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Should You Carry a Mortgage Into Retirement?

Although it remains the goal of many households to repay their mortgage by retirement, an increasing proportion now enters retirement with a mortgage. At the same time, households are increasingly likely to hold substantial amounts of financial assets, as a result of the growth of 401(k) and similar plans. Among households aged 60 to 69 in 2007, 41 percent had a mortgage. Of these, 51 percent had sufficient assets to repay their mortgage. These households could, if they wanted, be mortgage-free simply by selling some of their investments and mailing a check to the lender. But would this be wise?

A July 2009 *Issue in Brief* by Anthony Webb, a research economist at the Center for Retirement Research at Boston College, considers whether households should use retirement or non-retirement wealth to pay down their mortgage. It first shows that it is unlikely that many retired households will be able to earn a return on risk-free investments such as bank certificates of deposit, Treasury bills, and Treasury bonds that will exceed the cost of their mortgage. Liquidity considerations aside, households holding such assets will generally be better off using them to pay down their mortgage. It then considers and (for most households) rejects the argument that households should retain their mortgage because they can earn a higher expected return in stocks and other risky assets. It concludes with practical advice for most households.

The Risk-Free Case

A household that chooses not to repay a mortgage is, in effect, choosing to finance the ownership of its financial assets with borrowed money. If the after-tax return on the household's risk-free assets, such as bank certificates of deposit, Treasury bills, and Treasury bonds, exceeds the after-tax interest cost of the mortgage, the household has an opportunity to make a risk-free profit. As discussed in the report, this situation is rare and, liquidity considerations aside, the household will generally be better off using such financial assets to pay down its mortgage.

As an example, assume the mortgage interest rate equals five percent, about the average for newly-originated 30-year mortgages (a historically low rate). If the household does not itemize, this is both the before and after-tax interest rate. If the household itemizes and faces a tax rate of 25 percent, the after-tax cost would be 3.75 percent. Now, assume that the interest rate on short-term deposits is 3.0 percent, significantly above the interest rate at the time of writing. At our assumed 25 percent tax rate, the household earns a net return of only 2.25 percent on money invested in a taxable account (or 1.5 percent less than the cost of the mortgage, and the household would be better off repaying its mortgage whether or not it itemizes.

The Risky Case

The Risk-free analysis applies to strategies that are guaranteed to leave the household no worse off. But an alternative for households that choose not to repay their mortgage is to invest in stocks. Stocks offer a higher expected return than the interest cost of the mortgage, but also carry the risk of loss. Over the period 1925-2006, stocks yielded an average real return of 7.1 percent. Although many financial advisers recommend that retired households invest their financial assets in a mixture of stocks and bonds, only a very small minority of retired households has all, or almost all, of their financial assets invested in stocks. As discussed in the report and applied to two theoretical households with differing stock/bond investment mixes, all except this small minority will be better off repaying their mortgage.

Conclusion

The report concludes that the above analysis indicates that retired households are, in theory, better off repaying their mortgage. In addition to this theoretical conclusion, there is also a very practical argument against borrowing to invest. If a household with a mortgage mismanages its investments, or over-estimates the rate at which it can decumulate those investments, it risks losing the house, its only remaining asset.

One argument that is sometimes cited in favor of not repaying the mortgage is that retaining a mortgage increases the household's liquidity, and enables it to better cope with sudden unexpected expenses. But households that retain a mortgage need to consider what they would do if the bad event actually happened – i.e., how they would maintain their mortgage payments once their financial assets had been spent.

The full *Issue in Brief* can be found at: http://crr.bc.edu/images/stories/Briefs/ib_9-15.pdf.

[Note: You should consult a competent financial advisor about your personal circumstances before taking any steps as described in the article above!]