

real estate

What to know before you refinance

Bankrate.com 

It's important to calculate how long it will take to break even on the costs of refinancing your mortgage. But don't overlook other factors that also influence whether you should refinance and the type of loan to select.

By Bankrate.com



The most fundamental consideration in whether a homeowner should refinance an existing mortgage is the break-even point, which represents how soon the cost of the refinance will be recaptured through lower monthly payments. But while the break-even point is easy enough to calculate, other factors may also influence your decision and, if it's a go, the type of loan you'll select.

While there is no rule of thumb for the maximum payback period, or break-even point, that makes sense for most borrowers, three years or fewer typically is considered reasonable if you intend to keep your mortgage at least that long.

If you can get a true zero-cost refinance, your break-even point will occur immediately. In that case, it may make sense to refinance your mortgage even if your interest rate is lowered by just an eighth of a percentage point, because you'll save money every month, though the amount may be small, says Bob Walters, chief economist at Quicken Loans. A true no-cost refinance means you pay no money upfront and neither your loan amount nor your interest rate is increased to build any costs into your new loan.

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To calculate a break-even point, divide the expected total cost of your refinance by the monthly savings on your loan payment. The result is the number of months that would be required to recoup the cost.

Example: Calculate break-even point

Cost of refinance: \$2,125

Monthly savings: \$125

Break-even point: 17 months

While the break-even point is a useful analysis, the decision to refinance can become more complicated by other factors:

Your current loan has an adjustable interest rate.

Your new loan will have a longer or shorter term than your current loan.

Your new loan will require mortgage insurance.

You're willing to pay points to lower the interest rate on your new loan.

You want to cash out equity or consolidate other debts such as a credit-card balance or car loan.

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Adjustable versus fixed interest rate

Lenders and mortgage brokers say borrowers should opt for a fixed-rate mortgage rather than a hybrid loan or adjustable-rate mortgage, because the interest-rate differential isn't large enough to warrant the higher risk of an ARM.

"There is no question at all that consumers should get a fixed-rate mortgage," says Greg Gwizdz, national sales manager at Wells Fargo Home Mortgage in Des Moines, Iowa.

The decision is a bit more complicated for borrowers who have an ARM and want to eliminate the risk of a higher rate in the future. In such cases, refinancing to lock in a fixed rate might make sense, even if the payback period isn't attractive.

"Even if you think you might move, but you aren't sure, you might be better off getting out of that ARM now because rates are at an all-time low," Gwizdz says.

Longer or shorter term

Much less consensus exists on whether borrowers should refinance into a new loan with a longer or shorter term.

Don Frommeyer, senior vice president of AmTrust Mortgage in Carmel, Ind., says many of his customers prefer a slightly shorter term of perhaps 25 years, rather than 30, on their new loan, even if 26 or 27 years remained on their existing loan.

"The payment is going to go up a little bit, but they are reducing the term," he says.

Steve Thorne, a loan officer with Meridian Residential in Cary, N.C., has noticed a trend in the opposite direction. He says a lot of people are refinancing from a shorter term into a longer term "due to a job loss, a spouse's job loss or to cash out and consolidate debt."

Gwizdz recommends a customized approach that balances the borrower's need to reduce the monthly payment and make progress toward repayment of the loan. That might mean a new loan with a 20- or 25-year term or perhaps a term of 26, 27 or 28 years.

"We see people who bought a house in 2000, refinanced in 2003, refinanced in 2006 and are now going to refinance again. They have owned their home for nine years, and they still have 30 years left on their mortgage," he says. "They keep focusing on the fact that the payment is lower, but multiply the payment times the number of (additional) years that you are going to have to pay it, and you are actually going backward."

Fifteen-year loans have been a popular choice for homeowners who want to refinance. But Walters believes these shorter terms are appropriate only for homeowners who have substantial savings and excellent job security. Without those safety nets, he argues, there is a substantial risk that the significantly higher payments on a 15-year loan could become burdensome if you lost your job or suffered an illness or disability.

A safer way to pay off a loan more quickly is to make payments on a 30-year loan as if the term were only 15 years. That way, "if life happens to you, you'll have the ability to fall back on a lower payment," he says.

Home affordability calculator

The answer to the longer-or-shorter conundrum may depend on your response to a simple question, suggests Joe Metzler, a mortgage specialist with

Mortgages Unlimited in St. Paul, Minn. He asks: "Do you need to lower your payment because times are tough or are you just looking to take advantage of today's rates?" If a lower payment is your objective, a longer term might be appropriate. If your motivation is to capture a low rate, you might want to consider a shorter term.

Mortgage insurance

Nationwide drops in home values may present a challenge for homeowners who want to refinance, because a higher loan-to-value ratio can trigger the need for mortgage insurance. This issue "is killing a lot of the enthusiasm" to refinance, Metzler says. If you'd like to refinance but are short on equity, you should still do the math, because your mortgage insurance payments may be tax-deductible and could be eliminated if your equity increased in the future.

Discount points

A similar break-even analysis can help you decide whether to pay discount points to buy down (i.e., reduce) the interest rate on your new mortgage. Here's an example that assumes a half-point discount on the interest rate for a payment of one point, which is equal to 1% of the loan amount.

Example: Calculate break-even analysis

Loan amount: \$250,000
 Term: 30 years
 Payment at 5.5%: \$1,419.47
 Cost of one point: \$2,500
 Payment at 5%: \$1,342.05
 Monthly savings: \$77.42
 Break-even point: 33 months (\$2,500 divided by \$77.42)

Keep in mind that if you add the point (or points) to your loan balance, your new payment will be higher than it would be if you paid the point upfront in cash.

Debt consolidation

Homeowners who want to tap equity to pay off other debts, remodel their home or make other purchases face a more complicated decision to refinance, in part because other debts or options, such as a home equity line of credit, will involve various rates and terms. Debt consolidation may make sense if the refinance would strengthen your overall financial situation and you're disciplined enough not to run up more debts. Debt consolidation can "improve your household cash flow dramatically," Thorne says, and that's an important goal for some homeowners today.

By Marcie Geffner, Bankrate.com

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