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Should homeowner pay off mortgage or invest in RRSP?

It's RRSP season, and, judging from the avalanche of promotional hype, it may seem there's only one choice for Canadians: invest as much as you can afford into a Registered Retirement Savings Plan, and do it every year until you retire.

When you're 25, saving for retirement 40 years into the future can seem like a luxury while you're struggling under a heavy mortgage burden.

Most mortgages today offer borrowers the option of prepaying up to 10 or 15 per cent of the original principal amount annually. As well, some allow the option of increasing monthly payments by up to double the original amount.

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Taking advantage of these extra payments will pay down the mortgage faster, saving on interest costs, and allowing a 25-year mortgage to be paid off after 22, 18 or even 15 years - depending on the amount and frequency of the prepayments. For many young homeowners, that's just about the time the kids will be needing money for college.

In contrast, a 20-something homeowner can put the money into an RRSP and watch it compound dramatically over the next 40-plus years. Of course, it is fully taxable on withdrawal. Some writers say that the mortgage will be paid off in 25 years in any event, but the RRSP tax benefits will compound tax-free for decades after that.

This assumes that a 25-year amortized mortgage will be renewed after the first five years on a 20-year amortization, and five years later, on a 15-year amortization, and so on until the five-year amortization in year 20. In my experience, many borrowers keep renewing perpetually on a 25-year amortization basis because the payments will be lower than on a shorter amortization.

This way, the mortgage never gets paid off. The truth is that there is no definitive answer. For some, paying down the mortgage is the better alternative, and for others, the RRSP is better.

The experts are divided on the subject but before making a decision there are several factors to consider, including current salary, planned age of retirement, membership in a pension plan and the type of plan it is - private, public or executive.

Here is a thumbnail sketch of some important considerations:

INTEREST RATE. Over the lifetime of the mortgage, the homeowner should compare the expected rate of return of the investments inside the RRSP with the overall mortgage rates during the term of the mortgage.

Generally speaking, if the mortgage interest rates are higher than the return earned inside the RRSP, it is better to pay down the mortgage. If the return inside the RRSP is higher, other factors come into play. Some advisers suggest there is a preference for paying down the mortgage if the mortgage rate is at least two percentage points higher than the investment returns in an RRSP.

For example, if the mortgage rate is 7.5 per cent and the RRSP is earning 5 per cent, it is better to pay off the mortgage.

This is somewhat simplified, and makes the assumption that all of the tax savings from the RRSP contribution are used to pay down the mortgage, or, on the other hand, the increased cash flow from eventually having lower mortgage payments will be used to put more money into the RRSP.

YOUR AGE. The closer you get to retirement, the more important it becomes to have sufficient assets inside an RRSP to fund retirement. But building equity in a home is equally important to many homeowners. If a 25-year old has no RRSP until her mortgage is paid off, 15 years later at age 40, she can still make considerable RRSP contributions over the following 25 years before retirement. That's still lots of time to play catch-up.

YOUR INVESTMENT GOALS. Are you an astute investor with a good track record? If so, investing in an RRSP could produce high returns. If, however, your plan holds bonds or investment certificates, the mortgage might be a better bet.

WORRIES ABOUT LIQUIDITY IN THE FUTURE. An RRSP provides a ready source of funds in an emergency, if it is invested in assets that can easily be cashed. But having a large equity in a home allows a homeowner to obtain an equity line of credit - either unsecured or secured by a second mortgage. The equity built up in the house is its own nest egg.

YOUR PENSION PLAN. A generous workplace pension plan that will provide a secure retirement offers the opportunity to concentrate on the mortgage more than the RRSP. On the other hand, some writers feel the RRSP generally becomes more attractive as the salary increases and the plan becomes more generous. The choice becomes a personal one. Those with no pension plan are usually better off paying down the mortgage if their RRSP is earning less than the rate on the mortgage.

INHERITANCE. By the time many young people today reach retirement, they will have inherited the wealth of their parents or grandparents. If retirement looks secure for this reason, paying down the mortgage would seem to make more sense while they are in their 20s and 30s.

INVESTMENT DISCIPLINE. Once the mortgage is finally paid off, the amount of the former monthly payments should be regularly used to ``catch up'' on the RRSP. Will you have the discipline to do that, or will the new car showroom or travel agent's office beckon?

PREPAYMENT PENALTIES. If there is a penalty to prepay the mortgage, it might be better to wait until the term is over, or switch institutions when possible, to find a lender with prepayment privileges better suited to your needs.

Whichever vehicle you choose for your investments, the bottom line is paying off a mortgage and investing in an RRSP are both important components for a good financial plan. It's just that my preference is always toward paying off the mortgage.

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