Independent Investor

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Home Refinancing Basics

In recent years, Americans seeking to capitalize on low interest rates have lined up to refinance their mortgages--often resulting in significantly lower monthly payments. While it's true that refinancing has the potential to help reduce the costs associated with borrowing money to own a home, it is not necessarily a strategy that makes sense for every individual in every situation. So before you make a commitment to refinance your mortgage, take some time to do your homework and determine whether such a move is the right one for you.

To Refinance or Not

The old and arbitrary rule of thumb said that refinancing only makes sense if you can lower your interest rate by at least two percentage points (e.g., from 7% to 5%). But what really matters is how long it will take you to break even and whether you plan to stay in your home that long. In other words, make sure you understand--and are comfortable with--the amount of time it will take for your overall savings to compensate for the cost of the refinancing.

Consider this: If you had a $200,000, 30-year mortgage with a 7.5% interest rate, your monthly payment would be $1,398. If you refinanced at 4.5%, your new monthly payment would be $1,013, a savings of $385 per month. Assuming that your new closing costs amounted to $2,000, it would take a little over five months to break even ($385 x 5.2 = $2,002). If you planned to stay in your home for at least five more months, then refinancing may make sense. If you planned to sell the house before then, you might not want to bother refinancing. (See table below for additional examples.)

All Mortgages Are Not Created Equal

Try to avoid the mistake of choosing a mortgage based only on its stated annual percentage rate (APR), because there are many other variables to consider, such as:

The term of the mortgage -- This is the amount of time (e.g., 15, 20, 30 years) it will take you to pay off the loan's principal and interest. Although shorter-term mortgages typically offer lower interest rates than long-term mortgages, they usually involve higher monthly payments. On the other hand, they can result in significantly reduced interest costs over time.

The variability of the interest rate -- There are two basic types of mortgages: those with "fixed" (i.e., unchanging) interest rates and those with variable rates, which can change after a predetermined amount of time has passed, such as one year or five years. While an adjustable-rate mortgage (ARM) usually offers a lower introductory rate than a fixed-rate mortgage with a comparable term, the ARM's rate could jump in the future if interest rates rise. If you plan to stay in your home for a long time, it may make sense to opt for the predictability and security of a fixed rate, whereas an ARM might make sense if you plan to sell before its rate is allowed to go up. Also, keep in mind that interest rates have hovered near historical lows in recent years and are more likely to increase than decrease over time.

Points -- Points (also known as "origination fees" or "discount fees") are fees that you pay to a lender or broker when you close the deal. While a "no cost" or "zero points" mortgage does not carry this up-front cost, it could prove to be more expensive if the lender charges a higher interest rate instead. So you'll need to determine whether the savings from a lower rate justify the added costs of paying points. (One point is equal to one percent of the loan's value.)

How Much Would You Save?

A homeowner with a 30-year, $200,000 mortgage charging 7.5% interest would pay $1,398 each month. The table below illustrates the potential monthly savings and the various break-even periods that would result from refinancing at different rates.

Rate After Refinancing	New Monthly Payment	Monthly Savings	Months to Break Even*
7.0%	$1,331	$67	30
6.5%	$1,264	$134	15
6.0%	$1,199	$199	10
5.5%	$1,136	$262	8
5.0%	$1,074	$324	6
4.5%	$1,013	$385	5

*Assumes $2,000 closing costs. Rounded up to the next month.

Stick With What You Know?

Finally, keep in mind that your current lender may make it easier and cheaper to refinance than another lender would. That's because your current lender is likely to have all of your important financial information on hand already, which reduces the time and resources necessary to process your application. But don't let that be your only consideration. To make a well-informed, confident decision you'll need to shop around, crunch the numbers and ask plenty of questions.