



Refinancing Your Home

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The best time to refinance depends on many things. These include: the interest rate difference between your existing mortgage rate and the new mortgage, current interest rate, closing fees for refinancing, how long you plan to stay in your home, your tax bracket, your lender, and even your local housing market.

You may be a refinancing candidate if you are paying at least two percentage points above the present interest rate. For example, if you are currently paying 12% interest on a \$60,000 30-year mortgage, your monthly principle and interest payment runs \$617.16. By refinancing the same mortgage at a 10% rate, your payment would be \$526.56, a \$90.60 savings. Property taxes and insurance cost will remain constant even with a lower interest rate.

Since there are settlement or closing costs for refinancing, you should consider the 2-percentage-point spread as the minimum. This spread enables you to recover the closing costs through savings and interest payments, normally within two to three years. If you plan to live in a home longer, you may consider refinancing with a difference smaller than 2%. On the other hand, if you have to pay mortgage "prepayment penalties," you might decide to wait for a larger difference than two interest percentage points.

Closing Costs

Since most lenders handle refinancing as a new mortgage, there are charges that are usually incurred. These are likely to include: a loan origination fee (approximately 1 percent of the loan amount); discount points (usually 0 to 5 percent of the loan amount); an application fee (between 0 and \$250); an appraisal fee (\$100 to \$350); title examination (approximately \$250); title insurance for the lender (approximately \$3.50 per \$1,000 of the loan); a land survey (about \$150); a credit report (approximately \$50); document preparation fees (about \$10); and legal fees including notary and recording fees (at least \$250).

Special attention should be given to discount points which are an up-front fee collected by the lender with each point equaling one percent of the loan amount. Charging points is a technique lenders use to adjust interest rates. The lower the interest rate the more points you normally pay.

Many lenders routinely offer two or more choices of point-interest rate combinations. For example, you may be offered a choice between an interest rate with two points or a half a percent higher with no points. Each point you pay will probably lower the interest rate by the overall value of the loan between 1/8 to 1/4 of one percent. If you decide to refinance a \$55,000 mortgage at 9.5 % with 2 discount points, be prepared to pay \$1,100 as a fee to the lender.

Consider any prepayment penalty applied to your existing mortgage. Prepayment penalty is the percentage of the old loan you must pay if you pay off the loan early. Generally, prepayment penalties only apply to the first five years of the loan life. The penalty may start at 5 % of the loan if you pay it off in the first year, 4 % for total payment the second year, and so on until after the fifth year when no penalty normally applies.

Calculate your break-even period, the time it takes to recover the closing costs and begin to save money from the lower payments. To do this, you must secure from the lender the amount of the closing costs, the amount of the monthly payment for a mortgage you are considering and the amount of the prepayment penalties (if any) for your existing mortgage. Divide the total cost (including the closing costs, points and prepayment penalty) by the reduction in your monthly payments if you were to refinance. For example, if refinancing a mortgage requires \$2,500 in closing and prepayment costs, but you would save \$180 a month in mortgage payments, the break-even period is about 14 months (\$2,500 divided by \$180).

Tax Considerations and Refinancing

There are three tax considerations. First, paying a lower interest rate on your mortgage means you will have less interest to deduct on your income tax return. That of course, will increase your tax payments and decrease the total savings from a new lower interest mortgage. The lower your tax bracket, the longer it may take you to recoup the cost of refinancing.

The second consideration is that discount points and the loan origination fee (if it is for general processing costs only, not specific costs such as a title search) are usually tax deductible. The Internal Revenue Service requires that interest points paid in advance for refinancing cannot be deducted all at once in the year you refinance. They must be spread over the life of the mortgage. The IRS does allow you to deduct the points immediately if the proceeds of refinancing are used to pay for the substantial refurbishment of your home. Be sure to check with the IRS to see if any new rulings have been released as additional regulations concerning refinancing may be issued.

The third consideration is the 1986 Tax Reform Act has important implications for the refinancing decision: mortgage, interest, and points remain deductible, but you may be in a lower tax bracket. This could make shorter-term mortgages such as the 15-year mortgage more desirable, especially to homeowners who are in tax brackets of 33% or above.

Often in the refinancing process, individuals decided to borrow equity from their home. The amount available to be withdrawn is usually dependent upon the appraised value of the home and the loan value ratio you choose. Normally, an individual can refinance up to 80% of the current value of the home.

The lender may offer to finance part or all of the closing costs so that you do not have to pay for these costs up front. The points will then be added to the loan balance. Although this may sound good and enable you to refinance with little or no out-of-pocket expense, you will be paying interest on these costs for the life of the loan.

If you decide to refinance for more than the original loan amount and your home has appreciated in value, check the tax code carefully. Generally, you can take the full interest deduction only if the amount of the new mortgage is equal to or below the original price you paid for the house, plus the amount you have spent on "home improvements" and the amount, if any, you have borrowed against your house. For example, if your original home cost \$60,000, you added \$10,000 of home improvement cost, \$4,000 educational expenses, and \$1,000 medical expenses, then \$75,000 is the maximum mortgage amount with fully deductible interest.

Types of Mortgages

- A 15 year mortgage is amortized over a shorter period of time, building equity quicker with less interest expense.
- A biweekly mortgage payment decreased the length of a 30 year loan by approximately 11 years thereby saving interest expenses.
- A fixed-rate mortgage helps reduce risk of future interest rate and payment increased.
- Adjustable-rate mortgages have variable interest rates based on several economic predictors. Some adjustable-rate mortgages permit you to transfer to a fixed-rate mortgage, usually during the first five years of the loan.

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