

# Too much Money in Your RRIF?

## Don't Blame the Mandatory RRIF Withdrawals!

by Jim Otar, CFP, M.Eng.

Here is the basic premise of registered retirement savings (RRSP): The government allows you to save for retirement in an RRSP tax-free during your working years. When you retire you convert this to a registered retirement income fund (RRIF). The government expects to recover those deferred income taxes when you withdraw from the RRIF. To make sure these deferred taxes are collected sometime during your life, there is a minimum mandatory withdrawals for each age. Sounds like a good deal.

A recent research paper by the C.D. Howe Institute ("Outliving Our Savings: Registered Retirement Income Funds Rules Need a Big Update" by William B.P. Robson and Alexandre Laurin, June 4, 2014) suggest that the "high" mandatory withdrawal rates from RRIF accounts are the main cause of premature portfolio depletion. Others have joined the debate, with the ultimate goal of "reforming" the RRIF regulations so that these minimum withdrawals be decreased and taxes are deferred longer. Some even go further and suggest that doing so will eventually give governments more income tax revenue. I am sure we will hear more arguments from experts as the plot thickens.

It is implied that this "problem" applies to everyone with a RRIF. In reality, it applies mostly to those who are lucky enough to save large amounts of money in their retirement savings. I would not be surprised if we soon see a chorus of chatter from the financial industry demanding a reduction of RRIF minimums so we all (except the government) can hang on to our tax-deferred assets longer.

Let us try to answer one key question: **Do current mandatory withdrawal levels indeed cause retirees run out of money prematurely?** If our answer is "no", then all other arguments become irrelevant.

In our analysis, we use actual market history which we call "aftcasting" (as opposed to "forecasting"). We do not use Monte Carlo simulators or average returns, nor average inflation. Aftcasting displays the outcome of all historical asset values of all portfolios on the same chart, and it gives a bird's-eye view of all outcomes for a given scenario. It provides the success and failure statistics with exact historical accuracy because it includes the actual historical equity performance, inflation and interest rate, as well as the actual historical sequencing/correlation of these data sets.

For the equity benchmark, we use SP/TSX historical data since 1919, the earliest available data. As for the fixed income portion of the portfolio, we use the historical interest on 6-month CD plus a premium of 1% as the net yield for the fixed income portion of the portfolio. This reflects approximately a bond ladder with an average maturity of 5-7 years at current yields, no defaults, no capital gains and losses.

Rebalancing occurs annually if the target asset mix deviates by more than 3%. The withdrawal amount is indexed annually to CPI.

We have three hypothetical scenarios. Common to all are: \$500,000 in the RRSP, 40% equity and 60% fixed income, rebalanced annually if the target asset mix deviates by more than 3%, the owners are 65 years of age and they are just retiring. They want their money to last until age 100. Here is what differentiates each scenario:

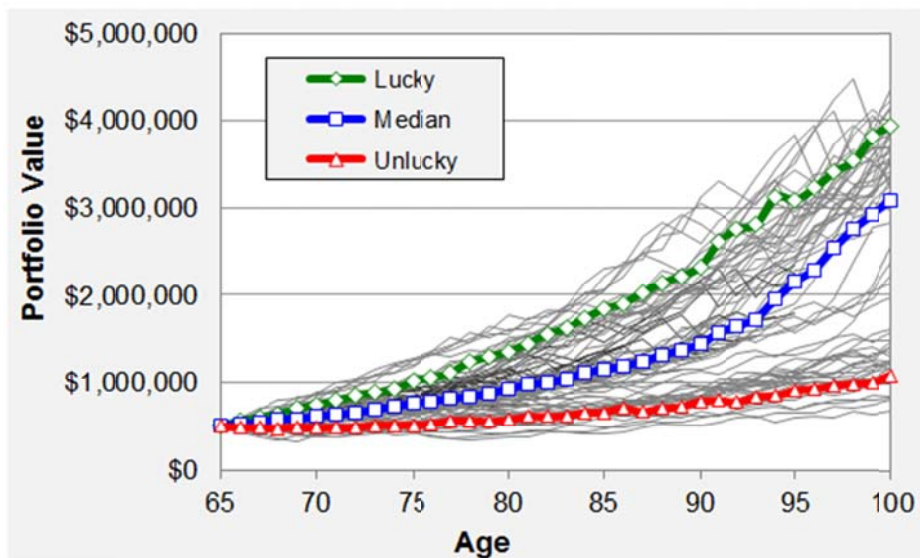
Scenario 1: Bob has a lot of other income. He needs only \$10,000/year from his RRSP/RRIF.

Scenario 2: Debbie needs \$30,000/year from her RRIF

Scenario 3: Mark needs \$40,000 from his RRIF

**Scenario 1:** Bob needs \$10,000/year, indexed to CPI, from his retirement savings. Until he is 71, he just withdraws this amount from his RRSP. At 71, he converts his RRSP into a RRIF. At age 72, the minimum mandatory withdrawal rate is 7.48% of the portfolio value at the end of the previous calendar year. Now, he is forced to withdraw a lot more than he needs. He pays the income tax on that and saves or spends the remaining excess RRIF income.

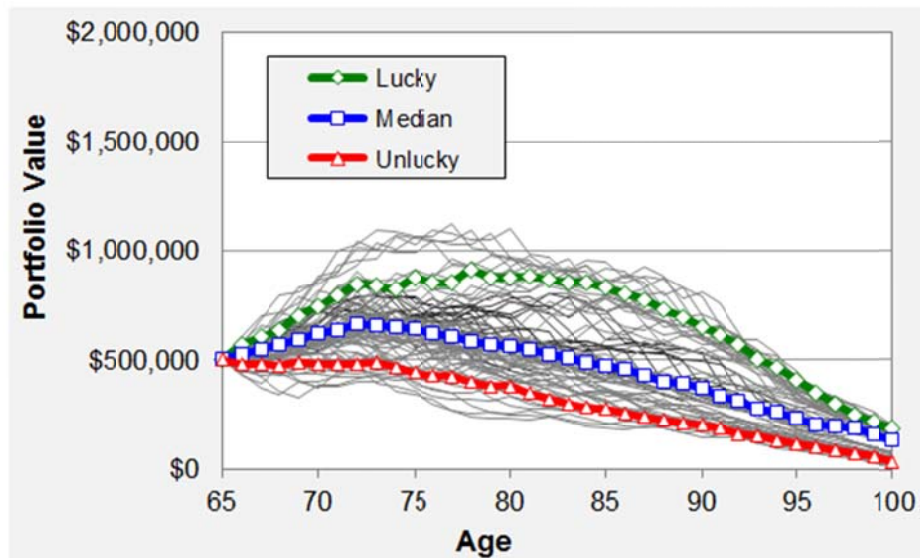
If there were no mandatory minimum withdrawals from his RRIF, this would have been aftcast:



This chart depicts aftcast for this portfolio. Each of the gray lines represents one specific starting year since 1919. The heavy blue line represents the median portfolio where half of the gray lines are above it and the other half are below. The green line on the chart is the “lucky” outcome which is the top decile (top 10%). The red line is the “unlucky” outcome, the bottom decile.

If the RRIF minimums did not exist, Bob would accumulate about \$4 million if he is lucky (i.e. markets dealt them a good hand), about \$1 million if they were unlucky and about \$3 million if they had the median outcome, all tax-deferred money!

The reality is, there are the mandatory RRIF withdrawals and he must pay his fair share of deferred taxes. Here is the aftcast:



In this case, even with the “high” mandatory withdrawals, the RRIF portfolio did not deplete during his lifetime. There was still some money left at age 100. And that is what RRIFs were designed for originally.

The bottom line is, if the 65-year old retiree needs less than the sustainable withdrawal rate (which is somewhere between 3% and 3.5% for a 35-year time horizon), indexed to inflation, then the current mandatory RRIF withdrawals do not cause the portfolio to run out of money. Even if he lives beyond age 100, he can save some of the surplus that he had throughout his retirement for the remaining few years.

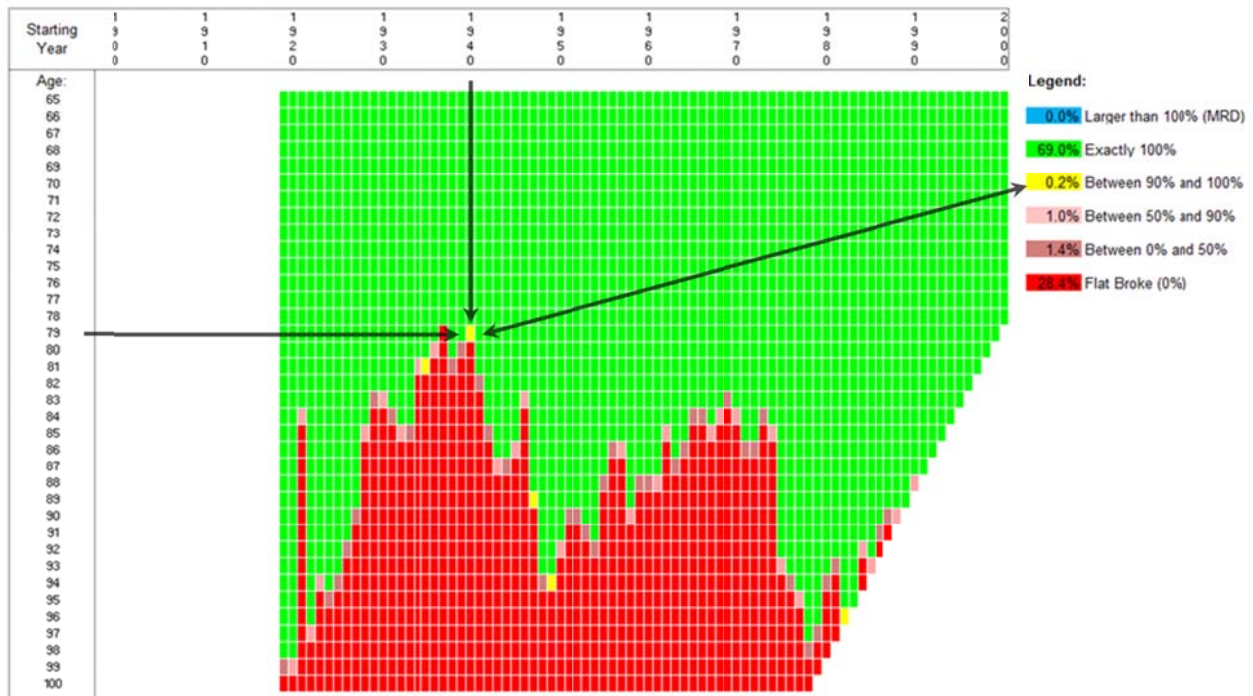
Do you think it is fair to expect working taxpayers to subsidize this tax deferral by reducing or removing the current minimums so that Bob can grow his RRIF to millions tax-free?

**Scenario 2:** Debbie needs \$30,000/year (indexed to CPI) from her RRIF. This amounts to a 6% initial withdrawal rate.

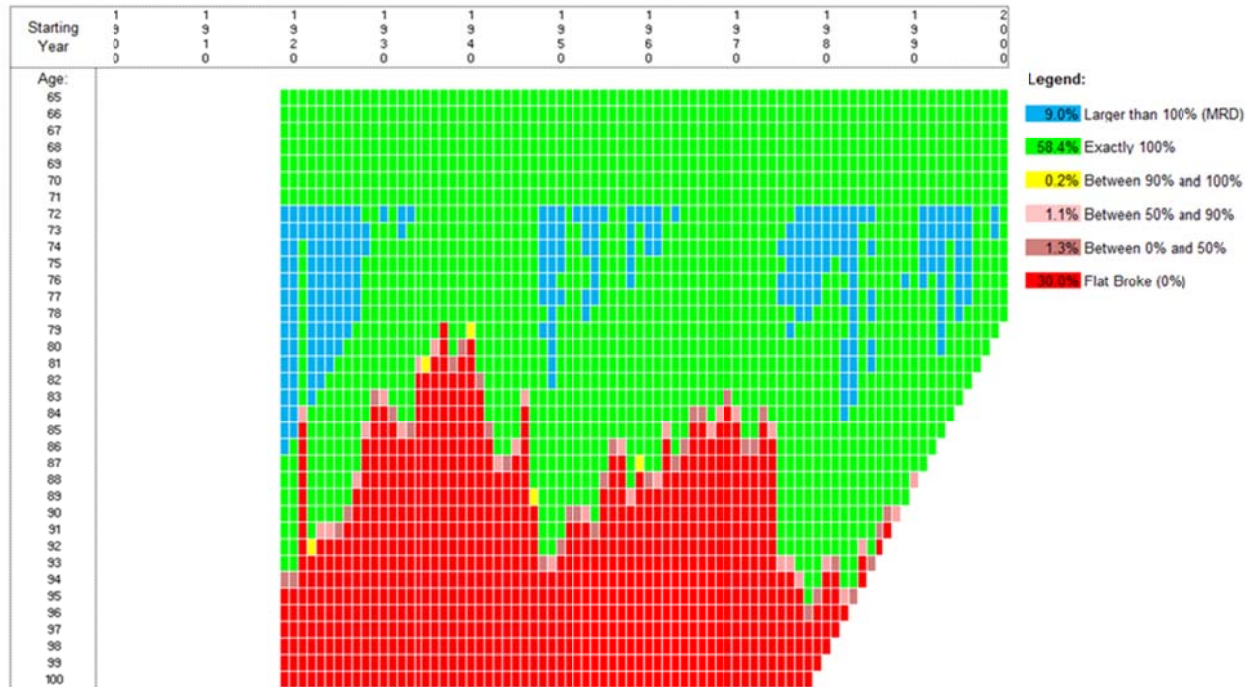
Now, we look at an “income carpet”. On this chart, the horizontal scale represents all starting years between 1919 and 2000. The vertical scale is the age. Each “knot” of the income carpet shows the level of income received for that age at that starting year, as a percentage of total income required in real, inflation-adjusted dollars. For example: for the starting year 1940 (the vertical arrow pointing down), when Debbie reached age 79 (the horizontal arrow pointing right), her income which is indexed to inflation for all years between age 65 and 79 (using actual historical inflation between 1940 and 1954), was between 90% and 100% of what she required from her portfolio, indicated by a yellow pixel, just before depleting in the following year at age 80.

Different colors indicate different ranges of percentages as indicated in the legend to the right of the chart. In a nutshell, green is good, red is bad. Blue means that the mandatory withdrawals are larger than what the retire needs for that starting year and that age. He can either spend the surplus or save it in an open investment account after paying the taxes.

The following chart shows the income carpet of Debbie, if there were no mandatory withdrawals:



We see here, that with no mandatory withdrawals at all, Debbie’s portfolios would be totally depleted in 28.4% of the time. However, this is a RRIF portfolio so the mandatory withdrawals apply. Here is the income carpet when mandatory withdrawals are included:



We see here, with mandatory withdrawals, Debbie’s portfolios would be totally depleted in 30% of the time. In other words, her higher-than-sustainable income needs caused a failure rate of 28.4% and the mandatory RRIF withdrawal caused an additional 1.6% failure.

In terms of absolute percentage, 95% of the failure was caused by their high withdrawal rate, which can be as a result of anything: insufficient accumulation, rosy assumptions, larger than expected portfolio costs/losses, bad planning, bad investments and so on. The remaining 5% can be attributed to Canada’s “high” mandatory withdrawal rates. Even if you totally eliminate the mandatory withdrawals, this would not put a dent in solving the problem.

**Scenario 3:** Mark needs \$40,000/year (indexed to CPI) from his RRIF. This amounts to a 8% initial withdrawal rate. We go through the similar analysis as we did for Scenario 2. Here are the results: If there were no mandatory withdrawals, their portfolios would have depleted in 48.2% of the time. With mandatory withdrawals, it would be exactly the same, 48.2%!

In terms of absolute percentage, 100% of the failure was caused by their high withdrawal rate, and 0% because of “high” mandatory withdrawal rates.

**Conclusion:**

The Canadian market history shows that the so-called “high” mandatory RRIF withdrawals have negligible or no effect on those who need income from their RRIFs or who are unlucky with their savings. On the other hand, it does a good job of recovering deferred income taxes from those who get lucky with their investments.

Once you see the historical perspective in such detail, it becomes clear that the current RRIF minimums are a fair system and there is no need to further subsidize those who get lucky in the process.

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