

SECTION 2: UNDERSTANDING IF REFINANCING FOR A BETTER RATE OR DIFFERENT TERMS IS RIGHT FOR YOU

What Is Mortgage Refinancing?

Mortgage refinancing is the process of taking out a new mortgage and using the money to pay off your current mortgage. It includes many of the same steps, and some of the same expenses, that were involved in applying for and getting the mortgage to purchase your home in the first place. The main distinction between your purchase loan and a refinance mortgage is that no property ownership is transferred during the refinance transaction.

Is Refinancing for a Better Rate or Different Terms Right for You?

Even though most mortgage loans have 30-year terms, most borrowers keep their mortgage loans for only five to ten years. Some pay off their mortgages when they sell their homes, and others refinance their loans for a variety of reasons. A key advantage of being a homeowner is the ability to change your mortgage terms through refinancing as changes occur in your financial needs or mortgage rates.

After becoming a homeowner, you may consider adjusting your mortgage payments or terms by refinancing because your financial situation, mortgage rates, or both have changed. How do you know if refinancing your mortgage loan for different terms makes sense for you? This can be a difficult decision, as it requires time, money and careful decision-making. Refinancing for different terms can be worthwhile, but it may not make sound financial sense for everyone.

If the rates or terms of mortgage loans available now are better than the rates and terms of the mortgage you have, refinancing can save you a significant amount of money. Refinancing is most likely to make sense for you if your existing mortgage has an interest rate that is higher than today's interest rates. You may want to refinance, however, for reasons other than just lower interest rates. You may want to convert an **adjustable-rate mortgage** (ARM) to a **fixed-rate mortgage**, or vice versa. Or you may want to convert to a mortgage with a shorter **loan term** to build up your equity faster and own your home outright sooner.

Today there are many good reasons to refinance to change the terms of your mortgage. Evaluating whether or not to refinance involves several steps, which you can do yourself or with the help of a reputable housing counselor:

- Set clear refinancing objectives based on your financial goals.
- Review your loan documents for the details of your current loan.

Understanding Your Options: Mortgage Refinance and Home-Equity Loans

➤ *Important Note About Refinancing to Save Money on Interest Rates*

In most cases, a lower interest rate will translate to a lower monthly payment. However, some refinance loans have high fees and extra charges that are financed into the loan, increasing your loan balance and your monthly principal and interest payment. When shopping for your refinance loan, look carefully at loan fees, other costs and what the monthly payments will be.

➤ *Important Note About FHA and VA Streamline Refinancing*
FHA and VA mortgages have a unique feature called streamlining. If you have an FHA or a VA loan and interest rates drop, you can refinance without an appraisal, credit check, income verification or qualifying ratios. "Streamline" refers to the limited documentation and underwriting required by the lender. The funding fee for a VA streamline refinance is .5 percent. For a FHA loan, lenders may offer **streamline refinances** in several ways, such as with no out-of-pocket expenses to you in exchange for a higher interest rate or with the closing costs included in the new loan amount if there is enough equity in the property. For more information, see section 5, *Understanding How to Shop for the Right Lender and Loan.*

- Research available refinance loan products.
- Add up the costs and benefits of refinancing. If the benefits exceed the costs, it probably makes sense to refinance. If costs exceed benefits, it probably does not.

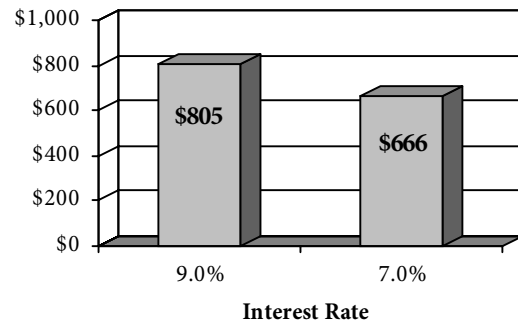
This section will help you determine whether or not refinancing makes sense for you at the present time. Keep in mind that you can refinance your loan more than once if your situation changes again.

Refinancing to Save Money on Interest Rates

If the interest rate on your existing mortgage is higher than what is currently available in the market, refinancing might make sense for you. Refinancing at a lower rate could reduce your monthly payments and the total amount of **interest** that you pay over the life of the loan. For example, if you had a \$100,000 mortgage with a 9 percent interest rate, your monthly principal and interest payments would be \$805.

If you refinanced the \$100,000 at 7 percent, your new principal and interest payments would be \$666, or a savings of \$139 per month or \$1,668 per year. Lowering your payments would free up money for other financial goals, like saving for retirement or reducing your credit card debt. If you plan to stay in your home for several years, the benefits you will gain from lower monthly payments may make good financial sense. However, refinancing does cost money, so you must decide if the savings you will accumulate during the time period you plan to stay in your home are enough to justify the costs.

Monthly Savings on Refinancing a \$100,000 Mortgage for a Lower Rate



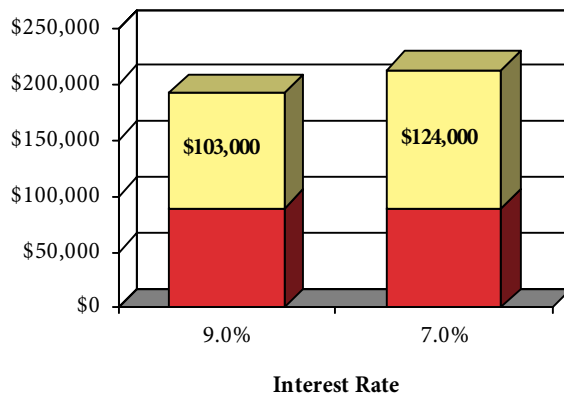
The old rule of thumb used to be to wait until interest rates drop at least two percentage points below the rate of your mortgage before you refinance. Now, however, many lenders offer no-cost and low-cost refinancing packages (costing approximately \$500) that reduce or even eliminate your out-of-pocket expenses by charging slightly higher rates or including some of the costs in the amount that is financed. With these newer programs, it can be worth your while to refinance to obtain a smaller reduction in interest rates.

An important factor in determining whether or not to refinance as it relates to saving money on interest rates is your **break-even point**, or how long it would take to recoup the total costs of refinancing, including closing costs, fees, points and prepayment penalties. In general, the larger the difference between the new interest rate and the rate on your existing loan, the shorter the break-even point, while the more it costs to obtain the new loan, the longer the break-even point.

If your new loan's term is close to the unexpired term on your existing loan, calculating your break-even point is easy. You simply divide the total cost of a new loan by the monthly savings on your principal and interest payments. Let's take another look at the example provided above. The savings of refinancing a \$100,000 mortgage from a 9 percent interest rate to a 7 percent rate was \$139 per month. If it were to cost \$2,000 to refinance, the break-even point would be just over 14 months ($\$2,000 \div \$139 = 14.4$). You will want to compare your break-even point to how long you plan to stay in your home, and evaluate whether or not it makes sense for you to refinance. It generally makes sense to refinance for a lower interest rate if you can recover your costs and make a decent return on your investment before you plan to sell your home or pay off your mortgage.

If you choose to extend your new loan's term beyond the unexpired term of your existing loan, you may take longer to own your home outright and end up paying more in total interest charges in the long run.

Total Interest Paid on Refinancing a \$100,000 Mortgage for a Lower Rate with a Longer Term



That is because when you refinance, you start over in paying off your mortgage. Using the example above, let's assume that you have already made payments for 10 years on your existing 30-year loan of \$100,000 with a 9 percent interest rate. At that point, your loan balance would be about \$89,000. If you kept your existing mortgage, your total interest charges for the remainder of the loan term would be approximately \$103,000. If you refinanced your loan balance of \$89,000 at a 7 percent rate for another 30-year loan term, your total interest

charges would be approximately \$124,000. If you plan on staying in your home for the entire loan term, the lower payments might not justify the longer term, as you would wind up making loan payments on your home for an additional 10 years and paying an additional \$21,000 in total interest charges.

Refinancing to Lower Your Monthly Payments

If interest rates are flat and you are looking for ways to reduce your regular expenses, there are two ways you can lower your **mortgage payment**. You can extend the term on your loan to lower your payment by switching from a 15- to 30-year term. Instead of paying off your home and owning it in 15 years, you would now own it in 30 years. The trade-off is higher overall interest charges and total costs associated with the loan.

➤ Important Note About Comparing Monthly Payments

If you are interested in lowering your monthly payments, make sure you understand what is included in the payments for any loan you are considering. Some lenders offer loans with payments that appear to be less than those for your existing mortgage by not including money for taxes and insurance in the payments. It is important that you look for a loan with payments that include the same items — principal, interest, taxes and insurance — as your previous loan so you can get an accurate picture of what your new payments will be as well as your monthly savings.

Another way to lower your payment is to switch from a mortgage program with **principal** and interest payments to one that allows interest-only payments. The trade-off is that none of your mortgage payment will be used to pay down the principal balance of your loan, meaning that the only way you can build equity is through home **appreciation**. If homes in the area are generally not increasing in value, you most likely will not build any equity. Or worse, you could owe more on your home than it is worth if homes in the area decrease in value.

Refinancing to Convert One Type of Mortgage to Another

The type of mortgage loan you selected to purchase your home may no longer be the best financing option for your financial situation today, and you may want to consider refinancing to obtain a more suitable loan product.

Refinancing to eliminate the risk of a fluctuating interest rate.

ARMs offer lower initial rates for a specific period of time, such as two, five or seven years, but payments and interest rates can increase after the “teaser” rate has ended. If you chose an ARM for its initial lower interest rate, but now your rate and payments have risen, or are about to increase, and you plan to stay in your home for a while, it may make sense for you to look at other loan options. If your ARM has a current rate that is near or higher than prevailing rate for a fixed-rate loan, you may decide to change to a fixed-rate mortgage for predictable monthly payments. Even if the rate on a new fixed-rate mortgage is a little higher than your current ARM, you may opt to change for the security of a fixed rate if you can afford the up-front costs of refinancing and the higher monthly payments. Some ARMs have a convertibility feature that allows you to convert your ARM to a fixed-rate mortgage by paying a small fee, usually one **point** (one percent of the loan amount), which may be a cheaper option than refinancing. Before you decide to refinance your ARM to a fixed-rate mortgage, check your **promissory note** to see if it has a convertibility feature and what the rate and fees would be.

There are many different types of ARMs, and some ARMs lack important consumer protections such as rate and payment **caps**. If you have an ARM that does not have the features you need, another option is for you to convert your existing ARM to a different ARM with lower rates or more desirable features, such as lower caps, a slower moving **index**, or a smaller **margin** to save money or feel more financially secure. For more information on typical features of ARMs, see section 5, Understanding How to Shop for the Right Lender and Loan.

Refinancing to eliminate a large balloon payment.

A **balloon-payment mortgage** is a type of short-term loan that offers relatively low monthly payments. The monthly payments are based on a 30-year **amortization** schedule, but then the entire loan balance matures in a period of five, seven or 10 years. You might have gotten a balloon-payment mortgage if you thought you would be staying in your home for a short period of time and selling it before the balance of your loan became due. However, if you have a balloon-payment mortgage that is coming due in the near future, and you lack the funds to pay the loan off and do not want to sell your home, you will need to refinance for a different type of loan to secure long-term financing for your home.

➤ Important Note

About When

Mortgage Insurance

May Be Required

Generally, when you have a conventional or FHA first mortgage loan with a **loan-to-value (LTV)** above 80 percent of the appraised value of the home, your lender will require mortgage insurance. If you refinance and get a conventional or FHA first mortgage loan with an LTV that is greater than 80 percent, you will have to pay for mortgage insurance as part of your monthly mortgage payments. Generally, the higher your loan's LTV, the higher your monthly mortgage insurance payments will be.

*Refinancing to improve terms on a **second mortgage**.*

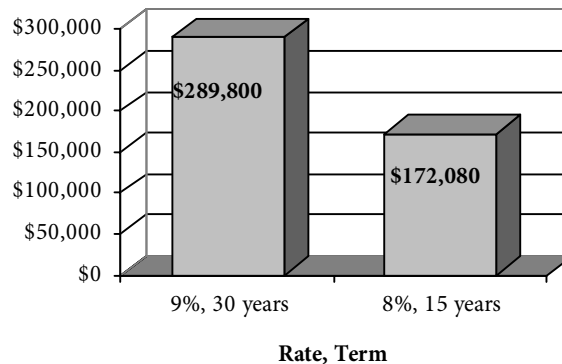
An **80/20** loan is a type of combination, or piggyback, financing for borrowers who lack the funds for a large down payment and wish to avoid paying **mortgage insurance**. If you chose this type of financing, you closed on two mortgage loans at the same time. The first mortgage was for 80 percent of the home's price, and the second mortgage was for the remaining 20 percent. There are a variety of options for the second mortgage. The interest rate on the second mortgage is usually higher than the rate on the first mortgage and does not carry a 30-year term. If you have an 80/20 loan with a high rate or otherwise undesirable second mortgage that you wish to replace, you may have two options, depending on your situation. The first is to refinance the second mortgage loan into a new second mortgage loan with more desirable features. The second is to replace both your first and second mortgages with a new first mortgage that is large enough to pay off both loans, if you have built enough equity in the home to avoid private mortgage insurance. One advantage of this option is having only one payment to make each month. A disadvantage may be the cost of refinancing. To decide which option is best for you, compare the costs of a new second mortgage with the costs of a new first mortgage that would pay off both of your existing loans (including mortgage insurance payments if applicable). If you obtained a second mortgage from a special loan program that offered low rates for second mortgages, you might be better off keeping the two loans you already have.

Refinancing to Build Equity Faster

If your financial resources have increased since you got your mortgage, you may want to convert to a mortgage with a shorter term, such as to 15 years from 30 years. Your monthly payments may be higher, but more of your payments will be applied to pay down the principal. Thus, you will own your home sooner and pay less interest over the long run. Normally interest rates on 15-year loans are lower than rates on 30-year loans. Plus, if interest rates have dropped below what you now pay on your 30-year loan, your monthly payments on a new 15-year loan may not increase by all that much. For example, if you had a \$100,000 mortgage with a 9 percent interest rate and a 30-year term, your monthly principal and interest payments would be \$805 and the total interest paid over the life of the

loan would be \$289,800. If you refinanced the \$100,000 at an 8 percent interest rate with a 15-year term, your new principal and interest payments would be \$956 and the total interest paid over the loan would be \$172,080. That is a savings of \$117,720 in interest paid over the life of the loan.

Total Interest Savings on Refinancing a \$100,000 Mortgage for a Shorter Term



➤ *Important Note About Biweekly Mortgages*

Another way to build equity faster without refinancing is to ask your loan servicer to restructure your existing mortgage into a **biweekly mortgage**. You will likely have to pay some additional fees and expenses to do so. With a biweekly mortgage, you make payments every two weeks instead of monthly. This results in one extra payment per year, so you end up paying off your loan in less than the original term and saving money on total interest charges. Keep in mind that you can realize similar savings on your own by making additional principal payments on your loan. A biweekly mortgage can reduce your financial flexibility by making the additional payments contractual rather than optional.

Keep in mind, however, that you may be able to build equity faster without refinancing by voluntarily including some extra money with your regular monthly mortgage payments. This money will be applied directly to principal to reduce your outstanding loan balance. This is called **prepayment**. Prepayment reduces your loan term and lowers the total interest owed over the life of the loan. Just adding just an extra \$50 a month to your monthly payment on a \$100,000, 30-year loan at a 7 percent interest rate would reduce your loan term by more than five years and save you around \$32,000 in total interest paid. If you are interested in prepaying your mortgage, contact your loan servicer to find out the proper procedures for doing so.

Important Considerations When Thinking About Refinancing a Mortgage for Better Rates or Different Terms

If your financial goal is to change or improve your existing loan terms, and you are trying to decide whether or not it makes sense for you to refinance right now, there are a variety of things for you to consider about the costs and benefits of refinancing. Although the interest rate may be an important factor in your decision to refinance, the following is a list of additional considerations:

➤ *Important Note About Prepayment Penalties*

Some lenders charge a fee for paying off your mortgage early called a **prepayment penalty** or fee. A typical prepayment penalty ranges from one to three points on the remaining principal balance if you repay through refinancing your mortgage within the first three years of the loan. To find out if your loan has a prepayment penalty, look at your **Truth-in-Lending statement** and/or the promissory note you received at closing. If your existing mortgage has a prepayment penalty clause, you will need to consider that fee as an additional cost of refinancing or wait until the prepayment penalty period is over before refinancing.

Source: *The Mortgage Kit*, Fifth Edition, by Thomas C. Steinmetz, 2003.

Personal Considerations

- How long do you plan to stay in your home? Refinancing generally makes sense when you plan to keep your property long enough to recapture the costs of refinancing.
- Are you anticipating any personal and financial changes in the near future? Before you invest in making any changes to your mortgage financing, consider your long-term needs as well as any short-term gains. Is refinancing the only or best way to accomplish your goals?

Financing Considerations

- Are rates lower? Lower rates are not the only reason to refinance. However, they can provide an extra incentive when you are looking to change other terms and features about your loan.
- How will refinancing affect your payments? If your payments will be higher, make sure you can afford them by preparing a realistic spending plan.
- What are the costs of refinancing? Be sure to consider **closing costs**, points, fees and prepayment penalties, and how you intend to pay for these costs.
- Does your lender offer any perks for refinancing? Your current lender may be able to waive or reduce certain closing costs and other fees involved in refinancing or offer quicker approval since you are already an established customer. For example, your current lender may offer to do an expedited **appraisal**, which costs much less than a full appraisal. Be sure to shop around to make sure your lender's rates are competitive with other lenders.

Equity Considerations

- How much equity do you have in your home? Your home may have appreciated in value and it may now be possible for you to avoid private mortgage insurance with a new mortgage loan that has a loan-to-value of less than 80 percent of your home's appraised value.

Understanding Your Options: Mortgage Refinance and Home-Equity Loans

- How will refinancing affect your home equity? You may have the option of financing your upfront costs when you refinance. The costs are added to the mortgage, which increases your loan balance and reduces your equity.
- What is the trend with property values in your area — are they increasing, decreasing or staying about the same? If they are increasing, you may be able to build equity more quickly with a lower interest rate and/or a shorter loan term.

Other Considerations

- How will refinancing affect your tax deductions? If you refinance at a lower rate and itemize your deductions, you will have less mortgage interest to deduct. However, you will be paying less in monthly mortgage payments, which may give you greater savings than your mortgage interest deductions did.
- Do you have a second mortgage? Refinancing only a first mortgage when you have two mortgages in place can be difficult, as it generally requires **subordination** from the second mortgage lender. With multiple mortgages, the earliest recorded loan is the one in first position. Thus, when you have two mortgages and only refinance the first one, your second mortgage becomes the earliest recorded loan on your home and can move into first position. However, most lenders want to make sure that their loan is recorded in “first position” on the title to your home. That way if you **default** on your mortgage and your home is sold in foreclosure, the loan that is in first position will be paid off first. Any remaining proceeds from the foreclosure sale will be used to pay off the junior (second or third) mortgages. A lender refinancing your first mortgage will typically not want to take the risk of being in second position. In such cases, it may be possible to have the lender on your second mortgage agree to subordinate its position and allow the lender who is giving you the refinance loan to be in first position. If your second mortgage lender is not willing to subordinate, you may have to apply for a refinance loan that is large enough to pay off both your mortgages in order to have the loans properly recorded.

The basic worksheets on the next page can help you decide if refinancing is right for you based on various considerations, such as your break-even point, how long you plan to stay in your home and your reason for refinancing. You may need the following information, depending on your reason for refinancing:

- Your current interest rate, loan balance and term.
- The interest rate and term for a new loan.
- Your approximate refinancing costs, including closing costs, fees, points and prepayment penalties.
- How long you plan to stay in your home.

➤ *Important Note About Mortgage Modification vs. Refinancing*

Loan modification is where your lender agrees to change the terms of your existing loan, often by lowering your interest rate, without requiring you to refinance. Only a small number of mortgages can be modified, and the lender will usually charge a fee of several hundred dollars. Modifiable loans are most likely to be offered through portfolio lenders, such as many credit unions, who keep loans on their books instead of selling them on the secondary market.

The difference between a **loan modification** and a refinance is whether or not you are getting a new loan. When you modify a mortgage, you keep repaying the same loan. When you refinance, you take out a new loan.

If your **lender** sold your loan, you may still be eligible for a special deal for refinancing with the same company. Call your **loan servicer's** customer service number, located in your payment book or on your monthly statement, to see if there are any special arrangements for existing loan customers.

Source: “Mortgage Modification, Easy Refis Available,” www.bankrate.com, by Holden Lewis, July 3, 2002.

Worksheet for Refinancing to Save Money on Interest Rates

Costs	Current Mortgage	Refinance Loan
A. Loan amount	1.	2.
B. Interest rate	1.	2.
C. Monthly principal and interest payment amount	1.	2.
D. Tax rate (see page 18 for 2005 tax rate schedules)	1.	2.
E. After-tax payment amount [$C \times (1-D)$]	1.	2.
F. Difference in after-tax payment amounts ($E1-E2$)		2.
G. Total closing costs		2.
H. Months to break even ($G2 \div F2$)		2.
I. How long you plan to stay in your home in months (years \times 12)		2.
J. Total savings ($F2 \times I2$)		

Worksheet for Refinancing to Build Equity Faster

Costs	Current Mortgage	Refinance Loan
A. Loan amount	1.	2.
B. Interest rate	1.	2.
C. Monthly principal and interest payment amount	1.	2.
D. Loan term in months (years \times 12)	1.	2.
E. Total interest paid for loan term [(D \times C)-A]	1.	2.
F. Difference in total interest paid (E1-E2)		

For more detailed and varied calculations, see the following mortgage refinance calculators online:

- Refinancing to save money on interest rates:
www.decisionaide.com/mpcalculators/refinancingonemortgage/refii.asp
- Refinancing to convert an ARM into a fixed-rate mortgage:
www.decisionaide.com/mpcalculators/refiarmtofrm/refiarmtofrm.asp
- Refinancing to convert two mortgages into one new mortgage:
www.decisionaide.com/mpcalculators/refinancingtwomortgages/refi2.asp
- Refinancing to build equity faster:
www.decisionaide.com/mpcalculators/investinginashorterterm-frm/frm30v15.asp

2005 Tax Rate Schedules

Filing Status: Single

Income Range	Tax Rate
\$0 to \$7,299	10%
\$7,300 to \$29,699	15%
\$29,700 to \$71,949	25%
\$71,950 to \$150,149	28%
\$150,150 to \$326,449	33%
\$326,450 to no limit	35%

Filing Status: Married Filing Jointly or Qualifying Widow(er)

Income Range	Tax Rate
\$0 to \$14,599	10%
\$14,600 to \$59,399	15%
\$59,400 to \$119,949	25%
\$119,950 to \$182,799	28%
\$182,800 to \$326,449	33%
\$326,450 to no limit	35%

Filing Status: Married Filing Separately

Income Range	Tax Rate
\$0 to \$7,299	10%
\$7,300 to \$29,699	15%
\$29,700 to \$59,974	25%
\$59,975 to \$91,399	28%
\$91,400 to \$163,224	33%
\$163,225 to no limit	35%

Filing Status: Head of Household

Income Range	Tax Rate
\$0 to \$10,449	10%
\$10,450 to \$39,799	15%
\$39,800 to \$102,799	25%
\$102,800 to \$166,449	28%
\$166,450 to \$326,449	33%
\$326,450 to no limit	35%

For updated schedules, see www.irs.gov.