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Refinancing? Be Sure to Weigh the Costs

Megan Mollman, AOL Real Estate Contributor

Home refinancings have climbed to their highest level in over a year as homeowners, spurred by rock-bottom interest rates, race to lock them in. As rates continue to dwindle lower, consumers are seeing this as an opportunity to refinance not just once, but multiple times.

But it's not an across-the-board type of decision and in some cases, says one mortgage broker, the benefits may be questionable. "Just because you get a 0.5 percent drop on the interest rate doesn't mean it's worth doing it," says Keith Stewart, a mortgage broker with NorthPoint Lending Group, Inc. "A lot of people are all about a lower monthly payment and they don't look at the big picture."

Factors such as how long you've owned your loan, the amount of your loan, the drop interest rates, how long you want to stay in your home and closing costs all play into making refinancing a financially prudent choice for you.

The Closing "Cost"

According to Bankrate.com's annual survey, the average closing cost, including lender, title and settlement fees, is $3,024 on a $200,000 mortgage. Though cost depends on the state where you live. New York and Texas topped the list as the most expensive with average closing costs in the $5,000-range.

Each time you rework the terms of your home loan, you pay the expense of various fees to the broker, lender and other third-parties. Closing costs include the fee paid to the title company, government recording fees, payments to the lender for the underwriting, and to the broker for processing the transaction.

Stewart says the general rule of thumb is that if you can recoup the cost of a refinancing within a year, then it is generally considered a wise decision. However, it may be easier for an individual with a higher loan amount to swallow the closing costs than a borrower with a smaller mortgage.

For instance, if you switch to an interest rate that is .5 percent lower on a 300,000 mortgage, you would save $1,500 a year. That's less than half of the national average closing cost. Making up the difference on closing costs is much doable on a 600,000 mortgage, where your interest savings would be $3,000 in year one, about the average expense of a closing.

You should also be aware of roll-in financing, the option to roll your closing costs into loan. While it eliminates a separate closing cost fee, you are on the hook for paying it off over the long haul and that could bump up monthly payments and grow your overall loan balance.

The Time Factor

Kirk Tatom, owner of Tatom Lending, says refinancing depends on how long you want to live in your home. His school of though weighs the pros and cons of refinancing by determining how long it would take to regain your losses and comparing it to projected number of years you plan to stay.

Divide the closing costs by your monthly savings to figure out how long it will take to break even, he says. His example: if you are saving $150 per month in interest and paid $5,400 in closing cost fees, then it will take you 36 months, or approximately 3 years, to negate the cost of the closing fees.

For a homeowner, who only plans to be in their home 2 to 3 years, a refinancing in this scenario is not smart strategically. In year three, the borrower is just beginning to save (or earn money back on the $5,400 investment).

The idea, says Tatom, is to look at refinancing as an investment, like bonds or a saving account earning interest."You are investing those closing costs to reap a return," he says.

Starting Over Again

For those who have had their mortgage for a significant amount of time, like 10 years into a 30-year home loan and moving to a subsequent 30-year loan, refinancing may be like taking a big step backwards. The move to lower interest rates may reduce your monthly mortgage payments, but you will be paying you loan off over a longer period of time, 40 years, and it's possible you could be paying a higher overall loan balance.

For this type of situation, you may want to consider refinancing into a 15, 20 or 25-year loan instead of another 30-year loan. Stewart says. "If you are seven years into a 30-year loan, you are starting all over time wise," he says. "Go for the 20-year loan to knock off three years off your mortgage payments."

The Bottom Line

In many cases, obtaining a lower interest rate through a refinance may help you save thousands and thousands over the course of your loan. Over the past couple of years, it's been extremely helpful to homeowners stuck with high interest rates from the pre-housing crisis era, and who have been struggling to pay their monthly dues. But real estate experts caution: Refinancing is not just a quick fix to save on your monthly payments, it's also a way to lower your loan balance and clear a sustainable fiscal path to owning your home.