When to know if you need to refinance a mortgage

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In some cases, refinancing a mortgage is done to lower payments by extending the time that the loan will exist.

For example, you might have a 15-year loan that is a couple of years old and are having trouble with the amount of the payments. You could refinance (and hopefully with a lower interest rate) to a 30-year loan and expect your payments to drop significantly. However, you will be making payments for much longer.

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A more common motivation to refinance a mortgage is to reduce the rate of interest paid on the loan.

Refinancing for this reason was common until recently, as mortgage rates ranged from only 2% to 4% since around 2009.

Dropping interest payments over a long mortgage can save tens of thousands of dollars.

However, refinancing is not free. Most of the time, this process takes time, paperwork and $2,000 to $5,0000 in various fees. There are certain instances in which refinancing a mortgage may not make sense. One time is during the last five years or so of a typical 15- to 30-year mortgage.

Next: When interest payments change is very small

Mortgage payments are amortized in a fashion that has you pay primarily interest in the first few years of the loan and then pay primarily principal back near the last few years. If you are near the end of your mortgage, you may actually be paying very little interest back per payment.

Lowering the interest rate on these small limited amount of interest payments may not be cost effective when you add in the fees and time needed to refinance.

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A second time that refinancing does not make sense is when the interest rate change is very small. The gains in reducing your interest rate by say one half percent is probably all eaten up by the refinancing fees.

A final time that refinancing makes little sense is when you are likely to sell the property within 1 to 3 years. Usually the “payback” time of recovering the refinance fees with lower payments is that same 1 to 3 years, so just about the time you are coming out ahead, you have disposed of the property.

When you are trying to compare new mortgage costs with old ones, have the lending institution run a schedule using exactly the same time on both mortgages and the same principal balance. They can adjust your current loan with extra payments to have the same term as a new shorter loan.

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Having this comparison will let you know the monthly savings from the new loan with the same payoff time and the same amount of principal owed. You can divide the monthly savings into the refinancing cost to see the number of months in which you save enough to justify the refinance fees.

Shop around

Borrowing money is like shopping at Wal-Mart. You are “buying” money just like you buy something off the shelf at the store. Prices (fees and interest rates) are often negotiable, and depend on how aggressive your lending institutions are at a given time.

Check with more than one lender. Good luck!

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