



## Consumer Tips February 2011: Refinancing by the Numbers

Last year, mortgage rates reached an historic low and enticed many homeowners to refinance their homes. However, just because you can get a rate that is lower than the rate on your current home loan doesn't mean that refinancing is a good idea. It is a numbers game and you've got to know how to examine the numbers to determine whether refinancing is right for you. If you won't save money, don't do it.

Let's assume you bought your house five years ago and got a \$160,000, 30-year fixed rate mortgage at an interest rate of 6.5 percent. You've shopped around for rates and have found that you can refinance your loan with a 30-year fixed rate mortgage at an interest rate of 4.8 percent. Is this a good deal? Let's run the numbers.

Your current monthly payment is \$1,011.37 and you owe \$149,777. If you refinance your mortgage for 30 years at a rate of 4.8 percent, your monthly payment will be \$785.83. That's a difference of \$225.54 every month or \$2,706.48 annually. Do you hear the sound of extra money jingling in your pockets? Are you ready to sign on the dotted line? Not so fast. There are more numbers you need to consider.

When you refinance a home loan, there are usually closing costs. Let's assume that the total cost to close the loan to refinance your home is \$2,498. Additionally, you need to consider taxes. The interest you pay on your home loan is deductible on your federal income taxes. However, because you will have a lower interest rate after you refinance, you will pay less in interest every year, and will lose some of the tax savings that you were getting. It isn't out of the question that your tax savings for deducting the interest paid could be reduced by \$800 the first year for someone who is in the 25% tax bracket. This means that in the first year it will cost you \$3,289 to refinance your home. Don't get discouraged; remember, you are saving \$2,706.48 annually in lower payments.

You can calculate your breakeven point by taking your costs to refinance (\$2,489) and dividing it by your monthly savings (\$225.54). Without considering taxes, you will breakeven in a little over 11 months and afterwards enjoy monthly savings of \$225.54. If you

take the reduced tax deduction into account, your breakeven point would be a little longer (about 3 months longer), and your monthly savings after you breakeven, while difficult to predict, might be around \$160 per month. This is still a tidy monthly savings.

If you are planning on staying in your current home for the next 30 years, you should also consider that it will take longer to pay off the loan to refinance your home than your current mortgage. In our example, you would have paid off your existing mortgage in 25 years (2036), but if you refinance you will pay off the refinanced mortgage in 30 years (2041). That's an additional five years of interest, but also an additional five years of interest deductions on your federal tax return. Of course, the amount of interest in the last five years of a loan is much less than the interest on any five-year period preceding it because interest paid is calculated on the remaining principal balance. In our example, interest paid in the last five years is about \$5,300; in the first year it was \$7,139. The additional interest scheduled to be paid in the five years after the original mortgage would have been paid off is not very useful in determining whether to refinance because: 1) Most people don't stay in a home 30 years, 2) the time value of the money is hard to calculate, and 3) the tax deduction during those five years is impossible to predict.

If you'd like to refinance your loan without extending the period it will take you to own your house free and clear, you should consider refinancing it with a community bank. Lenders who sell their mortgages into the secondary market are restricted to making loans for particular lengths of time (e.g., 15, 20, 30). Because many community bankers do not sell their mortgages, they are not restricted to particular lengths of time.

There are online calculators to help you do the same analysis we've done in this article. Bankrate.com has a calculator to determine if you will save by refinancing.

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