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Retirees: Think Twice About Paying Off Your Mortgage

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The countdown to retirement is on for millions of baby boomers and, thanks to a lifetime of diligent saving, some have amassed enough wealth to pay off their mortgages and live debt free

Conventional wisdom says it's best to pay off your mortgage before retirement, but given the low-interest rate environment, and the need to preserve cash in an unstable economy, that strategy is no longer absolute.

Paying off your house is one goal, but having a zero-mortgage liability is not the answer for everyone. If you don't have a stream of resources to replenish it, you might do yourself a disservice by taking money out of the bank to pay off your mortgage. Retirees themselves, it seems, are equally torn as to the most prudent course of action.

According to the Center for Retirement Research at Boston College, 41% of U.S. households aged 60 to 69 in 2007 maintained a mortgage. Of these, 51% had sufficient assets to repay their loans.

When it pays to borrow

While most financial planners agree that owning your home free and clear during retirement is a worthy goal, there are times when it makes more financial sense to keep your money in the market and use the earnings to pay off your loan. That's particularly true, if you need to invest (however conservatively) for growth.

There are a few retirees who feel like if they don't take the risk to get the growth, they're not going to be able to meet their retirement objectives and live the lifestyle they want. If you take a big chunk out of your nest egg and the income it was generating was being used to meet your mortgage payments, as well as additional living expenses, that may not be the right thing to do. Most retirees are advised to withdraw no more than 4% from their nest egg each year to ensure they won't outlive their income.

Thus, if you take \$200,000 out of a \$500,000 portfolio to pay off your house, your income based on that 4% draw-down rate would drop to \$12,000 from \$20,000 per year. (The \$20,000, of course, would have had to help pay for your mortgage.)

It's very dangerous to tie up all your money in your house, because your house is not going to generate income. It's nice security, but you lose flexibility and depending on how conservatively you invest your remaining portfolio you may not have enough income to live on.

What's your rate?

When determining whether to pay off or keep your mortgage, you should also consider your interest rate.

If the average after-tax return on your investments is greater than the after-tax cost of your mortgage, it may make sense to keep your money invested. Don't forget to factor in the effect of the mortgage-interest tax deduction.

If you're in the 30% tax bracket and you're able to claim the full deduction, a 5% loan is really only costing you roughly 3.5%. Thus, you'd only have to earn 4% on your investments to make it worth your while. (Given the low interest-rate environment, however it's nearly impossible to achieve that rate of return on more conservative, fixed-income products such as bonds and certificates of deposit.)

It's hard to find comparable risk-free investments, so you have to be able to stomach a loss if you want to go that route. You can't get a plain vanilla CD anymore, because those rates are too low.

Getting close

If you're nearing retirement but haven't yet quit, the case for keeping your mortgage and continuing to invest is more clear -- at least until you part ways with the boss.

According to a 2007 study by the Federal Reserve, directing extra money towards your low-interest mortgage loan at the expense of continued contribution to your 401(k) is a costly mistake.

Some 38% of the U.S. households that are accelerating their mortgage payments instead of saving in a tax-deferred account, such as a 401(k) or traditional IRA, are making the "wrong choice," it concluded.

For those households, reallocating their savings towards a tax-deferred account instead would yield a mean benefit of 11 cents to 17 cents per dollar, depending on the choice of investment assets in the account. In all, the study notes, "those misallocated savings are costing U.S. households as much as \$1.5 billion per year."

When to pay it off

Despite the limited scenarios in which keeping a mortgage during retirement might make sense, most retirees would be better off eliminating debt (however low the interest rate) for the peace of mind it affords.

Money, after all, isn't just about the math.

For the general population our guidance is still the old adage of paying off your mortgage before you retire. There isn't anything as safe as being rid of that mortgage and that burden before you hit a period of your life where you're not bringing in a paycheck.

Indeed, mortgages consume 20% to 30% of the typical household's fixed expenses.

While some maintain that using savings to pay off one's mortgage is unwise, as it leaves you less cash on hand for unexpected expenses, such as medical costs and home repairs, that argument lacks validity.

Households "need to consider what they would do if the bad event actually happened," . To wit, how they "would maintain their mortgage payments once their financial assets had been spent." Remember, too, you can always take out a home equity line of credit on your paid off home, which can satisfy the need for cash reserves.

If you can't pay off your mortgage in full without depleting your nest egg, at least shoot for a more manageable monthly payment.

I strongly advocate trying to pay down your mortgage, so when you reach retirement you're not faced with a standard of living crisis. There is some wisdom to paying off a portion of your mortgage so you have minimal payments and some left over in an emergency fund.

A generation ago, retirement planners often started with the premise of a paid off home, using Social Security, company pensions, and other income sources to help their clients cover living expenses.

Today, however, with interest rates at historic lows and many retirees chasing returns to offset losses incurred during the market meltdown, a mortgage-free retirement is not necessarily the long-term goal.

Deciding what makes sense for you depends on your financial profile, interest rate, and your ability to stomach risk.