

When Should We Refinance?

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Even when much of what we hear in the news is about mortgage foreclosure, people with an up-to-date mortgage loan are asking whether or not they should refinance. Current lower rates of interest and mortgage loan options are influencing this question.

The interest rate on a home mortgage is directly connected to the monthly payment. If you can get a lower interest rate, you can build equity in your home more quickly. Most lenders will agree that the greatest gain in refinance will be when the current interest rate is at least two points below your current mortgage loan interest rate and refinance charges are affordable.

Decreasing the term of your mortgage is another way to lower interest because shorter-term mortgages generally have a lower interest rate. With a shorter-term mortgage, you pay less interest and take less time to pay off the loan. Unfortunately, a shorter-term mortgage also means a higher monthly payment because more money goes to the loan principal. If you have the extra money to put towards a house payment, the short-term mortgage may be for you.

If you currently have an adjustable interest rate (ARM) mortgage loan, you probably should look at a fixed interest rate option. ARMs can challenge homeowners because they don't realize what impact a change in interest rate can do to their monthly payment. If you currently have an ARM and are considering a refinance to another ARM, ask the lender about the initial rate of interest, the fully indexed rate, and the rate adjustments you may face over the term of the loan.

As a financial counselor, I usually suggest a fixed rate of interest for a mortgage loan. Maintaining a constant rate of interest and monthly principal payment for the life of a loan is what I call "home owner peace of mind".

So, when is refinancing not a good idea?

One reason not to refinance is if you have had your mortgage a long time. In the later years of a mortgage, more of the payment applies to principal and helps build equity. By refinancing late in the mortgage, the amortization process is restarted and most of the payment will be credited to paying interest and not building equity.

A second reason is if your current mortgage has a prepayment penalty. If you are seeking refinance with the same lender, ask if the prepayment penalty could be waived with a new loan. If you have to pay the penalty, you will increase the time it takes to break even when you account for the costs of the refinance and the monthly savings expected.

A third reason not to refinance is if you plan to move from your home in the next few years. The monthly savings gained from lower monthly payments may not exceed the costs of refinancing. Use a break-even calculation to determine whether or not it is worthwhile to refinance.

Other considerations for a refinance include your eligibility to refinance depending on lender criteria as well as the costs to refinance which may be 3-6% of outstanding principal.

A good place to start seeking information and asking questions is with your current lender, but don't feel you have to stop there. Refinancing is your decision – seek and ask all you want to make a decision that will insure stability for your long-term financial future!

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