AARP Bulletin

YOU AND YOUR 3% MORTGAGE

Strategies for a low-rate home loan in a high-rate world

By KIMBERLY LANKFORD

If you bought a house or refinanced your mortgage in the decade leading up to the spring of 2022, you have a right to feel lucky. Mortgage rates were often below 4 percent in those years, reaching an all-time low of 2.65 percent in January 2021. Then came inflation. As of late October, the average 30-year fixed mortgage rate had risen to 7.79 percent.

"In the world of mortgages, that's a gigantic difference," says Jacob Channel, senior economist at LendingTree. Getting a rate that is about twice as big "could increase your monthly payments by thousands of dollars."

With a low fixed-rate mortgage, you can, of course, sit tight and just keep making payments. But the rise in overall interest rates, which affect savers as well as borrowers, might make you ponder adjusting your plans.

PREPAY THE MORTGAGE?

Strong investment yields may have you thinking you can now afford to pay off your mortgage or accelerate your payments. But you might consider investing that extra money instead, taking advantage of rates that are higher than your current mortgage rate.

"If your kids are done with college or your income has gone up and you have some more savings capacity, instead of paying down the low-rate mortgage faster, another conservative approach is to put that money in a money market account" with a yield higher than your mortgage rate, says Roger Young, a thought leadership director at T. Rowe Price.

Though money market accounts have the advantage of liquidity—you can cash them in almost instantly without penalty—there's no guarantee that their yields will stay high for long. So another tactic is to instead purchase U.S. Treasury debt, which has a guaranteed yield over the life of the note, thus locking in a rate for longer. (Seven- and 10-year notes yielded about 4.2 percent in early December.)

A related strategy, known as laddering, is to buy bonds maturing in different years—for example, three, five and seven years from now. "Bond yields have come down from recent highs, but are still higher than they've been in years," says Michelle Morris, a financial planner with Brio Financial Planning in Quincy, Massachusetts. "Instead of prepaying a mortgage costing 3 percent, use the cash to buy a Treasury bond ladder paying more."

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If you itemize your tax deductions, the case for keeping your mortgage is even stronger. "My husband and I have a 2.75 percent fixed 15-year mortgage with a low balance. We could pay it off, but I am watching the benefit each spring when we prepare our taxes," says Donna Skeels Cygan, a financial planner in Albuquerque and author of The Joy of Financial Security. "We itemize every year, so we get a tax benefit from the interest we pay, and our investments are doing far better than the net after-tax mortgage rate. I understand the psychological benefit of paying off a mortgage before retiring, but weigh the financial and tax benefits more heavily in this situation."

POSTPONE A MOVE?

A low-rate mortgage can act as a golden cage, keeping you in the same home even if you want to move. Trading a 3 percent mortgage for a 7 percent mortgage will cost you. "Consider holding off on selling your home if buying your next home will be unaffordable at current rates," says Rachael Burns, founder of True Worth Financial Planning in Folsom, California. If you must buy another home now, a big down payment will reduce your loan size, she says; if you don't have enough cash for a higher down payment, you may need to adjust your budget downward.

What about withdrawing a lump sum from a 401(k) or traditional IRA to avoid borrowing? Unfortunately, the tax hit on a large withdrawal could make the purchase more expensive, says Patrick Carney, a financial adviser with Rodgers & Associates in Lancaster, Pennsylvania. He suggests spreading out retirement fund withdrawals over several years: "Consider taking out a mortgage and coming up with a plan to get the mortgage paid down over time so that there's not a huge tax hit all in one year."

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