

## NUMBER CRUNCHING BY TALBOT STEVEN

# Benefits of RRSP catch-up loans

The "forced discipline" of a larger, longer-term loan can help clients reach their retirement goals

**S**MALL RRSP "TOP-UP" LOANS ARE widely accepted as a sound strategy, especially if they are repaid within a year. But does it make sense for clients to take out a larger loan to "catch up" temporarily on unused RRSP contribution room when it might take 10 or more years to repay?

The concept of leveraging or borrowing to invest — inside or outside of RRSPs — is one of the more controversial strategies in financial planning. Part of the challenge is that there is a lack of information on the subject to help advisors and investors make an informed decision.

Any objective evaluation should accurately account for the tax, mathematical and — perhaps most important — the behavioural implications. Some in the industry have suggested that financial advisors are more in the business of behaviour modification than financial planning. In other words, the critical factor in helping a client achieve their financial goals is your ability to get clients to do what they need to do, which is generally the opposite of what they naturally want to do.

As you know, when clients borrow to invest in RRSPs, the amount invested is tax-deductible, while the interest expense is not. When clients borrow to invest outside of RRSPs, the interest expense is generally tax-deductible and the amount invested is not.

To evaluate the merits of RRSP catch-up loans, consider the case of Kim, who might represent a typical client who should consider a larger RRSP loan.

Kim has \$20,000 of unused RRSP contribution room available, and can confidently invest \$2,000 after tax for each of the next 10 years. Since she is deep in the 40% tax bracket, borrowing \$20,000 to contribute to her RRSP produces a refund of \$8,000. The refund is paid against the loan to reduce the balance to \$12,000, to be paid off over 10 years.

Assuming a 9% cost of borrowing, the remaining \$12,000 loan balance can be paid off over 10 years with annual payments of \$1,715, made at the start of the year. Since the interest is not deductible, this is an

## RRSP catch-up loan analysis

RRSP Value After 10 Years, 9% Interest, 40% Tax

Return	Catch-Up Loan \$20,000	Spend Refund \$1,715/year	Reinvest Refund \$2,402/year	Gross-Up Refund \$2,859/year
0%	20,000	17,160 (-14%)	24,020 (20%)	28,590 (43%)
6%	35,820	23,970 (-33%)	33,560 (-6%)	39,950 (12%)
9%	47,350	28,410 (-40%)	39,770 (-16%)	47,350 (0%)
12%	62,120	33,720 (-46%)	47,200 (-24%)	56,190 (-10%)

ITALICIZED FIGURES IN BRACKETS SHOW THE PERCENTAGE INCREASE RELATIVE TO THE CATCH-UP STRATEGY.

SOURCE: TALBOT'S LEVERAGE PROFESSIONAL SOFTWARE

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after-tax commitment. The remaining issue to factor into the analysis is what Kim normally does with her annual RRSP refunds. As her advisor, you can show Kim how her after-tax investment of \$1,715 for 10 years can be invested in RRSPs in four different ways.

She can get \$20,000 growing tax-deferred in her RRSP today. Alternatively, she could use her cash flow to contribute to her RRSP annually and either spend, reinvest or gross up the refund.

If Kim spends the tax refunds generated by her RRSP contributions, her \$1,715 of after-tax cash flow produces annual RRSP contributions of only \$1,715. If she reinvests the 40% refund back into her RRSP, she gets annual contributions of \$2,402 (\$1,715 x 1.4). Even better is to gross up \$1,715 to an annual contribution of \$2,859. One way to do this is by using a gross-up loan of \$1,144, which, when added to her \$1,715, produces a \$2,859 RRSP contribution. The resulting refund is \$1,144, which completely and almost immediately pays off the loan.

At this point, it is relatively easy to crunch the numbers to show Kim how the RRSP strategies stack up mathematically. Since RRSPs grow tax-deferred, any financial calculator or spreadsheet can quickly reproduce the results in the table.

To be objective and give clients a complete picture of all possibilities, analyse a range of returns. This also ensures full disclosure and thus reduces your business risk, which is important with a controversial strategy such as leveraging.

As shown, when returns match or exceed the cost of borrowing, Kim will be at least as well off by borrowing to catch up temporarily on her RRSP contributions.

**S**ince most clients spend their RRSP refunds, they will end up with much less than they would produce with a catch-up loan, even when returns are as low as 0%.

When returns match the 9% interest expense, Kim has \$47,350 in her RRSP after 10 years using the catch-up strategy, but only \$28,410, or 40% less, by investing the same \$1,715 annually and spending the refunds. As you would expect, when returns are higher than the interest expense, borrowing to get more money compounding earlier always benefits the client.

It is important to explain to clients how the strategies compare when returns are below the non-deductible cost of borrowing. Note the results when returns average only two-thirds of the interest cost, or 6%. This could occur for conservative GIC investors, or if equity markets don't match their historical average of 9% to 12%.

By committing to the catch-up loan, Kim's \$20,000 growing at 6% becomes \$35,820 after 10 years. Even if Kim is very disciplined and reinvests every penny of every refund for each of the 10 years, she will only have \$33,560 10 years later, or 6% less.

The key point is not that the catch-up loan strategy is better for Kim when returns are only two-thirds of the interest expense. What's important is that she is now reinvesting 100% of every refund.

**T**he most significant benefit of using an RRSP catch-up loan, or any investment loan, is the forced discipline and resulting higher level of commitment it imposes on the client. Like a mortgage, paying off an investment loan is a forced savings plan, which is more effective than an automatic

savings plan. Once a mortgage is started, for example, the probability that a client will make the 47th payment is almost 100%.

What is the probability that a client makes the 47th pay-yourself-first payment without interruption? How many clients do you know who have asked to have their monthly contributions “temporarily” suspended?

The numbers show that RRSP catch-up loans benefit clients even when returns are below the cost of borrowing. The real reason to introduce catch-up loans to clients is that

they will increase their commitment to their retirement goal and reduce the chance of self-sabotaging their financial plan by reducing or suspending their contributions.

Critics of investment borrowing might argue that although the mathematics of RRSP catch-up loans are enticing, they should be avoided because of the emotional risks. The value that you deliver as an advisor lies in knowing your clients, and implementing what I call a “conservative” amount of leverage that does not cause clients financial

or emotional stress.

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