
HOYES • MICHALOS

& ASSOCIATES INC. – TRUSTEES IN BANKRUPTCY

**Annual Consumer Bankruptcy and
Proposal Report
2005**

Prepared By:

**J. Douglas Hoyes, BA, CA, CIRP, CBV, Trustee
Ted Michalos, BAS, CA, Trustee**

Hoyes, Michalos & Associates Inc.

Trustees in Bankruptcy

Principal Office:

204 – 607 King Street West

Kitchener, Ontario N2G 1C7

Phone: (519) 747-0660

www.hoyes.com

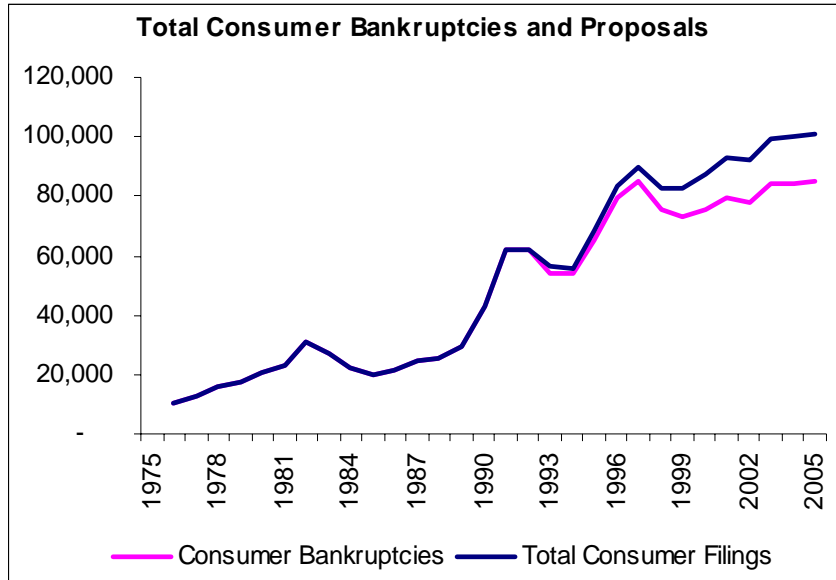
February 3, 2006

Table of Contents

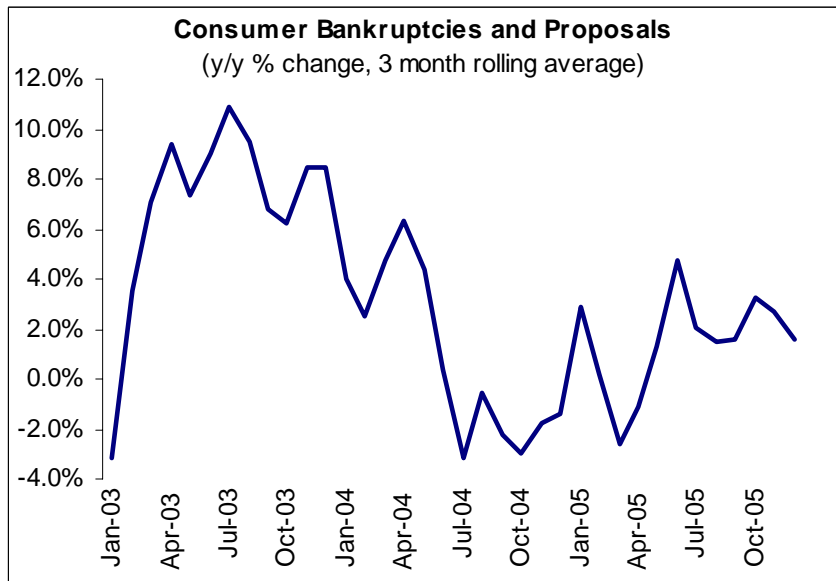
1. Executive Summary	1
2. Consumer Insolvencies Top 100,000 in 2005	3
3. Economic Drivers	5
4. Putting it all together: The Hoyes Michalos Indicator	13

1. Executive Summary

Finishing the year at 101,192, total consumer bankruptcies and consumer proposals (division II) increased a modest 1.2% in 2005 but surpassed the 100,000 mark for the first time¹ in Canada.



Source: Office of the Superintendent of Bankruptcy of Canada



Source: Office of the Superintendent of Bankruptcy of Canada

¹ In our analysis we have used the total number of summary administration bankruptcies and consumer proposals, which in 2005 totalled 101,192. The Office of the Superintendent of Bankruptcy, in their analysis found at <http://strategis.ic.gc.ca/epic/internet/inbsf-osb.nsf/en/br01570e.html> has also included ordinary administration bankruptcies and Division 1 proposals where the primary debts are consumer debts; the differences are minimal.

The following are some highlights of our analysis of this years consumer insolvency results:

- The rate of growth is increasing, with year over year growth in the second half of 2005 at 1.7% compared to 0.7% in the first half of the year.
- Consumer proposals increased at a much faster rate (up 6.4% for the year) than consumer bankruptcies (up 0.3%). We see the rapid increase in consumer proposals as a leading indicator of a continued upward trend in consumer bankruptcies in the coming months.
- Household debt per adult continued to rise, increasing 8.3% in 2004 and 8.9% in the first 10 months of 2005. The debt-to-income ratio increased to a record high of 118.3% by the third quarter of 2005.
- Consumer loan rates have remained at very low levels over the past year despite recent increases in short term rates. The cost of carrying higher levels of debt has remained relatively low. Interest payments on consumer debt as estimated by the Bank of Canada were only 7.46% of personal disposable income in the third quarter of 2005, up only slightly from a low of 7.3% in the second quarter of 2004.
- Real GDP growth is projected to be 2.9% in 2005 and is expected to expand by 3.0% in 2006. Unemployment declined for the third consecutive year to 6.7%. Sustained economic strength has helped keep the rate of bankruptcy growth at low to moderate levels over the past two years.
- Recent changes as a result of Bill C-55 and in particular the reduction in the waiting period for the automatic discharge of student loans from 10 years to 7, are expected to increase consumer filings in the short term a modest 1-2%. This will be a one-time increase, as it will only result in some filings being made earlier than they otherwise would.

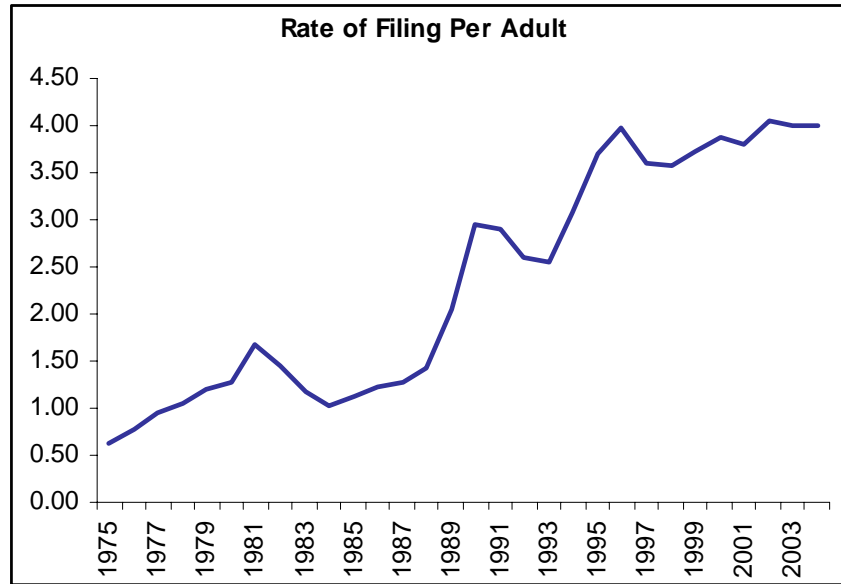
Hoyes, Michalos & Associates Inc. is a trustee in bankruptcy firm headquartered in Kitchener with 15 offices throughout Ontario, from Windsor through Toronto. We specialize in personal insolvency work (bankruptcies and proposals).

Hoyes, Michalos & Associates Inc. performed an in-depth analysis of recent trends in consumer insolvencies and consumer debt. From our analysis, we see an increased risk to the consumer on the brink of financial disaster (See our special report: *100,000+ Consumer Insolvencies in 2005: Canadians Are Carrying Too Much Debt*).

Overall, we predict an increase in the number of consumer bankruptcies and proposals in the range of 3-5% over the next two years.

2. Consumer Insolvencies Top 100,000 in 2005

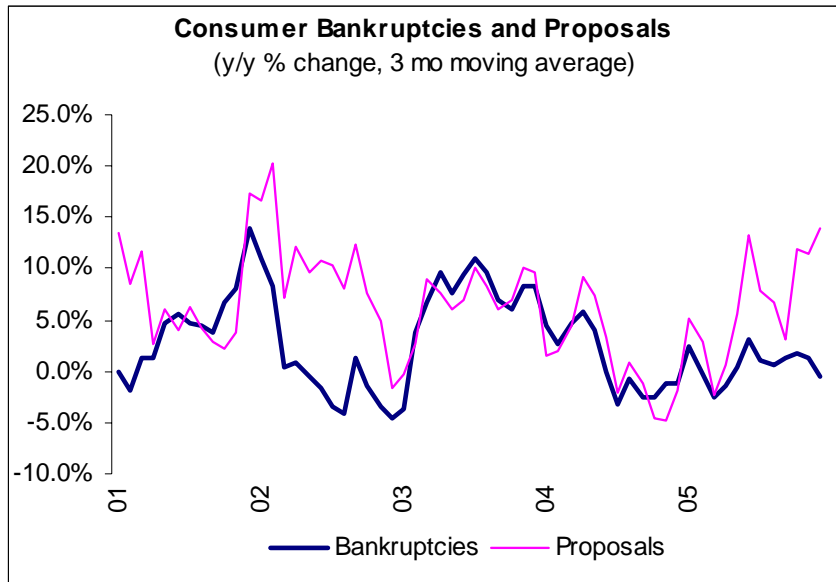
The number of consumer bankruptcies and proposals in Canada increased a modest 1.4% to 101,192 in 2005. Although total consumer filings increased over the 100,000 mark for the first time, the rate of filing per adult was unchanged at 4 per 1000 adults and down from its previous peak of 4.05 reached in 2003.



Source: Office of the Superintendent of Bankruptcy of Canada

It should be noted however that the pace of growth has increased. Year over year growth in the first half of the year was just 0.7% compared to 1.7% in the second half of the year.

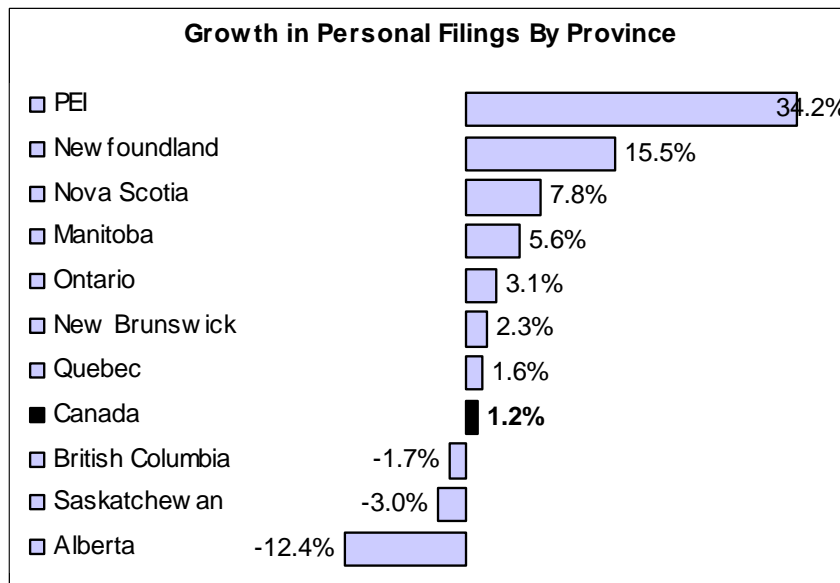
A look at filing growth also shows that consumer proposal growth has significantly outpaced growth in consumer bankruptcies. Consumer proposals increased 6.4% in 2005 compared to an increase of 0.3% for consumer bankruptcies. We see the increase in consumer proposals as a leading indicator of a continued upward trend in consumer bankruptcies in the coming months. In order to have a successful proposal, consumers must have the financial ability to continue to make monthly payments to their creditors for up to five years. Individuals that are extended beyond this ability are more likely to wait as long as possible before filing bankruptcy.



Source: Office of the Superintendent of Bankruptcy of Canada

Consumer proposals are increasing in popularity as an alternative over bankruptcy. Consumer proposals increased to a record 16.4% of total consumer filings in 2005.

Regionally, Atlantic Canada led the country in growth of consumer filings while growth declined in Alberta (-12.4%), Saskatchewan (-3.0%) and British Columbia (-1.7%). Ontario volumes were up 3.1% year over year, almost double the national average.



Source: Office of the Superintendent of Bankruptcy of Canada

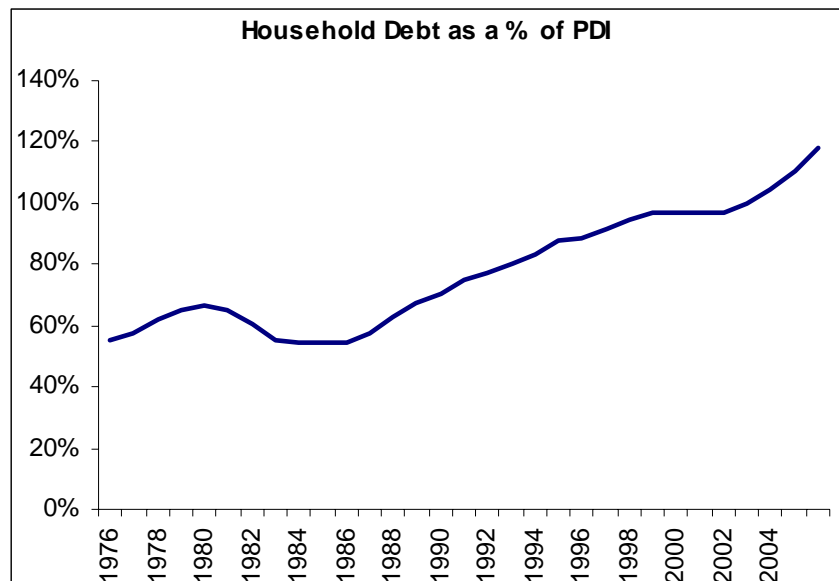
3. *Economic Drivers*

While individual consumers often sight such catastrophic events as marital break-up, job loss, income reduction and health problems as a primary cause of their bankruptcy or proposal, we can look to various macro-economic drivers to help us predict the overall level of bankruptcies for Canada as a whole. The main economic drivers of bankruptcy growth include:

1. Household Debt
2. Personal Disposable Income
3. Interest Rates and Debt Service Burden
4. Economic Growth and Unemployment
5. Credit Risk
6. Special Factors: The impact of Bill C-55 and in particular changes involving student loans

Canadians Are Carrying More Debt

Total household debt continues to increase at a rapid rate. Household debt per adult increased 8.3% in 2004 and is expected to grow by 9% in 2005.

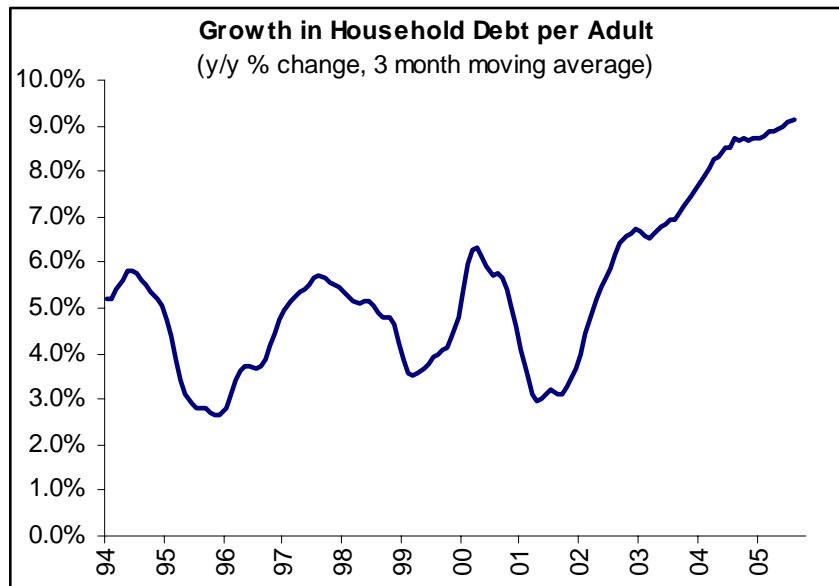


Source: Statistics Canada

Residential mortgages increased 9.7% in the first 10 months of 2005. Non-mortgage consumer loans increased at an even greater rate, up 11.7% in the first 10 months of 2005.

According to the Canadian Banker's Association, there were over 53.4 million Visa and Mastercards in circulation in Canada in 2004. Visa and Mastercard balances outstanding increased 8.5% in 2004 and an estimated 9.2% in 2005. This is of particular concern when predicting the level of bankruptcies as a recent study published by Hoyes, Michalos & Associates Inc. shows that, on average, our clients listed balances outstanding on an average of 3.7 credit cards per person when filing, with an average total credit card debt of \$35,960 per debtor.

The growth in household debt per person continued to outstrip the growth in personal disposable income. PDI per person increased 2.9% in 2004 compared to a growth of household debt per person of 8.8%. In 2005, the trend continued with PDI per person increasing just 2.8% in the first three quarters compared to an increase of 9.3% in household debt per person during the same period. The debt-to-income ratio increased to a record high of 118.3% by the third quarter of 2005.

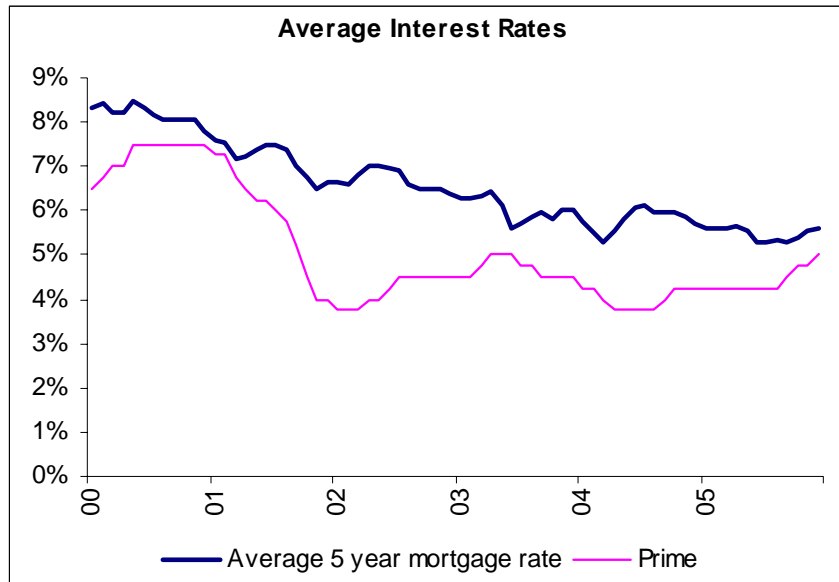


Source: Statistics Canada

We are projecting a growth in household debt of 7.3% in 2006 and an average debt-to-income ratio of 120.8% for 2006.

Cost of Servicing Debt Remains Low But With Risk Of Upward Pressure

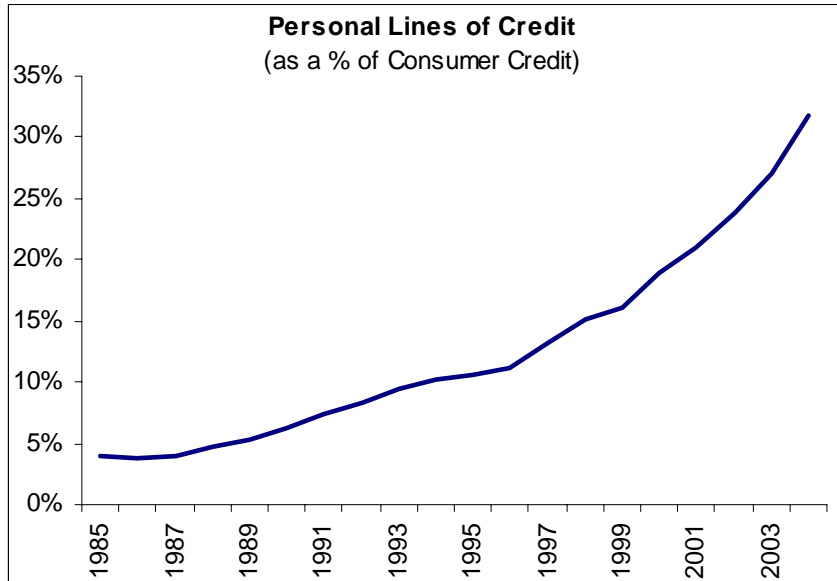
The increase in the debt-to-income ratio is not however the whole story. While rates have fluctuated slightly, expected increases in interest rates over the past year have not materialized. Consumer loan rates have remained at very low levels over the past two years despite recent increases in short term rates.



Source: Statistics Canada

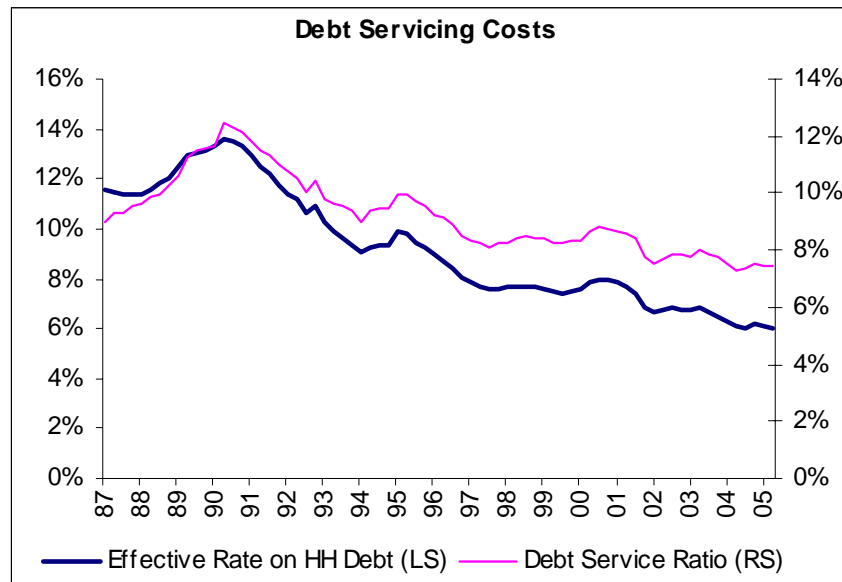
In addition, there have been several changes in the makeup of consumer debt that have resulted in a decline in the average rate paid by consumers on overall household debt.

First, there has been a growth in the use of personal lines of credit since 1999 away from higher interest products. PLC's have grown at an average rate of 25% over the past 5 years as an alternative to higher rate loans including fixed term loans and credit cards.



Source: Bank of Canada

Secondly, the use of variable-rate mortgages has increased. The Canadian Housing and Mortgage Corporation noted that 29% of mortgage customers surveyed in 2004 chose lower cost variable-rate mortgages, up from just 11% three years earlier.



Source: Bank of Canada

As a result, despite rising debt levels, the estimated cost of servicing debt remains relatively low. Interest payments on consumer debt as estimated by the Bank of Canada were only 7.46% of personal disposable income in the third quarter of 2005, up only slightly from a low of 7.3% in the second quarter of 2004.

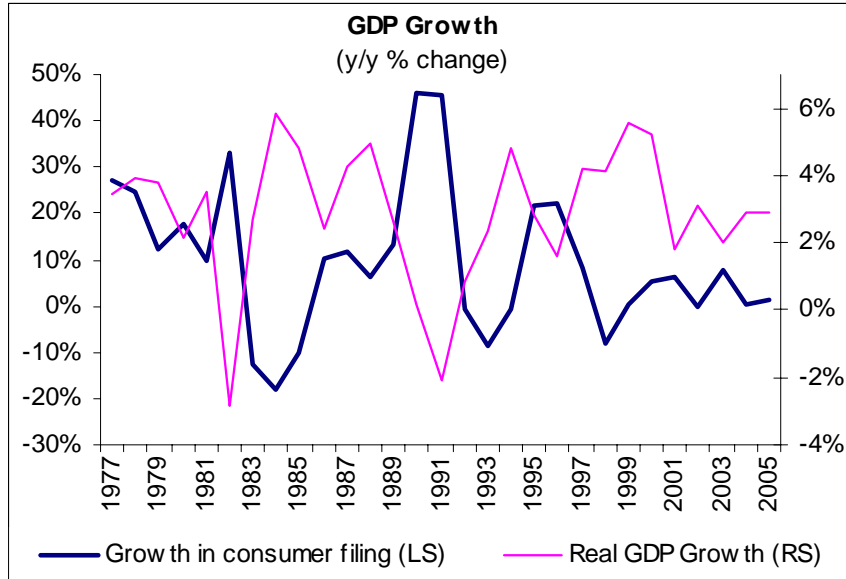
What does all this mean to the expected number of consumer filings going forward? The same factors that have helped consumers manage higher debt levels in the past may result in higher risks in the future:

- Interest rates are expected to rise over the next two years
- The increase in use of personal lines of credit, while lowering average interest costs in the past, are variable rate loans and will be immediately impacted by increases in interest rates
- Increasing uncertainty about interest rates and a flattening of the yield curve will likely result in a shift back to higher cost fixed rate and longer term mortgages.
- A study by HMA of the average Joe Debtor showed that the average consumer bankrupt carried credit card debt of \$9,625 per card compared to an overall average of \$2,329 according to the Canadian Bankers Association. Consumers on the verge of bankruptcy are more at risk to even small increases in interest costs or income reduction.

We are predicting a moderate increase in consumer interest rates in 2006 and 2007 (up 25bp in 2006 and another 50bp in 2007). We expect the debt-to-income ratio to increase to an average of 120.8% in 2006.

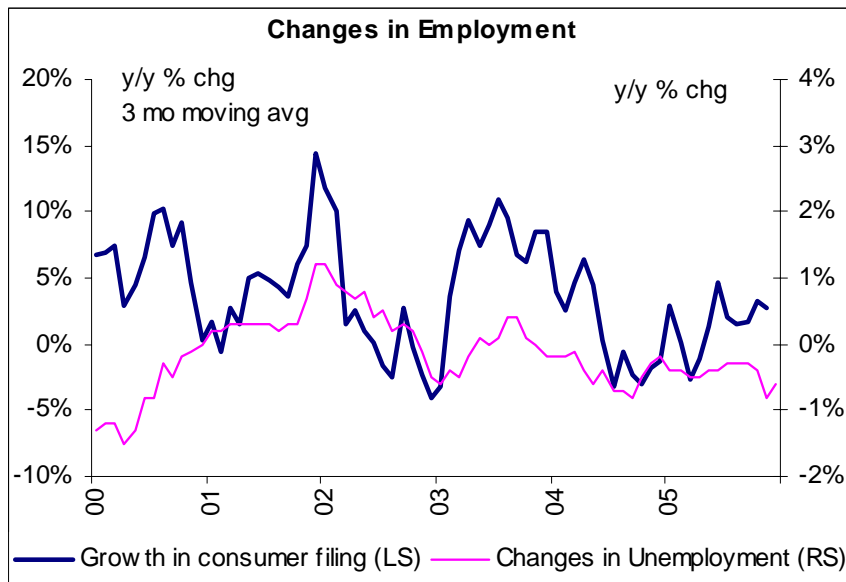
Unemployment Remains Low

Real GDP growth in Canada is projected to be 2.9% in 2005, unchanged from 2004. The unemployment rate in Canada declined for the third consecutive year to 6.7% in 2005.



Source: Statistics Canada

Our recent study of the average bankrupt showed that 33% of clients stated that lay-off or reduced income contributed to their financial problems. Sustained economic growth and low levels of unemployment in Canada in recent years have again contributed to relatively low to moderate consumer filing growth over the past two years.

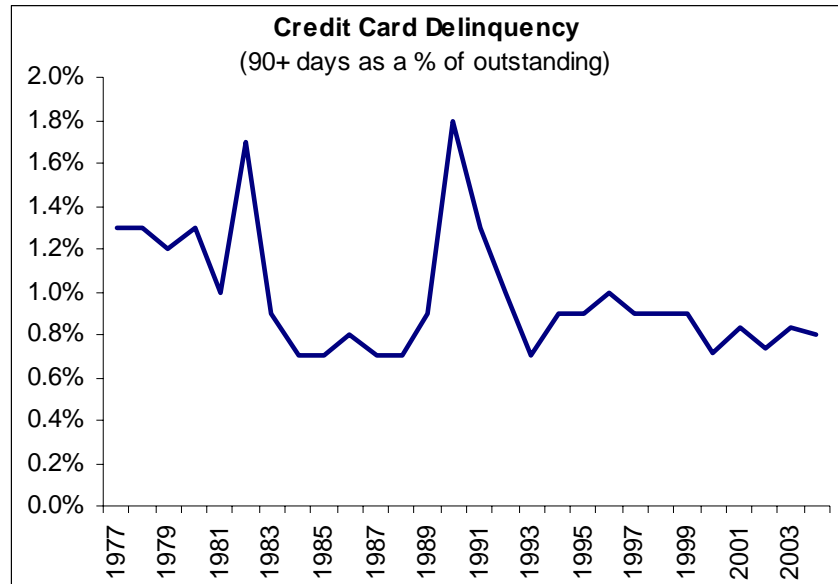


Source: Statistics Canada

We are predicting real GDP growth of 3.0% in 2005 and do not expect any significant changes in the unemployment rate.

Credit Quality Remains Good

The fact that the labour market has been relatively healthy for such a sustained period of time, in combination with low interest rates, has resulted in relatively good credit quality despite such high levels of household debt. The Canadian Banker's Association reports a delinquency ratio (accounts 90 days and over as a percentage of total outstanding) of 0.80% in 2004, down slightly from .84%.



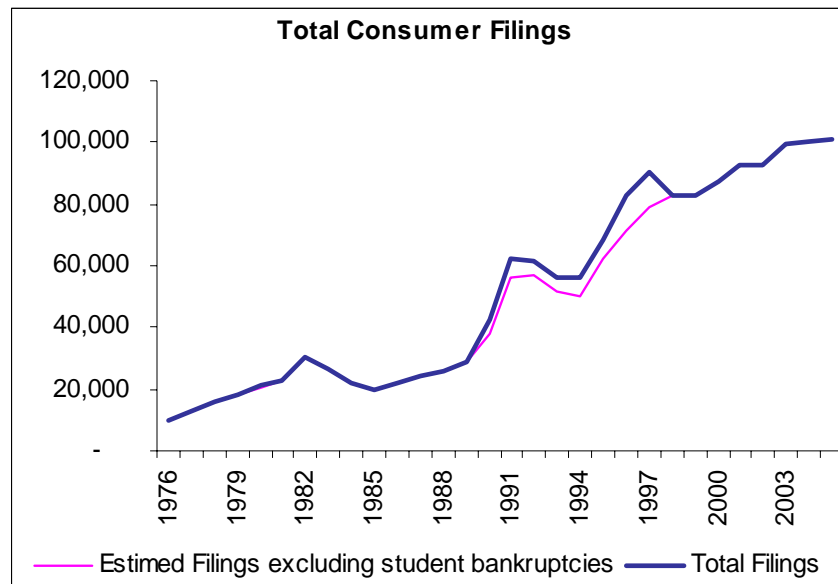
Source: Canadian Banker's Association

As noted earlier, the average bankrupt has a higher propensity towards credit card debt and as such we feel monitoring credit card delinquency rather than mortgage arrears is a better early indicator of changes in bankruptcy volumes.

We do not expect any significant change in unemployment levels for the next two years however increasing interest rates will likely put upward pressure on delinquency statistics.

Student Loans May Cause One Time Increase

Recent legislative changes as a result of Bill C-55 will reduce the time period a student must be out of school before their student loan debt could automatically be discharged from 10 years to 7 years. A bankrupt may also apply to the court if their student loans are more than five years old, and the court may discharge the debt if the bankrupt has acted in good faith, and the bankrupt has and will continue to experience financial difficulty to such an extent that the bankrupt will be unable to pay the debt. A look at historical filings can help us determine if this change will impact bankruptcy levels in the short term.



Source: Office of the Superintendent of Bankruptcy, HRDC, Statistics Canada

Prior to 1997 there was no waiting period for the discharge of student loans. In 1997, amendments were made such that only student loans over two years old were automatically discharged and in 1998 the time period was extended to 10 years. During the period 1990 to 1997 student bankruptcies accounted for an estimated 10% of total consumer filings.

Given that the recent changes to the Bank Act only reduced the waiting period to 7 years we do not expect a significant increase in consumer filings as a result of this change. A short-term increase of only 1-2% over the next two years is more likely. In addition, this will be a one-time adjustment, as it will only result in some filings being made earlier than they otherwise would.

4. Putting it all together: The Hoyes Michalos Indicator

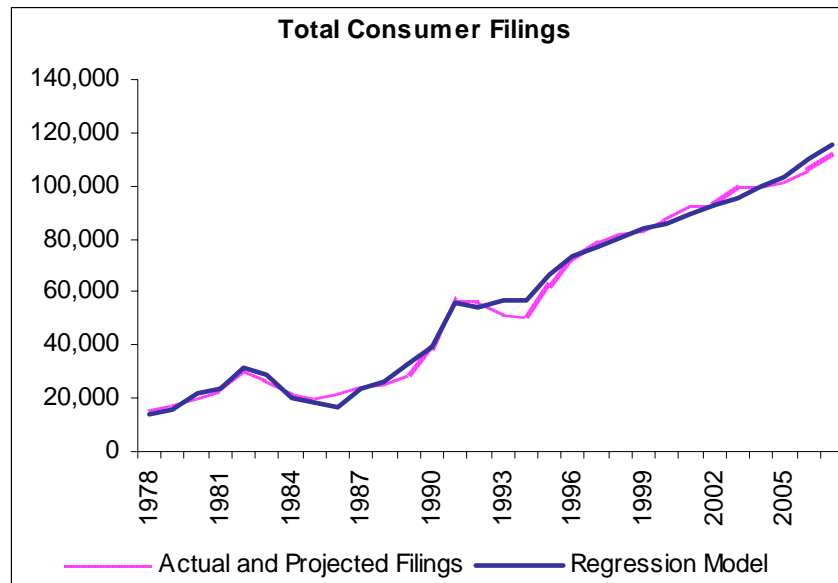
Based on the economic factors discussed in this report and our special report -- *100,000+ Consumer Insolvencies in 2005: Many Canadians Teetering On The Brink Of Financial Distress*, we've updated the Hoyes Michalos Indicator for predicting total consumer filings in Canada.

Using historical data and our expectations for the future, the model predicts a growth rate of 6% and 7% over the next two years.

$$\text{Hoyes Michalos Indicator} = -35783.6 + .0084 * \text{Population } 18^+ + 307351.8 * \text{change in unemployment} + 2.141 * \text{real HH credit per } 18^+ \text{ }^{(-3)} - 4.490 * \text{PDI per adult real} \text{ }^{(-1)} - 232190.6 * \text{Bank of Canada Effective Consumer Interest Rate} \text{ }^{(-2)} + 918377.7 * \text{Credit Card Delinquency Rate} \text{ }^{(-1)}$$

In plain English, this formula compares population growth, change in unemployment, real household credit per adult (lagged 3 years under the assumption you do not default on loans right away), real personal disposable income per adult, (lagged one year), average cost of debt (lagged 2 years) and credit card delinquency (lagged one year) to the number of consumer filings excluding student loan related bankruptcies between 1990 and 1997.

The model, over time, predicted consumer filing volumes with a high degree of accuracy as the following chart shows.



Source: Office of The Superintendent of Bankruptcy, Hoyes, Michalos & Associates Inc.

The model however over-projected consumer filings by approximately 2,000 files in 2005. We believe this is the impact of increased household wealth, and in particular residential housing values, in recent years.

Final Conclusion:

Overall Hoyes, Michalos & Associates predicts an increase in the number of consumer bankruptcies and proposals in the range of 3 to 5% over the next two years. Every 1% increase equates to another 1,000 Canadians facing financial distress.