



CGA-Canada shares its views on  
Indebtedness of Canadian households

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**Colloquium on Consumers Indebtedness**  
Montreal, QC  
March 12-13, 2009

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# Where Does the Money Go: The Increasing Reliance on Household Debt in Canada

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Colloque international sur la consommation  
March 12, 2009  
Montreal, Quebec

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## Background

- **Softer labour markets, declining business activity, and further downgrading of asset values will make it much harder to get up for those who fall.**
- **Sadly, this represents the end of what we could refer to as "good times".**

Good morning/afternoon. Thank you for the opportunity to participate in this panel discussion today. Increasing debt of Canadian households has been a subject of intense discussion for a good number of years. However, in the current economic situation, during the so-called "meltdown", the topic of household indebtedness is rapidly becoming a critical area. The importance is fostered not only by the deteriorating situation within the household sectors but also by rapidly disappearing buffers in other sectors of the economy. Softer labour markets, declining business activity, and further downgrading of asset values will make it much harder to get up for those who fall.

Before sharing my views on indebtedness of Canadian households, I'd like to take a moment to say few words on what is CGA-Canada. CGA-Canada is a self-regulating, professional association that represents Certified General Accountants (CGAs) and students in Canada, as well as Bermuda, Caribbean, China and Hong Kong. CGA-Canada sets standards, provides member services and delivers a Program of Professional Studies.

CGA-Canada also develops research on a range of topics that extend beyond accounting. This research aims to protect public interest, heighten public awareness, and serve as a factual basis for influencing social and economic policy. Over the years we looked at such topics as aging population, pensions, income trusts, productivity and competitiveness, budgetary balance of the federal government and others. The matter of household indebtedness came under our research radar in the early 2007. At that time we aimed to analyze the level of debt of Canadians and the risks associated with the rising level of the debt burden. Now, in the spring of 2009 we are embarking on this topic again seeking to understand the extent to which the economic and financial crisis worsened financial positions of Canadians who had already experienced some financial strains.

In that spirit, I would like to talk to you about our research findings for what we could now refer as "good times" (i.e. prior to 2007) and the changes in the household finances that we can observe as the financial crisis and economic downturn unfolds.

## Good times

- We know that household debt growth has been steadily increasing since 1984.
- Debt-to-asset ratio increased from 14.9% in 1990 to 16.2% in 2006 while debt-to-net worth moved from 18.2% to 19.4% and debt-to-income increased from 75.1% to 121.3%.
- Low-income Canadians are greatly affected.

Much of what we usually see in the literature and the media assesses economic conditions or events with some level of aggregation. As such, the primary aim of our research in 2007 was to identify perspectives of Canadians on the changing level of their indebtedness and wealth, and to examine these findings in the context of publicly available facts and figures. We did that by integrating the results of the public opinion survey commissioned by CGA-Canada with an analysis of available statistical information. Let me now turn to some of the main findings identified by our research as they stood in the spring 2007.

As we know, household debt adjusted for inflation and population growth has been steadily increasing since 1984. However, the overall financial condition of the household sector did not appear to be distressful from a historical point of view, nor did it seem to be rapidly deteriorating in 2007. Household debt measured in terms of debt-to-assets and debt-to-net worth ratios has only slightly deteriorated since 1990 being largely offset by strong performance of the housing and capital markets that have successfully pushed the asset value up prior to 2007. To be specific, the numbers looked as following: debt-to-asset ratio increased from 14.9% in 1990 to 16.2% in 2006 while debt-to-net worth moved from 18.2% to 19.4%.

Although these ratios are typical measures used to gauge the level of household indebtedness, they are not without limitation and are unable to fully capture all aspects of the household financial condition. Moreover, focusing on the overall household sector conceals the fact the financial situation of certain groups of households may be deteriorating much faster than the financial condition of the household sector may suggest. For instance, in 2007, the proportion of low income household devoting a larger fraction of their income to debt payments was higher than that for higher-income households.

## Credit

- **Until 2008, the housing market helped Canadians to maintain a balance between mortgage debt and residential assets.**
- **Household debt was at an all-time high, reaching \$1.3 trillion at the end of 2008.**
- **The household savings rate dropped from its highest of 20.2% in 1982 to its lowest of 1.2% in 2005.**

Some other negative changes at the household level were observed in the period between 1999 and 2005. The least wealthy 20% of households experienced the second fastest rate of debt growth when compared to other wealth groups. The number of indebted families grew at a higher rate (by 3 percentage points) than that for the overall number of Canadian families. And an increase in the overall household indebtedness was caused by increasing debt load of a typical Canadian family rather than by more affluent households.

Some suggest that household debt may be 'good' or 'bad'. Mortgage borrowing (the 'good' debt) is secured against residential assets and, thus, raising mortgage credit is usually of a lesser concern than an increase in consumer credit (the 'bad' debt) which is not backed by appreciable assets. But even 'good' debt can become 'bad' debt as we have seen of late a steep climb in foreclosure proceedings. Many of these proceedings do not favour the borrower as property values have eroded and many are left with a shrinking pool of collateral with which to manoeuvre. But during the realty hay day, the housing market helped Canadians to maintain a slightly improving balance between mortgage debt and residential assets. While this was good, it didn't offset the run up in consumer debt which was not well supported with accumulation of consumer durables or financial assets. For instance, the ratio of consumer credit to consumer durables nearly doubled between 1990 and 2006 moving from 47.9% to 82.5%. This suggests that the 'bad' debt was really bad as households were deploying borrowed funds for consumption rather than for accumulation of wealth.

Contrary to the statistical evidence that household debt was rising Canadians were more likely to gauge their debt as decreasing. This was probably one of the most surprising findings of our household survey conducted in 2007. Only 14% of all survey respondents claimed that their debt increased substantially while another 16% disclosed that their debt increased modestly. Moreover, many Canadians did not seem to fully appreciate how increasing debt may affect their ability to handle negative economic shocks. Some 27% of survey respondents saw no threat to their financial wellbeing if a moderate economic shock took place. This was a worrisome trend

even in 2007 as the pan-Canadian picture of strong economic growth, tight labour markets and rapidly appreciating housing assets was obscuring some important regional disparities.

Although the link between debt and savings is not necessarily a straightforward one, we gauged it alarming that increasing household indebtedness was accompanied by a decline in so-called 'active' savings (i.e. part of disposable income put aside). Although the lack of active savings was noticeably corrected by passive savings in the form of asset appreciation, this wealth was not distributed uniformly amongst households. Our survey also confirmed that Canadians had a fairly careless attitude to savings. For instance, one quarter of non-retired survey participants committed no resources to any type of regular savings; not even for retirement. The danger of the increasing-debt-declining-savings combination primarily relates to the fact that household may find themselves wedged between the need to address a rising debt-service burden and the necessity to accelerate a build-up of pension resources.

With these research findings in mind, the overarching conclusion of our 2007 analysis was that rapidly increasing household debt and deteriorating financial condition of the household sector was cause for concern. This is a case where we would have preferred to be wrong.

## Challenging times

- **Certain socio-economic groups are particularly susceptible to increasing debt.**
- **Rising debt is primarily caused by consumption motives rather than asset accumulation.**
- **Relatively few Canadians realize that negative economic shocks may have unfavourable consequences.**

Turning to the more recent "downturn", there is little doubt that unprecedented falls on the financial markets followed by a slump in the real economy affects finances of most Canadians. The central question is how much? With this in mind, CGA-Canada saw a fit to update our analysis of household debt. In November 2008, we repeated our public opinion survey asking Canadians again to reflect on their indebtedness, spending and saving. We will, as well, be looking into changes as they may be confirmed by the official stats. Although this research project is still a 'work in progress', I can share some of the key findings observed. A few points are worth mentioning.

First, although the proportion of Canadian families that are in debt did not change much, more and more Canadians gauge their debt as rising. While in 2007, those with decreasing debt outnumbered the respondents with increasing debt (42% to 35%), the situation reversed in 2008 when 42% of Canadians said their debt is going up. The number of those who said their debt increased a lot went up as well.

Certain socio-economic groups were particularly susceptible to increasing debt. Those with annual household income under \$35,000, households with children and younger respondents were much more likely to acknowledge that their debt had noticeably increased. We also notice that the number of retired respondents with increasing debt is going up at a faster pace than among non-retirees.

## Cause for concern

- **Even with the temporary relief of a line of credit, one quarter of Canadians would not be able to handle an unforeseen expenditure of \$5,000.**
- **10% of Canadians would face difficulty in dealing with a \$500 unforeseen expense.**

A second point worth mentioning is that the overwhelming majority (84%) of those whose debt has increased in the past 3 years are concerned about this pattern and the level of concern is growing. The number of individuals who think they have too much debt and have trouble managing it went up as well (from 17% in 2007 to 21% in 2008). However, the majority of households are still confident that they can either manage their debt well or take on more debt load.

Interesting though that even among respondents who could manage their debt well, the majority recognized that debt limits their ability to reach financial goals in the areas of retirement, education, leisure and travel, or financial security in unexpected circumstances.

Another continuing trend observed was that the rising debt is primarily caused by consumption motives rather than asset accumulation. Some 58% of respondents said that day-to-day living expenses are the main cause for the increasing debt (this was higher than the 52% reported in 2007). In turn, outlay that could potentially attract a return such as purchasing of a residence, enrolling in an educational program or spending on healthcare was among the least likely causes for increasing debt.

The fourth point relates to economic shocks. Relatively few Canadians realize that negative economic shocks may affect their financial wellbeing. For example, nearly one quarter (24%) did not think that a moderate decrease in housing or stocks, an increase in interest rates, cuts in salary, or reduced access to credit would noticeably affect their financial wellbeing. An overwhelming majority (87%) of those who owned residential structures did not feel that a moderate decline in the housing prices represented threat to them. And nearly 7 in 10 respondents holding private pension assets or mutual funds, stocks and bonds were insensitive to moderate changes in the stock market.

I should mention here that interpreting the survey results regarding the sensitivity to economic shocks is a bit tricky. To be able to compare the results of the two surveys, we preserved the wording of the questions as it was designed in 2007. As such, we asked respondents to reflect on their sensitivity to moderate shocks such as a 10% decrease in the stock market or a 10% decrease in housing prices. At the same time, the actual drops in the markets observed in 2008 were often worse compared to those mentioned in the survey questionnaire. This leaves a room for speculation that some respondents might have perceived a 10% decrease on the stock market as a reasonably dip when compared to the real market drop of 40%.

Returning to the key findings of our 2008 survey, another fairly disturbing result related to the ability of Canadians to handle unforeseen expenses. Even with the temporary relief of a credit card or line of credit, one quarter of Canadians would not be able to handle an unforeseen expenditure of \$5,000 and 1 in 10 would face difficulty in dealing with \$500 unforeseen expense.

## Culture of consumption

- Surveys show that increasing indebtedness puts a downward pressure on individuals' savings.
- For those who rely on passive savings in the form of housing assets appreciation, housing equity measured per home owner decreased from \$66,373 in 1999 to \$57,771 in 2005.
- Household debt has been increasing annually by 4.7% for the past 30 years outpacing gains in personal disposable income, assets and the gross domestic product (GDP).

One final point relates to savings. As may reasonably be expected, the survey showed that increasing indebtedness puts a downward pressure on individuals' savings, particularly among those who are not yet retired. Some 40% of individuals with increasing debt commit no resources to any type of regular savings (not even for retirement). This proportion was at the much lower level of 25% for all other respondents. Not surprising, then, that more than half (51%) of non-retired but indebted survey participant did not feel confident that their financial situation at retirement will be adequate. Only slightly more than one third of debt-free respondents felt the same way.

The worsening economic conditions did not seem to affect respondents' savings habits. The majority (78%) of surveyed said they would not change their saving patterns in order to build or rebuild the financial cushion, and only 16% told us they would accelerate the usual pace of saving as a response to the changing environment. This may be good news for some economists who seem increasingly worried that households may change their moods from 'culture of consumption' to excessive precarious savings which, in turn, will put additional downward pressure on GDP. However, it may also be a point of concern as increasing indebtedness escalates households' exposure to financial risks that may be caused by job instability or further asset erosion. After all, in the current environment of the soft labour market and declining business activity, savings (and modest EI) seem to be the principle sources of money most can rely on in the case of income interruption.

While collecting information on household attitudes and perceptions regarding their indebtedness was fairly straightforward, assessing the level of debt and its dynamic at the level of the household sector as a whole is somewhat more difficult. There are two reasons for that. First, there is a natural lag between the rapidly bursting out financial crisis and its spill over into the different sectors of the real economy. Second, even if the spill over has already occurred, there is another delay associated with collecting statistical information which becomes available after several months of lag. In practical terms this means that only now, at the beginning of March, are we getting some numbers that reflect household financial wellbeing as it was at the end of 2008 when 'technically' Canada was not yet categorized as being in recession. Recent data on the job

losses and bankruptcies leave little doubt that the situation of the household sector has worsened and most significant.

As I mentioned earlier, our research is still in progress and we are aiming to release our updated report in the late spring. It will be available on CGA-Canada web-page which is [www.cga.org/canada](http://www.cga.org/canada). For those interested, you may want to consult the website also to access our earlier report that incorporates a more detailed description of the facts and survey results discussed today. The report is titled “*Where Does the Money Go: The Increasing Reliance on Household Debt in Canada*”.

## Consider

- **Registered retirement savings plans**
- **Tax-free savings account**
- **Capital gains**
- **While lending institutions provide an important service, the risk tolerances of those institutions should not be exercised as a substitute for the judgment of individuals.**

In closing, I stress that we believe debt is rightfully a personal decision. It is however crucial that Canadians be aware of potential risks of increasing individual household debt. Households' knowledge and skill to understand their own financial circumstances and the motivation to borrow, to spend and to save become crucial to marshalling households' financial security and wellbeing. As such, Canadians need to take very seriously the issue of developing their financial capability – that is –improve their knowledge, skills and discipline when making financial decisions.

It is also important to remember that the risk tolerances of the financial institutions should not be exercised as a substitute for the judgment of individuals who must discern between the good and the bad of being in debt. Our other strong belief is that accumulation of appreciable financial assets, building of a larger more diversified financial cushion and retirement investment should remain long-term goals for Canadians.



**Questions?**

**Thank you!**



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CGA-Canada's website at  
[www.cga.org/canada](http://www.cga.org/canada).**