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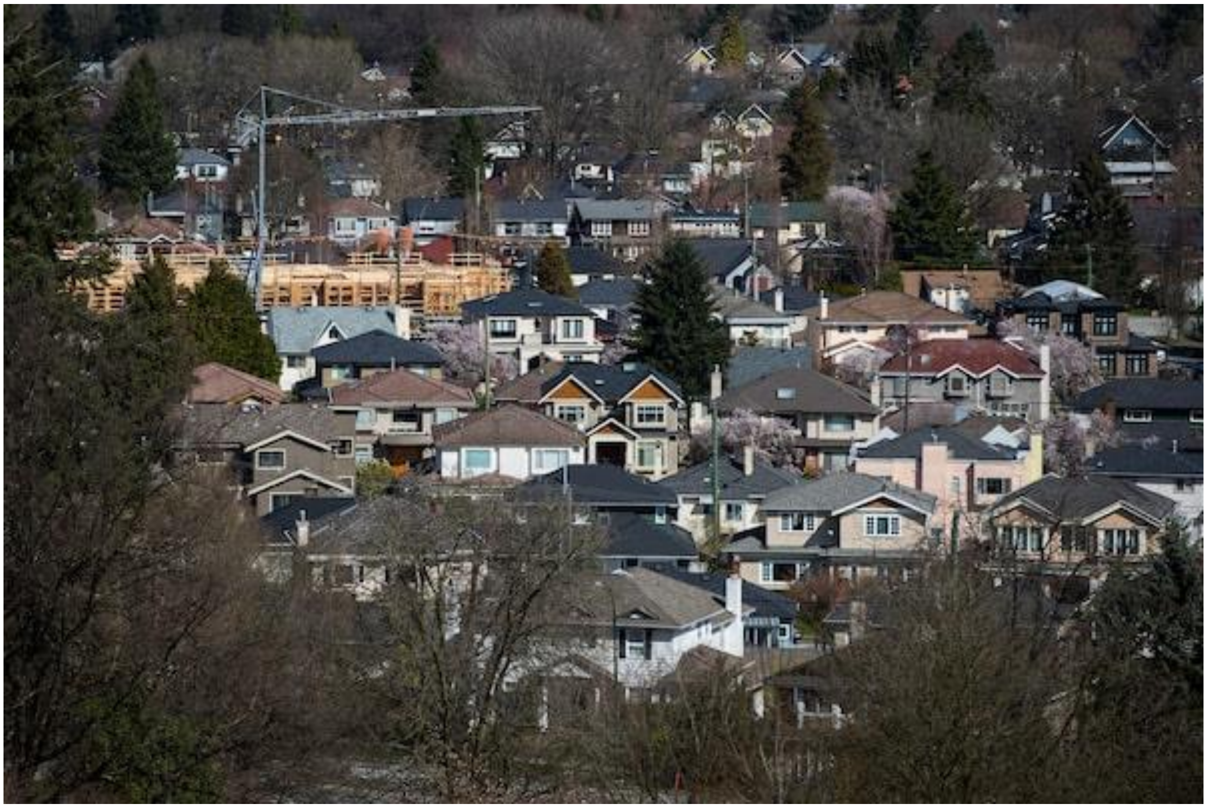
Canadians are paying highest portion of disposable income toward debt on record

MATT LUNDY || DECEMBER 13, 2023



A condo building is seen under construction surrounded by houses in Vancouver, B.C., on Friday March 30, 2018. DARRYL DYCK/THE CANADIAN PRESS

Canadians are directing a record portion of their disposable income to debt payments, a sign of increasing financial pressure on households after an abrupt end to near-zero interest rates.

The household debt service ratio – measured as total obligated debt payments as a proportion of disposable income – rose to 15.22 per cent in the third quarter, said Statistics Canada in a report Wednesday. Put another way, the average household is spending around 15 cents of every after-tax dollar to service their debt.

The latest figure is up from 15.08 per cent in the second quarter and marks the highest ratio in records that date back to 1990. And it's likely that the financial strain on

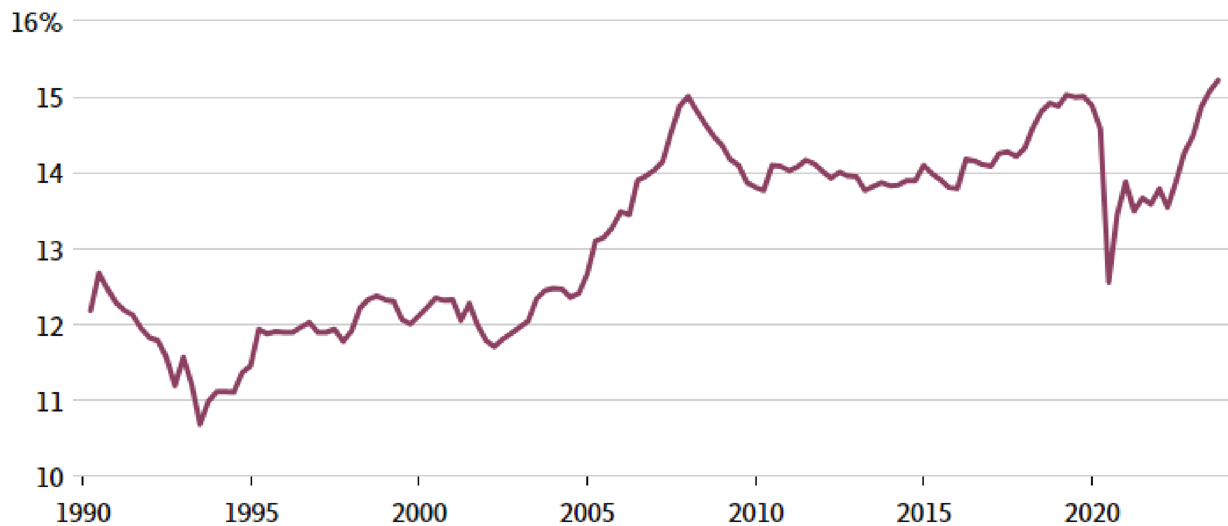
Canadian households will worsen, given that many homeowners have yet to renew their mortgages at higher interest rates.

"The main takeaway is that we're starting to see those debt service costs already pressuring household finances," said Shelly Kaushik, a Bank of Montreal economist. "But we haven't felt the full effect of those higher rates just yet."

Since the early 2000s, Canadians have dramatically ramped up their debt levels, partially overlapping with a period of rock-bottom interest rates that were meant to stimulate the economy after the Great Recession of 2008-09 and subsequently during the COVID-19 pandemic. But these low rates, combined with a housing shortage, fuelled a massive appreciation in home prices across the country, with buyers forced to take on ever increasing amounts of mortgage debt.

Household debt service ratio

Obligated debt payments as a proportion of disposable income



Note: Seasonally adjusted at annual rates

THE GLOBE AND MAIL, SOURCE: STATSCAN

Now, borrowers face a reckoning over their debt accumulation, because of a dramatic shift in lending conditions. In its bid to bring inflation under control, the Bank of Canada has raised its policy rate to 5 per cent from just 0.25 per cent in early 2022, the quickest pace of monetary policy tightening in decades.

Total mortgage interest payments have increased 90 per cent since the first quarter of 2022, Statscan noted in Wednesday's report.

However, the amount of mortgage principal paid has declined by 16.8 per cent. Many people with variable rate mortgages have not seen their monthly payments change, although more is dedicated to the interest portion. In some cases, the monthly payment does not fully cover the interest, so the remaining amount is added to the principal – a process known as negative amortization.

Over all, Canadians are directing 9.26 per cent of their disposable income to interest payments for all types of debt, the highest proportion since 1995.

In other respects, there has been some moderation. Total household debt of $2.9-trillion has grown by 3.2 per cent over the past year, lagging the increase in after-tax income. As a result, the ratio of household debt to disposable income fell to 181.6 per cent in the third quarter from 181.9 per cent in the second quarter. There has been a slowdown in borrowing amid higher interest rates, which is reflected in weak home-buying activity.

Between 2024 and 2026, an estimated $900-billion worth of Canadian mortgages at chartered banks are set to renew, with debtors facing a potential "payment shock" that depends on the path of interest rates, according to a recent report from RBC Capital Markets.

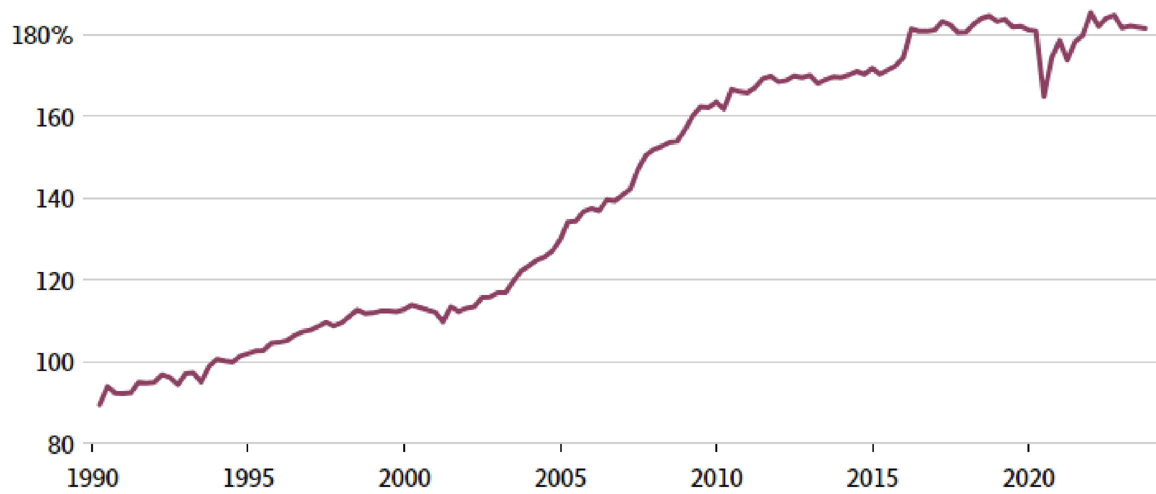
The consensus expectation on Bay Street is that the Bank of Canada has finished raising interest rates and will start to lower them by the middle of next year. In anticipation of those moves, bond yields have tumbled over the past few months, offering some modicum of relief to those renewing mortgages in the near term.

Still, many analysts expect borrowing rates to settle at higher levels than Canadians have grown accustomed to in recent years.

"The last decade or so of near-zero rates was historically an anomaly," Ms. Kaushik said. On mortgages, she added: "You would expect to see households still feeling that payment shock, even if the rates that they're renewed at are lower than what we're seeing today."

Household debt to disposable income ratio

Total credit market debt as a proportion of after-tax income



Note: Seasonally adjusted annual rates

THE GLOBE AND MAIL, SOURCE: STATSCAN

In separate numbers released Wednesday, the Bank of Canada said that one-third of new mortgages had a debt service ratio of more than 25 per cent – far higher than levels before the rate-hike campaign began.

"All else being equal, a household that spends a large portion of its income on mortgage payments may be more vulnerable to financial stress – it may be more likely to fall behind on debt payments if a negative income shock or a rise in mortgage interest rates were to occur," the central bank says.

Financial troubles are materializing in various ways. Through October, more than 102,000 consumer insolvencies have been filed this year, an increase of 23 per cent from the same period in 2022, according to federal data. On a per-capita basis, the insolvency rate is rising, but still lags behind levels seen just before the pandemic.

As of September, 0.16 per cent of residential mortgages were in arrears, meaning payments were overdue by three or more months, according to figures from the Canadian Bankers Association. These are some of the lowest delinquency rates on record and suggest homeowners aren't struggling to pay their mortgages.

Still, the rise in interest rates appears to be weighing heavily on consumption, with households forced to tighten their budgets. Consumer spending has effectively stalled over the past two quarters, and when the country's soaring population growth is taken into account, per-capita spending is on the decline.

Toronto-Dominion Bank economist Maria Solovieva said in a report Wednesday that "the combination of high debt levels and slower income growth will create an enduring drag on consumption and broader economic growth in turn."