Federal Analysis Says Higher Interest Rates Will Hit Younger, Middle Income Households

OTTAWA: Younger, middle-income households will be among those that feel the biggest financial sting from the Bank of Canada's gradual move towards higher interest rates, says a newly released federal analysis.

The Finance Department explored factors such as income, age and region in an effort to pinpoint the types of households that will be most affected by the central bank's ongoing rate-hiking trajectory, which follows years of extremely low interest rates.

Officials put a particular focus on how rising rates will start to squeeze "highly indebted households," which the document described as those already carrying debt-to-income levels of at least 350 per cent. Debt loads of this magnitude are held by 12 per cent of all Canadian households. Combined, the burdens concentrated in this category account for nearly 50 per cent of the country's total household debt, said the memo prepared for Finance Minister Bill Morneau last fall.

The document sought to answer another question: who are these stretched households? They most likely consist of households led by middle-income earners, Canadians under 45 years old, mortgage holders, the self-employed, and those in Ontario and British Columbia, it said.

"The expected increase in interest rates over the next few years will have various impacts on Canadian households, including an increase in the cost of servicing debt," said the document, which noted that about 70 per cent of households carry debt.

"Naturally, households with high debt levels would see the largest increases."

A closer look at the numbers showed that mortgages were the main factor for highly indebted households because they accounted for 85 per cent of their total debt burdens. The briefing note pointed out that younger households are more likely to have higher debt because a larger share of older households have paid off their mortgages. The analysis, obtained by The Canadian Press under the Access to Information Act, was based on 2012 numbers and was created in September 2017, shortly after a pair of Bank of Canada hikes. The reasons for using 2012 data are blacked out.

In recent weeks, the central bank raised its trend-setting interest rate for the fourth time in a year to bring the benchmark to 1.5 per cent _ its highest level since December 2008, but still very low by historical standards.

Governor Stephen Poloz has signalled more rate increases will be necessary over time thanks to the economy's resilience, but he has stressed the process will be gradual. His officials have estimated the bank's normal or neutral rate _ the preferred level when the economy is operating at full capacity and inflation is on target _ is between 2.5 per cent 3.5 per cent. With this neutral rate in mind, analysts expect Poloz to introduce several more quarter-point hikes and many believe the next one could arrive before the end of 2018.

The central bank raises its interest rate as a way to help keep inflation from climbing above its ideal target range of one to three per cent.

The Bank of Canada says it's closely watching how the economy adjusts to higher interest rates and has noted that household credit recently slowed to the point it's now below the growth rate of household income.

For years, however, Canadians have amassed significant piles of debt, including mortgages, during the extended era of low interest rates.

With some measures showing household debt loads are still close to record levels, the Finance Department document underlined possible developments that could help offset the rising costs of debt payments.

The memo said income growth, if high enough, could absorb the entire increase in debt-servicing costs. It also said greater returns from interest-bearing assets, like savings accounts, could provide a smaller amount of support for some households.

If necessary, there are less-appealing financial strategies that heavily indebted households could turn to, the memo said.

The suggestions include prolonging the duration of existing loans or cutting back on how much money households set aside for a rainy day. The document noted, however, that highly indebted households already have some of lowest savings rates, which suggests there's a limit to how much cash they can redirect to manage higher debt payments.

As a last resort, officials said households could sell off some of their liquid financial assets. "In the absence of income growth, households could employ a combination of responses to fully offset the rise in debt payments (i.e. extending amortization, reducing savings rates or selling financial assets)," the memo said.