Mitchell Byrum, CFP®

S. Harris Financial Group

INNOVATIVE STRATEGIES + PERSONAL FOCUS

When Should I Refinance?

There seems to be constantly swirling information on when to refinance a home mortgage. Amid the volatility and craziness of 2020 came a significant drop in mortgage rates, leading to an up-tick in home purchases and mortgage refinancing. While you may be hearing about friends and family going through the process of refinancing, you must determine if it is a good move for YOU and YOUR family.

Here are a few reasons you may want to consider refinancing:

- Cash flow: cutting the interest rate on a mortgage can reduce your monthly payment
- Debt consolidation through a cash-out refinance
- Eliminating the need to pay mortgage insurance by "walking into equity" through a higher appraisal
- Locking in a fixed interest rate for those with an adjustable rate mortgage (ARM)

When is the appropriate time to refinance?

The old rule of thumb for refinancing was the need to reduce the interest rate on the mortgage by at least 2%. My opinion is that even a 1% reduction in the interest rate should be cause for considering a refinance, but it's not always that simple.

It is important to understand the costs associated with refinancing and have a confident idea of the length of time you will spend in your home.

- **Example 1:** A 30-year, $200,000 mortgage with a 4.5% fixed interest rate would require a $1,013 monthly payment (not including mortgage insurance, homeowner's insurance, or property taxes). By refinancing to a 30-year, 3% fixed interest rate mortgage with $4,000 in closing costs, the payment would be reduced to $860 ($153 monthly difference). In this example, the mortgagee would "break-even" on their closing costs in about 27 months.
- **Example 2:** What if a new appraisal eliminated the need for mortgage insurance? If the mortgagee was paying $100 a month in mortgage insurance premiums, they would "break even" on their closing costs in about 16 months because their payment is now $253 lower than before.

Calculate your break-even point (like the examples above). If the months it takes to recoup the refinancing costs are well within the amount of time you plan to spend in the home, it probably is worth considering.

Be aware of the costs

Refinancing is a wonderful tool in the homeowner's toolbelt. However, it comes at a cost and, unfortunately, those costs are not always clear and simple. Typical closing costs include:

- Application fee
- Appraisal fee
- Credit report fee
- Attorney/legal fees
- Loan origination fee
- Survey costs
- Taxes

210.547.3450 | fax 210.547.3451 sharrisfinancial.com 4456 Lockhill Selma Road Suite 101 | San Antonio, Texas 78249

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- Title search
- Title insurance

It is also important to understand the difference between points and credits. These present tradeoffs in the way a mortgage is paid. Generally, the more points are paid at closing, the lower the interest rate on the loan. Adversely, if the lender gives credits towards closing costs, a higher interest rate should be expected. When shopping and comparing lenders, requesting quotes with no points and no credits will typically be the best way to compare apples and apples between lenders.

Other reasons to consider refinancing

There are a few less common, but valid reasons to consider a mortgage refinance. For individuals and families with a steady income, a cash-out refinance may be worth considering for debt consolidation purposes. Many times, the interest rate you will pay on a mortgage is less than the interest rate on other kinds of debt and, if the interest rate on other debt is variable, the fixed rate of a mortgage could be advantageous. Additionally, the interest paid on a mortgage is generally tax-deductible, which may become more of an advantage if standard-deductions are lowered back to pre-2018 levels. A cash-out refinancing typically means you are borrowing a max of 75% - 85% of the appraised value of the property, so for relatively new homeowners, this may not be an option.

Most lenders require mortgage insurance for loans above 80% of the property value.
For homeowners paying mortgage insurance who feel that the value of their property has appreciated in the time they owned it, a new appraisal may be an opportunity to eliminate mortgage insurance payments.

- **Example 3:** If a $200,000 property is purchased with a $190,000 mortgage, that means the owner has 5% equity in that property. That homeowner will have to pay mortgage insurance on that loan until they reach 20% equity, or the mortgage principal is paid down to $160,000. For illustration purposes, assume that after two years, this property owner has paid their mortgage principal down to $175,000 (12.5% equity), but believes the value of their home has gone up in that time. If a new appraisal finds that the home is now worth $218,750 or more, they will most likely eliminate the need for mortgage insurance when refinancing because they now have at least 20% equity in the property.

This can be a powerful savings tool when combined with a potential reduction in the mortgage payment itself, as seen in example 2.

When is refinancing a bad idea?

I do not believe that refinancing a mortgage for the sole purpose of reducing the term from 30 years to 15 is valid. If the interest rate reduction is simply too good to pass up, sure, that may be a different story. However, the flexibility that is retained with a 30-year mortgage and the lower payment it offers reduces the risk of not being able to make that payment in an emergency. If you are looking to pay off your mortgage faster, you can always make extra principal payments along the way to reduce the term of the loan.

Alternatively, dramatically increasing the length of your loan to lower your payment is probably not wise either. Going from a 15 or even 20-year term to a 30-year term could dramatically increase the amount of total interest paid over the life of the loan.

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There is also risk involved in cash-out refinancing. Your mortgage is secured by a lien on your home, so if you cannot make the mortgage payments, the lender can foreclose on the property and sell it to pay the mortgage. While a cash-out refinance to consolidate debt may make a lot of sense on paper, it could present too much risk if the homeowner is not fully confident in their ability to pay this new mortgage payment over the length of the loan.

Lastly, if you are not confident that you will own the home longer than the time it will take you to recoup the cost of the refinance, avoid the hassle altogether! The time you will avoid spending on gathering all the documents needed for refinancing will be better spent with friends or family.

If you have any questions or would like to hear more about our second opinion offering, please don't hesitate to reach out to me at mitchell@sharrisfinancial.com.

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