



Mortgage Insight: Should You Pre Pay Your Mortgage?

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If you own your home and/or investment property, especially if you are nearing retirement years and want to enjoy your properties with no monthly mortgage payments to make, your first thought might be prepaying the current mortgage.

For example, if you have a 7 percent home mortgage interest rate and you make an extra \$100 principal payment this month; you really invested your \$100 at 7 percent because you won't have to pay any more interest on that borrowed \$100. Your investment "earnings" from prepaying mortgage principal come in the form of future interest savings over the remaining life of that mortgage. In other words, you will avoid paying interest on the \$100 of that mortgage principal this year, next year and every year in the future.

In addition to the obvious interest savings, here are the important things to consider about prepaying an existing mortgage:

1. Unless you plan to keep a property at least 10 years, prepaying part of the mortgage principal periodically won't result in much total interest savings. The reason is the extra principal payments shorten the life of the mortgage, and the interest

savings come at the end or last few years of a mortgage's term.

2. Prepaying on a mortgage balance will leave the borrower with less cash available for other purposes. For this reason, it is often not smart to make a large lump-sum mortgage prepayment because you can't easily get that money back if you need it for an emergency or investment sometime in the future.

3. An exception to the rule that money "invested" prepaying a mortgage cannot be easily borrowed again except by refinancing with a new mortgage is a Home Equity Line of Credit (HELOC). Paying off or paying down a HELOC balance results in instant interest savings from prepayment, but the money can be quickly re-borrowed again by writing a check on the HELOC account. That's why I recommend, after paying off your mortgage, obtaining a HELOC secured by that property for emergency use.

The old saying "*Banks only lend money to people who don't really need it*" is true. If you experience an unexpected loss of income, through loss of a job or because of illness, I can promise you that your prospects for getting a loan- when you need it most- will be slim.

4. If your existing mortgage has only a few years remaining, such as a mortgage in the 25th year of a 30-year amortized term, the actual

interest savings will be small. This is hard to explain, but the reason is in the last few years of an amortized long-term mortgage, most of each monthly payment goes toward paying off the principal balance and very little is tax-deductible interest.

The best way to understand this is to print out a monthly amortization schedule of your mortgage for its remaining years showing each month's allocation to principal and interest. If your lender provides a monthly payment statement, you will see this principal-interest allocation each month.

5. If your home mortgage requires PMI (private mortgage insurance) monthly premiums, when the loan balance is paid down below 78 percent of its original balance (usually after about 11 years), be sure the lender cancels your PMI premiums. Or, if your loan-to-value ratio is 80 percent or lower, and you have an on-time payment record for the last 24 months, most mortgage lenders will cancel your PMI if you pay for a new appraisal by one of their "approved appraisers."

Check with your lender if you think you are eligible to cancel your PMI either from principal reduction and/or property-value appreciation. The PMI monthly premium savings can be huge!

6. Forget about losing the income tax interest-deduction savings

on your home mortgage. The reason is it is not a dollar-for-dollar saving. To illustrate, if you pay \$100 of mortgage interest and are in the 28 percent income tax bracket, you save \$28 of federal income taxes for each \$100 of home mortgage interest deducted. Paying \$100 of mortgage interest to the lender to save \$28 in income taxes is obviously NOT a "good deal." Of course, it's better than no tax deduction at all!

7. The "psychological value" of owning a property free and clear seems to be the major motivation why many homeowners make extra mortgage principal payments.

But frankly, owning a property free and clear, can also make many home owners worry that they have too much idle equity at risk to property value fluctuations.

8. There are several alternatives for putting "lazy" home equity to work for you. This avenue requires some frank and open consultation with your financial planner and your mortgage consultant. In recent years many

home owners have turned to extracting their home's equity and investing in carefully selected opportunities with extremely good results.

This is usually accomplished by utilizing very low rate interest only mortgages and investing the monthly savings- along with any equity that's been extracted- in investments that have a higher rate of return than the cost of the loan.

For example; utilizing a cash out mortgage with a rate of 4% in order to invest the home's equity and monthly savings in a vehicle that may generate a 7%, 8%, 9% or higher rate of return. In addition to the investment's return, the home owner is still experiencing appreciation of the property and also enjoying the tax deductibility of their mortgage payments.

In studies where these techniques have been utilized with disciplined home owners and under the watchful eye of a financial advisor and mortgage consultant, the increase in wealth experienced by a

home owner can be startling when compared to "passively" owning a home free and clear.

Financial advisors refer to the split in thinking among home owners as either "**Running from debt, or running toward wealth.**" You can only do one or the other!

In Summary

As with many other topics, there are several schools of thought as to whether or not it is best to prepay a mortgage. The best answer is that whether you do or not, is really up to you and your personal plans, preference and long-term financial goals. The correct answer will be whatever is right for you and as long as you have a good reason for doing either, you can't be wrong.

Many things have changed since our parents and grand-parents bought their homes. The cost of living and our economy in general bears almost nothing in common with the world they grew up in. Get some good advise from people you trust and find the answer that's right for you.

Claudio D. Varga is President of My Home Loan. The firm provides a wide variety of lending solutions for residential and commercial real estate. Claudio has been a licensed mortgage broker and consultant since 1998 and his clientele ranges from first time home buyers to professional multi-property real estate investors.

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