Strategies to Manage Household Debt and Accumulate Wealth

Interest rates in Canada remain low in an effort to support the economy and stimulate spending. Predictably, Canadians have complied in droves and embraced credit at unprecedented rates. While debt levels have risen to record heights, so too have financial assets.

On average, Canadian families owe approximately $1.65 for every after-tax dollar that they earn.[1] While debt management may be a concern for many Canadian families, this doesn't mean they all have a debt problem. In fact, the percentage of households that are debt-free has increased over the last three years.[2] A 2015 BMO Wealth Institute survey on household debt[3] noted that more than half (56%) of Canadians strive to pay off credit balances when possible, and 22% feel they are using debt to build wealth.

As a result, debt can be categorized as being 'good' or 'bad,' based on whether it enhances net wealth or threatens your household's financial situation.

Good debt

According to BMO's household debt survey, the majority of Canadian debt is used for home and auto financing, home improvement and education. For all but the wealthiest of Canadians, the rising costs of housing and education necessitate borrowing. Therefore, borrowing is not inherently inappropriate or ill-advised, and the focus should be on what the funds allow the household to achieve and if they will enhance wealth in the long run.

It is universally understood that loans that advance an individual's ability to purchase assets (homes, vehicles, investments) or to increase their income (business and education loans) are desirable. However, even this seemingly good debt should be accompanied by a strategy to repay it in full during the life of the asset – or by retirement in order to avoid having to repay the loans with reduced earnings.

When interest rates are low, it's a great time to make aggressive principal repayments. However, statistics have shown that debt service rates have not changed very much from the early 1990s, when interest rates were much higher.[4] It appears that many Canadians have used low interest rates to get larger loans on more expensive houses rather than to aggressively repay their debts. Another concern is that many Canadian families presume interest rates will remain low,[5] which could have caused them to take on the additional debt which will be hard for them to manage when borrowing costs eventually rise.

The following table shows the effect of incremental increases in mortgage lending rates on payments for a $300,000 mortgage with an amortization period of 25 years.

The Effect On Monthly Mortgage Payments Of Incremental Increases In Lending Rates From 2.75%

(Assumes a $300,000 mortgage with an amortization period of 25 years)

Rate	Monthly Payment	Cumulative Different ($)	Cumulative Difference (%)
2.75%	$1,382	n/a	n/a
3.75%	$1,538	$156	11.30%
4.75%	$1,702	$320	23.20%
5.75%	$1,875	$493	35.70%
6.75%	$2,055	$673	48.70%

Source: BMO Wealth Institute

Bad debt

Debt that doesn't advance your wealth or income prospects is considered bad debt and is generally used to allow an individual to enjoy a standard of living that cannot be supported by their earnings alone. Very often, these are unsecured loans such as credit card balances, lines of credit and bank loans.

The BMO survey revealed that almost one in ten Canadians have taken on such loans to supplement their income during an extended period of unemployment due to a layoff, maternity leave or an illness or injury. Should financial difficulties such as these necessitate the need to take on debt, it's important to develop a plan to rid yourself of the outstanding balances within a reasonable period. In so doing, your household can eliminate the debt in a methodical manner and get back to the business of creating financial stability and wealth.

Borrowers who habitually use credit to fill gaps in their earnings rather than for building wealth are the most vulnerable to an interruption in income or an increase in interest rates. Statistics have shown that 18% of households are considered heavy borrowers and that this sizeable cohort accounts for over 70% of all consumer debt.[6]

Debt management: An important element of wealth planning

From a financial planning perspective, the distinction between good debt (those that help a household to accumulate wealth) and bad debt (those that may potentially destabilize a household's financial situation) will dictate the type of lending products that are suitable and the aggressiveness with which the debt should be repaid. While the ultimate goal of most Canadians should be the elimination of debt, the first step should be to getting rid of bad debts.

Whether these bad debts were acquired during a period of financial hardship or through a lack of discipline, there are a number of strategies to deal with them including:

- the creation of a sustainable budget;
- restructuring debts to take advantage of low-interest products such as lines of credit or bank loans; and
- snowballing – a strategy where high-interest loans are targeted for payment ahead of lower-interest loans.

It's also important to note that individuals can make great strides in protecting and rehabilitating their creditworthiness by monitoring credit reports and correcting inaccuracies, avoiding bankruptcy, paying bills on time and keeping credit card balances low.

And, once bad debts are under control, Canadians may want to consider borrowing strategies that help them improve their net worth through the acquisition of assets (i.e., homes and securities) that will improve financial stability.

RRSP loans

A Registered Retirement Savings Plan (RRSP) loan is a good example of using debt to build retirement assets. If you're unable to make your full RRSP contribution, or you have unused contribution room from previous years, you may want to consider an RRSP loan. The benefits of making an RRSP contribution are two-fold; your contributions grow tax-free inside the RRSP and they are tax-deductible for income tax purposes. Since the interest paid on the RRSP loan is not tax deductible, you should try to pay off the loan as quickly as possible, and may use any resulting income tax refund to pay down the outstanding balance of the RRSP loan.

Smart debt

Canadians today are carrying more debt than previous generations. Debt habits, as well as the types of balances that are being carried, should be regularly reviewed. The smartest debts are those that enhance household financial stability, create wealth and most importantly, are part of a sound financial plan.

Your BMO Nesbitt Burns Investment Advisor will work with you to understand your debt needs and provide advice and services tailored to meet your personal goals, which will help you plan for a financially stronger future.

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[1] National balance sheet and financial flow accounts. Statistics Canada, Fourth Quarter 2015. www.statcan.gc.ca/daily-quotidien/160311/dq160311b-eng.htm
[2] Canadian household debt. Hsu, M. Ipsos, February 5, 2015.
[3] Survey conducted by ValidateIt™ for the BMO Wealth Institute from June 23–29, 2015, with a sample size of 1,014 Canadians. Overall probability results for a sample of this size would be accurate to within +/- 3.1%, 19 times out of 20.
[4] Bank of Canada, Financial System Review, December 2014.
[5] A recent BMO survey found that only 60% of Canadians expect interest rates to rise in the next five years.
[6] Canadian household debt. Hsu, M. Ipsos, February 5, 2015.

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