When (and When Not) to Refinance Your Mortgage by Investopedia Staff

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Refinancing a mortgage means paying off an existing loan and replacing it with a new one. There are many reasons why homeowners refinance: the opportunity to obtain a lower interest rate; the chance to shorten the term of their mortgage; the desire to convert from an adjustable-rate mortgage (ARM) to a fixed-rate mortgage, or vice versa; the opportunity to tap a home's equity in order to finance a large purchase; and the desire to consolidate debt.

Some of these motivations have benefits and pitfalls. And because refinancing can cost 3% to 6% of the loan's principal and – like taking out the original mortgage – requires appraisal, title search and application fees, it's important for a homeowner to determine whether his or her reason for refinancing offers a true benefit.

Securing a Lower Interest Rate

One of the best reasons to refinance is to lower the interest rate on your existing loan. Historically, the rule of thumb was that it was worth the money to refinance if you could reduce your interest rate by at least 2%. Today, many lenders say 1% savings is enough of an incentive to refinance.

Reducing your interest rate not only helps you save money, it also increases the rate at which you build equity in your home, and it can decrease the size of your monthly payment. For example, a 30-year fixed-rate mortgage with an interest rate of 9% on a $100,000 home has a principal and interest payment of $804.62. That same loan at 4.5% reduces your payment to $506.69.

Shortening the Loan's Term

When interest rates fall, homeowners often have the opportunity to refinance an existing loan for another loan that, without much change in the monthly payment, has a significantly shorter term. For that 30-year fixed-rate mortgage on a $100,000 home, refinancing from 9% to $5.5% can let you cut the term in half to 15 years, with only a slight change in the monthly payment from $804.62 to $817.08.

Converting Between Adjustable-Rate and Fixed-Rate Mortgages

While ARMs often start out offering lower rates than fixed-rate mortgages, periodic adjustments can result in rate increases that are higher than the rate available through a fixed-rate mortgage. When this occurs, converting to a fixed-rate mortgage results in a lower interest rate and eliminates concern over future interest-rate hikes.

Conversely, converting from a fixed-rate loan to an ARM can be a sound financial strategy in a falling-interest-rate environment. If rates continue to fall, the periodic rate adjustments on an ARM result in decreasing rates and smaller monthly mortgage payments, eliminating the need to refinance every time rates drop.With mortgage interest rates rising, on the other hand, as they have begun to do, this would be an unwise strategy.

Converting to an ARM, which often has a lower monthly payment than a fixed-term mortgage, may be a good idea for homeowners who don't plan to stay in their home for more than a few years. If interest rates are falling, these homeowners can reduce their loan's interest rate and monthly payment, but they won't have to worry about interest rates rising in the future because they won't be there that long.

Tapping Equity and Consolidating Debt

While the previously mentioned reasons to refinance are all financially sound, mortgage refinancing can be a slippery slope to never-ending debt. It's important to keep this in mind when considering refinancing for the purpose of tapping into home equity or consolidating debt.

Homeowners often access the equity in their homes to cover major expenses, such as the costs of home remodeling or a child's college education. These homeowners may justify such refinancing by pointing out that remodeling adds value to the home or that the interest rate on the mortgage loan is less than the rate on money borrowed from another source. Another justification is that the interest on mortgages is tax deductible (although the 2017 tax law has ruined this in for both existing and new mortgages). While these arguments may be true, increasing the number of years that you owe on your mortgage is rarely a smart financial decision, nor is spending a dollar on interest to get a 30-cent tax deduction.

Many homeowners refinance to consolidate their debt. At face value, replacing high-interest debt with a low-interest mortgage is a good idea. Unfortunately, refinancing does not bring with it an automatic dose of financial prudence. Take this step only if you are convinced you'll be able to resist the temptation to spend once the refinancing gets you out from under debt. Be aware that a large percentage of people who once generated high-interest debt on credit cards, cars and other purchases will simply do it again after the mortgage refinancing gives them the available credit to do so. This creates an instant quadruple loss composed of wasted fees on the refinancing, lost equity in the house, additional years of increased interest payments on the new mortgage and the return of high-interest debt once the credit cards are maxed out again – the possible result is an endless perpetuation of the debt cycle and eventual bankruptcy.

The Bottom Line

Refinancing can be a great financial move if it reduces your mortgage payment, shortens the term of your loan or helps you build equity more quickly. When used carefully, it can also be a valuable tool in getting debt under control. Before you refinance, take a careful look at your financial situation and ask yourself: How long do I plan to continue living in the house? And how much money will I save by refinancing? (For more information, see How Refinancing a Mortgage Affects Your Net Worth.)

Again, keep in mind that refinancing costs 3% to 6% of the loan's principal. It takes years to recoup that cost with the savings generated by a lower interest rate or a shorter term. So, if you are not planning to stay in the home for more than a few years, the cost of refinancing may negate any of the potential savings. It also pays to remember that a savvy homeowner is always looking for ways to reduce debt, build equity, save money and eliminate that mortgage payment. Taking cash out of your equity when you refinance doesn't help you achieve any of those goals.

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