LendingTree
WHEN BANKS COMPETE, YOU WIN

guide to:

REFINANCING YOUR HOME

- How to choose the best mortgage options for your needs
- Determine the best time to refinance

The LendingTreeSmart Borrower Center offers a range of articles about mortgages and home equity loans and can help you decide which type of loan best meets your needs.

Guide to

Refinancing Your Home

Looking to reduce your monthly mortgage payments, pay off outstanding debt or access some of the equity you've built up in your home? You may wish to consider mortgage refinancing.

Refinancing – paying off your current mortgage and taking out a new one – also enables you to take advantage of today's flexible mortgage options. While there are costs involved, if you make an informed decision with a view to the long term, you could end up saving a considerable amount over the life of your loan.

It's important, however, to understand the differences between the types of refinancing available, along with their costs and benefits, before deciding which option is right for you.

WHY REFINANCE?

1. Rate and Term Refinancing

For many people, the aim of refinancing is to either lower their monthly payments, pay their mortgage down faster, or reduce the amount of interest on their loan. These homeowners generally wish to keep their loan amount the same, while simply changing the way they pay it off. This is called rate and term refinancing, and it may help you:

- **To get a better interest rate.**
  If interest rates have fallen since you took out your mortgage, refinancing may enable you to get a better rate and lower monthly payments. For example, a $160,000 fixed rate mortgage with a 30-year term at 8 percent requires a monthly payment of $1,175. Lowering the rate to 6 percent drops the monthly payment to $960.

- **To switch from an ARM to a fixed-rate loan.**
  Perhaps the interest rate of your adjustable rate mortgage has gone up every adjustment period and you're concerned the trend will continue. Locking it in for a fixed term may mean higher payments initially but will prevent you from being hit with increasing monthly payments should interest rates continue to rise.

- **To refinance from a regular ARM to a hybrid ARM.**
  If you want to lock in the rate on your loan for just a few years, you may wish to refinance to a hybrid ARM that offers an initial fixed-rate period of, say, three, five or seven years before it starts to adjust on an annual basis. This will prevent you from worrying about rising interest rates during this time while still enabling you to take advantage of potentially lower ARM rates.

- **To obtain better loan features.**
  Your credit rating might have been mediocre when you took out your mortgage, but it has since improved. Refinancing may enable you to get a lower rate or, in the case of an adjustable rate mortgage, a more protective cap (a limit on how much your payments can increase).

- **To save money on interest and build equity more quickly.**
  A recent change in your financial situation may make it possible for you to pay off your loan faster by increasing your monthly payments. Refinancing a 30-year $100,000 mortgage at 6 percent with a 15-year $100,000 mortgage at the same rate would raise your monthly payments from $600 to $844 but allow you to pay down the *principal* in half the time and save you almost $64,000 in interest over the life of the loan. However, you can also build equity more quickly without refinancing by making additional principal payments each month.

- **To reduce your monthly payments.**
  If you are having difficulty meeting your monthly payments, you may wish to refinance your mortgage for a longer term. For example, if your initial mortgage was $150,000 at 7 percent for 30 years, your payment would be $1,000. Say you've owned your home for five years. You could refinance your remaining principal ($142,000) for 30 years at 7 percent, and your payment would drop to $945.

Keep in mind that you will pay more in interest over the life of the loan if you extend the term.

2. Cash-out Refinancing

The other major category of refinancing involves taking out a new mortgage with a larger principal than the one you're currently carrying. This is called *cash-out refinancing* and its goal is not simply to pay less interest, but to turn some of your *home equity* into cash. Reasons to do this include:

- **To free up money for a major expense.**
  You may have built up $180,000 in equity after 20 years of mortgage payments, and now you have two children whom you want to help through college. Rather than taking out a personal loan (which generally carries a higher interest rate with no tax advantage), you can refinance your mortgage, adding $40,000 to the principal, and use that money for tuition.

- **To consolidate debt.**
  Perhaps you have $50,000 in credit card debt with interest rates as high as 18 percent. Now that you have curtailed your spending, you decide to refinance your mortgage, adding $50,000 to the principal and locking it in at 6 percent. This will allow you to *consolidate your debt* and pay it off at a third of its present rate.

- **To combine first and second mortgages.**
  If you have a first mortgage of $100,000 and a *home equity loan* of $30,000, each with a different lender, you may wish to raise the *principal* of your first mortgage to $130,000 to cover both loans, with the aim of getting a better rate and the convenience of just one payment.

Remember, though, that with cash-out refinancing the loan is secured by your home. If you can't afford a higher payment and you fall behind, you risk losing your home.

Guide to Refinancing Your Home

IS REFINANCING RIGHT FOR YOU?

Before you determine whether refinancing makes financial sense, consider the questions below. When you have the answers, use the *Calculate Your Break-Even Point* worksheet to see how long it will take to start realizing your savings.

How long do you plan to be in your home?

The benefits of refinancing add up over time, so if you're planning to move in a year or two, any potential savings will likely never be realized. In addition, factor in that you may be extending the time it takes to own your home "free and clear." In general, the longer you plan to stay in your current home, the more sense it makes to consider refinancing.

What is the penalty for getting out of your existing mortgage?

In order to discourage homeowners from refinancing as soon as rates drop, many mortgages carry a penalty if you pay them off early. The amount varies, but it's usually a small percentage of the outstanding balance, or an amount equivalent to a certain number of monthly interest payments.

What are the costs of the new mortgage?

Closing costs can add up quickly when you take out a mortgage. You may be asked to pay an application fee, an appraisal fee, survey costs, origination fees, title search and insurance fees, and legal costs, all of which can amount to thousands of dollars. Even if you are able to secure a lower interest rate, these fees may exceed what you're saving with the lower monthly payments. It's crucial that you understand exactly what charges you will incur when refinancing.

Closing costs can be paid in different ways. Some homeowners add them to the principal of their mortgage, rather than paying them in cash. Lenders may even waive the fees in exchange for a higher rate of interest. In general, though, if you plan to stay in your home for several years, you will get the most out of refinancing if you pay all the closing costs up-front and secure the lowest interest rate possible.

How much will you save?

Refinancing a mortgage is generally worth considering if the interest you're now paying is at least half a percentage point higher than the new rate for which you qualify, assuming you're going to be in your home for at least another four years. If it's less than this, or you're planning to move in the near future, the fees you're charged may eat up any potential savings.

But it's important to be sure you're not comparing apples and oranges. For example, if you're moving from a fixed rate mortgage to an ARM, your rate will almost certainly drop in the short term, but it may rise significantly over the course of the loan. Similarly, introductory rates may apply for only a short period, after which they can rise substantially.

If you're paying for points on your new mortgage, remember to also factor in that extra cost. You may be attracted by a mortgage that will bring your rate down to 7 percent from 9 percent. However, if the new mortgage comes with two or three points, this will significantly reduce your savings, despite the lower interest rate and smaller monthly payment.

The easiest way to compare mortgage rates is to consider their *annual percentage rate* (APR). This formula, devised by the federal government, expresses the total cost of borrowing – the base interest rate, plus points and other charges – as a simple percentage. Since all lenders must follow the same rules in calculating the APR, borrowers can use it as a good basis for comparing the cost of loans.

Can I get new terms from my current lender?

Your mortgage lender may be willing to renegotiate your contract rather than lose you as a customer. For example, if your reason for refinancing is that your home has risen in value and you want to avoid private mortgage insurance (PMI), your lender may agree to drop the requirement if they have a current appraisal. Having your lender arrange to have your home appraised again usually costs $150 to $400, which could be much cheaper than refinancing your home. By law, lenders are obliged to cancel PMI on mortgages signed on or after July 29, 1999, once you reach 22 percent equity in your home, provided your payments are current.

HOME EQUITY LOANS: AN ALTERNATIVE TO REFINANCING

If you're considering cash-out refinancing, you should also explore an alternative: a home equity loan (HEL). Unlike refinancing, which involves replacing your first mortgage, home equity loans are separate loans on top of your existing mortgage. For this reason, they are sometimes called second mortgages.

A HEL is secured with your property, so lenders can offer lower rates than you'd get with an unsecured loan, though it will usually be higher than a first mortgage. You can also structure the loan as a revolving line of credit that you can draw on as needed, and this flexibility may make it more attractive than a lump-sum loan.

Cash-out refinancing may still make more sense if there has been a significant drop in interest rates and you want to lock in at a lower rate for a longer term. At other times, a home equity loan is often a better choice. To help compare the two, use the Cash-out Refinancing vs. Home Equity calculator in the LendingTree Smart Borrower Center. In either case, make sure you are not borrowing beyond your means. Defaulting on either type of loan could put your house in jeopardy.

WORKSHEET 1:

Calculate Your Break-Even Point

Deciding whether refinancing is worthwhile comes down to a simple question: How long will it take for the money you save with your new mortgage to exceed the costs of acquiring it? In other words, what is the *break-even point*?

Let's assume that you took out your current 30-year mortgage with a principal of $150,000 and a fixed rate of 8 percent. Your monthly payment is $1,100, and after six years in your home, the remaining principal is $140,737. You would now like to refinance for another 30-year mortgage at 6 percent, which carries a monthly payment of $844:

Example		**Your Numbers**	
Old monthly payment	$1,100	Old monthly payment	
New monthly payment	$844	New monthly payment	
Savings per month	**$256**	**Savings per month**	

Now add up the costs of closing your first mortgage and taking out a new one:		**Your Numbers**	
Prepayment penalty (0.5% of outstanding balance)	$704	Prepayment penalty	
Closing costs on new mortgage	$2,000	Closing costs on new mortgage	
2 *points* charged by new lender (2% of principal)	$2,814	Points charged by new lender	
Total cost of refinancing	**$5,518**	**Total cost of refinancing**	

You can then calculate your break-even point by dividing the cost of refinancing by the monthly savings: $5,518 ÷ $256 = 21.6 months	Cost of refinancing	
	Savings per month	
	Break-even point	

In our example, you would break even on your refinance in just under two years. This is a simplified calculation, however – determining your actual break-even point depends on several other factors, including your tax situation and whether you pay closing costs up-front or add them to your new mortgage. You can use the Refinancing Calculator in the LendingTree Smart Borrower Center to calculate your savings. Or consult a financial advisor who is familiar with your tax situation.

WORKSHEET 2: REFINANCING YOUR HOME

What to Ask Your Lender

It's crucial that you understand the terms of your contract before you sign. Have this worksheet with you when you talk to prospective lenders and use it to help you compare their offers.

	Offer 1	Offer 2	Offer 3	Offer 4
What is the interest rate, and how will it change over the term of the loan?				
Do I have to pay points to achieve this rate?				
How long will you guarantee the interest rate and points, and is there a lock-in charge?				
What is the term of the loan?				
Will there be a lump sum payment (a "balloon") due at the end of the term?				
What will my monthly payment be?				
Will I need to pay private mortgage insurance?				
Is there a penalty if I pay off the mortgage before the end of the term?				
What closing fees and other costs are associated with the mortgage?				
What is the APR (including points, origination fee, mortgage insurance and any other fees)?				
What documentation do I need to provide (employment record, home insurance, etc.)?				
How long will the approval process take?				

Glossary

Adjustable rate mortgage (ARM): A mortgage in which the interest rate is adjusted periodically based on an index.

Annual percentage rate (APR): The annual cost of a loan to a borrower. Like an interest rate, the APR is expressed as a percentage of the loan amount. Unlike an interest rate, however, it includes other charges or fees to reflect the total cost of the loan. The Federal Truth in Lending Act requires that every consumer loan agreement disclose the APR in large, bold print. Since all lenders must follow the same rules to ensure the accuracy of the APR, borrowers can use the APR as a good basis for comparing the cost of loans.

Break-even point: The point at which a homeowner will begin realizing savings after refinancing a mortgage.

Cash-out refinancing: A refinancing transaction in which the money the borrower receives from the new loan exceeds the total amount used to repay the existing first mortgage, closing costs, points; and satisfy any outstanding subordinate mortgage liens. In other words, a refinance transaction in which the borrower receives additional cash he can use for any purpose.

Closing costs: Includes a loan origination fee, points, appraisal fee, title search and insurance, survey, taxes, deed recording fee, credit report charge and other costs assessed at settlement. The closing costs usually are about two percent to six percent of the mortgage amount.

Consolidating debt: Taking out a large, lower-interest loan (such as a home equity loan) in order to pay off other debts with higher rates, such as credit cards.

Home equity: The difference between the market value of a home and any outstanding mortgage balance. A person who has a $50,000 mortgage on a $150,000 home has accumulated $100,000 in home equity.

Home equity loan: A loan taken out in addition to a first mortgage that is secured with the borrower's house or property. Sometimes referred to as a second mortgage.

Index: A published interest rate against which lenders measure the difference between the current interest rate on an adjustable rate mortgage and that earned by other investments (such as one- three-, and five-year U.S. Treasury Security yields, the monthly average interest rate on loans closed by savings and loan institutions, and the monthly average Costs-of-Funds incurred by savings and loans). This is used to adjust the interest rate on the mortgage up or down.

Points: A borrower may lower the interest rate on a loan at closing by buying points. Each point is equal to one percent of the loan amount – for example, two points on a $100,000 mortgage would cost $2,000. Also referred to as discount points.

Principal: The amount of debt, not counting interest, left on a loan.

Private mortgage insurance (PMI): Insurance that is usually required by the mortgage lender if the borrower has a down payment of less than 20 percent of the home's value. PMI requires an initial premium payment of one to five percent of the mortgage amount and may require an additional monthly fee.

Rate and term refinancing: A refinancing option in which the principal of the mortgage remains the same, and only the interest rate, term and other features are adjusted.

Additional Resources

WHERE TO LEARN MORE

www.LendingTree.com/smartborrower

The LendingTree Smart Borrower Center offers a range of articles about mortgages and refinancing and can help you decide which type of loan best meets your needs.

Additional sources of information:

The Federal Reserve Board:
www.federalreserve.gov/consumers.htm

Federal Citizen Information Center:
www.pueblo.gsa.gov

Department of Housing and Urban Development:
www.hud.gov

Center for Responsible Lending:
www.responsiblelending.org