When to Refinance Your Home

There are a number of situations in which refinancing a home mortgage makes sense. For example, you may have purchased a home years ago when interest rates were much higher and now want to take advantage of a decline in mortgage rates. In addition, a homeowner with a volatile variable rate mortgage may want to switch to more predictable fixed-rate loan. Then again, you may even want to shorten the term of your loan.

Is Refinancing Worth the Trouble?

Refinancing can be very beneficial, but it is not always the smart thing to do; the costs associated with refinancing must be balanced against any potential savings.

A general rule of thumb is that refinancing a fixed-mortgage makes sense when the interest rate on the current mortgage is at least 2 percentage points higher than the prevailing market rate.

In some instances, however, following this "rule" may cost the homeowner a lot of money as a very small percentage point spread may justify refinancing if other factors are present.

Other Factors Which Must Be Considered

There are a number of factors which must be considered in this "cost vs. benefits" calculation, including:

- **Closing costs:** Possible pre-payment penalties on the old loan, points and fees on the new loan, and attorney fees generally will total 3% to 4% of the loan amount and must generally be paid when the new loan closes. The borrower must consider the loss of earning power of these funds in future income projections.
- **Projected length of ownership:** The closing costs can be spread over the period of the loan; therefore, the longer the projected period of ownership, the smaller the spread between the old and new mortgages can be.
- **Income tax bracket of the owner:** Higher interest payments mean larger income tax deductions; therefore, the effect on one's taxable income must be considered.
- **Loans in excess of certain limits:** The interest on loan amounts in excess of acquisition debt on a first and second residence (up to $1,000,000), plus $100,000 in home equity loans, is **not** deductible. Acquisition debt refers to loans incurred to buy, construct, or substantially improve a qualified residence.[1]

[1] Federal income tax law; state or local law may vary.

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The New Mortgage - Variable Rate vs. Fixed Rate

Variable Rate	Fixed Rate
• Initially lower interest rate than with a fixed rate loan, but will increase if interest rates go up or decrease if interest rates go down. • Most variable rate mortgages have a limit or a cap on annual rate increases and on lifetime increases.[1] • Usually preferred for short-term ownership of home; e.g., 2 - 3 yrs	• Rate does not change if interest rates go up or down. • Best for owners with a fixed income or those who plan to stay in their home for several years. • Rates and monthly payments are higher than with a variable loan, at least in the early years. • Fixed rate loans may not be assumable.

How Many Months Will It Take to Break Even?

The real cost of refinancing is the closing costs. Determine how many months it will take to make up these costs from the savings under the new loan.

$ ________	-	$ ________	=	$ ________
Old Payment		New Lower Payment		Monthly Savings

$ ________	÷	$ ________	=	________
Closing Costs		Monthly Savings		Number of Months to Break Even

Refinancing an old home loan could mean lower monthly payments and perhaps changing from a variable rate to a fixed rate. If projected time in the house is short, the closing costs may consume any savings.

Also, if one plans to sell in a year or two, a variable rate mortgage with an initially lower rate may be more advantageous. Assuming the refinanced mortgage principal is less than the acquisition debt (up to $1,000,000) and $100,000 in home equity loans, the interest paid will generally be deductible. Consider paying off other consumer debt first on which the interest payments are no longer deductible.

[1] Be certain that an annual cap is part of the loan, and carefully examine the index to which the rate is tied.

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