E*TRADE

Refinancing Your Home Loan

Part 1: Should You Refinance? Reasons and Strategies

Related Topics

- Part 2: Refinancing Costs
- Part 3: Reconveyance— A Final Step When You Pay Off a Loan

Quick summary:

- If you have a fixed rate loan, a rule of thumb is that it may pay to refinance if current interest rates are at least one percent below the rate of your current loan. It depends on how long you'll stay in your home as to whether the costs of refinancing make it worthwhile.
- With adjustable-rate loans, you may be more interested in refinancing to change to a fixed-rate loan to avoid future rate increases on the adjustable loan rather than getting a lower interest rate now.
- Refinancing benefits may include getting you a lower interest rate, lowering your monthly home loan payments, changing an adjustable-rate loan to a fixed-rate loan (or vice-versa), paying off a large balloon payment, giving you cash in hand or shortening the life of your loan.
- Refinancing downsides may include taking on more debt, incurring costs that are not all tax deductible, triggering a prepayment penalty and exposing yourself to personal liability on the new loan.

The potential benefits of refinancing

As a homeowner, you're always on the lookout for a lower interest rate on your home loan. If you spot one, it may be the right time to refinance your home loan.

But be aware that lower interest rates aren't the only way refinancing can benefit you.

Refinancing may allow you to:

- Change from an adjustable rate loan to a fixed rate loan or vice-versa
- Get a lower interest rate and reduce your monthly payment on all of your home loans
- Convert non-tax deductible debt (such as personal credit card interest) into potentially tax-deductible debt
- Shorten the life of your loan
- Convert your home's equity into cash to improve your home, buy another property, pay for your child's college education or to use for another purpose determined by you
- Pay off a balloon payment on your existing loan
- Consolidate your monthly bills

A rule of thumb is that if you are refinancing a fixed rate loan, it may pay to refinance if current interest rates are at least one percent below the rate of your current loan. It depends on how long you'll stay in your home as to whether the costs of refinancing make it worthwhile.
With adjustable-rate loans, you may be more interested in changing to a fixed-rate loan to avoid future rate increases on the adjustable loan rather than getting a lower interest rate now.

The potential downsides of refinancing

- Interest rates may go down after you refinance
- Not all of the interest or other costs on your refinanced loan may be tax deductible. Check with your tax advisor. And, with a lower-rate loan of the same size, you'll have less interest to deduct.
- If you sell your home or refinance it again before you've recouped the costs of refinancing, you'll be out of pocket some money.
- You may be extending your loan and, depending on your age, delaying your retirement—suppose you have a 30-year loan that's 10 years old with 20 years left. If you refinance it and take out another 30-year loan, you've just extended the loan payback period by 10 years. You may find that you can't afford to retire before your loan does and that could put a crimp in your retirement plans. You might decide to take out a 20-year loan instead in this instance.
- Your existing loan may have a prepayment penalty that's triggered by the refinancing (see Your Loan's Prepayment Penalty). However, if you refinance with the same lender, you *may* be able to avoid the penalty. Ask.
- In your state you may have personal liability on a default on a refinanced loan but *not* on a default on your original home loan that you took out as part of your home purchase. Get legal advice on what personal liability protection you have or don't have.
- If you're refinancing to convert credit card bills into a home loan obligation, you may put your home at risk of foreclosure if you don't pay the refinanced home loan. Also, if you're not disciplined, you might go out and run up credit cards bills all over again. Then you'd have to pay back not only the old credit card debts that are now in the form of a home loan but also your new credit card debts.

Refinancing may be a way to fatten the cash in your wallet or purse through a lower interest rate or cash-out refinancing where you get money in hand. Just make sure refinancing is the right step for *your* pocketbook and your circumstances and that you're solving a problem and not creating a new one.

Refinancing Costs >>

Refinancing Your Home Loan

Part 2: Refinancing Costs

Related Articles & Tools

- Part 1: Should You Refinance? Reasons and Strategies
- Part 3: Reconveyance— A Final Step When You Pay Off a Loan

Quick summary:

- When you refinance, you may pay the same types of costs as with your original home loan plus potentially a new one—a prepayment penalty on your existing loan.
- Determine your break-even point—how long you need to keep the new loan to make incurring the refinancing costs worthwhile. The break-even calculation depends on the refinancing costs, your current interest rate and monthly payment, your new interest rate and monthly payment, your income tax bracket and how long you'll stay in your home.
- Be aware of the hidden cost of refinancing and how to help avoid or minimize it.
- Try to deal with a lender that will guarantee in writing the amount of all fees.
- Don't take on a larger mortgage than you can afford.

Five steps to calculate the real costs and your break-even point on refinancing your home loan

Loan costs vary according to the lender, the type of loan, the amount being borrowed, the location of the property and other factors. Try to deal with a lender that will guarantee in writing the amount of all fees.

Step 1: Add up the one-time refinancing costs before considering any income tax benefits

Loan costs can occur at the beginning, middle and end of the refinancing process. These one-time costs are different than the recurring monthly costs on a refinanced mortgage.

Shop around and be aware that some lenders charge more fees and higher fees than others. Some will guarantee what you'll pay in total loan costs; most do not—they just estimate your costs.

The upfront stage

There are four items to be aware of here.

- Some lenders charge you application fee and some don't. The fee might be $300 to $500. Find out (i) whether the fee is refundable if the loan does not close or if you decide to cancel and (ii) whether it's credited against your costs at the loan's closing.
- Lenders should give you a good-faith estimate of what loan costs you'll pay when you get your loan. Some lenders go a step further and guarantee in writing that the estimated costs will be the actual costs you'll pay. If your costs aren't guaranteed in writing in advance, you could be surprised by much higher costs when you're about to sign the loan papers. If you balk at the fees, you might lose your loan and its favorable interest rate.
- Different lenders have different loan processing time frames. Find out how long it'll be before your loan can be completed.
- Some lenders offer loans where you don't pay any loan costs out of your pocket. Instead, the fees are added to your loan amount and your interest rate will probably be higher, too.

The middle stage

You may pay an appraiser's fee during the loan process or at the end.

Also, you may pay a "lock-in fee." A lock-in fee is usually non-refundable and it's paid by you to lock in (guarantee) an interest rate for a limited period of time. It's important for you to timely supply information requested by your lender to avoid having a delay on your part that causes the lock-in to expire. Usually, the lock-in fee is credited against your costs at the loan's closing.

Keep in mind that if you pay a lock-in fee and rates go down before your loan closes, you probably won't be allowed by your lender to take advantage of the lower rate (or you may be required to pay another fee to do so).

The end stage—the loan's closing

Here's where the bulk of the fees are paid. The main loan costs are:

- Points
    - There are two types of points: (1) a "loan origination fee" and (2) discount points. Usually, points refers to discounts points—a fee that reduces the interest rate you pay on a loan. One point equals 1% of the loan amount. For example, 1½ points on a loan amount of $100,000 equals $1,500. Points are paid when your loan closes.
- The more you pay in points at the loan's closing, the lower your interest rate. Sometimes it pays to pay more points but it can take years to recoup this cost.
- Appraisal fee
- Escrow or closing fee
- Lender's processing fee
- Lender's underwriting fee
- Loan document preparation fee
- Title insurance charges
- Recording fees
- Prepayment penalty on your existing loan
- Some loans have prepayment penalties. Some do not. Sometimes your existing lender will waive the prepayment penalty on your original loan if you take out a refinancing loan with the lender. Ask.

There can be other loan costs, too.

Do your investigation upfront to determine the types and amounts of costs you'll probably be facing and which ones can be tied down with certainty. If possible, get all of your loan costs guaranteed in writing at the beginning of the loan application process.

Step 2: Determine your income tax bracket

If you itemize your income tax deductions, it's important to know your income tax bracket since some of the refinancing costs as well as the monthly mortgage interest costs may be tax deductible. Determine your combined federal, state and local income tax bracket.

Step 3: Calculate your pre-tax anticipated monthly savings with the refinanced loan

If you're taking out a refinancing loan to lower your interest rate or to secure a fixed-rate loan, your monthly payment amount should be lower than the one you pay currently or that you will pay if you keep an adjustable-rate loan that will increase in the future.

Determine how much you'll save each month by first deducting your new monthly payment from your existing monthly payment (or your anticipated monthly payment if you kept your adjustable-rate loan). Then, add to that amount the after-tax benefit of deducting points over the life of the loan.

Step 4: Calculate your *after-tax* monthly benefit of the refinancing loan

If your interest payments will be lower on your refinanced loan, you will be taking a smaller income tax deduction on your refinanced loan. Take the difference in just the interest portion of your monthly payment times your income tax bracket and subtract that result from the results in Step 3. This gives you your after-tax benefit of the refinancing loan.

Step 5: Divide your up-front refinancing costs (Step 1) by your *after-tax* monthly benefit from the refinancing loan (Step 4)

The result tells you your break-even point—how many months you'll have to keep the loan to pay for the refinancing costs.

The hidden cost of refinancing

With any loan, your original home loan or a refinancing loan, the bulk of your monthly payments in the early years of the loan goes towards paying interest. The amount allocated to the repayment of the principal increases over time but it starts out very slowly. In many cases, it takes around 20 years of payments before your principal payments are larger than your interest payments.

This is where the hidden cost of refinancing comes into play. If you keep replacing a 30-year loan with another 30-year loan, you're extending the day when your mortgage will be paid off. One technique to stay closer on course to ultimate repayment is to make your refinancing loan about the same length as the remaining period of your original loan. So if you've been making payments for five years on your original 30-year loan, try to get a refinancing loan with a 25-year length. This can greatly reduce the total amount of interest paid by you over the life of your loan.

Once a loan is paid off, whether it's your original loan or a refinancing loan, it's a time for celebration. But it's also important that your repayment be documented in the public records.

Reconveyance: A Final Step When You Pay Off a Loan >>

Refinancing Your Home Loan

Part 3: Reconveyance—A Final Step When You Pay Off A Loan

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- Part 2: Refinance Costs

Quick summary:

- When you pay off a loan, you *don't* want to burn your mortgage documents. You *do* want to make sure the proper document (usually a *reconveyance*) is recorded as a public document showing the loan has been paid off in full.

- If the proper document showing payment in full hasn't been recorded, it could affect your credit score, prevent you from selling your home at a later date or cause you to pay an extra cost so a buyer has assurance that good title is being received and your home is not subject to the lien of your home loan(s).

Importance of getting a reconveyance

If the proper document showing payment in full hasn't been recorded, it could affect your credit score, prevent you from selling your home at a later date or cause you to pay for a bond or other instrument so a buyer of your home is assured that good title is being received and not subject to the lien of your home loan(s).

How buyers and the world know you've paid off the loans

Don't "burn" any of your home loan documents when you've paid off your loan. Instead, make sure the proper document (usually a *reconveyance*) has been recorded (filed with your county recorder or other appropriate governmental agency) as a public record showing that your home loan has been paid off in full.

When you take out a mortgage (loan) on your home, the loan documents (or copies) are in two places:

- Your lender's records

- Public records

The loan document (usually called a mortgage or a deed of trust) is recorded (filed) in the county records or with another governmental agency to show in the public records that *you owe* the borrowed money and that there's a loan against your home.

Similarly, when you *pay off* a loan, a payoff document *should* go into those same two places. That doesn't always happen. Even if your lender's records show that your loan has been paid off, the public records may still show that you owe the money unless and until the proper payoff document is recorded in the public records.

While lenders are always very prompt in recording the document that says you owe money, sometimes they aren't as prompt in recording the document that says you've paid off the loan. That document telling the world your home loan has been repaid is usually known as a *reconveyance*.

Steps to take when your loan is paid off

It's not enough for the records of the home loan lender to show you've paid off your loan. To avoid impairing your credit and making it look as if your home loan is still unpaid, make sure:

1. A *reconveyance* (or other appropriate equivalent document) is filed/recorded with the correct governmental agency and

2. The three credit reporting agencies (Equifax, Experian and TransUnion) also show that your loan has been paid off.

Take these two steps to preserve your credit record, show that you've paid off your debt and clear up the title to your home.

Two circumstances to get a reconveyance

You will want the lender of the loan being paid off to record a reconveyance in two instances:

1. When *you* make the final payment on a home loan from your own funds or from the proceeds of a home sale

2. When a *new lender* refinances your home and the new lender pays off the loan with the *old* lender as part of the refinancing process

Timing to complete a reconveyance

How long does it take for your old lender to record a reconveyance? It varies but there's usually a time-gap between a loan being paid off and a reconveyance being recorded. It's probably a good idea for you to follow up with the lender of a paid-off loan sixty-days after the loan has been paid off to find out the status of your receiving a reconveyance.

Receiving a recorded reconveyance is one of those things that can slip through the cracks if it's not handled fairly soon after a loan is paid off in full. It can be much more difficult to obtain the reconveyance many years later especially if the lender has been merged with or been sold to other companies in the intervening years and its records are difficult to locate.

If you are considering refinancing your mortgage in an effort to get cash, you may want to consider a home equity loan.

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