Debt and cash flow management take priority as interest rates set to surge

Helen Burnett-Nichols
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Clients with unsecured lines of credit or HELOCs are concerned about increasing monthly payments, or more money going towards interest, as are those with variable-rate mortgages, says one advisor.

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The stage is set for the cost of servicing certain types of debt to rise significantly as the Bank of Canada is planning to increase interest rates aggressively this year.

That's causing many people to become concerned about the impact of higher payments on their cash flow. In turn, they're looking to their advisors for guidance and strategies to ensure they're ready to meet their changing debt obligations.

As a whole, Canadians are carrying a significant amount of outstanding debt. Statistics Canada reported that household debt as a proportion of household disposable income hit the highest level on record in the fourth quarter of 2021, with Canadians owing $1.86 for every dollar. Of the $50-billion in household debt in the quarter, more than $46-billion was mortgage-related.

A recent MNP Debt Index poll conducted by Ipsos also showed that more than half (55 per cent) of Canadians, including 45 per cent of those who rate their financial situation as "excellent," are concerned about the impact of rising interest rates.

From a personal debt standpoint, many people are at risk of having their future plans affected negatively if interest rates rise a few percentage points, says Stephanie Holmes-Winton, founder and chief executive officer of CacheFlo Inc. in Halifax, which provides online learning and behaviour-based tools for advisors and clients.

"Clients could be stopping their [registered retirement savings plan (RRSP)] or [tax-free savings account (TFSA)] contributions. They could be cashing things out to deal with short-term cash flow crunches," she says. "All of that has a really horrid long-term effect on their financial scenario."

Woody Yang, certified financial planner and advisor with BlueShore Financial Credit Union in Vancouver, says although many clients are positioned well to weather interest rate increases, those with unsecured lines of credit or home equity lines of credit (HELOCs) have been concerned about increasing monthly payments or more money going toward interest, as are those with variable-rate mortgages.

"I don't think everyone's prepared. A lot of clients are probably living in that perfect bubble of the past couple of years [in which the] 'Stock market is doing great, interest rates are low, and we're able to borrow more money,'" she says.

As such, Ms. Yang has been working to prepare clients who carry debt. Specifically, she's encouraging them to run a stress test by making higher payments now. That gives them a sense of what their cash flow will look like as interest rates rise further.

Cut spending and consolidate debt

Other strategies she uses are to explore whether clients are able to cut discretionary spending to free up extra cash and consider opportunities to restructure their debt to manage payments better and decrease overall interest paid. Ms. Yang also looks into whether there are ways for clients to increase their income.

"We need to be very proactive to deal with the changing environment and implement those strategies discussed with an advisor to try to stay ahead of the change," she says.

While rising interest rates and the higher cost of gas and groceries are out of clients' control, Daniel Evans, investment coach and certified financial planner with Money Coaches Canada Inc. in Vancouver, says advisors can help to show how these expenses impact day-to-day cash flow and make a plan to allocate money for the increases.

The first step is to have a clear picture of income and expenses before looking at scenarios that include higher interest rates. "Then, we have a conversation around how to subsidize some of these changes. So, clients are already aware of what's happening before it actually happens," he says.

Mr. Evans says this can involve cutting discretionary expenses as well as changing their savings strategy – while still contributing to TFSAs or RRSPs – to service their debt if necessary.

"Perhaps in this environment, we tilt from those investments," he says. "Just put a bit more down on the mortgage or the debt, not only because we have a choice to, but it could be that we have to."

Check in as 'financial dragons' come out

Daniel Frost, financial advisor and certified cash flow specialist with the Frost Group at Raymond James Ltd. in Medicine Hat, Alta., says Canadians are already facing several challenges this year, from carbon tax increases to rising mortgage rates affecting those coming up for renewal.

"It's not just interest rates. There are a lot of financial dragons coming out of the woodwork that are going to put a few people in a bad spot," he says.

Mr. Frost is focusing on ensuring that clients with debt are as efficient as possible in servicing it. For example, using a HELOC where appropriate to consolidate several higher interest sources of debt.

In cases where there are multiple types of debt, focusing efforts on the lowest balance is a short-term win that may also provide clients with excess cash flow to start tackling the higher balances, he says.

Meanwhile, Ms. Holmes-Winton says advisors should aim to make debt management a part of the plan.

That should include having proactive conversations with clients – even those who appear unaffected by the current environment – and collecting and updating data on their debt regularly so that it's reflected accurately in their records. Checking debt-to-income ratios annually to ensure clients are on track is also important.

Clients who may have seemed fine in the past with debt could be at serious risk now because higher interest rates, in addition to runaway inflation, are concerning, Ms. Holmes-Winton says.

“[Debt] just needs to be managed, dealt with, and to be part of the overall strategy,” she adds.