growing portion of indebted households in Québec are in a weaker financial position now than they were 10 years ago doesn't hold water, at least not when the value of debts and assets are taken into account.

The third indicator is having knowledge of the proportion of households that fall into the high-risk zone—which allows you to evaluate the potential impact on the scope of payment defaults. If over time the weight of debt contracted by households with a DAR equal to or greater than 2 has become a greater burden, the damage will be more extensive if bankruptcy is declared. Over the past 10 years, the percentage has slightly fallen from 2.9% in 2000 to 2.5% last year, despite the 4.7% spike recorded in 2008 after the financial crisis erupted (graph 7). Individuals with a DAR in the critical zone therefore felt the shock arising from the depreciation in the value of their assets. The stock market correction that lasted throughout the global recession is a good example. Since the number of highly vulnerable households is tracking a similar path, the

Graph 7 – Personal bankruptcies in Québec are in line with the number of at-risk households



Sources: Ipsos Reid and Desjardins, Economic Studies

share of debt held by these households was sure to rise as well. According to several Bank of Canada studies on this issue, there are no thresholds for the indicator that helps assess the risk to which the financial system is exposed.

What is reassuring is the fact that the portion of total debt held by households with less financial strength has dropped again, but recent history has shown that a jolt could lead to a severe drop in assets that could quickly cloud the horizon. According to our estimates, a 10% drop in the price of houses in Québec would have a similar impact on households' financial position as the 35% plunge by the stock market in 2008 which triggered a 20% slide or so in the value of financial assets (according to Ipsos Reid data survey). Since the value of non-financial assets, such as real estate, is clearly greater than that of financial assets, a sudden depreciation, to a lesser extent, in prices could have a similar negative impact on households' balance sheets.

That said, a line can be drawn between the composition of household assets and the ability to quickly tap into liquidities to pay back debt. If the principal home is the main asset held, it is ill-advised to sell the family home to pay off debts. To make sure you have a sufficient financial cushion, it is better to hold fairly liquid assets should you ever need to reimburse debts quickly if unforeseen financial difficulties arise. This healthier situation could allow households to hang on to their main residence, as applicable. Certain studies⁶ have shown that, over time, household assets have become less liquid, less diversified and riskier than in the past. This could help explain the increase in personal bankruptcies since the year 2000.

QUÉBECERS MAY BE IN DEBT, BUT THEY'RE BUILDING THEIR ASSETS

In short, the analysis of the data gathered by Ipsos Reid's *Canadian Financial Monitor* survey paints a broad picture of the financial position of Québec's indebted households by taking assets into account. This diagnostic is reassuring for several reasons. First of all, the sharp advance in personal loans in the past 10 years is supported by a sustained increase in the value of assets held. The DAR, which helps determine whether a household has sufficient assets to limit the risk of payment default and ultimately avoid bankruptcy, has fluctuated little since the year 2000. The DAR has remained within a limited range that points to a generally healthy financial position. Québecers may have gone deeper into debt

⁶ Certified General Accountants Association of Canada, "Where's the Money Now: The State of Canadian Household Debt as Conditions for Economic Recovery Emerge," May 2010.

these past few years, but they've also built up their assets. Contrary to popular belief, the balance sheets in households overall has not deteriorated in the past 10 years.

Beyond the general DAR trend, which can conceal major financial difficulties in some households, the distribution of these households based on the DAR allows us to better assess the risk level. About 85% of indebted households fall into the financial security zone established by Statistics Canada ($DAR < 0.8$), and 11% are in the discomfort zone ($DAR \geq 0.8$ and < 2) while 4% of households have a DAR equal to or greater than 2. Approximately 4%, or more than 185,000 households out of 3.3 million in Québec, have a DAR greater than 2. This level is usually associated with financial insolvency, when individuals declare bankruptcy or submit a proposal to their creditors. In the past few years, the equivalent of 25% of individuals with a DAR greater than 2 have declared bankruptcy. That said, 10 years ago there were twice as many vulnerable households as there are today, which is quite reassuring.

An *Economic Viewpoint* to be published at a later date will present a detailed portrait of Québécois' financial position, painting a more accurate picture. We intend to create a balance sheet of Québécois' debts and assets based on age groups and income brackets. This will help pinpoint the characteristics of at-risk households and those in a relatively comfortable financial position. According to the Ipsos Reid databank, about 30% of Québécois had no debt at all in 2010, and their balance sheets clearly reflect the difference vs. indebted households (70%). While this *Economic Viewpoint* highlights the situation in indebted households exclusively, our next analysis will also target the profile of those who cannot resort to borrowing. This will provide more in-depth information and a better overview of Québec households' balance sheets.

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