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The 5 Step Guide to Borrowing From Your RRSP – Read All the Steps Before Implementing The Strategy

Step 1)

The RRSP mortgage allows you to borrow money from your RRSP account and pay this money back with interest into the same account. The RRSP account is being treated like a lender – and money is being taken from the bank account and repaid to the bank account as if the process was with a lender. The difference here is that your RRSP is receiving the interest, and a bank would act as the administrator, which means it is making sure that you are paying the loan back according to the rules. For doing this, the bank would receive a fee to oversee the process.

You can borrow any amount that you have in your RRSP, but you must have the money in the account to borrow it. The only thing you can use the money for is a mortgage either on a principal residence, or commercial property. You can lend money to someone else as well using this method, but you must do your diligence that there is a secured property that the mortgage is affiliated with, and it is appraised and on title and the usual parameters that exist when buying real estate. The property has to be secured against the RRSP mortgage as collateral. What interest rate can you charge? You have to charge the market rate according to the CRA tax rules (link is below) which can vary from the lowest to the highest amount that is quoted on mortgages at a bank as an example.

http://www.cra-arc.gc.ca/E/pub/tp/it320r3/README.html

Step 2)

What are the advantages?

The interest on the loan is being paid back to your RRSP. Therefore you get to keep the interest.

Since with respect to the RRSP, your loan is deemed to be an investment, the money being paid back will not be taxed until it is withdrawn from the RRSP in retirement, as it would be with any other investment that is made from the RRSP account.

Will an RRSP mortgage affect my credit score? In theory, since you are borrowing money from yourself, this should not affect your credit score since you are the borrower and the lender. If for some reason you don't pay back the RRSP mortgage, and it goes into default, this may show up as an instance where you didn't pay back money that you borrowed. If you are at risk of not paying back the RRSP mortgage or you are not sure of the risk over the life of the RRSP mortgage, contact the providers of the credit sore information. The links are provided below.

https://www.econsumer.equifax.ca/trial_en.html
http://www.transunion.ca/
http://www.freecreditreportsincanada.ca/

Step 3)

What are the disadvantages?

There are fees to set up this arrangement and they can get fairly expensive, but that will depend on how much money you are able to borrow from your RRSP. There is a fee to set up this arrangement with the bank, which is typically a one-time fee. There would be fees for appraisal of the property, mortgage insurance, legal fees for setting up the mortgage, and an annual fee from the bank to administer the mortgage. The larger the amount of money that you are borrowing, the cheaper the fees tend to be as a percentage since the fees are fixed dollar amounts each year. As an example, if you paying $1000 per year in fees to do the RRSP mortgage, this $1000 would apply if the amount borrowed was $50,000 or $500,000. The bank makes sure that you are paying the mortgage back on time and by the rules. There is a sample calculation in step 4 of this document.

Not all banks administer these kinds of mortgages. The ones who do this at this time are B2B Trust (a division of Laurentian Bank), Canadian Western Trust and Olympia Trust. Please note that TD Waterhouse used to administer these kinds of mortgages, but they no longer do so as of April 2012. There is a fair amount of paperwork involved in setting up an RRSP mortgage, but once it is set up, there is little work to do. The links below have application forms as well - read them over to cover any nuances of the institution over and above the CRA rules. The Trust companies listed below will administer these mortgages anywhere in Canada but not in Quebec.

http://www.olympiatrust.com/plans/pdf/Mortgage%20Investment%20Direction%20and%20Indemnity%20Agreement%20Version%2006-2011%20-%20FILLABLE.pdf

https://b2bbank.com/search/results.sn?q=RRSP+mortgage

http://www.cwt.ca/iris/mortgage_broker/IMBA_docs/ArmsLengthInfoPackage_INTER_June2011.pdf

If you have limited funds and you are paying interest into your RRSP for your own mortgage, you may not have additional money to contribute to your RRSP over and above this amount.

You may be losing future compounding from your RRSP future contributions, since money you would have contributed would be coming into the RRSP as debt repayment instead of new money. You must also remember that you would be paying your mortgage anyway, so this may not be relevant to you. If you are lending money to someone else, this is also not going to limit your contribution funds. Your overall financial picture and whether the original reason for borrowing from your RRSP was beneficial are keys to understanding whether future compounding will affect you or not.

If you have a mortgage in your RRSP, you may have a high proportion of fixed income investments, as a mortgage acts like a bond when it comes to risk and return profile. Depending on your situation, this may create too much fixed income in your portfolio and not enough other investments, which could reduce any advantages from diversification.

You can change the terms of the loan agreement once you set it up, but like any mortgage, there would be penalties. You would likely be able to change terms upon renewal to avoid these penalties. The same strategies apply for mortgages as they do for RRSP mortgages. If you want to make lump sum payments, you would have to allow that in the mortgage agreement. If you want to change the interest rate or the length of the contract, this would be done on renewal as well. Thought should be given as to how the whole financial picture looks when you set this up so you don't have to make too many adjustments.

Step 4)

How do I know it is worth it for me?

You would have to first ask: what are all my options with the money from this RRSP mortgage? If you are using it to pay down higher interest debt or to get out of a temporary cash squeeze, this may be the answer for you. Do you have bad credit? If the answer is yes, this idea may work better than obtaining another type of loan, but only if you follow the rules of paying the mortgage back.

This calculator below may help to determine what the income generated would be for a mortgage scenario.

http://www.lifeinsurancecanada.com/mortgage-vs-rrsp

The next question to ask is: will I be able to commit to paying the RRSP mortgage consistently until the next renewal period arrives? If you have a poor history when it comes to discipline, or problems paying off debt in general, this loan may not be for you.

The third question is: how likely is it that I will lose my job over the lifetime of the mortgage? If you have a mortgage with a bank, the situation would be the same. If the answer is likely, or very likely, this loan would not be a good idea unless you have a means of paying the entire amount in a short term - 2 or 3 months.

The fourth question to ask is: what other alternatives are there to this type of loan? If you are borrowing due to a crisis, you may not have many options. If this loan is for a down payment on a house, there may be options but they may be too expensive. All other options should be explored before this one unless you have resources to pay the loan quickly.

As an investor, you would ask “will I get a good rate or return for a low level of risk compared to other investment options?” Look at your past personal investment record and your investment capability as well as your risk tolerance and your ability to manage debt as clues to whether this is a good idea. If you are lending money to someone else, how much faith do I have that they will pay me back? Do I have enough equity in the real estate that is tied to the mortgage that I can foreclose and sell the property and receive my money back after expenses? You should also compare the prevailing market interest rate to the average return on other investments like dividends, bonds or real estate rental properties. The RRSP mortgage would be more lucrative in a higher interest rate environment compared to a low interest rate environment, which is where we are now. You may want to consider this strategy at a later date when the numbers are more favourable.

Example Calculation:

There are two scenarios presented: a $50,000 RRSP mortgage and a $200,000 RRSP mortgage. The two scenarios are designed to illustrate what happens as the dollar amounts get larger. Many articles will tell you that doing an RRSP mortgage is expensive and it can be, but it depends on your situation.

For the $50,000 RRSP mortgage situation, the setup costs will first be tabulated. The application from to the Trustee, or the administrator of the mortgage (Olympia Trust, Canadian Western Trust or B2B Trust) would cost between $50 and $300. $150 will be used as an average. The property would have to be appraised, so an appraisal fee is about $250. A lawyer would be needed to draw up the mortgage document and due the diligence with respect to title, liens and registration, which would be an estimated $1000. Lastly, there would be a need for mortgage insurance. This will depend on the Loan/Value Ratio which is the dollar amount of the loan/the dollar amount of the appraisal value of the property. The closer the ratio is to 1, the higher the risk would be that a drop in the value of the property would jeopardize the mortgage. The highest limit imposed by the CRA is 0.85 – so using this as an estimated loan/value ratio, the cost would be around 2% of the mortgage loan, which is $1000. This is a one-time fee, so the total setup costs would be around $2400. It is assumed that the RRSP is already at an institution that can do RRSP mortgages. If it is not, there may be fees to transfer between the institutions. If you need to sell any investments within the RRSP to make cash available, and these have redemption penalties or selling fees, this should also be added to the setup costs. For all of these fees, it pays to shop around, and fees will vary by institution, lawyer or insurance company. The annual fee for administering the mortgage would be around $200. In the first year, the total fees would be $2600, or 5.2% based on a $50,000 amount. In the subsequent years, this cost drops to 0.4%, or $200/$50,000 per year.

If the RRSP is receiving a 5% interest rate, this translates into $2500 in interest received per year. This means that the first year would not make much return, but you would make about 4.5% in return every year thereafter.

For the $200,000 RRSP mortgage situation, the setup would be similar. These will be identical for the application from to the Trustee, the appraisal, and the lawyer. So far, these costs are about $1400. For the mortgage insurance, using 0.85 as the loan ratio, the cost would be around 2% of the mortgage loan, which is $4000. This is a one-time fee, so the total setup costs would be around $5400. The same transfer fees would apply if the RRSP needs to be transferred between institutions, or redemption fees to sell any investments within the RRSP. The annual fee for administering the mortgage would still be around $200. In the first year, the total fees would be $5600, or 2.8% based on a $200,000 amount. In the subsequent years, this cost drops to 0.1% per year, or $200/$200,000.

If the RRSP is receiving a 5% interest rate, this translates into $10,000 in interest received per year plus any principal amounts that would be repaid back to the RRSP. In this situation, the return would be around 2.2% in the first year, and 5% in every year after that.

For the $200,000 situation, the fees are much cheaper in proportion to the $50,000 amount, so this will be important in deciding whether to implement the RRSP mortgage or not. You should also look at what the alternative investments returns are, and what fees they charge. An MER on mutual fund can go between 1% and 3%, and sales fees can be 5% to buy, and another 5% to sell unless you hold them for a long period of time. This should be investigated for what investments you have in your RRSP and how they compare. The volatility of the returns should also be considered as a mortgage to yourself is one of the safest returns you can achieve.

Step 5)

Alternative arrangements

You can borrow money from your RRSP for your own needs. You can also borrow money from a RRIF or a Locked in Account the same way, depending on what province the plan is administered in. If you don't need money for yourself, you can lend money to someone else provided that you do the diligence such that the borrower will pay the loan back. You can also do an RRSP mortgage for an investment property and deduct the interest from your tax return.

Other Sources:

http://www.boomerandecho.com/pros-and-cons-of-holding-your-mortgage-in-your-rrsp/

http://www2.canada.com/business/fp/money/rrsp+house+mortgage/6138321/story.html?id=6138321

http://www.barrymcguire.ca/home/123-you-can-have-your-cake-a-eat-it-too-says-the-cra.html

http://wheredoesallmymoneygo.com/holding-your-own-mortgage-inside-your-rrsp/

If you need specific information for your needs, contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This article is intended for people who want to learn about the world of finance and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**