The Refinance Rule of Thumb

Colin Robertson March 21, 2012 2 Comments »

If you're considering refinancing your mortgage, you may have searched for the "refinance rule of thumb" to help you make your decision.

Of course, there isn't a single refinance rule of thumb. One popular one is that you should only refinance if your new interest rate will be two percentage points lower than your current mortgage rate.

Only Refinance If the New Mortgage Rate is 2% Lower

For example, if your current mortgage rate is 6%, that rule would tell you refinance only if you could snag a rate of 4% or lower.

But clearly this rule is much too broad, just like any other rule out there. When it comes down to it, a refinance decision will be unique to you and your situation, not anyone else's.

[See the latest mortgage rates from dozens of lenders, updated daily.]

This old rule assumes most mortgage amounts are pretty small, unlike the jumbo loans we see nowadays.

Let's take a look at some math to illustrate why this refinance rule falls short:

Loan amount: $500,000
Loan type: 30-year fixed-rate mortgage
Current mortgage rate: 5%
Refinance mortgage rate: 4%
Cost to refinance: $4000

In this scenario, the existing mortgage payment is $2,684.11. If refinanced to 5%, the monthly mortgage payment falls to $2,387.08. That's a difference of nearly $300 a month, which will certainly make it easier to meet your mortgage obligation.

However, it will take 13 months to recoup the cost of the refinance ($4000/$297).

That said, the refinance "breakeven period" (time to recoup your costs) is very short here. So we don't need to follow that "2% lower rate" refinance rule.

But what if the loan amount is only $100,000? The game changes in a hurry. Your mortgage payment would drop from $536.82 to $477.42. That's roughly $60 in monthly savings, not very significant.

Assuming the cost of the mortgage was still somewhere around $3,000, it would take 50 months, or more than four years, to recoup the costs associated with the refinance.

So if you were thinking about selling your home in the short term, it probably wouldn't make sense to throw money toward a refinance.

This is probably why this old refinance rule exists. But home prices are higher these days, so it's not a good rule to follow for everyone.

Only Refinance If You'll Save "X" Dollars Each Month

Another common refinance rule of thumb says only to refinance if you plan to live in your home for "X" amount of years, or only to refinance if you'll save "X" dollars each month.

Again, as seen in our example above, you can't just rely on a blanket rule to determine if refinancing is a good idea or not.

Some borrowers may need to stay in their home for five years to save money, while others may only need to stick around for just over a year.

But plans change, and you may find yourself living in your home much longer (or shorter) than anticipated.

And if you look at the refinance savings in dollar amounts, it will really depend on the cost of the refinance and how long you make the new payment.

If it's a no cost refinance, you won't even have to worry about the break-even period.

So it'd be foolish to get caught up on this rule unless you have a bulletproof plan.

[Does refinancing hurt your credit score?]

Consider the Mortgage Term

Finally, consider the mortgage term when refinancing, and the total amount of interest you can avoid paying over the life of the loan.

If you're currently five years into a 30-year fixed mortgage, and refinance into a 15-year fixed mortgage, you'll shave 10 years off your mortgage term.

Assuming mortgage rates are lower at the time of refinance, you'll save both in monthly payment and in total interest paid, which will shorten your break-even period and maximize your savings.

[30-year fixed vs. 15-year fixed]

Also factor in your current loan type versus what you plan to refinance into. If you're currently holding an adjustable-rate mortgage that will reset higher soon, the decision to refinance may be even more compelling.

At the end of the day, you shouldn't use any general rule to determine whether or not you should refinance.

Doing so is lazy, especially when it's not that hard to run a few numbers to see what will make sense for you.

If you feel overwhelmed by all the math, ask a loan officer or mortgage broker to run some scenarios for you to illustrate the potential savings and break-even periods.

And take your time – you're not shopping for a big screen TV, you're making one of the biggest financial decisions of your life.

Tip: When to refinance a home mortgage.

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(photo: angermann)

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2 Comments

Michael March 22, 2012 at 6:24 am -

Your 1st example comparing a $100K mortgae @ 4.0% vs. 5.0% is not taking into account that the 4% is going to pay more every month towards your principal so you have to add that amount (your $) to the out of pocket.

Colin Robertson March 22, 2012 at 9:14 am -

Good point Michael, which is all the more reason why you can't rely on a single rule to refinance.

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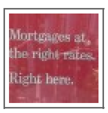

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