RRSPs versus mortgages: What should you pay down first?

It's an age-old question—slash your house payments or save more money? Here's how to decide.

Every Canadian homeowner has likely asked themselves if they should pay off their mortgage or contribute more to their registered retirement savings plan (RRSP). For Dawna Satov, a self-described "nervous Nelly," the answer was easy: "I made a conscious decision to focus on paying down the mortgage first, which probably has to do with my erratic income," says the 65-year-old Toronto-based real estate professional, who works on commission. "It was important that if anything happened and I couldn't work, my monthly expenses would be less."

Most others, though, struggle with the decision, since both options can help you achieve your long-term retirement goals. Pay off your mortgage early, you'll have more to invest later on; save now, and you'll have more time to grow your money. Satov, a mom of three, chose the first option. She paid off her primary residence in 2009 and then started investing more in her RRSPs. "When my children were little, we felt it was important that if something happened to us, we wanted to be as mortgage-free as possible," she says.

While there's no right or wrong answer, here are some things to consider when trying to decide what you should do first.

Pay attention to tax

Start by looking at your income. If you're in a high tax bracket now and expect to be in a lower one in retirement, then saving in an RRSP first could make sense. That's because the money you invest during your working years will reduce your taxable income, which could lead to tax savings, while the tax paid on the money you withdraw is based on your current tax bracket, which is typically lower in retirement. However, if you expect to be in a higher tax bracket in retirement than you are now, prioritizing mortgage payments may be the better way to go.

Calculate the rate of return

Paying down your mortgage offers a guaranteed rate of return, since you know how much interest your lender is charging. If your mortgage rate is 3% then you'd be earning a 3% return by paying off your debt. If you're a more conservative investor, then the interest savings may be greater than what you would earn on your low-risk investments. However, if you're more aggressive and think you can earn a higher return in the market, say, 5%, then you may want to utilize your RRSP. Of course, market returns fluctuate. If you have a bad year then you could make less—and even lose money—than you would by paying down your mortgage.

Know yourself

Some people hate carrying debt, while others prefer to see their bank balances rise. If being in debt bugs you, then it's OK to pay the mortgage off first even if you may be able to make more money in the market. If you like knowing that you have money saved up for retirement then it's fine to invest in an RRSP. However, there is a little more to it than that. If you know you won't increase your RRSP contributions once the mortgage is paid off, then it may be better to save on a regular schedule since you're already paying down your mortgage every month.

Think about employment

If your employment situation is less stable—maybe you're an entrepreneur and don't receive an income every week or you're on contract work—then consider paying off your mortgage. Life is a lot a lot less stressful when your biggest debt is taken care of. And if you are mortgage-free, being between contracts won't be as challenging as it might be if you have regular house payments to make. On the flipside, if you're working at a place that has an employee matching program, where if you save 5% of a paycheque the company kicks in the same amount, then investing that money—and especially the workplace contribution—is ideal.

Consider your age

Age can play an important part in this decision, too. If you're young and have a long investment time horizon then you can afford to lose money if markets decline. For you, it may be better to invest in the market since your money should grow significantly over your lifetime. However, if you're near retirement and your mortgage isn't paid off then consider cutting it down. It's a good idea to have as little debt as possible, as you may not earn enough in retirement to continue making big payments.

While there are some other factors to consider—will you get dinged a hefty pre-payment fee when you put a lump sum on your mortgage? Do you have high-interest-rate credit card debt that should be eliminated first?—generally, you will be better off prioritizing your RRSP if you think those investments will outperform your mortgage rate. Otherwise, pay off your home. If you really can't decide, there's always the combo approach: maximize annual RRSP contributions and use the tax refund to pay down your mortgage faster.