Money Management

Is It Time To Refinance Your Mortgage?

By The North Carolina Association Of Certified Public Accountants

Homeowners everywhere are lining up to trade in their old mortgages for new ones with lower rates or better terms. While it's tempting to jump at the chance for a lower monthly payment, homeowners should take the time to determine whether refinancing makes good financial sense. For homeowners who don't plan to stay in their homes long enough to offset the closing costs, refinancing can be a costly mistake.

Why Refinance?

In the past, the rule of thumb was that you should consider refinancing when mortgage interest rates fall two percentage points below your current rate. Over the years, conventional wisdom about rates, timing and other refinancing factors has changed.

The majority of individuals who refinance do so to lower their monthly payments by taking advantage of a lower interest rate. But borrowing at a lower rate is no longer the only reason to refinance. For many homeowners who reluctantly agreed to an adjustable-rate mortgage (ARM) when rates were high, refinancing provides the opportunity to switch to a fixed-rate loan with predictable payment. These people won't necessarily save a lot of money, but they do get the peace of mind that comes with knowing that their payments won't change if interest rates rise.

For individuals in need of money, perhaps to pay tuition bills or finance a new business venture, refinancing is a way to tap the equity they have built up in their homes. Equity includes the down payment, the amount paid against the principal of the mortgage and any appreciation in the home's market value. If you obtain a lower interest rate and your property has appreciated, you may be able to refinance your mortgage for a larger amount without a major increase in your monthly payment.

You can also use refinancing to switch to a shorter-term mortgage. A lower interest rate can make it possible for you to swap your 30-year mortgage for a 15-year loan with only a small increase in your monthly payment. Because you will be paying off the principal faster, you can save thousands of dollars in interest costs and down your home outright sooner.

The Cost of Refinancing

Refinancing involves the same complex process and the same closing fees as obtaining a first mortgage. In some instances, upfront closing costs may delay the financial benefits of refinancing for several years or even may make refinancing a losing proposition for you. This is why one of your most important considerations in the decision to refinance is whether you plan to stay in your house long enough to recoup your refinancing costs.

When you refinance, you may also be faced with paying points. A point is equal to 1 percent of the loan amount. Points are usually the most expensive costa associated with refinancing. Other refinancing expenses include the cost of a new appraisal to make certain that your house has maintained its market value, the cost of a new title search to verify that you own the property you are seeking to refinance, title insurance, legal fees, and application fees. Your total closing costs could be as high as 3 to 5 percent of the loan amount. You may be able to save on closing costs by checking with your current lender first. Banks that want to hold onto valuable customers may be willing to waive certain requirements.

Should You Refinance?

To determine whether or not it makes financial sense for you to refinance your mortgage, you'll need to find out how long it will take for your monthly savings to offset the cost of refinancing. First, determine what your monthly payment would be on your new loan. Compare this amount to your current payment to see how much you will save each month. If your current payment includes taxes, insurance, etc., be sure to exclude these costs for purposes of comparison. Next, total all the costs associated with refinancing. Finally, divide your total closing costs by the amount you would save monthly. This resulting figure represents the number of months it will take you to pay off your refinancing costs. If you don't plan to stay in your house long enough to reach this break-even point, refinancing probably doesn't make sense for you.

Shopping for a loan

The list of refinancing options has grown to meet the needs of borrowers and lenders. Your options include conventional 15- or 30-year fixed-rate loans, adjustable-rate mortgages, and balloon mortgages. The latter variation offers a rate that is fixed, usually for seven years. At the end of seven years, you have the option of paying off the remainder of the loan or renegotiating it at the current interest rate. Whatever type of mortgage you select, shop around for the best interest rates.

Tax Concerns

homeowners need to consider the tax implications of refinancing. First, it's important to note that although points paid upfront when you buy or construct a home are fully deductible in the year of the purchase. Points paid in connection with refinancing must be deducted over the life of the loan, whether you pay them in cash or add them to the loan amount. There's one exception: If yo plan to use part of the new loan for home improvements, the points that are attributable to that part of the loan are deductible immediately.

Also remember that a reduction in your interest rate means a smaller interest deduction on your tax return. If you have claimed extra allowances on your W-4 form based on your mortgage interest deduction, and refinancing significantly reduces the amount of interest you pay, you need to recalculate the number of allowances you have claimed.

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