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Financial Considerations of Refinancing a Mortgage

Declining interest rates have homeowners considering updating their mortgage

Homeowners who diligently follow mortgage interest rates may soon be tempted to refinance their current loan. However, there are a number of things to consider beyond the lower rate before starting the refinancing process.

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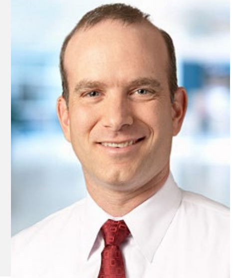

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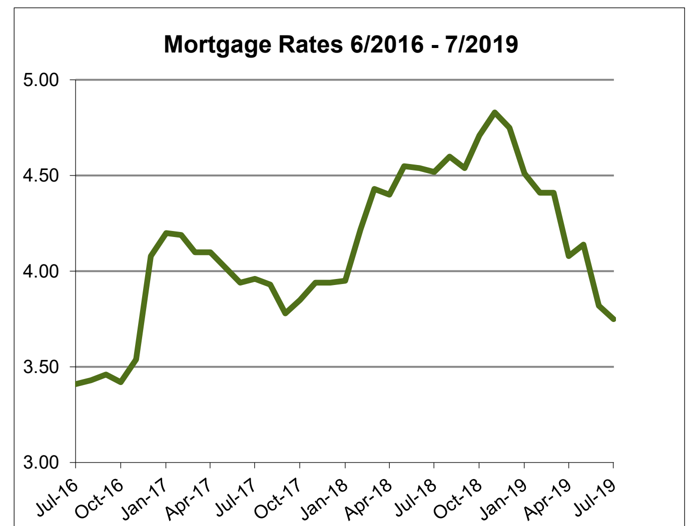
Decreases in mortgage rates often bring a flurry of activity around home buying and refinancing of existing mortgages. After a fairly steady rise in rates over the last two-and-a-half years, rates are beginning to move downward again, causing current homeowners to ask – is now the time to refinance?



Source: 2019 Primary Mortgage Market Survey, 30-year fixed-rate mortgage, Freddie Mac, published July 11, 2019.

However, just because the interest rate offered by your bank is lower than what you're paying now doesn't mean it makes sense to automatically refinance the loan. There are a variety of factors to consider before giving your bank the OK to draw up the paperwork.

ARE YOU EXTENDING THE TERM OF YOUR LOAN?

The whole point of refinancing is to reduce their monthly cost of owning the home. For example, say you have a $300,000 mortgage, with 25 years remaining, at a rate of 4.7%. In that case, your monthly payment is about $1,700. If your bank offers you a new 30 year loan at 4.0%, on the same size loan, your monthly payment will fall to about $1,430, a savings of $270 per month.

But while your monthly payment is lower, you've extended the life of your loan by 5 years. That longer loan will end up costing you more than $5,000 in additional interest over the life of the loan – even with a lower interest rate. If you stayed with a 25 year loan at the same 4.0%, your monthly payment wouldn't drop as much – only a little over $100 – but over the life of the loan you would save over $35,000 in interest expense. Banks typically offer lower interest rates for shorter term loans, as well, although each bank has its own policy on that.

Another option if you refinance to a new 30-year loan is to continue making the same payments as you were doing on the original loan. Using the previous example, assume you refinanced to the new 30 year loan with a rate of 4.0%, but kept your monthly payment at $1,700 as before. In this case, you would pay off the new loan nearly three years earlier than with your original loan, and you would have reduced your interest cost over the life of the loan by $58,000. Doing this doesn't save you anything on your current monthly mortgage payment, but it means fewer monthly payments and a lot less total interest expense.

THE TRUE COST OF REFINANCING

While the interest rate offered on your new loan may be lower than your current rate, there are expenses associated with making the switch. Usually a refinancing involves fixed expenses like an appraisal, loan application fee, recording fee, title search fee, etc. While costs can vary widely across lenders, expenses of $1,000 or more are not unusual. In addition, a loan origination fee may also apply, which is typically about 1% of the loan balance. Using our example above, that would mean an additional $3,000 cost, bringing total costs to $4,000 or more.

These costs are usually paid up-front and will reduce the benefit you get from the lower interest rate. For example, in the first scenario above, the savings was about $270 per month. If the expenses of the refinancing were $4,000, it would take 18 months of payments before the monthly savings matched the up-front costs. If you don't plan to be in the home for that long, refinancing the loan probably doesn't make sense.

Lenders will often offer discounts on their expenses, or perhaps a fixed-dollar refinancing cost, rather than something based on the size of the loan. Be sure to shop around to different lenders, keeping in mind that the interest rate on the loan isn't the only expense to consider.

In some cases, lenders will allow you to roll these expenses into the new loan, rather paying them separately. However, doing that increases the cost of those expenses, as you would have to pay interest to the lender on that amount. For example, say the $4,000 cost above was added to the $300,000, 30-year loan at 4.0% in our first example above. That increase in the loan would cause the monthly payment to go up almost $20 and it would add almost $2,900 of additional interest expense over the 30-year life of the loan.

Increasing the size of the loan during the refinancing also brings about another issue – income taxes.

TAX DEDUCTION FOR MORTGAGE INTEREST

The tax reforms passed in late 2017 have changed the way we look at the tax deduction for mortgage interest. Interest on a loan used to buy, build or substantially improve a home has always been tax-deductible as long the loan didn't exceed a threshold. The Tax Cuts & Jobs Act reduced that threshold from $1 million to $750,000. However, this only applies to loans taken out after December 14, 2017. If you're refinancing a loan that originated before that date, you're grandfathered under the higher limit, so no worries that refinancing an older loan cause you to be subject to the lower threshold.

The other significant change under the TCJA is that interest on a home equity loan is no longer tax deductible, and there is no grandfathering of existing loans. Prior to this change, interest on a home equity loan of up $100,000 could be deducted. When refinancing an existing mortgage, any increase in the size of the loan from just prior to the refinancing is considered a home equity loan, not acquisition debt. If the refinancing costs charged by the lender are rolled into the new loan, that portion of the loan will be considered a home equity loan, and the interest on that portion will be non-deductible.

This rule also applies when someone does a "cash out" or debt consolidation refinancing. If you use the refinancing to access some of the equity in your home, the interest on that will be non-deductible, even if it's used to pay off debt such as an existing home equity loan. If you do a "cash out" refinancing, and then use that extra cash to make improvements to the home, that portion of the loan will be considered acquisition debt and would be eligible for a tax deduction. However, because that portion is considered a new loan, it would be subject to the lower $750,000 debt limit.

Falling mortgage interest rates are certainly an enticement to reconsider your debt situation. However, be careful not to be lured into a loan that ultimately ends up costing you more than you were expecting. Be sure to shop around and understand all your options.