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Pre-Retirement Mortgage Payoff?

The decision is not as cut and dry as it appears.

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By Walid L. Petiri | Posted: 03-16-12 | 04:00 PM | Email Article

Should you own your home, free and clear, before you retire? At first blush, the answer seems obvious: yes. In retirement, you will live on a fixed amount -- from investments, Social Security and pensions – and likely less income than when you were working. So losing the mortgage millstone seems like a very good thing.

Lots of people are facing this question, According to the Pew Research Center, over 10,000 baby boomers will turn 65 every day for the next 19 years. Why not make extra mortgage payments to get the job done before retiring? Plus, gain the emotional comfort of being debt free at a time when your earning power is diminished.

The reality is that the decision is not as cut and dry as it appears. If you decide to put more money toward your mortgage, that money potentially could do more for you if directed elsewhere. Should you pay down low-interest mortgage debt, or should you invest the money into a tax-advantaged account that could yield a higher future return?

About the Author

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Mortgage loans are near all-time lows

The current interest rates on most mortgages are below 4% for a 30-year conventional loan, according to Bankrate.com. Because mortgage interest is tax deductable, if your home loan carries a 4% interest rate, your after-tax borrowing rate could be 3% or lower. Even for homeowners whose mortgages are underwater -- meaning their home is valued at less than they owe -- low interest rates and tax benefits still endure.

Ultimately, when paying your mortgage off early, you assume there is a greater value in reducing your debt than in building your nest egg. And you assume your investments earn a higher return than your mortgage rate.

Before tackling mortgage debt, though, focus on paying off credit card or other non tax-deductible interest rate debt. Cards often carry yearly rates around 16%, Bankrate says.

What if your house is underwater?
Prepaying an underwater mortgage is senseless unless you are planning to retire at your current address. Either way, rather than make extra mortgage payments, the money is better directed toward a tax-deferred investment account, an emergency savings fund or needed insurance coverage.

The Fed says don't bother
In 2006, the Federal Reserve Bank of Chicago released a study saying that 16% of American households with conventional 30-year home loans were making extra mortgage payments yearly. The study concluded that almost 40% of these borrowers were making the wrong choice. It argued that the same households could get an average benefit of 11 to 17 cents more per dollar by reallocating their money into a tax-deferred retirement account.

Other alternatives for your extra cash
You save taxes on each dollar you direct into individual retirement accounts, 401(k)s and other tax-deferred plans. These dollars have the chance to grow without taxation until you either retire or six months after your 70th birthday, when mandatory distributions must begin. Most Americans enter a lower tax bracket in retirement, so your taxable income and federal tax rate could be lower when you withdraw your retirement money.

If your employer provides an employer match on 401(k), 403(b) or other retirement plans, you effectively collect free money by directing funds to those accounts. The more you put in, the higher the match.

Consider your insurance needs during retirement. Most families are underinsured and the money for extra mortgage payments could be directed toward long-term care insurance for baby boomers, disability coverage for younger families or life insurance to provide for surviving dependents.

Always remember that once money is paid to whittle down your mortgage debt, it is gone. But the money you accumulate in other assets can be accessible if needed.

Let's Think
What counts is what is most important for you. If you are cautious and prefer to have more expenses controlled during retirement, then pay off your mortgage before you retire. When you pay off a debt that you owe, you effectively get an instant return on your money. Plus you have comfort in reducing a future expense. You may be tantalizingly close to the end of your mortgage, and paying it off is easy.

Conversely, retiring your mortgage early while not saving enough to meet your retirement needs is a bad choice. This is especially true if you are optimistic and believe that the market will provide you higher return rates than your debt interest.

There is not a one-size-fits-all answer to this question. If you're unsure which choice would be most beneficial to you, consider consulting a qualified financial professional.

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