

By William J. Birney

# Refinancing Your Home Mortgage

**As a result of falling interest rates, it may be possible to save money with a new loan**

The Federal Reserve has cut its key lending rate a dozen times since January 2001. In a survey by Freddie Mac, the quasi-governmental purchaser of the home loans of many Americans, the median age of home loans refinanced in the first quarter of 2001 was only 1.6 years—the lowest it has been since Freddie Mac started tracking this figure. Additionally, refinancers generally have enjoyed an appreciation of their property in recent years, allowing them to take advantage of newfound equity.

If in 2001 you financed \$250,000 for the purchase of a new home at the then-current fixed interest rate of 7.875 percent, your current mortgage payment is \$1,813 per month. If you qualify at rates effective November 2002 (which may be as low as 6.125 percent), your monthly payment would be \$1,494—a monthly savings of \$319. If you put less than 20 percent down on your original purchase, your lender likely required private mortgage insurance (PMI) on the mortgage. If your refinanced mortgage is less than 80 percent of your home's newly appraised value, you would not have to pay the PMI premiums of \$50 or more per month.

Keep in mind, however, that while refinancing reduces the monthly mortgage payment, it also typically increases the term of the loan—which can dramatically increase the total cost of the loan. Since the largest interest charges occur at the start of the loan, and beginning a new loan means making those high interest payments all over again, if a borrower takes the full time to pay off the new loan, refinancing could easily cost more than keeping the current loan. But there are other reasons to exchange your current loan.

Perhaps you want to tap the equity that has built up in your home since your original purchase or last refinance. In that case, you could elect a “cash-out refi” by obtaining a new loan based on the home's current appraised value, thereby allowing you to pay off what is owed on the old loan and eliminate any secondary financing or other outstanding debt, or reinvest the money in home improvements (potentially further increasing the home's value).

Another reason to refinance might be to switch from an adjustable-rate mortgage (ARM), in which the loan's interest rate changes based on market conditions, to a fixed-rate loan, which offers the certainty of set payment amounts no matter what happens to interest rates in the future. Alternatively, since ARMs often start at rates substantially lower than those charged for fixed-rate loans, you might want to switch from a fixed rate loan to an ARM (or different type of ARM) to take advantage of a particularly low introductory interest rate. The variety of different loan programs in this category has grown in the last few years so that beyond simply considering whether the loan should be adjustable or fixed, borrowers now have the option to choose from a number of hybrids in which they make fixed interest-

only payments for a certain period of time, after which the interest rate floats (or adjusts) to the market interest rate. At that time the borrower makes a fully amortized payment of principal and interest for the remainder of the loan term.

Finally, you may want to build the equity in your home faster by shortening the term of the loan. You can do that by swapping your current 30-year mortgage for a 15- or 20-year loan. If interest rates have come down enough, you may even be able to achieve this change with only a marginal increase in your monthly mortgage payment. However, a disciplined borrower can achieve the same result by making additional principal payments on a 30-year mortgage (for example, a borrower who makes one additional mortgage payment per year can reduce a 30-year loan term by eight years), so financial planners caution borrowers not to commit too much money to their homes.

## Rules of Thumb

At one time, the general rule was that it paid to refinance only when the new loan's interest rate was two percentage points lower than the current loan's. But with the variety of loan programs now available, that rule is now too simple. The term “no cost,” however, is something of a misnomer, because it does not mean that the refinance is free; it simply means that the borrower will not have to pay anything out of pocket at closing. The fees charged by the lender will either be added to the new loan's principal or the interest rate will be somewhat higher.

To really compare apples to apples, you should compare the after-tax cost of the proposed loan with that of the current loan. Since mortgage interest is deductible from federal taxes, the after-tax cost of the loan equals the principal and interest payment after deducting the taxes saved by the deduction. Continuing the example in which a \$250,000 loan (with a current balance of \$245,942) is refinanced for a 30-year term at 6.125 percent, at a total cost of \$2,000, the current monthly mortgage payment is about \$1,813, of which about \$1,615 is interest. That translates into an after-tax payment of about \$1,360 (assuming the borrower is in the 28 percent tax bracket). The new loan's monthly payment would be about \$1,494, of which about \$1,276 is interest, for an after-tax cost of about \$1,136 and savings of about \$224 per month. At the new interest rate, it will take about nine months before the bor-



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rower breaks even. Therefore, if the borrower plans to stay in the house longer than nine months, refinancing may make sense.

Refinancing does not always make sense, however. Some borrowers with second mortgages, a lot of debt, or trouble paying bills on time might discover that they would pay more by refinancing than they will by sticking with the loan that they already have. Such borrowers may also not want to put their house at risk by consolidating unsecured debt into a larger secured mortgage. Alternatively, such a borrower may be able to obtain a home equity line of credit (HELOC), which depending on current interest rates could be at an interest rate lower than that of first mortgages—as is the case now. For borrowers who do not require much money and do not intend to have the loan outstanding for long, the no-cost lure of a HELOC can be persuasive. With a HELOC the borrower pays interest-only payments only when the line is accessed and then only on the monies that are actually borrowed. Principal is payable upon maturity—which typically occurs after 10 years. This type of loan permits borrowers to tap their equity when it is necessary without having to go through the lengthy and time-consuming process of obtaining yet another mortgage loan.

As soon as you have made the decision that you want to refinance, your first step should be to make certain that you have a clear picture of your financial situation—in much the same way that you prepared in obtaining your current loan. Review and understand the terms of your current loan, analyze your current financial situation, and obtain, review, and correct any discrepancies or problems on your credit reports.

#### Where to Start

Your current lender knows your payment history and is familiar with the property. You would think that it would be easier for your current lender to refinance your existing loan, at a better price than what a third-party lender could offer, since it is easier to keep a good customer than it is to find a new one. In some cases when the borrower is not seeking cash-out refinancing, the current lender may even be able to modify the existing loan by reducing the interest rate, without refinancing the existing loan. However, the majority of loans are packaged with other loans and sold to third-party investors, with the result that the current lender is limited to servicing the loan and the existing loan is not able to be modified. Many lenders, however, can offer streamlined refinancing in which the appraisal can

be obtained electronically, the title search is abbreviated, and other items and documentation that would normally be required on a new loan are omitted.

If you are looking elsewhere, consider your credit union; local savings and loan; community bank; local, regional, or national mortgage company; and even a commercial brokerage bank. Under the Real Estate Settlement Procedures Act, within three days after the loan application has been submitted, the amount of fees and charges that are to be paid in connection with the loan will be provided on the Good Faith Estimate. The estimate sets forth the annual percentage rate for the loan, which is the total charges calculated on an annual basis and stated as a percentage, including not only the interest rate but also such one-time loan fees as discount points that increase your overall costs. While the Good Faith Estimate is not perfect—in that it assumes that the loan will continue until maturity—it is an invaluable tool for the borrower to use in comparing proposed new loans. Practically everyone these days is in the home loan field, and there is a plethora of good lenders and mortgage brokers to choose from, but it will always pay to confirm for yourself the loan programs, interest rates, and terms available to you. ■

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