Update on Quebec households’ financial position

Over the past three years, Economic Studies has published some in-depth analyses on the indebtedness of Quebec households. First, we carried out a diagnosis of the weight of people’s debt in relation to their income\(^1\). Second, we analyzed borrowing trends, while also considering changes in assets\(^2\). This enabled us to quantify the percentage of households that were financially vulnerable. Finally, a detailed picture according to age group and income bracket enabled us to better define the profile of households that were likely to run into financial difficulty\(^3\). In continuation of these detailed studies, here is a brief update with 2012 data on the main household debt indicators in Quebec.

\(^1\) How vulnerable are Quebec households to interest rate increases? November 2, 2010.

\(^2\) Taking stock: Quebec households’ financial position - Debt vs. household assets, June 17, 2011.

\(^3\) Financial situation in Quebec households - Vulnerability depends heavily on borrowers’ profiles, October 27, 2011.

PART 1: DEBT TRENDS IN RELATION TO INCOME

The household debt ratio, which refers to credit outstanding compared against after tax income, keeps rising (graph 1). This indicator enables us to make comparisons between the weight of debt in Quebec and in Canada. Average real estate prices (graph 2), which are relatively higher in Canada than in Quebec mostly explain the gap in mortgage debt and, thus, in the debt ratio. However, this measure does not tell us enough to assess households’ financial ability to make their payments on their loans, as it does not take interest rates into account.

The weight of principal and interest payments in relation to income gives us a good picture of the debt burden. In fact, the debt service ratio (DSR) has fluctuated little in the past 10 years (graph 3 on page 2), which confirms that the lower cost of credit has offset the higher borrowing levels. The size of monthly payments compared with income has stayed practically the same, as has the risk of default. The proportion of overdue loans is currently similar to what it was in 2002 (graph 4 on page 2).

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Today’s low mortgage rates are enabling borrowers to meet their financial obligations, with the result that overdue loans are very low compared with the 1990s. Back then, a relatively weak debt ratio in a high interest rate environment had sent the default rate climbing. The current global economic and financial uncertainties will keep retail interest rates low until the end of 2013 or even beyond. Barring a recession, which would generate serious deterioration of the labour market as happened in 2008–2009, personal bankruptcies will stay contained (graph 5). Any risk associated with rising interest rates is not immediately threatening, at least for the next several quarters.

To determine whether a larger proportion of indebted households are in a precarious position, we need to look at the distribution based on the DSR. Households whose ratio is higher than 40% are deemed vulnerable and at risk of defaulting on their payment obligations. Those whose ratio lies between 30% and 40% are at some potential risk, as they could quickly swing over into an uncomfortable position. The distribution of indebted households has remained steady over the past 10 years (graph 6).

Despite the growing level of debt, the proportion of households that are at risk of defaulting on their financial commitments has not risen due to the lower interest rates.

Higher borrowing costs, which seem to be far off, will have a major impact on households’ balance sheets within a few years. The repeated warnings by the Bank of Canada on the subject, along with the tightening of rules governing insured mortgage loans, are intended to limit the potential damage by curbing the growth of credit. Over the years, sensitivity to a rise in interest rates has increased. The growing popularity of personal lines of credit and variable-rate mortgage loans (graph 7 on page 3), which are directly tied to the key interest rates set by the Bank of Canada, means that borrowers will immediately feel the effect of future rate increases. In 2012, lines of credit accounted for 10% of household borrowing compared with 4% 10 years ago (graphs 8 and 9 on page 3). The size of credit card debt has remained relatively stable, and credit card interest rates do not fluctuate much over time, so the risk does not seem to have increased in that area.
PART 2: DEBT TRENDS IN RELATION TO ASSETS

Apart from debt, we must also evaluate households’ assets to have a full picture of their financial position. In the past 10 years, strong growth in debt has been supported by a sustained increase in the value of assets. According to data from Ipsos Reid’s Canadian Financial Monitor survey, household debt stands, on average, at around $75,000, compared with nearly $275,000 for assets (graph 10). The debt/asset ratio (DAR) determines whether the assets are sufficient to limit the risk of default on payments. According to Statistics Canada, a ratio of 0.8 is considered high, because the comfort zone lies beyond that threshold. Collectively speaking, households’ DAR has stayed within a comfortable range over the past 10 years, i.e. between 0.2 and 0.3 (graph 11). The weight of debt in relation to assets still reflects a generally healthy situation.

The critical threshold for this ratio, that is, the level that generally causes serious trouble, is deemed to be 2. Quebec consumers who declare bankruptcy or who make a debt settlement proposal to their creditors usually have debts that are twice as high as their assets (graph 12 on page 4). The vast majority of Quebeckers (over 80%) stand within the financial safety zone (DAR < 0.8), which is quite reassuring. However, the proportion of households that find themselves in the discomfort zone (DAR ≥ 0.8) is fairly sizable: 11%. Finally, 5% of households stand beyond the critical threshold (DAR > 2), which frequently leads to an insolvent position. Taking into account the values of both debt and assets, the proportion of indebted households that are at risk is low (graph 13 on page 4).

Graph 7 – The number of variable-rate mortgage loans has grown since the year 2000

Graph 8 and 9 – Quebec’s debt make up has evolved in the last ten years

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

Graph 11 – The debt-to-asset ratio in Quebec households has been fairly stable for the past 10 years
PART 3: DEBT AND ASSET TRENDS IN RELATION TO BORROWER PROFILE

The amount of household borrowing is moderate for some, considerable for others. More than half of all households have less than $50,000 of total debt (graphs 14 and 15). However, the amount of household debt surpasses $100,000 in about 30% of cases, including 20% with debt in excess of $150,000. Ten years ago, fewer than 5% racked up more than $150,000 of debt, because the price of real estate had not yet skyrocketed. The distribution of households based on assets has also changed considerably because of this factor. In 2002, approximately one third of households possessed assets above $150,000, compared with 60% now.

Growth in debt and assets (graphs 16 and 17) has made its mark on the overall distribution there of, and on their composition by age group. The fastest growth in debt has occurred among those aged 35 to 44. Contrary to popular belief, the debt growth of households below the age of 35 has not been faster than for other households. Therefore, this age group does not bear primary responsibility for the overall increase in debt in Quebec. The increase in debt has been supported by an increase in the value of assets for all age groups. For
households between the ages of 35 and 44, debts have climbed much faster than assets, so their overall financial position has deteriorated, although not to the point of being problematic.

Household patterns of saving, borrowing and consumption vary greatly with age. Young people use borrowing to build their wealth, since their spending usually exceeds their income. Over time, income increases and the debts are gradually paid off. We should therefore expect young households to be characterized by financial fragility, which gradually diminishes as they grow older, in keeping with the cycle of life. The debt/asset ratio numbers (graph 18) are consistent with these expectations. Compared with 10 years ago, there is a slight deterioration in most of the age groups, except for those above age 65. If we divide households into three risk zones, we can draw the same conclusions a bit more precisely (graph 19). Young households bear closer watching, because the risk of financial difficulty they face is clearly higher.

The ability of households to borrow, and then to meet their financial obligations, depends largely on their income. The fact that the financial burden is proportional to income tells us that highly indebted households are not necessarily those that have trouble making ends meet. Over the past 10 years, average debts have risen faster in the upper income brackets, especially those of $100,000 or more (graph 20). Although assets have increased in all the groups, the increase was less for those with incomes above $100,000 (graph 21). Therefore, the debt/asset ratio has deteriorated only for the highest wage earners, while it has fallen in all the other income brackets (graph 22 on page 6). This does not mean that their position is precarious, but rather that their financial position has deteriorated in the past 10 years. If we look beyond the general trend of the debt/asset ratio, dividing households into three
risk zones will give us a better idea of which income bracket has the most fragile financial position. Over 10% of households earning less than $35,000 find themselves in a precarious position, compared with 5% for all households (graph 23). Thus, the number of households showing a degree of financial fragility decreases as income goes up. Moreover, households whose debt exceeds $150,000 are concentrated in the two highest income quintiles (graph 24).

CONCLUSION

Although debts are still climbing faster than income, other indicators of financial vulnerability have been fairly stable in Quebec in the past 10 years. Given that the prospect of key interest rate increases is far off, due to global economic and financial uncertainties, households seem to be in less jeopardy in the near term. Nevertheless, the Bank of Canada, with good reason, keeps sending a preventive message in an effort to contain household debt. In addition, the federal government has tightened mortgage rules several times since 2008, a situation that finally seems to be curbing mortgage credit growth. Quebeckers may not be at the brink of a precipice, but they need to make sure they will be able to cope with higher interest rates in the future without too much trouble.

Other risks are also threatening the financial situation of the province’s households. Sharper erosion in the global economy as a result of another upswing by strains in Europe or a U.S. economy weakened by the fiscal cliff could disrupt Quebec’s economy. Major job losses would have serious repercussions for households’ financial situation. While the picture for households in general does not stoke the concerns that already exist, our analysis shows that certain groups warrant special attention.

The situation in Quebec remains worrisome, however. Should a gradual increase in interest rates in general come to pass, a growing number of households would find themselves in the discomfort zone, with a greater risk of payment defaults and a greater number of personal bankruptcies. This medium-term outlook regarding the impact of future interest rate increases promotes the risk of significant deterioration in financial positions. Since interest rate increases seem to be on hold for the next few quarters, households should seize this opportunity to repair their balance sheets. If the most fragile among them take advantage of this respite to reduce their reliance on debt, they will face less trouble down the road.

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