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MANAGING DEBT HAS BECOME AS IMPORTANT AS MANAGING ASSETS SAY TD ECONOMISTS

- **Debts, just like assets, need to be managed**
- **Key tenets of financial planning can be applied to liabilities, such as mortgages**
- **Research and understand financial debts, just like investments**
- **Risk should be minimized on liabilities and assets**
- **Don’t try to time the market**
- **Choose investment over consumption by favouring ‘good’ debt**
- **The recommendation of saving early and often can involve paying down debt**
- **Build a financial plan, and include liabilities in the plan**

TORONTO – Canadians have become more indebted than ever before, suggesting that debt management has become critical, say TD economists in a recent report entitled “*Managing Household Debt as Important as Managing Assets*”. The study is available at www.td.com/economics. “The growth in personal liabilities has been a powerful trend that has greatly impacted the balance sheets of households. This has a major implication for financial planning, which has traditionally focused on the accumulation of assets, particularly through portfolio decisions. However, the management of liabilities has now become just as important,” suggests Craig Alexander, Vice President & Deputy Chief Economist of TD Bank Financial Group.

To illustrate this point, the research paper takes some key tenets of financial investing and applies their recommendations to the largest financial obligation that individuals usually take on – a home mortgage.

“Just as it is important to research financial investments, it is equally imperative that homebuyers understand the available options and their financial obligations with respect to a particular mortgage,” notes Alexander. There are many choices to be made, such as whether to go with a fixed mortgage rate or a variable mortgage rate. “There is no right or wrong decision here; it is all about personal preference – just like financial risk tolerance,” remarks Alexander. There are also a wide variety of other choices that have to be made. “A critical assessment of all the options will help ensure that the mortgage meets the individual's needs," states Alexander.

Mortgage risk should be managed just like any other investment. "When shopping for a home, start with an evaluation of what can be afforded. As a general rule, mortgage payments and property taxes should not exceed 32 per cent of household income," comments Alexander. It is also critical to judge affordability on the basis of current and future financial commitments as well, such as student loans, auto loans and credit card payments. A usual recommendation is that total debt service costs should not exceed 40% of gross income. Getting pre-approved for a mortgage can help in these assessments. "But, just because one is approved for a certain mortgage limit does not mean the whole amount should be used. Like all financial decisions, it is important to understand the difference between needs and wants," remarks Alexander.

There is also an inherent difference in managing financial assets and financial liabilities. For assets, the recommendation is to diversify across many products in order to spread the financial risk. For liabilities, the general suggestion is consolidation, as pooling debt can sometimes result in lower interest rates and reduced monthly payments – but this tends to apply more to credit card debt and other loans than to mortgages. With respect to mortgages, new financial innovations do offer the opportunity to diversify interest rate risk, by having the mortgage divided, with a portion at fixed rates and a portion at variable rates.

The financial planning recommendation of not trying to time the market is also relevant. It is often suggested that individuals might want to take a short-term mortgage if they believe interest rates will fall, with the idea being to avoid locking in at higher interest rates. "This strategy can be risky, as the expected decline in rates may not materialize and rates might even head higher if unanticipated economic developments unfold," suggests Alexander.

Individuals should differentiate between 'good' debt and 'bad' debt. Good debt is the assumption of liabilities for financial gain or a superior quality of life. For example, education loans and mortgages represent investments that can provide significant returns, such as higher income in the case of the former or a usually appreciating asset in the case of the latter. In contrast, sustained high credit card balances that are acquired through impulse purchases represent consumption and generally undesirable debt.

Another fundamental principal of financial planning is save early and often. This recommendation is based on the advantage of compound returns. In other words, the financial return obtained in one year will itself create financial returns in subsequent years. For debt management, the role is reversed. In order to save, debts should be paid down as quickly as possible, so that future interest payments can be reduced. For example, an individual that shifts from monthly mortgage payments to bi-weekly payments can save thousands of dollars over the lifetime of a mortgage. "This is not pocket change and it can help materially with saving for retirement or funding other priorities, such as a child's university education," suggests Alexander.

There is an old adage that if you don't know where you want to go, you won't get there. The implication is that one needs to build a financial plan that realistically assesses the lifestyle that an individual wants during their working career and during retirement. "All Canadians should have a financial plan, and debt management should be part of it," notes Alexander.

"We live in a credit-driven society today. This means that financial literacy should include an understanding of debt management, while financial planning should include discussions about liabilities as much as assets," concludes Alexander.

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The report, *Managing Household Debt as Important as Managing Assets*, is available in PDF format on the TD Economics' Home Page at www.td.com/economics.