



Running on empty: Dealing with client debt

April 2008



Help your clients go from shopping-spree to debt-free

We encourage you to ask all your clients a simple question: "Do you have debt?" If they do, why not mention that you can help them with debt solutions designed to improve their overall financial plan. You'll be surprised at where this conversation may lead.

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Make your clients' debt disappear

BY BRYAN BORZYKOWSKI

There are plenty of bad four-letter words in the English language, but when it comes to financial planning, there's none as nasty as debt. With credit cards, lines of credit, second mortgages and even leverage options, it's easy for clients to find themselves owing their banks thousands of dollars.

In fact, Canadians are carrying more debt than ever before. According to Statistics Canada, in 2005 Canucks had an estimated \$760 billion in debts, nearly 1.5 times higher than in 1999. While three-quarters of that is a result of higher mortgages than in years past, lines of credit loans more than doubled between 1999 and 2005, accounting for 9% of all debt. Add vehicle loans and credit card debt, which account for 6.1% and 3.4% of all debt respectively, and citizens of the Great White North are in some serious financial trouble.

For financial advisors, this is bad news. If a client has debt, creating a solid financial plan is that much more challenging.

"It's a no-win situation," says Hugh Smilestone, a Halifax-based CFP with DundeeWealth. "Most financial plans are predicated on the assumption that the client is debt-free. You have to be able to talk net cash flow during retirement, but you can't in good faith discuss that if it's not net."

While there's no magic bullet to reduce debt, the best approach is creating a detailed financial plan for your clients.

So what's an advisor to do when a client comes to him or her with massive debts? First off, decide whether or not you want to represent that person.

"It depends on how old they are," says Smilestone. "If they're in their early 30s, they have to get their act together. But if they haven't, those people never change. It doesn't matter what

educational background they have; they always live beyond their means, and whatever I say or do isn't going to change anything."

Wade Walters, a CFP with Victoria-based W.H. Stuart & Associates, says he has no problem taking on a debt-laden client, though he's not naive to the challenges that he'd face. "We gather information about the client and what their cash flow is and what caused the debt. Then we just see what we can do with it."

Ultimately, having no debt is the ideal. Owing money late in life will wreak havoc on your clients' retirement years.

Credit card debt is especially worrisome for advisors, as high interest rates can make it nearly impossible for people to pay off the plastic. Peter Andreana, a CFP with Continuum II in Burlington, Ont., says any debt that can't be paid down in two months is trouble.

"Ideally a client should be paying off a credit card on a monthly basis," he says. "If they're turning anything over, they're spending more than they're making."

Consolidating high-interest credit card debt by taking out a line of credit with a lower interest rate is one option advisors have when reducing a client's debt. Walters says using a line of credit works well if a client has two unmanageable credit cards. "The line of credit is taken out and used to pay off those two cards so they have one debt now, at a much lower interest rate," he says.

But consolidation doesn't always help, especially if a line of credit is already maxed out. Andreana says some advisors suggest putting those debts onto a mortgage. Credit cards +

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and lines of credit will then be back to zero, but that's not necessarily a good thing.

"You've just created more credit room," he says. "And you've taken a debt that you should have paid off in less than a year and moved it to a 25-year amortization. At the outset, it sounds like a good idea – it fixes cash flow problems – but in fact you're paying more interest because it's now over a number of years."

While there's no magic bullet to reduce debt, the best approach is creating a detailed financial plan for your clients. That way they can see just how much they're spending and how much they need to save to pay down their debts.

"One of the cornerstones of any financial plan is debt management," says Smilestone. "You have to have debts wrapped up in time for retirement. Letting kids sponge off your client when they're in their 20s or 30s is not part of anyone's financial plan, as far as I know."

"The first step is always gathering information about the client," adds Walters. "We have to look at everything, from their lifestyle to budget, though they probably don't have a budget if they got themselves into debt."

Andreana says the first step for getting a client out of debt is to create a monthly budget. "Sit down and figure out what the client is taking in on a non-net basis, what is going into their bank account on a household basis, what they're spending on groceries, entertainment, travel and clothes. Bring that to a monthly amount and come up with a monthly budget and nine times out of 10, people are spending more than they're making."

He explains that a lot of clients can manage their out-of-control spending habits; it's just that they have no idea how much money they're wasting on frivolous items. Once clients figure that out, it's simply a matter of changing their lifestyle and focusing on debt reduction.

"Don't worry about keeping up with the Joneses," says Andreana. "Worry about how much is in an account today."

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What seems like small insignificant decisions winds up to be a boatload of debt at the end of the month."

Large credit card statements are bad, but most homeowners are also saddled with a huge mortgage. Of course, paying off a home is a much different type of debt than a line of credit, but it's still debt that needs to be reduced.

"Get that mortgage paid down," says Smilestone. "You're only allowed a 10% lump sum payment every year, so what I suggest for people who have good solid cash flow is put half into an RSP; the other half goes into a savings account [to use to pay the lump sum]. It makes the whole financial plan more flexible when you're not carrying around huge mortgage debt."

"We always encourage clients to pay it off sooner rather than later, because it's a non-deductible payment," adds Walters. "Maybe take that 25-year mortgage and do biweekly payments. Just that little bit makes a difference."

Credit card debt is especially worrisome for advisors, as high interest rates can make it nearly impossible for people to pay off the plastic.

Ultimately, having no debt is the ideal. Owing money late in life will wreak havoc on your clients' retirement years. Smilestone explains that middle-aged clients should be saving money, not overspending it. "During the decade when a couple's in their 50s, that's when they should start socking it away," he says.

Clearly, many people don't follow Smilestone's advice. He says about 20% of his clients live debt-free. "People are creatures of habit," he says. "The ones that are diligent and sticking to a financial plan, and utilize their skill set to manage retirement and expectations will be the ones who will do this. The ones that don't will carry debts right into retirement."

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Good debt versus bad debt

BY BRYAN BORZYKOWSKI

For many clients, the thought of landing in the red is enough to make them sick to their stomach. What most may not be aware of, though, is that not all debt is bad debt.

“Any debt where you can write off interest is good debt and any debt where you can’t write off interest is bad debt,” says Ted Rechtshaffen, president and CEO of Toronto-based TriDelta Financial Partners. “Any debt that’s at a very low interest rate can be good debt, too.”

Figuring out what’s good and what’s bad isn’t easy, though, as many cash-conscious clients are hard-wired to avoid owing money. Of course, high-interest credit cards can run someone into major financial trouble, but dismissing credit outright is foolish. “Credit cards are not a bad thing,” says Laurie Campbell, executive director at Credit Canada in Toronto. “It’s not a bad way to finance something, and it’s difficult to live without one.”

While it seems obvious, it’s imperative to pay off a credit card every month. It’s something many clients don’t do, though, and that’s when good credit turns into something ugly.

“Credit cards can offer convenience,” says Patricia Lovett-Reid, senior vice-president with TD Waterhouse Canada. “However, when that extra purchase comes through, and the client says they’re going to pay it off next month, it can get to the point when debt payments become so large that they’re digging into a household budget.”

While credit cards can’t do much besides allow a client to purchase a big-screen TV without dealing in cash, other forms of debt can actually help reduce taxes. Rechtshaffen explains that if someone borrows money for an income-generating venture, the interest on that loan is tax-deductible.

“The main cases of that would be borrowing to invest in a non-registered account or borrowing to buy income-producing

real estate,” he says. “If a client rents out a basement, they can write off a third of the mortgage interest.”

Simply taking out a mortgage in order to buy a house is usually considered good debt, but financing a home, even if it will increase in value over time, can go awry. Increasing interest rates, for one, can be detrimental to mortgage payments. Campbell says if rates rise, “it could turn into bad debt if you can’t keep up.”

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As well, if a client wants to buy that dream house but ends up scraping by in other areas of his or her life, then the good debt turns bad. “If I’m in a financial position to manage debt comfortably, then a mortgage might be good debt,” says Rechtshaffen. “Personal real estate is, generally speaking, a good investment and a tax shelter, but if the client is eating cat food and sitting on crates, then it’s bad because they can’t support that debt.”

While mortgage and credit card debt are the most common, there are other reasons to go into the red. Improving “human capital” as Lovett-Reid puts it, for example, is one good reason for taking out a loan. “These are investments for the future,” she says.

The most common way people prop up their human capital is through education, so student loans are often considered good debt. “After someone graduates, they’re in a position where they will have a job and because income will be higher with education, a client can repay that debt,” says Campbell. “When it goes wrong is when you ignore that debt, and it goes into collections.”

Improving investment fortunes is another, and much riskier, way to get a positive return on a loan. With so many companies offering leveraged investment options these days, many people are asking advisors if taking out a loan to fund a stock purchase is the right thing to do. “Usually people who ask that are the ones we convince not to,” says Rechtshaffen. “And it’s not because theoretically it doesn’t make sense, but investors need to be aware of the risk and be able to deal with it if it doesn’t work out so well.”

However your client chooses to handle debt, having too much of it, no matter what, is always a bad thing.

He says leveraged investing is for people with significant assets in real estate who can use their real estate equity more effectively.

Campbell agrees that investment loans aren’t just for anyone. She adds that in today’s unstable market climate, landing that positive return is increasingly more difficult. “There are no guaranteed wins,” she says. “There’s always going to be success stories out there, but for each success, there are 10 horror stories. It takes a savvy investor who can watch the markets every single moment of the day.”

Loans aren’t always about going into debt; Rechtshaffen says that borrowing money is a good way to improve a client’s wealth. He says someone with a net worth of \$2 million who

has \$500,000 in debt-free real estate, another half a million in investment assets and no debt at all is facing some significant risks.

“There’s real risk because you are overly concentrated in real estate, and you want to have greater diversification,” he explains. “One of the ways to do that without selling real estate is to borrow some money against the property.”

In one example, Rechtshaffen says a person who owns a home, has money in an RSP but is without non-registered cash has a diversification problem, especially if the real estate market goes down. “Their whole net worth is going to drop, and these people also have a cash flow problem,” he explains.

To deal with that, Rechtshaffen suggests taking out a \$500,000 mortgage and investing it. “They’ve taken care of the cash flow problem, they haven’t had to sell the house, and their overall portfolio is much more diversified depending how they invest it.”

However your client chooses to handle debt, having too much of it, no matter what, is always a bad thing.

“Whatever the debt is, find out if the client is paying the least amount possible,” says Rechtshaffen. “Is there an opportunity to make some of it tax deductible, and is it manageable? If someone has too much debt, you might have to put them on a debt diet.”

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New legislation makes bankruptcy more expensive

BY MARK NOBLE

When clients are drowning in debt, sometimes the only way to rescue them is to file for bankruptcy. But with new legislation passed in December, this process is about to become far more complicated and expensive.

Currently, if Canadians file for bankruptcy, they are considered insolvent for nine months after they've been declared bankrupt. During that period, clients are required to pay back 50% of any surplus income over \$1,836 a month to their trustee and creditors.

With bankruptcy poised to become substantially more expensive, Hoyes expects many debtors will choose to go for a consumer proposal over bankruptcy, particularly since its range is now more in line with the levels of debt Canadians rack up these days.

Under Bill C-12, which has been approved by the Senate but is not yet in force, this bankruptcy period has been extended to at least 21 months for all classes of personal bankruptcy.

"For somebody who earns a lot of money in salary, or even say a factory worker who makes \$25 an hour, plus overtime, a bankruptcy can get very expensive," says Douglas Hoyes, a CA and co-founder of Kitchener, Ontario-based Hoyes, Michalos and Associates. "They have added another year to that, so if you have surplus income, you will automatically be bankrupt for 21 months instead of nine. If you have been bankrupt before, you will automatically be bankrupt for 24 months. You will automatically be bankrupt for 36 months if

you have been bankrupt before and you earn more than the minimum income."

If the majority of debts are tax debts, a client could be bankrupt for even longer. Under the new law, tax debts will be treated differently from all other debts. If the total personal income tax debts are more than \$200,000, and if they represent more than 75% of the bankrupt's total unsecured debts, the bankrupt is not eligible for an automatic discharge.

Instead, a discharge hearing will be held on the date the client would have been automatically discharged if the majority of debt was to private creditors.

Fortunately, Bill C-12 has made alternatives to bankruptcy more flexible, most notably consumer proposal plans, which are a way for debtors to negotiate a legally binding repayment plan with their creditors, through a licensed trustee. Hoyes says this method is preferable for many clients because it lets them negotiate to keep certain assets intact.

"You might have some assets or own a fancy car and don't want to go bankrupt and lose those things," Hoyes says. "Instead of going bankrupt, we can negotiate a settlement with the creditors. For example, say you owe \$75,000 in credit card debt; instead of choosing to go bankrupt, we could negotiate a settlement where you pay \$25,000 over the next five years. That's an alternative."

The new legislation has vastly increased the maximum size of consumer proposals that can be filed. Under the new law, people can negotiate a consumer proposal on up to \$250,000 of their debt excluding mortgages on their principal residence. The old limit was \$75,000.

With bankruptcy poised to become substantially more expensive, Hoyes expects many debtors will choose to go for a consumer proposal over bankruptcy, particularly since its range is now more in line with the levels of debt Canadians rack up these days.

He stresses that if advisors want their clients to go this route, they need to remember it's a legal process which must be handled by a licensed bankruptcy trustee.

Those who do choose the bankruptcy process will have some relief granted to them. Most notably, the new rule will make RRSP assets exempt from seizure. Currently RRSP assets, apart from those locked in as part of a pension or in a creditor-protected segregated fund, can be seized.

Hoyes believes the new rule is fair given that pension assets are protected from creditors and for many Canadians an RRSP is their main retirement savings vehicle.

A new rule Hoyes doesn't believe is fair is the rule that student loans will still not be allowed to discharge during bankruptcy for seven years after the student has graduated. The new legislation reduces this period from 10 years, but Hoyes believes it's still a burden for those facing bankruptcy.

"If you're a self-employed guy you don't have a pension," says Hoyes. "If you're diligent and you've been putting your money in your RRSP for retirement, why should you be treated differently than that guy who has a pension he isn't going to lose when he goes bankrupt?"

"In practical terms though, most people that go bankrupt don't have a boatload of money in their RRSPs anyway. If you've lost your job and you're fighting to get back on track, you probably already cashed in your RRSP just to pay the rent. It sounds like a big change, but it isn't really."

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"If I was going to go to start a business and a few years later went bankrupt and had accrued all sorts of tax debt, that tax debt will be wiped out," he says. "Why are students different than anyone else? We understand they have the benefit of their education, but we recommend the government make it two years if they're going to put a time limit on it. Don't make it so onerous that people have to struggle for seven years to get through it."

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Getting clients to disclose debts is vital

BY WAYNE ROTHE

Imagine that you're at the doctor's office for a medical issue and the doctor asks about your symptoms. Would you refuse to answer?

The likely answer is no. The accuracy of your diagnosis and the effectiveness of the recommended treatment depend on full disclosure of all material facts.

The same goes for the financial advisory community. The quality of our diagnosis depends on our clients' full and accurate disclosure of all material facts. That includes everything — incomes, assets, financial and life goals, insurance policies and that elephant that's often in the room: debts.

Uncovering what your client owes to his or her credit card company or mortgage provider is essential to creating a healthy financial plan. Only when we know our clients' debts can we suggest ways to pay them off faster and to improve their financial situation. Reducing a client's debt load frees up cash flow that can be used for other purposes such as making RRSP contributions or topping up life or disability insurance.

Finding out about those debts should take place during the know-your-client (KYC) process. But let's face it: KYC forms are pretty meagre, asking for only the bare-bones minimum of information. Anyone who relies solely on them is taking a risk and missing an opportunity. So drawing out accurate information, especially when it comes to debts, should be an advisor's top priority.

While most people are, we hope, forthcoming about all of their financial issues, debts could be one topic that will make your client squeamish. To ease any discomfort, it's important that you're not judgmental. Show understanding and a sincere desire to help.

If the client is hesitant to release certain personal information, it might help to say something along the lines of, "I understand that your privacy is important. Let me tell you why I need this information to complete a comprehensive financial plan. As a certified financial planner, my responsibility is to provide the best advice possible in ALL areas of your personal financial planning. There is a reason for every question I ask in our fact-finding meetings. If you want to know why I ask a certain question, please stop me and ask."

KYC forms are pretty meagre, asking for only the bare-bones minimum of information. Anyone who relies solely on them is taking a risk and missing an opportunity. So drawing out accurate information, especially when it comes to debts, should be an advisor's top priority.

If this little speech doesn't convince the client, I say to that person that with full information I can provide a written, goal-oriented financial review that will likely reveal areas where I've identified deficiencies in their financial planning, with recommendations and timelines. This report would be our action plan going forward.

If you have a younger client base, it's likely they'll have some debt. If that 30-something client is worried about what he or she owes, I tell the client that having some debt is normal and not to get too discouraged. The important thing is to get the client to focus on paying the debts off and avoid carrying credit card or any other high-interest debts. +

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Some clients might be concerned that they can't invest if they're carrying a debt load. That's not the case, and I make sure to let them know that. I will usually have them pay off their credit card debts first before investing, but I may advise differently depending on the interest rates.

If you have a younger client base, it's likely they'll have some debt.

In a worst-case scenario, if a client still won't reveal what debts he or she has, I'm prepared to tell that person that the full disclosure of information is non-negotiable; I cannot take on clients who don't comply. Fortunately, I've never had to use this tactic.

Getting clients to disclose debts is vital

While these tips might help draw out sensitive, but crucial, information from your clients, really they should want to tell us about their debts. Don't they come to us for help with their financial issues? Once clients know that you're sincere in the desire to help them be successful, it's more than likely that they'll want you to know everything about them so that you can properly help them.

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Debt in brief

AVERAGE BANKRUPT CANADIAN, AVERAGE CANADIAN

(April 2008) Hoyes, Michalos & Associates Inc. examined approximately 3,000 insolvency filings as part of their presentation to the Senate Committee on Banking, Trading and Commerce. The result was a new study that reveals that “a typical bankrupt is a male, 42 years old. He has one dependent and has a monthly income of around \$2,071 and he has total unsecured debt of over \$51,000.”

This is virtually the same profile of the average Canadian, said Douglas Hoyes, a trustee with Hoyes, Michalos & Associates Inc.

In Ontario, a record 42,434 bankruptcies were filed in 2007, up 8.2% from 2006.

The study was released to correspond to the federal government’s recent revision of bankruptcy laws. Trustee Ted Michalos commented that “the new laws, when enacted, will provide some relief to bankrupts with student loans and RRSPs, but bankrupts with tax debt or significant monthly income will end up paying more. We expect to see an increase in the number of proposals filed to deal with these debts. The new laws could also alter the profile of those we see filing for bankruptcy.”

CANADIANS DREAM OF HAVING NO DEBT

(April 2008) If Canadians had a magic button to rid themselves of the most bothersome aspect in their lives, most

would erase credit card debt and mortgage payments first, according to a new Angus Reid Strategies survey sponsored by Intuit Canada, makers of QuickTax.

According to the survey, debt is at the top of Canadians’ deduction wish list, with 26% of respondents choosing to deduct credit card debt from their lives. Twenty-two per cent chose to remove mortgage debt.

DESPITE DEBT, CONSUMERS CLAIM DISCIPLINE

(April 2008) Practice makes perfect — or so Canadians seem to think when it comes to spending. A survey released by Bank of Montreal found that 93% consider themselves to be “smart spenders,” and 26% went so far as to say they are “very disciplined.”

Then again, 78% of survey respondents had debts beyond their mortgage, with an average debt load of \$29,400.

There is some hope, however, that they might be racking up debt as an investment. When asked what they would do with additional credit, 41% said they would spend it on home renovations, and 34% said they would invest in their retirement savings.

Vancouver residents appeared most concerned with planning ahead, with 45% saying they would use additional credit to invest for retirement. Montreal was home to the most disciplined spenders — as defined by themselves — with 64% saying they did not want to live beyond their means.

To Clients: Managing Debt

Dear **[Client's name]**:

Spring has finally arrived and warmer weather is just around the corner. At this time of year, many of us start to think about home renovations, garden projects and summer vacations. But while we often know what we want to accomplish, sometimes we are not sure where the money will come from.

That's where I might be able to help. If you're planning for a large expense this year, you may wish to meet with me to discuss some of the following:

BUDGET MANAGEMENT

I can work with you to create a household budget that will help you establish control over your finances. Together we can determine what current expenditures need to be eliminated or adjusted so you can achieve your short-term goals.

DEBT MANAGEMENT

I can help you come up with a strategy for eliminating debt. For example, are you paying too much on your credit cards and loans? Instead of paying 18% to 20% interest for consumer debt, it may make sense to consolidate your loans for a much lower rate — perhaps as little as 6%, depending on your credit history and current financial situation.

If you think a move like this could help free up money you need for other things, I'd be happy to explain your options and refer you to a loan officer or mortgage specialist who can be of assistance.

SHORT-TERM SAVINGS VEHICLES

Most day-to-day bank accounts pay little or no interest. If you'd like to set aside funds for an upcoming expense, I can offer a number of specialized, higher-interest savings vehicles that may suit your needs.

By investing in a savings account like **[insert high-interest savings account product here]**, you could be earning significantly higher returns. GICs, money market, or T-bill accounts could be other alternatives. And for next year's savings strategy, we'll have the new Tax-Free Savings Account, which will allow you to contribute \$5,000 annually and have investment income, including capital gains, accumulate tax-free. Withdrawals will also be tax-free.

If there are things you would like to accomplish before next winter, don't delay. Please don't hesitate to contact me at the number above.

Sincerely,

[Your signature]

[Your name]