

THERE'S AN ELEPHANT HIDING IN YOUR HOUSE

Statistics Canada advises that there are approximately 3.5 million families who own a home with a mortgage. The total mortgage debt that is currently being serviced by these families is about 500 billion dollars. The banks and other lenders are collecting a reasonable market-driven interest rate from the homeowners. Unlike Americans, Canadians are unable to claim their mortgage interest as a tax deduction.

That 500 billion dollars has been borrowed and spent by Canadians to purchase their homes. The money has been used. But there is a very large opportunity hidden in plain sight. It is that same 500 billion dollars. Because of Canadian tax rules regarding the deductibility of interest, that money can be used a second time. 500 billion of non-deductible house mortgages can and should be converted into 500 billion in tax deductible investment loans. We have found the elephant. It is your house mortgage.

The investment industry, working with both the willing assistance of the lending industry and the financial planning industry, should embark now on a mission to teach the population about the benefits of converting their mortgage loans (bad debt) to investment loans (good debt). If this mortgage debt were to be converted as suggested, the process would release 500 billion dollars into the economy to purchase investments for the homeowners. This rather simple act of debt conversion makes the interest expense tax deductible for the homeowner. The process costs next to nothing to implement and all the players benefit, especially those families converting their debt from the bad kind to the good kind.

More important than the tax refunds is the fact that the homeowners will begin gathering assets **now** as opposed to after they have spent many years trying to pay off the mortgage. Holding constant a debt already taken (the mortgage) in order to accumulate investments early in life, has a demonstrably superior financial outcome compared to the process most Canadians currently follow – pay off the mortgage, then begin an investment program.

What are the benefits that accrue to the homeowner, the banker, the tax department and Canada?

A. Benefits for the Homeowner:

1. *Debt will not increase.* Instead, it will remain constant until conversion has been completed. This is a debt conversion strategy, not a leveraging strategy.
2. The rate of interest will be low (prime or better) since the house is the security for the investment credit line.
3. Any reduction of the first mortgage is borrowed back and used to purchase investments - starting immediately.
4. The interest expense on the investment credit line will generate a tax deduction. The tax deduction will produce a tax refund cheque.
5. The tax refund cheque each year will be used to pay the mortgage down even faster. The amount paid down against the mortgage will be immediately re-borrowed and invested.
6. The tax refunds will get larger each year as conversion progresses.

7. The investment portfolio will compound its value over the years ahead.
8. The investments will be free and clear because the house is the security for the investment loan, not the investments themselves.
9. Since the investment portfolio is free and clear, there can be no margin call.
10. The process is reversible. Since the investments are free and clear they will be available in times of trouble to protect the home, the homeowner and the lender.
11. The homeowner will make the choice to invest in stocks, bonds, mutual funds, investment real estate, his own business, or someone else's business. The interest expense will be tax deductible.
12. The investor will automatically be enjoying the benefits that accrue to those who invest regularly and often, starting now.
13. The length of time to complete the conversion is easy to calculate and will vary from family to family, but the strategy always reduces the income tax bill. Assuming this "found" money is wisely utilized to make incremental payments against the mortgage, it can also be said that the strategy always reduces the length of the mortgage as well.
14. The projected investment returns are subject to the usual market risks. Risks are reduced by the long time horizons related to mortgages. Responsible professionals will encourage homeowners to practice asset diversification, to purchase quality investments, to invest regularly and often, to seek professional assistance and to suppress greed.

B. Benefits for the Lender:

1. The constant and expensive struggle to find replacement mortgage business to offset daily mortgage principal reductions will end. This is because it will be to the financial advantage of the mortgagor to maintain his debt at a constant level while he converts it from bad debt to good debt. If bad debt is reduced, good debt of the same amount replaces it immediately. The bank's asset does not erode.
2. The lending risk has already been accepted by the bank in making the original non-deductible loan to the mortgagor. No new risk is taken by the bank in accommodating the request of the borrower to allow him to convert his existing non-deductible debt to the deductible variety. The same house is the security for both loans.
3. The mortgagor gets financially stronger as each month goes by because he is building a free and clear diversified investment portfolio without increasing his debt. There is no leveraging because debt does not increase.
4. The mortgagor gets financially stronger as each year goes by because a free new incremental income is generated as a by-product of the strategy: tax refund cheques. Unlike most family income, this free new income from the tax department is also not taxable income. It is tax-free income that will be targeted by wise homeowners to roll through the first mortgage so that the "re-borrow and invest" activity can be repeated year after year.

5. This new family income improves the debt-service ratio of the customer. A stronger customer is a better customer. As the debt-service ratio improves, the risk of non-performing loans in the mortgage and secured lending sectors is reduced.
6. Mortgage default ratios will drop. The mortgagor is not going to let his house be taken for lack of cash to make a mortgage payment should he lose his job, for example. The investment portfolio is free and clear and the process *is reversible* if required.
7. Lenders who offer credit line first mortgages in conjunction with the Readvanceable Mortgage will be providing the benefits that accrue when using the excellent “Australian” mortgage product so successfully marketed by Manulife.
8. Lenders offering Readvanceable Mortgages as well as investment products will be in an excellent position to enjoy the collateral business available by providing the investments that are required to make this strategy perform.

C. Benefits for the Tax Department:

1. The government has recognized the importance of providing tax deductions to businesses and to wealthy people willing to borrow to invest in the economy because their investment leads to the creation of new businesses and new jobs. The proposed debt conversion strategy will extend the reach of the government’s policies to include millions of average Canadians. It is a way to extend tax benefits to those who need them most. But there is a *quid pro quo* – the tax benefits will only accrue if the not-wealthy Canadian is willing to invest. With this strategy he will now be able to.
2. The *quid pro quo* is also the difference between the free deductible mortgage programs proposed by Joe Clark and Ernie Eves to buy votes. Their programs were freebies with few benefits to Canada. The strategy suggested here is a value exchange – the homeowner benefits, and in return Canada gains a financially stronger citizen, now and in retirement.
3. Any disruption in government taxation cash flow will be modest because the process for most Canadians will take a few years. As the speed of conversion accelerates, the effects of new investment and new jobs will be generating new tax revenues, which will offset the tax refunds paid out to those utilizing the proposed strategy.

D. Benefits for Canada:

1. The free and clear investment pool this strategy generates will produce financially stronger families and will result in fewer bankruptcies and less need for welfare.
2. Families will be better able to take care of their own financial needs in retirement. The free and clear investment portfolio will generate retirement income for Canadians in their senior years, thus reducing the need for government support.
3. Over half of Canada’s corporate pension plans are in trouble. Families everywhere will be grateful for this opportunity to build their own personal retirement plan. If you want it done right, do it yourself.

4. The Reverse Mortgage has been gaining attention in recent years as lenders attempt to find ways to supply cash to needy seniors who are house rich and cash poor. The Reverse Mortgage is a symptom of what happens if the population fixates on mortgage pay down rather than asset gathering during their working years.

The proposed solution solves the above problem with elegance, ease and efficiency. Instead of taking the senior's home as security for a cash flow loan during his or her retirement, why not provide the education and the tools to enable him or her to make their equity work to their advantage at the front end of life, just like wealthy people do?

Treat the problem, not the symptom.

E. Is there a Downside?

1. We all know there is no free lunch, so who is paying for these proposed advantages?

This proposal is largely composed of rearranging the way people deal with their mortgage and their investments. There is one change that has a cost to it. Those homeowners who have been dutifully reducing their mortgage each month are making that money available for the next homebuyer to have a mortgage for his new house. This will change because of the laws of supply and demand. Because the strategy requires that newly created equity be immediately re-borrowed for investments, there will be less money available to provide mortgages to those coming behind. The price of money might therefore be expected to increase for all borrowers, not just homeowners.

In a similar fashion, if people are buying more investments it can be expected that the increased demand will lead to an increase in the cost of those investments and a reduction in their yield.

2. The proposition put forward requires that the homeowner learn to understand the important difference between the non-deductible debt of their house mortgage and the deductible debt of an investment loan. With this understanding, most will appreciate the advantage of suspending their desire to get to zero debt in order to allow their investment portfolio to accumulate during the conversion process. For some, it will be impossible to live with debt of any kind, good or bad.
3. When the conversion is completed, the homeowner may wish to resume their course to zero debt by starting to make payments on the new deductible investment loan.

It can be shown mathematically that they will be financially better off to leave the debt in place, paying interest only, once the interest has been made deductible. If this is done, they will receive ongoing tax refund cheques for the rest of their life. Moreover, their cash flow can be used to continue to increase their investments rather than being used to pay off a loan they have worked so hard to convert to the deductible variety. Ultimately, that decision is theirs to make. Some people are so debt adverse they will do whatever it takes to get to zero debt – even if it means fewer assets and lower income.

F. This Strategy is Already Available

A Canadian with a \$200,000 mortgage should take steps immediately to convert that mortgage to a \$200,000 investment credit line as quickly as possible, starting now. He may need the help

of a financial planner to organize the plan, arrange the re-advanceable mortgage and supply the investment portfolio. The help of these professionals is desirable as there are usually additional steps that may be available that will optimize results for the homeowner.

The good news is that this strategy is already available. It is called *The Smith Manoeuvre* and it has been quietly in use for 20 years in B.C. It is the subject of a book entitled *The Smith Manoeuvre* which is a Canadian Best Seller having sold over 10,000 copies. There are many financial planners across Canada offering to assist homeowners with its implementation. Most banks and credit unions now offer Readvanceable Mortgages, although many are not yet up to speed on how these Readvanceable Mortgages are utilized with *The Smith Manoeuvre*. For this reason, it is recommended that homeowners seek out a financial planner who is already implementing *The Smith Manoeuvre*. A list is available online at www.smithman.net.

The book can be ordered on line, along with a companion CD called *The Smithman Calculator*. The CD illustrates specific improvements that can be expected by any homeowner when mortgage particulars and investment assumptions are input. *The Smithman Calculator* will determine how many years will be lopped off of the first mortgage, as well as how much will be received free from the taxman in tax-refund cheques. Most importantly, *The Smithman Calculator* allows the user to determine the size of the investment portfolio at any point in the future.

Order online at www.smithman.net or phone toll free to order at 1-800-792-0825.

Also available for download from the same website is a PowerPoint presentation with text that explains *The Smith Manoeuvre* in detail. This presentation is suitable to use as a tool to describe *The Smith Manoeuvre* to others.

Five hundred billion dollars in non-deductible mortgages needs to be converted to five hundred billion dollars of deductible investment loans. The strategy will not work unless the new borrowings are used for investment – the money cannot be used for consumption, so there will be no leakage in this program. It will be a pleasure for those in the industry to facilitate *The Smith Manoeuvre*, as they will be dealing with willing and motivated homeowners who are anxious to get started immediately on putting this exciting strategy to work.

The financial professionals in the finance, planning and investment industry should not simply participate in this financial revolution – they should lead it.

Fraser Smith
Victoria, B.C.
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info@smithman.net

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Fraser Smith is a retired financial strategist in Saanichton, B.C. on Vancouver Island. He is the author of "The Smith Manoeuvre" and the developer of financial software "The Smithman Calculator". For more information visit www.smithman.net. Contact 250-652-0825.