TD Bank Financial Group

TD Economics

Special Report

May 1, 2009

THE OUTLOOK FOR CONSUMER INSOLVENCY IN CANADA

There has been a sharp increase in personal insolvencies in recent months, reflecting the impact of the severe recession. The natural questions are: first, whether the increase in insolvency has been sharper during the current downturn than in past recessions; and, second, how many Canadians are at risk in the coming months? The latest trends suggest that the rise in insolvency is slightly faster than the experience in the early stages of the 1990/91 recession, but the absolute number of insolvencies is significantly higher, even adjusting for population growth since the last downturn. In terms of the outlook, a simple model of consumer insolvency suggests that the key drivers of consumer bankruptcy are unemployment and personal indebtedness as a share of personal disposable income (PDI). In terms of these factors, the economic downturn is likely to see the unemployment rate climb to 10% in the early part of 2010 – reflecting the lagged nature of this indicator that will continue to increase even when the economic recovery has taken hold. Meanwhile, the personal debt-to-PDI ratio is also likely to increase, as personal liabilities continue to grow, albeit at a slower pace than in the past, and as personal disposable income (PDI) growth advances at a meagre rate in 2009 and 2010. These forecasts imply that personal insolvency will advance sharply in the quarters ahead, with the ratio rising from the prevailing 4.3 per 1000 individuals (over the age of 15) to close to 6 per 1000 in 2010. The implication is that a record 150,000 to 160,000 Canadians are likely to experience insolvency in both 2009 and 2010.

Defining Insolvency

As a starting point, one needs to understand exactly what personal insolvency means. Consumer insolvencies are the sum of consumer bankruptcies and consumer proposals.

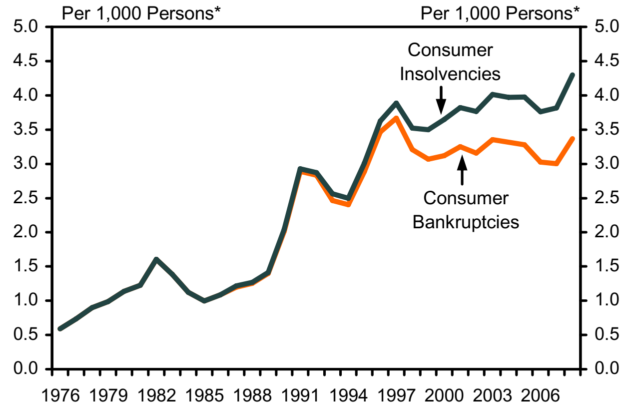
HIGHLIGHTS

- **Rising unemployment and heightened household debt will drive a substantial increase in consumer insolvencies (combining both bankruptcies and consumer proposals) over the next two years.**
- **Based on these drivers, we anticipate that consumer insolvencies will rise to near 6 insolvencies per 1,000 persons – or around 150,000 to 160,000 – during each of 2009 and 2010.**
- **Relative to insolvencies in past years, insolvent consumers today are much deeper in debt – carrying higher liabilities in absolute dollar terms and relative to their assets.**
- **As the future economic recovery takes hold, insolvencies will diminish, but they will not return to the levels before the downturn.**

Bankruptcy is a legal process that is conducted through a trustee that allows financially distressed individuals to eliminate some of their unmanageable financial obligations. Under bankruptcy, any unsecured credit obligations can be written off, but it does not affect secured loans (such as home mortgages and auto loans) where the creditor has a claim against the property. Declaring personal bankruptcy is traditionally a last resort, as it influences the availability and price of credit for years thereafter.

An alternative to personal bankruptcy was introduced in 1990s, which is referred to as consumer proposals. A proposal can be undertaken if an individual owes less than $75,000 in consumer debt, not including the mortgage on their principal residence. The process is carried out through a trustee and it allows a renegotiation of the financial obli-

CONSUMER INSOLVENCIES PER CAPITA



Source: Office of the Superintendent of Bankruptcy, Statistics Canada
* Persons over 15 years old (Labour Force Survey)

gations of the individual. For example, changes can be negotiated over how much of the credit will be repaid and/or the timing of the repayment.

In either proposals and bankruptcies, an individual's liabilities exceed their assets. However, the character of insolvency differs markedly between the two routes. For 2008, individuals filing consumer proposals on average had liabilities in excess of assets by approximately $9,000 and $0.91 of assets for each dollar of liabilities. In contrast, individuals filing for bankruptcy had average liabilities in excess of assets by approximately $39,000 and $0.51 of assets for each dollar of liabilities.

Trends in bankruptcies and proposals prior to the current recession

Even before the recent economic downturn, there was a rising trend in personal insolvency. Bankruptcies climbed from 0.5 per 1000 individuals in the mid-1970s to close to above 1 per 1000 in the late 1980s. During, and in the wake of, the 1990-91 recession, bankruptcies soared with the ratio jumping to almost 3 per 1000. When the economic recovery subsequently unfolded, the incidence of bankruptcy did not decline. In the 1996/97, there was a temporary rush of bankruptcy filings in advance of a change in the treatment of student loan obligations. When that effect waned, bankruptcies remained relatively stable in the 3 to 3.5 per 1000 range in the late 1990s and 2000s. However, the incidence of insolvency continued to rise, due to the introduction and increased use of consumer proposals. As a result, personal insolvency was around 4 per 1000 individuals just prior to the recent economic downturn.

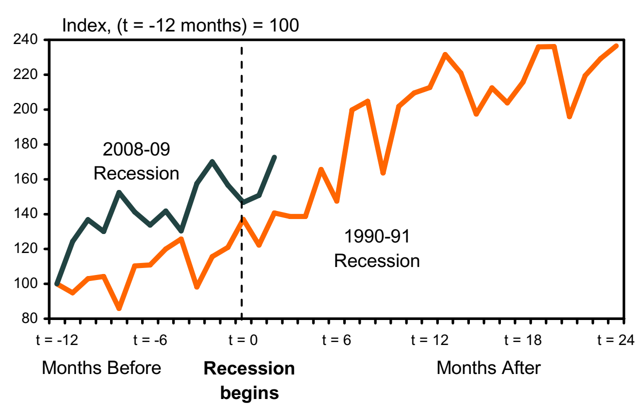
In 2008, personal insolvencies soared as the recession approached and then took hold, rising 14% year-over-year. The increase was broadly based, with a 17% increase in proposals and a 13% increase in bankruptcy filings. The trend accelerated further in early 2009. In February 2009, personal insolvencies were up a staggering 28% year-over-year, supported by a 38% surge in proposals and a 25% jump in bankruptcies.

A natural question is whether the sharp increase in bankruptcies and proposals was different this economic cycle than in past recessions? Historical comparisons are regrettably problematic. Proposals did not exist during the 1990-1991 recession. However, the increase in filings for just bankruptcy heading into the 2008 recession was comparable with the last recession. The increase in personal insolvencies (bankruptcies plus proposals) has been faster than personal bankruptcies in the early 1990s, but this is not entirely an equivalent comparison. Some of the recent consumer proposals would have likely been bankruptcies in the 1990s recession, but not all of the proposals would have resulted in bankruptcy. This suggests that the recent rise in consumer insolvency is only modestly greater than during the prior recession. Two other historical observations are that it is not surprising that insolvencies started to rise significantly before the recession took hold, and insolvencies are likely to continue to climb in the months ahead.

Key drivers to personal insolvency

In order to understand the above mentioned trends, it is

GROWTH IN INSOLVENCIES PER CAPITA RELATIVE TO PREVIOUS RECESSION



Source: Office of the Superintendent of Bankruptcy, Statistics Canada
Note: Per persons over 15 years old;

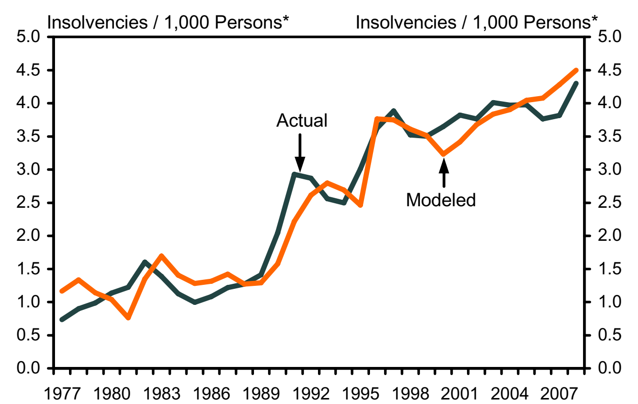
useful to establish the major economic drivers to personal insolvency. Although many factors have an influence, the two most significant influences are the unemployment rate and personal indebtedness as a share of personal income.

The unemployment rate has a powerful cyclical effect. Unemployment rises sharply during recessions, and Canadians have greater difficulty meeting their financial commitments when this occurs. This is a key reason that personal bankruptcy increased considerably during the 1990-91 recession, and it is a major explanation why personal insolvency is rising today.

The other key driver is personal indebtedness. It is the structural increase in the personal liability to personal disposable income (PDI) ratio that appears to explain the rising trend in personal insolvency over time regardless of the state of the economy. The implication is that individuals have become steadily more leveraged over the past many years and that increases the odds of running into problems meeting financial commitments regardless of economic conditions.

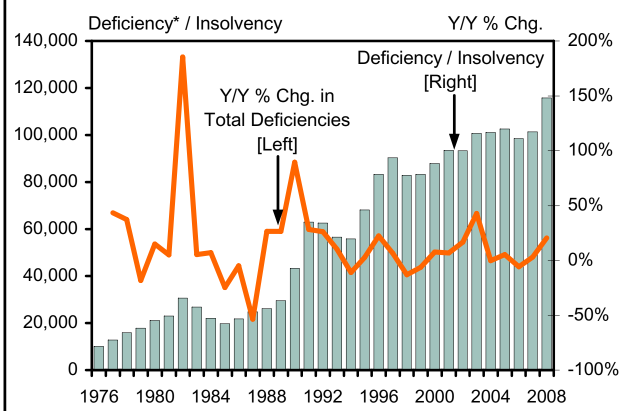
The chart below shows the results of a very simple model that relates changes in personal insolvency to movements in the national unemployment rate and to personal indebtedness. The model also seems to explain well the recent surge in insolvencies. The unemployment rate went from a low of 5.8% in January 2008 to 8.0% in March of 2009. Meanwhile, the debt-to-PDI ratio climbed to a record high last year. There was also a very strong correlation between the number of individuals entering insolvency and their excess of outstanding liabilities relative to their assets

CANADIAN CONSUMER INSOLVENCIES



Source: Office of the Superintendent of Bankruptcy Canada, Statistics Canada
Forecast by TD Economics
* Persons over 15 years of Age (Labour Force Survey)

TOTAL DEFICIENCY OF INSOLVENT CANADIAN CONSUMERS



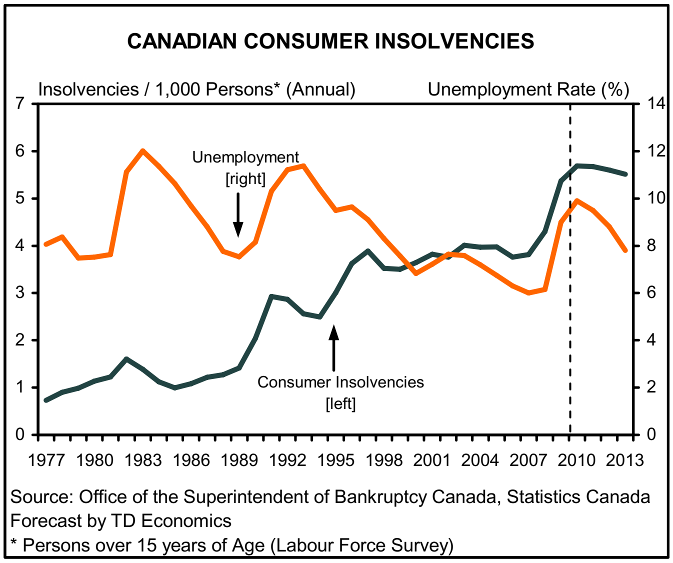
Source: Office of the Superintendent of Bankruptcy, Statistics Canada

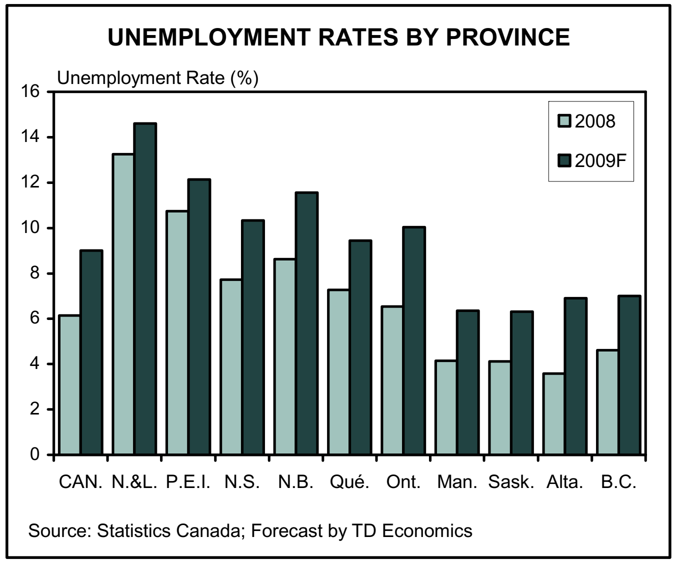
(defined as the "deficiency"), again highlighting the importance of indebtedness as a driver of insolvency. That is, insolvent individuals today are carrying higher levels of debt and have a much greater average "deficiency" (liabilities minus assets per insolvency) than in the past.

Bankruptcies and proposals to increase sharply in the coming months

Given the economic relationships, the question becomes what is the outlook? The key economic drivers point to a further significant increase in personal insolvencies. The national unemployment rate is expected to rise to 10% in early 2010. Furthermore, even after unemployment peaks, the subsequent decline in the unemployment rate will be gradual. TD Economics is forecasting an unemployment rate of 9.5% in 2011, dropping to only 7.8% in 2013. Meanwhile, the personal debt-to-PDI ratio is expected to rise further. Personal disposable income growth is forecast to slow from 6.0% in 2008 to a mere 0.6% in 2009 and recover to only 1.9% in 2010. Personal liability growth is also projected to moderate from the 11.6% in 2008, but it is expected to advance at 6.6% in 2009 and 2.5% in 2010. We project that debt-to-PDI will continue to climb in 2011 to 2013, though at a more moderate pace.

These forecasts are consistent with personal insolvencies rising to almost 6 per 1000 individuals in 2010. The number of personal insolvencies is likely to rise from the almost 116,000 in 2008 to the 150,000 to 160,000 range in both 2009 and 2010. Furthermore, with levels of high unemployment persisting after recovery takes hold and debt-to-PDI remaining at all-time highs, insolvencies will likely





remain elevated above 5 per 1000 individuals –equivalent to around 140,000 to 150,000 insolvencies per year.

The fact that the economic downturn will be felt across the entire nation suggests that the rise in personal insolvency fuelled by the increase in unemployment will be from coast-to-coast. From a sector perspective, workers in the manufacturing sector, which is bearing the brunt of the world economic downturn, are particularly vulnerable. The manufacturing sector accounts for 55% of Canada's year-over-year job losses to March. However, the increase in personal indebtedness in prior years was neither regional nor influenced by sector of employment, implying again that the rise in personal insolvency will be felt across the country.

High debt and high unemployment mean increased insolvency risk

The combination of high debt-to-PDI and rising unemployment will increase the number of insolvencies over the coming year. The rise in unemployment acts as a cyclical driver. As indebted individuals become unemployed, they can no longer service their debts and fall into insolvency. In contrast, the high levels of personal indebtedness, as reflected in the personal debt-to-PDI ratio, represents a structural vulnerability. Since individuals are carrying a greater amount of debt – in both absolute and relative terms – they have a greater risk of insolvency regardless of economic conditions. As the economic recovery takes hold, consumer insolvencies are likely to decline, which will contrast the experience in the early 1990s. However, the eventual retreat will not return insolvencies to the levels that preceded the economic downturn.

Craig Alexander
VP & Deputy Chief Economist
416-982-8064

Grant Bishop, Economist
416-982-8063