High household debt is a threat to the economy – less so banks

By Craig Alexander
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A recent report from the Bank for International Settlements (BIS) triggered headlines that Canada is among the top three countries in the world at risk of a banking crisis. Such a statement conjures up memories of the 2008-09 financial crisis, making it very ominous. But how does one reconcile the BIS assessment with the finding of the World Economic Forum that, for the past nine years, Canada has had one of the soundest banking systems in the world?

The BIS is absolutely right that Canadian households have accumulated a lot of debt and that this situation poses a major risk to the economy. A sharp increase in interest rates or in unemployment would take a toll on household finances, leading to falling home prices and significantly lower consumer spending, which could derail economic growth.

The BIS concerns reflect its international and historical analysis that there is a correlation between certain financial metrics and banking crises. The BIS focuses on private-sector debt as a share of the economy and compares the current level with its long-term trend. Residential property prices relative to their long-term trends and debt-service costs are also evaluated. Based on these metrics, it should come as no surprise that the warning lights are flashing red for Canada. Indeed, the Bank of Canada has repeatedly warned of the risks of household debt in its publication Financial System Review. The federal government has responded with many rounds of mortgage regulation tightening, while Ontario and British Columbia have introduced provincial measures. In other words, Canadian policymakers have been striving to address the risks.

However, the BIS report goes beyond the issue of household debt in suggesting that the Canadian banking system itself is at risk. In fact, the risks are likely less than they appear.

First, correlation is not causation. Countries that have experienced banking crises have tended to have credit as a share of GDP well above normal, but that is not the same as saying financial stress indicators cause a banking crisis.

Second, the type and distribution of debt matters in terms of the risk it poses to the financial system. Prior to the 2009 financial crisis, almost 40 per cent of mortgage origination in the United States was subprime (i.e., high-risk) mortgages. When the financial crisis hit, about 5 per cent of subprime mortgages went into foreclosure, compared with 1 per cent of prime mortgages. In Canada, the subprime market has been 3 per cent to 5 per cent of mortgages, which lessens the risk to the financial system. A U.S.-style plunge in home prices would certainly lead to financial strains for Canadian banks, as mortgage originations would collapse and there would be higher loan losses, but the issue is whether it would lead to bank failures. The comparatively higher quality of Canadian household debt improves the resilience of the domestic banking system.

Third, Canadian banks maintain considerable capital to absorb losses. Indeed, they held far more capital than their U.S. counterparts before the financial crisis. Since the crisis, global bank regulators have required all major banks to hold a larger capital buffer.

Another critical mitigating factor is that all mortgages originated in Canada that have less than a 20-per-cent down payment must have mortgage insurance. Should home prices plunge, the most at-risk loans would be households in which the value of the mortgage exceeds the new value of the home – known as negative equity. Obviously, the lower-down-payment homes are at greatest risk, but in the case of default, mortgage insurance kicks in. In Canada it is backed by the federal government, which pretty much guarantees the insurance will be paid. The vulnerability is the exposure of banks to non-insured mortgages, but these borrowers tend to have considerable equity in their homes.

As part of regulatory oversight, the Office of the Superintendent of Financial Institutions requires federally regulated banks to do stress-test scenarios. These tests assess how they could cope with bleak economic scenarios, including a deep recession and a large-scale drop in home prices. The bank regulators review the scenario outcomes in detail and the conclusion from past stress tests is that Canadian banks remain solvent.

So the BIS is absolutely right to flag concerns about high household debt and elevated home prices in Canada, because they do pose a risk to the economy. But even in the case of a deep economic recession and plunge in home prices, Canada is unlikely to experience bank failures. The type of debt Canadians hold, the capital buffer available and the security of mortgage insurance would all temper the fallout on our major financial institutions.

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