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MANAGING IN TOUGH TIMES INITIATIVE

FAMILY FINANCIAL MANAGEMENT

UNIVERSITY OF KENTUCKY
College of Agriculture

Cooperative
Extension Service
Katie Keith
116 Erikson Hall
Lexington, KY 40506
(859) 257-2097
Fax: (859) 257-7565

September 2012

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THIS MONTH'S TOPIC:

Mortgage Math: Should I Consider Refinancing My Home?

With home interest rates at historic lows, many people are considering refinancing their home to lower their monthly mortgage payment. A low interest rate can be very enticing; however, there are many factors to consider. One is how long you plan to stay in your home. A lower mortgage rate will result in a lower monthly payment for as long as you remain in your home; but as part of your refinancing, you will pay certain fees, such as closing costs. If you are planning on moving in the near future, be certain that you will remain in your home long enough to recover the costs of the new mortgage. Although you can determine a rough estimate of the number of months you'll need to break even by dividing the cost of the loan by your monthly savings, the math for an accurate estimate on tax-deductable interest and savings is more complicated.

Many consider refinancing their home to lower monthly mortgage payments

Use the following steps to determine the number of months it will take to break even or generate any savings from refinancing:

1. Determine your savings per month by subtracting your new monthly mortgage payment from your current monthly mortgage payment. The result is your pretax savings.

2. Multiple your savings by your current tax rate.

3. Subtract the result of step 2 from step 1, to determine after-tax monthly savings.

4. Divide your after-tax monthly savings by the total cost your new loan.

Consider the following example, assuming by refinancing you will reduce your monthly mortgage payment by $100:

- If your current tax rate is 25 percent, multiply 100 by .25, which equals $25.
- Your actual after-tax savings is $75.
- If the total cost of your new loan is $2,000, it will take over 26 months to break even (2000/75 = 26.666).

If you plan on living in your home for a long time, the decision to refinance may make sense. However, there are many other considerations in the decision to refinance, such as length of time of your current mortgage, the type of loan you have or if your mortgage has a prepayment penalty.

Length of Current Mortgage

In the early years of a home loan, the majority of monthly payments are applied toward interest, with a small portion credited to the principal. If you have had your home mortgage for several years, a greater portion of your monthly payment will be applied to your principal, allowing you to build equity. When you refinance and extend the term of the loan beyond the remaining term of the current loan, more of your payment will once again be applied to interest instead of equity. This can result in a significant amount of additional interest.

Prepayment Penalties

Be certain to check with your home mortgage lender regarding any prepayment penalties on your loan. A prepayment penalty is a charge that you pay if you pay your home loan off early. Not all home mortgage loans have a prepayment penalty. If you are refinancing with the same company, they may be willing to waive the penalty. If not, you will want to include the cost of the penalty in your break-even calculation.

Written by: Jennifer Hunter, Ph.D., University of Kentucky Extension Specialist Family Resource Management

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Designed by:
Katie Keith
University of Kentucky
Cooperative Extension Service
116 Erikson Hall
Lexington, KY 40506-0050
(859) 257-2097
Katie.Keith@uky.edu

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MoneyWise is a Managing in Tough Times initiative.