Refinancing

Here is what you will learn in this tutorial:

1. What does "saving money" on a refinance mean?
2. What hazards must be avoided?
3. Determining whether or not you will save money: what is the "break-even" period?
4. How do you find the break-even period?

This tutorial is for those who want to save money on their one existing mortgage. If you have a mortgage but need to raise cash, or if you now have two mortgages and want to consolidate, then this tutorial may not be relevant to your situation.

What Does "Saving Money" on a Refinance Mean?

Saving money means that over the period you will hold the mortgage, the total costs net of offsets will be lower on the new mortgage than on the existing one.

The costs include a) Origination costs - points and other settlement costs, on the new mortgage only; b) Monthly payments of principal and interest, on both mortgages; and c) Lost interest on (a) and (b), also on both mortgages. Cost offsets on both mortgages are tax savings, and reduction in the loan balance.

If the interest rate on the new mortgage is lower and there are no points or other settlement costs, the new mortgage will save you money, even if you pay it off after one month. However, a "no-cost" mortgage carries a higher rate. If you expect to have the new loan more than 3 or 4 years, you usually save more if you pay your own settlement costs rather than have the lender pay them in exchange for a higher rate.

Most borrowers, therefore, incur refinance costs upfront that must be recovered over time through the savings generated by the lower interest rate. The critical number is the "break-even period" -- the *minimum* length of time you must hold the new mortgage to make the refinancing pay.

What Hazards Must Be Avoided?

The refinancing market is something of a jungle, but you are safe if you observe one basic principle: *You cannot save money on a refinance unless the interest rate on the new mortgage is below the rate on the existing one*. Those who argue that you will profit by refinancing into their mortgage at a higher rate are either fooling themselves or are out to fool you.

Some con artists will show you that your total interest payments will decline if you refinance into their higher-rate loan. However, they get that result by assuming that you will repay your new mortgage (but not your old one) on an accelerated (biweekly) schedule. You don't

need to pay a higher rate to accelerate your repayments.

Some others will show you that your monthly payment will decline if you refinance into their higher-rate loan. However, they get that result by extending the term. Often an extension of the term can reduce the payment by more than the higher rate increases it. Of course, if your income has decreased for some reason, the lower payment may be what you need to cure a cash flow problem. You have to judge for yourself.

Determining Whether or Not You Will Save Money: What Is the "Break-Even" Period?

The break-even period is the number of months before the savings from the lower rate completely offset the upfront refinance costs. Even if you are not sure how long you will have the mortgage, if you are confident that you will have it longer than the break-even period, you know the refinance will pay.

How Do You Find the Break-Even Period?

Collect the following information:

Your Income Tax Rate: **This is the tax rate you pay on your last dollar of income. If you pay only Federal income taxes, it is the highest of the Federal tax brackets you used. Currently, these brackets are 10%, 15%, 25%, 28%, 33%, and 35%. If you also pay state and/or local income taxes, you should add the highest bracket you used in connection with these taxes. For example, if your highest Federal tax bracket is 28% and the highest state bracket is 5%, you should enter 33%.**

Remaining Term on Your Existing Loan: **This is the number of months until the balance is paid off if you continue making the mortgage payments you are making now. It is the original term less the number of months that have expired since origination, provided a) you have a fixed-rate mortgage, and b) you have not made any extra payments. If one or both of these conditions does not hold, or if you do not know how many months remain on your existing loan, use the Remaining Term calculator below to find your remaining term.**

Term on New Loan: **For borrowers looking for a fixed-rate mortgage (FRM), a 15-year term is the best bet if you can afford the payment. Most borrowers who take adjustable rate mortgages (ARMs) opt for 30-year or 40-year terms. We never recommend 15-year terms.**

Whether Points and Other Costs Are Paid in Cash or Financed: **Finance the costs if you must, but doing so will extend the BEP. In some cases, having to finance the costs could swing the refinance from profitable to unprofitable.**

Return on Additional Monthly Cash Flow: **This could be the single most important factor in determining the profitability of a refinance. You can effectively pay off your house sooner by properly investing the monthly savings instead of applying additional amounts**

to the principal balance. We can show you how.

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