Mortgages or margaritas: Is paying down debt putting your retirement at risk?

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The contributions you make to your RRSP allow you to claim a tax deduction on your previous year's tax return. For Canadians who are facing debt, however, contributing to an RRSP may seem like a luxury they simply can't afford. The decision to pay down debt, at the expense of retirement savings, is often an emotional one that isn't driven by the numbers. With low mortgage interest rates, neglecting your long-term savings in favour of debt repayment may result in sacrificing the quality of your retirement.

Canadians want to be debt-free

Many Canadians want to pay down debt simply for the financial freedom of being debt free. This emotional rationale often outweighs more practical reasons, such as concerns that interest rates may increase in the future or that their current debt level was too high for comfort.

So why the rush to pay off debt? It's probably safe to speculate that market turmoil in recent years has caused investors to seek financial safety. And what's safer than getting out of debt, right?

Not necessarily. When interest rates on debt are low, the short-sighted objective of getting out of debt now may actually negatively impact your long-term retirement savings.

Debt repayment vs. RRSP / TFSA contributions

In another report, The RRSP, the TFSA and the Mortgage,[1] we showed that when your tax rate today is the same as your expected tax rate upon retirement, the decision to invest in an RRSP / TFSA or pay down debt boils down to a mathematical question: Can you get a higher rate of return on your investments than the interest rate on your debt, given a level of risk at which you are comfortable? If so, then investing is the better bet; otherwise, paying down debt is the better choice.

For consumer debt, such as credit cards and personal loans, the interest rate can be quite high, often approaching 20%. Since it may be difficult, if not downright impossible, to get a higher rate of return on investments with a reasonable amount of risk, it almost always makes sense to pay off this kind of debt before making contributions to an RRSP / TFSA.

On the other hand, if you have low-rate debt, it might make sense to leave your debt outstanding and, instead, contribute to an RRSP / TFSA if you expect to get a better rate of return on investments over the long term.

[1] The report "The RRSP, the TFSA and the Mortgage" is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/rrsp-tfsa-mortgage-en.pdf.

Of course, investing in the bond or equity markets as you might do within your RRSP / TFSA cannot be compared to paying down your mortgage, which is more similar to a risk-free investment such as a Government of Canada bond.[2] If you have a high level of debt and would not be able to sustain an increase in mortgage interest rates, it might be best to minimize your risk and simply focus on debt repayment. But if you are willing to tolerate some risk in your investment portfolio while saving for longer-term goals, such as retirement that may be 20 or 30 years away, choosing to invest via an RRSP/ TFSA may result in more money at the end of the day, albeit with an assumption of greater risk.

The benefit of contributing to an RRSP or TFSA, rather than paying off low-cost debt

To illustrate, let's look at the potential benefit (increase in net worth) from saving for retirement in an RRSP / TFSA versus paying off debt. As noted above, if the long-term rate of return on investments in an RRSP / TFSA exceeds the mortgage interest rate, investing may yield a greater benefit than paying off debt. Whether an RRSP or TFSA will be the best choice for your long-term investing, however, depends on your tax rates upon RRSP or TFSA contribution and withdrawal.

We will use three examples to illustrate the impact of varying tax rates. In each example, we will assume that you have $2,500 of surplus pre-tax earnings annually that can be used to make extra payments on your mortgage or to invest in a portfolio of stocks and bonds in your RRSP / TFSA for retirement.

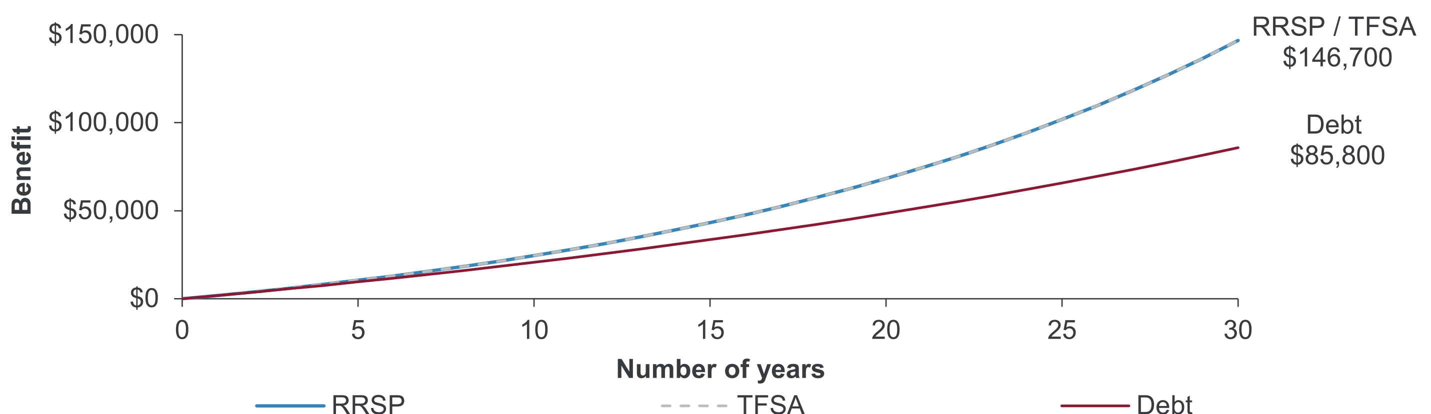
We will assume a 6% rate of return on long-term investments in your RRSP / TFSA[3] and a 3% rate of interest on your mortgage, keeping in mind that you would be taking on more risk by investing in a portfolio of stocks and bonds than the risk-free rate associated with paying down debt.

Example 1 – Marginal tax rate remains the same

Suppose that you expect to have a marginal tax rate of 30%, both at the time of contribution to an RRSP or TFSA and at the time of withdrawal.

Figure 1 shows that if you were to use your surplus earnings to make contributions to an RRSP or TFSA, your after-tax benefit (increase in net worth) would be $146,700[4] after 30 years. If, instead, you were to use your surplus earnings to repay debt, your benefit would be only $85,800.

Figure 1 – Benefit when marginal tax rate is 30% upon contribution and withdrawal; RRSP / TFSA return = 6%; Rate on debt = 3%



[2] As of June 28, 2022, the yield on ten-year Government of Canada bonds was 3.32%, per bankofcanada.ca/rates/interest-rates/canadian-bonds/.

[3] As of June 30, 2022, the S&P TSX Composite Index had an average return (calculated as the geometric mean) of 7.85% (20 years) and 8.69% (40 years) and the FTSE TMX Canada Universe Bond Index (which tracks the Canadian bond market) had an average return of 4.08% (20 years) and 7.96% (40 years). Past performance of the markets is no guarantee that these results can be duplicated in the future.

[4] All numbers in the examples have been rounded to the nearest hundred.

The “RRSP / TFSA advantage” is calculated as the difference between the benefit from RRSP / TFSA contributions and the benefit from debt repayment. The RRSP / TFSA advantage is $60,900 ($146,700 - $85,800) after 30 years when your marginal tax rate is expected to be the same today as it is when you retire.

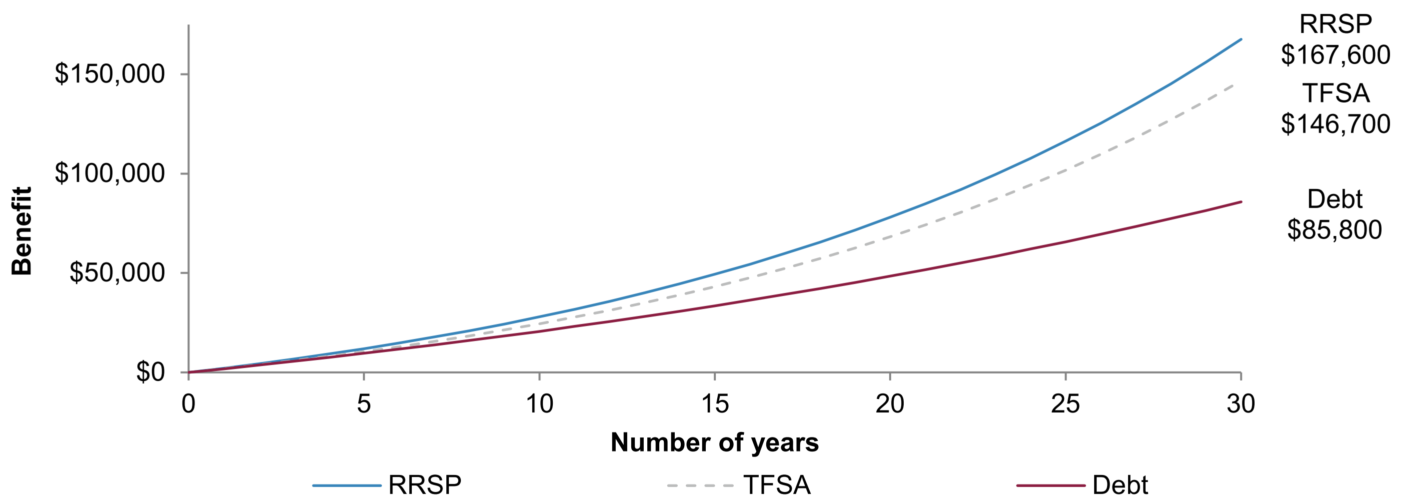
Example 2 – Marginal tax rate drops in retirement

Now let’s look at the benefit if you currently have a marginal tax rate of 30% but anticipate that you will have a lower marginal tax rate of 20% by the time you withdraw funds from your RRSP or TFSA.

An anticipated drop in your marginal tax rate has no impact on the benefit from a TFSA strategy or debt repayment. Figure 2, therefore, shows that after 30 years the TFSA benefit remains at $146,700 (as in Example 1) and the debt repayment benefit remains at $85,800 (also unchanged from Example 1).

In contrast, an anticipated drop in your marginal tax rate in retirement boosts the benefit from investing in an RRSP, since less tax is paid at the time of RRSP withdrawal. Figure 2 shows that after 30 years the RRSP benefit is $167,600. Since the RRSP benefit is higher than the TFSA or debt repayment benefit, an RRSP investment is the better choice.

Figure 2 – Benefit when marginal tax rate is 30% upon contribution and 20% upon withdrawal; RRSP / TFSA return = 6%; Rate on Debt = 3%



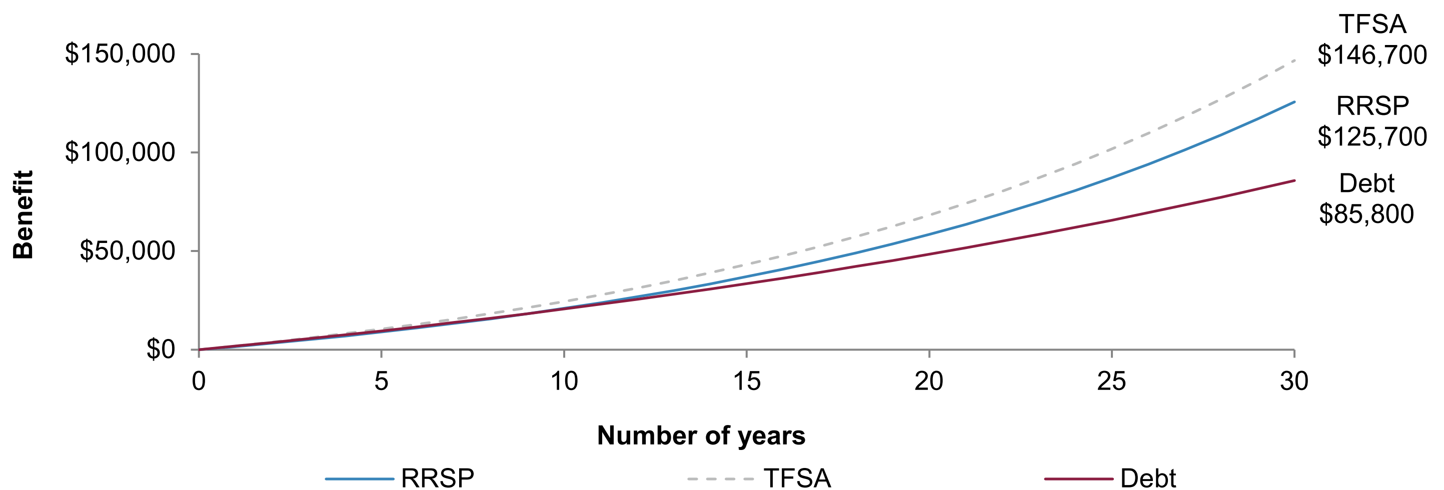
Example 3 – Marginal tax rate increases in retirement

Finally, let’s examine the benefit if you currently have a marginal tax rate of 30% but expect that your marginal tax rate will increase to 40% at the time of withdrawal from your RRSP or TFSA.

As noted in Example 2, a change in your expected future marginal tax rate has no impact on the TFSA benefit or the debt repayment benefit. Figure 3 shows that after 30 years these amounts remain at $146,700 and $85,800, respectively.

On the other hand, when your marginal tax rate at the time of withdrawal is expected to be higher than it is at the time of contribution, more tax is paid at the time of RRSP withdrawal, thereby decreasing the RRSP benefit. From Figure 3, we can see that the RRSP benefit is $125,700 after 30 years, making the TFSA the best choice.

Figure 3 – Benefit when marginal tax rate is 30% upon contribution and 40% upon withdrawal; RRSP / TFSA return = 6%; Rate on Debt = 3%



Conclusion

While you certainly may sleep better at night, you may not be doing yourself any favours by rushing to get out of debt while mortgage interest rates are at lower levels.

If you are able to tolerate some risk in your investment portfolio and have a long enough time horizon before retirement, you may be able to realize a significant benefit by contributing to an RRSP / TFSA and skipping the extra payments on any low-rate debt.

When the rate of return on investments exceeds the rate of interest on debt, investing (either in an RRSP or TFSA) may be a better choice. If you expect your tax rates to remain constant, then you will have an equal benefit from either investing in an RRSP or TFSA. If you expect your tax rate to decrease upon withdrawal, then you may realize a greater benefit from investing in an RRSP than a TFSA. In contrast, if you expect your tax rate to increase upon withdrawal, then investing in a TFSA may yield a greater benefit than an RRSP.

So instead of putting everything towards paying off any low-rate mortgage, consider whether you should focus some of your financial resources on increasing your retirement savings via an RRSP / TFSA.

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