

The power of mortgage prepayments

By Jim Middlemiss • Bankrate.com

Canadians seeking a sure-fire investment return should look no further than their mortgage. Paying it down as quickly as you can will, in most cases, result in a stellar return on your investment, according to financial experts.

"You really need to look at prepayment options. Paying down even \$1 of principal has huge benefits over the life of a mortgage," says Scott Plaskett, a certified financial planner and CEO of Ironshield Financial Planning Inc. in Etobicoke, Ont.

Don Blair, a mortgage agent at MortgageTech Corp. in Richmond Hill, Ont., agrees. He says mortgages are front-loaded when it comes to interest, so in the early years, most of the money you pay goes toward paying the interest on the amount you borrow.

"If you borrow 95 percent, you are paying \$3 of interest for every \$1 of principal you pay," he explains. So, by paying an extra \$1 of principal, that's \$3 less you'll have to pay in interest, at least in the early stages of a mortgage.

"If you can put some extra money down, it's like a 300 percent rate of return. I can't imagine anyone saying no to a 300 percent return on their investment," he says.

For those who borrow 80 percent of their home's price, 70 cents of every dollar they pay goes toward interest in the first five years or so of the mortgage, says Blair.

Deciding between investing vs. paying down your mortgage Scott Ellison, a certified financial planner with Rudderham Norwood Ellison Investment Counsel in Halifax, says because mortgages are paid with after-tax dollars, you have to earn more than \$1 to pay \$1 in interest, and you should factor that into your decision whether to use extra funds for investing or to pay down your mortgage.

For example, if you have a mortgage with an interest rate of 5.2 percent and you make an extra payment, it has the same impact as earning 8 percent or 9 percent on the same amount of money had you invested it instead.

"Paying off your mortgage is a guaranteed rate of return," says Ellison.

But before plowing your spare dough into your mortgage, you need to make sure you can afford it. Plaskett says while you might end up paying off your mortgage faster, you could be left without any retirement savings.

Ellison adds that if you're pouring your resources into your mortgage, but living on credit cards or lines of credit to pay your living expenses, you're farther behind, since the interest rates on those debt products are likely to be higher than the mortgage rate.

A range of prepayment options. Once you determine that prepaying your mortgage is your best option, you need to figure out how to do that most efficiently.

Feisal Panjwani, a Langley, B.C., mortgage consultant with Invis, says one option is to make a lump-sum payment. "Most lenders allow you to make a lump-sum payment of 10 to 25 percent of the value of your mortgage." Typically, it's in the 15 percent to 20 percent range, but you need to shop around.

The lump-sum payment is based on either the original amount you borrowed or the amount currently outstanding. Since mortgages decrease with each payment, Panjwani says it's best to negotiate a lump-sum payment option based on the original amount you borrow. That way, if you come into an inheritance, a big bonus or save a ton of money, you can pay down the largest amount possible.

Another factor to consider is when you can make a lump-sum payment. Some mortgages allow prepayments during the year, while others permit it only on the anniversary date. Still others allow you to make prepayments on the day you make your regular payment.

Blair says most people do not maximize their lump-sum payment option because it's hard to save thousands of dollars in the course of a year. If you have a \$150,000 mortgage, a 20-percent lump-sum payment option means you could pay an additional \$30,000. But who has that kind of money?

If you can't pay the maximum, pay something, even if it's a few thousand dollars each year. That will still save you thousands of dollars in interest payments.

Be flexible or double up. Another prepayment option involves taking advantage of flexible payments. Most banks allow you to increase your regular payment up to a set maximum, such as 15 percent, while others allow you to double up your payments.

Blair says if you have a \$1,000 per-month mortgage payment and increase it by 15 percent to \$1,150, you could shave off as much as five and a half years on a \$200,000 mortgage.

You can also pay off your mortgage faster by moving to a different payment schedule. Instead of making monthly payments, make them biweekly or even weekly. Using an accelerated mortgage, which simply calculates the payment differently over the span of a year compared to paying monthly, you actually make one extra payment in the calendar year. By paying more and paying faster, you reduce your principal earlier, which lowers the amount of interest you pay.

Panjwani says if your payment is an odd number, such as \$473, bump it up to a nice round figure, such as \$500. "Any extra little bit goes toward the principal."

Plaskett stresses that while prepaying your mortgage can be beneficial, it depends on your total financial picture and shouldn't come at the expense of your retirement plans. "You can't pay for a meal with a door knob," he warns. "You may be in retirement and have this wonderful net worth all tied up in your home equity. How are you going to access it unless you sell?"

Jim Middlemiss is a freelance writer and lawyer based in Toronto. He's a frequent contributor to the National Post, Investment Executive and Wall Street & Technology.

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