An Update on Households' Finances: Consumers Ride Out the Pandemic Storm but Clouds Loom

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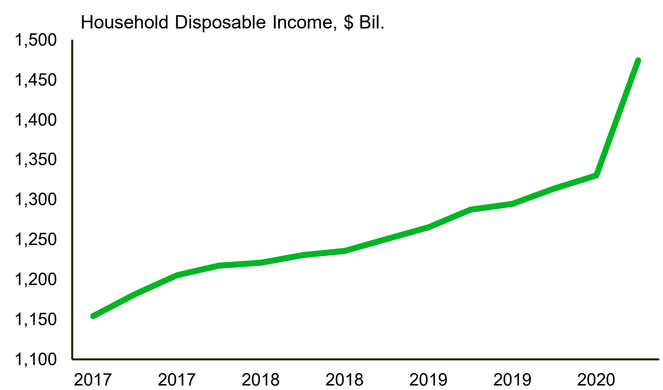
Highlights

- The high level of household debt in Canada was one of the major risks heading into this pandemic-induced recession. It is still early days of the recovery, but so far, thanks to the large-scale and swift policy response, households have fared better than one would have anticipated at the start of the health crisis.
- Extensive measures rolled out by the governments and financial institutions have helped to shore up household income, boosted savings and accelerated a recovery in consumer spending. Other financial indicators have also improved. Wealth had fully recovered from an early-year slump, reaching a new high in Q2. Moreover, debt growth has taken a pause while consumer insolvencies have plunged.
- While helping households to weather the storm, various support programs have distorted the historical relationship between unemployment and measures of credit performance. As such, the improvement in delinquency rates and insolvencies is a temporary illusion, and like illusions do, it will begin to dissipate as support diminishes.
- The real test whether consumers can stand on their own still lies ahead. The employment recovery is expected to be uneven, exacerbating pressure on some households, such as younger Canadians and non-homeowners. These segments were already showing signs of financial stress prior to the pandemic.
- The support stemming from mortgage deferral programs will also begin to wane, increasing the pressure on homeowners. On the plus side, an overall high quality of mortgage credit in Canada, significant home equity and additional savings amassed by many households should help to lessen the increase in mortgage delinquencies.

Canadians always eagerly await the summer months, but this year the anticipation was even greater than normal. This is because the summer brought with it an easing in COVID-19 restrictions, helping to kickstart the labor market recovery and the healing process of the household balance sheets. Overall, it appears that households have fared better than one would have anticipated at the start of the health crisis. One of the major risks heading into this pandemic-induced recession was the high level of household indebtedness in Canada, which could greatly amplify the hit to the economy and slow the subsequent recovery. It seems that thanks to a large-scale and timely policy response, the worst-case scenario of skyrocketing insolvencies and tumbling home prices (and consequently wealth) has been avoided, at least so far.

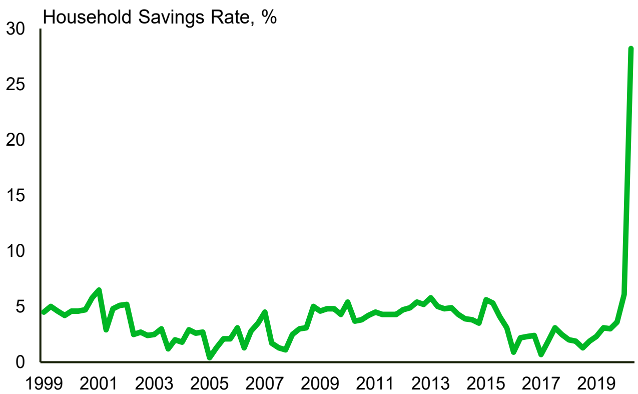
Indeed, the coordinated and extensive set of measures rolled out by the government and financial institutions at the start of the pandemic have aided in shoring up household finances and kept

Chart 1: Government Transfers Boost Disposable Income



Source: Statistics Canada, TD Economics

Chart 2: Savings Rate Spiked In Q2

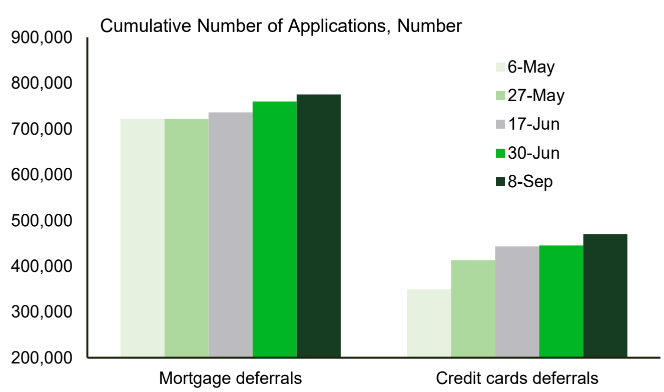


Source: Statistics Canada, TD Economics

financial risks at bay. CERB and other government transfer payments more than filled in the void left by the drop in employment income in the second quarter, sending after-tax income up sharply (Chart 1). Together with massive drop in consumer spending, these measures helped to propel savings rate to an astounding 28.2%, quite a far cry from its pre-virus range of 2-3% (Chart 2). In per capita dollar terms, the increase is similarly impressive, with quarterly savings rising from $380/per adult in 2019 Q4 to roughly $3,340 in the second quarter of this year.

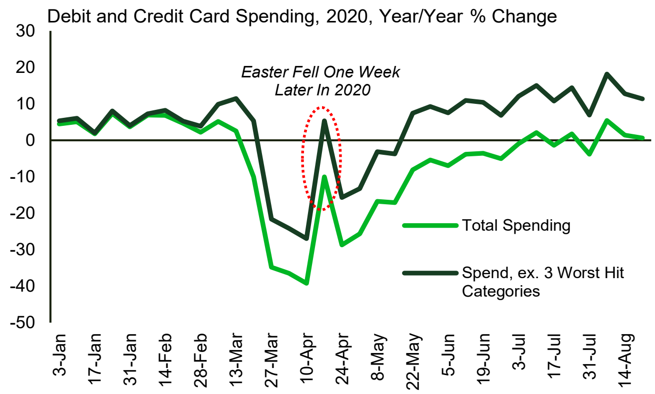
A significant number of households also took advantage of various payment deferral programs offered by financial institutions (Chart 3). Statistics Canada data released last week revealed that obligated principal payments have declined by $2.8 billion (non-annualized) in Q2, roughly evenly split between mortgage and non-mortgage credit. This has helped to push down the average debt service ratio to 12.4% - a level last seen back in 2004.

Chart 3: Financial Institutions Offer Extensive Deferral Programs



Source: Canadian Bankers Association, TD Economics

Chart 4: Consumer Spending Recovers



Source: TD Economics. Last data point August 21, 2020. Worst Hit Categories are Travel, Transportation, Recreation & Entertainment.

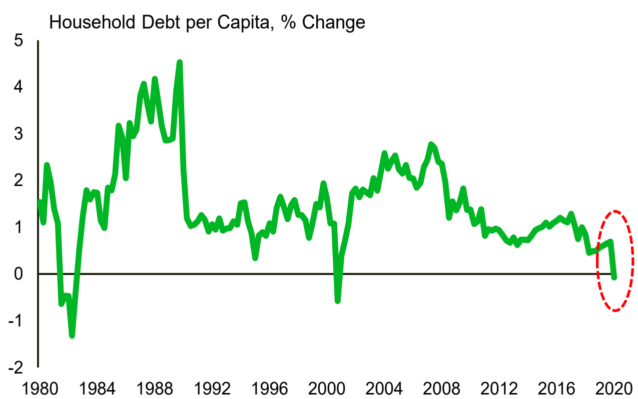
These various buffers have helped to lower risks and to accelerate the recovery in its early stages. As a result, once restrictions began to ease and businesses re-opened, consumer activity was swift to rebound. If we were to put a letter on it, the re-acceleration in consumer spending looks pretty V-shaped coast-to-coast (report). After contracting by over 40% y/y at the peak of the shutdowns, TD's anonymous aggregated debit and credit card data shows that spending growth had turned positive over the course of summer (report). Excluding the three large spending categories hardest hit by the pandemic – travel, entertainment, and transportation – gains are even more impressive (Chart 4).

Wealth Rebounds and Debt Growth Hits A Pause Button

While various support programs have been instrumental behind this robust performance, there have been several other contributers. Chief among them are 1) the significant pent-up demand (for both consumer goods and housing) which had built up during the lockdown, 2) a strong recovery in the labor market and 3) historically low interest rates.

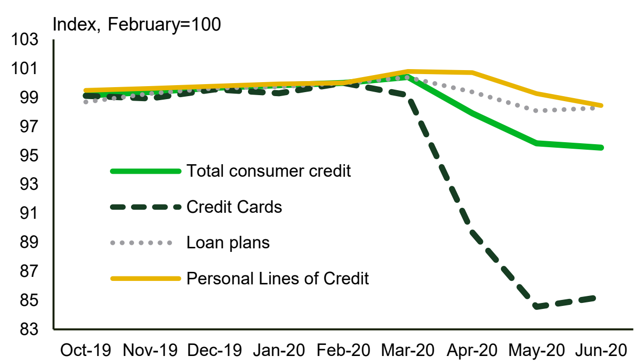
After taking a hit in Q1, household wealth too has bounced back smartly this past quarter, recovering all losses and then some largely thanks to hefty gains in financial asset valuations. Boosted by the revival in the economic activity and the extraordinary monetary stimulus provided by global central banks, equity markets have been on a roll: by the end of August the S&P 500 had recouped all losses from the plunge it suffered earlier this year. It was also anything but a summer lull in the housing market. Home sales and

Chart 5: Per Capita Debt Contracts in Q2



Source: Bank of Canada, TD Economics

Chart 6: Consumer Credit Contracts as Credit Card Balances Take a Dive



Source: Bank of Canada, TD Economics

prices have sprung back to life with exceptional vigor, with average Canadian home prices in August rising 13% above their February level.

Furthermore, thanks to the extraordinary support measures, we have not yet seen signs of deterioration of various credit quality metrics. In fact, the available data suggests that at least some households have used the lockdown phase of the crisis to throttle down spending and to pay down debt. In addition to accumulating more precautionary savings, Canadians have hit the pause button on debt accumulation, with per capita credit balances marginally contracting in Q2 (Chart 5). This was entirely due to a sharp decline in consumer credit balances. Credit card balances, in particular, fell by a whopping 13% on the quarter, while aggregate consumer credit had contracted by 3.7% (see Chart 6). Consumer credit now accounts for just under 27% of total household credit – the lowest share since 1995. The decline in consumer credit balances was driven largely by the drop in consumer spending and consequently new borrowing. However, government income support payments and a decline in interest rates also likely helped to accelerate debt repayment.

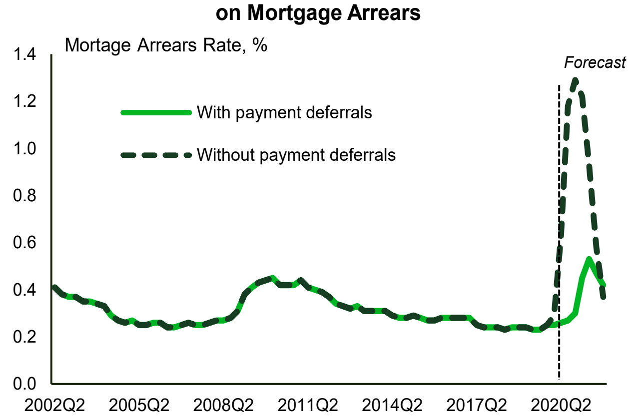
Unemployment Surges and Insolvencies Plunge – Say What?

Yes, you read it right. Perhaps, counter intuitively, delinquency rates on a variety of consumer credit products declined even as the unemployment skyrocketed. However, when looking at the incoming data one needs to keep in mind that this crisis is not like the others. Credit deferral programs and an unprecedented amount of income assistance rolled out by the government have upended the historical relationship between unemployment and various credit performance indicators. Thus, this improvement in credit performance metrics is a temporary illusion, and like illusions do, it will begin to dissipate once the support diminishes.

Based on TransUnion data, nearly 10% of consumers (or 2.6 million of accounts) had deferred status on at least one credit product in June. Among those with deferral, about 27% had deferred mortgages, 32% had deferred credit cards, and 10% deferred an auto loan. According to the Canadian Bankers Association, nearly 800k Canadians (or 16% of all mortgage holders) have asked for a mortgage deferral at some point during this crisis. Without these deferral measures, many accounts would have been past due, leading to considerably higher delinquency rates.

Given the rapid and dramatic increase in joblessness, the rise in arrears rates would have been both swift and significant.

Chart 7: Mortgage Deferrals Ease the Pressure on Mortgage Arrears



Source: CBA, TD Economics, Forecast by the Bank of Canada.

In their earlier report, the Bank of Canada had estimated that in the absence of mortgage deferral programs, mortgage arrears would have increased much quicker and to a much higher level (nearly three times the peak level seen during the financial crisis) than otherwise (see Chart 7).

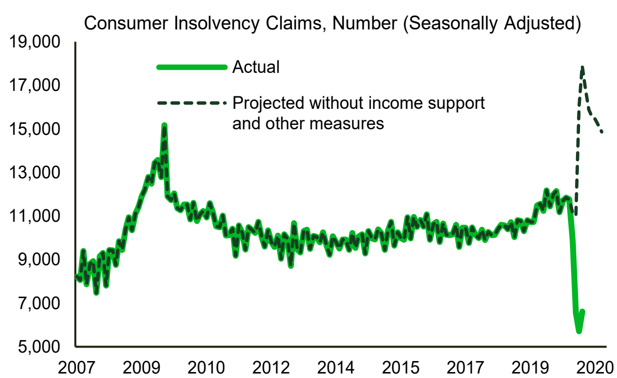
Our model suggests that based on the prevailing unemployment rate, consumer insolvencies would have also skyrocketed in the absence of interventions (see Chart 8). Instead, consumer insolvencies were down 42% from their year-ago level in June – a reversal of the upside trend we've been seeing prior to this crisis.

However, just like delinquency rates, consumer insolvencies are currently artificially low for a number of reasons. Payment deferral programs reduced the urgency to file for insolvency as the creditors are more patient, and disruptions to court operations could have also impacted filings. Furthermore, government payments, such as CERB and EI, cannot be garnished by creditors, so unemployed consumers may be "creditor-proof" until they become employed again and will have income to protect. This suggests that insolvencies will begin to rise once these temporary deferral programs expire.

Uneven Recovery

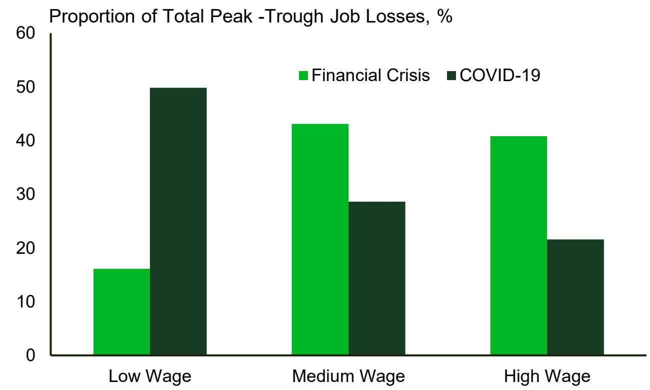
This crisis is a marathon, not a sprint and we are not out of the woods yet. It's clear that thanks to the prompt policy response, the risk of a credit deleveraging cycle in Canada had been lowered substantially. However, employment fundamentals and consumer finances can't diverge indefinitely, and the easing of government and credit relief programs will be a real test if consumers can stand on

Chart 8: Insolvencies Would Have Skyrocketed Without Government Support/Deferrals



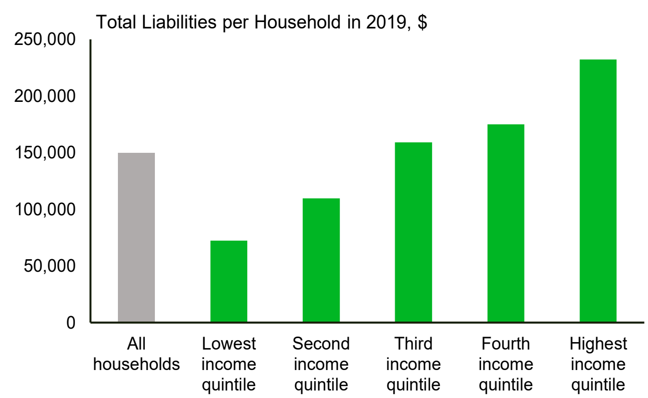
Source: Office of Superintendent of Bankruptcy, TD Economics

Chart 9: Job Losses Concentrated in Low Wage Industries



Source: Statistics Canada, TD Economics

Chart 10: Debt Distribution by Income Quintiles



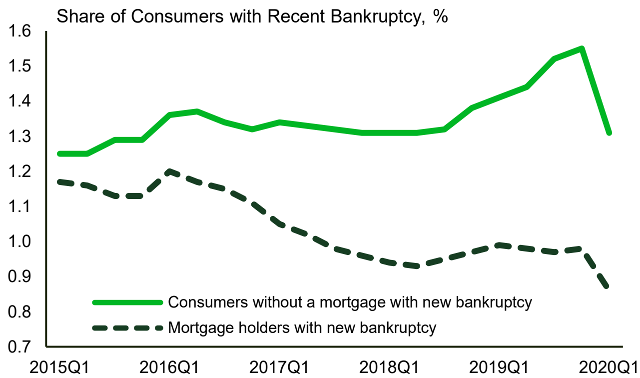
Source: Statistics Canada (Table 36-10-0585-01), TD Economics

their own, particularly given that employment recovery is expected to be protracted and uneven across industries and population segments.

Job losses during the current downturn have been heavily skewed toward lower-wage industries as well as younger Canadians – two demographics with below average debt loads, largely due to their lower propensity to have a mortgage (Charts 9 and 10). However, these groups also have limited financial buffers, such as wealth and savings, making them more prone to financial distress. The personal finances of younger Canadians and renters were already deteriorating prior to the health crisis, with bankruptcy on the rise among non-mortgage holders (Chart 11).

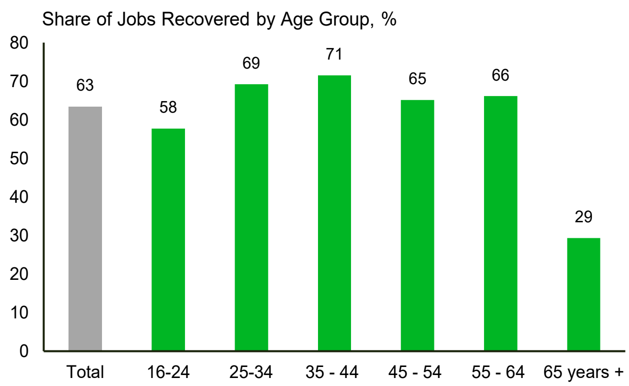
Older adults (those 65 years or older) have also so far seen a weaker employment recovery than other age groups. Given their higher vulnerability to the virus, health concerns have likely prompted some to retire while others are

Chart 11: Bankruptcy Was on the Rise Among Non-Homeowners Prior to the Crisis



Source: Equifax, CMHC, TD Economics

Chart 12: Yonger and Older Canadians Lag in Employment Recovery



Source: Statistics Canada, TD Economics

staying at home due to safety concerns (Chart 12). This could increase financial stress among those older Canadians, who have relied on the extra income to supplement their retirement earnings.

The Real Test Still Ahead As Support Programs Wane

For majority of CERB recipients, benefits were expected to end in September-October. Ditto for mortgage deferral programs, which were originally offered by many banks for up to six months. This would have been a financial double whammy for households, with support programs ending in a cliff-like manner. However, based on the latest Federal Government announcement earlier last month, income support withdrawal looks to be less of a cliff and more of moderate slope.

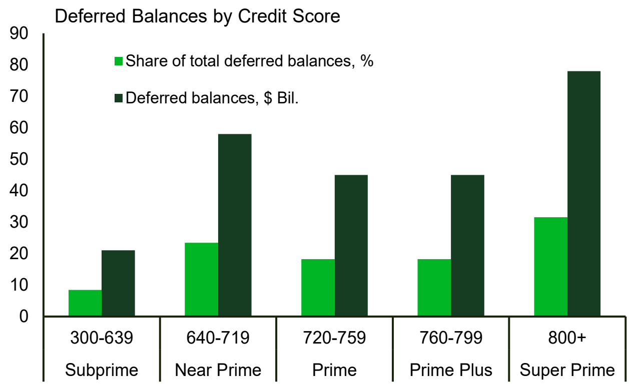
Realizing the risks, the Federal government extended CERB by one additional month, and modified Canada's EI system to easily transition CERB recipients into it. The revamped EI program will significantly lower qualification requirements and higher minimum payouts, with the floor payment set on $400 per week compared to $500 under CERB. New benefits in the amount of $400/week were also extended to self-employed workers, who were not traditionally covered by EI. Changes to EI program constitute a considerable improvement on what many of the workers, particularly those in the lower-paying industries and the self-employed, would have been receiving under the old program rules. However, changes are still net negative relative to CERB, constituting a 20% income reduction for households getting the minimum EI payment. On the plus side, changes to the program are going to be in place for at least a year, leading to more certainty for the recipients.

However, the future of mortgage forbearance programs – the largest deferral program by the size of deferred balances – remains uncertain and represents a downside risk to the housing market outlook and the household sector at large. Based on TransUnion data, mortgage deferrals accounted for slightly less than a third of deferred accounts but made up a whopping 88% of deferred balances. Also, compared to other categories of credit, the roll-off of mortgage deferrals has been happening at a slower pace.

Perhaps unsurprisingly, the return to regular payments on deferred mortgages has so far gone hand-in-hand with the improvement in the labour market. About 23% of homeowners who had requested a mortgage deferral at some point during the crisis have since resumed their payments by the end of July.[1] Meanwhile, as of July the number of unemployed Canadians between the ages of 24-64 declined by 20% from its peak in May.

Looking ahead, the performance of these deferred loans will remain closely tied to the labor market improvement as well as patience on behalf of lenders. Most deferrals are set to expire in September-October of this year. This is well before the labor market will be fully back to health, as we expect it will take until the start of 2022 for the unemployment rate to decline meaningfully. As such, after the initial deferral period expires, financial institutions will continue to have programs in place to help customers that still find themselves in financial difficulty. As a result, mortgage delinquency rates will likely increase at a relatively measured pace toward the end of 2020 or the start of 2021.

Chart 13 : Deferred Balances by Credit Score



Source: TransUnion, TD Economics

Further consolation comes from the fact that the Canadian housing market is tight, with a low inventory of houses on the market relative to the population. Thus, any extra listings due to financial pressure and/or distressed selling wold not be hitting an oversupplied market. It is also encouraging, that the overall credit quality of mortgage debt is high, with only a fraction of balances held by borrowers with less than prime scores and little equity.[2] This is also true for deferred mortgage balances, the bulk of which are held by borrowers with solid credit scores. Deferred balances held by borrowers with above-prime scores accounted for 68%, while balances held by borrowers with below prime scores represented about a third (Chart 13).

Furthermore, the majority of homeowners with deferred mortgages have loan-to-value ratio of less than 80%, and thus have an equity buffer in the event they might be forced to sell. Having equity in the house will likely prompt those homeowners, who believe their financial situation is unlikely to improve, to sell the house way ahead of any actions by the lender, particularly while the housing market is tight as it has been. Lastly, savings accumulated over the last several months could provide additional financial runway while the labour market continues to heal.

Concluding Remarks

So far, the consumer side of the economy has held up better than was expected at the start of the crisis. Consumer spending and the housing market have staged a strong rebound. Some households have managed to pay down debt, increase their savings cushion and build more financial wealth thanks in part to booming stock markets. All this is good news, since, as much as we all really want to put the pandemic firmly behind us, in some way the tough times are likely still ahead.

Federal government income support programs and payment deferrals by financial institutions have so far been paramount for averting the delinquency tsunami and protecting the economy. However, these supports are beginning to wane while unemployment remains higher than the peak seen during the last recession, not to mention the risk of the second wave of infections that might be looming. The state of the labour market and consumer finances cannot diverge indefinitely, and delinquencies and consumer insolvencies will likely begin to rise at the end of this year and into 2021. The increase is likely to be more gradual and less dramatic than we would have seen in the absence of support measures. Of course, all outcomes continue to be highly dependent on government policy, lenders and the virus itself.

References

1. Canadian Bankers Association. https://cba.ca/canadian-banks-are-standing-by-canadians

2. Royal Bank of Canada Third Quarter Results. https://www.rbc.com/investor-relations/_assets-custom/pdf/2020q3slides.pd

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