

Should I Select a 15 or 30 Year Mortgage?

Clients invariably ask the question: is a 15 year or 30 year mortgage better?

The conventional argument compares the interest paid in each scenario. The reasoning goes something like this: the 15 year option is superior because you will pay less interest to the bank than you will with a 30 year mortgage.



The Example

Let us compare a \$250,000 loan, with a 15 and 30 year duration, both at 4% interest. Without any critical analysis, the conventional argument and numbers seem compelling.

15 year mortgage

180 payments, 4% interest

Monthly payment = \$1,849.22

Total payments = \$332,859.60

Interest payments = \$82,859.60

30 year mortgage

360 payments, 4% interest

Monthly payment = \$1,193.54

Total Payments = \$429,674.40

Interest payments = \$179,674.40

Off the bat, we see choosing the 15 year mortgage results in a 54% higher monthly payment, but the 30 year mortgage translates to 116% more interest paid. If you can afford the higher payment option, the 15 year is the winner, right?

Let us assume the borrower selects the 30 year mortgage and deposits the difference between the monthly payments into a cash accumulation account, with the objective of using the accumulated dollars to pay off the mortgage early.

\$1,849.22 monthly payment (15 year)

- \$1,193.54 monthly payment (30 year)

\$655.68 /month to be deposited into a cash accumulation account

So each year, the 30 year borrower is depositing \$7,868.16 into the cash accumulation account. And, in 15 years, if we assume a net 4% rate of return over 15 years, the funds in the cash accumulation account would grow to \$161,000.

Ironically, in year 15 of the 30 year mortgage, the outstanding principal due is \$161,000.

At that point, assuming there is no pre-payment penalty (there is no prepayment penalty associated with most residential mortgages), our borrower could use the savings in the cash accumulation account to pay off the loan.

In this scenario, the outcome is the same. The amount borrowed, the interest rate and total monthly payments are equal. In addition, the house is paid off in 15 years.

Other practical issues to consider

Deductible Interest. With the 30 year mortgage, the borrower pays \$126,193 in interest over the first 15 years. With the 15 year mortgage, the total interest paid is \$82,859. If the homeowner is able to itemize deductions, the 30 year option provides 52% more in deductible interest (one of the few tax deductions the IRS still allows!)

Lower Risk of default. In a household that can afford the 15 year mortgage, but goes with the 30 year, there is additional attractive appeal. In the event of job loss, with the cash accumulation account you have cash on hand to help make monthly payments, whereas with the 15 year mortgage, your equity is tied up in the home.

Opportunity. The accumulated savings can also be accessed if other financial opportunities arise. With the 15 year mortgage, the accumulation of equity is in the home, and let us remember, that that real estate is not guaranteed to retain its value (we saw the real estate market depreciate in 2008).



So while the conventional argument for the 15 year over the 30 year option seems to make sense on its face, a deeper dive reveals that the 30 year mortgage affords the homebuyer more options. You may be better off taking the 30 year, saving the "extra" payments and ultimately pay off the mortgage in a lump sum. Along the way, you get the potential tax benefits and an overall improved level of accessibility and flexibility to your money.

BUT... you are thinking, 30 year mortgages typically have higher interest rates than their 15 year counterparts. In addition, interest rates are at all-time lows. How can the separate cash accumulation account deliver returns equal to 4% so that in year 15 the balance is enough to pay off the remaining principal of the loan?

Let's put it to the test. Let's compare the same 30 year mortgage at 4% , with a 15 year mortgage at 3.1%. This means that the monthly difference in payments between the 15 year and the 30 year is only \$544.96 per month (not the \$655.68 in our previous example). This translates to \$6,539.52 per year deposited into the wealth accumulation account. Let's couple this with the assumption that the wealth accumulation account only nets 1.5% return over the next 15 years.

After 180 monthly payments (or 15 years), the 30 year mortgage has an outstanding balance of \$161,357. The accumulation account in this example has only \$110,721. This is a deficiency of \$50,636.

Even with this deficiency, the \$50,000 gap can be eliminated in just 4 ½ more years at a net 1.5%, and in just 3 short years with a net 4% rate of return.

Is this a bad tradeoff for the tax, accessibility, flexibility and control that come with establishing a wealth accumulation account? The ultimate issue is the value you place on having personal control over your financial life.

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