Lessons Learned From Rising Canadian Household Insolvencies
by Benjamin Tal and Avery Shenfeld

Sometimes you have to learn things the hard way. But with some luck, you might get a hint of trouble that delivers the lesson with less pain. That is probably the case for the recent upturn in Canadian household insolvencies. That trajectory, while not great news for those involved, has thus far not been too damaging to investors, the economy, or the financial system. It does, however, provide some key takeaways that could be insightful for investors, financial institutions, and perhaps most importantly, monetary policy makers.

On the surface, the acceleration in the year-over-year percent change in the number of insolvencies looks fairly dramatic, but that’s from very tame levels. On a per-capita basis, we’re neither climbing as steeply nor as far as in the last recession, and unlike the 2008-10 period, most of these insolvencies are now “proposals” to restructure debt rather than outright bankruptcies (Chart 1).

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. As we shall see, that has meant that loss rates for financial institutions have not spiked nearly as much as the number of insolvencies.

Still, the trend isn’t your friend right now, and it’s been mirrored, if only slightly, in another early warning sign. While still miles below recession levels, the share of consumers with low credit scores (below 680) has nudged higher in the past year (Chart 2).

Who, What and Why

Obviously, this isn’t the typical cyclical climb in household credit stress, which comes when a recession leads to widespread job losses and, as a result, defaults on funds borrowed by those with dented incomes. Canada’s unemployment rate hovered near multi-decade lows prior to November. While there has been regional economic weakness, particularly in oil-centered

Chart 1
The Big Picture

Source: Innovation, Science & Economic Development Canada, CIBC

Chart 2
Early Signs

Source: Equifax, CIBC
Alberta, the climb in insolvencies has not been isolated to that province. Indeed, Ontario has seen just as large of a spike, and only Quebec and Saskatchewan haven’t been part of the national increase (Chart 3). So, its not really about job losses or economic weakness per se.

The trend is also touching all age groups. While younger Canadians are more likely to run into difficulty, the share of insolvencies coming from those over 55 has been rising, and unlike the case for younger households, the 55+ insolvency rate has eclipsed the prior cycles’ high (Chart 4).

Looking at what types of debt are behind the insolvency climb gives some clues as to why we’re seeing higher insolvencies in an otherwise healthy economy. For all the headlines about Canadians binging on mortgage debt in a long housing boom, that’s not where the problem lies. Nearly two-thirds of the credit outstanding to the household sector is in the form of mortgages, but their performance remains rock solid. Arrears on mortgages have trended steadily downward, while arrears and delinquencies on other forms of credit are starting to edge higher (Chart 5).

Of course, that’s typical and reasonable that households will put a priority on keeping their mortgage debt serviced and let the credit card or other loans fall behind. As well, absent large house price declines that put borrowers into negative equity positions, a house can always be sold to pay the principal. That’s particularly true for a seasoned pool of mortgages that, in many cases, will have had years of paying down the principal and rising equity. So it’s the performance of non-mortgage consumer debt that is the canary in the coal mine we need to watch for turning points in the credit cycle.

**Sudden Insolvencies**

How are those canaries singing these days? Typically, in advance of an insolvency, we see a greater share of loans that are 30 days delinquent moving into 60+ days, and then 90 days, and longer. That has in fact been the case since 2017 (Chart 6). Those already behind on non-mortgage debt service payments are finding it more difficult to catch up with overdue bills. That suggests that shorter arrears bear closer watching now as they are more likely to graduate to a default.
But what’s new in this cycle is that the climb in insolvencies has been sharper than what delinquencies over 90 days would typically have suggested (Chart 7), by jumping straight into a proposal before they’ve actually missed payments. Of course, they must show that they can’t cope with their debt load or sell an asset like a house to pay it down. Rather than struggle on with missed payments, there seems to be a growing awareness (enhanced through marketing) that there are insolvency trustees out there who can negotiate an alternative through the proposal process.

**Interest Rate Sensitivity**

Still, the issue is, why are households struggling with payments in the absence of a material weakening in the national labour market? The answer lies in looking at precisely which credit products are experiencing rising write-off rates.

**Chart 6**

*Share of Delinquent Loans Moving From ...*

<table>
<thead>
<tr>
<th>Period</th>
<th>30 Days+ to 60 Days+ Pockets</th>
<th>60 Days+ to 90 Days+ Pockets</th>
<th>90 Days+ to Write-Off Pockets</th>
</tr>
</thead>
<tbody>
<tr>
<td>(3-Qtrs moving avg)</td>
<td>74%</td>
<td>87%</td>
<td>62%</td>
</tr>
<tr>
<td>2010</td>
<td>73%</td>
<td>86%</td>
<td>60%</td>
</tr>
<tr>
<td>2013</td>
<td>71%</td>
<td>84%</td>
<td>58%</td>
</tr>
<tr>
<td>2016</td>
<td>69%</td>
<td>82%</td>
<td>56%</td>
</tr>
<tr>
<td>2019</td>
<td>67%</td>
<td>80%</td>
<td>54%</td>
</tr>
</tbody>
</table>

Source: Equifax, CIBC

**Chart 7**

*Insolvency Rate and Delinquency Rate Decoupling*

![Graph showing the decoupling trend between insolvency and delinquency rates]

Source: Innovation, Science & Economic Development Canada, Statistics Canada, Equifax, CIBC

**Chart 8**

*Write-Off Rates*

<table>
<thead>
<tr>
<th>Product</th>
<th>2010</th>
<th>2013</th>
<th>2016</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auto Finance</td>
<td>0.7%</td>
<td>0.6%</td>
<td>0.5%</td>
<td>0.4%</td>
</tr>
<tr>
<td>Bank Loans</td>
<td>0.4%</td>
<td>0.3%</td>
<td>0.2%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Cards</td>
<td>4.0%</td>
<td>3.5%</td>
<td>3.0%</td>
<td>2.5%</td>
</tr>
<tr>
<td>HELOC</td>
<td>0.08%</td>
<td>0.07%</td>
<td>0.06%</td>
<td>0.05%</td>
</tr>
<tr>
<td>ULOC</td>
<td>1.2%</td>
<td>1.1%</td>
<td>1.0%</td>
<td>0.9%</td>
</tr>
</tbody>
</table>

Source: Equifax, CIBC
The bulk of the problem is in those products where interest rates were being reset with increases in prime tied to Bank of Canada rate hikes in 2018. Note for example that write-offs are up sharply on both unsecured lines of credit (ULOCs) and secured lines of credit (HELOC), but show no trend for credit cards, which are also unsecured but where borrowing rates don’t move in lock step with monetary policy (Chart 8). Households have been shifting debt from credit cards to lines to save on interest costs but were then squeezed as rates on ULOCs began to climb.

Adding it all up, there has been a clear trend to increases in the share of balances that are delinquent coming from interest-rate-sensitive products (Chart 9, left), and much of that climb took place after rate hikes by the Bank of Canada pushed up prime rates (Chart 9, right).

Lessons Learned

One clear take-away is that we’ve done a small-scale experiment in the Canadian economy, and the results have confirmed our pre-existing hypothesis. This economy, with its legacy of higher household debt, would be much more sensitive to interest rate hikes than in the past.

If raising the overnight rate to only 1.75% could set off a climb in insolvencies, before any major job losses have been seen, it’s clear that taking rates to anywhere near what was historically neutral, or even where some models might currently put neutral, could prove to be overkill. Monetary policy will have to look a bit dovish to be only neutral for the economy as a result.

For investors, however, provided the central bank keeps its eye on this experiment and keeps interest rates in check, headlines about soaring insolvencies need to be put in perspective. These are “proposals”, as opposed to more costly bankruptcies. While we have seen rising loan-loss-provisions among major Canadian banks, taken as a share of their growing pool of such assets, the loss rates have been much more stable (Chart 10). Moreover, credit providers appear to be taking the lessons learned to heart, with interest rate sensitive products seeing essentially zero growth on a year-on-year basis.

Investors in securitized consumer debt can also take comfort in how assets in those pools are performing.
Credit card ABS vehicles tend to use better seasoned or slightly higher credit quality accounts than the overall pool of the issuing financial institution. As a result, we’ve yet to see any uptrend in late stage delinquencies among those tracked by Moody’s (Chart 11).

More broadly, having leaned on debt financed consumption and housing to get back to full employment in this cycle, we’ve long understood that the Canadian economy would be more vulnerable to a given dose of interest rate hikes. The experiment of the policy tightening in 2018 put that thesis to the test, and the lessons learned should help guide both the Bank of Canada and market participants towards avoiding tougher lessons ahead.