5 Mortgage Strategies for Retirement

By Robert Margetic

Mortgages and other debt have carried stigma for millennia. We were warned of the evils of borrowing money in the bible, by Shakespeare and by countless pundits and philosophers over time. But our society encourages us to pursue the American dream through home ownership and the only way to secure the American dream is to take on a mortgage.

The home purchase push went into overdrive after our veterans returned home from World War II. Home ownership became the mantra, GI loans became the norm and suburbia flourished. The children of these veterans also bought into home ownership as both a place to live and a prudent investment. One key difference between the veterans and their brood is the veterans paid off their mortgage before they retired with deeds of trust burning parties.

The World War II veterans were highly influenced by the debacles of debt during the depression of the 1930s. People lost their farms and homes because they could no longer make the monthly payments. This learned behavior lasted their lifetime as they regularly shunned debt of any type.

Times changed. Debt became the new American mantra. We leverage our investments, spend future pay raises today and live the lifestyle we all deserve became the new learned behavior. Governments and financial markets made it all so easy. In fact, current economic growth is highly dependent on maintaining this excessive consumer materialism.

But, as we approach retirement we realize this party cannot go on. The bills have come due and we know we should probably pay them before we quit work. We now face a conflict of whether to save more for retirement or pay off our debts. Both require we forego some level of current consumption. Paying down credit card and other debt seems obvious, but mortgage debt weaves its way through our lives in complex ways.

In our quest for lower monthly payments and possibly take out some home equity, many of us refinanced with abandon in the latest low interest environment. Paying a lower interest rate generally makes sense but one of the side effects of refinancing is it extends the duration of the mortgage. We may have traded a mortgage with ten years left to refinance one with thirty years left.

Although our level of debt may be the same, the lower monthly payments are merely an illusion that we are saving money. Our debt has been extended and we are just paying it off at a slower rate. If we pay the new amount over the new time period the total interest we pay by staying in debt longer can be more than the amount we saved through lower monthly payments.

Our parents' generation paid off their mortgages prior to retirement. We now must consider whether we should do the same. There is no right or wrong answer mostly it depends on the tradeoffs you are comfortable living with. There are five basic strategies to consider:

1. **Keep Existing Mortgage** – For those who recently refinanced and have a lock on a long term low fixed interest rate, this strategy can make sense. In general, once retired, it is harder to borrow money since we no longer have a paying job. This access to capital allows us to keep our savings and liquidity in tack to be prepared for uncertain events.

   The key test of the viability of this strategy is to be able to maintain servicing the debt. We can determine our ability by figuring out how much the monthly payment is relative to our total income. First determine your monthly income by adding your Social Security, Pensions and the expected income taken from savings. Next take the monthly payment and divide it by your total expected monthly income. For example, if your mortgage payment is $1,000 per month and your total expected income is $3,000 per month your expense ratio is 1/3 or 33%. Generally we enter the danger zone when our monthly ratio exceeds 33%. If your ratio is higher than consider one of the other alternatives.
2. **Refinance-** This option makes sense if your current interest rate is higher than the current market rate for fixed mortgage rates; you have home equity and high credit card or other consumer debt; or if you have a variable interest rate. This is not the time to take money out of your house to buy consumer goods. The goal of the refinancing is not to increase your total outstanding debt.

   Credit card and other consumer debt should be eliminated prior to retirement. Consumer debt is a tough trap to get out of once retired. Although this strategy does not reduce total debt, the ongoing carrying cost should be lower. Refinancing is also cheaper than paying off consumer debt with taxable IRA distributions. Variable rate consumer debt and variable rate mortgages shift interest rate risk to the retiree. Retirees generally have a fixed income, having a variable debt with the potential to increase can squeeze the retiree and force unpleasant lifestyle tradeoffs as more fixed income shifts to pay the monthly mortgage. This is not the time to increase financial risk with a variable rate mortgage.
3. **Mortgage as a Wealth Builder** - The basic concept here is you can earn more money on your investments than paying off your mortgage. For example, if your mortgage is 5%, some may feel they can earn more than this on their savings thus building wealth in retirement. There is a need for some portion of savings to grow in value. Inflation is the scourge of the fixed income crowd. Living expenses will rise and unexpected health costs become more likely as we age. Some portion of our overall wealth needs to be invested for growth but we should be cautious if we borrow to accomplish this.

   Straddling our mortgage with our investments can only be done effectively if we take on more investment risk. Mortgage rates our deductible, but comparable low

risk investments pay less on an after tax basis than we pay on our mortgages because most of them are of shorter duration. CDs, Treasury Bills and such pay considerably less than long term mortgages. These investments are taxable and their after tax return generally will be no better than the after tax payment on your mortgage. For this strategy to work, you must take on more investment risk. Money would have to be invested in lower quality, long term bonds, stocks, or other risk assets to make this work. This strategy always carries the possibility of losing money on your investments.

4. **Pay off Mortgage** – This strategy helps us sleep better at night and is the safest as we no longer carry debt. We lower the likelihood of being forced to sell our house because we cannot make the monthly payments. We also have locked up our wealth in an asset that tends to hold its value over time. The best scenario is we have paid off the mortgage over its fifteen or thirty year term and we do not have to pay off a large lump sum at retirement.

   If we have a substantial balance to pay off at retirement, then we need to look at the impact of using up a portion of our savings to accomplish this. First, it will be quite expensive if we use IRA or 401(k) money to pay the mortgage as these funds are subject to ordinary income taxes. Second, if we must sell appreciated assets we may have capital gains taxes to pay. Each requires more than one dollar sold to pay off one dollar of debt. There is also an impact on our access to cash; we now have less cash. We need a portion of cash to meet emergencies and we need a portion dedicated to grow in value to meet future inflation. We may have paid off our mortgage and can sleep better at night at the expense of being less prepared for emergencies if we draw down too much of our savings.
5. **Move Down** – This strategy sells the current house and buys a smaller house and reinvests the difference. There can be a number of reasons to move: a smaller house is easier to maintain; condo living is less time demanding; active living or retirement living arrangements can meet other lifestyle goals and the reinvested equity can supply the necessary supplemental income we need to meet our retirement goals. The new home can be debt free or at least the total mortgage can be substantially reduced thus increasing our overall sense of security.

   But, we have to be ready to move and the move down strategy is subject to market risks. We may not be able to sell our home for what we think it is worth. There is purchase risk in buying the next place and if we are to finance the deal, there is interest rate risk. The key uncertainty to this strategy is adapting to the new living arrangements. Family disruptions can occur. New social networks may be harder to build and the new location may be more appealing in our fantasy than in reality.

Deciding what to do with our mortgage can be the most important financial decision we make in retirement. New retirees have lived with debt most of their lives and are more comfortable with it than their parents. There is always risk in debt as can be seen with

the current mortgage meltdown and banking crises. But, knowing the risks of debt, if handled responsibly can help us meet our retirement lifestyle objectives.

The ideal amount of mortgage debt is to balance security and liquidity. We use up available cash to pay down a mortgage. We may owe less but we have less cash to generate monthly income. We may feel more secure with the mortgage paid but we are more vulnerable to unexpected expenses as we have less cash. Mortgage debt requires ongoing servicing. The debt is fixed and certain, but our ability to pay is subject to risk and uncertainty. What will happen to Social Security? Will financial markets crash yet again? Mortgages can facilitate our lifestyle yet requires responsible diligence. We each need to find our balance between debt and security.