The Power of Bi-Weekly Mortgage Payments

These days it's hard to imagine anyone being thrilled about a conventional mortgage rate of 18.25 percent, but back in August 1982, it seemed like a real deal. Just a year earlier, the rate was a staggering 21.75 percent! With Canadian homeowners across the country sweating, credit unions came up with a novel but simple idea to help cool things down: bi-weekly mortgage payments.

Surprisingly big savings

Bi-weekly payments are the easiest and most effective way for borrowers to save thousands of dollars in interest. To understand the mechanics behind weekly mortgages, let's say Henry and Anne borrow $142,772.35 at 7 percent per annum, calculated half-yearly, not in advance, and amortized over 25 years. Their blended monthly payment (principal and interest) is $1,000. Over the next 25 years, they will repay the mortgage and an additional $157,227.49 in interest.

But if Henry and Anne split their monthly payment into two bite-sized tidbits and paid $500 every two weeks instead of $1,000 each month, it chops the interest expense to $124,238—a move that would save them $32,989 in interest (a non-deductible expense since interest is generally paid in after-tax dollars).

13 can be a lucky number for mortgages

Bi-weekly mortgages work for two reasons. One is the accelerated reduction of principal. More payments (26 vs.12) each year means the principal is reduced faster. The second is the built-in prepayment of principal. Each year contains 12 months, but 26 two-week periods. By paying $500 every two weeks, Henry and Anne are sneaking in an extra payment every year, reducing their mortgage by $13,000 instead of $12,000 annually. Since interest is charged on the outstanding principal, every extra penny reduces the amount owed, cutting the total interest cost.

Getting the real deal

But unfortunately, not all bi-weekly mortgages are calculated correctly: sometimes taking the total amount paid annually, and simply dividing it by 26 bi-weekly payments compromises the concept.

This method divides the $12,000 owed into 26 smaller but inedible chunks. Borrowers accomplish next to nothing. Paying $461.15 bi-weekly trims less than two monthly payments off the 25-year amortization, and saves borrowers only $1,100 over that period.

How can you make sure you get the real deal, slashing five years off amortization? Just arm yourself with a calculator. Negotiate the best possible rate, ignoring the issue of weekly payments. Ask for the normal monthly payment, amortized over 25 years. Then divide that figure by two for a bi-weekly mortgage. The number on the calculator screen is the amount you want to pay.

Remember: You won't reap much simply by making weekly or bi-weekly mortgage payments. To save big money, the bi-weekly mortgage payment must be 1/2 of the standard monthly payment, amortized over 25 years. Anything else is sleight of hand.