

Should You Extend the Duration of Your Mortgage Loan?

In the February to April 2008 issue of the iFAST INSIGHT, a financial adviser shared his views on why keeping your mortgage loan's term as short as possible is a better strategy. But ALFRED CHIA from SingCapital Pte Ltd takes a different view. Find out more here.



By taking shorter term repayment options for your mortgage loan, you can save tens of thousands of dollars in interest payments. In addition, there is the satisfaction that you own your asset at a younger age. So, would a 20-year mortgage repayment scheme be a better choice than a 30-year plan? Table 1 shows the difference.

On the surface, it may appear prudent to shorten the repayment term for the mortgage loan in light of the large amount of interest saved. But let's take a closer look and see if there is any drawback to this.

Look Beyond the Interest Savings

One often forgotten element to consider in keeping the length of the mortgage loan short is to look beyond the interest savings. When you make extra mortgage payments for a shorter term repayment, you are actually 'investing' more of your discretionary cash into an asset that some regard as an investment that can be sold later at a profit. But others

may consider a property as an asset that is used by the family and do not plan to sell it simply based on the fact that it can make a profit. Furthermore, investing in real estate is to a certain degree fairly illiquid, particularly when property prices are falling rapidly and the asset has gone into negative equity.

You could be in a frustrating situation if you come across an exciting investment opportunity, but find that you have used up all your spare cash in financing your home. You may also want to have some extra cash set aside into a retirement fund and the yield from this fund could help you retire more comfortably with not just a roof over your head, but with some cash in hand as well.

You may also need the cash that is locked up in the repayment of the property during a difficult period, e.g., pay for unexpected contingencies like sickness or death in the family or for the fees of your children's overseas education. Under such circumstances, you would appreciate the benefits of having a more liquid investment, something which you can

TABLE 1: HOW YOU CAN SAVE WITH A SHORTER MORTGAGE TERM

SUPPOSE YOU HAVE A MORTGAGE LOAN OF \$500,000 AT AN AVERAGE INTEREST RATE OF 5% THROUGHOUT THE LOAN TERM. WE COMPARE THE MONTHLY AND LIFETIME COST FOR A MORTGAGE LOAN BASED ON DIFFERENT TERMS:

TERM (YEARS)	MONTHLY INSTALMENT	EXTRA INSTALMENT (PER MONTH)	INTEREST COST OVER THE LOAN TERM	AMOUNT SAVED
30	\$2,685	0	\$466,278	0
25	\$2,922	\$237	\$376,886	\$89,392
20	\$3,300	\$615	\$292,000	\$174,278
15	\$3,953	\$1,268	\$211,715	\$254,563
10	\$5,303	\$2,618	\$136,393	\$329,885

TABLE 2: COMPARISONS BETWEEN A 15-YEAR LOAN AND 30-YEAR LOAN

	15-YEAR LOAN TERM	30-YEAR LOAN TERM
Monthly Instalment	\$3,953	\$2,685
Total Interest paid	\$211,715	\$466,278

convert into cash for immediate use.

There is a better method to alleviate this situation: pay less into the repayment of your mortgage plan and invest the difference in investments that can generate higher returns.

Let's look at Table 2, which compares two loan terms based on a loan of \$500,000 at an average interest rate of 5% over the entire loan periods.

It would cost you \$254,563 more if you opted for a mortgage loan of 30 years, instead of a mortgage loan of 15 years. The difference in the monthly repayment between the two periods is \$1,268. However, if you are able to invest this difference into a Regular Savings Plan (RSP), you could accumulate \$439,122 at the end of 15 years based on a projected return of 8% per annum. In that sense, you can still have the option to pay off your home loan early and have higher liquidity at hand.

An RSP invokes dollar cost averaging, as it removes the stress of market timing and the frustration of not

being able to capture a market's lowest points. Naturally there is the risk element when it comes to investment, but investments over the long term generally yield good returns. It must always be remembered that in such plans, the time factor is important, in order to allow yields to be maximised over the longer term. This will allow the market cycles to even or average out for a higher potential average rate.

For those privileged to have an HDB concessionary loan, the current interest rate is 2.6% (which is based on CPF Ordinary Account interest rate + 0.1%), and the rate has been at the same level since the year 2000. This group of owners will be able to benefit more, as the cost of their loan interest is lower. Furthermore, the HDB rules do not allow HDB owners to remortgage their home after they have paid off their loan. Such owners will find their asset very illiquid, as opposed to a private property owner who can always remortgage their property for an equity loan. As HDB owners, however, their funds are "tied up" and

they may miss out on great opportunities to invest in a second property or in the equity markets.

The choice gets tougher if your loan interest is more than 5% p.a. as the perceived rate of return versus the interest rate on the mortgage loan gets narrower. One can further manage this by refinancing to manage and factor in a lower interest cost. For example, if one had refinanced at the right time from year 2002 to the present day, the average interest cost would be about 2.5% p.a. Based on a current loan package, as an example, the first year's interest rate can be as low as 1.8%. There are also loan packages that offer you cash rebates of as high as 1.5% of the loan amount. You may even find mortgages that will pay you the same interest rate on your current account as the interest rate that is charged on your mortgage plan!

In the extreme event that the loan interest rises to above 5% p.a., you can always do a partial repayment with the income earned from the investment to reduce the loan. It is therefore important to have a financial adviser who is able to update you on the different options offered in the market.

Conclusion

If you are certain that you can meet the higher monthly payments, and want ownership without any risk from the additional investments, then a shorter loan repayment is the answer. But with a longer mortgage term, this would ease the strain of your cash flow. You can then invest the difference and still re-work the repayment period into a shorter one if you choose to do so in future. This, of course, will give you additional options and flexibility in managing what to many of us is a worrisome and often frightening amount of debt hanging over our heads for much of our lifetime. **iFAST**