MAKING EXTRA MORTGAGE PAYMENTS? NOT SO FAST

While paying off your home's mortgage may give you a great feeling of liberation and peace of mind, if you're doing it to save money, it may not be as good of a deal as it sounds on the surface.

By: Michael Tove- September 13, 2018

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

Before jumping on that, consider the following:

1. You Might Not Be Saving Very Much.

Mortgage interest is calculated differently from interest on other items (like credit cards). Essentially, the majority of your first monthly payment is interest, while the last payment is mostly principal. Each regular monthly payment you make applies to the next payment due, and any extra payment applies to the last payment due.

For example, assume you have a 30-year mortgage with a monthly payment of $2,000. Your first payment includes about $360 in principal and $1,640 in interest, while the last payment includes about $60 in interest and $1,940 in principal. If you made a double payment of $4,000 (to "save" on interest), all you're saving is $60, and that's 30 years from now. Put another way, it's a return of less than 0.1% per year.

In other words, making those extra payments is like paying off an interest-free loan prematurely. You save next to nothing and now don't have the money to work for you in your own account.

2. You Can Probably Out-Earn the Mortgage Interest You'd Save.

If rather than make that extra $2,000 payment, you invested it in anything — even a money market account — paying 1% interest, after 30 years, it would have grown to $2,695.70. In other words, to "save" $60 in interest, you gave up $695.70 in interest. Now imagine that math compounding each and every payment for 360 months. Now imagine that you got a decent return.

For example, suppose you have a 30-year loan of $419,000 at 4% interest. Your standard monthly payment of principal plus interest would be $2,005. If you paid an extra $2,000 per month, you'd save almost $204,000 in interest and pay the loan off in under 11 years, shaving about 19 years off your payment schedule. Sounds pretty good, right? Not so fast. It might not be the best use of your money. Here's why:

Suppose instead of making extra payments, you deposited the $2,000 per month in an account earning that same 4% per year. You would have contributed a total $720,000 plus earned $679,000 on that sum, for a grand total of nearly $1.4 million. Since you didn't pay off the mortgage early, you would still pay around $300,000 in interest over the course of 30 years, but you would end up $379,000 ahead. That handily beats the $204,000 you would have saved by prepaying the mortgage.

3. You Lose to Inflation.

Unless you have an adjustable rate mortgage (ARM), mortgage payments are fixed, meaning they remain constant. Thus, when adjusted for inflation, they become progressively smaller over time. For example, assuming 2.5% inflation, a $2,000 monthly payment today is the inflation-adjusted equivalent of $953.49. If the banker said you could pay $2,000 now or $953.49 tomorrow, it'd be an easy decision to pay less later. Unfortunately, the message of "pay extra and save" fails to consider the Time Value of Money.

4. Mortgage Payment Schedules Have No Impact on "Profit" When You Sell the Home.

Despite popular opinion, a home (meaning your primary residence; your personal dwelling) is not an investment, and regardless of what you paid for it, when you eventually sell, any increased value is yours. For example, suppose you buy a $500,000 home with $0 down and your best friend buys an identical house for $500,000 cash. A year later you both sell for $550,000. You both "pocket" $50,000.

The fact that one was mortgaged and the other wasn't, makes no difference. Where the real difference lies is that you used a bank's money to buy your house and kept your money in your own pocket, (allowing it to work for you), instead of giving it all to the seller (and allowing it to work for them). Money only works for one party and that's the party that possesses it.

Is it ever OK to pay off a mortgage early?

Yes! There are some valid reasons why someone might want to pay off their mortgage early.

1. If you expect your retirement income will be less than your earning years, then timing the completion of house payments for retirement may make sense.
2. Peace of mind. There are people who simply do not like having a house payment loom over their heads. This would be particularly true for someone in an uncertain job situation. Having no mortgage payment protects the home from foreclosure if employment is suddenly terminated and prospects of finding a new job are low.
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. 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 contributed to the mortgage default bubble in 2007. If you have one, paying it off sooner than later is a good idea, as interest rates are on the rise these days.

Are There Other Ways to Reduce a Mortgage Payment?

Yes. Rather than paying your mortgage off early, you may want to consider refinancing, although as interest rates rise, the value of this option may be vanishing.

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. If there was a strong advantage in having a different mortgage schedule, why did your mortgage lender recommend the schedule that you have?

Also, with the majority of interest being paid up front, the mortgage company has already made most of its money by the time you pay the mortgage off. When a borrower pays off their loan early, the lender benefits, because it just reduced its debt load and increased its liquidity ahead of schedule. The lender now gets to go lend your money to someone else, and make a lot more.

Therefore, while there are times when paying off a mortgage early can make sense don't buy into the canned line "you'll save so much," because in many cases, it simply may not be true.

Michael Tove Ph.D., CEP, RFC, president and founder of AIN Services, is an insurance licensed Certified Estate Planner and Registered Financial Consultant. Dr. Tove's philosophy is that every client, regardless of net worth, deserves the best planning possible.

For more information, call 800-363-2296 or visit www.ain-services.com.

Advisory services offered through CoreCap Advisors, Inc., a registered investment advisor.
AIN Services and CoreCap are separate and unaffiliated entities.