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Privy Council Office | Bureau du Conseil privé

Ottawa, Canada
K1A 0A3

June 3, 2024

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MEMORANDUM FOR THE PRIME MINISTER
c.c.: John Hannaford, Christiane Fox

The Financial Situation of Households

(Information)

- Attached is a deck for information entitled *The Financial Situation of Households: An update on strengths and vulnerabilities*. This deck provides an overview of how the financial situation of households has evolved since the onset of the pandemic, including a breakdown of income and wealth indicators by income quintiles, age groups and between homeowners and renters.
- While debt levels have stabilized overall, debt service ratios have increased in the past two years as a result of higher interest rates and are expected to remain at historic highs for some time, even with potential rate cuts. That said, wages broadly grew in line with inflation, recession fears have eased over the past year and the vast majority of homeowners appear able to make their higher mortgage payments.
- However, the combination of higher interest rates, higher cost of living (particularly around housing) and the end of significant pandemic-related income support has generated increased financial vulnerabilities for certain households, particularly for low-income renters.
- After improving in 2020 owing to significant pandemic-related government support, poverty rates have increased, notably among non-elderly single individuals, although they remain lower than in 2015. With rising food prices, the share of the population experiencing food insecurity also rose in 2022 across family types. We will continue to monitor the situation and update you as required.

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Mollie Johnson
Deputy Secretary to the Cabinet

Attachment: Deck – The Financial Situation of Households
Bourély/Kim/Brunelle-Côté/aj

Canada

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The Financial Situation of Households:
An update on strengths and vulnerabilities

Liaison Secretariat for Macroeconomic Policy
Privy Council Office
June 2024

Canada

Context

- Household debt increased during the pandemic, as many households took on mortgages to purchase a home while interest rates were low.
- Rate increases by the Bank of Canada (BoC) slowed household consumption as intended and helped bring down inflation. However, higher rates raised debt service costs for homeowners with mortgages.
- Homeowners tend to have sufficient income to make their mortgage payments and have remained resilient so far. However, renters are also facing steep rent increases. As many renters have low income and benefited less from higher wages, their financial situation has deteriorated, and some are falling behind on non-mortgage debt obligations.
- Financial distress and poverty indicators now allow for a fair comparison after the end of significant but temporary pandemic-related government income support in 2020 and 2021. Following notable improvements between 2015 and 2020, poverty rates are increasing again past the pandemic, reflecting the higher cost of living.

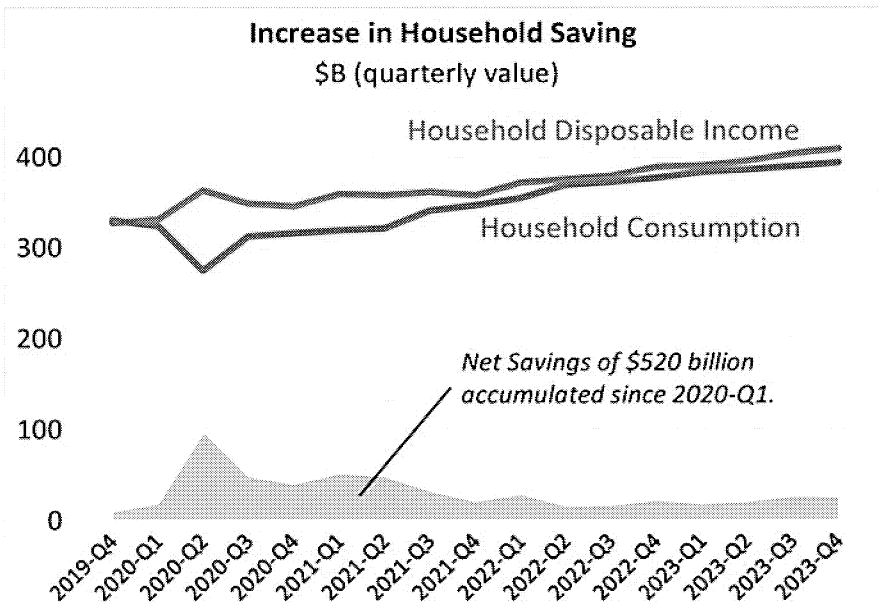
Households have been prudent, which contributed to an economic slowdown.

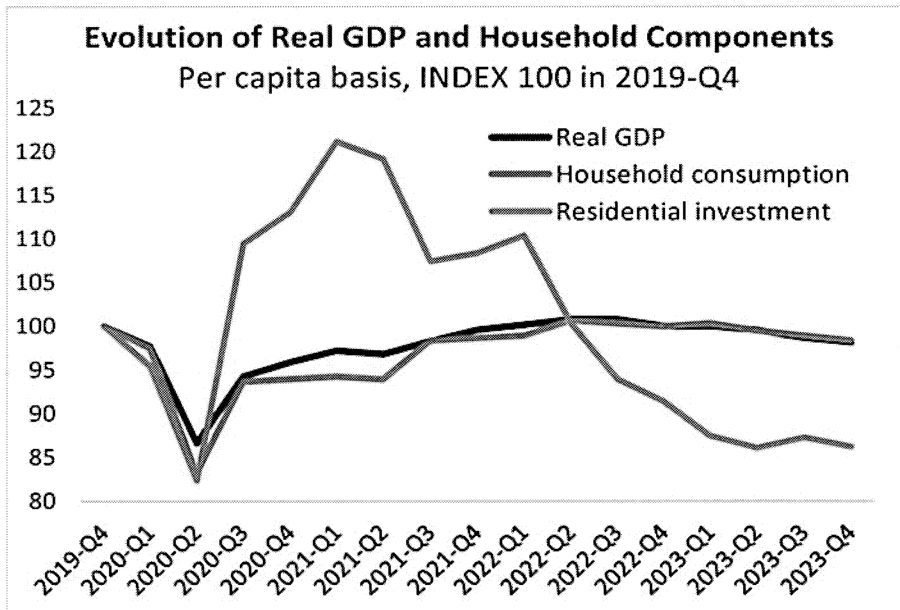
Overall, households have been prudent by keeping consumption well under disposable income to enable ongoing savings.

As a result, consumers accumulated significant savings, some invested in real estate and some put in bank deposits, available for future consumption.

Overall household demand has remained subdued, which created a drag on economy activity, as intended by the Bank of Canada's restrictive monetary policy.

On a per capita basis, real household consumption remains below pre-pandemic levels (-1.7%) and residential investment is undergoing a slump amid elevated interest rates, past its surge in 2020 and 2021.





Household debt is elevated but stabilized and assets still offer safeguards

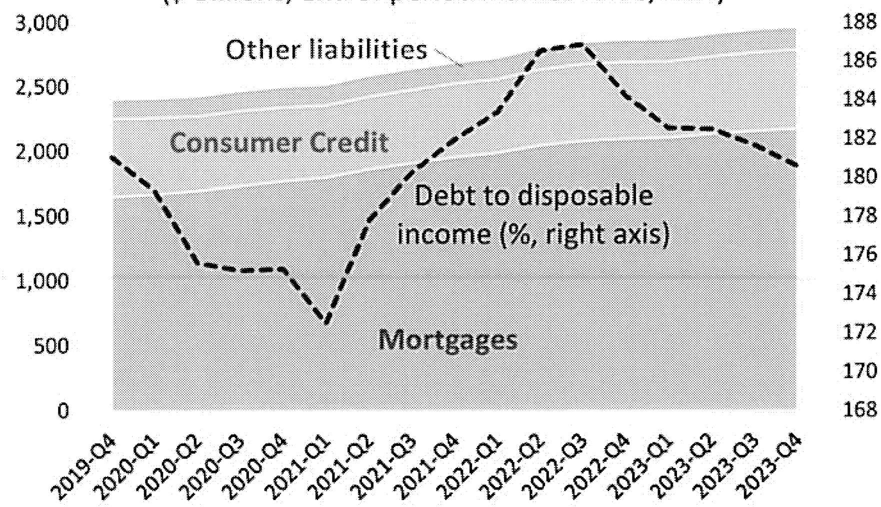
Household debt as a share of disposable income peaked in 2022-Q3, to a historical high of 187%.

However, this ratio fell to 181% in 2023-Q4, as higher interest rates slowed household spending and discouraged new borrowings, and as disposable income kept growing.

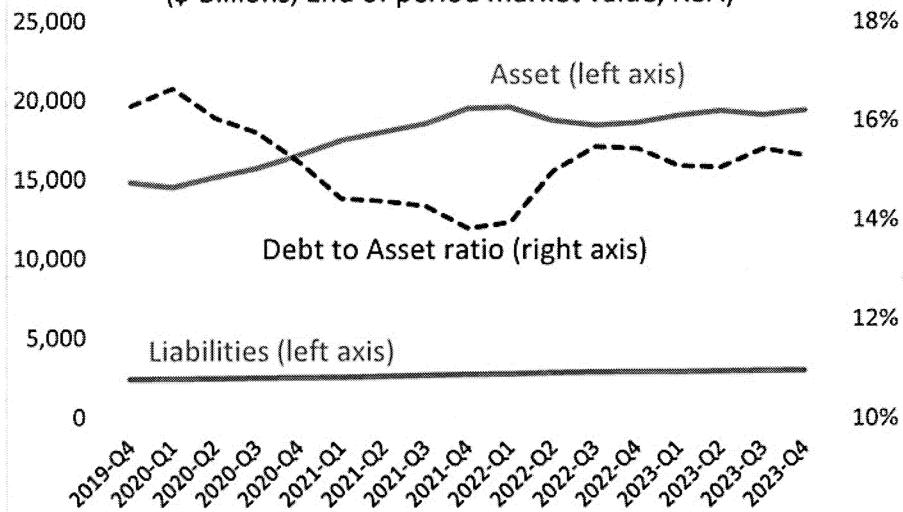
As new debt was mostly incurred to acquire new homes and asset prices rose in 2020 and 2021, the debt-to-asset ratio declined from 2020-Q1 to 2022-Q1.

While asset price corrections in 2022 have lifted the debt-to-asset ratio, it remains below pre-pandemic level.

Composition of Household Liabilities
($ Billions, End of period market value, NSA)



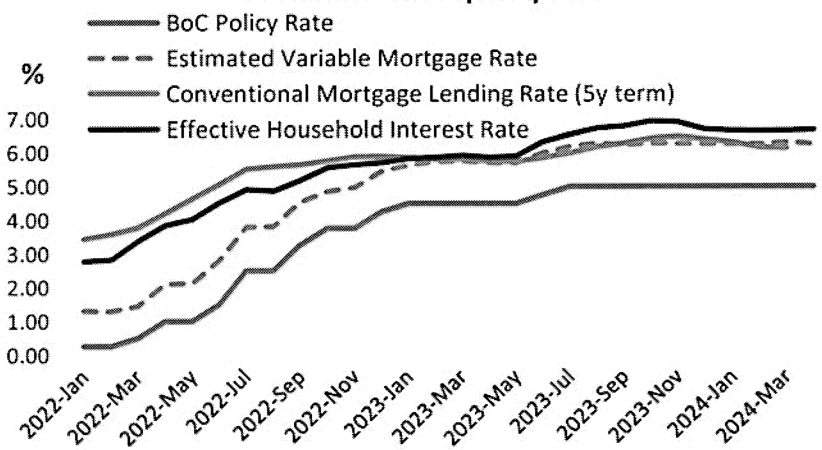
Assets and Liabilities of the Household Sector
($ Billions, End of period market value, NSA)



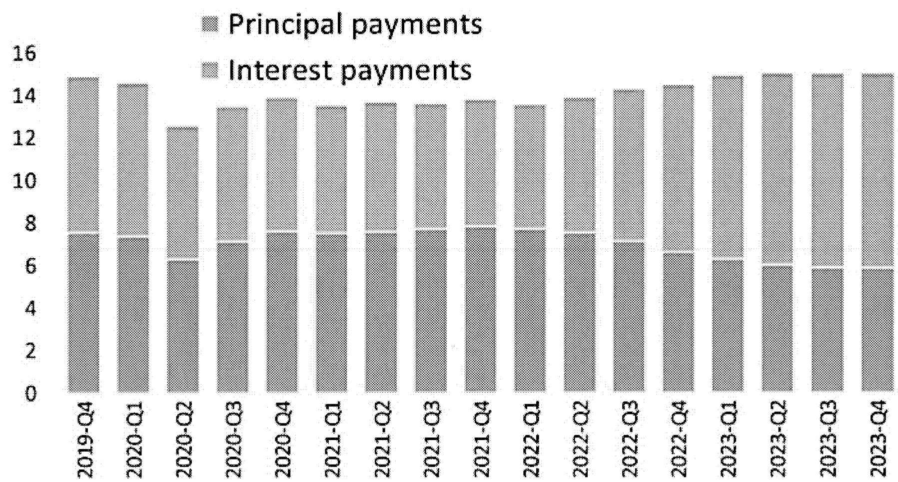
Nevertheless, elevated debt levels and higher interest rates resulted in higher debt service costs.

- While household borrowings slowed down, mortgages and other loans are still being renewed at higher interest rates. As a result, existing debt levels have become more costly to service, using a larger share of disposable income.
- The average debt service ratio has increased significantly over the past two years before stabilizing to around 15% of disposable income in 2023. While interest payments are creeping up, some households have managed to lower their principal payments. As a result of elevated debt service ratios :
  - Indebted households have a smaller share of disposable income available for consumption, and
  - Many households are getting behind in making required debt payments.

Interest rates on new borrowings rose in 2022 and 2023 but stabilized in the past year.



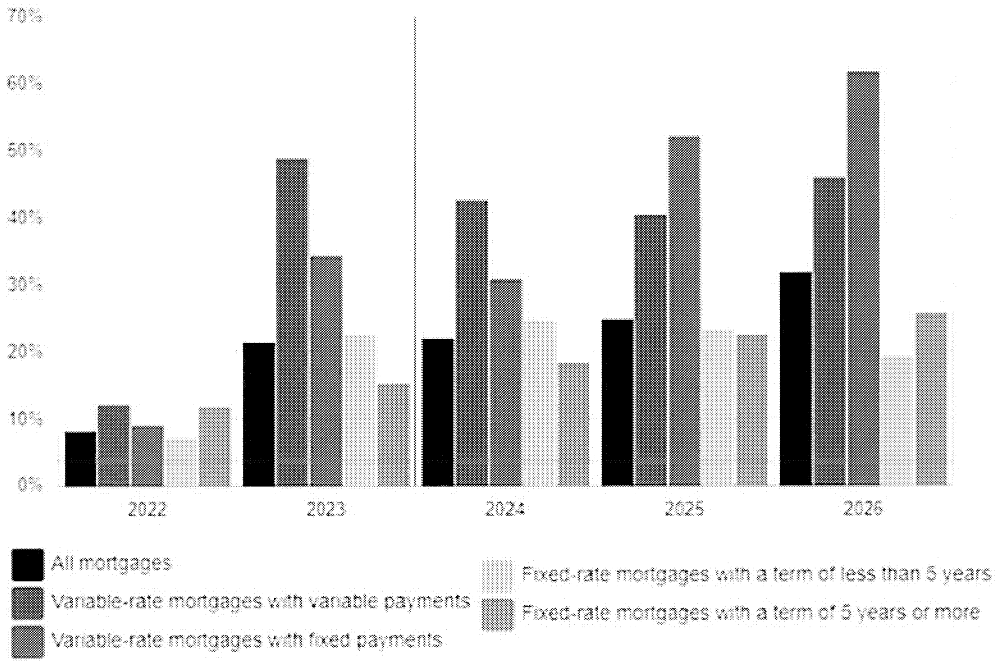
Household Debt Service to Disposable Income Ratio (%)



The impact of higher rates is still playing out on mortgages.

About 37% of households are renters	About 35% of households have mortgages	About 28% of households are owners without a mortgage (fully-paid)

Median percentage increase in mortgage payment at renewal compared with at origination



Source: Bank of Canada Financial System Review - 2024

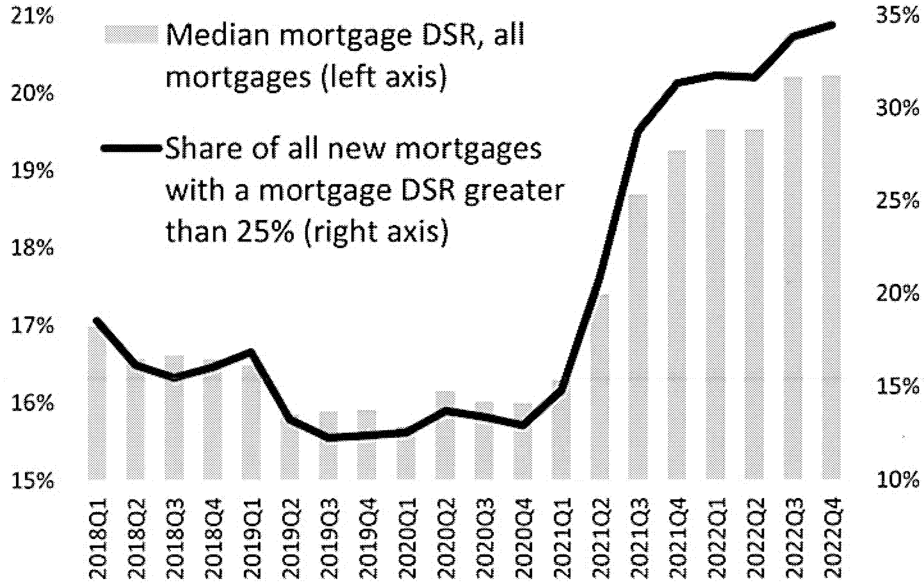
- Households with mortgages are being affected by higher rates based on timing of renewal and mortgage type.
- As of mid-2024, about half of all outstanding mortgages are held by borrowers who have yet to face higher rates because their payments were fixed for five years (with either a fixed or variable mortgage rate).
- Households that hold these fixed mortgages (part of *yellow* and *blue*) will generally see a larger payment increase than those that have already renewed, given offered fixed mortgage rates were particularly low at originations in 2020 and 2021.
- Households with variable-rate mortgages (*red* and *green*) were already being affected by higher rates prior to renewal. Compared to origination, they will have incurred the largest increases at renewal, with mortgage payments ultimately up by 40% to 60%.

Higher mortgage costs are putting increased financial strain on homebuyers and preventing renters from entering the housing market.

Mortgage payments are taking an increasing share of households' income, making them more financially vulnerable if their income declines or they face an unexpected large expense.

Mortgage Debt Service Ratio

(DSR: share of income dedicated to mortgage payments)

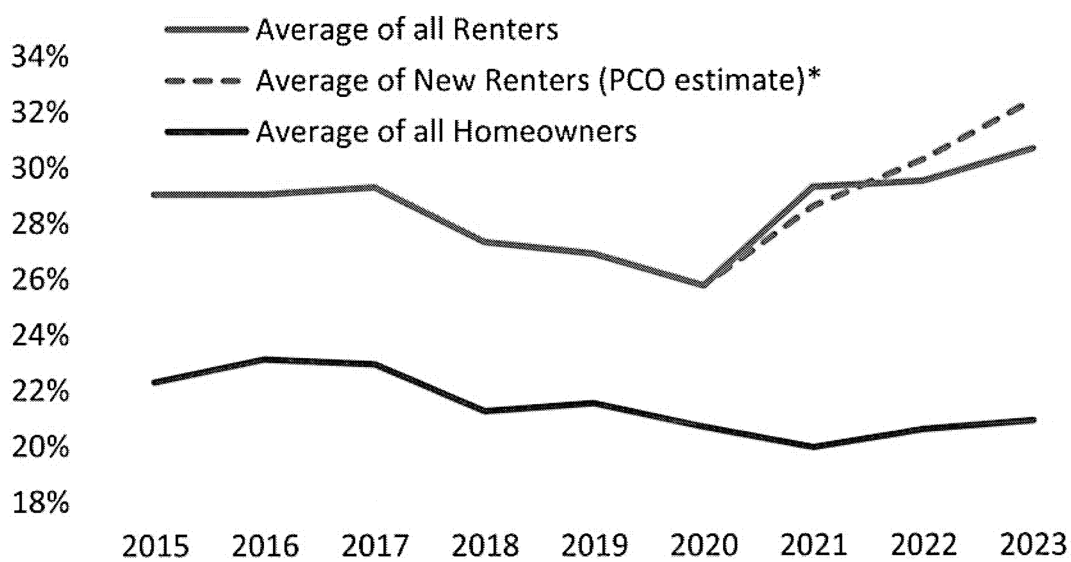


Source: Bank of Canada Indicators of financial vulnerabilities

- Across <u>all</u> mortgages, the median Debt Service Ratio (DSR) increased to about 20% in 2023-Q4, 4 p.p. above pre-pandemic (see *grey* bar). This is despite households opting for smaller mortgage loans and for longer amortization periods.
- To identify the most vulnerable households, the Bank of Canada looks at the share of new mortgages with a DSR greater than 25%.
  - About 35% of <u>new</u> mortgages now require homebuyers to spend more than 25% of their income on mortgage payments (see ***black*** line), more than twice the pre-pandemic share.
  - This is also preventing many prospective homebuyers from entering the housing market and remain renters, which is in turn keeping upward demand pressure on rents.

Renters are being affected by increasing rental costs, particularly new tenants.

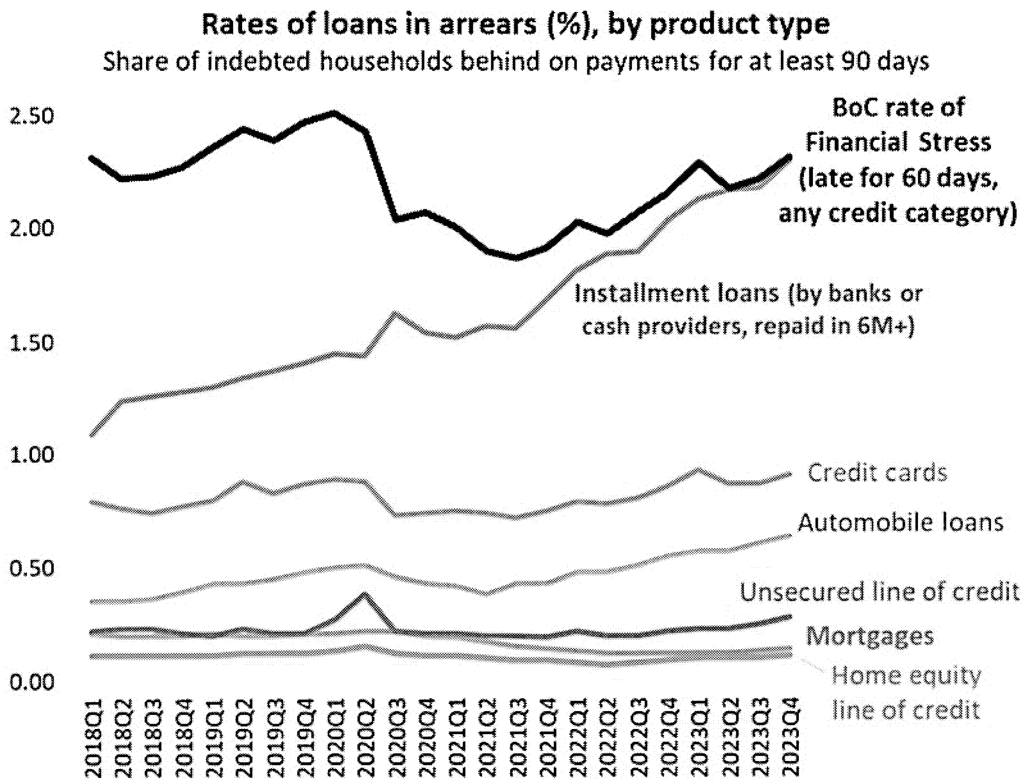
Housing Costs (housing, water, electricity, gas and other fuels) as a share of disposable income (based on Statistics Canada DHEA)



* PCO estimate for new renters based on differential between growth rates of asking rents (Rentals.ca) and Rent Consumption Price Index (CPI). Same renter disposible income (DHEA)

- Rent has increased by about 20% from pre-pandemic levels.
- On average, renters are having to allocate a larger share of their disposable income to pay for housing-related expenditure at 30.6%, up 3.8 p.p. from pre-pandemic levels.
- Given the recent significant increases in asking rents, new tenant are estimated to have to allocated about 5.5 p.p. more of their disposable income from pre-pandemic levels.
- On the other hand, homeowners are allocating a much smaller share of their disposable income to housing costs, 21% on average. This reflects that 45% of homeowners (or 28% of households) have already fully paid their mortgage, and the generally higher income of homeowners.

Some households are starting to fall behind on non-mortgage debt obligations…



Source: Bank of Canada Indicators of financial vulnerabilities

Tracking households that are having difficulty making debt payments provides a good indicator of financial strain.

- The Bank of Canada's rate of financial stress – the share of indebted households that are behind on payments for at least 60 days in any credit category – has increased in the past three years, back around pre-pandemic levels.
- The rate of arrears is notably increasing for installment loans, which represent a very small share of total liabilities but are often used by households with poor credit ratings.
- More widely used, automobiles loans and credit cards are also recording a rise in arrears.

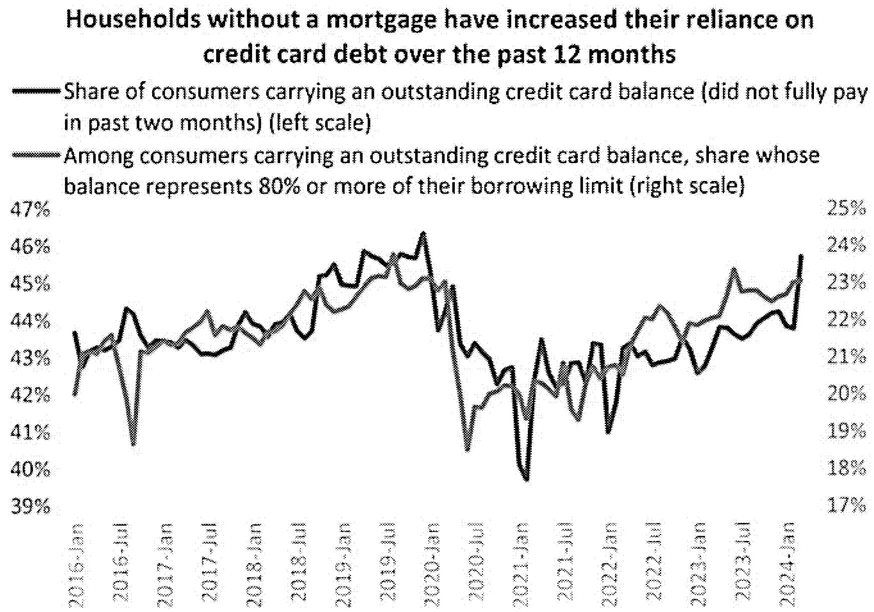
… resulting in consumer insolvencies going back up to pre-pandemic levels.

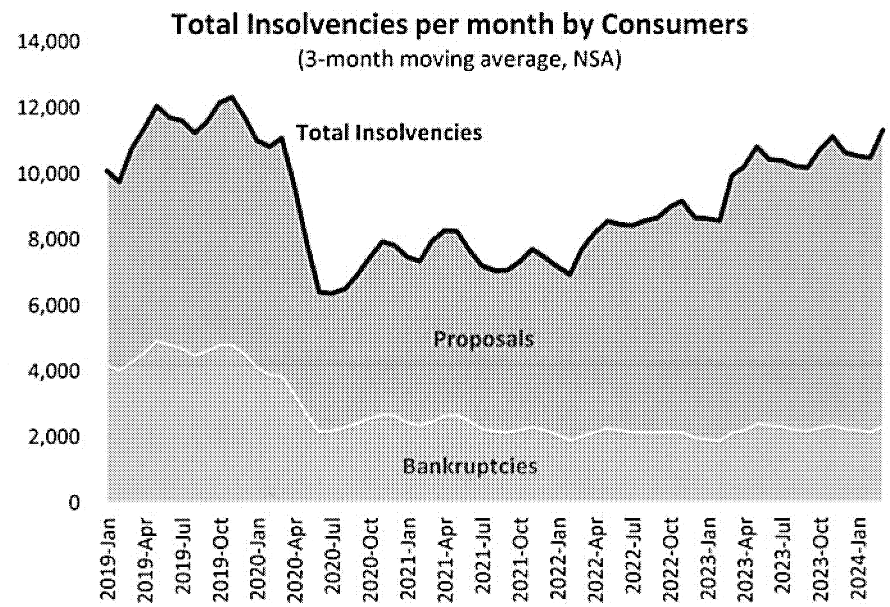
The BoC finds that financial stress have risen primarily among households without a mortgage, as many struggle after paying rent.

Borrowers without a mortgage who carry large credit card balances are significantly more likely to miss a future debt payment and their numbers have increased in the past year.

As a small but growing share of households are facing mounting debt combined with rising interest rates, more individuals are considering declaring insolvency as a viable option.

So far, consumers have leaned towards "proposals", i.e. settling debt by working with creditors.



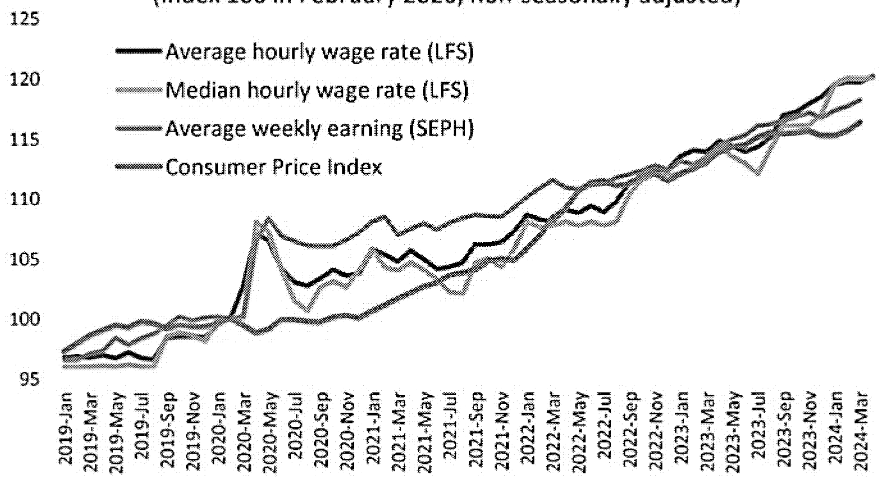


Source: Bank of Canada Financial System Review - 2024

Wages have broadly kept pace with the cost of living...

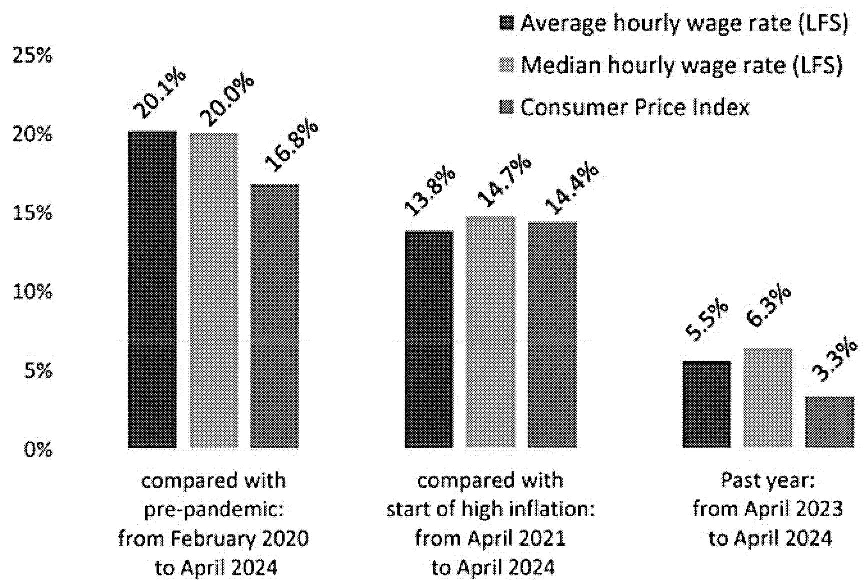
- Thanks to a strong economic recovery in 2021 and 2022 and a still resilient labour market, both average and median hourly wages grew more than CPI inflation since the start of the pandemic and in the past year.
- From April 2021 when inflation started to accelerate, hourly wages have broadly remained in line with inflation.
- Average weekly earnings for payroll employees have also kept pace with inflation since the start of the pandemic. While weekly earnings took an early lead to inflation, that lead narrowed with rising inflation in late 2021 and early 2022.

Comparison between the Consumer Price Index (CPI) and Wages
(Index 100 in February 2020, non-seasonally adjusted)



LFS: The Labor Force Survey is a household survey and is the only source of monthly estimates of total employment, including self-employment, full- and part-time employment, and unemployment.
SEPH: The Survey of Employment, Payrolls and Hours is produced by a combination of a census of payroll deductions, provided by the Canada Revenue Agency, and the Business Payrolls Survey.

Change in Prices Compared to Change in Wages



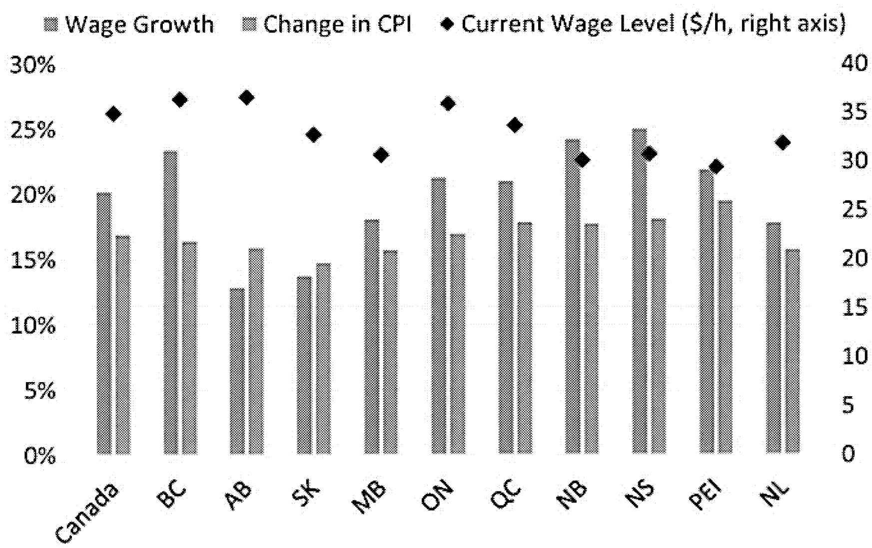
… but wage growth has been uneven, potentially leaving some households with a loss of purchasing power.

By province, wage growth notably grew more than Consumer Price Indexes (CPI) in BC and in the Maritimes (NB, NS, PEI).

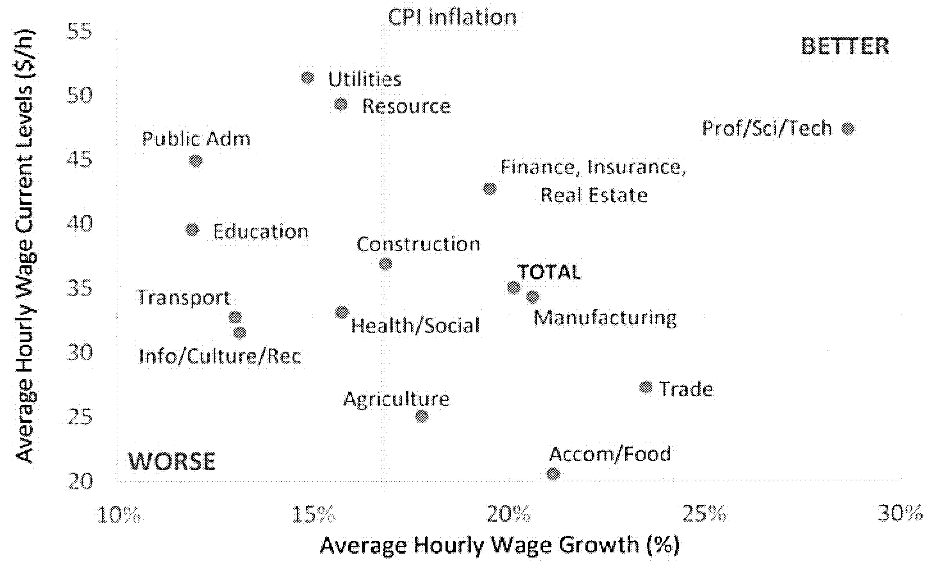
However, wage growth grew to a lesser extent in the prairies than elsewhere in Canada. At the same time, inflation has also tended to be less severe in the prairies since the onset of the pandemic.

Wage growth has varied significantly between industries. Of note:
- 'Professionals, Science and Technical' services recorded strong growth, which had a high level of wage to begin with.
- 'Accommodation and food' recorded strong growth but wages remain low.
- Resource industries recorded less growth, but wages are still relatively high.
- 'Information, culture and recreation' recorded weaker growth from relatively low levels.

Average Hourly Wage Growth and Change in CPI (February 2020 to April 2024) and Current Wage Level, by Province

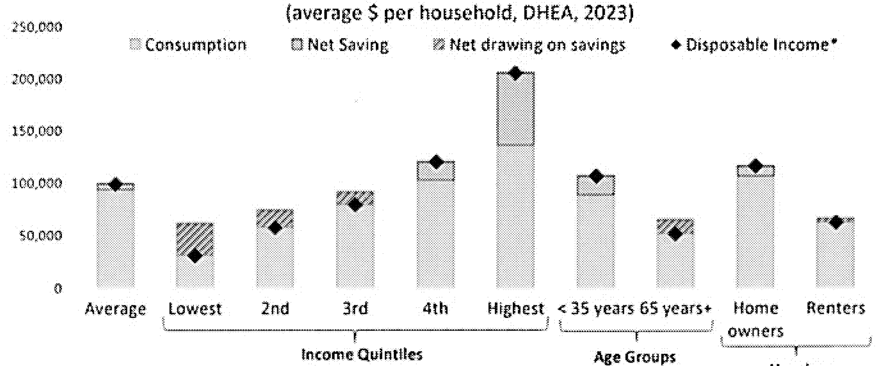


Average Hourly Wage Growth (February 2020 to April 2024) and Current Levels, by Industries (LFS)



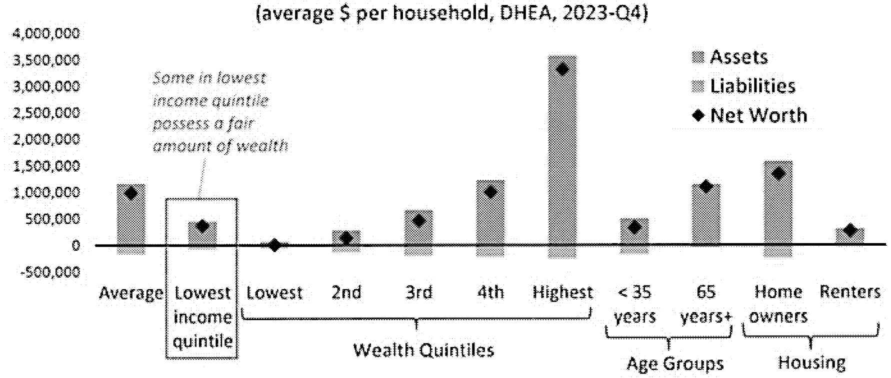
Rise in financial stress is occurring in a context of longstanding large disparities in income and wealth.

Household disposable income, consumption and savings
(average $ per household, DHEA, 2023)



* Disposable income includes change in pension entitlements

Household assets, liabilities and net worth
(average $ per household, DHEA, 2023-Q4)



Large income disparities between households...

- Among low-income households, most need to limit consumption due to budget constraints, even though a minority (such as retired people and self-employed with temporarily reduced income) can draw from previously accumulated wealth.
- Higher income households benefit from income well above their consumption levels, enabling large savings and more investments.

... in turn generate even more pronounced wealth disparities.

- The highest wealth quintile has about 67% of the total household net worth, while the two lowest wealth quintiles have only 2.8%.

While low-income households are financially vulnerable, smaller debt levels suggest they do not represent a systemic macro-financial risk.

- While many low-income households owe debt on credit cards or instalment loans, amounts owed are small from a macro perspective.
- The large majority of low-income/low-wealth households are renters that stand to be more affected by rising rents and increased debt service costs on non-mortgage debt.

Higher interest rates and strong wage growth benefited higher income households, which contributed to inequality.

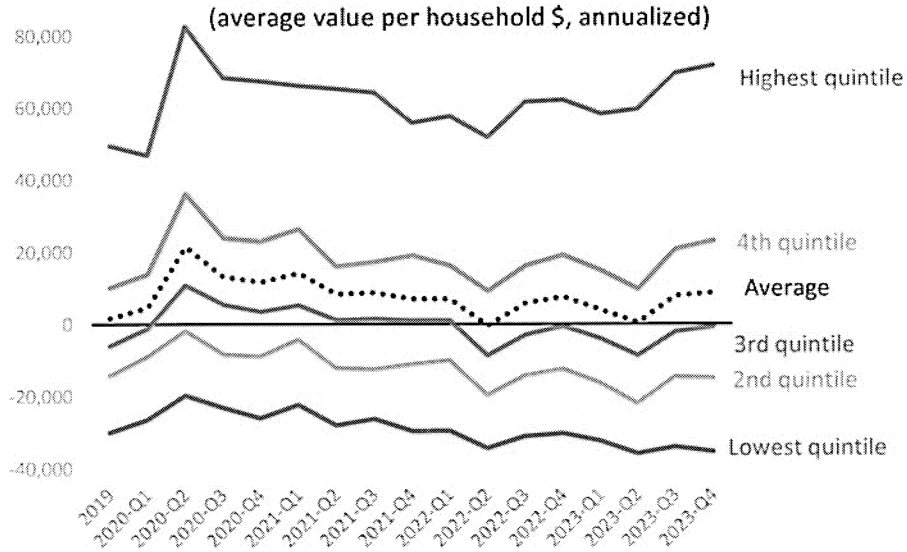
Affluent households, in the highest and 4th income quintiles, have been able to maintain their standard of living, while realizing increased savings.

For the lowest, 2nd and 3rd quintiles, most households need to keep consumption under budgetary constraints but net drawing on savings has increased, as more households have fallen behind on debt obligations.

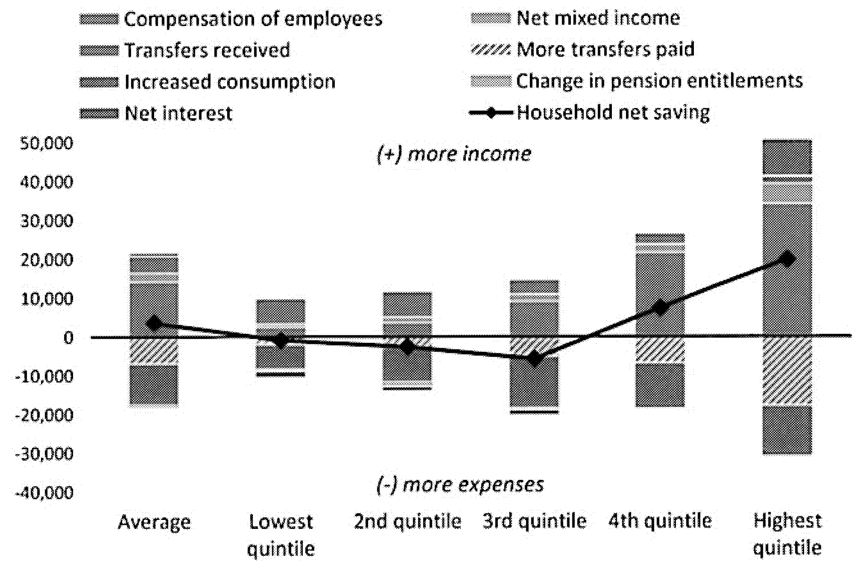
A robust labour market benefited all workers but wage gains were larger for higher income households, who typically work more.

High interest rates affected lower income quintiles (through higher interest payments) but benefited the highest income quintile (through higher dividends and investment income from accumulated assets).

Household Net Savings (+) and Net Drawing on Savings (-) by Income Quintiles (average value per household $, annualized)



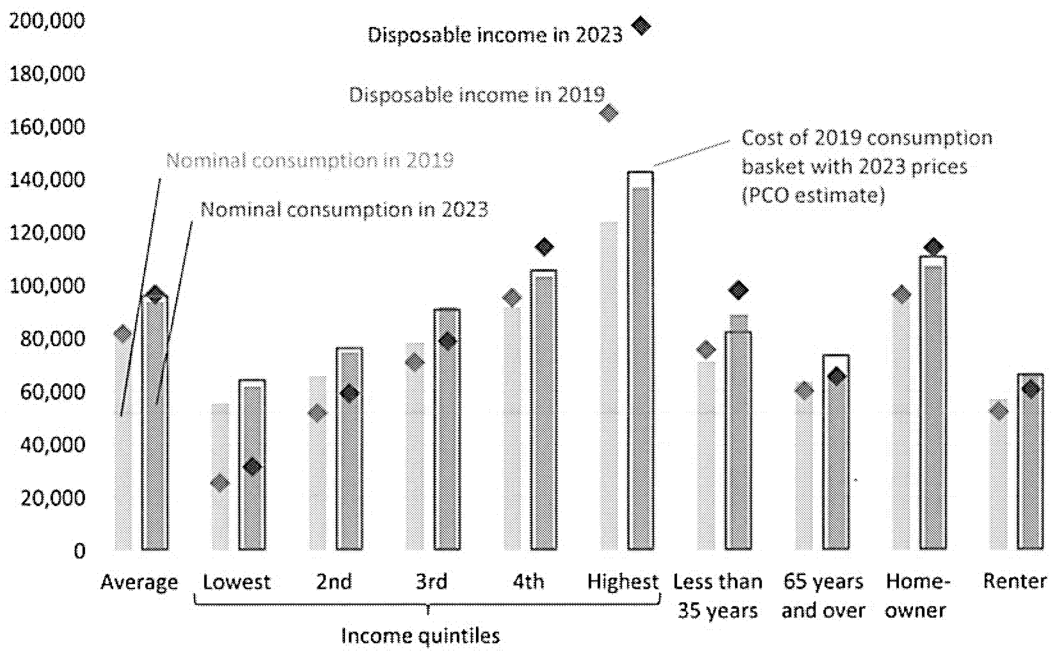
Change in Net Savings from 2019 to 2023 (average $ per household)



Household consumption mostly grew as a result of higher prices, rather than households buying more goods and services.

Household consumption mostly grew in line with prices, thereby allowing most households to maintain their standard of living. However, households with budget constraints did not buy as much goods and services than in 2019.

Change in Consumption between 2019 and 2023 and whether households were able to maintain standard of living

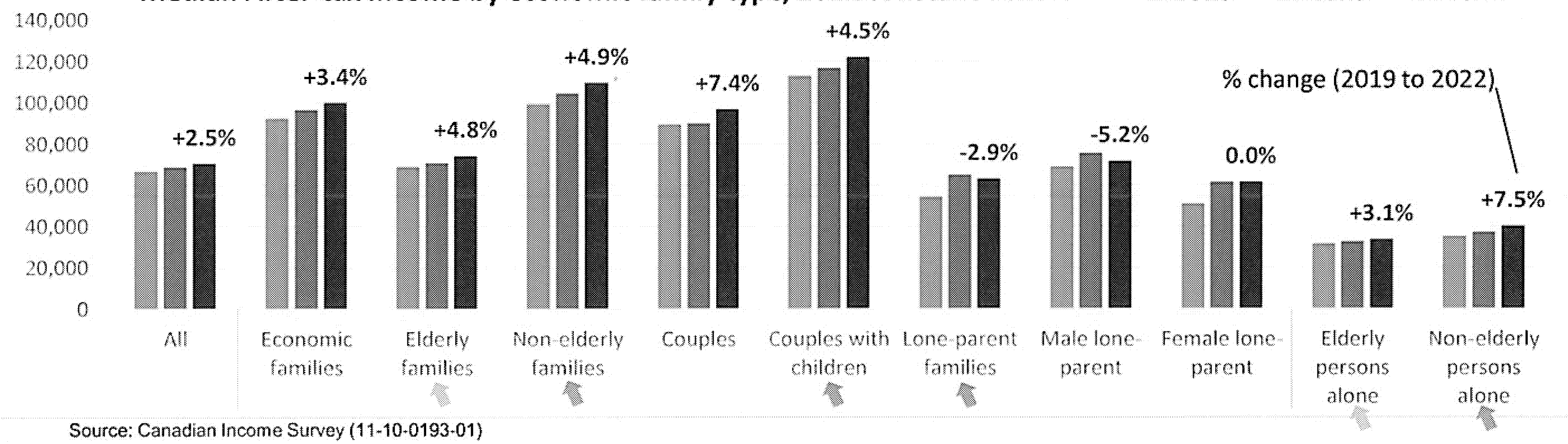


- Spending by low-income quintiles (lowest + 2nd) did not increase enough to keep up with the higher cost of living. This suggests many low-income households purchased a lesser quantity of goods and services in 2023 than in 2019. (Later slides will discuss those no longer able to afford a basic standard of living and falling in poverty as a result.)
- Higher income quintiles also did not purchase as much goods and services than in 2019, reflecting their choice to moderate spending on luxury or non-essential items.
- This was also the case for homeowners overall, mostly reflecting lower spending for transportation (perhaps due to teleworking).
- Of note, spending by some household categories exceeded the amount required to maintain their 2019 consumption basket. The 'Less than 35 years' increased housing spending by 40% (vs the Shelter price index growing 19.4%). The 3rd income quintile spent slightly more than required by price changes on housing and communications.

Being part of a family allows individuals to earn more and share expenses while single individuals tend to earn less without the ability to share expenses.

- The Canadian Income Survey provides data on a median basis that can be more representative of socio-economic groups than averages, which are often skewed by very high earners.
- While households with two earners can be expected to make more than single earners, the typical median non-elderly *family* has a disposable income more than twice that of the median non-elderly *person* living alone ($109,500 vs. $40,100, in 2022).
- While the median lone parent earns about a third in market income than the median couple with children, thanks to significant transfers, the median lone-parent family had a disposable income about half of that for couples with children. Nonetheless, the median couple with children saw an increase in real disposable income since 2019, while the median lone-parent saw a decline.
- While elderly families and elderly persons living alone earn less than younger cohorts, they often have savings to draw from.

Median After-tax Income by economic family type, 2022 constant dollars



Source: Canadian Income Survey (11-10-0193-01)

Rising shelter and food costs have raised the cost of a basic standard of living, under which households are considered to be living in poverty.

The Market Basket Measure (MBM) is based on the cost of a specific basket of goods and services representing a modest, basic standard of living for a reference family (couple with two children), in each region.

These costs are compared to the disposable income of families to determine whether or not they fall below the poverty line.

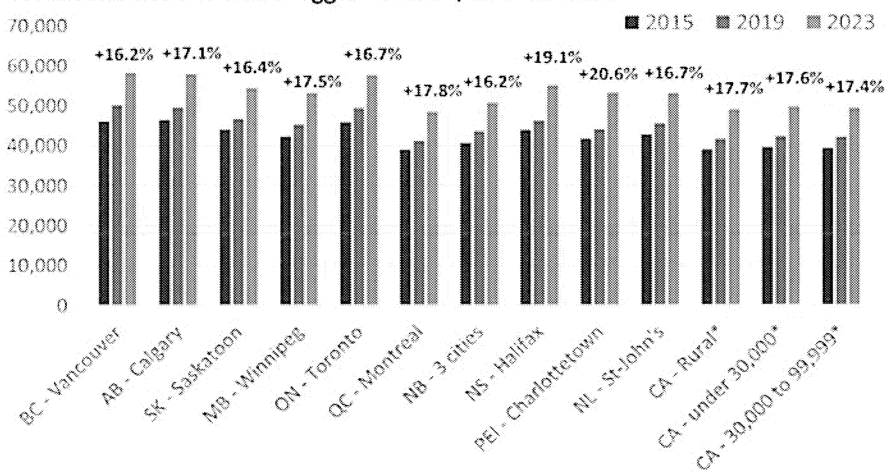
Reflecting elevated inflation in recent years, poverty lines as measured by the MBM have increased by about 16% to 20% on a nominal basis.

MBM estimates are higher for large cities such as Vancouver, Calgary and Toronto, where shelter costs are the highest. While large cities often offer better wages, those that don't work full time are more at risk of poverty.

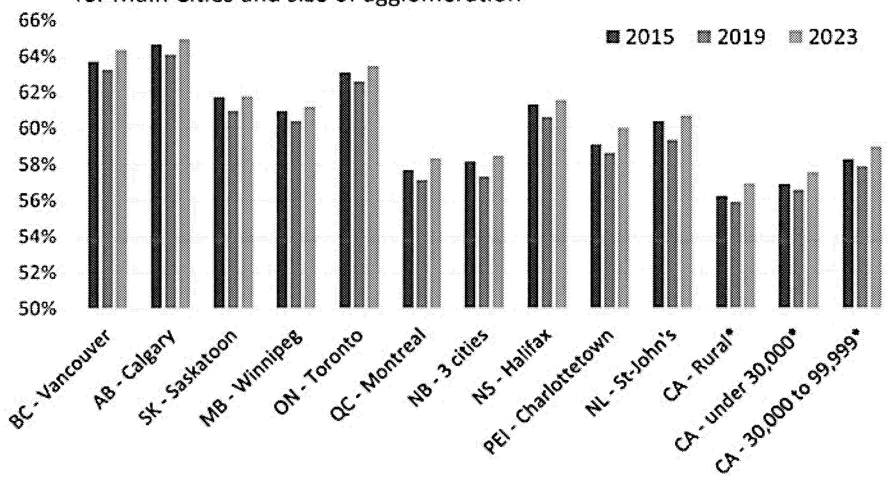
At the other end, MBM estimates tend to be lower for less populated agglomerations given lower shelter costs.

As prices significantly increased for food and shelter, such essential items represented an even larger share of MBMs in 2023, compared to 2019.

Market Basket Measure (MBM) thresholds for the reference family
for Main Cities and size of agglomeration, current dollars



Share of MBM Spent on Food and Shelter for Main Cities
for Main Cities and size of agglomeration



* PCO calculations based on population weighted averages

As a result, poverty rates are increasing again after falling significantly since 2015.

In line with lower per capita income levels, persons living alone tend to be more likely to be in poverty than persons that are part of a family.

In particular, non-elderly persons with disabilities and living alone are most at risk of poverty, often reflecting challenges to working full-time.

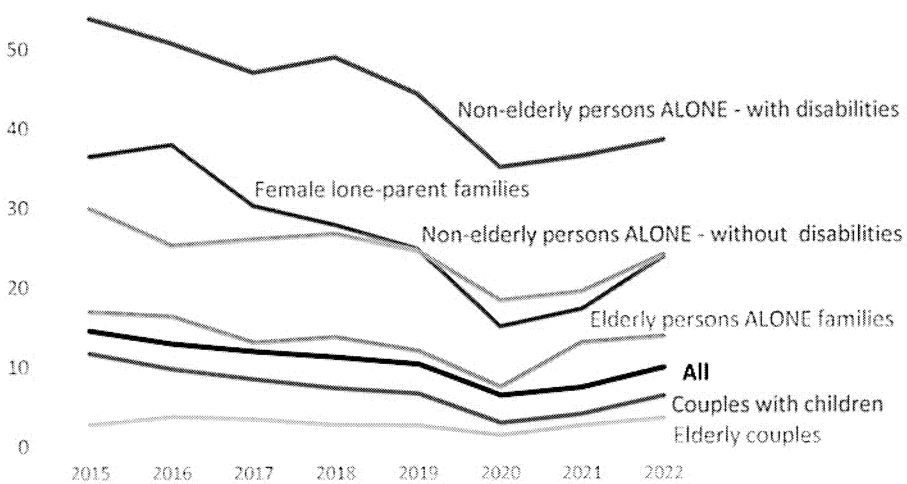
Elderly couples and couples with children are least likely to be in poverty.

In line with increased poverty rates and rising food prices, a larger share of the population is experiencing **food insecurity**, moderate or severe.

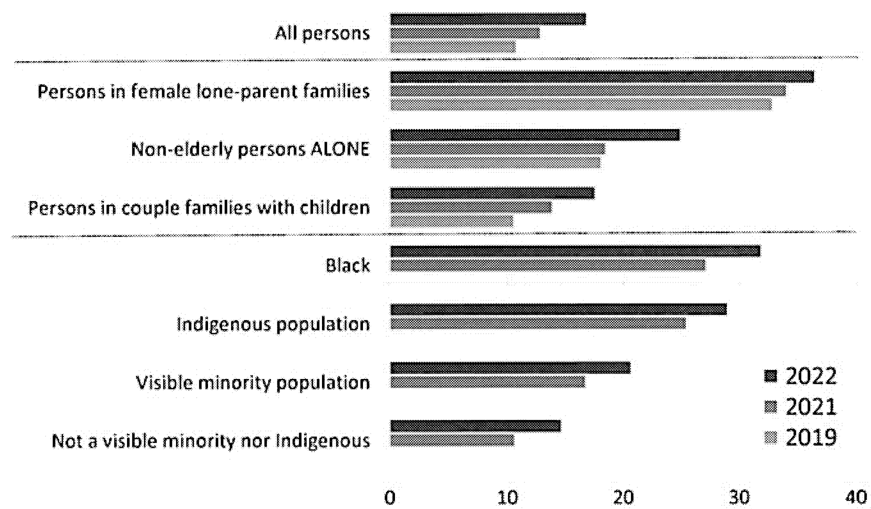
Non-elderly persons living alone and female lone-parent families are most at risk of experiencing food insecurity, particularly if also part of visible minority.

Statcan also reported that families who had a person with a disability as the major income earner were more likely to report food insecurity.

Percentage of persons in low income, for select family and disability status
using Market basket measure, 2018 base



Share of Persons with Food Insecurity, Moderate or Severe



Key Take-aways

- While debt levels have stabilized, debt service ratios have increased in the past two years as a result of higher interest rates and are expected to remain at historic highs for some time, even with potential rate cuts, as many households are set to renew mortgages over the next two years at rates significantly higher than at origination.
- While higher debt service costs will continue to affect household consumption, recession fears have eased over the past year and the vast majority of homeowners appear able to make their higher mortgage payments.
- However, the combination of higher interest rates, higher cost of living (particularly around housing) and the end of significant pandemic-related income support has generated increased financial vulnerabilities for certain households, even though they do not represent a systemic risk.
- A relatively small but growing number of households is struggling to fulfill debt obligations, and this now seems to be particularly the case for low-income renters, which are facing rising rents, rather than mortgage holders, who are more likely to have a stable source of income.
- Poverty rates are increasing again, mostly among non-elderly single individuals. With rising food prices, the share of the population experiencing food insecurity also rose in 2022 across family types. While wages broadly grew in line with inflation, many low-income households do not, or are not able to, work full-time.