Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Concerned About Household Debt

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Re: **What to Make of Rising Consumer Insolvency**

For much of the last decade, Canadians have been told their debt levels were unsustainable and that a day of reckoning was fast approaching. Data recently released by the Office of the Superintendent of Bankruptcy (OSB) seem to indicate that day has arrived.

According to the data, insolvencies by Canadian consumers were up 9.2 percent in October 2018, compared to a year earlier.

To say the least, these results appear alarming. But in light of what we know about homeownership and net worth, we are not so sure.

The data show that Canadians' net worth has never been higher. Moreover, the data do not distinguish between the more harmful economic effects from households in negative net asset positions, or balance sheet insolvency — where one remains in debt even after selling one's assets — and cash-flow insolvency, better known as illiquidity.

Before the financial crisis, Canadians' household net worth was a little over seven times disposable income. It dipped during the financial crisis, bottoming out at 6.25 times disposable income. However, since then, with low interest rates boosting housing prices, we have witnessed a mostly continuous upward trend, and in the third quarter of 2018, net worth was almost nine times disposable income. Moreover, while debt to GDP has increased from 75 percent in 2007 to 100 per cent today, debt to net worth is almost identical, at around 20 percent.

Most people's first reaction to the different stories told by the OSB and wealth data is likely that the rich have gained most from rising house prices.

However, between 1999 and 2012, total wealth in Canada for households in both the top and bottom income quintiles grew at approximately the same rate, meaning both income quintiles held about the same percentage of total wealth at the end of this period as they did at the beginning. In other words, the inequality explanation appears insufficient.

An alternative explanation is that the *Bankruptcy and Insolvency Act* includes both "cash flow insolvency" and "balance sheet insolvency" but does not distinguish between the two — and the OSB data reflect this fact. Balance sheet insolvency entails a negative net asset position. On the other hand, cash flow insolvency refers to the difficulty meeting payments on one's gross debt because of the difficulty selling one's assets. This type of insolvency is commonly referred to as illiquidity.

Much of Canadians' assets are in the form of real estate. Although it is possible to refinance a home, you cannot sell a fraction of a house in order to help pay off consumer debt. So, as interest rates rise, as they have in part due to five hikes to the overnight rate by the Bank of Canada since the middle of 2017, Canadian households start feeling the illiquidity pinch.

But that is not the same as balance sheet insolvency. For a Canadian household to truly be insolvent in this sense it would have be unable to clear its debts once it did sell its assets, real estate or otherwise. And here the data are unclear since the only distinction is between bankruptcies and consumer proposals, which are an alternative to bankruptcy where the lender and borrower strike a deal where the latter pays back a portion of their debt over the ensuing five years, and, critically, does not have to sell his or her house.

Consumer proposals increased 15.8 percent, while bankruptcies only went up 1.8 percent. With stable debt to net worth, and two-thirds of Canadian households owning homes, it could be that the bulk of these consumer proposals are a result of illiquidity concerns.

By no means are we suggesting all is well. Indeed, consumer proposals were up across the country, and this fact should be reason enough to focus the minds of policymakers.

But with what we know about rising net worth over the last decade, it is not yet time to ring the alarm bell.

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