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Canadians are optimistic about the economy and personal incomes.

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Canadians want to cut debt — but they're struggling to maintain their commitment to their debt-reduction goals.

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As regulatory interventions cause housing markets to level off or cool, residential lending is poised to slow and then decline.

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Banks need to look to cost control and new products and services to make up for lost residential lending income.

The tide turns: Canadians, debt and retail lending

Our analysis of consumer lending in Canada and what it means for banks





Executive summary

When it comes to household debt, Canadians want to do the right thing. They want to cut their debt. There's just one problem: they struggle with their resolve.

Canadians remain relatively comfortable with the debt they're carrying, but there are signs of unease. While 57% of the 1,228 people we surveyed felt their debt level was about right, down from 59% last year, another 35% felt their debt was too high, up from 33% last year. In both cases, the trend is more pronounced in households with over CA\$100,000 in annual income.

Regardless of what they think about their current debt level, a majority (66%) told us that they intend to reduce their debt this year, up from 63% last year. Canadians are hearing the warnings of governments, the Bank of Canada and others, it would seem.

However, Canadians may not be heeding these warnings, given that Canadian household debt spiked to a new high in the third quarter of last year — 164.6%¹ of disposable income. Why? Our survey suggests that Canadians' resolve is slipping. Of the 60% of respondents who said they had set a debt-reduction goal last year, only 23% reported real success against this goal— while 26% were outright unsuccessful. What's more, Canadians appear to be less willing to postpone major purchases such as new cars, houses and renovations.

It may be that Canadians are still willing to incur debt because they remain rather upbeat about the economy and their own income prospects. Over half (55%) feel Canada's economy will remain steady or grow, and nearly half (46%) expect their income to rise over the next five years.

1. Statistics Canada. Q3 2012.



Despite Canadians' wavering resolution and rising household debt levels, the tide is turning on consumer debt and retail lending in Canada. Regulatory interventions appear to be helping to cool real estate lending markets. As housing prices level off, or even fall in some regions, we will see a decline in the number of houses changing hands, leading to a reduction in the volume of new mortgage originations. Looking ahead to the medium term, new loan volumes will likely stagnate and then gradually decline.

The challenge for Canada's banks is how to replace the income lost as retail lending slows. Banks need to focus on developing new value-added products and services that consumers will pay for — including mobile products aimed at the smartphone generation, wealth management, and business banking. At the same time, banks need to continue to manage their costs aggressively — and strategically in the face of strong headwinds to growth.

57% of Canadians feel their debt is about right, but...

...66% want to reduce their debt

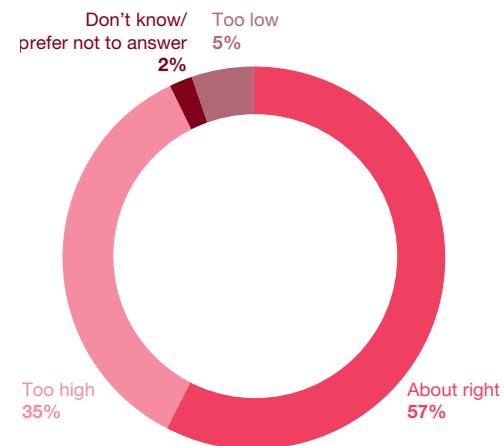
2013 PwC consumer lending survey results

Debt levels

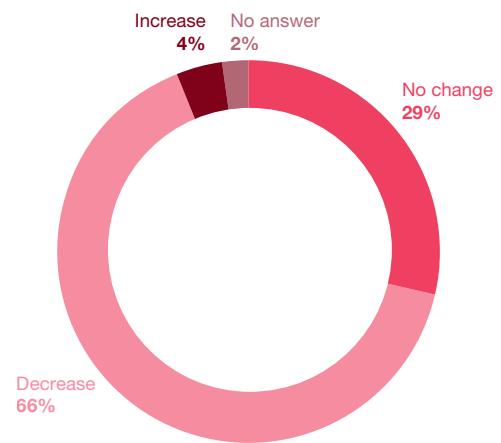
Household debt may have hit a new high in 2012, but the majority of Canadians appear remarkably comfortable with the level of debt they're carrying: 57% of respondents felt their debt level was about right, down from 59% last year. However, there are signs of increasing unease over debt loads: 35% of respondents felt their debt was too high, up slightly from 33% last year.

The trend is more pronounced among Canadians with CA\$100,000-plus household incomes. This year, 60% of respondents in this group said their debt load was about right, down from 68% two years ago. As well, 34% now feel their debt is too high—a jump from 28% two years ago.

Feelings about debt levels



Debt level intentions



Canadian household debt reached 164.6% of disposable income last year

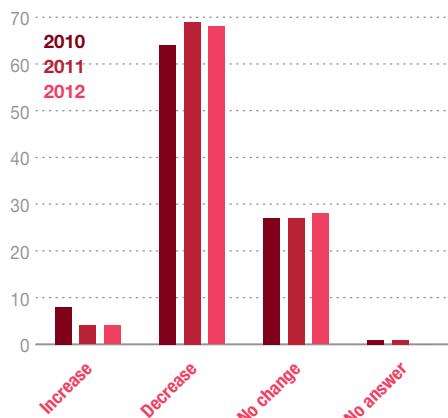
Managing debt... sort of

Overall, two-thirds (66%) of Canadians want to reduce their debt this year, though the intention is logically stronger among those who also feel their debt is too high. While 93% of those who said their debt level was too high intend to take action to reduce it, only 55% of those who feel their debt level was about right intend to take similar action.

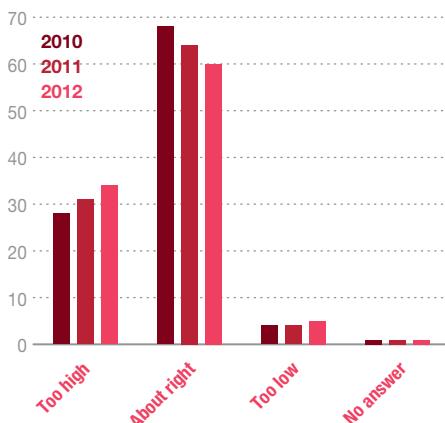
The main motivator for doing so is fear of being unable to pay off their debt (49% of respondents), followed by job security and uncertainty in the financial markets (both 35%). Younger Canadians and non-homeowners are more likely to worry about their ability to pay off debt. Concern over the financial markets is more likely to trouble Canadians as they age, as well as those who are homeowners.

And just how successful are Canadians at seeing their debt-reduction goals through? Sixty percent of respondents said that last year, they had set a goal of reducing their debt. Only 23% felt they were very successful in achieving their goal. Another 51% felt they were somewhat successful, while 26% admitted that they were unsuccessful.

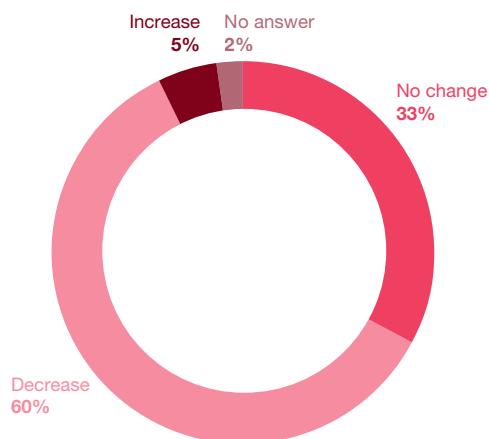
Feelings about debt levels (>\$100K income)



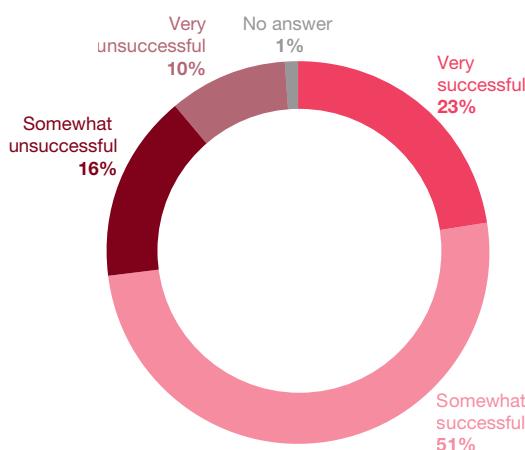
Debt level intentions (>\$100K income)



Debt level intentions 12 months ago



Success in achieving debt reduction goals

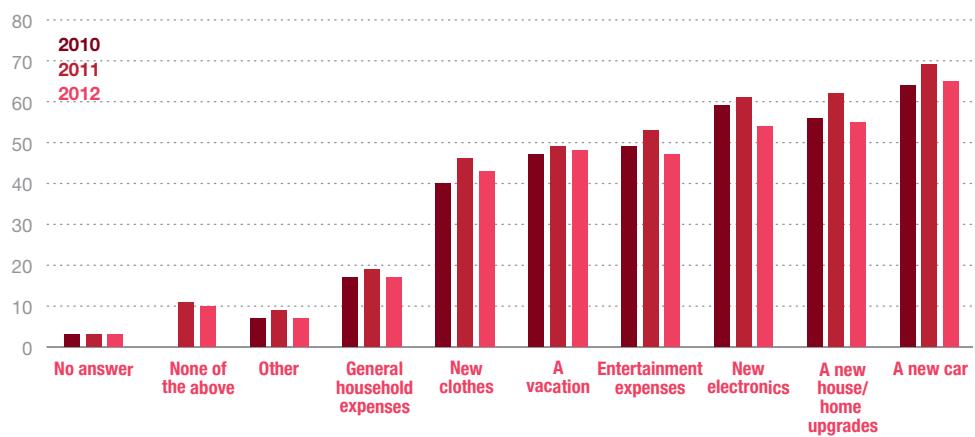


Discretionary spending— Canadians tiring of financial diet?

Our survey indicates that Canadians are finding it more and more difficult to maintain their debt-reduction discipline. We were surprised to see that Canadians are less willing to postpone major purchases such as new cars, new houses or renovations than in previous years. As the most recent Canadian household debt figures would suggest, Canadians appear willing to take on more debt.

Other market observations reinforce this finding. Vehicle sales in Canada enjoyed their second-highest year on record in 2012² and residential real estate activity was unexpectedly strong in the first half of 2012 (before new OSFI guidelines went into effect).

Willingness to postpone purchases



***Canadians appear less
willing to postpone
major purchases***

2. The Globe and Mail, January 3, 2013. "Low rates drive vehicle sales to 10-year high."

Canadians optimistic on economy

Canadians' commitment to long-term debt reduction may be wavering in part because they're relatively positive about the economy. Over half of our survey respondents (55%) feel Canada's economy will remain steady or grow, up from 48% last year.

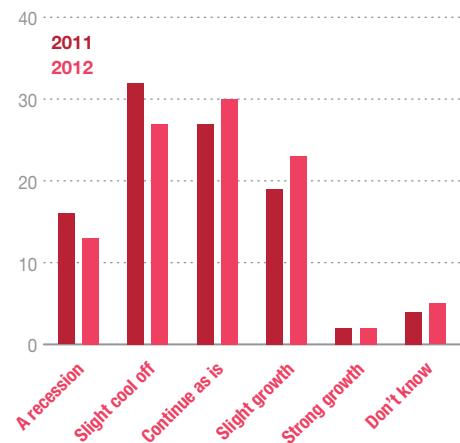
Canadians also feel secure about their income prospects. Nearly half of respondents overall (46%) expect their income to rise over the next five years, and younger Canadians (18–34) and those in their income-earning prime (35–54) are even more bullish on their prospects.

Canadians' economic optimism may simply be a reflection of the fact that Canada emerged from the 2008 global recession in comparatively better shape than some other countries. Since then, persistently low interest rates and the enduring strength of many Canadian housing markets may have persuaded many Canadians that they can service their debt — or more debt — with relative ease.

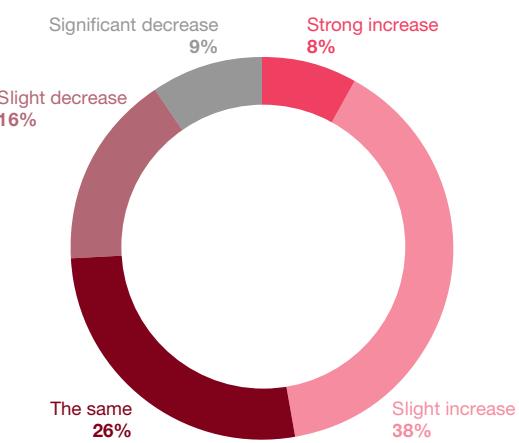
But we also believe that simple human nature is a factor. It's one thing to make a resolution, but it's entirely something else to maintain the long-term discipline needed to see that commitment through. In part, this is why the federal government has taken measures to tighten lending rules — to save Canadians from themselves and help keep them on a debt diet.

55% feel Canada's economy will remain steady or grow — 46% feel their incomes will rise over the next five years

Expectations of the economy



Income growth expectations



The tide is turning on consumer lending

The decline of retail lending?

The tide is turning on consumer lending. Successive regulatory interventions, most recently the introduction of OSFI's B-20 guidelines and further changes to federally backed mortgage insurance, appear to be having their intended effect of cooling Canada's real estate market. As housing prices level off — or even fall in some markets — the "wealth effect" created by years of rising house values will begin to diminish. As housing sale volumes decline, we ultimately expect to see a parallel drop in new mortgage originations.

This may prove to be the push Canadians need to tackle their debt despite their wavering commitment. Looking ahead, we forecast that new loan volumes will stagnate at first before starting to drop gradually. As this happens, Canada's banks will need to find ways to supplement this once-lucrative but declining business.

Enough is enough – time to stop changing mortgage rules

In recent years, the federal government and the Bank of Canada have taken several actions to tighten mortgage lending rules. These changes were made to tackle Canadians' high debt levels and prevent a US-style housing market free fall.

In particular, we've seen significant restrictions placed on the use of government-backed insured mortgage lending. Eligible amortization periods have been shortened repeatedly, investment properties no longer qualify and refinancing rules have been tightened. Under OSFI's B-20 guidelines, underwriting rules are more stringent and home equity lines of credit are capped at 65% loan-to-value.

Taken individually, each change is a prudent step that should curtail riskier lending. But markets are complex, and it's not clear how changing so many lending variables in such a short span of time will affect Canada's residential lending and, by extension, its housing market.

For years, government-backed mortgage insurance has successfully helped Canadians to get on and move up the property ladder. Yet with insurance harder to obtain, it seems likely that we'll see fewer Canadians able to purchase their first home and buy their way onto the property ladder. The question is whether more people than expected will find themselves unable to buy into the market or move up. Should that happen, housing supply could quickly outstrip demand and potentially put pressure on prices.

This is just one scenario, of course. To date, supply and demand have remained relatively equal, and prices have steadied with the exception of a few markets, notably Vancouver. Housing markets can be unpredictable and even irrational. That said, policymakers should consider avoiding further changes to mortgage lending until they can better assess the impact of the changes they've already made.



How banks can respond

Residential lending accounts for 30% of the banks' Canadian-dollar denominated assets and 35% of their overall income. With rising capital requirements already putting pressure on Canadian banks' financials, a slowdown in residential lending is an unwelcome development. There may be no perfect fix, but there are a range of strategies banks can explore to deal with their changing business.

Some strategies are better than others, of course. Interest rate price wars are a potential option, but these only trade short-term market share gains for long-term margin compression. Banks could also expand unsecured lines of credit or compete more aggressively against captive auto lenders in auto financing, but this won't replace lost residential lending volumes. As well, it may incur additional scrutiny — and intervention — from governments and regulators already very concerned about Canadians' debt levels.

Banks may also want to look at expanding commercial lending, which generally provides higher yields and appears to be a growing market. The Bank of Canada's recent figures on business borrowing and lending indicate that business credit increased 7% year-over-year in November 2012, as Canada's small and medium-sized businesses borrow to capitalize on low rates and seize opportunities after a period of slower investment and pent-up demand.

Canada's banks need to address the challenge of declining residential lending by pursuing a coordinated suite of options — strategies to both grow revenues and improve the bottom line. These include:

- improving interest rate spreads through better insights on pricing in defined market segments
- improving the customer experience so that customers, their expectations raised through their interactions with non-financial services companies, find doing business with their banks easier and more enjoyable
- aggressively managing costs, especially around back-office and operational activities, through process improvement, outsourcing, joint ventures and enhanced workforce management



*Canada's banks
are exploring new
products and services
that Canadians are
willing to pay for*

3. PwC, Financial mobile services consumer survey, 2011.

New products and services are part of the solution

Canada's banks should continue to invest their time and resources into developing new products and services that Canadians want and will pay for. Some of these are relatively straightforward and closely related to existing offerings: new insurance products, warranty and identity theft protection and home repair coverage, for example. For small business owners, banks should continue to enhance their cash management and treasury services. Although it may not replace mortgage revenue, our survey suggests that banks ultimately could generate sizeable revenue from new digital products and services.

We asked respondents for their views on digital wallets — smartphone applications that would replace payment tools such as debit and credit cards, store loyalty program information and track payments and other expenditures. Three out of four respondents (76%) said they would find a digital wallet convenient — and one in three (34%) would find it “very”

convenient. Respondents also told us that they'd be willing to pay CA\$1.10 per month, on average, for such a product. This generally implies there's even more fee upside once adoption takes hold.

As with other innovative uses of data, respondents' major concerns with digital wallet use include fraud and security risks (cited by 78%) and personal data privacy (69%). As well, more than half of the respondents (56%) hold banks responsible for safeguarding their financial data while using digital wallets. This could translate into a competitive advantage for banks. Our financial services consumer survey showed that 67% of Canadians and Americans surveyed would prefer that their mobile payments be enabled by their banks. And 76% expect funds to be transferred between bank accounts, no matter who provides the digital wallet or mobile payment service.³ Clearly, consumers want their banks involved in mobile payments.

Digital wallets aren't the only digital product banks could explore. We also asked respondents about a mobile or web enabled financial management application that would track, categorize and benchmark transactions and expenditures across all of a consumer's accounts and provide planning help, alerts and reminders. Nearly three-quarters (71%) of respondents felt such a product would be valuable — and they told us that they would be willing to spend an average of CA\$0.90 per month on such a product. Naturally, these ideas are early stage, and will evolve as they become widely accepted.

Respondents also saw value in a digital safety deposit box that would allow consumers to securely store electronic copies of vital documents, get reminders of renewals or updates, and leave instructions on handling documents upon death or incapacity. Here too, nearly three-quarters (73%) of respondents felt the product would be valuable. Respondents also said they would spend CA\$1.20 per month, on average, for such a product.

As these three examples show, there's a definite appetite for new products and services, especially in the mobile and digital areas. Products such as digital wallets and financial management applications are not only innovative opportunities, but also help improve Canadians' financial literacy — a frequently cited goal for Financial Consumer Agency of Canada, Bank of Canada and the Ministry of Finance.

Customers are demanding that banks play a role in providing security over their personal financial information — and this isn't just permission, it's trust. Moreover, and perhaps more importantly for Canada's banks, there's also revenue potential in these products. Capitalizing on these opportunities will be vital as banks respond to a changing economic environment and an anticipated drop in residential lending.



Methodology

Our survey was completed online using Leger Marketing's online panel, LegerWeb. A sample of 1,228 Canadians, aged 18 or older, was surveyed. Two distinct groups were surveyed:

- homeowners or aspiring homeowners with household incomes of CA\$100,000 or more
- members of the general population who did not fit into the above category

A probability sample of the same size would yield a margin of error of +/- 2.8%, 19 times out of 20.



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