ECONOMICS

Assessing Household Debt's Sensitivity to Higher Interest Rates

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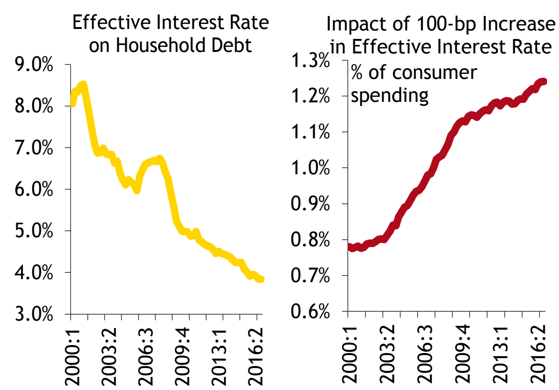
The Bank of Canada is on the move, rates are expected to rise again before the end of the year, and if everything goes according to plan, the Bank might move by an additional 50 basis points in 2018. It's hardly a secret that the Canadian economy in general, and the real estate market in particular, are more sensitive to higher rates now than in any other time in recent history. But how sensitive?

Headline numbers clearly don't tell the whole story. To get a full understanding of the impact of higher rates we also have to visit the margins of the debt market spectrum. We conclude that those margins are not wide enough to generate a wave of defaults following the Bank's expected tightening. Consumer spending is likely to soften due to increased debt payments, while the pace of growth in mortgage outstanding is expected to cool notably as the impact of higher rates is amplified by the expected changes to qualifying rate criteria on the non-insured segment of the market.

Asymmetrical Power

The ability of the Bank of Canada to impact credit demand via lower interest rates in recent years was compromised by the fact that the easing took place from an already low level of interest rates. Today, the opposite is the case. The low starting point is enhancing the Bank's impact. Chart 1 tells the tale. The effective interest rate on all household debt (that is interest payment as a % of total debt) is just under 4%. A full percentage-point increase in that effective rate will cost borrowers more than $20 billion a year in additional debt payment cost. That could potentially translate to 1.3% of forgone consumer spending. Before the recession, that measure stood at around 1.1%. So roughly speaking, when it comes to the negative impact on spending, we are 20% more sensitive to higher rates than we were a decade ago, and 60% more sensitive than we were in the early 2000s.

Chart 1
Increased Sensitivity to Higher Rates

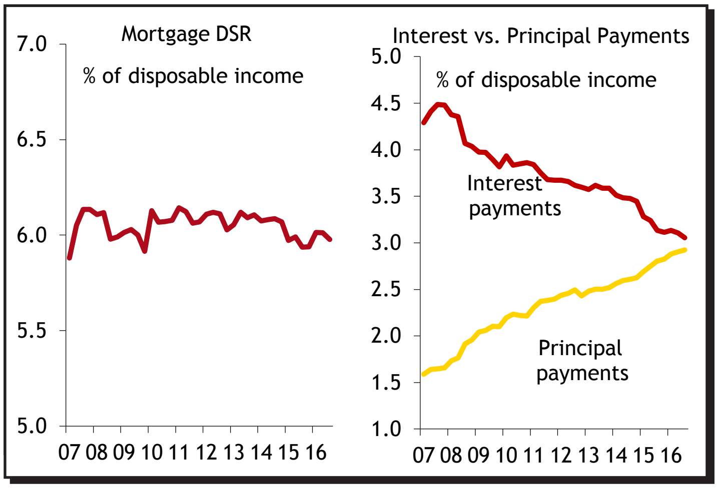


Source: Statistics Canada, CIBC

That increased sensitivity would be even worse if it were not for the changes in underwriting policies over the past few years, alongside some responsible borrowing by Canadians. The Bank of Canada's debt service ratio has been remarkably stable in recent years, despite a growing debt load. This stability, however, masks two opposing forces, with interest payments as a share of disposable income falling and principal

Chart 2

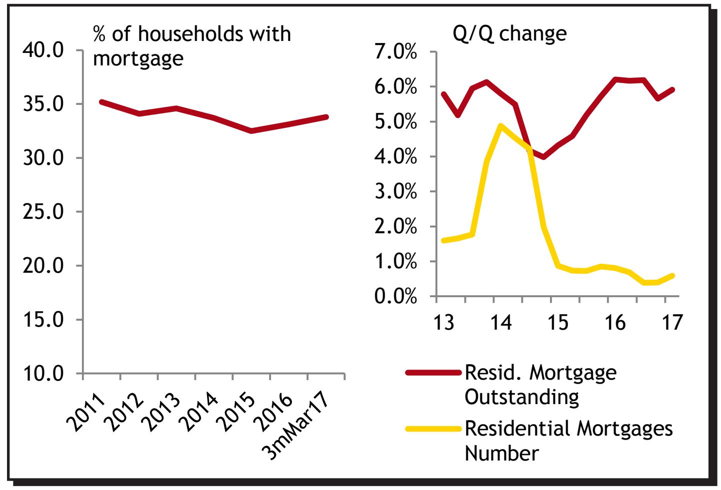
Stable Debt Service Ratio Masks Rising Principal Payments



Source: Bank of Canada, Statistics Canada, CIBC

Chart 4

Growth in Mortgage Outstanding Largely Due to Larger Mortgages, Not More Mortgages



Source: Statistics Canada, CIBC

payments now accounting for a record-high 50% of total household debt servicing costs (Chart 2).

The impact of policy changes is also very visible in the diverging trajectories of mortgage growth and housing sales (Chart 3). Before the recession the mortgage market needed 10% annual growth to support monthly sales of around 40,000 units, today 6% growth in mortgage outstanding is sufficient.

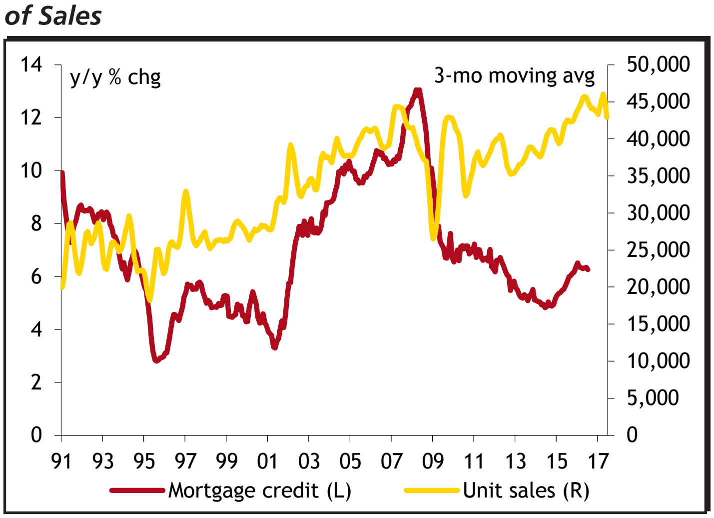
And contrary to popular belief and to the pre-crisis situation in the US, the low interest rate environment in Canada did not lead to a surge in the number of mortgage borrowers in Canada. In fact, the share of home owners with mortgages has been relatively stable in recent years, in Canada as whole and even in Toronto and Vancouver. With the number of mortgages hardly rising and mortgage outstanding expanding by 6.2% year-over-year, almost the entire $82 billion in overall growth in mortgage outstanding during the past year was due to larger mortgages, not more of them (Chart 4).

And so far those borrowers have behaved well. The average credit score is still elevated, despite trending downward in recent years (Chart 5), the credit distribution is stable and delinquency rates continue to hover around historic lows (Chart 6).

Now, credit scores are good predictors of default…until they're not. That is, during normal times credit scores can be very reliable indicators of the probabilities of default. But during recessionary periods they lose a lot of their predictive power. Any analysis of the impact of higher rates on defaults must take this factor into account. Our

Chart 3

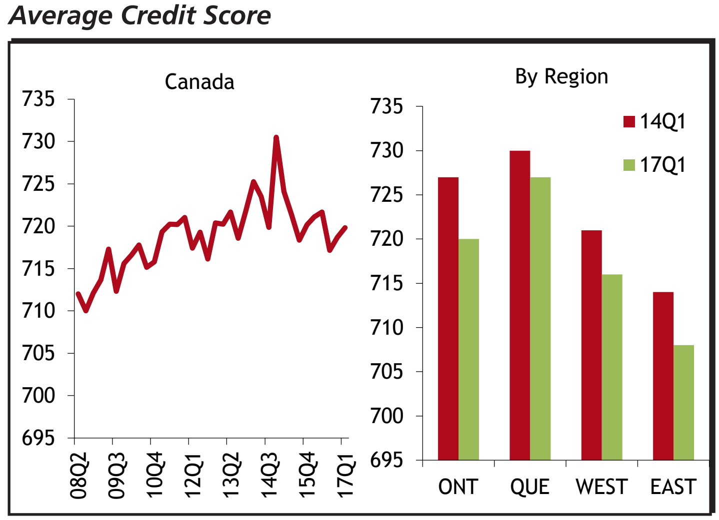
Less Mortgage Growth Needed to Support Same Level of Sales



Source: Statistics Canada, CIBC

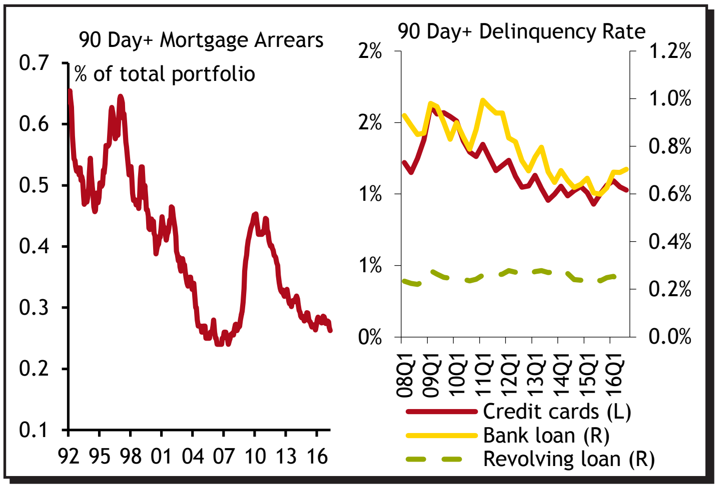
Chart 5

Average Credit Score



Source: Equifax, CIBC

Chart 6
Very Little Bad Debt



Source: Equifax, CIBC

working assumption is that the strong fundamentals of the economy (which are the reason for higher rates) will prevent the economy from falling into a recession in the coming two to three years.

Digging Deeper

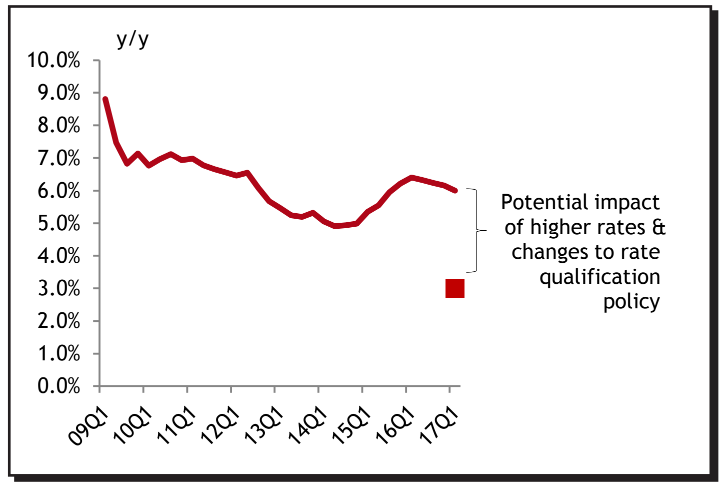
Higher rates along the curve will immediately impact an estimated 50% of total household debt. And if history is a guide, that number can fall by the time the Bank moves again as borrowers return to the comfort of fixed rates.

From a default risk perspective we zoomed in on the most rate-sensitive segment of the mortgage spectrum, those with more than 45% total debt service ratio (TDSR). Utilizing information from various sources we estimate that that segment accounts for around 10% of mortgage outstanding. Now, the reason why those borrowers are allowed to carry such a high TDSR is largely due to the fact that they possess a high credit score, which compensates for the risk associated with the elevated level of debt service cost. Therefore, assuming no recession in the near-term, the likelihood of default among this group due to higher rates is relatively low.

So for the foreseeable future, higher rates, are unlikely to lead to a surge in default—at least not until the next recession. They, however, will work to slow down the pace of mortgage originations. Given recent changes to regulations regarding qualifying rates to the insured segment of the mortgage market, the impact of higher rates on originations will not be as significant as it was in the recent past, with a cumulative impact of 100 basis points of tightening reducing growth in outstanding by a full percentage point.

However, the proposed changes introduced by OSFI (to apply a 200 basis point increase to the qualifying rate of the non-insured mortgage segment of the market) could be more significant. We estimate that such a move, if implemented, could cut growth in mortgage outstanding by two percentage points from the current 6.0% annual growth. Add to it the possibility of a reduced average size of mortgage due to lower house prices and it's not unreasonable to assume that within a year or two mortgage growth in Canada would be half of what it is now (Chart 7).

Chart 7
Growth in Mortgage Outstanding Could Slow Notably



Source: Statistics Canada, CIBC

Bottom Line

At least for now, this is not a credit quality story. It's a growth story. With the Bank of Canada 20% more powerful than before the recession, the potential damage due to policy overshooting is notably higher today. And that's where the risk resides. Too severe rate-induced slowing in consumer spending and real estate activity could be recessionary, and eventually turn the growth story into a credit quality story.

The Bank of Canada is not oblivious to this fact, and even acknowledged, when it hiked recently, that consumers are more sensitive to interest rates in this cycle. Our working assumption, therefore, is that the disease is also the cure, and that the increased sensitivity to higher rates will prevent the Bank from moving too rapidly. The more immediate risk is the proposed rate qualification regulatory changes which we believe have the potential to notably slow down growth in mortgage originations. Given current slowing activity in the market, it might be advisable to rethink the timing of the implementation of those polices.