Give Yourself a Mortgage!

— a Moneysaver Article by H.Michael Wise

For most people, their home is their largest single asset. Furthermore, most people have to borrow money from the bank in order to purchase their property. Those who have owned more than one house, and those who have reduced their mortgage, may find that it becomes possible to use another source of financing: the assets in their RRSPs.

The rules governing RRSPs and RRIFs (and LIRAs and LRIFs in some provinces) permit an individual to hold a mortgage as an asset within the plan. A person may grant the mortgage to an unrelated party, or he may choose to finance his own personal residential property, or a rental residential property. The latter case is called a non arms-length mortgage.

In this article, I will describe the steps I went through to obtain a non arms-length mortgage on my private residence.

My wife and I have lived in our home for over 20 years. We had paid out our mortgage a number of years ago. Ever since we bought the house, the value has remained just slightly above the average price for Calgary residential real estate. The appreciation, excluding the cost of the improvements we have made to the property, has been only around 3% per year. This is less than the rate of inflation. While some may have become rich dabbling in real estate, we have not!

An opportunity came along to make a low-risk investment that offers a very attractive current yield of 9.2%. We required financing of $100,000 in addition to our own resources. We examined the possibility of an unsecured line of credit floating at prime + 2%. This was impractical for a number of reasons. We examined the possibility of a secured line of credit floating at prime, but rejected this because we did not want to take the interest rate risk. Our bank offered a home mortgage at 6.5% for 5 years. Ultimately, my wife and I chose to finance the investment through a $100,000 mortgage on our property, funded by my self-directed RRSP.

Is It a Good Investment?

As a financial advisor, one of the first questions I had to ask myself was whether the mortgage was an appropriate investment for the RRSP, or would it hinder the growth of our retirement savings. I am fairly conservative, and manage my financial assets with a 60% equities / 40% fixed income asset mix. The mortgage would represent less than half of our investments, and could therefore serve as the fixed income portion of my portfolio, without changing my investment policy.

As for interest rate, we chose a rate that was equivalent to the highest published rate for 5-year monthly-pay GICs. We therefore gave our RRSP a fixed income investment that was equivalent to the best rate available out in the market at the time.

As far as security, I think I'm a good credit risk. Besides, the rules governing RRSPs say that non arms-length mortgages have to be insured through CMHC or G.E. Capital. Our home has joint ownership. If I had sole title, my wife would have had to separately guarantee the mortgage.

Finally, our monthly mortgage payments get paid into my RRSP. This has created a regular source of funds to invest using dollar cost averaging. This money goes totally into equity investments.

In sum, a residential mortgage fit within our investment plan. We then began the process of obtaining the mortgage.

The Mechanics

In my work, I deal with 3 different trustees for self-directed RRSPs: MRS Trust, Laurentian Bank, and Canadian Western Trust. Each of these institutions handles non arms-length mortgages within self-directed RRSPs. They all have publications that list the requirements and the fees payable.

The following table lists the fees for a standard residential mortgage:

Table 1

	MRS Trust	Laurentian Bank	Cdn Western Trust
Application Fee	$50.00	$160.50	$267.50
Mortgage Insurance & Appraisal Fee*	$235.00	$235.00	$235.00
Legal Fees	Company lawyer or yours	Company lawyer or yours	Company lawyer or yours

SD-RRSP Trustee Fee	$214.00 annually	$133.75 annually	$133.75 annually
Mortgage Administration Fee	$214.00 annually (deducted from mortgage payments)	$187.25 annually	$107.00 annually
Permitted Interest Rate	Not less than 2% below current market rates	Same as offered by Laurentian Bank	Within 1% of the lowest published mortgage rate
Mortgage Insurance	Depends on loan ratio	Depends on loan ratio	Depends on loan ratio
* These were "on sale" when I made my application. My cost was $185.00			

You'll notice that although Canadian Western Trust has a higher application fee, the annual fees are much less. The annual fees are far more important when considering your choice of trustee. Your financial advisor may only deal with a single trustee and may not have the best price; you may have to shop around for another advisor, and be prepared to switch firms if necessary.

I mentioned earlier that it is necessary to get mortgage insurance for a non arms-length mortgage. (It is not required for an arms-length mortgage). This coverage ensures that your RRSP will not be out of pocket if you (the borrower) default on the payments. There are 2 suppliers of insurance: CMHC and G.E. Capital.

Both companies will insure 1st or 2nd mortgages to finance the purchase of a residential property (either personal residence or rental), refinance an existing property, or finance renovations.

G.E. Capital will also insure 1st mortgages for the purpose of equity takeout for investment, debt consolidation, or consumer purchase. However, G.E. Capital is not active in all parts of Canada, and will not consider mortgages in a RIF.

Both companies have the same insurance fee structure:

Loan Value Ratio	% of Mortgage Loan	Cost for $100,000 Mortgage
Less than 65%	0.50%	$500.
65-75%	0.75%	$750.
75-80%	1.25%	$1,250.
80-85%	2.00%	$2,000.
85-90%	2.50%	$2,500.
>90%	Not available	

The insurance fee shown is a one-time upfront cost. You can pay it immediately, or add it onto the face value of your mortgage. In my case, the loan represented less than 65% of the value of our home, and I added the insurance fee onto the mortgage. The mortgage loan was therefore $100,500.

I wanted an equity takeout mortgage, so I had to use G.E. Capital. Of the trustees mentioned above, only Canadian Western Trust deals with G.E. Capital. Since my self-directed RRSP was with another trustee, my first step was to make a T2033 transfer "in kind" to CWT. The former trustee charged an exit fee of $160.50 to handle the transfer.

All of the trustees require the same information when making the loan application:

- A completed application form.
- A personal income statement and balance sheet. The trustee has a duty to confirm that the loan meets their internal lending policies. The trustee may require an independent credit check from a rating service.
- Verification of income. This might be a letter from your employer. If self-employed, the trustee requires personal and corporate income tax statements for the past 3 years.
- Copy of the purchase agreement for a new purchase.

If refinancing, the trustee needs the following documents:

- Copy of current assessment and property tax notice;
- Certificate of title;
- Payout statement from current lenders (if any).
- The trustee's application fee;
- The mortgage insurer's application and appraisal fees;
- Name, address and contact numbers of the lawyer you want to handle the transaction.
- Desired term, interest rate and conditions you want in the mortgage contract.
- Desired date of closing; frequency of payments (weekly, bi-weekly or monthly), and desired dates for the payments.
- Void cheque for setting up direct debit of the mortgage payments from your bank account.

If there are insufficient funds in a single RRSP account, the trustees will permit the mortgage to be split between 2 accounts (for example the husband and wife might each have RRSPs). However, in this case each plan will be charged the annual fees. This could make the whole exercise quite expensive.

We decided that we wanted a fully open mortgage with unlimited prepayment privileges, and a 5-year term on a 25-year amortization. At the time of application, the big banks had posted 5-year mortgage rates of 6.80%, and the lowest published rate was 6.05% at Trimark Trust and Firstline Mortgage. Using CWT's guideline, we set the interest rate on our mortgage loan at 5.05%. As mentioned earlier, this coincided with the highest published rate offered for 5-year monthly-pay GICs (from Home Savings and Loan).

Things move very fast once you make the application. It is necessary to sell sufficient securities ahead of time to have cash available in the RRSP to fund the mortgage. If you have back-end load mutual funds, you might incur redemption penalties. It is possible to reduce these through a little foresight, taking advantage of the "10% free redemption" clause each calendar year to build up a portfolio of front-end load funds. Your advisor should make this switch without charging a fee.

The insurer's appraiser inspected our property within a couple of days of application; CWT sent a commitment letter that outlined the terms and conditions under which we would get the mortgage within a week of application. We signed and returned the commitment letter, and our lawyer received her instructions from CWT and drafted the mortgage papers. It took 2 weeks from when we signed the commitment letter to when we signed the mortgage documents. CWT advanced the funds from our RRSP to the lawyer "in trust" shortly thereafter, and she forwarded the funds to us. The whole process, from initial application to receipt of proceeds, took less than a month. Our lawyer charged us $250.00 in fees, plus $245.85 in disbursements.

Our total expenses to obtain a $100,000 mortgage amounted to $1,619.55. This includes the trustee exit fee and the mortgage insurance fee, neither of which were out-of-pocket costs. The front-end cost was therefore 1.6% of the investment. Our annual cost of maintaining the mortgage in our RRSP will be $107.00, which is only 0.1% of the mortgage principal. Compare this expense ratio to mortgage mutual funds that have average MERs in excess of 1.5%!

Since we obtained the mortgage for investment purposes, the costs to set up the mortgage are considered an expense and deductible from our investment income. The mortgage interest is also a deductible expense. Overall, we consider our experience has been favourable.

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