Research Paper

Should I Pay Off My Mortgage Early?

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INTRODUCTION

Many homeowners will often wonder if they should use a portion of their investible assets to pay off their home mortgage. This is primarily a mathematical exercise, but also must take into account factors such as risk to future income, the homeowner's desire to eliminate debt, and a need to divert the monthly payments used to pay the mortgage to fund other savings or expense categories.

This paper will summarize the benefits and disadvantages of paying off a mortgage early and provide a recommended analysis process.

BENEFITS OF PAYING OFF YOUR MORTGAGE EARLY

1. Reduce money spent on interest.
    a. Each month that you make a mortgage payment, a portion of that payment is going toward interest. By reducing the number of mortgage payments made, you reduce the amount paid for interest.
    b. Paying off your mortgage early could save tens of thousands of dollars. To assess the potential interest saving, examine your loan payment schedule to assess the overall (or remaining) amount of payments owed that cover the interest portion of the loan.
    c. As the remainder of the mortgage term decreases, the value of prepaying (from an interest payment reduction factor) also decreases. This is due to the structure of most home mortgages, which weigh the interest portion of the monthly payments highest at the beginning of the loan term. Thus, as you near the end of the loan term, most of the monthly payment is applied to the principal, and a small portion is applied to interest.

2. No more monthly payments. By eliminating monthly mortgage payments, you free up that cash to put toward other investments or expenses.

3. You own the home outright. For many, this is a significant motivation, as they may fear financial uncertainty regarding job/income security and fluctuations, they may not want to leave heirs with debt, or they just feel more comfortable by eliminating debt.

DISADVANTAGES OF PAYING OFF YOUR MORTGAGE EARLY

1. You may be able to earn more by investing the available cash instead of paying off the mortgage. If your projected after-tax investment rate of return is greater than your mortgage interest rate, that will favor investing the money instead of paying off the mortgage.

2. Some banks have mortgage prepayment penalties. This is rarely imposed beyond the first 2-3 years of a mortgage, but you should always check with your lender before making pre-payments.

3. If you itemize deductions on your tax return, you will lose the mortgage interest tax deduction. Most taxpayers are now leveraging the increased standard deduction, so this is less likely to be a factor for most homeowners.

4. Paying off your mortgage may slightly reduce your credit score. Several factors make up your credit score, and 10% of your credit score is based on your mix of credit types (car loans, mortgages, revolving debt). This should be a fairly small drop, and I wouldn't weigh this factor heavily, but it's something to consider.

BOTTOM LINE

When analyzing your particular situation regarding a mortgage prepayment, consider:

1. When comparing the interest, dividend or capital gain potential that your available cash may earn instead of using it to pay off your mortgage, ensure that you are looking at the after-tax rate of return of the investment for a fair comparison.

   Example: if your mortgage interest rate is 4%, and you expect a rate of investment return (pre-tax) of 4.5%, your analysis may initially lead you to favor the investment. However, if your tax rate on the investment return is 25%, your net after-tax investment gain is 3.375%, which leads to paying off the mortgage debt as a more-favorable option.

2. If you are itemizing deductions, ensure that you are accounting for the net tax payment savings related to your mortgage interest deduction when comparing the benefit of pre-payment vs. the benefit of maintaining the mortgage.

3. When paying off a mortgage early, or making excess payments against your mortgage, make sure that all extra payments are applied to your principal, not interest.

4. Once you make an early payment or pay off a mortgage in full, you can't undo that action. A good option that allows the homeowner to retain flexibility in the use of excess monthly income or cash on hand is to consider making limited mortgage pre-payments, either by converting to a biweekly payment schedule or by making homeowner-initiated periodical payments against your remaining principal. This has several advantages:
   a. It reduces the amount of interest paid over the life of the mortgage.
   b. It reduces the loan period, resulting in an earlier mortgage pay-off date.
   c. You retain the flexibility to skip prepayments in case situations arise that require the excess income or cash to be used for other purposes.

REFERENCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. https://www.bankrate.com/mortgages/early-payoff/#pros-v-cons
2. https://www.principal.com/individuals/build-your-knowledge/should-you-pay-your-mortgage-answer-may-surprise-you
3. https://www.schwab.com/learn/story/should-you-pay-off-mortgage-before-you-retire