Impact of the Pandemic on Key Canadian Household Financial Indicators

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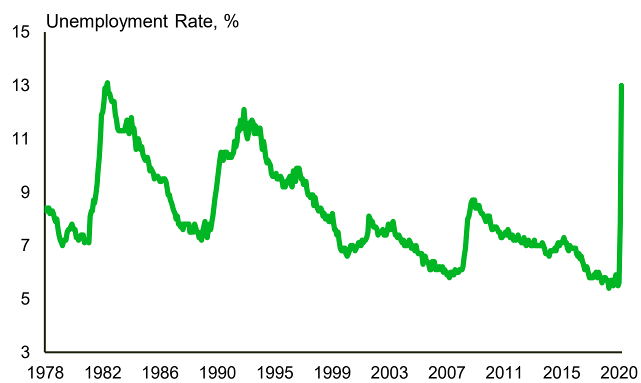
Highlights

- Canadian household finances were stretched coming into this year and will face a serious test from COVID-19.
- Temporary income replacement and debt deferral programs will go a long way in helping households whose livelihood has been impacted by the pandemic. Still, economic disruptions brought about by the pandemic will leave a lasting mark on household finances and indicators of financial wellbeing.
- On the one hand, debt servicing costs are expected to decline precipitously. Household wealth has also taken a hit, but robust gains over the past decade should provide a financial lifeline during the downturn.
- On the other hand, the saving rate is expected to increase as households reduce spending and ramp up precautionary savings due to elevated economic uncertainty. While debt growth is likely to slow, the short-term shock to disposable income is likely to push up the debt-to-income ratio in the near-term. Together, a higher saving rate and leverage ratio suggests increased downside risk to the outlook for consumer spending.

Canadian household finances, which have long been a source of economic vulnerability, will face a serious test this year from the COVID-19 pandemic. Since mid-March, non-essential businesses across the country have been ordered to close, leaving millions of people out of work (Chart 1). While the government moved in quickly to roll out temporary income replacement programs to support households whose livelihood has been impacted by the pandemic, these programs will not fully replace lost income. We expect it will take until at least the second half of 2021 for the unemployment rate to return to its pre-crisis level, suggesting that the economic pain will linger for some time to come.

Needless to say, the disruptions will leave a mark on key metrics of household financial health. In this report, we outline our expectations for saving, borrowing and wealth with the caveat that forecasts are clouded by larger-than-usual uncertainty. However, while we may have less precision hitting the exact numbers, directional movements should still provide a useful benchmark for the months ahead.

Chart 1: Uneployment Rate Surges in April



Source: Statistics Canada, TD Economics

Saving Rate Expected to Rise

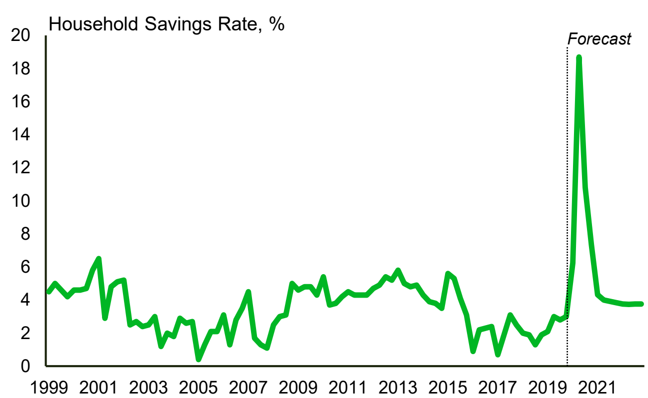
The low saving rate of Canadian households has received significant attention among analysts and the media. The personal saving rate hovered near 2% during the 2016-2018 period, falling to as little as 1.8% in 2018 – equivalent to just $852 per household.[1] This is not necessarily as troublesome as it may seem. It is well known that

Canadians have accumulated significant wealth over the last decade thanks to brisk gains in home prices and equities. This increase in wealth is one explanation for the lower saving rate. On the one hand, wealth gains may have reduced the need for households to save out of personal income. On the other hand, gains in net worth also boosted household spending as they tapped into their wealth, with higher consumption in turn leading to lower saving rate.

Research from the Bank of Canada has found a significant positive relationship between home equity extraction and consumer spending in Canada.[2] As wealth gains slowed toward the end of 2018 and into 2019, consumer spending moderated and the saving rate edged higher, rising to 3% by end of 2019. In addition to the wealth effect, higher interest rates on GICs, and some precautionary motives – an increased willingness to pay down debt amid rising debt servicing costs and a need to save more for larger down payments post-B-20 regulations for example, could have also impacted households saving behavior last year.

The precautionary savings motive will become even more important this year as households face employment and income uncertainty, as well as a drop in wealth. The saving rate likely spiked in the second quarter due to an abrupt drop in consumption as a direct result of quarantine measures, but even as the economy stages a recovery in the second half of 2020 and into 2021, it is likely to remain elevated (Chart 2). High household indebtedness will likely further exacerbate households' savings response, as consumers keep a tighter grip on their purse strings even with rock-bottom interest rates. Indeed, research has shown that monetary policy and low interest rates are less effective in boosting consumption when households are highly indebted.[3]

Chart 2: Saving Rate to Remain Elevated Post Crisis



Source: Statistics Canada, TD Economics

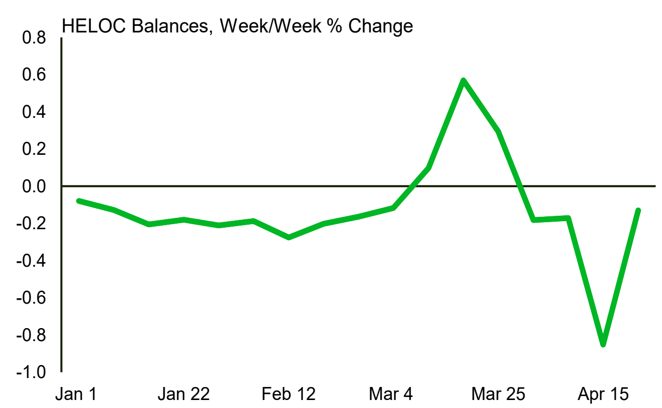
Slower Debt Growth but Higher Leverage

Even as economic growth slowed precipitously in March, household credit growth picked up noticeably, with both consumer and mortgage credit accelerating on a monthly basis. On the mortgage side, this acceleration could be capturing strong growth in home sales in February, a pickup in refinancing activity as mortgage rates declined, and lastly mortgage deferrals, which would also increase outstanding mortgage balances.

The reasons for the acceleration in consumer debt in March are less obvious, particularly given the precipitous decline in retail and auto sales in the second half of the month. One explanation is that it reflects households' stocking up on supplies ahead of the pandemic. Another is growth in HELOCs, which tend to move with new mortgage credit. Households may have tapped their home equity lines to cover income shortfall due to job losses, particularly before government support programs became operational. Indeed, evidence from the U.S., where lending data is more timely, appears to confirm just that, with home equity loans surging in March before tumbling back down in April (Chart 3).

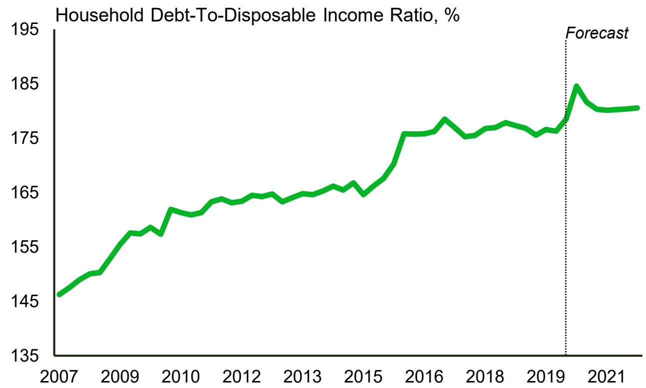
Despite the rush in borrowing in March, we expect credit to slow noticeably in the second quarter and contract in the third, reflecting the steep drop in home sales and purchases of cars and other durables, as well as broad-based decline in spending on many discretionary items, such as travel. Credit is expected to return to growth in the fourth quarter and beyond, but it will likely trail disposable income, due to more cautious consumer behavior, higher delinquencies and elevated unemployment, which is expected to normalize only toward the second half of end of next year.

Chart 3: U.S. Households Tap HELOCs in March



Source: Federal Reserve Board, TD Economics

Chart 4: Household Leverage Expected To Increase



Source: Statistics Canada, TD Economics

Despite the slowdown in credit growth, this year's hit to personal income will cause household leverage – measured as the debt-to-disposable income ratio – to spike (Chart 4). The ratio is expected to gradually decline in 2021 but to remain above its 2019 level. This outlook assumes a moderate increase in delinquency rates and that, thanks to the government's income support programs, households will be able to avoid a protracted deleveraging cycle, like the one seen in the U.S. in the aftermath of the global financial crisis.

Debt Servicing Costs Are Once Again On A Downward Trend

Last year, high debt service costs were an important driver of consumer insolvencies, as the share of household income devoted to debt servicing reached a record high. Households are facing even greater challenges this year, but at least higher interest rates won't be one of them. Even prior to this crisis, we were expecting the debt service ratio to fall this year. And fall it will. Given the broad decline in market interest rates so far this year, debt servicing costs are expected to ease far more than previously expected, falling in both absolute terms and as a share of income. This will provide an additional, much needed relief to households' bottom lines (Chart 5).

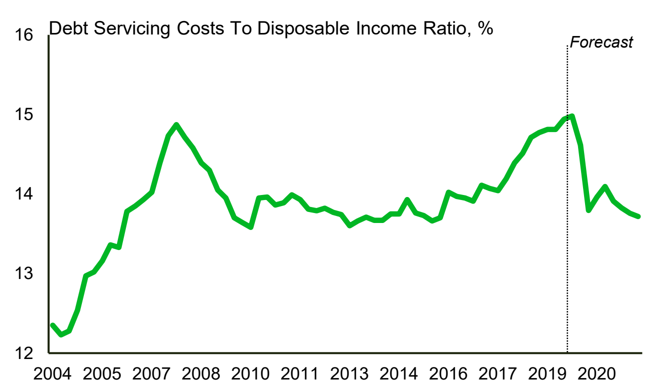
Deferrals on mortgage and consumer credit, and discounted interest rates on consumer credit, will also contribute to lowering debt servicing payments in the near-term but their impact is difficult to quantify precisely. This is especially true when it comes to consumer credit, where deferral terms are less uniform across products and financial institutions. Assistance comes in many forms: for some products, all payments can be deferred, for others, only principal payments can be deferred but not the interest. Generally speaking, deferral terms on consumer loans tend to be shorter in duration (i.e., ranging from two to four months) than deferral terms on mortgages. Among all consumer loan categories, most deferral requests appear to be for auto loans, second only for requests for mortgage deferrals. Thus, they will likely have the largest impact on consumer debt service costs.

All in all, after taking into account payment deferrals, the ratio of debt payments to disposable income is expected to decline from nearly 15% at the end of last year to 13.7% by the end of 2021 – the lowest level since the end of 2015.

Household Wealth Takes a Short-term Hit

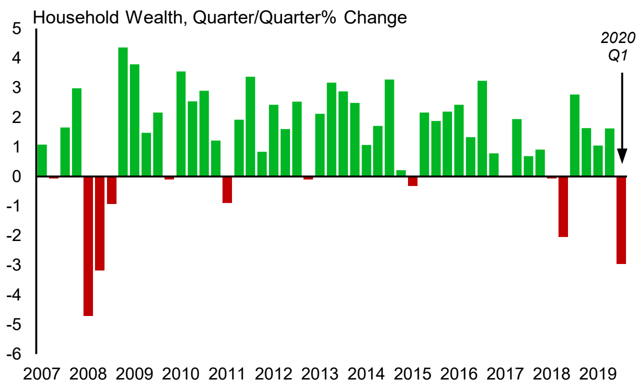
Given the drop in equity prices in the first quarter and the collapse of oil prices, household wealth contracted sharply in the first quarter of this year. In addition to this, the deferral of mortgage payments and lower home prices will also weigh on wealth in the first half of the year, since deferred payments slow home equity accumulation. According to the Canadian Bankers Association, between March and April, there were 720 thousand requests for mortgage deferrals. If this trend continues, the number of total deferrals could reach 900k in June, equivalent to roughly 18% of number of outstanding mortgages in Canada. The average mortgage payment in Canada is around $1,400 and around 40% of this amount goes toward principal repayment. Under these assumptions, mortgage deferrals are estimated to have lowered household wealth by roughly $300 million in the first quarter, and by $1.2 billion in the second.

Chart 5: Debt Servicing Costs To Decline



Source: Statistics Canada, TD Economics

Chart 6: Household Wealth Takes A Short-term Hit



Source: Statistics Canada, TD Economics

All in all, the drop in household wealth in the first quarter looks to have been the largest since the Global Financial Crisis (Chart 6). The good news is that responding to aggressive central bank easing actions, financial markets have recouped much of their losses since the end of March. While it is far from certain, the worst may be behind us. Meanwhile, home prices have showed resilience so far in the second quarter, as sharp declines in sales have been accompanied by a falling supply of listings on the market. Preliminary data for April point to downward pressure in some markets, such as the GTA, but that largely reflected compositional shifts in the sales.

Wealth Preservation Is Key For Preventing Prolonged Household Deleveraging

Whether these trends persist in the coming months is subject to considerable uncertainty. Provided that job markets start a recovery by late spring, demand should bounce off its lows and support modest gains in home prices and household net wealth. If the pandemic-related disruptions prove to be more protracted, housing demand will continue to soften and supply could pick up, through, for example, increased distressed selling by investors.

Barring an outsized home price correction, many Canadian households are expected to maintain a significant wealth cushion, which will help them to ride out the current downturn. Over the past decade, Canadian households built significant wealth reserves through asset appreciation. Since the end of 2009, household wealth rose by 84% to $11.7 trillion, with nearly half of it in real estate. As of 2019, average net worth is estimated to be near 800 thousand per household.

One fly in the ointment is that wealth distribution is highly unequal, with large differences across age and income groups as well as geographically. For example, based on the Statistics Canada Survey of Financial Security, roughly 8% of Canadians had less than $500 in wealth in 2016. For households in the lowest quintile, this share reaches nearly a quarter. Highly unequal distribution means that the median household wealth a lot lower than the average, around $350 thousand per household.

Despite significant distributional issues, it is still true that many Canadian households have large wealth reserves, which could come in handy for riding out the current crisis. Previous Statistics Canada research showed that homeowners (with or without a mortgage) were less likely to be in financial distress and to miss non-mortgage payments. Furthermore, families with higher valued assets relative to their debt were also less likely to experience financial distress, making the debt-to-asset ratio a better predictor of household's financial distress than the often-cited debt-to-income ratio. This makes sense since assets can be sold or re-mortgaged with proceeds used to pay-off debt or as a short-term income replacement.

As far as housing wealth is concerned, Canadian households fare better than the U.S. counterparts. Owner's equity makes up 74% of the value of real estate among Canadian households, nearly 10 percentage points higher than the same metric south of the border. Only 16% of all active mortgages held by chartered banks in Canada in 2018 had a loan-to-value (LTV) ratio higher than 80%, (meaning they had less than 20% equity stake in their homes), while the vast majority of households have more than that.[4]

Owners with less than less than 20% equity in their homes will be most susceptible to a large price correction and also have limited options in terms of accessing home equity to alleviate any financial strain. Ditto for renters, who also have limited wealth or liquidity reserves to tap during the crisis. While data are difficult to come by, anecdotal evidence suggests that homeowners accounted for only about a quarter of consumer insolvencies last year, with non-homeowners making up the rest. The current crisis will likely exacerbate this trend.

With courts currently closed and many support programs in place, insolvency filings are, for the most part, on hold, and so it may be some time before we see the true impact of COVID-19 on insolvency rates. But, as payment deferrals and income replacement programs wrap up, consumer insolvencies are likely to increase to recession levels at the end of this year and into the next year.

Bottom Line

Highly leveraged Canadian households are facing very uncertain and challenging times as a result of the COVID-19 pandemic. Realizing this, governments, financial institutions and the Bank of Canada have rolled out an unprecedented suite of measures aimed at supporting households and limiting the economic fallout. These measures should help avoid a protracted household deleveraging cycle and preserve the lion's share of the wealth that households have amassed over the years. Lower interest rates and payment deferrals will also help to keep debt servicing costs more manageable, while a sizeable wealth cushion will offer an additional buffer to tap into to weather the storm. Once the dust settles, households will likely emerge out of this crisis with higher saving rate, but also higher leverage, increasing the downside risk to the longer-term consumer spending outlook.

Endnotes

1. "Distributions of household economic accounts, income, consumption and saving, by characteristic". Statistics Canada. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610058701&pickMembers%5B0%5D=2.3&pickMembers%5B1%5D=3.1

2. Anson T. Y. Ho, Mikael Khan, Monica Mow, Brian Peterson "Home Equity Extraction and Household Spending in Canada". Bank of Canada. https://www.bankofcanada.ca/2019/09/staff-analytical-note-2019-27/

3. Sami Alpanda & Sarah Zubairy, 2019. "Household Debt Overhang and Transmission of Monetary Policy," Journal of Money, Credit and Banking, Blackwell Publishing, vol. 51(5), pages 1265-1307, August. https://ideas.repec.org/a/wly/jmoncb/v51y2019i5p1265-1307.html