Focus on **Financial Planning**

For most Canadians, buying a house or condominium is the single largest financial commitment they will ever make. What sort of things should advisors discuss with clients who are thinking about purchasing their first home? *The Insurance Journal* asked a number of Certified Financial Planners for their opinions.

Anxious to prevent a U.S.-style housing bubble and subprime mortgage mess from forming in Canada, the federal department of finance announced last July that it is changing the eligibility criteria for government backed mortgage insurance.

As of Oct. 15, 2008, no money down, 40 year mortgages will no longer be supported by the *Canada Mortgage and Housing Corporation*. The new maximum amortization period is now 35 years, and new home buyers will have to have both a minimum initial deposit equal to five per cent of the purchase price, as well as a credit score of at least 620. There are also new documentation standards which will require borrowers to provide evidence to support the reasonableness of the property value, as well as his or her level of income.

Now that lending rules have tightened, where will cash strapped buyers find their down payment? If history is any guide, many will turn to their RRSPs. Under the Home Buyers Plan (HBP), someone who wants to finance the purchase or building of a home may withdraw up to $20,000 from an RRSP. Provided those funds are repaid over a 15-year-period, there are no tax consequences. According to the most recent data published by *Statistics Canada*, nearly 1.4 million people took advantage of the program between 1992 and 2006, withdrawing a total of $14.2 billion.

The HBP may be a popular source of funds, but that doesn't mean it's always a good choice. **Susie Draho**, CFP, an advisor with **RBC Wealth Management** in Winnipeg, points out that when people funds from their retirement plans, they are foregoing

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Ghislaine Brunet
gbrunet@repcom.ca
(514) 762-1667 ext. 231

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investment returns. For younger clients, this isn't terribly serious. "Although they loose the compounding effect on the growth of the RSP, they still have enough years to contribute and achieve their retirement goal," she says. "Older clients have more to consider when making a choice to draw from their RSP. The cost to their retirement plan is much greater, since they do not have time on their side, and may never catch up."

In some cases HBP participants may even choose not to repay the funds and declare the income instead. Take the case of someone who has little or no employment income, perhaps a parent who has left the work force to stay at home with a child. If he or she withdrew the maximum under the HBP, $1,333.33 must either be repaid into the RRSP each year or declared as taxable income. But without a salary, the consequences of including this in income may be negligible. "The trade-off between the build-up of equity by buying the home and availability of cash flow may be worth it," notes **Peter Ficek**, a CFP in Calgary. Much depends on the prevailing interest rates and the performance of the local housing market, but in some cases "you will find that it is just a money wash," he says.

"Many clients still feel that they may be denied a mortgage if they don't accept the financial institution's mortgage insurance."
— Zaid Mohammed

Time value of money

Mr. Ficek says that when clients come to him for advice about buying a home, one of the first things he discusses is the Total Debt Service Ratio (TDSR), one of the benchmarks lenders use to determine how large a mortgage a client can carry. It's calculated by adding together the monthly mortgage principal and interest, property taxes, heating costs, half of any condo fees, as well as any loan or credit card payments, and dividing that amount by the client's gross monthly income. The final result, he says, should not be more than 35% to 42%.

He then talks about the time value of money (TVM), and the idea that money available today is actually worth more than the same amount in the future because of its earning potential. Once clients understand the TVM concept and the effects of interest rates, down payments and amortization schedules, their plans may change. "They may decide on a different amortization, consolidate their affairs into one account, consider a larger down payment or none at all, or even postpone the buying or upgrading to a more expensive home," says Mr. Ficek.

Dangers of longer amortizations

It used to be that most mortgages in Canada were for 25 years, but with rising housing prices have come longer amortization periods. This has allowed many first time buyers to gain a foothold in the market, but at what cost?

"How many times over do you want to pay for your house?" asks **Kevin Gebert**, a CFP in Surrey, British Columbia. He says that he has clients who opted for 40 year mortgages before the CMHC rules were changed. "The main reason for this decision is that it was the only way to fund the purchase of their new home," he notes. "The danger of any amortization schedule is the renewal mortgage rate in 5, 7, 10 years in the future."

Mr. Gebert warns that if mortgage rates were to rise faster than a family's income, some homeowners may be squeezed at renewal. If the amortization schedule is already so long that there's no wiggle room, then they could even be forced to sell. His solution is to set aside funds to use as a cushion when the first rate term is up. "If you have to amortize at 30 or 35 years it is best that you plan upon renewal to be able to have a good payment against the principal so that you may be able to amortize over a 20-year schedule," he recommends.

Mortgage insurance

Once the details of the loan itself have been settled, there remains the question of insurance. Most home owners see the need to take out a life policy to pay off such a large debt, and many lenders even insist upon it, refusing to advance funds without proof of coverage.

Zaid Mohammed, CFP, is an advisor in Winnipeg, and points out that there are a plethora of reasons why consumers should buy their own policy rather than accept the creditors group insurance offered by the bank. Individual coverage allows them to name their own beneficiary, lock in rates, obtain level rather than declining coverage, and it allows them to carry their insurance coverage from lender to lender without having to provide evidence of insurability. He notes, however, two reasons why many clients don't buy their own policies.

"First, many seem to quickly choose convenience when they are offered the mortgage insurance at the time of getting their mortgage. In that sense, clients are doing themselves an injustice by not learning more before they purchase. Second, many clients still feel that they may be denied a mortgage if they don't accept the financial institution's mortgage insurance. This seems to be especially the case with younger people anxious to get a mortgage and immigrants who do not have a full understanding of the Canadian financial system," says Mr. Mohammed. "I am also concerned insurance option may not be a licensed insurance agent."

Andrew Rickard, CFP

Additional Resources:

Mortgage Wise, a booklet produced by the Canadian Bankers Association
http://www.cba.ca/en/viewpub.asp?fl=6&sl=23&docid=29&pg=1

RC4135, the Canada Revenue Agency guide to the Home Buyers Plan
http://www.cra-arc.gc.ca/E/pub/tg/rc4135/README.html

CMHC information page on mortgage loan insurance
http://www.cmhc-schl.gc.ca/en/co/moloin/index.cfm

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