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Storm Clouds Gather Around Canadian Consumer Credit

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Storm Clouds Gather Around Canadian Consumer Credit

BY CRISTIAN DERITIS AND MARK HOPKINS

The Canadian economy in general and the consumer segment in particular were surprisingly unscathed by the economic recessions in the U.S. and Europe. Recent data suggest this good fortune may be starting to turn, however. Since the fall, the economy's rate of expansion has slowed as global threats have mounted, effectively halting the country's steady march toward full employment. Economic headwinds, both within Canada and abroad, will limit consumer borrowing and lead to deteriorating credit quality over the next few years.

Canada's ability to outperform has relied on the strength of household demand, as consumers have held fast to the credit-financed spending patterns abandoned by their peers in the U.S. and Europe. Increasing rates of leverage, encouraged by cheap global interest rates, have contributed to steady growth in consumption and a vibrant housing market, stimulating new residential investment. But they also have prompted fears that a credit bubble may be forming, increasing risks to the financial system. For the moment, Canada remains well-positioned to weather a renewed global downturn. Like any small, open economy, however, it cannot sustain its current rate of growth indefinitely without additional support from its trading partners, particularly the U.S.

Front and centre on the minds of Canadian analysts now is whether the economy's transition to slower growth will be contained or whether increased consumer borrowing over the past few years will translate into higher default rates once wage and asset values stabilize or should financial contagion from Europe cause global credit markets to seize up. Although upside risks do exist, and a number of domestic indicators of credit market health remain positive, the risk of a rapid reversal in Canadian consumer credit conditions is building.

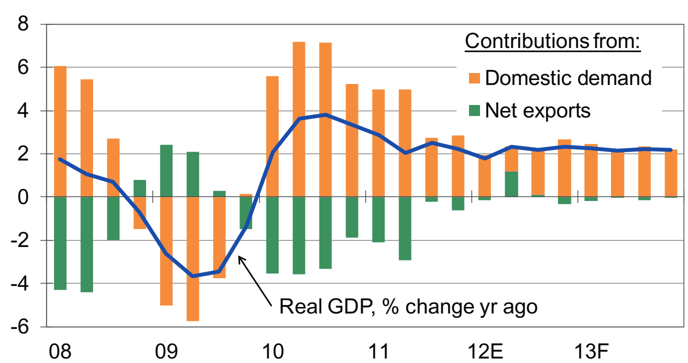
O(uch) Canada!

Canada was first among the G-7 countries to recover fully from the recession and enter expansion, averaging faster than 3% annual growth in real GDP from the third quarter of 2009 through the third quarter of 2011. Since the fourth quarter of 2011, however, growth has averaged just 1.9%, a bit slower than the country's current potential rate. Business investment and inventory restocking were the main drivers in the first quarter, but domestic demand disappointed overall as consumption spending, a key driver in 2011, slowed sharply to start 2012. Spending on durables, which is particularly sensitive to consumer sentiment, remained flat as concerns began to mount again over the fate of the euro zone and slower income growth at home.

Domestic demand will remain the key driver of output this year, but growth is likely to slow further (see Chart 1). Wage income growth decelerated and corporate profits fell measurably in the first quarter, suggesting private consumption and business investment spending may contribute less to output growth in the near term than they have over the recovery to date. In effect, the domestic economy is slowing to cruising speed prematurely, short of reaching full employment. The weak recovery in the U.S. and Europe has prevented a full rebound in exports, which constitute one-third of Canada's GDP, leaving idle a critical engine of income growth for Canadian households.

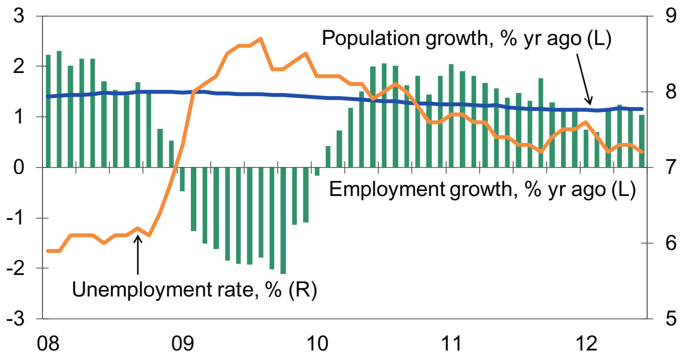
Although trade is now generating less drag than earlier in the recovery, exports will be slow to recover. The Canadian dollar has traditionally sold at a significant discount against the U.S. dollar in foreign exchange

Chart 1: Getting By, but Little Help From Friends



Sources: Statistics Canada, Moody's Analytics

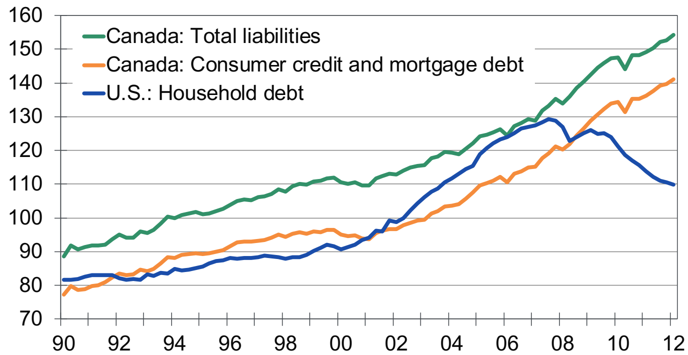
Chart 2: Progress Disrupted in Labour Market



Sources: Statistics Canada, Moody's Analytics

Chart 3: Iconoclasts, Amid Global Deleveraging

Household debt, % of disposable income



Sources: Statistics Canada, Federal Reserve, Moody's Analytics

markets; as a result, most prices in Canada range from 10% to 25% above those of the same goods or services in the U.S. Driven by strong global demand for Canadian commodities, the loonie is now trading near parity with the U.S. dollar. This has created a sharp competitive disadvantage for Canadian manufacturers and some retailers, most of whom operate within 160 kilometres of the U.S. border. This competitive gap will narrow gradually over time, as arbitrage opportunities place downward pressure on Canadian prices, but the country's balance of trade will remain in deficit through next year, with net trade contributing little to overall GDP growth this year or next. This makes it even more critical that domestic demand in Canada maintains its forward momentum.

Slouching toward full employment

Over the past four quarters, demand has grown more slowly than the economy's capacity to produce—adding to, rather than removing, excess slack in the labour market. Over the 12 months through June, employment grew by just 1%, slower than the rate of population growth (see Chart 2). Even more troubling than the slowing pace of job creation, progress has been sporadic, increasing uncertainty over the trajectory of the economy. More than three-quarters of the employment gains registered since June 2011 came amid a sudden spurt of job growth in March and April. About 140,000 jobs were added in those two months, double the total number added over the preceding 10 months.

Together with the slight rise in inflation in April, this spurred speculation that the Bank of Canada could hike rates later this year. Subsequent data rule that possibility out, however, and reaffirm our baseline forecast that the bank will stay sidelined until early 2013. Falling commodity prices have eased inflationary pressures, and net job gains in May and June were less than half the number necessary to permanently lower the unemployment rate.

National statistics obscure a wide variation in regional economic performance, however. Labour markets remain quite tight in the western provinces, which have benefited most from high commodity prices and new investment by energy and mining companies. Despite this resource boom, rates of inflation in the West have run slightly below the national average. Inflation has been highest in the Atlantic provinces, where unemployment rates are also much higher. This regional disparity creates a challenge in setting appropriate monetary policy, but to date neither the western boom nor eastern stagflation has presented sufficient cause to require action by the Bank of Canada. As a result, banks will remain focused on national trends and global events, relying on natural market adjustment mechanisms and fiscal policy measures to remedy regional imbalances over the medium run.

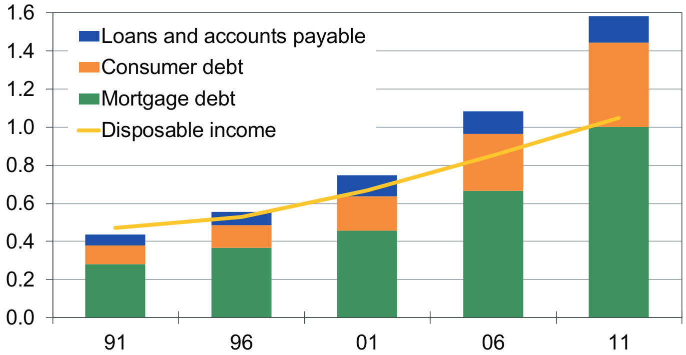
The joys of leverage

The Canadian economy has grown steadily over the past few years, yet interest rates remain near record lows, closely matching those of the U.S., where aggressive monetary stimulus measures and investor risk aversion have pushed down short-term lending rates and long-run bond yields. This combination of steady income growth, a low and falling rate of unemployment, and easy financing terms has encouraged households to run up new debt to finance the rising cost of homes as well as their own consumption. Although growth in household debt has been outpacing disposable income steadily for some time, the ratio of debt to disposable income has risen to a level exceeding that of the U.S. prior to its financial crisis, raising fears that households are overleveraged (see Chart 3).

Although U.S. consumers have been reducing outstanding balances, or deleveraging, ever since entering recession in 2008, Canadians have done just the opposite. As a share of disposable income, debt grew more slowly in Canada than in the U.S. throughout the 2000s, and Canadians held lower levels of consumer and mortgage debt. That trend has now reversed: While the U.S. debt-to-income ratio has fallen back to 110%, the ratio in Canada has surpassed 150% and reaches new highs with each passing quarter. Credit and mortgage debt alone has surpassed 140% of disposable income, well above the peak reached in the U.S. just prior to the recession. Between 2006 and 2011, household balances of consumer credit and mortgage debt each expanded by around 50%, an average annual pace exceeding 8%

Chart 4: Household Debt Up 50% in Last 5 Years

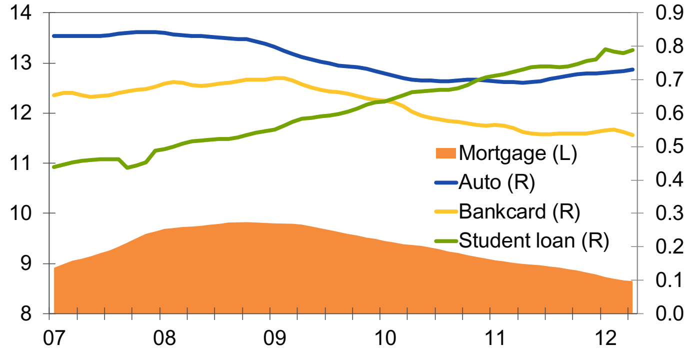
Liabilities of individuals and unincorporated businesses, $ tril



Sources: Statistics Canada, Moody's Analytics

Chart 5: Deleveraging Due Not Just to Mortgages

Total balances, $ tril, 3-mo MA



Sources: Equifax, Moody's Analytics

and twice the rate of growth in disposable income (see Chart 4).

While most of the balance reduction in the U.S. has been involuntary, resulting from charge-offs of bad mortgage debt, consumers have reduced outstanding balances on auto loans, credit cards, home equity loans, and consumer finance loans (see Chart 5). The only segment that has not experienced a reduction is student lending, which has grown throughout the period as more individuals opt to increase their educational levels and as tuitions have risen rapidly.

Although Canadians have not deleveraged in a similar fashion, consumers and lenders have turned more cautious. As evidenced in Chart 6, consumer debt increased at a slower pace in 2011 than in 2010, with the year-over-year growth rate falling to 2.4% from 7.4%. Since most of the outstanding consumer credit outside of mortgages takes the form of revolving bank credit and credit cards in Canada (see Chart 7), most of the slowdown in overall debt levels is attributable to slower growth in these sectors. Indeed, revolving credit increased by only 1% in 2011, while bank installment loans continued to expand by 5%.

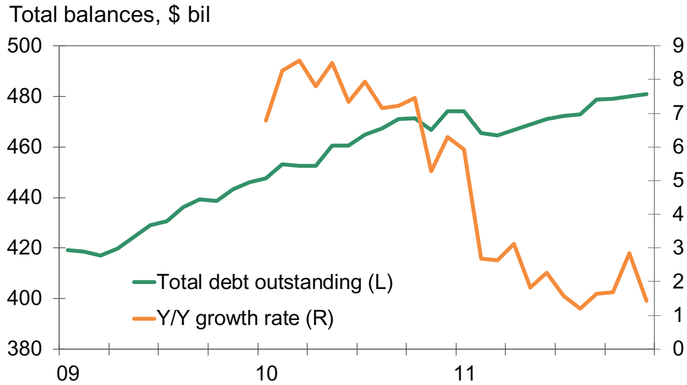
Historically, tighter lending standards and stronger household balance sheets have resulted in a stronger credit profile for consumer loan portfolios in Canada relative to the U.S. As of the end of last year, prime balances were eight times as large as balances to subprime borrowers, with the differential continuing to increase (see Chart 8). Though this is certainly an encouraging sign, it is important to note that measured creditworthiness tends to be highest right before a significant correction, as was the case in the U.S. (see Chart 9). The U.S. housing bubble allowed households to borrow aggressively at competitive rates. The mirage of high asset values provided consumers who became overextended with an escape valve. They could either sell their homes at inflated values to pay off their debts, or they could increase their borrowing to pay their existing creditors. Creditworthiness looked strong as a result but was clearly unsustainable.

Such evidence does not bode well for Canada, but other data suggest that the situation has not been so dramatic. Average credit risk scores are within their historical range, slightly decreasing as the economy has grown (see Chart 10). Average bankruptcy risk continues to decrease in the current environment as well, as reflected by a significant improvement of the bankruptcy scores provided by Equifax Canada.

Either by choice or necessity, Canadian consumers are charging less on their credit cards than a year ago. Part of this is motivated by an increasing sense of caution and uncertainty among consumers, given the global economic situation. But lenders have played a large role as well, having decreased

Chart 6: HH Borrowing Decelerates in Canada

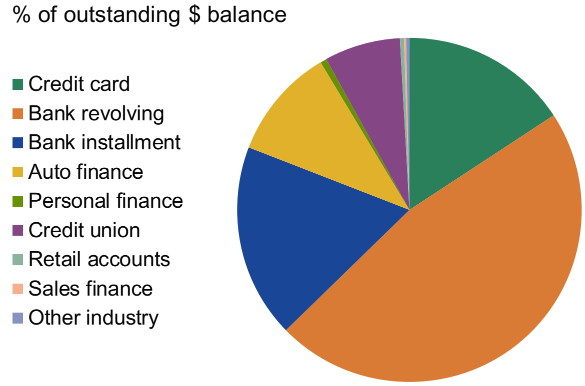
Total balances, $ bil



Sources: Equifax Canada, Moody's Analytics

Chart 7: Bank Loans Dominate

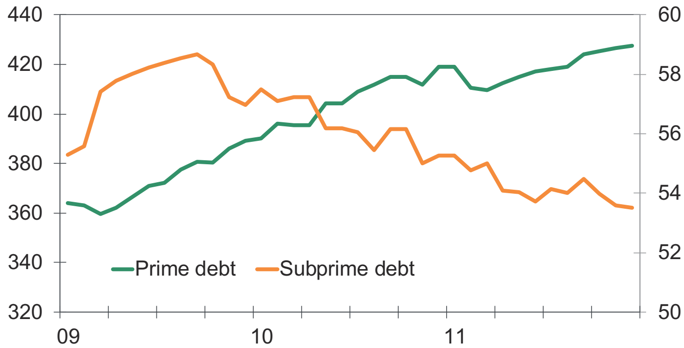
% of outstanding $ balance



Sources: Equifax Canada, Moody's Analytics

Chart 8: Canadian Subprime Borrowing Declines

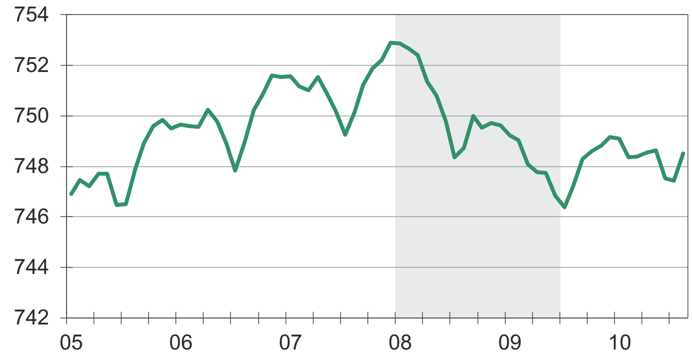
Total balances, $ bil



Sources: Equifax Canada, Moody's Analytics

Chart 9: U.S. Scores Peaked at Recession's Start

Avg Vantage credit score



Sources: Equifax, Moody's Analytics

credit limits on credit cards, shrinking the amount of credit available to consumers. Bank installment and bank revolving loans also show a significant contraction from those levels in the previous year.

Similar to the U.S., auto lending has remained robust, growing at close to a 10% annual rate in 2011 as consumers looked to satisfy some of the demand that built up during the Great Recession (see Chart 11). As in the U.S., the bulk of this lending is coming from auto finance companies over banks. This category includes captive auto finance companies that may provide easier credit terms in order to favour new-car sales from the manufacturing parent companies.

The Canadian and U.S. consumer credit landscapes differ significantly in the area of home equity lending. Whereas the use of home equity lines of credit has been widespread in the U.S., these lending products make up a very small share of household credit exposures in Canada (see Chart 12). Home equity loans and second mortgages have complicated the U.S. foreclosure crisis immensely because of the conflicting incentives of first and second lien mortgage holders. Second liens have limited the ability of some borrowers to refinance their mortgages to take advantage of record low rates. Loan servicers have also run into barriers when trying to modify first mortgages, as the cooperation of second lien holders is needed to preserve the legal rights of the first mortgage-holder during a loan modification.

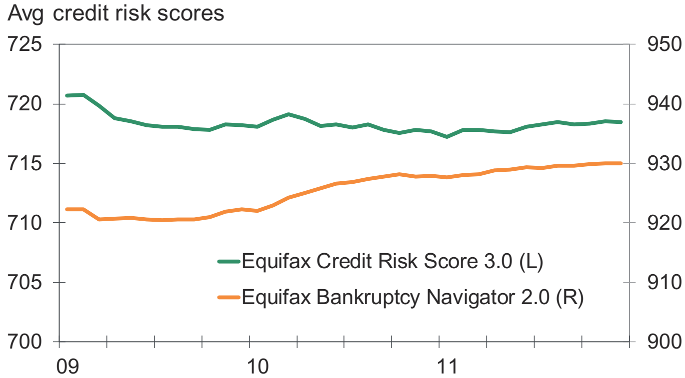
Even if the Canadian housing market should falter and foreclosures should rise, the limited volume of second mortgages among Canadian homeowners suggests that the legal and procedural issues that have plagued the U.S. market would be largely avoided. This would mitigate the spillover effects brought on by the U.S. housing bust. A Canadian housing crisis would likely be shorter and shallower than the U.S. experience.

Calm before the storm?

Although the growth rate for outstanding balances is decelerating, delinquency rates have remained low across all stages of delinquency (see Chart 13) and consumer loan products (see Chart 14). Such behaviour is not uncommon during a credit boom because of the so-called denominator effect. That is, rapidly expanded lending can lead to low delinquency rates in the short run, as new loans contribute to outstanding balances while contributing little in the way of new delinquencies for the first few months or quarters after origination. A relatively stable and expanding economy can also mask underlying deterioration in credit quality, as even distressed borrowers have greater flexibility in paying back their loans.

Chart 10: Canadian Credit Scores Stable

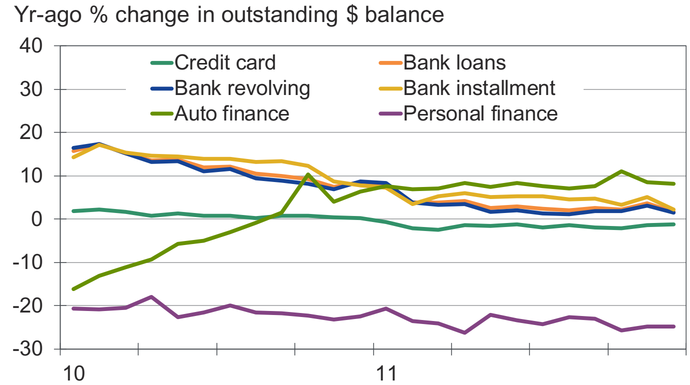
Avg credit risk scores



Sources: Equifax Canada, Moody's Analytics

Chart 11: Auto Loans Growth Remains Strong

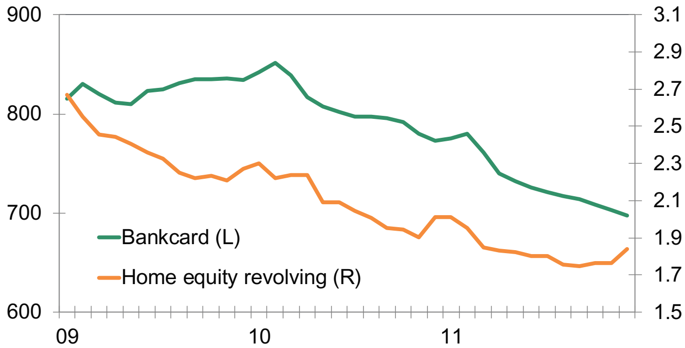
Yr-ago % change in outstanding $ balance



Sources: Equifax Canada, Moody's Analytics

Chart 12: HELOCs a Small Share of Balances

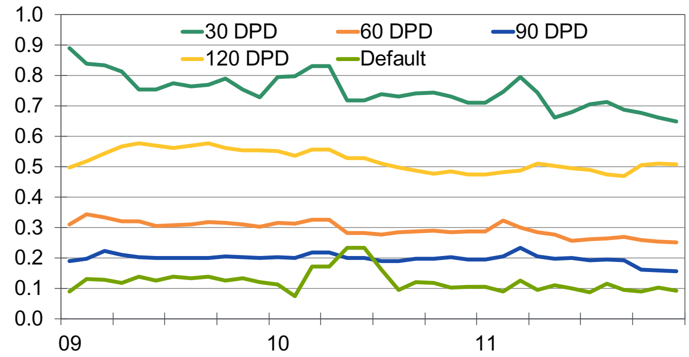
Total balances, $ bil



Sources: Equifax Canada, Moody's Analytics

Chart 13: Delinquency Rates Low and Stable…

% of outstanding $ balance



Sources: Equifax Canada, Moody's Analytics

Delinquency data available from Equifax Canada suggest that early-stage, or 30 days past due, delinquent balances have remained constant over the past three years for all major industry groups. Recent monthly data show a decreasing or stabilizing trend as well. Lower early-stage delinquent balances have translated to lower year-over-year late-stage delinquent balances for all except the retail and sales finance sectors (see Chart 15). Though the increase in these delinquency rates is troubling, it is worth noting that the relative volume of these segments is small. Lenders have also taken notice, and tighter lending standards should lead to an improved credit profile.

Delinquency rates for auto finance loans have demonstrated improvement, having consistently decreased during 2011 after peaking in the fall 2009. This has been driven by the healthy growth in total outstanding balances and a continued decrease in delinquency balances. However, the decrease slowed at the end of 2011, suggesting that the improvements in performance may be coming to an end as a slowing economy pushes more consumers into default.

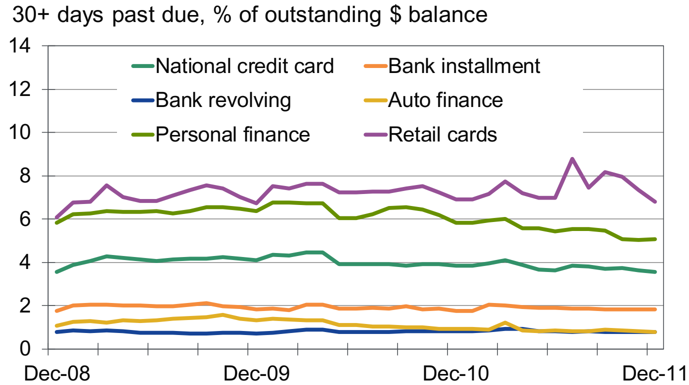
While economists and analysts have expressed concern regarding the rapid balance growth in credit cards, most of the concern, as well as most of the total household debt increase, has come from mortgage debt. Particularly alarming in this regard is the sharp rise in house prices over the past decade, which has driven up demand for mortgage credit (see Chart 16). Although the rate of price growth has moderated substantially since the recession, home values remain elevated in many areas of the country. As a result, homebuyers are being required to stretch budgets further than normal to afford purchases.

The experience of the U.S., Japan, Spain and other countries after home values appreciated quickly in an environment of easy credit is well known. It is not unreasonable, therefore, to expect a similar housing market correction in Canada. One significant difference, however, is the fact that bank lending practices tend to be more conservative in Canada. For example, banks typically require a down payment of 20% or more along with an excellent credit history. As a result, households typically have large equity cushions, at least on paper, and would be less likely to have negative equity or be under water in the event of a moderate price decline. Since the recession began, however, these owner equity cushions have deflated at the same time that financial asset valuations have stagnated, increasing household debt-to-equity ratios sharply (see Chart 17).

The rise in Canadian house prices does vary significantly by region but has been promulgated largely by two macroeconomic factors: low interest rates and the relatively

Chart 14: …Across Loan Products

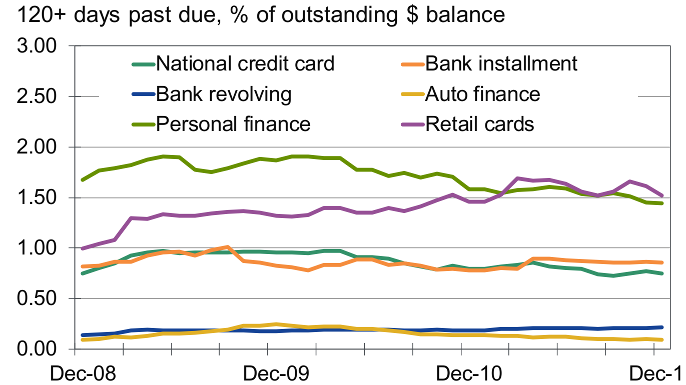
30+ days past due, % of outstanding $ balance



Sources: Equifax Canada, Moody's Analytics

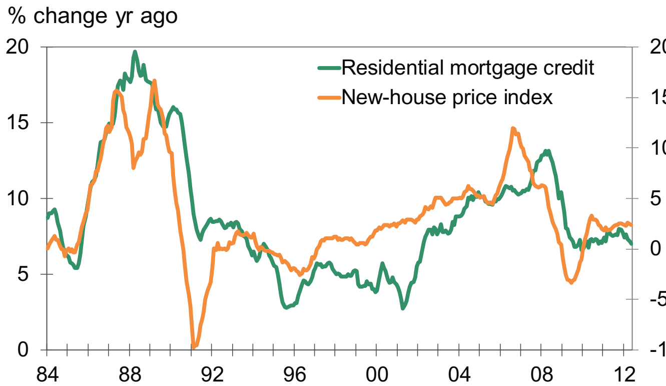
Chart 15: Late-Stage Delinquencies High

120+ days past due, % of outstanding $ balance



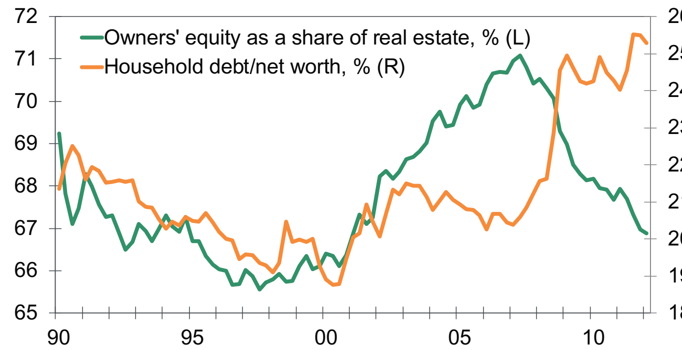
Sources: Equifax Canada, Moody's Analytics

Chart 16: House Prices Fueled Credit Demand



Sources: Statistics Canada, BLS, Moody's Analytics

Chart 17: Equity Cushions Are Shrinking



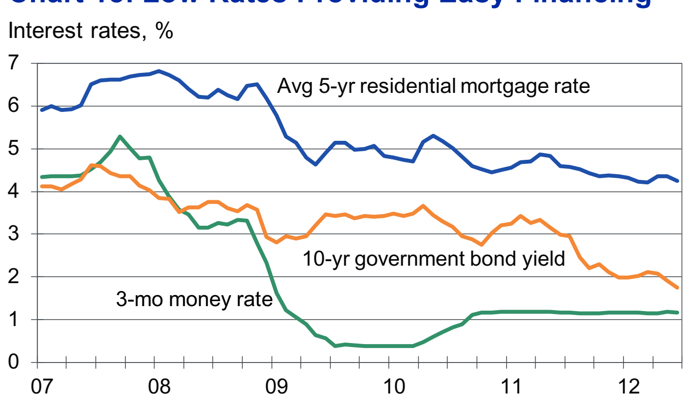
Sources: Statistics Canada, Moody's Analytics

brief and shallow recession, which has kept the unemployment rate low and provided steady income growth. Canada's current low interest rates are, in turn, attributable to two factors. At the short end of the yield curve, the Bank of Canada's efforts to stabilize the exchange rate against the U.S. dollar have meant, in effect, that Canada is importing the aggressively expansionary monetary policy of the U.S. Federal Reserve. Although the Canadian overnight rate is 1%, which is above that of the Federal Reserve, the Fed's commitment to holding its policy rate low has constrained the ability of the Bank of Canada to tighten any further.

Canadian borrowing costs have also tracked U.S. rates at the longer end of the yield curve, where a heightened level of risk aversion among global investors over the past year has helped drive Canadian government bond yields lower. This flight to safety has led already-low Canadian mortgage rates to decline even further (see Chart 18). In the case of several major urban real estate markets, the inflow of foreign saving has had an even more direct impact on prices. Vancouver, in particular, has had a boom in demand for high-end properties in recent years, driven by hot money inflows from wealthy Asian investors who have sought hard assets denominated in stable currencies. This effect has been most pronounced at the top end of the market, but foreign demand has contributed to higher prices across the board. As a result, Vancouver has been ranked as the second least-affordable English-speaking city in the world, after Hong Kong.

Vancouver is a particularly stark example and, in a nation as large and diverse as Canada, not terribly representative of the state of real estate markets elsewhere in the country. Nevertheless, relative to national income and interest rate trends, it is clear that, on average, Canadian homes have become less affordable and, in some urban markets, overvalued by as much as 10% to 15%. A correction in real estate prices looms as a downside risk for Vancouver and Toronto, but average national home prices are unlikely to decline outright. Rather, under the Moody's Analytics baseline forecast, a gradual adjustment will occur in real terms over the next several years, as growth in house prices slows below the rate of inflation.

Chart 18: Low Rates Providing Easy Financing



Sources: Bank of Canada, Moody's Analytics

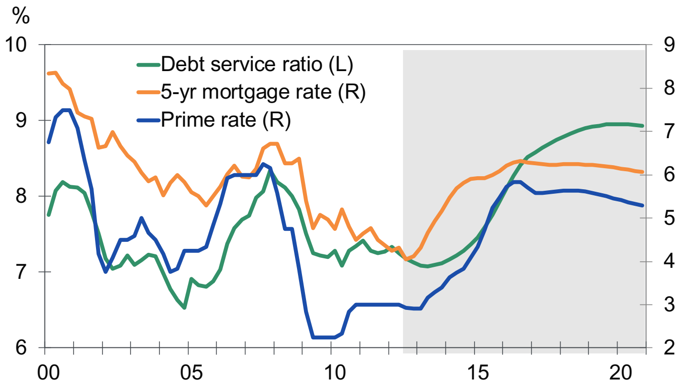
Even without a drop in national house prices, however, the housing market represents a serious threat to the stability of Canadian credit markets. Canadian leverage ratios have clearly risen to a dangerous point, well in excess of that experienced in the U.S. amid its own housing boom. The current steady, upward trend in the debt-to-income ratio is not sustainable, and thus drives our conclusion that a correction is coming. Larger down payments and equity buffers may help cushion the blow somewhat, but rising debt-to-income ratios will limit the amount of flexibility that households will have to adjust their finances, at least in the short term.

The decrease in the volume of total accounts, coupled with an increase in total outstanding balances and a decrease in delinquent balances, has led to a faster than expected decline in the delinquency rate, which is a positive sign of healthy growth. Lenders are moving to tighten standards further and discourage households from incurring even more debt. Whether these measures are sufficient to affect the performance of existing debt will depend largely on broader economic forces and the ability of the Canadian economy to adjust to changing behaviours across its border.

Rates moving on up

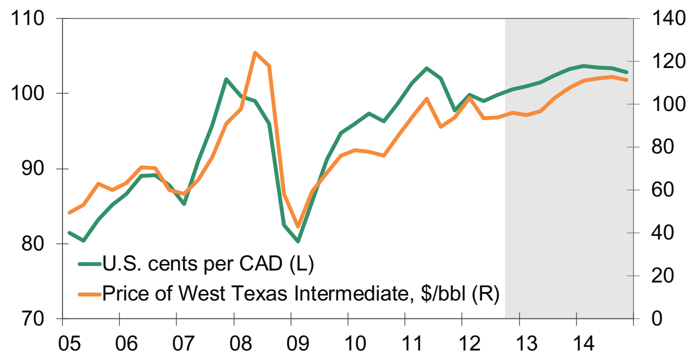
The Bank of Canada is likely to raise rates before the end of 2013. With the Federal Reserve committed to holding U.S.

Chart 19: Future Debt Service Will Exceed Norm



Sources: Statistics Canada, Moody's Analytics

Chart 20: Loonie Will Remain Near USD Parity



Sources: Statistics Canada, Moody's Analytics

short-term rates low through 2014, the bank will likely delay tightening as long as possible; with the outlook for global growth somewhat darker in the near term, the probability has shifted toward rate hikes coming later rather than sooner. Nevertheless, as Europe recovers and the U.S. passes over its fiscal cliff, the clouds that have hung over the Canadian economy will begin to lift and growth should accelerate. Once unemployment falls below 7%, the Bank of Canada will turn more hawkish in its language, telegraphing a rate hike to avoid unmooring expectations regarding inflation.

This will quickly begin to put upward pressure on borrowing costs, as lenders price in future short-term interest rate hikes. A more optimistic outlook among investors will also reduce the risk premium built into current bond prices that have driven down yields on government debt. As a result, mortgage rates will likely rise even in advance of actual tightening. As debt is rolled over and new debt accrued, the increase in interest rates, combined with the marked increase in debt loads, will cause households' cost of debt service to rise to a higher share of their disposable income than prior to the crisis (see Chart 19).

This will lead to one of two outcomes: (1) The financial sector, which relies heavily on retail banking, could reap a windfall as higher debt service payments boost profits, or (2) Canadian consumers will find themselves overstretched as they begin to roll over their debt at higher rates, causing delinquency rates to rise and potentially triggering defaults on consumer and mortgage debt.

Thanks to their larger equity cushions, far fewer Canadian homeowners are likely to be under water on their mortgages should higher interest rates trigger a decline in house prices. As a result, the risk of default on home loans is less than it was in the U.S. In other respects, however, Canadian households face even greater risks to their balance sheets. Relative to the U.S., where 30-year fixed-rate mortgages are the most prevalent, Canadian homeowners are far less well- insulated from interest rate risk. This rate risk is particularly problematic, given the high degree of leverage and the concern that homebuyers' demand is being driven by speculative pressures.

In order to offset the loose credit policy of the Bank of Canada and preempt overly speculative risk-taking in real estate markets, the Canadian government has taken a number of steps to tighten mortgage rules, including limiting the size and shortening the maturity of home loans backed by the Canada Mortgage and Housing Corp. The CMHC insures mortgages with high loan-to-value ratios, providing liquidity to facilitate borrowing by first-time homebuyers. The measures will also affect those drawing on home equity for investment purposes, however. These steps should offset some of the pressures generated by low interest rates, but will not eliminate them all. Moreover, with the economy cooling, it is unclear whether Ottawa would be willing to take more aggressive steps to constrain activity in the housing market, which remains one of the few bright spots in the economy.

Europa, Europa

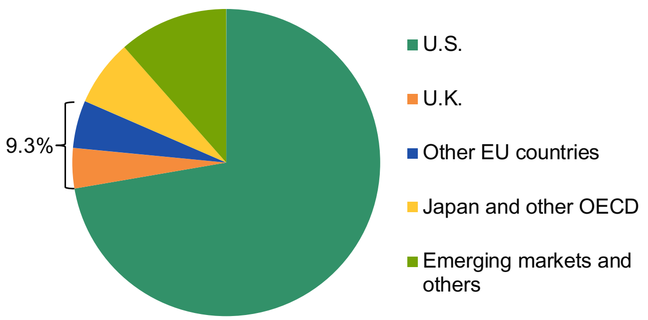
As the fate of the European monetary union grows more uncertain, global investors are growing more risk averse. The comparative safety of loonie-denominated assets, together with global demand for commodities that will remain robust over the longer term, will keep the Canadian currency strong for some time (see Chart 20). This will weigh on exporters but encourage continued capital inflows from abroad, which will support asset prices and affordable borrowing costs.

The impact of Europe's current troubles is already being felt in Canada, through slower growth and an eroding trade balance. The linkages of the Canadian economy to Europe are more indirect than direct, coming principally through the country's close trade and financial ties to the U.S. (see Chart 21). Europe itself accounts for around only 9% of Canadian exports, and Canadian banks have little direct exposure to euro zone sovereign debt and the European financial system. Nonetheless, contagion from Europe remains a significant risk, as the Canadian economy would not be immune to the disruption of global trade and financial flows that would result from a disorderly breakup of the euro zone.

Although the threats remain elevated but contained, the Canadian economy will benefit from global risk aversion, which has

Chart 21: European Shocks Will Come Indirectly

Share of merchandise exports, 2011



Sources: Statistics Canada, Moody's Analytics

pushed down longer-maturity government and private bond yields in Canada. Should a euro zone crisis spark a global liquidity crisis, Canadian interest rates could rise sharply, however, particularly if worries over the U.S. fiscal path cause investors to suddenly place a risk premium on U.S. debt.

Conclusion

The Canadian financial system remains one of the soundest in the industrialized world, and credit quality remains strong. Canadian banks continue to be well-capitalized and well-regulated, and they operate largely on a traditional retail-banking model, as opposed to investment banking, which provides a more stable revenue stream and less balance sheet risk than the U.S. financial system. The financial industry is also more concentrated, which has traditionally improved coordination while limiting competitive pressures, allowing the system to maintain a more conservative, less aggressive set of lending practices.

Nevertheless, the risks facing the financial system are mounting. A deceleration in the global recovery this year will weigh on Canadian exports, equity prices and employment opportunities. Slowing income growth and rising interest rates will put greater pressure on Canadian households, who will see the cost of debt service eat a larger share of their earnings. Rising debt service costs create an upside risk for bank revenues, but Canadian households' ever-rising leverage ratios have left them with little wiggle room to afford higher interest rates, suggesting that delinquency and default rates will rise.

The recent tightening of lending standards, combined with a long tradition of conservative mortgage lending practices, will limit the rise in losses and prevent a mortgage crisis or credit crunch of the same scale experienced by the U.S. during the Great Recession. Nevertheless, with the economy now relying heavily on the continued expansion of household spending, any retrenchment in the consumer sector will likely place the economy on the brink of a second recession, creating the potential for a much more serious downward spiral in employment, household spending, and the quantity and quality of outstanding credit.

About the Authors

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Cristian de Ritis is a director at Moody's Analytics. He performs consumer credit modeling and analysis with the firm's Credit Analytics group and contributes to the analysis for CreditForecast.com. Before joining the Moody's Analytics West Chester PA operation, Cris worked for Fannie Mae and taught at Johns Hopkins University in Washington DC. He received a PhD and MA in economics from Johns Hopkins University and graduated summa cum laude from Michigan State University with a bachelor's degree in economics.

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Mark Hopkins is a senior economist at Moody's Analytics. His responsibilities include macroeconomic research, regional economics and healthcare. Dr. Hopkins contributes to the Moody's Analytics U.S. macroeconomic model and is responsible for forecasting Canada's economy. He also analyzes healthcare and covers the state of Colorado and its metropolitan areas. Previously, Mark taught macroeconomics at Gettysburg College and served as international economist on the staff of the President's Council of Economic Advisers. He has published several articles and chapters related to international economics, economic growth and foreign policy. He received his PhD in economics from the University of Wisconsin-Madison, an M.Sc. from the London School of Economics, and a BA from Wesleyan University.

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Economic & Consumer Credit Analytics

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Moody's Analytics added Economy.com to its portfolio in 2005. Its economics and consumer credit analytics arm is based in West Chester PA, a suburb of Philadelphia, with offices in London and Sydney. More information is available at www.economy.com.

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