Household debt in Canada – the good, the bad, and the ugly.

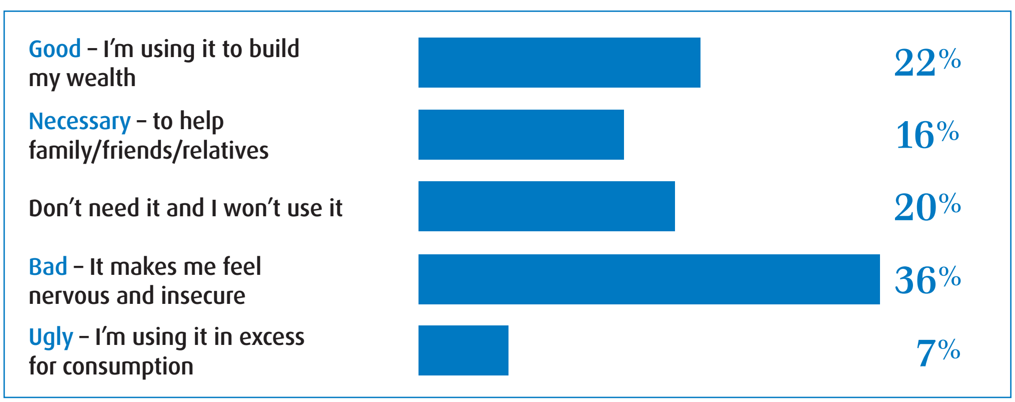
The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

Interest rates in Canada have been deliberately kept low in an effort to support the economy and stimulate spending. True to their nature, Canadians have complied in droves and have embraced credit at unprecedented rates. Fortunately, it seems Canadians are beginning to reduce the amount of debt that negatively affects their personal financial situation and replace these so-called bad debts with debts that strengthen their financial position.

Headlines warning of the high levels of household debt in Canada are easy to find. On average, Canadian families owe approximately $1.63 for every after-tax dollar that they earn.[1] This is a new record high for household credit market debt to disposable income. While debt management should be a concern for many Canadian families, this doesn't mean they all have a debt problem. In fact, the statistics are skewed by the fact that 12% of Canadian households owe $2.50 or more for every after-tax dollar they earn[2] – well above the national average. This means that there are many households that have debt-to-income ratios that are much lower than the national average. Furthermore, it is encouraging to note that the percentage of households that are debt-free has increased over the last three years.[3] A recent BMO Wealth Institute survey on household debt[4] noted that more than half (56%) of Canadians strive to pay off credit balances when possible. The key is to determine if your household is using debt properly or is one whose financial situation could become vulnerable.

Debts can be loosely defined as being good, bad, or even ugly, based on whether they enhance net wealth or destabilize the household's financial situation. When contemplating the word debt, the survey reveals that 43% of Canadians consider it to be bad (or ugly), and most feel nervous or insecure when thinking about it.

How Canadians feel about debt



Source: BMO Wealth Institute survey by ValidateIt, June 2015

56% of Canadians **strive to pay off their credit** balances when possible.

Almost half of Canadians feel nervous or insecure when they think about the word **debt**.

The Good

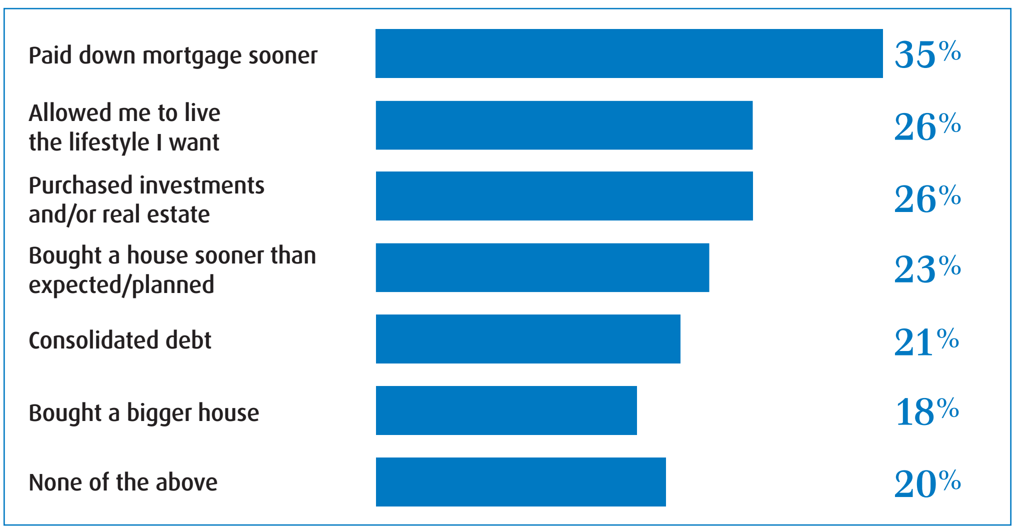
According to the BMO household debt survey, the majority of Canadian debt is used for home and auto financing, home improvement, and education. For all but the wealthiest of Canadians, the costs of housing and education necessitate borrowing. Therefore, borrowing is not inherently inappropriate or ill-advised, and the focus should be on what the funds allow the household to achieve and if they will enhance wealth in the long run.

It is universally understood that loans that advance an individual's ability to purchase assets (homes, vehicles, investments) or to increase their income (business loans, education loans) are desirable. However, even these seemingly good loans should be accompanied by a strategy to repay them in full during the life of the asset – or by retirement – in order to avoid having to repay the loans with reduced earnings.

Furthermore, in our prevailing low interest rate environment, it is easy to become complacent about these loans, as evidenced by the following table illustrating financial decisions that have been influenced by low interest rates – such as entering the housing market sooner than planned (23%), and purchasing bigger, more expensive homes (18%).

Low interest rates have influenced financial decisions for 23% to enter the housing market sooner than planned and 18% were **influenced to purchase** bigger more expensive homes.

Financial decisions that have been influenced by low interest rates



Source: BMO Wealth Institute survey by ValidateIt, June 2015

Is the level of debt in Canada related to rising house prices? The survey results revealed that just under half of Canadians (47%) felt it was influenced by soaring real estate values, while 40% thought it was due to low interest rates. BMO Senior Economist Sal Guatieri warns that…

> … falling interest rates and rising house prices have led to a vicious cycle of rising household indebtedness that risks spinning in reverse if interest rates rise too quickly.

When interest rates are low, it's a great time to make aggressive principal repayments, as evidenced by 35% of those surveyed who are looking to pay down their mortgage sooner. However, statistics have shown that debt service rates have not changed very much from the early 1990s, when interest rates were much higher.[2] It appears that many Canadians have used low interest rates to get larger loans on more expensive houses rather than to aggressively repay their debts. This is a risky strategy, as illustrated by the following table showing the effect of incremental increases in mortgage lending rates on payments.

The effect of incremental increases in lending rates on mortgage payments

Rate (%)	Monthly Payment	$ Difference	% Difference	Cumulative $ Difference	Cumulative % Difference
2.75	$1,382	N/A	N/A	N/A	N/A
3.75	$1,538	$156	11.30%	$156	11.30%
4.75	$1,702	$164	10.70%	$320	23.20%
5.75	$1,875	$173	10.20%	$493	35.70%
6.75	$2,055	$180	9.60%	$673	48.70%

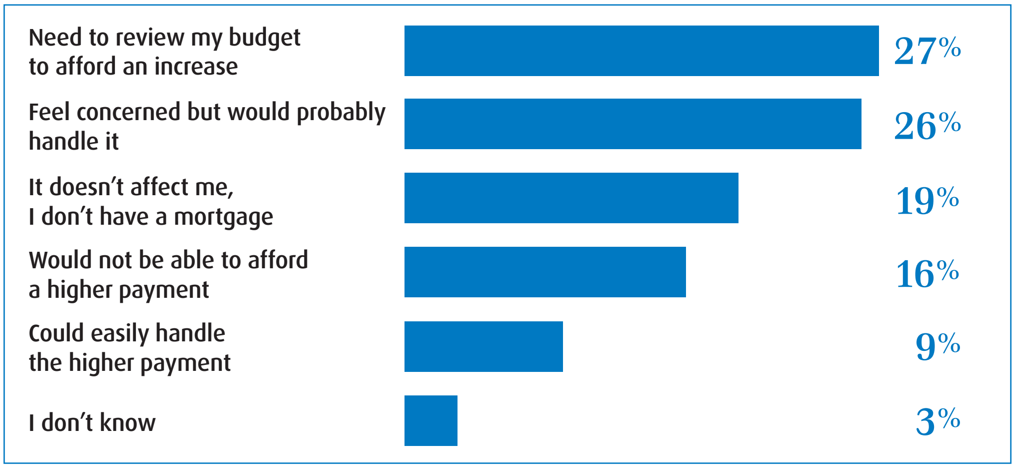
Source: BMO Wealth Institute.

Survey respondents were presented with a hypothetical scenario of interest rates rising by 3 percentage points, causing an increase in mortgage payments of $500 per month. A quarter of Canadians felt concerned but thought they could handle the increase, or that they needed to review their budget to afford the increase. However, a significant number of Canadians (16%) felt that they would not be able to afford a higher payment. Given that interest rates are likely to increase in the foreseeable future, there's no better time to put together a detailed debt management plan.

47% of Canadians felt the level of **debt carried had been influenced by soaring real estate values**, whereas **40%** felt it had been **influenced by low interest rates**.

16% of Canadians would **not be able to afford a $500 increase in their mortgage** payment from rising interest rates.

Ability of Canadians to handle a higher mortgage payment



Source: BMO Wealth Institute survey by ValidateIt, June 2015

The Bad

Bad loans are those that do not advance wealth or income prospects, but instead allow an individual to enjoy a standard of living that cannot be supported by earnings alone. Very often, these are unsecured loans such as credit card balances, lines of credit and bank loans. While vilifying these borrowers makes for great news coverage, the survey revealed that almost one in ten Canadians take on such loans to supplement their income during an extended period of unemployment due to a layoff, maternity leave, or an illness or injury. In a recent paper, Statistics Canada reported that 14% of Canadian families have consumer debts that exceed their annual after-tax income.[5] However, the period studied included the recent recession, when unemployment rose sharply. The money borrowed may have been used to maintain a family's standard of living during a difficult time. The difference between this type of borrowing and borrowing that results in long-term financial instability is the ability of the household to create a plan to rid itself of the outstanding balances within a reasonable period. In so doing, the household can eliminate the loans in a methodical manner and get back to the business of creating financial stability and wealth.

The Ugly

Any investigation of debt would be remiss if it did not discuss the worst debt offenders – the borrowers who habitually use credit to fill gaps in their earnings rather than for building equity. It is these households who are the most vulnerable to an interruption in income or an increase in interest rates. Among the most concerning statistics are the numbers of young couples and seniors with significant debts. Statistics have shown that 18% of households are considered heavy borrowers and that this sizeable cohort accounts for over 70% of all consumer debt.[6] A closer look at these heavy borrowers shows a high proportion of young families whose earnings are 42% higher than average, but who are carrying 2.6 times the debt load of the general population.[6] Of some comfort, many of these families have assets that could be used to reduce their indebtedness. These families would benefit from a detailed financial plan to put their debts behind them and to help create a stable financial future.

In almost all urban centres, the cost of purchasing a home is higher than it was a generation ago, even after inflation is taken into consideration. It is therefore easy to understand why those entering the real estate market need to borrow more than ever before. According to the survey, 39% of baby boomers felt that soaring real estate values had influenced the level of debt they carried, compared with 44% of gen Xers and 55% of millennials. However, when mortgages are excluded from these calculations, as they were in Statistics Canada's 2012 study,[7] the youngest cohort in the study still exhibited unprecedented levels of consumer debt. These balances were unrelated to home purchases or the building of equity.

On the latter end of the age spectrum, an Ipsos survey in 2014[8] found that 49% of those over 65 were carrying debt, with mortgages comprising 59% of this debt. It is likely that these debt balances would be serviced with reduced earnings. Furthermore, the Ipsos survey reported that the debt-to-income level for seniors was approximately $0.80; much less than the national average of $1.63 but more than the same cohort reported in 2009. Taken together, these figures suggest that chronic borrowers could be setting themselves up for a lifetime of debt servicing.

Debt management: An important element of a wealth plan

From a financial planning perspective, the distinction between good debts (those that help a household to accumulate wealth) and bad or ugly debts (those that may potentially destabilize a household's financial situation) will dictate the type of lending products that are suitable and the aggressiveness with which the debt should be repaid. While the ultimate goal of most Canadians should be the elimination of debt, the first step should be to get rid of bad debts.

18% of Canadians households are considered **heavy borrowers** and account for 70% of all consumer debt.

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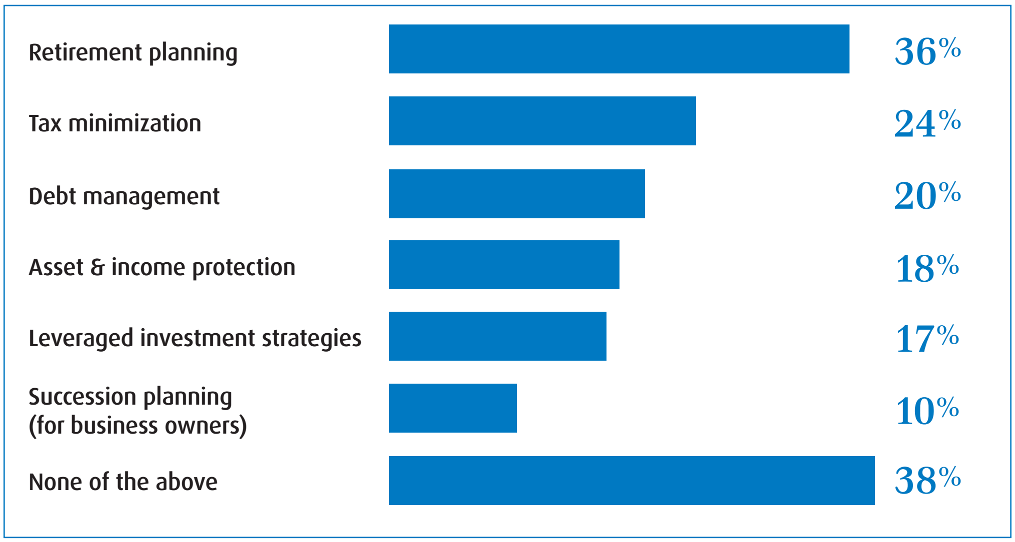
Whether these bad debts were acquired during a period of financial difficulty or just through a lack of discipline, financial planners and lending specialists have a number of strategies to deal with them; these include the creation of sustainable budgets, restructuring debts to take advantage of low-interest products such as lines of credit or bank loans, and snowballing – a strategy in which high-interest loans are targeted ahead of lower-interest loans. Below is a list of strategies discussed with a financial professional in the last 12 months, with retirement planning topping the list for 36% of Canadians.

Strategies discussed with a financial professional in the last 12 months



Source: BMO Wealth Institute survey by ValidateIt, June 2015

Although only 20% discussed debt management strategies, individual borrowers can make great strides in protecting and rehabilitating their creditworthiness by monitoring credit reports and correcting inaccuracies, avoiding bankruptcy, paying bills on time and keeping credit card balances low.

Debt strategies for wealth preservation and accumulation

With destabilizing loans under control, Canadians can look to borrowing strategies that will help them to improve their net worth through the acquisition of assets (homes, securities, and property) and other products that will improve financial stability.

20% of Canadians have had discussions about **debt management strategies** with a financial professional in the last 12 months.

Emergency funds

An emergency fund is an important component of any wealth plan – it will help to maintain financial security. This is a pool of money that is set aside to cover the cost of unexpected expenses or the loss of income. In the absence of an emergency fund, it might be necessary to sell investments to raise cash at an inopportune time. Savings accumulated in a non-registered account or a Tax-Free Savings Account (TFSA) could be designated as an emergency fund; alternatively, a secured line of credit could be used. However, even a preferred loan like a line of credit should be repaid as soon as possible, so it is available if needed again in a pinch.

RRSP loans

Lines of credit and loans for the acquisition of assets may be beneficial for wealth accumulation. An RRSP loan can allow an individual to borrow funds to use as a contribution to an RRSP. The benefits are twofold – the lump sum gets tax-deferred growth and the contribution is deducted directly from income. Additionally, executives with robust stock option positions often find themselves with large holdings in a single stock which may create diversification issues in their investment portfolios. By borrowing to invest in an RRSP, these individuals can essentially build a portfolio around these positions – reducing the concentration of their stock position and protecting their portfolio from generalized market (or unsystematic) risks. This lending strategy can expand an individual's choices of how to manage their financial affairs and should be discussed with financial planners and lending specialists to ensure that a strategy to repay the loan can be implemented.

36%

of Canadians have had a **retirement planning** discussion with a financial professional in the last 12 months.

Leveraged investing strategies

There are loans whose interest payments actually provide tax benefits. According to the Income Tax Act 20(1)(c):

> Interest paid on loans borrowed for the purpose of earning income from a business or property is deductible in the year that the interest is paid.

This applies to loans used to purchase or create businesses, or to acquire investment properties and other investment products. The advantageous tax treatment makes it less important to repay this type of loan aggressively.

As appealing as it seems to be able to borrow for the purpose of accumulating wealth, these types of loans are not without their risks and should only be considered as part of a well-thought-out financial plan. For example, when considering a traditional leveraged investing strategy in which one borrows funds to purchase investments, it is important to understand that both investment gains and losses are amplified. For this reason, this strategy is best suited to investors who already have a strong foundation of wealth and financial stability. In fact, the IIROC Client Relationship Model proposes that the method of financing the trade should be part of the due diligence of the advisor and that leveraged accounts should be monitored more frequently than long positions.[9]

The Ontario Securities Commission recommends specific strategies to reduce the inherent risks of leveraged investing[10]:

> The risks of leveraged investing decline with time, so leveraged investors should invest for the long term.
>
> Risk can be reduced by making blended principal and interest payments against the loan.
>
> Risks can be mitigated by maintaining a disciplined investment strategy rather than following trends.

17% of Canadians have had discussions with a financial professional about **leveraged investing strategies** in last 12 months.

RRIF meltdown

A RRIF meltdown can be used to limit the taxation on RRIF withdrawals. In this strategy, an investment loan is designed to have interest charges that are identical to the amount withdrawn from the RRIF each year. In so doing, the taxable RRIF income reported on the tax return is balanced by the deduction allowed for the interest expense – effectively allowing taxpayers to experience no net tax consequences from their RRIF withdrawals. On closer examination, however, taxes are simply being replaced by interest payments; albeit with the opportunity to use the borrowed funds to build a portfolio of assets.

24% of Canadians have discussed **tax minimization strategies** with a financial professional in the last 12 months.

Debt swap

Lastly, many individuals have tried to find ways to turn their home equity into a deductible debt by borrowing from home equity to purchase investments. This debt swap is often achieved by selling an investment portfolio to repay an existing mortgage and then taking out a secured investment loan to replace the portfolio. Variations of this strategy have caught the attention of the Canada Revenue Agency and have been challenged under general anti-avoidance rules. Again, as a leveraged investment strategy, the debt swap requires the skills of an investment advisor and a lending specialist to ensure that the strategy will be acceptable to tax authorities and ultimately enhance wealth.

Smart debt

Considering the debt load of the nation, there is no question that Canadians today are carrying more debt than previous generations. Their debt habits, as well as the types of balances that are being carried, should be carefully considered. Furthermore, although borrowing to invest sounds lucrative and sophisticated, investment authorities warn of the pitfalls of taking on too much debt for the wrong reasons.

We believe that the smartest debts are those that enhance household financial stability, create wealth and most importantly, are part of a sound financial plan. A BMO financial professional or an independent financial advisor who partners with a BMO lending specialist will work with you to understand your debt needs. Together they will provide you with advice and services tailored to meet your personal goals, which will help you plan for a financially stronger future.

Footnotes

1 National balance sheet accounts. Statistics Canada, March 12, 2015. www.statcan.gc.ca/daily-quotidien/150312/dq150312a-eng.htm

2 Bank of Canada, Financial System Review, December 2014.

3 Canadian household debt. Hsu, M. Ipsos, February 5, 2015.

4 Survey conducted by ValidateIt™ for the BMO Wealth Institute from June 23–29, 2015, with a sample size of 1,014 Canadians. Overall probability results for a sample of this size would be accurate to within +/- 3.1%, 19 times out of 20.

5 Changes in debt and assets of Canadian families, 1999 to 2012. Statistics Canada, April 29, 2015. www.statcan.gc.ca/daily-quotidien/150429/dq150429b-eng.htm

6 Canadian household debt. Hsu, M. Ipsos, February 5, 2015.

7 The evolution of wealth over the life cycle. Statistics Canada, June 22, 2012. www.statcan.gc.ca/pub/75-001-x/2012003/article/11690-eng.htm

8 The Canadian Financial Monitor. Ipsos, 2014.

9 Borrowing for investment purposes. From IIROC Client Relationship Model Rules Notice 12-0108, March 26, 2012. www.osc.gov.on.ca/en/Marketplaces_srr-iiroc_20120413_gn-crm.htm

10 Important information about the risks of leveraged investing and costs of investing. Ontario Securities Commission, January 23, 2012. www.osc.gov.on.ca/en/Investors_inv_news_20120123_cost-investing.htm

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