



When It Is and Isn't Profitable to Pay Off Your Mortgage Early

A special report from Real Estate Expert Bob Bruss

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Report #00312

Money is one of my favorite topics. You're also probably interested in this subject. Even if you don't care much about money, I'm certain you realize it is a necessity. Most of us need or want more of it. Even my multi-millionaire friends will eagerly try to save \$10 or \$20 at a "sale," knowing they can well afford the product at its full price.

However, when it comes to mortgages, we're talking about "big money." Often, we don't realize HOW big!

EXAMPLE: Suppose you are buying a home and need a \$100,000 mortgage. One mortgage lender offers you a 30-year fixed rate mortgage at 8.25% with lots of paperwork hassles. Another lender offers you an "easy qualifier" mortgage with virtually no paperwork at 8.50%. Neither mortgage has any hidden costs or extra fees. Which loan should you take? The monthly payment on the 8.25% mortgage is \$751.27. The monthly payment on the 8.50% mortgage is \$768.91. That's just \$17.64 per month more. Many of us will take the 8.50% mortgage because it is so easy to obtain. However, over the 30-year life of these mortgages, if you select the 8.50% home loan, you will pay \$6,350.40 more than if you took the 8.25% mortgage!

"But this month's topic is about whether or not it is smart to prepay an existing mortgage," I can hear you shout. True! However, if we first spend extra time shopping for the best mortgage, the issue of prepaying or not prepaying it won't be such a critical topic.

HOW TO VIEW PRE-PAYING A MORTGAGE. Years ago, a very wise real estate investor, the late Don Kendall from Fresno, CA (who owned over 60 rental houses when he died at age 73) taught me that every dollar I prepay on my mortgage principal is really an investment at the interest rate on that mortgage. To illustrate, if my mortgage interest rate is 8% and I prepay just \$1 on that loan's principal, I just made an investment at 8%. That's a pretty good return on investment today!

EXAMPLE: Suppose you have an extra \$1,000 and you “invest it” by paying down your mortgage principal by \$1,000 in January 2000. If your mortgage is at an 8% interest rate, you avoided paying or saved interest on \$1,000 of your mortgage principal this year. That annual saving is \$80. At first, that might not seem like a “big deal” to save just \$80 interest. However, if your mortgage has many years remaining, you will save that \$80 per year over and over every year. Although you can’t see or spend that \$80 annual interest saving on the \$1,000 invested by paying down your mortgage, that’s a pretty good investment if you plan to keep your home for many years. If you keep your home 20 years, that’s a \$1,600 total interest savings over 20 years on your \$1,000 mortgage principal investment.

But there is more to consider than just the rate of return on the amount of mortgage prepaid dollars. Prepaying a few extra dollars every month, to hurry the ultimate day the mortgage will be paid in full, is one thing. But rushing to prepay a mortgage when your funds might be needed in the future (and the borrower then cannot qualify to refinance) is an entirely different matter.

EXAMPLE: Several years ago, one of the saddest letters I received for my “Real Estate Mailbag” newspaper column was from a homeowner who used an inheritance to pay down his home loan by \$65,000. Of course, his monthly mortgage payment didn’t decline. Nor could he refinance with his lender when he later became unemployed and need additional funds for living expenses. When you’re unemployed or sick, it’s pretty hard to refinance no matter how great your past credit and payment history.

Lump sum mortgage prepayments like that can be a major mistake if the funds will ever be needed in the future for an emergency or investment opportunity. The big problem is we don’t know when we will need extra money and when we won’t be able to qualify to borrow money. For this reason, I recommend NOT making lump sum mortgage prepayments. If you want to prepay an extra \$100 or \$200, perhaps more, each month toward principal on your mortgage, that’s fine. Just be sure it is money you will never need again in the future.

EXAMPLE: I hold a second mortgage on a house I sold to a nice couple about 10 years ago. The monthly payment on their 9% interest rate amortized mortgage is \$1,047.86. For the last few years, they have been paying me an extra \$200 per month principal payment. If they keep this up, they will earn big interest savings (at 9%) and own their home in fewer years than planned. Since the husband is a bartender at a nearby neighborhood bar (he walks to work), I suspect that family won’t be moving any time soon. However, if they need to take cash out of their home equity, the only way they can do so is to refinance because I’m not going to subordinate my second mortgage to a new first mortgage.

IF YOU HAVE AN OLD MORTGAGE, DON'T RUSH TO PREPAY IT. Although very few home mortgages last until their 30-year maturity, due to home sales or refinances, a few do. I have one of those old mortgages on an out-of-state property. This loan has only about seven years remaining. But I would be foolish to prepay it, although it has a 9% interest rate.

EXAMPLE: Last week I received a new set of monthly payment coupons from one of my lenders — Homeside Lending. Isn't that a terrible name for a mortgage company? It sounds like one of those rip-off high interest rate "sub-prime" lenders. But my interest rate is "only" 9%. That mortgage has had so many loan servicers (the loan is now owned by Freddie Mac) I have lost track of their names. But the loan balance is paid down to only \$16,455.41. The monthly P&I payment is just \$258.29, allocated this month \$132.87 to principal and \$125.42 to interest. Since over 50% of my P&I payment is now going toward principal reduction, why should I rush to prepay this old mortgage, which only has only a few years left? My interest savings would be very small. In addition, the loan servicer has an escrow impound account to pay my property taxes when they come due and it doesn't cost me even \$1 extra! Of course, I realize the loan servicer earns interest on my escrow impound account balance until they have to pay the taxes, but the minimal lost interest is worth it for me not having to worry about when the out-of-state property taxes come due twice a year.

By the way, I do NOT recommend setting up escrow impound accounts for paying property taxes and/or fire insurance premiums along with your mortgage payments. The escrow account on the loan above was required because it was originally a PMI (private mortgage insurance) loan. Too often, loan servicers overcharge and build up huge escrow account reserves. To illustrate, Homeside Lending just paid my property taxes two months ago. But Homeside already has enough overcharges to pay my next property tax bill due in November. Although that's illegal, nobody is policing the loan servicers. Once a year, however, Homeside usually makes an escrow accounting and sends me a small refund (i.e. overcharge) check. Aren't they nice? Unless you have a FHA, VA, or PMI (private mortgage insurance) home loan where escrow impounds are required. When obtaining a mortgage, avoid such escrow accounts. By the way, some lenders now charge outrageous "escrow waiver fees" of \$500 or more. Don't do business with nasty lenders like that.

My old Homeside mortgage was originally a 90% PMI mortgage, but the PMI premium was removed years ago. If you have a home loan with required PMI, be sure to check periodically for your loan-to-value ratio. That means the percentage of your mortgage balance compared to your home's current market value.

EXAMPLE: Suppose you paid \$100,000 for your house or condo and obtained a \$90,000 mortgage. That is a 90% loan-to-value ratio. If it is a conventional mortgage (meaning it is not a VA or FHA government-backed mortgage), your lender probably required PMI. In such a situation, the lender usually adds the PMI premium to the monthly mortgage payment. Some lenders, however, charge up-front PMI premiums at the time of loan closing. Others don't charge a PMI premium, but charge a higher than normal interest rate for the life of the mortgage. If you pay a separate PMI premium each month, along with your monthly mortgage payment, after the loan-to-value ratio drops to 80% or 75%,

most lenders allow you to drop the PMI premium. BUT, WHEN YOU QUALIFY, YOU'VE GOT TO ASK YOUR LENDER TO CANCEL THE PMI! Mortgage lenders rarely volunteer to drop PMI (because they don't know when your residence reaches the 75% or 80% loan-to-value ratio). A new appraisal will be required, costing the borrower around \$300. But it is money well spent if you can cancel your monthly PMI premiums and save many times that amount.

WHY PREPAY YOUR MORTGAGE? The obvious answer is prepaying a mortgage will save interest dollars by (1) shortening the mortgage's life to end mortgage interest payments a few years early and (2) paying down the mortgage faster than originally scheduled, thus reducing the annual interest cost while the mortgage still exists. However, if you only plan to stay in your home a short time, such as less than 10 years, the interest savings by making extra monthly mortgage principal payments, such as \$100 per month, will be minimal because the extra principal paydown won't be significant in just 10 years. This is especially true in the early years of your home loan when most of the monthly payments go to pay interest. However, substantial interest savings result from LONG-TERM extra principal prepayments month after month for many years, not from short-term prepayment plans, such as for only 10 years.

A second perceived mortgage prepayment advantage is to get rid of disliked monthly mortgage payments early. Some homeowners hate making monthly mortgage payments. Personally, while I can't say I love making mortgage payments, I'm thankful I have the cash to make those payments. I don't worry about being able to afford the monthly payments. But I would worry if I couldn't afford the payments.

A third major reason many homeowners want to prepay their mortgage to get it paid off is, they think that without mortgage payments to make each month, they will have then plenty of money to (1) invest, or (2) buy things they can't afford now, such as vacations, new cars, boats, RVs. etc. Depending on how the leftover money from no mortgage payments is spent by the homeowner, this can turn out to be the best reason of all (by making other profitable, smart investments — such as fixer-upper rental houses), or the worst reason (by wasting the extra money on frivolous “toys”).

HOW MUCH CAN I SAVE BY GRADUALLY PREPAYING MY HOME MORTGAGE? The exact answer to your question depends on your mortgage's interest rate and its remaining years. Here is a little chart of a \$100,000 mortgage comparing interest rates and lifetime mortgage costs over its full term:

INTEREST	7%	8%	9%	PAYMENTS	7%	8%	9%
15 YEARS	\$61,789	\$72,019	\$82,567	15 YEARS	\$899	\$956	\$1015
30 YEARS	\$139,512	\$164,157	\$189,663	30 YEARS	\$666	\$734	\$805

As this chart shows, the savings on a 15-year mortgage, compared to a 30-year mortgage at the same interest rate, are well over 50%. But the increased monthly payment to get the loan paid off in 15 years is substantial — more than most homeowners can afford.

What is the message of this chart? If you can afford the higher 15-year mortgage payments, plan to keep your home more than 15 years, and want to pay off your mortgage as rapidly as possible, take the 15-year mortgage. Or, if you already have a 30-year mortgage but want to get your loan paid off in 15 years, or perhaps 20 years, increase your monthly payment by adding extra principal to each payment, thus decreasing the mortgage's term and saving interest.

If you already have a 30-year mortgage which is a few years old, here are the approximate minimum percentages of your existing monthly payment which you should add to each monthly payment to get the loan paid off in the desired number of years (the exact increase percent depends on your loan's interest rate and the age of the mortgage — the lower the interest rate, the higher the percentage of payment increase required to get the loan paid off early):

20-year mortgage payoff = 10% monthly payment increase

15-year mortgage payoff = 20% monthly payment increase

10-year mortgage payoff = 50% monthly payment increase

EXAMPLE: Suppose you have a \$100,000 existing mortgage balance on a fairly new 30-year loan at 8% percent interest, payable at \$734 per month, which you want to get paid off in 20 years (instead of 30 years). You would need to increase your monthly payment by \$102.68 (that's 14%) by adding \$102.68 principal to each monthly mortgage payment you make for the next 20 years. However, if your \$100,000 existing 30-year mortgage has a 7% interest rate, and an existing payment of \$666, to get that loan paid off in 20 years, you will need to increase each monthly payment by \$109.30 (that's 16%). Isn't that interesting? Now, suppose your new 30-year home loan has a 9% interest rate, payable at \$805 per month. If you decide to get it paid off in 20 years, you'll need to increase the monthly payment by \$95 to \$900. That \$95 increase is only a 12% increase.

To summarize this chart and its application to specific loan interest rates, the lower the 30-year loan's interest rate, the higher the percentage of increased monthly payment needed to pay it off in 20 years. Incidentally, if our 30-year example \$100,000 home loan has a 10% interest rate, its \$878 monthly payment needs to be increased exactly 10% by \$87 per month to \$965 monthly to pay off this loan in 20 years.

HOW TO CALCULATE YOUR EXACT MORTGAGE INTEREST PAYMENT AND SAVINGS BY PRE-PAYING EXTRA PRINCIPAL EACH MONTH. Since you will be saving thousands of interest dollars by making extra monthly mortgage principal payments, it will pay to invest in a small financial calculator. Office Depot, Staples, Office Max and other office supply stores have them available at modest cost, typically less than \$40, be sure to get one which calculates monthly mortgage payments. Then read the simple instruction booklet, which comes with the calculator. I can't recommend one brand over another because I haven't compared them all. Texas Instruments and Hewlett-Packard are probably the best-known brands. Personally, for years I've used one manufactured for real estate salespeople by Calculated Industries.

FORGET ABOUT INCOME TAX SAVINGS FROM THE HOME MORTGAGE INTEREST DEDUCTION. At this point, I can hear some negative thinker saying "But what about the income tax savings I get for my mortgage interest deduction. If I prepay my home loan, after a few years my interest deduction will plummet to zero and my income taxes will go up."

That's absolutely correct. But will your income taxes increase by the thousands of interest dollars you saved each year by paying off your home loan early? No!

The income tax deduction for mortgage interest is really a government subsidy for homeowners and real estate investors. Although itemized interest deductions reduce the after-tax cost of home ownership, it is not a dollar-for-dollar saving.

EXAMPLE: Suppose you pay \$100 of tax-deductible home mortgage interest. If you are in the 28% federal income tax bracket, you will save \$28 of federal income taxes for each \$100 of home mortgage interest deduction. Saving \$28 in income taxes for each \$100 you paid out in cash is NOT a good deal, is it? However, it is better than getting no government subsidy for home ownership!

Because the income tax deduction for home mortgage interest payments is not a good deal, it should be ignored because it costs \$100 cash for each \$28 of income tax dollar savings. When your home loan is paid off, you will lose this government subsidy. But you will gain the far greater savings of not having to pay out any mortgage interest dollars. In summary, forget the income tax deduction for mortgage interest because the interest savings will far outweigh the income taxes saved.

CAN MY MORTGAGE LENDER STOP ME FROM PRE-PAYING MY MORTGAGE? Virtually every home loan I've seen allows mortgage principal prepayments of at least 20% per year without any prepayment penalty. Many home loans have no prepayment penalties. If you make extra mortgage principal payments each month of a few hundred dollars, you aren't likely to run into any mortgage prepayment limit.

Most lenders encourage extra mortgage principal payments. Why? The reason is the faster the lender gets their principal repaid, the greater the lender's yield on the remaining mortgage principal balance. I won't go into the details here (because most home loan borrowers don't care and won't understand the mathematical reasons), but that's why some savvy private party lenders will offer to reduce a mortgage's interest rate if borrowers will agree to increase their monthly payments. If you're interested in this topic, we still have a few copies of Special Report #94242 "How to Earn Big Profits from Discounted Mortgages."

However, many commercial mortgages prohibit any extra monthly principal payments. These are called "locked-in" mortgages, which cannot be prepaid or, if permitted by the mortgage terms, require a very stiff prepayment penalty for principal paydown. The reason is the lender wants to continue earning the agreed yield over the mortgage's original term, such as 20 or 30 years. But most states have laws prohibiting locked-in mortgages, except for a few years, on one-to-four residential units.

EXAMPLE: When I was selling real estate at Grubb & Ellis Co., Realtors, in San Francisco, I sold a large apartment building overlooking Dolores Park. The buyer, Richard, arranged a new mortgage at 9% from a local S&L. But the existing lender, Prudential Insurance, refused to allow its old 5% mortgage to be paid off early! Since I had a large sales commission involved, and Richard was getting mad at me (he had a terrible temper!), I was concerned about losing the sale. So one morning I got on an early flight to visit the Prudential mortgage office in Los Angeles. Their Vice President explained to me why Prudential counts on that 5% yield on its money for many years and doesn't want to be paid off early. My reminding him that Prudential could loan out the money at a higher yield around 9% did no good. Finally, around 5 PM, he obviously wanted to go home. But I think he didn't want to throw me out of his office. Reluctantly, he said "Well, it's only a few hundred thousand dollars so I guess we can make an exception and accept prepayment." He didn't even charge a prepayment penalty! I remember going over to Musso & Frank's in Hollywood for a nice steak dinner to celebrate. Then I caught a late flight back to San Francisco. It was a long but very profitable negotiation day.

SHOULD I CONVERT MY HOME LOAN TO A BI-WEEKLY MORTGAGE? Several times a month I receive letters for my "Real Estate Mailbag" newspaper column asking, "Should I convert my home loan to a bi-weekly mortgage?" The reader usually includes photocopies of solicitations they have received from their mortgage lender, or a company hired by the lender. These bi-weekly mortgage conversions usually require payment of up-front fees of \$395, plus \$5 or \$6 monthly fees.

The lender often sends the borrower calculations of how much the borrower can save in interest by allowing the lender (or the outside third-party company) to dip into the borrower's checking or savings account every two weeks for 50% of the current monthly principal and interest payment. Worse yet, are the individuals who prey on friends, relatives and co-workers to set up similar biweekly mortgage payment plans, usually with up-front fees of \$300 to \$500 (most of which goes to the individual, by the way). These plans can be especially dangerous because they are administered by uninsured third parties who automatically take authorized bi-weekly payments from the borrower's checking or savings account, put it into a fund controlled by the third-party promoter, and then make the borrower's regular monthly mortgage payment, periodically adding extra principal payments.

The net result of bi-weekly mortgages is the borrower is making the equivalent of 13 monthly payments each 12 months and the loan will be paid off in about 22 years, depending on the loan's interest rate and remaining loan term. The interest savings can be substantial. However, borrowers should be aware their mortgage is not being converted from a monthly payment mortgage into a true bi-weekly mortgage (very few lenders originate true bi-weekly mortgages because there isn't much of a secondary mortgage market for selling such loans to investors).

Instead of signing up for a bi-weekly mortgage payment plan, if you like the idea of paying off your mortgage in about 22 years and saving thousands of dollars of interest, set up your own "bi-weekly mortgage." All you need to do is divide your monthly principal and interest payment (don't include any property tax and insurance escrow impound amount you pay monthly with your mortgage payment); then add this amount to each regular monthly mortgage payment

EXAMPLE: Suppose your monthly principal and interest payment is \$1,200. Dividing by 12 produces the result of \$100. By adding that amount to each monthly mortgage payment, AND CLEARLY LABELING IT AS AN EXTRA PRINCIPAL PAYMENT, you will be making the equivalent of 13 monthly mortgage payments each year, reducing your loan's life to about 22 years.

CONSIDER THE "JUMP AHEAD" MORTGAGE PREPAYMENT PLAN. If you have a loan amortization schedule for your mortgage (lenders usually charge \$5 or \$10 for a copy), figure out where you are on that schedule. Then, in addition to making your current month's mortgage payment, add next month's principal to your payment. If you keep doing this, the extra principal amount you add each month will gradually increase. The long-term result is you will be cutting your mortgage's life in half, saving thousands of interest dollars!

With this "jump ahead" mortgage prepayment plan, you must always make the scheduled monthly mortgage payment then; add the next month's principal payment. You'll need an amortization schedule for your loan to implement this plan. But many borrowers like it because the extra principal payments start out very small, but gradually increasing each month as you "jump ahead" on the amortization schedule.

SUMMARY: Mortgage prepayments can be very smart if you plan to keep your home a long time — at least 15 years. However, if you only plan to keep your home a few years, the interest savings from making extra principal mortgage prepayments won't be very dramatic. Please be aware your extra principal payments cannot be recovered from your lender if you encounter financial hardship, nor will your monthly mortgage payment be reduced. For this reason, if you might ever need the extra principal prepayment money, rather than paying it to the lender, you might want to set it aside in a high-yielding certificate of deposit or other safe investment where you can easily get it without incurring the costs and delays of home mortgage refinancing. When making extra mortgage principal prepayments, ALWAYS clearly indicate to the lender the extra payment is for principal reduction (otherwise, the lender might put it into your escrow impound account for property taxes and insurance payments). Some borrowers make extra principal payments with a separate check to the lender, clearly marking it "Principal reduction."

SPECIAL CONSIDERATIONS IF YOU LIVE IN EARTHQUAKE TERRITORY. If you live in earthquake territory, such as California, Washington, and Alaska, or parts of Missouri and Nevada, or your home is prone to other natural disasters such as floods, hurricanes, or tornados, having a large mortgage on your property can be advantageous. To illustrate, in the 1989 San Francisco earthquake, property owners who had small or no mortgages were on their own to repair damage. But realty owners with large mortgages were able to easily refinance with the same lender to pay the cost of repairs because the mortgage lenders did not want to foreclose on damaged properties. If you do not carry adequate earthquake insurance and other hazard insurance for the replacement cost of your property, I suggest you keep a large mortgage on your property if it is prone to natural disaster damage.

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