

Financial position of households in Quebec and Ontario

Over the past five years, Economic Studies have published a few in-depth analyses of Quebec household debt. First, a diagnosis of the burden of personal debt in relation to income was performed.¹ Second, borrowing trends were analyzed, with attention to asset trends as well.² Based on these, it was possible to estimate the percentage of households that were financially vulnerable. Finally, a detailed snapshot according to age group and income bracket made it possible to better identify which households were most likely to run into financial difficulties.³ To follow up on those detailed studies, here is a brief update, with data from 2014, of the main indicators pertaining to household debt in Quebec.

¹ Desjardins, Economic Studies, *Economic Viewpoint*, "How vulnerable are Québec households to interest rate increases?", November 2, 2010, http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv1102a.pdf.

² Desjardins, Economic Studies, *Economic Viewpoint*, "Taking stock: Québec households' financial position - Debt vs. household assets", June 17, 2011, http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv1106a.pdf.

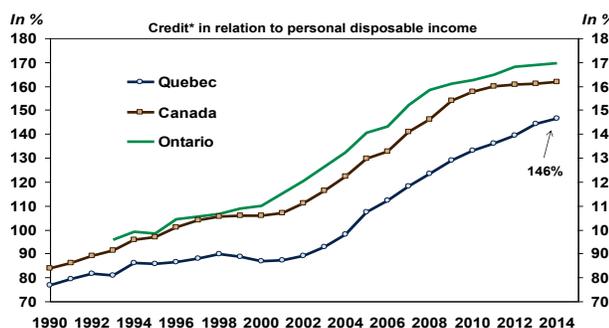
³ Desjardins, Economic Studies, *Economic Viewpoint*, "Financial situation in Québec households - Vulnerability depends heavily on borrowers' profiles", October 27, 2011, http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv111027a.pdf.

A HIGH DEBT RATIO, BUT LOW INTEREST PAYMENTS

It is well known that Quebecers' debt has grown much faster than their income in recent years (graph 1). Rising home prices and a higher rate of home ownership have inflated the mortgage debts incurred by households, seeming to increase their debt burden. Based on the traditional debt ratio, i.e. individuals' total outstanding debt over personal after-tax income, the situation in Quebec would appear to be less worrisome than in the country as a whole, and far less tense than in Ontario. Even though household incomes are lower in Quebec, that fact alone is not enough to account for the divergence in debt ratios. The higher cost of homes,

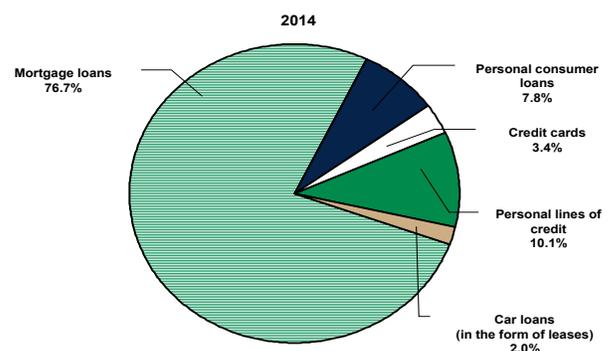
which is reflected in the amount of mortgage credit, is the main reason for a higher debt ratio in our neighbour province and the rest of Canada. In 2014, average home prices were in the neighbourhood of \$270,000 in Quebec, \$410,000 in Canada and \$430,000 in Ontario. Given that outstanding mortgage debt outweighs the other types, such as lines of credit, consumer loans and credit card balances (graph 2), this is the factor that most influences the debt ratio. Although imperfect, this indicator tells us that households' debt-to-income ratio is lower in Quebec than in Ontario and in Canada.

Graph 1 – The household debt ratio has reached a peak



* Total outstanding consumer credit and residential mortgage credit.
Sources: Statistics Canada, Canada Mortgage and Housing Corporation, Bank of Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

Graph 2 – Distribution of Quebec household debt: Mortgages play a key role



Sources: Ipsos Reid and Desjardins, Economic Studies

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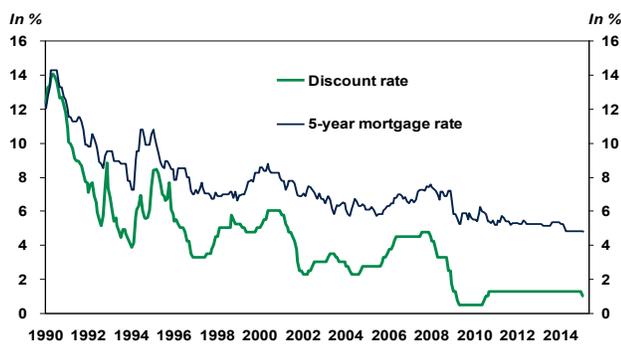
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NOTE TO READERS: The letters **K**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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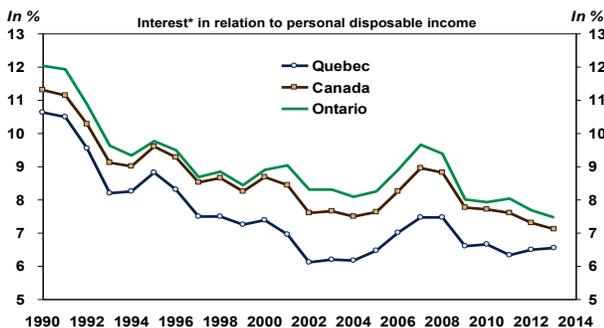
This debt ratio, the high level of which would at first glance appear uncomfortable, has two significant shortcomings. First of all, the amount of debt to be repaid over several years is not representative in relation to households' annual income. Based on this calculation, it is as if the entire debt, in particular mortgage loans, had to be repaid in full using the after-tax income of a single year! Secondly, it does not take into account the interest payments associated with those loans. The fact is that the downwards trend in interest rates that has been observed in recent years (graph 3) has had the effect of lightening the interest payment burden throughout the country. The ratio calculated by Statistics Canada shows that the burden of interest paid on all types of loans, in relation to household income, is relatively low from a historical perspective (graph 4).

Graph 3 – Interest rates in Canada have fallen substantially in recent years



Sources: Statistics Canada and Desjardins, Economic Studies

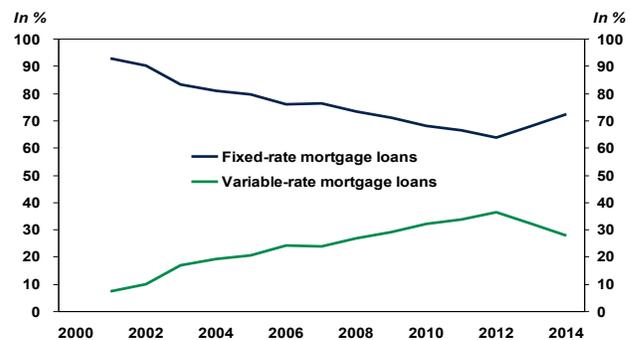
Graph 4 – The burden of interest payments has diminished in recent years



* Interest paid on mortgage loans and all other consumer loans.
Sources: Statistics Canada and Desjardins, Economic Studies

Apart from the low interest rates, changes in the types of loans have also had the effect of reducing interest payments. Mortgage loans with a fixed interest rate have become far less popular in the past fifteen years or so. According to Ipsos Reid data, the proportion of fixed-rate loans is around 70%, compared with over 90% in 2001 (graph 5). Thus variable-rate mortgages are capturing over a quarter of the market. This growing popularity has enabled many homeowners to enjoy the benefit of the Bank of Canada's (BoC) interest rate cuts in recent years. Moreover, the more widespread use of personal lines of credit (including mortgage lines), at the expense of conventional consumer loans, has also reduced interest payments. Lines of credit come with lower interest rates that vary according to the BoC's key rates, just like variable-rate mortgage loans. This trend has worked in borrowers' favour in a context of falling interest rates; however, they are more vulnerable to the gradual increase in borrowing costs that will occur in the years to come.

Graph 5 – The proportion of variable-rate mortgage loans has increased

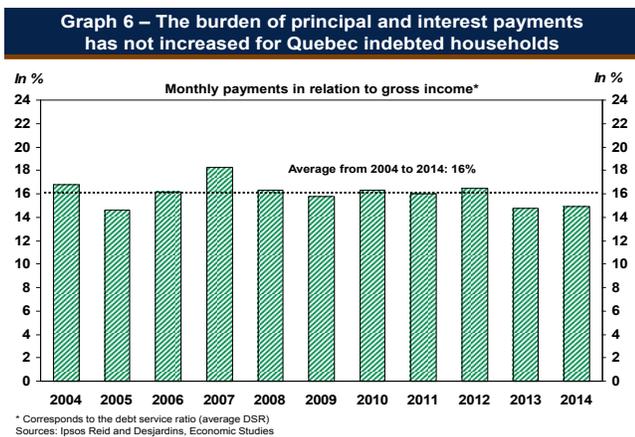


Sources: Ipsos Reid and Desjardins, Economic Studies

THE REPAYMENT CAPACITY IS STABLE

The two debt indicators discussed above, i.e. debt in relation to income and the burden of interest payments, point to different conclusions. On one hand, the debt-to-income ratio, which reflects only the burden of amounts borrowed, has reached a peak in Quebec. On the other hand, the ratio of interest payments to income has shrunk in recent years. Each of these measurements is incomplete, since it is the total of principal and interest payments in relation to income that best reflects households' financial capacity to meet their obligations. This ratio, known as the debt service ratio (DSR), enables us to correctly evaluate whether the

burden of households' monthly payments has increased. The fact is that the average DSR has fluctuated very little in Quebec over the past ten years, barely moving from an average of 16% (graph 6). Consequently, the proportion of gross income allocated to paying down debt (principal and interest) has remained the same. Based on this very comprehensive indicator, households' financial capacity to repay their debt has remained stable over the years, along with the risk of payment default.



Beyond the general debt trend, the distribution of households provides a clearer idea of what proportion of them have too much debt. According to the microdata collected by Ipsos Reid's "Canadian Financial Monitor" survey, the proportion of gross income allocated to debt repayment can be calculated for every household of the sample (box 1). If the monthly payments eat up a high percentage of gross income, there is a more strong probability that the borrower will not fulfil his financial commitments. The Bank of Canada has clearly established the discomfort zone in this regard. Households where the DSR exceeds the critical threshold of 40% are considered vulnerable, i.e. they may find it difficult to make their monthly payments. They are not all doomed to declare personal bankruptcy, but the probability of that happening is relatively high.

Households with a high monthly payments in relation to income are in the minority, since approximately 90% of them are sitting in the financial comfort zone. However, last year, 5% of indebted households had a DSR above the critical threshold of 40% (graph 7); this percentage has held steady for the past several years. Households whose DSR stands between 30% and 40% also present potential risk, since they could quickly find themselves in a precarious position should unforeseen circumstances arise. Over 5%

**BOX 1
METHOD OF CALCULATION**

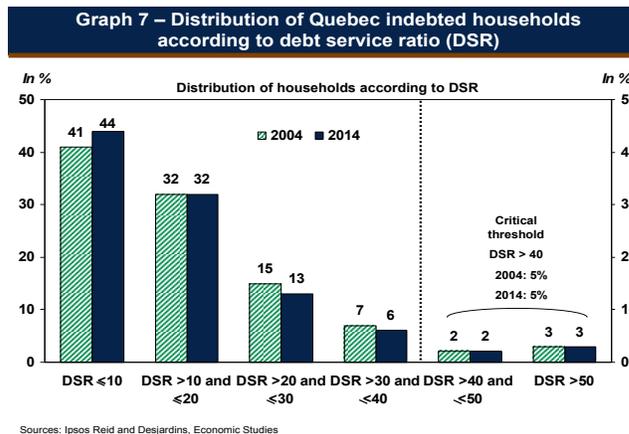
$$DSR_j = \frac{\sum_i Payments_i}{Income_j} = \frac{\sum_i (capital_i + interest_i)}{Income_j}$$

Where:

- *DSR (j)*: household's debt service ratio (*j*) or weight of household payments (*j*) vs. gross income;
- *Payments*: household payments (*j*) on different loans (*i*) = (credit cards, automobile loans, personal loans, personal lines of credit, mortgages);
- *Income*: total household gross income (*j*).

The following information is available for all loans other than credit card loans:

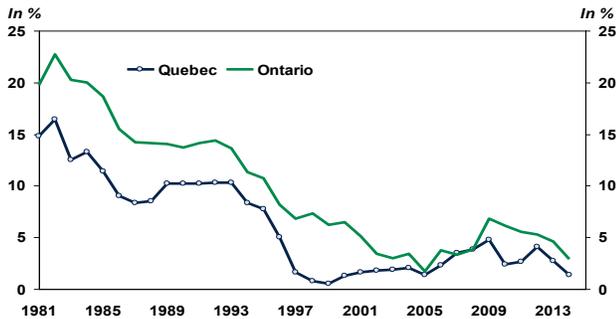
- Monthly payment made;
- Interest rate in effect;
- Duration in years, but not the maturity;
- Balance.



of them did end up in that situation in 2014. The larger the share of a household's income that is eaten up by monthly debt payments, the more sensitive that household is to certain life events such as a separation, serious illness or job loss. More generally, a change of economic conditions that triggers higher interest rates or layoffs that reduce income can also put a household's financial position in jeopardy.

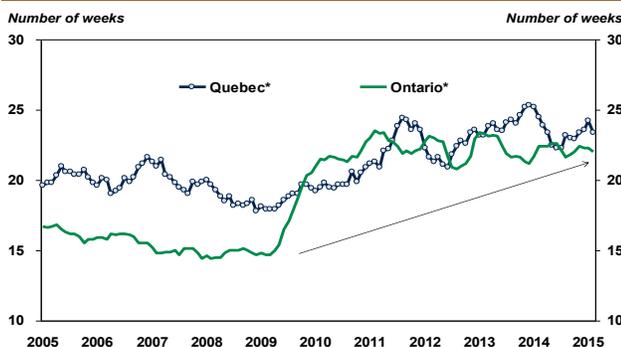
Even though the overall debt burden is contained, some households have little leeway for coping with an unforeseen event, such as a sudden drop in employment income. The savings rate is very low in Quebec and Ontario (graph 8), with the result that some households' financial cushion is insufficient in the event of job loss. This makes it tougher to keep up with monthly payments. It has become more difficult for many households to weather the storm, so to speak, because the average duration of unemployment has lengthened since the last recession in both Quebec and Ontario (graph 9). In general, it can take around six months to find another job, requiring considerable savings to get through that period without experiencing serious financial setbacks that could lead to bankruptcy.

Graph 8 – The low savings rate makes households vulnerable to unforeseen events



Sources: Statistics Canada, Institut de la statistique du Québec and Desjardins, Economic Studies

Graph 9 – The average duration of unemployment has increased to nearly six months in Quebec and Ontario

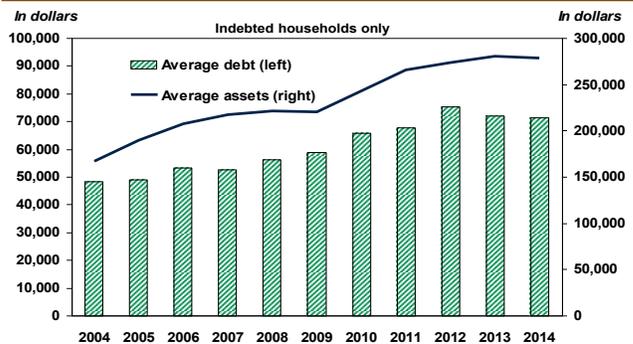


*6-month moving averages
Sources: Statistics Canada and Desjardins, Economic Studies

THE VALUE OF ASSETS IS ALSO IMPORTANT

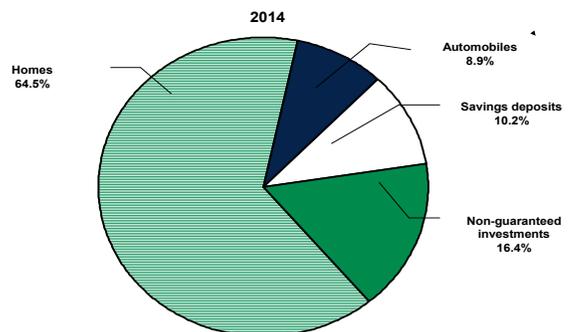
Households that are smothered by their debt burden sometimes have sufficient assets to ensure their financial security. Before reaching the point of insolvency, they can sell their assets, be it their home or some of their investments. Thus to have a complete picture of households' financial situation, we need to assess the value of their assets as well as their debts. According to the data of Ipsos Reid's "Canadian Financial Monitor" survey, household debt stands, on average, at around \$70,000, compared to nearly \$280,000 for assets (graph 10). Over the past ten years, the sharp growth in debt has been supported by a sustained increase in the value of assets, consisting mainly of real property (graph 11). Homes can serve as a bank of last resort, but selling times have become longer in recent years. Given the slowdown in the housing market, it took an average of 112 days to sell a single-family home in Quebec in 2014, and 130 days for a condo. Thus this capital cannot be accessed instantly in the event of financial difficulties. On the other hand, the value of real estate assets offers the advantage of being fairly stable, contrary to financial assets whose value fluctuates with the ups and downs of the stock market.

Graph 10 – In the past ten years, Quebecers's debts have grown at nearly the same pace as their assets



Sources: Ipsos Reid and Desjardins, Economic Studies

Graph 11 – Asset makeup of indebted Quebec households

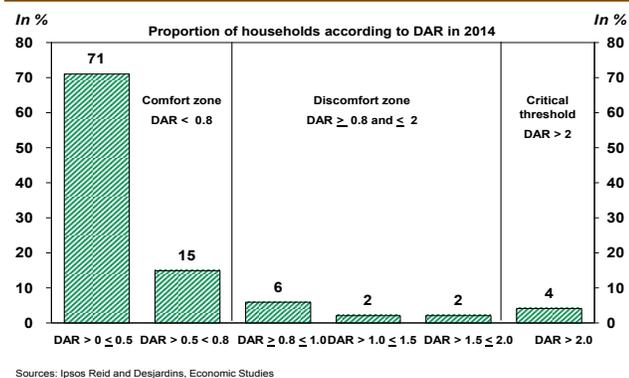


Sources: Ipsos Reid and Desjardins, Economic Studies

The debt/asset ratio (DAR) determines whether the assets are sufficient to limit the risk of borrowers defaulting on their payments. According to Statistics Canada, a ratio of 0.8 is considered high, with the comfort zone lying below that threshold. Over the past ten years, the DAR of all households in general has fluctuated within a comfortable range, between 0.2 and 0.3. Thus the burden of debt in relation to assets still leaves households in a generally sound position. The critical threshold for this ratio, i.e. a level that generally leads to major problems, is deemed to be 2. Quebec consumers who declare bankruptcy or who make a proposal to their creditors to settle their debts usually have twice as many debts as assets.

The vast majority of Quebecers, i.e. over 85%, stand within the financial security zone (DAR < 0.8), which is quite reassuring. But the proportion of households standing in the discomfort zone (DAR ≥ 0.8 et ≤ 2) is considerable: 10%. Finally, 4% of households are beyond the critical threshold (DAR > 2) that frequently leads to insolvency. When we consider the values of both debts and assets, the proportion of indebted households that are at risk is small (graph 12).

Graph 12 – Distribution of indebted households according to debt/asset ratio (DAR)



CONCLUSION

While debt keeps climbing faster than income, the low interest rates are keeping the burden of households' monthly payments at a reasonable level. The proportion of borrowers who are at risk of failing to meet their financial obligations has remained quite stable over the past ten years. However, the ability to cope with an event causing a drop in income, such as a job loss or a critical illness, has diminished. The low savings rate and longer periods of unemployment also make households more vulnerable to an eventual rise in interest rates.

Given that the prospect of key interest rate hikes by the Bank of Canada has dimmed due to the turmoil generated by falling oil prices, households appear to be less threatened in the short term. But while they are not at the edge of a cliff, Quebecers need to make sure that they will be able to handle the eventual rise in interest rates without too much trouble. Furthermore, the province is not completely immune to the possibility of deteriorating economic conditions which could do damage to the labour market and reduce household income. A shock, such as a sudden drop in home prices⁴, or a stock market correction, could also change things in a hurry. However, the current value of debt in relation to that of assets is, in general, sound.

Households' financial positions, which appear to be under control at the moment, could change rapidly. Should all interest rates start gradually heading up, a growing proportion of households would find themselves in the discomfort zone and the incidence of payment defaults would rise, as would the number of personal bankruptcies. This medium-term concern about the impact of eventual interest rate hikes increases the risk of significant deterioration in households' financial position. Given that interest rate hikes appear to be on the back burner for a few more quarters, households should take this opportunity to put their finances in order. If the more fragile among them manage to benefit from this respite to reduce their level of debt, they will face fewer difficulties down the road.

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⁴ Desjardins, Economic Studies, *Economic Viewpoint*, "Simulation results: If residential property prices were to decline, what impact would this have on the financial position of Quebec's households?", May 6, 2014, <http://www.desjardins.com/ressources/pdf/pv140506e.pdf?resVer=1399381726000>.