Making Extra Mortgage Payments? Not so fast.

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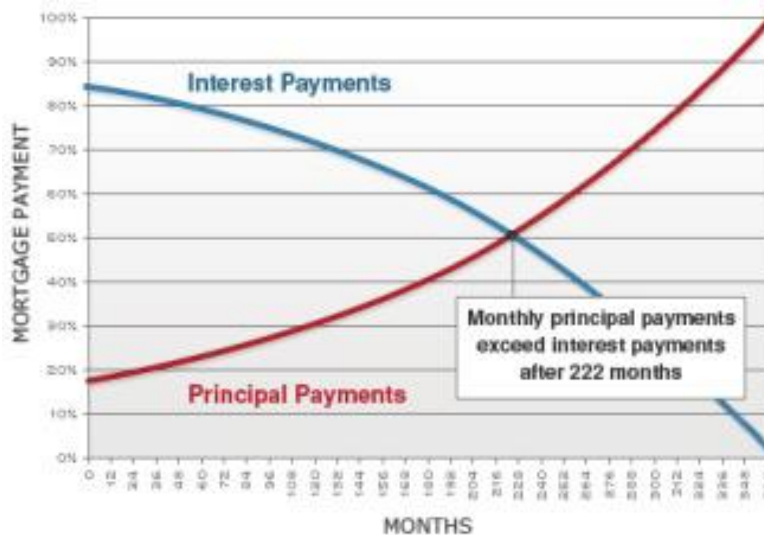
You recently bought a home. Congratulations. Your new mortgage company just sent you a payment statement which includes a teaser saying "*you can save a lot of money by paying extra each month.*" Before jumping on that, consider the following:

1. Mortgage interest – at least in most states – is calculated differently from interest on other items (like credit cards). Essentially, the majority of your first monthly payment is interest while the last is mostly principal. When you make the regular monthly payment that applies to the next payment due. And any extra payment applies to the last payment due. For example, assume your monthly mortgage payment is $2000 on a 30-year loan. The first payment of that schedule includes about $360 in principal and $1640 in interest. Conversely, the last payment includes about $60 interest and $1940 in principal. If you make a double payment of $4000 (to "save" interest), all you're saving is $60 – thirty years from now. Put another way, that's a return of less than 0.1% per year.



   If you "invested" that extra $2000 payment in anything – even a money market account paying a "whopping" 1% you'd have $2695.70. In other words, you'd have gained $695.70 instead of "saving" $60. Now imagine that math compounding each and every payment for 360 months. Now imagine that you actually get a decent return (5-7% per year).

2. Mortgage payments are fixed (not counting Adjustable Rate Mortgages). They do not increase through the years with inflation. That means, when adjusted for inflation, they become progressively smaller over time. For example, start with a $2000 monthly payment today. Assuming an average inflation of just 2.5%, thirty years from now, the inflation-adjusted equivalent is just $953.49. It's called the Time-Value of Money.

3. Despite popular opinion, a home (meaning your primary residence; your personal dwelling) is not an investment. Everyone must live somewhere so there is no reasonable ability to "liquidate the

investment (meaning sell your home) to take profit." And regardless of what the house was worth when you bought it – and regardless of how much of it "the bank owns," when you sell it, any increased value is yours. For example, suppose you buy a $500,000 home for $0 down and your best friend buys an identical house for $500,000 with cash. Later you both sell for $550,000.
Both of you "pocket" $50,000. The fact that one was mortgaged and the other was not makes no difference in profit.

4. Mortgage interest deduction: OK so here's the one that everyone *thinks* is the best reason to not pay off a mortgage that's actually not. Under current tax code, you get to deduct mortgage interest when it exceeds 10% of your Adjusted Gross Income. So if you just bought a house with a $2000 monthly mortgage and your annual interest is $19,680 ($1640/month from the above example) and your taxable income (AGI) is $196,800, you get NO mortgage interest deduction. OK so maybe you don't earn that much. Maybe you only earn half. Great. Your mortgage interest deduction will be $9840 in the first year. That's good, except getting a $9840 deduction doesn't mean you actually "save" $9840. What you save is the tax that would be otherwise due. Thus, if your net effective tax rate was 20%, what you save is $1968. And that gets progressively smaller each and every year for about 12 years; then it goes away – and that's assuming you never get a raise. From that point on, no deduction. But, if you have a 30 year mortgage and you double up on every monthly payment, you "save" 15 years. Except the deduction would only last about 12 years, meaning there are three years where you would get no mortgage interest deduction. In addition, for most of those 12 years, the tax savings will be significantly less than $1968 (based on the above example). At the end of the day, the total savings is modest at best and while any savings is good, the magnitude of the savings is not what people commonly think and many people get none.

Is it ever OK to pay off a mortgage early?
There are times when paying off a mortgage early does make sense.

1. If you expect your retirement income will be less than while in your earning years, then timing the completion of house payments for retirement makes sense. In addition, the added monthly payments creates a net budget that will more closely approximate what your retirement income would look like when you get there.

2. Peace of mind. There are people who simply do not like the burden of having a house payment loom over their heads. This would be particularly true for someone in a job situation where long-term employment is uncertain. Having no mortgage payment protects the home from foreclosure if employment is suddenly terminated and prospects of finding a new job are low. A consideration of age in this situation is critical. The older people become, the less likely they will be hired in a new job comparable to their previous one. Employers typically want younger workers who will be around a long time (yes, the irony is palpable) and who they can pay less.

3. Medical issues. A person who has a developing or worsening chronic illness may find getting out from under a mortgage before the disease worsens to a point of being very expensive is a big financial advantage and in line with good planning.

4. Interest rates are rising and you have an Adjustable Rate Mortgage (ARM). Less common now than a decade ago, these lending devices are structured to provide a low monthly payment in the initial years and rises later when (presumably) you earn more and can afford more – at least that's the "official" theory. However, it was ARMs that gave rise to the mortgage default bubble in 2007. None-the-less, if you have one, getting out from under it is a good idea.

Different ways to pay off a mortgage early.
There are two distinct ways to reduce a mortgage without doubling up on mortgage payments.

1. Refinance. Even with recent historically low interest rates, there are ways to refinance to advantage. For example, rather than doubling up on mortgage payments, refinance to a shorter term. Depending on individual circumstances, you may be able to significantly shorten your mortgage time for less money and, at least for a while, actually get a mortgage interest deduction in the initial years of the new loan cycle.
2. Pay off lump sum. This is without doubt, the quickest way to pay off a mortgage and there is one event which would favor this direction: inheritance. If you are the recipient of an inheritance, using some of the money to pay off the house can offer a significant benefit.
    a. Unless the inheritance is from an IRA (or similar), there may be no tax consequence for liquidating the inherited asset. This is because you get a "Step-up in Basis" meaning you inherit the invested asset at fair market value on the date of death and can be sold with no taxable gain.
    b. You were not (or should not have been) relying on the inheritance for your daily living needs. Thus, using the "windfall" to secure your financial future may well be a smarter use of the money than buying some fancy toy or even investing it for future return.

Summary:
The decision to pay off a mortgage ahead of schedule is something to discuss with an independent financial planner; not your mortgage banker or representative who has a conflict of interest in providing that advice. Think about it. Paying it off early is decidedly in their benefit. First of all, if there was a strong advantage in having a different mortgage schedule, why do you have one that you do? Second, as has already been shown, the majority of your interest is paid up front so the mortgage company has already made most of their money. When you pay off principal early, the lender benefits because they just reduced their debt load and increased their liquidity ahead of schedule. They now get to go loan *your* money to someone else, and make a lot more because the interest is mostly up front. Therefore, while there are times when paying off a mortgage early does and can make sense, do not buy into the canned line "you'll save so much" because that's simply not true.

Additional Reading:

Business Insider. Aug 23, 2016. http://www.businessinsider.com/im-worth-15-million-and-id-never-recommend-paying-off-your-mortgage-early-2016-8

Personal Finance. July 16, 2017. https://dqydj.com/why-you-shouldnt-pay-off-your-mortgage/

US News & World Report. Dec 3, 2015 https://loans.usnews.com/things-to-consider-before-paying-off-a-mortgage-early