How To Save Big On Your Mortgage

I'm often asked if it makes more sense to prepay a mortgage or invest the money in stocks and bonds. Rather than ponder which asset will get you a higher return, I think the better question is which investment decision will free you financially and allow you to retire earlier.

In my 9 years of experience as a financial advisor for Morgan Stanley, the clients who paid their debts off early -- specifically their mortgages -- retired 5 to 10 years before those who didn't.

If your goal is to retire sooner than your friends, sleep well at night, and save a lot of money over time, here's the best approach I know of prepaying your mortgage.

Going Biweekly

When you set up a biweekly mortgage payment plan, instead of making your monthly mortgage payment the way you normally do you split it down the middle and pay half every two weeks.

The result is that you end up making one extra full payment every year. (Twenty-six half payments is the equivalent of 13 full payments.) The best part is that the extra payment is made gradually over the course of the year, so you don't feel the pinch. And since most people are paid every two weeks, a biweekly payment plan turns out to be a phenomenal budgeting tool.

Anyone can do this. You don't need a special mortgage, and you can set it up anytime.

Pay More, Save More

Say your mortgage payment is $2,000 a month. With a biweekly plan, instead of sending a $2,000 check to your mortgage lender each month, you would send them $1,000 every two weeks.

By doing this, the miracle of compound interest reduces your debt. You actually end up paying off your mortgage early -- somewhere between 5 and 10 years early, depending on the duration of your loan and your interest rate.

On average, a U.S. homeowner with a $300,000 mortgage can save upwards of $100,000 over the life of his or her mortgage just by following this simple program. And if that's not enough incentive, think about being debt-free and potentially ready to retire years sooner than you'd planned.

Let's compare the difference between a monthly and a biweekly payment plan for a $300,000, 30-year mortgage with an interest rate of 7 percent. The monthly payoff schedule winds up incurring a total of $418,026.69 with interest charges over the life of the loan.

The biweekly schedule, on the other hand, runs up just $311,876.19 with interest. So switching to the biweekly plan will save you more than $106,000. Your mortgage may be smaller or larger, so run the numbers for your mortgage to see how much you can save.

Automate It, Of Course

The great thing about switching to a biweekly payment plan is that it allows you to save money over the long run without refinancing or otherwise changing your mortgage. All it takes is one call.

Most mortgage lenders offer programs designed to totally automate your biweekly mortgage plan. At Wells Fargo, for example, it's called the Accelerated Ownership Plan. Citibank calls it the BiWeekly Advantage Plan. To enroll, all you need to do is phone your lender or go online. Many banks even offer this service for free to customers who do their banking with them.

Banks that don't offer this service will usually refer you to an outside company that runs the program for them. These companies generally charge a setup fee between $200 and $400. In addition, there's a transfer charge of $2.50 to $6.95 each time your money is moved from your checking account to your mortgage account.

To be sure you're dealing with a reputable firm, I recommend using one that's referred to you by your mortgage company. One of the biggest such firms is a company called Paymap Inc. It currently provides this service through its Equity Accelerator program, which is powered by Western Union. To find out more, visit their web site or call (800) 209-9700.

(By the way, I'm not affiliated with Paymap or Western Union in any way, and I don't make money by recommending them. Whenever I mention a specific service or product in my column, it's simply to offer a resource for readers -- not to get a commission.)

What to Ask Before Signing Up

When dealing with a service company, be sure to ask the following critical questions:

• When exactly do they fund the extra payments toward your mortgage?

The answer should be "immediately." You're making extra payments to pay down your mortgage faster. That won't happen if the service company is holding onto your payments for any reason.

• What happens if you refinance?

Determine whether the service is transferable to a new mortgage company, or if you'll have to go through the setup process again -- including paying another fee.

• How much will it cost to use the program?

Get a clear understanding of how the costs involved compare to the savings you'll realize, so you can make an informed decision (see the next section).

Cost vs. Savings

Let's do the math. If you're paying $2.50 per transfer every two weeks, that comes to roughly $65 a year. Over 22 years, it totals just over $1,430, not including the setup fee. Figure that the transfer fee will probably go up a little over time, and there's no question that a biweekly mortgage system will cost you a few thousand dollars.

So why do it? The answer is that the few thousand dollars you're spending will save you tens of thousands of dollars, if not more.

In the example above, you would've saved more than $106,000 over the life of the mortgage. Assuming that you signed up with the most expensive program out there to handle your biweekly payments, and spent $5,000 over 22 years, you're still ahead over $100,000.

Going It Alone

Are there other, no-cost mortgage prepayment options? Sure. You could pay an additional 10 percent of your mortgage each month and have it applied directly toward the principal. Or you could make one extra payment at the end of the year and again have it go toward your principal.

But note that word "could" -- some things are much easier said than done. Just as most people won't save if they don't make it automatic, most of us won't make extra mortgage payments unless it's automated.

If you decide to do it yourself, my suggestion is that you pay an extra 10 percent a month and send it as a separate payment -- automatically, of course. Make a point of telling your lender to apply any extra payments toward your principal, and then check your monthly statements to make sure they've applied it correctly.

Credit – David Bach