Household debt of Canadian families reaches new levels (May 2011)

It's no secret that Canadians have, over the past decade or so, taken on an unprecedented level of personal and family debt. An extraordinarily low interest rate environment, the increased availability of credit through a variety of sources and credit vehicles and a generally more "relaxed" attitude toward debt have all combined to make personal debt—sometimes substantial personal debt—more the rule than the exception.

The first cautions about the level of debt of Canadian families started being heard about five and a half years ago when Statistics Canada reported (at http://www.statcan.gc.ca/daily-quotidien/050916/dq050916a-eng.htm) that, in the second quarter of 2005, the average debt of Canadian households was greater than their annual disposable income. Specifically, Canadian households owed $1.08 for every dollar of disposable income.

Since that time, and particularly in the past year, a number of financial authorities, including the Bank of Canada and the Office of the Superintendent of Bankruptcy have issued statements warning of the dangers of excessive household debt. Specifically, the concern is that Canadians have, in a low interest rate environment, taken on substantial amounts of debt which cannot be sustained over the long term. Or, as put by the Bank of Canada: "Ordinary times will eventually return and, with them, more normal interest rates and costs of borrowing. It is the responsibility of households to ensure that in the future, they can service the debts they take on today".

In February 2011, the Vanier Institute of the Family issued its annual report on The Current State of Canadian Family Finances (available on the Institute's Web site at http://www.vifamily.ca/node/783), and that report contained figures which indicate that the level of Canadian household debt has reached two new unwelcome benchmarks. Specifically, the Institute's report indicated that, for 2010, the average debt of Canadian families as a percentage of disposable income, had reached 150%. In other words, the average debt load of Canadian households as a percentage of disposable income has increased by nearly 50% (from 108% to 150%) over the course of the last five years. Notably, it had taken 15 years for that percentage to increase from 93% (in 1990) to 108% (in 2005). And, according to the Vanier Institute, under current trends, that "ratio could easily reach 160% within the next two years".

In addition to the increase in debt as a percentage of disposable income, the Institute reported that, for the first time, the average debt load of Canadian families surpassed the $100,000 figure. While that number is significant in and of itself, what will likely prove to be of greater significance over the next few years is the composition of that debt.

While debt comes in an increasingly varied number of forms, there are, essentially, only two basic types of personal debt—secured and unsecured. In the former, the lender "secures" the debt against an asset owned by the borrower, meaning that if the debt is not repaid on time, the lender has the right to seize and sell the underlying asset in order to be repaid. The kind of secured debt most familiar to Canadians is, of course, a mortgage. The mortgage lender loans money to a borrower for the purchase of a house, but retains the right to seize and sell that house if the mortgage is not repaid as required. Unsecured debt, by contrast, is money provided to a borrower on no more than the strength of the borrower's promise to repay—and the best example of that type of debt familiar to most Canadians is a credit card.

From a borrower's perspective, the biggest difference between the two types of debts is how "exposed" the borrower is. With secured debt, the borrower has an asset whose value nearly always exceeds the amount of the debt. And, in the event that a borrower can no longer meet his or her loan obligations, the option of selling the underlying asset and repaying the debt from the proceeds of sale is always there. However, with unsecured debt, the borrower is in a much more tenuous position. Borrowers who encounter difficulty in repaying unsecured debt have no ready underlying asset which they can sell in order to rid themselves of the debt. Absent a windfall in the form of an (unlikely) lottery win, or an inheritance, unsecured debt must be repaid from current cash flow, meaning that there must either be an increase in income, or funds must be reallocated from other household expenditures. It is just this circumstance which underlies the current concern among financial authorities. And, as the Vanier Institute figures show, there is reason for that concern.

While most reports on the debt owed by Canadian families focus on the overall total debt figure, the Vanier Institute report goes one step further and breaks down the total debt load of Canadian households into its component parts. As noted, the total average outstanding debt of Canadian households (for the third quarter of 2010) now stands at just over $100,000. According to the Vanier Institute report, about $63,000 of that debt is composed of mortgage debt, meaning that, on average, the amount of debt held by Canadian households in what the Vanier Institute describes as "consumer credit/loans" (which would presumable include credit card debt, unsecured lines of credit and personal loans generally) is just over $36,000. At the current prime rate of 3%, the monthly interest cost alone (without any repayment of principal) of servicing such a debt is $90. And of course, almost no unsecured debt is provided at an interest rate as low as prime. More typically, the interest rate charged on credit card debt can range anywhere from 12% (meaning a monthly interest cost of $360.) to above 25%. The concern expressed by the Bank of Canada and the Office of the Superintendent of Bankruptcy is for what will happen should that interest cost of household indebtedness double in amount—or more.

While no one knows how quickly rates will increase or to what extent, an increase in rates in the near term is very likely. And, while most Canadians are aware that current interest rates are low, very few are likely aware of just how seldom rates have been at such low levels. The Bank of Canada maintains a record of interest rates levied on various types of debt instruments over the past 75 years—since 1935. Those figures show that, since 1935, the prime rate has been less than the current rate of 3.0% during only one time period—from March 2009 to August 2010.

As well, it's not likely that many Canadians under the age of 45 can actually remember what it's like to carry a significant debt load in a high interest rate environment—and what can happen when carrying that debt load becomes unsustainable. In mid-1990, the prime rate reached 14.75%, which seems very high until it is compared to the almost unimaginable 22.75% rate in effect a decade earlier in August 1981. If similar interest rates were charged on the $36,000 of consumer debt which represents the Canadian household average, the monthly interest cost alone would reach $443 (at 14.75%) or $683 (at 22.75%)—an amount that simply couldn't be accommodated by most family budgets, which are already being squeezed by higher food and energy costs. Significant increases in the cost of non-discretionary expenditures like food and energy, when combined with higher carrying costs on existing indebtedness could create a “perfect storm” of financial pressures sufficient to push many families into bankruptcy.

It’s a gloomy scenario, to be sure—but not an unavoidable one. For families carrying significant debt, especially unsecured debt, the best option is to pay off that debt while interest rates remain low, starting with the debt carrying the highest interest rate. However, while that may be the best option, it’s not a terribly realistic one. For many Canadian families, paying off personal debt within a short time frame is just not possible, especially in the face of inflationary pressure on other household expenditures. Where paying off personal debt off in the near term isn’t possible, the next best option is to fix the interest rate levied on that debt while rates are still relatively low. A consolidation loan (at a lower, fixed rate of interest) may be possible or, where there is significant equity in the family home, it may be possible to roll the debt into the existing mortgage at a much lower rate of interest—and to fix that rate of interest at current rates for the next few years.

While the combination of inflation and rising interest rates is an unnerving one for families carrying significant personal debt, it is possible to take steps to mitigate, to some degree, the impact of those changes. The time for doing so, however, is growing shorter.