Borrowing From Peter To Invest In Paul - Your Financing Options Explained

Russ Morrison

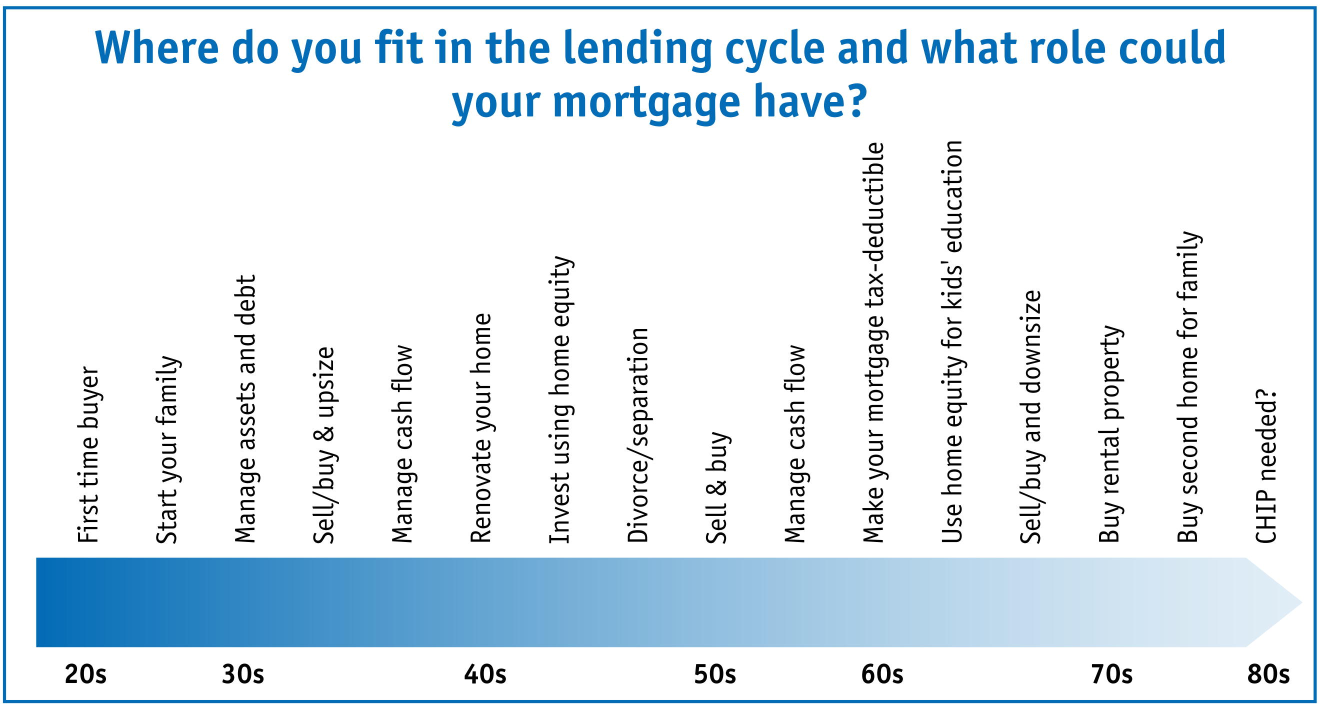
Every financing product has a purpose and niche, and every homeowner has a purpose, need, or requirement for why they choose a particular financing option. In this article, when I reference “financing”, I am referring to one or more of the following terms: mortgage, line of credit, or any other method of gaining or receiving a loan from a lender. Some homeowners (often new ones) start off with little equity but that will change over their ‘lending cycle’ (see figure 1). This is extremely important because in today’s financing world, the more equity you have in your home, the more lenders and lending options are at your disposal. This can vastly increase your chances of achieving your long-term financial planning goals.

Strategies for Borrowing Against Your Home

Every lending option has its pros and cons. The information below can help you select the right product for your particular goals and needs.

Property Tax Deferral Programs (PTDP)

The Property Tax Deferment Program is a low-interest provincial loan program designed to help qualified BC homeowners with 25% equity in their homes pay their annual property taxes. The borrowing rate is adjusted twice a year and is pegged at 2% less than the province’s own borrowing rate. At this point, it currently sits at 1%. PTDP can be financially helpful for homeowners 55 or older; a surviving spouse of any age; persons with disabilities, and a parent or step-parent financially supporting a child.



Pros: • Not having to pay yearly property tax bills frees up money for other purposes, which can include paying down higher interest loans.

• People taking advantage of the program are still able to file/claim their Home Owners Grants.

Cons: • Interest is charged every month (although it need not be paid until the owners move or die).

• A restrictive lien is registered against your property and once the lien is registered, you can only change your property title to add your spouse – which means changing mortgage lenders can be more difficult unless the lien is removed.

• Ultimately you will have to pay back these taxes at some point so be sure not to forget about them! When you sell your home it will be paid from your equity, which can be a large unexpected expense.

Reverse Mortgages

Colin is right in saying the CHIP (Canadian Home Income Plan) is the largest player in this game in Canada. CHIP Reverse Mortgage is a loan secured by your home with no need to make any payments for as long as you or your spouse lives there. Ultimately this product is designed for people who need cash flow. Be sure to fully research this product before using it.

Pros: • No payments need be made during your life and it does increase cash flow if used appropriately.

• Depending on your geographic location, the type of housing you own, your age and gender, and the amount of your current debt, you can access up to 50% of your home equity.

• You can receive your money in installments or in one lump sum, which could provide an early inheritance to kids, help you purchase property in warmer climate and, of course, serve as an investment loan, among other things.

• Access to this product is not restricted by your current income, health, or credit score.

• You will never be forced to sell or move as a result of changing home values or changes to your income.

Cons: • Interest will rapidly accumulate on the amount you borrow, which can quickly eat away at your home equity.

• Reverse mortgage lenders charge a higher interest rate than you would receive on a traditional mortgage or line of credit. This can ultimately mean less money in your estate to leave to your children or other heirs.

• If you're borrowing for investment purposes, this means that your investments need to earn a greater return before you're in the black.

Secured Line of Credit
(otherwise known as a "HELOC" – Home Equity Line of Credit)

You can acquire a HELOC through many mortgage lenders across Canada and are typically offered to consumers at prime plus .50%. When a client advises me that they require a HELOC, I make sure they are aware of the difference between a HELOC and the more traditional form of mortgage financing. The two main differences are:

➥ With a HELOC your equity is readvanceable – which means you can pay down your HELOC with no penalty cost and re-draw on it at your convenience based on an overall approved limit. This is very similar to how a credit card works, except you aren't forced to pay interest at credit card rates. As well, you are only required to pay the interest as it accrues, whereas with a traditional mortgage, you are also required to pay down some of the principal with each payment. As the mortgage industry has evolved, so has its products. Lenders now offer combination products such as the Scotiabank STEP and the National All-In-One, which allow you to combine a mortgage and a HELOC together for more flexibility.

Pros: • Minimum payments are only interest only, which increases cash flow and may work well for people who hope to pay this expense exclusively with investment returns.

• Any loan principal that is paid down is later readvanceable, which is ideal for investors who like to buy and sell.

• There is no penalty for paying down the loan in full at any point, unlike traditional mortgages.

• A HELOC allows clients to access funds quickly with little cost or red tape, to pay as little as the interest accrued that month, or as much as the outstanding balance at any point, all without penalty.

Cons: • The interest rate is still higher than that of a traditional mortgage.

• This type of loan can be dangerous in the wrong hands; some borrowers will be better off with the required principal payments associated with traditional mortgages, because some may also find it too convenient to access for purposes that are ultimately not in their best interests.

Remortgaging *(a.k.a. Re-financing)*

Or Taking Out A Second Mortgage

(Private lender financing)

When homeowners need money, accessing their home equity is often the most cost-effective option. To do this, you can increase an existing mortgage, add a HELOC, or take out a second mortgage. All of these options must be weighed against each other in order to determine the best cost option for your personal timeline. I often suggest first looking at adding a HELOC as a separate debt on top of an existing mortgage. If this is not a viable option, then it may be necessary to refinance and increase an existing mortgage. Sometimes, however, homeowners fall outside of the box used by mortgage lenders to approve either of these options. If so, then a second mortgage could be a solution. An "out-of-the-box" homeowner may be one experiencing credit and/or employment concerns who does not have the equity needed to re-finance. It doesn't mean, however, that just because you have a second mortgage or are utilizing a private lender that you have credit and/or income concerns. I have personally used private financing to access funds for home construction and know many clients who also use this type of financing to quickly gain access to home equity on short notice. Due to the higher interest rates and principal payment requirements that go along with second mortgages and the charges that may go along with refinancing existing ones, these two types of financing may not be cost-effective solutions for investment loans, even though they definitely have their place in other instances.

Pros: • Quick and simpler access to equity and lower mortgage payments (in most cases)

• Second mortgages are helpful if credit and/or income concerns apply, they can decrease the overall cost of credit.

Cons: • Mortgage penalties, fees and higher rates may apply with second mortgage financing – especially when using private lenders.

All-in-One And Readvanceable Mortgages

• (A) All-in-One Mortgages

➥ I refer to all-in-one mortgages as 'Multi-Purpose' products. They are generally suited to – and advantageous to investors, entrepreneurs, small to medium-sized businesses, or homeowners that will need access to funds quickly or need to draw equity for future costs (such as a child's college/university tuition, vacation purchases in Canada or the US, etc.). This type of product is one that will keep your account out of your shoebox full of receipts and make life much more organized. With this type of product you can ultimately split your mortgage into numerous tiers, giving you the ability to label/name all of your financing tiers thus keeping track of tax-deductible interest. These products may even allow you to have different financing categories for different components of your total all-in-one mortgage so you can handcraft the best blend of products and rates for your individual needs. Some lenders that offer this type of product are National Bank (who offers a product called All-in-One) and Scotiabank (who offers a product called STEP – Scotia Total Equity Plan).

Pros: • This is a great way to separate and track tax-deductible debt. By paying interest-only on tax-deductible debt and directing any principal payments towards non-deductible subaccounts, investors can maximize the tax efficiency of their investment loans.

• This product also offers a quick and simple way to access equity and lower mortgage payments (in most cases), which can ultimately decrease the overall cost of borrowing.

Cons: • In some cases, interest rates may be slightly higher.

• This product is more complex and, as a result, may take some time to truly understand the product.

• This product may not be suitable for people too tempted by access to easy credit or people who would benefit by a structured payment schedule ultimately designed to pay down all or some of the principal over time.

- **(B) Readvanceable Mortgages:**

➥ This product is similar to the 'Multi-Purpose' product in that it can be split up into tiers; however, it functions and acts much differently. The main benefit of this product is that all of your income and expenses are either deposited or taken out of this account so you pay down the amount you are owing quicker. All of your day-to-day banking transactions come from this account so it acts essentially as your savings account (your savings would be your borrowing limit less the amount that you owe). This product can be very useful when a borrower's income significantly exceeds their expenses as this excess is immediately applied against the borrower's total debt. As you only pay interest on the amount owing, this strategy reduces interest expenses and ultimately means that the borrower may be able to pay down their mortgage faster. There are a few different lenders that offer these types of products such as Manulife Bank (their product is known as the Manulife One) and Envision Credit Union in BC (who offer a product known as the Redfrog).

Pros: • This product offers a great way to keep track of tax-deductible debt and provides a quick and simple way to access equity.

• Borrowers may have lower mortgage payments (interest-only payments apply) and ultimately can decrease the overall cost of credit.

Cons: • Interest rates are higher than a more traditional mortgage product where payments include principal and interest.

• A learning curve on how to best use the product may apply and as I've already warned, this product can be easily abused by the wrong type of homeowners.

Simple Interest Versus Compounding Interest

Simple interest and compound interest are named for the way in which they are calculated. The difference between simple and compound mortgage interest is that simple mortgage interest is calculated on a daily basis, while compound mortgage interest in Canada is, for the most part, charged on a semi-annual basis.

Simple interest is charged only on the principal amount owing.

Compound interest is calculated semi-annually, so every six months your mortgage lender calculates the interest you owe on the balance of the mortgage.

So where does all of this fit in to mortgage products and which one is the most beneficial? All mortgages – with the exception of revolving accounts/lines of credit will pay compound interest and any revolving accounts are subject to simple interest.

One of the main benefits when working with products such as the Manulife One and Redfrog is that you only pay interest on the balance you owe that day, so if one day your account receives a deposit such as your paycheque then you will only pay interest on the amount owing after your deposit. This type of interest and product can be very helpful in paying down the amount you owe on your home quicker, and helps you pay less interest if your monthly income exceeds your monthly expenses on a consistent basis.

But remember, this type of product can be easily neglected and/or abused because the funds are so easily accessible. In many cases a standard mortgage product which takes into account compound interest is most beneficial especially when a homeowner has very little equity in their home.

Still have questions? Don't hesitate to get in touch with a mortgage professional, who can help you assess your unique financial situation.

Russ Morrison AMP, is a Senior Mortgage Broker based in the Vancouver/Fraser Valley area, who has been actively working in the mortgage industry since 1999. He prides himself on being able to help homeowners with more than just finding a low rate, but also educating and showing them how to best utilize the numerous options available in today's mortgage industry.