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Economics

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Searching for vulnerabilities

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The increased sensitivity of households to higher interest rates is well documented. What was a theoretical risk or a stress test, became a reality. The impact on the consumer is clear and evident. But to what extent will the interest rate induced recessionary conditions in the household credit space morph from a macro story into a credit quality issue?

Zero credit

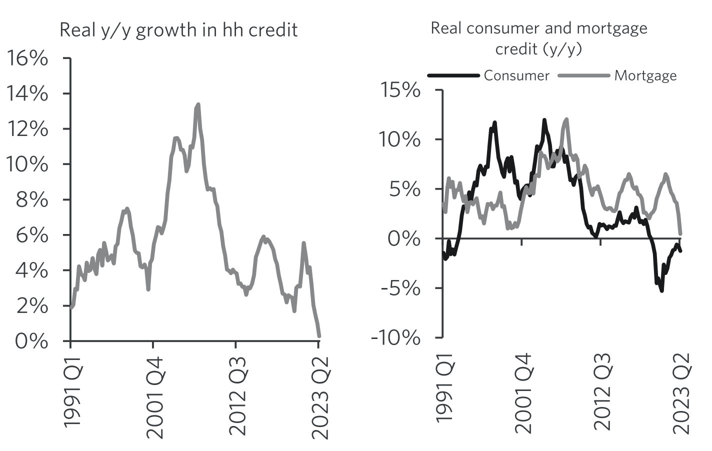
The impact of the aggressive tightening campaign by the Bank of Canada may not be fully visible yet in labour market statistics and perhaps even in headline GDP growth. But household credit conditions clearly reflect the pain. At barely above the zero mark, the year-over-year real growth in total outstanding credit is the lowest seen since the double dip recession of the 1980s. it's now well below the growth rates seen during the 2008 recession, and is a full percentage point under the growth rate seen at the depths of the 1991 recession (Chart 1, left). That dramatic slowing is evident not only in the ultra-rate sensitive mortgage market, but also in consumer credit where inflation adjusted y/y growth is now in negative territory (Chart 1, right).

The speedy and aggressive slowing in the pace of credit growth reflects both supply and demand forces. The Bank of Canada's senior loan officer survey points to some tightening in credit availability relative to the level seen during the pandemic. And the actual numbers support what's in the survey. As illustrated in Chart 2 left, the year-over-year growth rate in credit limits available to households is now rising by half the pace seen in mid-2022 and below the pre-pandemic rate. In real terms limits are hardly growing. At the same time, households are less eager to use that available credit, with the utilization rate falling in recent months (Chart 2, right).

Debt payment: early signs of stress

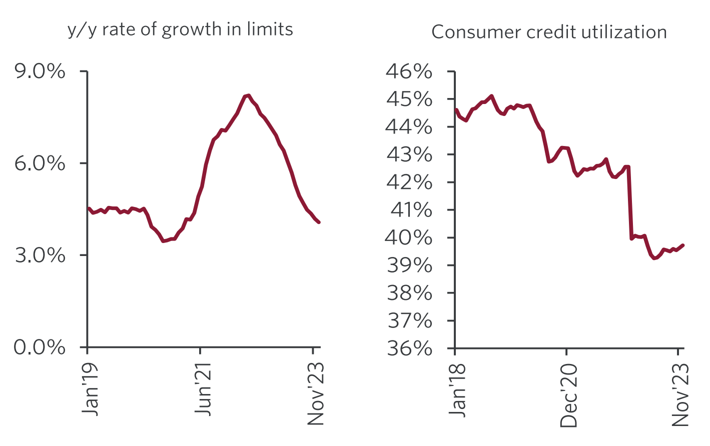
On the surface some signs of vulnerability are already evident. On a year-over-year basis, the number of consumer insolvencies is now rising by more than 20%. However, that increase is from a very tame level. On a per-capita basis, we're neither climbing as steeply nor as far as in previous slowdowns. What's more, as opposed to previous episodes of rising insolvencies, the vast majority (currently a record high of 80%)

Chart 1: Household credit growth in recessionary territory



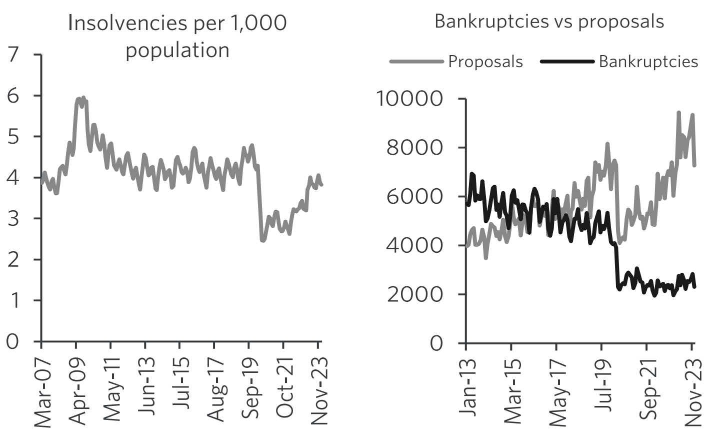
Source: Statistics Canada, CIBC

Chart 2: Credit?...No thanks



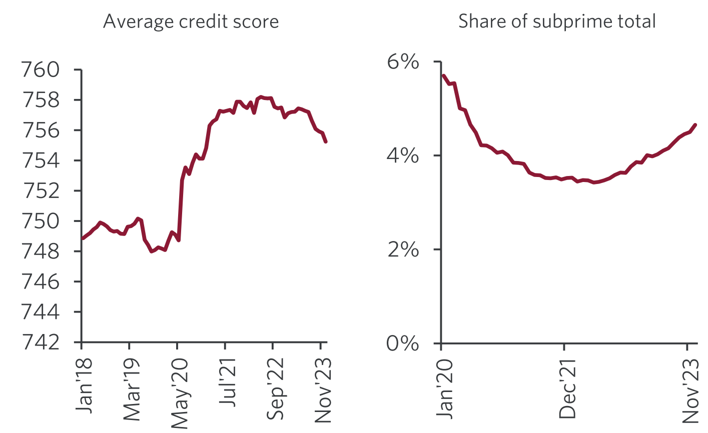
Source: TU, CIBC

Chart 3: Rising proposals, falling bankruptcies



Source: Statistics Canada, CIBC

Chart 5: Rising risk profile



Source: TU, CIBC

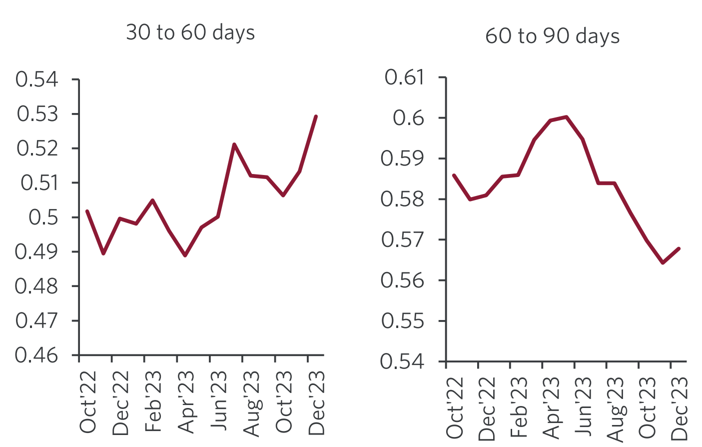
of these insolvencies are "proposals" to restructure debt rather than outright bankruptcies (Chart 3). That's important because the legal costs and the losses per proposal are lower for lenders than in bankruptcies, and the recovery rate is much higher. That means that loss rates for financial institutions are not spiking nearly as much as the number of insolvencies.

Chart 4 illustrates another dimension of increased communication and coordination between lenders and borrowers. The spike in interest rates has led to a notable increase in the 30-60 day delinquency category but the share of those delinquent accounts that move to the 60-90 day delinquency category is actually declining. Also encouraging is the fact that the share of mortgages that are in a trigger rate position (a situation in which interest payments account for 100% of debt service payments) has been falling steadily in recent months. That early treatment of the symptoms was not seen in previous recessions.

Still, as it stands now, the trend isn't your friend. Insolvencies are on the rise, the average credit score, while still above 2019 levels, is trending downward, and the share of subprime borrowers in outstanding is on the rise (Chart 5) — all in an environment of an historically low unemployment rate. What's more, the current cycle also demonstrates an interesting development in which the climb in insolvencies came earlier, and has been sharper than what delinquencies over 90 days would typically have suggested (Chart 6), with households increasingly moving directly into a proposal situation before going through the delinquency channel. That means that in search for vulnerabilities, we need to focus on even earlier signals than in the past.

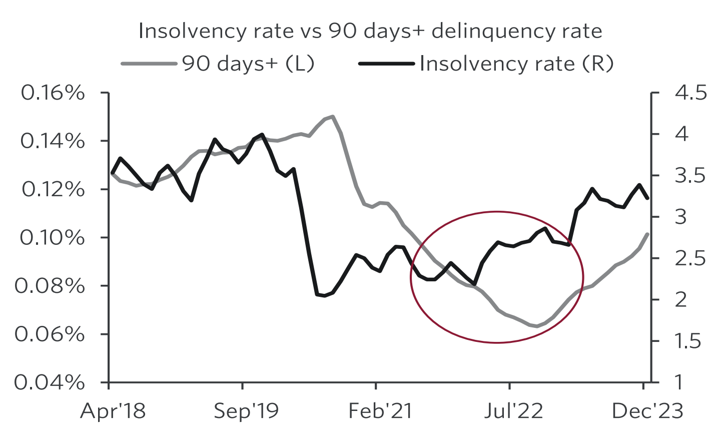
The obvious place to start the search is in the mortgage market. As it stands now, we estimate that 50% of all mortgages outstanding have already repriced to reflect tighter monetary conditions. That means that more than one trillion dollars' worth of mortgages have yet to be renewed in the coming years (Chart 7). Based on term distributions and our interest rate forecast, we estimate that the average interest payment shock in 2024-26 will amount to around 15% a year (Chart 8). The

Chart 4: Delinquencies moving from...



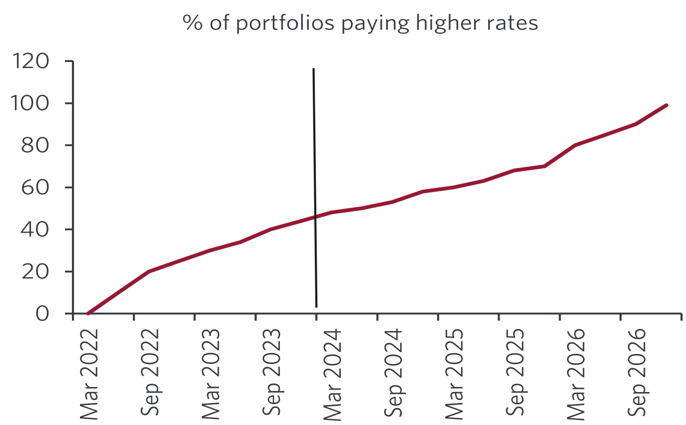
Source: TU, CIBC

Chart 6: Sudden insolvencies



Source: TU, CIBC

Chart 7: Half-way there



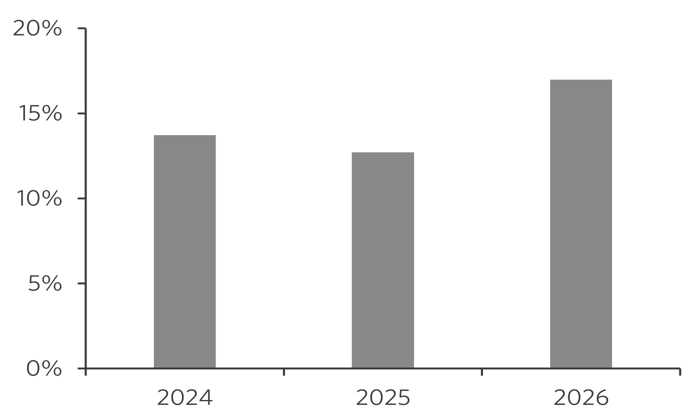
Source: Statistics Canada, CIBC

key word here is average. That estimate includes mortgages that were repriced recently to short-term rates that, in fact, will see their interest payments dropping between 2024 and 2026. So, while Chart 8 gives us a reasonable picture of the shock to the consumer from a macro perspective, it masks the pain at the margins — where credit risk resides.

Are there already visible signs of stress in the mortgage portfolio? While the trend in overall delinquency rates is up, those are still notably below rates seen in the pre-Covid period (Chart 9, left). However, when you dig deeper and zoom in on the margins of the margin: 30+ day delinquency rates among sub and near sub-prime borrowers, the increase in delinquencies is more rapid and is now already at a level seen in 2019 (Chart 9 right). Historically, that rate has been a good leading indicator for what's to come in the rest of the portfolio.

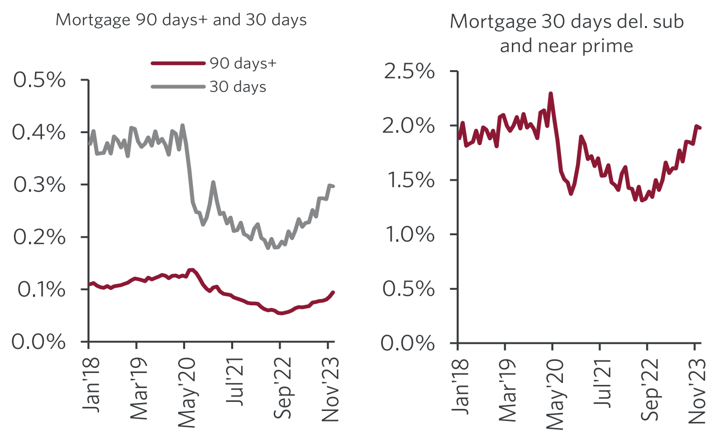
Another way to assess the stress level among mortgage borrowers is to focus on their other debt. After all, you probably will prefer to be late on your line of credit or credit card

Chart 8: Mortgage payment shock



Source: Statistics Canada, CIBC

Chart 9: Mortgage delinquencies — approaching 2019 levels

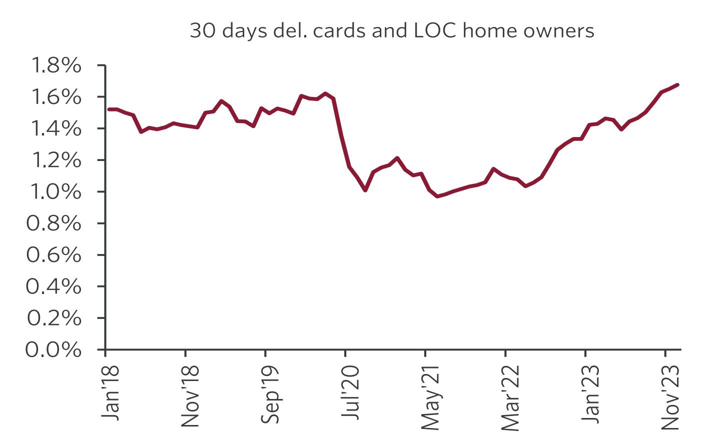


Source: TU, CIBC

payments before delaying mortgage payments. And as illustrated in Chart 10, the 30-day delinquency rate on lines and credit cards among homeowners has risen notably in recent quarters and it is now well above the 2019 level. And this measure probably underestimates the real level of stress since it includes homebuyers with no mortgage — traditionally a group with strong credit standing. Based on past correlations, we estimate that that delinquency rate is 0.3% above where it should be given the current unemployment rate.

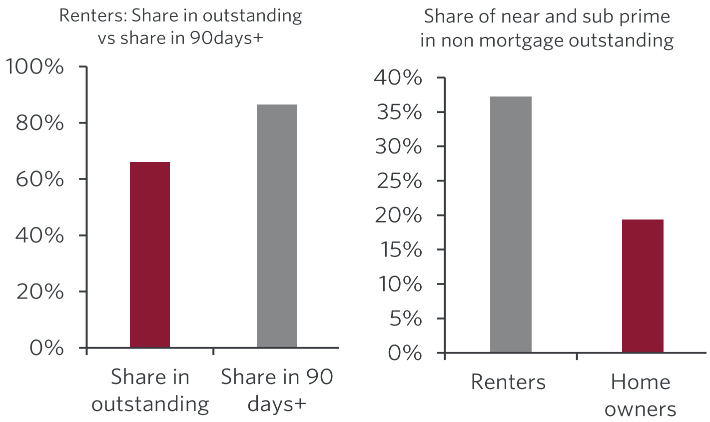
The next step is to focus on debt held by renters. That segment of the market accounts for over 60% of total non-mortgage debt outstanding, but close to 85% of serious delinquencies (Chart 11). No less than one third of renters are in the sub-prime or near sub-prime category. Renters are also more vulnerable to job losses in the early stages of economic slowdowns. Close to 35% of total debt held by renters is in the form of lines of credit, and that's where we see early signs of stress with both 30-day and 90+ day delinquency rates rising rapidly to surpass 2019 levels (Chart 12).

Chart 10: Early signs of stress in non-mortgage debt held by home-owners



Source: TU, CIBC

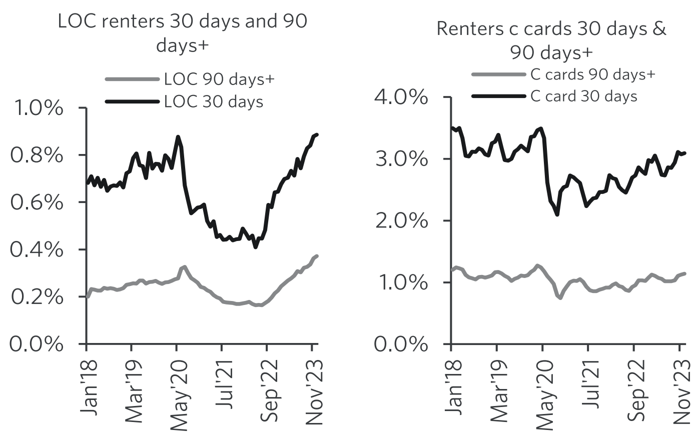
Chart 11: Higer risk profile among renters



Source: TU, CIBC

Bottom line: the elevated level of households' interest rate sensitivity is fully visible in the macro space with rapidly slowing mortgage and non-mortgage credit growth. However, when it comes to credit quality you have to dig deep to find early signs of vulnerability. But they do exist. Sudden insolvencies are on the rise, while early-stage delinquencies in the below-prime mortgage space are rising strongly. Non-mortgage debt held by homeowners is now well above 2019 levels with still 50% of mortgage outstanding yet to be repriced. Renters, who carry a higher level of risk, are feeling the double impact of a weakening labour market and rapidly rising rent, and are showing clear signs of stress in the important lines of credit portfolio. The upward trajectory in delinquency rates is likely to continue and in fact accelerate in the coming quarters. But the fact that we had to dig deep to find signs of stress, combined with our expectations that the unemployment rate will not exceed 6.5% — miles below the rate seen during recessionary periods in the past, means that upcoming credit losses will be manageable and should be seen more as a signpost of a squeeze on spending as opposed to large potential credit risk event.

Chart 12: Lines of credit delinquency rate rising fast among renters



Source: TU, CIBC

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