A Consumer's Guide to Refinancing

Have interest rates fallen? Or do you expect them to go up? Has your credit score improved enough so that you might be eligible for a lower-rate mortgage? Would you like to switch into a different type of mortgage?

The answers to these questions will influence your decision to refinance your mortgage. But before deciding, you need to understand all that refinancing involves. Your home may be your most valuable financial asset, so you want to be careful when choosing a lender or broker and specific mortgage terms. Remember that, along with the potential benefits to refinancing, there are also costs.

When you refinance, you pay off your existing mortgage and create a new one. You may even decide to combine both a primary mortgage and a second mortgage into a new loan. Refinancing may remind you of what you went through in obtaining your original mortgage, since you may encounter many of the same procedures--and the same types of costs--the second time around.

Why consider refinancing?

Lowering your interest rate

The interest rate on your mortgage is tied directly to how much you pay on your mortgage each month--lower rates usually mean lower payments. You may be able to get a lower rate because of changes in the market conditions or because your credit score has improved. A lower interest rate also may allow you to build equity in your home more quickly.

For example, compare the monthly payments (for principal and interest) on a 30-year fixed-rate loan of $200,000 at 5.5% and 6.0%.

Monthly payment @ 6.0%	$1,199
Monthly payment @ 5.5%	$1,136
The difference each month is	$63
But over a year's time, the difference adds up to	$756
Over 10 years, you will have saved	$7,560

Adjusting the length of your mortgage

Increase the term of your mortgage: You may want a mortgage with a longer term to reduce the amount that you pay each month. However, this will also increase the length of time you will make mortgage payments and the total amount that you end up paying toward interest.

Decrease the term of your mortgage: Shorter-term mortgages--for example, a 15-year mortgage instead of a 30-year mortgage--generally have lower interest rates. Plus, you pay off your loan sooner, further reducing your total interest costs. The trade-off is that your monthly payments usually are higher because you are paying more of the principal each month.

For example, compare the total interest costs for a fixed-rate loan of $200,000 at 6% for 30 years with a fixed-rate loan at 5.5% for 15 years.

	Monthly payment	Total interest
30-year loan @ 6.0%	$1,199	$231,640
15-year loan @ 5.5%	$1,634	$ 94,120

Tip: Refinancing is not the only way to decrease the term of your mortgage. By paying a little extra on principal each month, you will pay off the loan sooner and reduce the term of your loan. For example, adding $50 each month to your principal payment on the 30-year loan above reduces the term by 3 years and saves you more than $27,000 in interest costs.

Changing from an adjustable-rate mortgage to a fixed-rate mortgage

If you have an adjustable-rate mortgage, or ARM, your monthly payments will change as the interest rate changes. With this kind of mortgage, your payments could increase or decrease.

You may find yourself uncomfortable with the prospect that your mortgage payments could go up. In this case, you may want to consider switching to a fixed-rate mortgage to give yourself some peace of mind by having a steady interest rate and monthly payment. You also might prefer a fixed-rate mortgage if you think interest rates will be increasing in the future.

Tip: If your monthly payment on a fixed-rate loan includes escrow amounts for taxes and insurance, your payment each month could change over time due to changes in property taxes, insurance, or community association fees.

Getting an ARM with better terms

If you currently have an ARM, will the next interest rate adjustment increase your monthly payments substantially? You may choose to refinance to get another ARM with better terms. For example, the new loan may start out at a lower interest rate. Or the new loan may offer smaller interest rate adjustments or lower payment caps, which means that the interest rate cannot exceed a certain amount. For more details, see the *Consumer Handbook on Adjustable-Rate Mortgages*.

Tip: If you are refinancing from one ARM to another, check the initial rate and the fully-indexed rate. Also ask about the rate adjustments you might face over the term of the loan.

Getting cash out from the equity built up in your home

Home equity is the dollar-value difference between the balance you owe on your mortgage and the value of your property. When you refinance for an amount greater than what you owe on your home, you can receive the difference in a cash payment (this is called a cash-out refinancing). You might choose to do this, for example, if you need cash to make home improvements or pay for a child's education.

Remember, though, that when you take out equity, you own less of your home. It will take time to build your equity back up. This means that if you need to sell your home, you will not put as much money in your pocket after the sale.

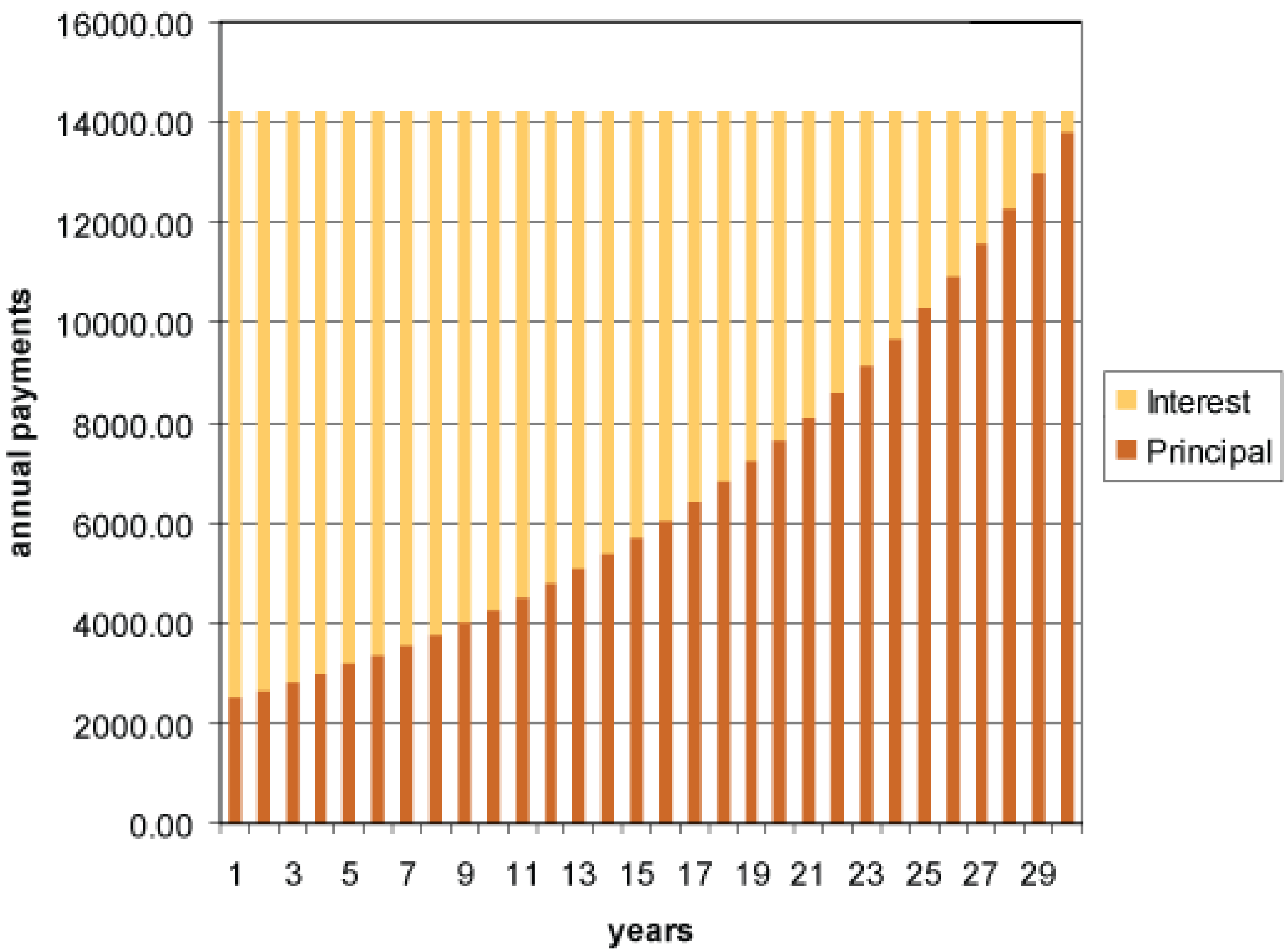
If you are considering a cash-out refinancing, think about other alternatives as well. You could shop for a home equity loan or home equity line of credit instead. Compare a home equity loan with a cash-out refinancing to see which is a better deal for you. See *What You Should Know about Home Equity Lines of Credit*.

Tip: Many financial advisers caution against cash-out refinancing to pay down unsecured debt (such as credit cards) or short-term secured debt (such as car loans). You may want to talk with a trusted financial adviser before you choose cash-out refinancing as a debt-consolidation plan.

When is refinancing not a good idea?

You've had your mortgage for a long time.
The amortization chart shows that the proportion of your payment that is credited to the principal of your loan increases each year, while the proportion credited to the interest decreases each year. In the later years of your mortgage, more of your payment applies to principal and helps build equity. By refinancing late in your mortgage, you will restart the amortization process, and most of your monthly payment will be credited to paying interest again and not to building equity.

Amortization of a $200,000 loan for 30 years at 5.9% [d]



Your current mortgage has a prepayment penalty
A prepayment penalty is a fee that lenders might charge if you pay off your mortgage loan early, including for refinancing. If you are refinancing with the same lender, ask whether the prepayment penalty can be waived. You should carefully consider the costs of any prepayment penalty against the savings you expect to gain from refinancing. Paying a prepayment penalty

will increase the time it will take to break even, when you account for the costs of the refinance and the monthly savings you expect to gain.

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--a break-even calculation will help you determine whether it is worthwhile to refinance, if you are planning to move in the near future.

Are you eligible to refinance?

Determining your eligibility for refinancing is similar to the approval process that you went through with your first mortgage. Your lender will consider your income and assets, credit score, other debts, the current value of the property, and the amount you want to borrow. If your credit score has improved, you may be able to get a loan at a lower rate. On the other hand, if your credit score is lower now than when you got your current mortgage, you may have to pay a higher interest rate on a new loan.

Lenders will look at the amount of the loan you request and the value of your home, determined from an appraisal. If the loan-to-value (LTV) ratio does not fall within their lending guidelines, they may not be willing to make a loan, or may offer you a loan with less-favorable terms than you already have.

If housing prices fall, your home may not be worth as much as you owe on the mortgage. Even if home prices stay the same, if you have a loan that includes negative amortization (when your monthly payment is less than the interest you owe, the unpaid interest is added to the amount you owe), you may owe more on your mortgage than you originally borrowed. If this is the case, it could be difficult for you to refinance.

What will refinancing cost?

It is not unusual to pay 3 percent to 6 percent of your outstanding principal in refinancing fees. These expenses are in addition to any prepayment penalties or other costs for paying off any mortgages you might have.

Refinancing fees vary from state to state and lender to lender. Here are some typical fees and average cost ranges you are most likely to pay when refinancing. For more information on settlement or closing costs, see the*Consumer's Guide to Settlement Costs*.

> **Tip:** You can ask for a copy of your settlement cost papers (the HUD-1 form) one day in advance of your loan closing. This will give you a chance to review the documents and verify the terms.

Application fee. This charge covers the initial costs of processing your loan request and checking your credit report. If your loan is denied, you still may have to pay this fee.
Cost range = $75 to $300

Loan origination fee. The fee charged by the lender or broker to evaluate and prepare your mortgage loan.
Cost range = 0% to 1.5% of the loan principal

Points. A point is equal to 1 percent of the amount of your mortgage loan. There are two kinds of points you might pay. The first is loan-discount points, a one-time charge paid to reduce the interest rate of your loan. Second, some lenders and brokers also charge points to earn money on the loan. The number of points you are charged can be negotiated with the lender.
Cost range = 0% to 3% of the loan principal

> **Tip:** The length of time that you expect to keep the mortgage helps you determine whether it is worthwhile to pay points up front to reduce your interest rate. Unlike points paid on your original mortgage, points paid to refinance may not be fully deductible on your income taxes in the year they are paid. Check with the Internal Revenue Service to find the current rules for deducting points.

Appraisal fee. This fee pays for an appraisal of your home, in order to assure the lenders that the property is worth at least as much as the loan amount. Some lenders and brokers include the appraisal fee as part of the application fee. You are entitled to a copy of the appraisal, but you must ask the lender for it. If you are refinancing and you have had a recent appraisal, you can check to see if the lender will waive the requirement for a new appraisal.
Cost range = $300 to $700

Inspection fee. The lender may require a termite inspection and an analysis of the structural condition of the property by a property inspector, engineer, or consultant. Lenders may require a septic system test and a water test to make sure the well and water system will maintain an adequate supply of water for the house. Your state may require additional, specific inspections (for example, pest inspections in southern states).
Cost range = $175 to $350

Attorney review/closing fee. The lender will usually charge you for fees paid to the lawyer or company that conducts the closing for the lender.
Cost range = $500 to $1,000

Homeowner's insurance. Your lender will require that you have a homeowner's insurance policy (sometimes called hazard insurance) in effect at settlement. The policy protects against physical damage to the house by fire, wind, vandalism, and other causes covered by your policy. This policy insures that the lender's investment will be protected even if the house is destroyed.

With refinancing, you may only have to show that you have a policy in effect.
Cost range = $300 to $1,000

FHA, RDS, or VA fees or PMI. These fees may be required for loans insured by federal government housing programs, such as loans insured by the Federal Housing Administration (FHA) or the Rural Development Services (RDS) and loans guaranteed by the Department of Veterans Affairs (VA), as well as conventional loans insured by private mortgage insurance (PMI). Insured loans and guarantee programs generally apply if the amount you are borrowing is more than 80% of the value of the property. Both government and private mortgage insurance cover the lender's risk that you will not make all the loan payments.
Cost ranges: FHA = 1.5% plus 1/2% per year; RDS = 1.75%; VA = 1.25% to 2%; PMI = 0.5% to 1.5%

Title search and title insurance. This fee covers the cost of searching the property's records to ensure that you are the rightful owner and to check for liens. Title insurance covers the lender against errors in the results of the title search. If a problem arises, the insurance covers the lender's investment in your mortgage.
Cost range = $700 to $900

> **Tip:** Ask the company carrying your current title insurance policy what it would cost to reissue the policy for a new loan. This may reduce your cost.

Survey fee. Lenders require a survey, to confirm the location of buildings and improvements on the land. Some lenders require a complete (and more costly) survey to ensure that the house and other structures are legally where you say they are. You may not have to pay this fee if a survey has recently been conducted for your property.
Cost range = $150 to $400

Prepayment penalty. Some lenders charge a fee if you pay off your existing mortgage early. Loans insured or guaranteed by the federal government generally cannot include a prepayment penalty, and some lenders, such as federal credit unions, cannot include prepayment penalties. Also some states prohibit this fee.
Cost range = one to six months' interest payments

What is "no-cost" refinancing?

Lenders often define "no-cost" refinancing differently, so be sure to ask about the specific terms offered by each lender. Basically, there are two ways to avoid paying up-front fees.

The first is an arrangement in which the lender covers the closing costs, but charges you a higher interest rate. You will pay this higher rate for the life of the loan.

Tip: Ask the lender or broker for a comparison of the up-front costs, principal, rate, and payments with and without this rate trade-off.

The second is when refinancing fees are included in ("rolled into" or "financed into") your loan--they become part of the principal you borrow. While you will not be required to pay cash up front, you will instead end up repaying these fees with interest over the life of your loan.

Tip: When lenders offer a "no-cost" loan, they may include a prepayment penalty to discourage you from refinancing within the first few years of the loan. Ask the lender offering a no-cost loan to explain all the fees and penalties before you agree to these terms.

How do you calculate the break-even period?

Use the step-by-step worksheet below to give you a ballpark estimate of the time it will take to recover your refinancing costs before you benefit from a lower mortgage rate. The example assumes a $200,000, 30-year fixed-rate mortgage at 5% and a current loan at 6%. The fees for the new loan are $2,500, paid in cash at closing.

	Example	**Your numbers**
1. Your current monthly mortgage payment	$1,199	
2. Subtract your new monthly payment	- $1,073	
3. This equals your monthly savings	$ 126	
4. Subract your tax rate from 1 (e.g. 1 - 0.28 = 0.72)	0.72	
5. Multiply your monthly savings (#3) by your after-tax rate (#4)	126 x 0.72	
6. This equals your after-tax savings	$ 91	

7. Total of your new loan's fees and closing costs	$2,500	
8. Divide total costs by your monthly after-tax savings (from #6)	$2,500 / 91	
9. This is the number of months it will take you to recover your refinancing costs	27 months	

Tip: Calculate the financial benefit of refinancing in one, two, or three years. Does the benefit compare with your plans for staying in your home?

If you plan to stay in the house until you pay off the mortgage, you may also want to look at the total interest you will pay under both the old and new loans.

You may also want to compare the equity build-up in both loans. If you have had your current loan for a while, more of your payment goes to principal, helping you build equity. If your new loan has a term that is longer than the remaining term on your existing mortgage, less of the early payments will go to principal, slowing down the equity build-up in your home.

Refinancing calculators

Many online mortgage calculators are designed to calculate the effect of refinancing your mortgage. These calculators usually require information about your current mortgage (such as the remaining principal, interest rate, and years remaining on your mortgage), the new loan that you are considering (such as principal, interest rate, and term), and the upfront or closing costs that you will pay for the loan. Some may ask for your tax rate and the rate of interest you can get on investments (assuming you will invest your savings). Refinance calculators will show the amount you will save compared with the costs you will pay, so that you can determine whether the refinancing offer is right for you.

Compare loans before deciding

Shop around and compare all the terms that different lenders offer--both interest rates and costs. Remember, shopping, comparing, and negotiating can save you thousands of dollars.

Lenders are required by federal law to provide a "good faith estimate" within three days of receiving your loan application. You can ask your lender for an estimate of the closing costs for the loan. The estimate should give you a detailed approximation of all costs involved in closing. Review these documents carefully and compare these costs with those for other loans. You can also ask for a copy of the HUD-1 settlement cost form one day before you are due to sign the final documents.

> **Tip:** If you want to make sure the interest rate your lender offers you is the rate you get when you close the loan, ask about a mortgage lock-in (also called a rate lock or rate commitment). Any lock-in promise should be in writing. Make sure your lender explains any costs or obligations before you sign.

Use newspapers and the Internet to shop

Your local newspaper and the Internet are good places to start shopping for a loan. You can usually find information on interest rates and points offered by several lenders. Since rates and points can change daily, you'll want to check information sources often when shopping for a home loan.

Be careful with advertisements

Any initial information you receive about mortgages probably will come from advertisements, mail, phone, and door-to-door solicitations from builders, real estate brokers, mortgage brokers, and lenders. Although this information can be helpful, keep in mind that these are marketing materials--the ads and mailings are designed to make the mortgage look as attractive as possible. These advertisements may play up low initial interest rates and monthly payments, without emphasizing that those rates and payments could increase substantially later. So get all the facts and make sure any offers you consider meet your financial needs.

Any ad for an ARM that shows an introductory interest rate should also show how long the rate is in effect and the annual percentage rate, or APR, on the loan. If the APR is much higher than the initial rate, that is a sign that your payments may increase a lot after the introductory period, even if market interest rates stay the same.

> **Tip:** If there is a big difference between the initial interest rate and the APR listed in the ad, it may mean that there are high fees associated with the loan.

Choosing a mortgage may be the most important financial decision you will make. You should get all the information you need to make the right decision. Ask questions about loan features when you talk to lenders, mortgage brokers, settlement or closing agents, your attorney, and other professionals involved in the transaction--and keep asking until you get clear and complete answers.