Mortgage Prepayment Guide

Mar 25, 2019 **Keith Gumbinger** HSH.com

Whether to prepay your mortgage or not is a common question asked by homeowners, both first-timers and seasoned veterans. It's a complex issue, revolving around how you feel about and manage your debts, how savvy you are as an investor, and how finely tuned your financial planning skills are.

In this multi-part guide, accessible at right, we'll help you understand the issue more clearly and give you the tools you need to calculate savings and create a strategy that works for you. Click on the links to each section in the guide to get the information that you need.

Should I Prepay my Mortgage?

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Should I Prepay my Mortgage?

There are three indisputable facts about paying off your mortgage more quickly than your contract specifies.

1. Perhaps most important is that paying it off early is a guaranteed way to save money -- possibly a considerable amount.
2. There's also the fact that you may be able to own your home outright years sooner, freeing up years' worth of monthly payments.
3. Plus, the more rapid buildup of available equity can be a huge asset in your retirement "nest egg," and can be a ready source of funds in an emergency.

On the other hand, consider that your mortgage may be the least costly debt in your portfolio. This was true before the 2018 change to the mortgage interest deduction, and even with that change, it still may be the case. It's also true that it's possible to get a better return on your money from other, differently-performing investments, like stocks or even other kinds of bonds.

Between those, there are several possibilities and potentials, all of which should be considered as part of any financial strategy.

» Calculator: Achieve the rate you want by prepaying your mortgage
» Calculator: Reaching home equity goals via mortgage prepayment

Mortgage prepayment philosophy

It used to be that retiring your life's largest debt was a reason to celebrate with a "mortgage burning party." Your parents (and grandparents) were likely to treat debt like a scourge, and wanted to rid themselves of financial indenture at the earliest chance. Today, changing attitudes toward money and debt management have made this attitude seem almost quaint, as refinancing and home equity borrowing have replaced the act of holding a "lien satisfied" note from the county officer.

More than 40% of homeowners 65 and older had mortgage debt on their primary residences in 2016, up from 22% in 1995, according to the Joint Center for Housing Studies of Harvard University. Of course, having mortgage debt when you are older means that you have less equity available to tap, whether by conventional means or via a reverse mortgage or HECM. This may limit some future financial options.

But a mortgage burning party is not really obsolete. In fact, it could be the crown jewel of a structured, effective financial plan.

When is a good time to prepay my mortgage?

When prepaying your mortgage, there's no "bad" time to do it, but there are four basic tenets to understand.

1. To get the maximum interest savings from your prepayment, start prepaying as early in the mortgage term as you can, as additional payments made early in your mortgage term have the greatest cumulative effect on cost.
2. For most prepayment methods to give you significant results, have the discipline to make them on as regular a basis as you can.
3. The higher the interest rate on your mortgage, the greater benefit of prepaying it. The longer the original term of your mortgage, the greater the benefit of repayment.

The type of mortgage you have can result in special considerations related to your prepayment decision. Familiarize yourself with unique aspects related to prepaying adjustable-rate mortgages (ARMs) or interest-only mortgages in our next article, Prepaying ARMs and interest-only mortgages.

If you don't have an ARM or a mortgage with I/O payments, you can also jump ahead to should I prepay my mortgage on invest instead?

Prepaying ARMs and Interest-Only Loans

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Prepaying Special Mortgages: ARMs and Interest-Only Loans

Most borrowers have fixed-rate mortgages, but other mortgage types wax and wane in popularity with the ebb and flow of interest rates. Two special cases to consider: Adjustable Rate Mortgages (ARMs) and Interest-Only home loans.

How you can benefit when you prepay an ARM

If you've got an ARM (or are considering taking one) and expect to prepay it, there are some differences you need to understand.

When you prepay a fixed-rate mortgage, whether conventional or FHA, the effect of doing so actually shortens the term of your loan, and much of your savings comes from not having to make any mortgage payments at the end of your term. This is because your fixed-rate loan has a fixed-amortization schedule set out at the beginning of your loan. Once set, the lender generally never revisits it.

Expert's note: *In some cases when making significant prepayments on a fixed-rate mortgage loan (e.g. 25% or more of the outstanding balance in a single payment), a lender or servicer *may* agree to recast your mortgage. A recast can involve the lender re-amortizing your loan with the new lower balance over the remaining loan term. This has the effect of lowering your monthly payments, but of course does not shorten the term of your loan. Recasting is a voluntary action and is most commonly available for loans a lender holds in portfolio; some loans may not be eligible for a recast. Also, if they are willing to do this, a lender or servicer may charge a fee to recast your loan.*

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Prepaying your adjustable rate mortgage is slightly different than prepaying a fixed-rate loan. At regular intervals, your mortgage lender or servicer reviews the remaining outstanding balance on your ARM loan, calculates your coming period's interest rate, and informs you of your new rate and payment, which is based upon what term remains of your original term.

This means that, unlike a fixed-rate mortgage, prepaying an ARM doesn't really shorten the term by much, but these regular resets mean savings come in the form of monthly payments (and interest charges) that are lower than they would be absent you making any prepayments.

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Prepaying an ARM

Here are two example prepayment scenarios and outcomes from prepaying an ARM.

Reducing monthly payments. For example, if you took a 1-year ARM for $100,000 at an interest rate of 3%, your [monthly mortgage payment] would be $421.60 per month; at the end of the year, you would still owe $97,912.24 in principal. Let's say that your new interest rate for the coming year rises to 5%, with a remaining term of 29 years. Your payment would rise to $533.48 per month.

Instead of simply letting the entire balance be subject to a new, higher interest rate, you decide to prepay your loan with a $5,000 bonus right before the interest rate and payment adjustment is made. Your loan balance falls to $92,912.24, and at 5%, your monthly payment becomes only $506.24, more than $27 per month less than it would have been otherwise.

Because your payments for the next year are calculated on a single outstanding balance, you'll want to make your prepayment just before that rate and remaining-term "reset" is done. Otherwise, you might have to wait an entire year or more until the beneficial effects kick in, and you'll have paid interest during that time instead of avoiding it entirely.

Managing interest rate increases. Prepaying your ARM can be a way to ameliorate a rising interest rate environment, helping to keep your required monthly payments lower than they would otherwise be, and even if you don't have a slug of cash to throw at your mortgage, making small regular monthly payments can offer some protection, too.

For example, let's say you took a $100,000 5/1 hybrid ARM five years ago at an interest rate of 4%. This means you have a fixed rate of 4% for the first five years of the loan and then change to an adjustable rate every year for the remainder of the mortgage term. Your initial payment is $477.42 per month. After five years, the rate is due to adjust, and your new interest rate is slated to be 6%.

Without making any prepayment at all, your remaining balance subject to the new 6% interest rate would be $90,447.20, and your monthly payment would rise to $582.75, an increase of $105.33 per month.

During the original fixed-rate loan period with a 4% interest rate, if you made a $50 per month prepayment starting at the first payment until the loan's first rate adjustment at month 61, you would have trimmed the balance subject to the rate adjustment down to $87,132.39 remaining principal. With a new interest rate of 6%, your new monthly payment would be $561.4 -- only $83.98 higher.

Sending the extra $50 per month for five years is now "paying you back" by saving you $21.35 per month for the next year and beyond, as future subsequent interest rate changes are also applied against a smaller-than-originally-expected remaining balance, even if you never make any additional prepayments.

Without explaining all the complicated math behind it, this is also akin to never making any prepayments and having a remaining balance of $90,447.20 after five years -- but rather than the loan reset with a new 6% interest rate, your $50 per month prepayment has given you the equivalent of a new interest rate of 5.61%. Of course, someone who didn't prepay his loan is stuck with the full lift to a 6% rate! In effect, you ameliorated a portion of the interest rate increase via prepayment, as your new required monthly payment is lower.

An oddity: Prepaying an interest-only mortgage

It might seem strange to select a mortgage that requires payments of only interest for a time and take steps to retire principal, too.

However, it's not a crazy idea. Interest-only (IO) mortgages are usually (although not always) ARMs, but even when they are fixed-rate products, paying down even some principal can help to offset a difficult and foreseeable payment shock down the road. Payment shocks can occur even if the mortgage is a fixed rate, as when the IO period ends, the borrower is left with a much shorter period over which to pay off the mortgage with fully-amortizing payments of both interest and principal, creating a so-called "payment spike."

For example, let's consider a 30-year fixed-rate mortgage of $100,000 with a 10-year interest only period at an interest rate of 4.5%. For the first 10 years, the interest-only payment is just $375, but remember that no principal is being retired. After the 120th payment, there are 240 payments (20 years) remaining of the original 30-year term and still a $100,000 principal amount; however, the payment now switches to a fully-amortizing one containing both principal and interest. With the same 4.5% interest rate, but only 20 years over which to repay the principal, the new payment would become $632.65, an increase of 68.7% -- a potentially painful jump.

Even if you didn't want to cover all the principal ($131.69) needed to make it a fully-amortizing loan in the first 10 years, any prepayments you make would mean a smaller loan balance when the reset to fully-amortizing payments comes. After the 10th year, a fully-amortizing loan as above would have a remaining balance of $80,089, so about 20% of the loan would have been retired. Sending even half of this amount -- $10,000 over 10 years (around $83 per month) -- means that the reset would see the required payment rise to $569.64, a somewhat less painful increase of "only" about 51.9%.

Curious about whether or not you should prepay your mortgage? Review our previous article: Should I prepay my mortgage?

Prepaying a mortgage is an important financial commitment and should be weighed against alternative investments. Read the next article: Prepay your mortgage or invest instead?

Should You Prepay Your Mortgage or Invest?

Mar 25, 2019 **Keith Gumbinger** HSH.com

Prepay Mortgage or Invest Instead?

Whenever the discussion of prepaying your mortgage comes up, someone always suggests that it's better to invest the money instead. That may be true–or not--depending upon several factors. There certainly have been periods in the past when investing would have been the best allocation of your extra dollars. At other times, you simply would have thrown your money into a big hole.

Investing in your mortgage differs from investing in the stock market in that it provides a known, guaranteed return over time. You never have to worry about the market hitting top or bottom, buying or selling opportunities, or what the [Federal Reserve] might do. What kind of guaranteed return are we discussing?

Mortgage prepayments prior to 2018

Before recent changes in the mortgage interest deduction (MID), the math to determine your return was a little complicated. First, the deduction was only available to those who itemized their deductions on their tax returns; in general, this meant you needed a combination of interest, property taxes and other deductions to be greater than the standard deduction available to you.

For most homeowners, the standard deduction for single taxpayers and married couples filing separately was $6,350 in 2017; for married couples filing jointly, the standard deduction was $12,700. As such, you needed a combination of deductions including mortgage interest to be more than these dollar amounts to make it worthwhile to itemize and capture some tax savings. Homeowners with big mortgages or those in high property tax states commonly rose above this threshold.

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However, borrowers with small mortgages and especially those in low-tax states were often better served with the standard deduction and so they didn't much benefit from the MID.

Up until 2017, it used to be that the 'return' from prepaying your mortgage was the equivalent of the after-tax interest rate being charged on your mortgage. This might sound a little complicated, but if you had a 6% first mortgage and were in the 28% tax bracket and it was worth itemizing, your after tax "return" when prepaying your mortgage is about 4.32%, guaranteed. While well below the average return of the stock market over time, this is better than many "cash" investments.

If you want to calculate the after-tax return on your prepayment 'investment,' the math is fairly simple. Take the interest rate on your mortgage loan, multiply it by the inverse (from 100) of the tax bracket you fall into. In the example above, the 28% bracket gives you an inverse factor of 72% (100% minus 28% = 72%). Now, multiply your interest rate - 5% - times .72 (72%) and you'll come up with an after-tax return to beat of 3.60%.

Prepaying a mortgage after 2018

Starting with the 2018 tax year, more generous standard deductions for the above taxpayers of $12,000 (single) and $24,000 (married) kick in, it's a fair bet that many folks will no longer itemize their returns, so there will no longer be an "after-tax" component to the savings of prepayment. It will simply be a one-for-one comparison, and a 4% interest rate being charged on your mortgage means prepaying it will return a full 4% on your money.

Of course, if your total deductions will be above the new thresholds and you will be itemizing, the math above for after-tax return still applies.

Of course, that doesn't settle the argument as to whether it's better to prepay your mortgage or invest, given today's mortgage rates. Why not simply leave yourself flexible, and consider prepaying your mortgage as part of an investment plan, like investing in a bond fund. If stocks look like a better opportunity to you, with greater potential, send your money there, and use dividends or stock sales to fund your prepayments.

Buy low, sell high... and prepay your mortgage.

If you have an adjustable rate mortgage or interest-only home loan, read our previous article on prepaying ARMs and interest-only mortgages.

For specific investment alternatives to prepaying your mortgage, review our next article on choices other than prepaying your mortgage.

Choices Other Than Prepaying Your Mortgage

Mar 25, 2019 **Keith Gumbinger** HSH.com

Choices Other Than Prepaying Your Mortgage

Prepaying your mortgage is a great idea, but it might just be the last place you should send any extra money you come across. Consider dedicating funds to areas of your life where you might benefit more rapidly and to a greater extent than the long-term advantages of retiring your mortgage, especially at today's mortgage rates.

Alternative investments to mortgage prepayment

Since most people have a finite amount of money to invest, it's worthwhile to evaluate where you stand on other financial imperatives before cutting a check to prepay your mortgage. Think about whether directing funds to one of the seven areas below makes more sense.

- **Life Insurance.**
  Whether investment-type contracts, annuities, or just good old plain "term life," life insurance may be crucial to your family's financial health. If you have no life insurance policy, or insufficient life insurance, your untimely demise could put your family or loved ones in emotional and financial distress. Level-payment term insurance is fairly inexpensive, with policies typically available for just a few hundred dollars per year--about the cost of a year's typical mortgage prepayments. Plus, the younger you are, the cheaper insurance costs. A life insurance policy is a low-cost way to protect your family, and may be a better near-term allocation of your

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resources.

What about a "mortgage" or "credit life" insurance policy --one that pays off your mortgage in the event of your death? Most experts believe that your money would be better spent on a standard life insurance policy (or increasing the benefit on an existing policy) to cover the loan amount. It's likely to be a better value; plus, this additional capital allows your beneficiaries much greater flexibility in their decision making process--the mortgage could be retired from those proceeds, or other bills could be paid.

- **Disability Insurance.**
  Are you the sole wage-earner in your household? Are you self-employed? If you should become disabled as a result of an accident, could your financial life continue without your salary's contribution for months or even years? The peace of mind a disability insurance policy could bring to you may outweigh any you might achieve from a smaller outstanding mortgage balance. Individual disability policies can be expensive when compared with life insurance, but statistically you are many times more likely to become disabled than you are to die. It's certainly a consideration if you have some money left over at the end of the month.

- **Retirement Savings.**
  Although some people become disabled or die during their working careers, many more live well into retirement age. Sadly, many need to continue to work beyond age 65 because they failed to take advantage of IRA, 401k, Keogh plans or other retirement savings options. Perhaps the most important component of any investment strategy is the one over which we do have some control: time. The magic of compounding assets over long periods of time is what makes money grow, and contributions to retirement savings plans today can yield many times their "cost." If you aren't fully funding your IRA, Keogh, SEP, 401k or other long-term tax-sheltered retirement plan, it could be wise to do so long before you send additional money to your mortgage lender.

- **Credit Card Debt.**
  This is among the most expensive and common form of consumer debt; these non-tax-deductible interest rates can be 16% or higher. The average US household held some $6,358 in outstanding credit card debt at the beginning of 2018, according to Experian. With a 3% minimum repayment rate and a 16% interest rate, this would take almost four years to retire -- and cost $1,984 in interest. Accelerating the repayment on the debt with the highest interest rate--even with small balances when compared to a mortgage loan--can return significant savings. Eliminating this debt frees up money which can be allocated to other more productive areas. Because of

high interest rates and what can be very long payment schedules at small minimum payments, most analysts recommend tackling this kind of debt first.

- **Education Plans.**
  The costs of sending a child to school have been rising quickly for many years. If you have hopes of sending your child to college, you could be faced with six-figure bills for a four-year school. While retiring your mortgage debt and building home equity might be a worthy goal, you might need to balance this with establishing and regularly contributing to an Education Savings Account. Many states sponsor Section 529 plans, and the sooner you begin funding those accounts the better position you may be in when large tuition bills are due.

- **Emergency Fund.**
  Socking away a stockpile of cash to cover emergencies is essential. But how much? Many recommendations focus around three months' worth of living expenses, but in this case, more is better. We suggest as much as six months' worth of living expenses, divided evenly between ready, liquid interest-bearing accounts such as money market or savings and short-term Certificates of Deposit, which are somewhat less accessible.

- **Home improvement.**
  Homeowners shouldn't be caught unprepared when inevitable home repairs and maintenance are required and on-going improvements over time should ultimately help to protect your investment. Avoid dipping into your emergency fund by planning ahead to pay for inevitable repairs by setting aside at between one and three percent of your home's purchase for regular upkeep. Follow a home maintenance checklist to avoid costly repairs at inopportune times.

- **Enjoying your life.**
  There is much to be said about using resources for vacations or respites that rejuvenate us, and for experiences that enrich our lives. All of these are "investments" in their own right, with "returns" both tangible and intangible. Is it better to pay a bit more toward your mortgage, or to take your children out to a ballgame, or your spouse out for a romantic dinner? Your mortgage will persist for years regardless of how much additional principal you send, but opportunities like these may present themselves for only short periods of time. Of course, if you already go out on the town regularly, this advice isn't for you. Consider spending a few more nights at home, and prepaying your mortgage instead.

Still interested in prepaying your mortgage?

Prepaying your mortgage isn't just a simple question with easy, numerical answers in a ledger or spreadsheet. There are many resource applications that can bring equal or greater rewards.

Now that you've investigated it this deeply, it should be clear that prepaying your mortgage is only a part of a larger, more encompassing financial strategy. If you've prepared for emergencies, disabilities, an untimely death, your retirement, and your child's education; if you've wiped out or reduced your plastic (and other) consumer debts; if you set money aside for household maintenance; if you've kept a little to help enjoy life; and if you still have some money left over, congratulations. You might be a candidate to begin prepaying your mortgage.

Our previous article, Prepay your mortgage or invest instead?, explained tax-related considerations for prepaying your mortgage. After reviewing this article on the alternatives to mortgage prepayment, it may be worthwhile to see if refinancing your mortgage could be the right option for you. See our next article: Refinance instead of prepaying my mortgage?.

Refinance Mortgage Instead of Prepaying?

Mar 25, 2019 **Keith Gumbinger** HSH.com

Refinance Mortgage Instead of Prepaying?

Prepaying your mortgage can save you money in the long run and free you from debt years sooner. But, should you voluntarily accelerate your mortgage's amortization?

Unfortunately, even with all the arguments for prepaying your mortgage, most homeowners don't do it, as least not regularly. That $5,000 earmarked for a one-time prepayment gets spent, or the $50-per-month extra payment goes to other expenses.

It's hard to have the committed discipline to attack a mountain of debt with such a small shovel. It takes a discouragingly long time to make a significant dent, and the gratification of having no mortgage to pay is usually years away. If you're one of those people who just can't seem to make it happen, you might consider a bi-weekly payment plan (discussed later). After you overcome the initial inertia and arrange for it, the savings happen automatically.

Refinancing could be better than mortgage prepayment

There may be a better way, however, using a method which actually forces you to send more money each month to your mortgage, and allows your debt to be retired years sooner: refinancing to a shorter-term mortgage.

You might be surprised to learn that the payments on a 15-year fixed rate mortgage (FRM) aren't double that of a comparable 30-year.

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Depending upon mortgage interest rates, a 15-year term carries a monthly payment roughly 30% higher than that of its longer cousin, but sending that additional 30% creates tremendous savings. Interest rates for 15-year mortgages can be substantially lower than 30-year loans, so there are interest savings to be had despite potentially higher payments.

Consider this: a $100,000 30-year fixed rate mortgage loan at 4.5% will see you pay back over $82,405 in interest over 360 monthly payments. Your monthly principal and interest payment is $506.69.

A $100,000 15-year fixed rate mortgage at 4% allows you to pay back only $33,144 in interest over 180 monthly payments. Your monthly payment is $233 higher than the 30-year term, but creates about $50,000 in interest savings... and you have no mortgage after only 15 years.

The savings are even more impressive if you refinance from a higher interest rate. Assume you have a 6%, 30-year fixed rate mortgage with a $100,000 balance. You're scheduled to pay $600 per month, with total interest charges of $115,838 over the entire term, and you've been in your home for one year. You decide to refinance, with an outstanding balance of $98,772.

You choose a 15-year fixed rate mortgage at 4%. Your monthly payment rises to $731 per month (an increase of about 22%), but over the term of the loan, you are scheduled to pay only $32,737 in interest. Subtracting the interest you've already paid in first year ($5,967), and assuming 2% costs to refinance ($1,975), your net interest savings are over $75,000.

In effect, for an additional $131 per month, you are mortgage free in a total of just 16 years. If your income has risen, but your savings haven't, or you can't seem to find funds to prepay your mortgage on a regular basis, consider refinancing to a shorter term. For you, it would be a forced (rather than voluntary) mortgage prepayment plan.

If the change to a 15-year term brings a monthly payment that is too high (or if you can't qualify), consider a 20-year term. The increase in the monthly payment should be less, but you still chop nine years off your loan, so some significant savings can be enjoyed.

You can compare multiple mortgages at the same time with our mortgage calculator.

Refinance mortgage with same payment, shorter term

Given the right intersection of time and interest rate differential, it is possible to swap to a 15-year FRM with no change in the monthly payment at all. As an example, you have a $100,000 30-year FRM at 5%; the payment is $536.82 per month. To keep this same monthly payment with a new 15-year FRM at 4%, the remaining balance will need to be $72,574; which should be the remaining balance on your 30-year loan at about the 161st payment.

After about 13 years into your original mortgage, you will have paid $58,924 in interest out of a total due of $93,256 in total interest cost, so there would still be $34,962 in interest to be paid. You refinance to a new 15-year FRM at 4%, instantly chopping 19 months off the time left in your original loan, resulting in a total remaining interest cost of $24,034. You just saved nearly $11,000 in interest expense (some of those savings may be lost to closing costs for the new mortgage, though). A refinance calculator can help you determine whether or not to change your existing mortgage and how to cover the costs of a refinace.

Want savings, but can't or don't want to refinance your mortgage?

With interest rates moving away from about 60-year lows around 2016, it's reasonable for homeowners to balk at refinancing. Trading a lower interest rate for a higher one has no appeal and changing mortgage underwriting standards or to your own income and debt profile can mean you may not be in a position to refinance.

There is a way to prepay your mortgage and achieve savings equivalent to an actual refinance, without the hassle and expense. Consider a concept HSH developed, where "**mortgage prepayment is equivalent to a refinance**" (Prepayment::Refinance), and let the HSH-engineered Prepayment::Refinance ("PreFi") Calculator do the complex math for you.

There are a few concepts to grasp as you begin:

- Very often, a refinance is done to lower the mortgage's interest rate and monthly payment. This usually results in long-term interest savings.
- For fixed-rate mortgages, increasing your monthly payment above what is required (prepaying) also results in lower total interest cost for the mortgage.

As an example, let's say you have a $100,000 30-year fixed-rate mortgage with a 4% interest rate. You have made 12 monthly payments.

If you make no prepayments, you have 29 years remaining on your loan and will pay total interest charges over that time of $67,903.52.

- You would like to refinance, but today's 15-year fixed rates are close to 4.25% and the combination of shorter terms and higher interest rate means increasing monthly payments quite a bit, so it's just not worth it even if you can qualify for the new mortgage.
- You can, however, send in an extra $100 per month. Starting with the 13th payment, you do so and continue until the loan is retired. By your action, your remaining loan term has been shortened to just 21 years, and the total interest you have paid is $47,043.91.

The total interest you paid is equivalent to having refinanced your $98,238.98 mortgage for a new 29 years at an interest rate of 2.907%; this is the "effective interest rate" you have engineered for your mortgage rather than the 4% contract interest rate for which you signed on. *You have achieved savings equivalent to refinancing by prepaying your mortgage*.

Creating a better effective mortgage interest rate or term by prepaying

Perhaps you are lamenting the fact that you have a 4.5% interest rate on your existing mortgage loan, and missed the chance to refinance when rates were at 3.75%. Mathematically, it's possible to prepay your mortgage to achieve an effective interest rate you want.

Using the above $100,000 30-year loan, but with a 4.5% interest rate, and assuming you made the same 12 monthly payments, how much additional monthly payment would you need to make to have an effective 3.75% interest rate? The amortization can be pretty complicated, but that's where our unique LowerRate Prepayment Calculator comes in. Starting with the 13th monthly payment, a monthly prepayment of just $50.54 is enough to make the interest paid over the remaining 29-year term equivalent to having a 3.75% interest rate.

Perhaps you want to prepay your loan to produce a mortgage with a 20-year term at 3.75% -- generating the same interest savings as though you had refinanced to this rate and term? Send in an extra $193.73 per month and it happens.

The math may be complicated and the concept a challenge to grasp, but the savings, interest rate or term you are after may be pretty easy to attain.

Having reviewed our previous article Choices other than prepaying your mortgage and assessed whether or not refinancing could be a good solution, be sure to read our next article: Before prepaying, review your mortgage contract.

Before Prepaying Mortgage: Review Contract

Mar 25, 2019 **Keith Gumbinger** HSH.com

Before Prepaying Mortgage: Review Contract

In recent years, many mortgages--especially adjustable rate mortgages (ARMs)--include "prepayment penalty" clauses. A true prepayment penalty strictly forbids sending in any additional money to retire your mortgage more quickly than originally contracted, without paying a cash penalty. Prepayment penalties are largely banned in most states, but enterprising underwriters unearthed a legal loophole that could cost you.

The majority of recent mortgage loans lack "prepayment penalty" clauses, per se; rather, they are structured as "anti-refinancing" clauses, which don't prevent sending additional money, but apply only to total or partial repayments which are in excess of a given percentage (usually 20% or more of the outstanding balance), typically during the early years of your mortgage term. If you have a recent loan and plan to prepay, you should check the terms of your contract. If need be, adjust your mortgage prepayments to a level that doesn't trigger a penalty now, and add more to your later payments.

Take time to decide on exactly how you plan on prepaying your mortgage and define the timeframe in which you hope to pay off your mortgage. The greatest prepayment benefits come when starting early in your loan term; different mortgage prepayment methods can create different outcomes and savings, but most important is to make a commitment you can stick with over the long haul. Even small, painless prepayments can have tremendous cumulative effect... but you need to commit to making them month after month to really achieve results.

Prepaying mortgage regularly vs. occasionally

Once you're in a position to prepay your mortgage, decide exactly how to do it. There are five common prepayment methods:

1. Regular, fixed monthly applications of additional principal
2. Rounding monthly payments
3. Automatic bi-weekly payments
4. 13th monthly payment
5. Large lump-sum prepayment

Making irregular prepayments — as funds permit — can also help you pay down your mortgage (this complicates accounting, but can save some money overall.)

If you've considered Refinancing instead of prepaying your mortgage and determined that prepaying makes the most sense for you, review our next article detailing various mortgage prepayment methods.

Guide to mortgage prepayment

1. Should I Prepay my Mortgage?
2. Prepaying ARMs and Interest-Only Loans
3. Should You Prepay Your Mortgage or Invest?
4. Choices Other Than Prepaying Your Mortgage
5. Refinance Mortgage Instead of Prepaying?
6. **Before Prepaying Mortgage: Review Contract**
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Mortgage Prepayment Methods

Mar 25, 2019 **Keith Gumbinger** HSH.com

Mortgage Prepayment Methods

If you've decided to pay down or pay off your mortgage early by prepaying your loan, there are five common ways to achieve your goal.

1. **Regular monthly mortgage prepayments**

   Regular monthly prepayments may be the best approach for most people. It might not save more money than certain other methods, but it can build a pattern of behavior that allows you to take small regular recurring bites out your mountain of mortgage debt.

   For example, let's say you have a $100,000 30-year fixed-rate mortgage with an interest rate of 4% that started just 12 months ago. You think you can start sending in an extra $50 per month on top of the scheduled $477.42 amount due, so you start this with the 13th payment. If you continue this until the loan comes to a conclusion, you'll have chopped almost 5 years off your original 30-year term -- and saved some $12,420 in interest costs. If you could cover an additional $100 per month from the same starting point about eight years would be trimmed from the term, with almost $21,000 in savings compared to not making prepayments at all.

   When you start the mortgage prepayment process matters. If you wait until you're five years into your loan to start sending another $50 per month, the savings diminish; instead of more than $12K in savings, you'll achieve just over $8,800 in savings and cut the total term by less than four years.

   Our mortgage amortization calculator easily handles regular mortgage prepayments.

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Expert tip: If you made a downpayment of less than 20% when you bought your home, your loan probably required private mortgage insurance (PMI). Through amortization, prepayment and property-price appreciation, you should be able to cancel that PMI policy at some point, perhaps as quickly as two years from when you bought your home. When you do get to a place where you can cancel PMI, you'll free up funds to prepay your mortgage every month, and all you have to do is keep your mortgage payment exactly the same as it was when PMI was required!

2. **Rounding monthly mortgage prepayments**

Maybe you don't feel like you can commit an extra $50 or $100 per month to your mortgage. After all, there are always plenty of things competing for a chunk of your budget each month.

However, there is a method that can save you some money with just a simple checkbook trick: Rounding your monthly mortgage payment up to the next closest significant dollar increment.

For example, if your payment is $477.42 per month, you simply round up the payment to the next nearest $10 increment ($480) -- a $2.58 per month prepayment.

Before you laugh, consider this: Starting with the first payment on your mortgage, this small, incremental prepayment should trim three months off your mortgage term and save you over $850 in interest costs. Not a bad result for the flick of a pen!

If you can make a bigger commitment, say, by rounding up your payment to an even $500 per month (a $22.58 per month prepayment) you can eliminate 29 months of future mortgage payments and keep almost $6,760 in interest savings to boot.

How much might you save with this painless mortgage prepayment method? Try our RoundUp Mortgage Prepayment Calculator to find out.

In addition to being pretty painless, one additional benefit of this small-dollar prepayment method is that it can be applied to virtually any other debts you might have, incrementally trimming interest costs as you go.

3. **Automatic bi-weekly mortgage prepayments**

   A bi-weekly payment plan is another fairly painless way of making additional payments on your mortgage. While some mortgages are originated as true bi-weeklies, most start out as traditional 30-year terms, with a bi-weekly payment plan added later.

   In a bi-weekly arrangement, you are make a payment of principal and interest every two weeks, and each payment is half of what a normal monthly mortgage payment would be. Since there are 26 bi-weekly periods per year (52 weeks, divided by two) you're actually making the equivalent of thirteen monthly payments each year.

   Because mortgage servicers don't want to manage more than twice the volume of checks, the vast majority of bi-weekly payment plans are conducted using Electronic Fund Transfers (automatic deductions) from an account you specify. Every 14 days, the servicer accesses the account and draws the appropriate funds.

   While they work and are automatic, there are certain aspects of bi-weekly payment plans to consider:

   • First, you may be solicited by outside private firms who will "manage" your account for you – for a fee. Sometimes these are only one-time fees, but others have regular recurring charges which you'll want to avoid to maximize savings. Before retaining an outside firm, check with your existing lender or servicer to see if such a plan is available directly from them. If so, one can often be initiated with just a small one-time startup fee, typically no more than a few hundred dollars.

   • Second, be aware that you'll likely be required to fund that account with (and maintain) a pool of cash equivalent to two months' worth of payments, which could be a deterrent to joining up. Although you can sometimes select an interest-bearing account for the deposit, you must still amass the funds initially.

There is no doubt that bi-weekly payment plans work, though. A 30-year mortgage, paid on a bi-weekly basis from day one, should be paid off in just under 23 years. Using an example loan of $100,000 at 4% interest, you could trim the term by almost 50 months and save over $11,000 in total interest cost.

Track biweekly mortgage payment savings with our mortgage amortization calculator.

4. **13th monthly payment**

   If you don't have the cash available or desire to join a bi-weekly payment plan, you can obtain almost exactly the same interest and loan-term savings by simply sending in one extra monthly payment of principal and interest each year (a 13th monthly payment). Keep in mind, though, that this is not automatic, and you'll need the discipline to do it every year to achieve the same savings. If you get an annual bonus, tax refund or other lump-sum payment on an annual basis, you might consider this method instead of a biweekly plan.

   Rather than making half a payment every two weeks, sending an extra $477.42 as a lump-sum starting with the 12th monthly payment and doing it every 12 months thereafter will trim about 49 months off the original 360 month term, saving just under $11,000 in interest cost. The results are virtually identical to the savings and term reduction under a biweekly payment plan.

5. **Large lump-sum prepayment**

   There's always the option of sending a large amount of cash, such as an instant-lottery ticket payout or other windfall. This is likely to have a lesser effect the further along you are in your mortgage. The reason for this is that in the early years of your mortgage, payments largely comprise interest, and interest charges are high because your loan's principal amount remains high. By way of example, apply a $5,000 lump sum payment of principal to an 4%, $100,000 loan at the 13th payment; this simple one-time act has the effect of trimming some 32 months off the 30-year term, and saves you over $10,000 in interest cost. You just doubled your $5,000 windfall!

   However, that same $5,000 sent with the 39th monthly payment shortens the term by only about 30 months, with still-appreciable savings of over $8,800. Lump-sum prepaying early in your mortgage allows for long-term compounding of a lesser dollar amount, which translates into greater savings for you.

This larger, lump sum arrangement might work well if you expect to get annual bonuses, or can even be a good way to use some (or even all) of any tax refunds you get every year (provided other financial areas of your life have been attended to, of course).

Creating a mortgage prepayment subsidy account

If you do have a lump sum available but hate to part with it, there is a way to hedge your bet and retain it as working or emergency capital, but still have the means to prepay your mortgage. Instead of sending a lump sum in to your mortgage in all at once, you instead can use it as a basis for a kind of "mortgage prepayment subsidy account."

In this method, you retain your original $5,000 but slowly chip away at it, using small pieces to fund regular monthly prepayments of your mortgage. For example, a $5,000 windfall translates into 200 $25 blocks, or 100 $50 blocks. As an example, and again starting from payment 12 of your 30-year loan, sending in an extra $25 per month from payment 12 to 211 would save you $6,265 in interest cost and trim the term to a total of 341 months; a $50 prepayment from payments 12 to 111 would reduce the term by 29 months and total interest costs by $8,404.

It bears considering that the smallest prepayment in our example -- $25 per month -- could be nearly self-perpetuating. At 3% simple interest, that $5,000 would return $150 over the next year, or about 6 "free" prepayments, and you'll still have your $5,000 liquid instead of locked up in your home. Find something with a 6% simple cash yield and you could have a $25 prepayment generated from that $5,000 for the life of your loan (alternately, a $10,000 windfall at 3% would achieve the same results). Of course, you could retain all $5,000 in an interest-bearing account and use the annual interest for "rounding up" your payment.

Prepay mortgage to shorten your loan term

You now know that prepaying can both save you money and shorten your loan term. However, you may not realize that you can actually determine the term of your loan by prepaying it.

Imagine you are reviewing future financial goals. You're 40 years old, just traded up to a new, bigger home, with a 30-year fixed rate mortgage. But, you're looking forward to retiring at age 63, and the prospect of having a mortgage to pay on a fixed income for seven years isn't in your budgetary plans.

Since it would be hard to find a lender offering a 23-year fixed rate loan, you can make one by prepaying. To find out how much additional money you'll need to send to meet your goal, use a prepayment calculator to determine what your monthly payment is now, and what it would be for a term of 23 years. The difference between the two becomes the amount of each month's prepayment, and you're on the road to a more comfortable retirement.

For example: a $100,000 loan amount, for 30 years at an interest rate of 4%, carries a monthly payment of $477.42, while the same loan amount and interest rate with a term of 23 years has a monthly payment of $554.76 -- and the difference between the two ($77.34) becomes your monthly prepayment amount to achieve that 23-year term. This method works for any term you desire. HSH's "It's My Term" prepayment calculator can help you do the math -- and see the savings.

If you read our previous article and reviewed your mortgage contract to avoid penalties, and have identified the best prepayment method for your circumstances, you can begin to consider what comes next when your mortgage is paid off.

Mortgage Paid Off: Next Steps

Mar 25, 2019 **Keith Gumbinger** HSH.com

Mortgage Paid Off: Next Steps

It's fine to celebrate paying off your mortgage early — just be sure to tie up some administrative loose ends after the party. Depending on state and local customs, there may be things you need to do to make sure everything is in order.

Mortgage payoff documentation

Once your loan is satisfied, you should receive certain documents from your mortgage lender or servicer. These may include a statement showing that your balance is paid in full, such as:

- Canceled promissory note
- Certificate of satisfaction
- Canceled mortgage or deed of trust

Other common terms for these documents are:

- Mortgage release or Release of mortgage
- Satisfaction of mortgage or Mortgage satisfaction
- Deed of reconveyance
- Release of trust deed

For the most part, any canceled note and mortgage paperwork you receive from your lender is simply for your records.

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Filing official deed payoff record

Generally, a lender or mortgage servicer sends a document to the county recorder of deeds' office (or the official entity in your location handling property records).

However, this important step can take some time. A mortgage lien holder does have a legal obligation to release the lien when the debt is paid, but since this final step of handling your loan doesn't generate any revenue for the lender (just expenses for processing and recording) it may not be treated as a priority. So, allow your servicer some time to release the lien, perhaps up to 90 days, then follow up to see if it has happened.

If your lender doesn't automatically do this -- or has completed a "satisfaction notice" and sent it to you but not the local authority -- you can take steps to file it yourself. You may need nothing more than the original promissory note with the marking "paid and canceled" on it or your lender's satisfaction notice. Contact your local registrar's or county clerk's office to find out about the procedure to file the paperwork and whether or not there is a fee to do so.

To see if it has been completed by your lender, there's generally no reason to have to actually drive to the county recorder's office -- the vast majority of local jurisdictions make these records available online. One good place to start might be NETROnline which offers connections to online records in all states. Alternately, you can search online for "property records [your county or parish and state]" to see what comes back for your location.

If you've paid off your mortgage and waited a few months, and checked online records but see no recorded release, contact your lender or servicer's Lien Release Department to find out about your paperwork's status. Ultimately, it's to your benefit to have all your mortgage's loose ends tied up, or you could end of with a "cloud" or "defect" on your title that can make it a challenge when it comes time to sell your home.

Obtain mortgage escrow refund due and plan ahead

If your servicer has been handling routine payments for property taxes and homeowner's insurance on your behalf, there may be some money left in your mortgage escrow account. A refund of any money in the escrow account in advance of regularly scheduled payments should be returned to you. If you are due a refund, expect to see it come to you within the next 90 days.

If your servicer was handling property tax and insurance payments for you, they are now fully your responsibility.

- Contact your homeowner's insurance company and let them know that you've paid off the mortgage and that bills should be sent directly to you.
- Ask that any reference to the former mortgage holder be removed from the policy.
- Budget for ongoing property taxes and begin accumulating funds to pay them.
- Determine tax payment timing (some local tax authorities accept annual payments and others expect quarterly remittances) and arrange to have invoices sent directly to you.

After you're certain that everything's properly recorded and complete, check your credit report to make sure that the mortgage satisfaction has been noted there. You can get a copy of your credit records free of charge at AnnualCreditReport.com, the government-sponsored site where records from all three credit bureaus are consolidated and made available.

For your filing cabinet or safe deposit box, retain some documents related to your mortgage. For loans made up to mid-2015, keep the loan's original HUD-1 form (for more recent mortgages, this is the loan's "Closing Disclosure" form). This shows the original price you paid for your property, which becomes the basis for calculating any capital gains taxes you may owe when it comes time to sell.

Also save copies of the deed and any notice(s) of mortgage satisfaction you've received over the years (including any from any previous refinances).

You determined a method to prepay your mortgage and succeeded in retiring it -- congratulations!

You can return to the previous article and review various mortgage prepayment methods, or even jump back to the beginning of this Mortgage Prepayment Guide.

If you're interested in borrowing from the equity you accumulated, see our Guide to Home Equity Loan and Lines of Credit.

If you're over 62 and want to learn how to tap your equity payment free, you'll want to check out our comprehensive Guide to Reverse Mortgages and Home Equity Conversion Mortgages.