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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

So far this year, more than 6 of10 mortgage applications are for refinancing.

The dollar's slide has coincided with a marked improvement in U.S. export performance. From 2004 to 2007, U.S. exports grew 8.3% a year, on average. In the four years prior to that period, annual growth of exports was a mere 0.6%

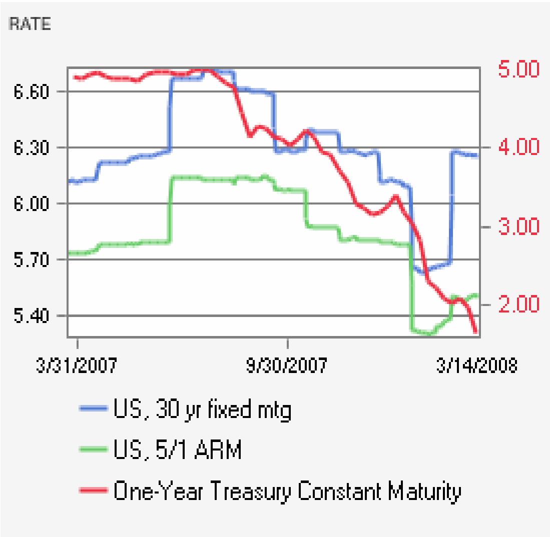
Refinancing One's Home Mortgage

A great deal of negative publicity has surrounded the subprime mortgage lending market over the past nine months. As a practical matter, most of our readers enjoy fine credit histories and borrow in conventional markets. The Federal Reserve has been lowering their target rate on short term lending in an effort to quell turmoil in the credit sector. This has had some effect on mortgage interest rates as well – possibly opening up refinancing opportunities for borrowers with good credit. This article will focus on the issues to be weighed in any refinancing decision.

Different borrowers, of course, are taxed differently. The degree to which mortgage interest is offset by tax savings varies considerably. As such, this review can only serve as a guideline and is not definitive as to everyone's particular situation. The advice herein should apply approximately to most borrowers, however.

When a prospective borrower applies for a new mortgage, the government requires that the lender provide a "Good Faith Estimate" (GFE) within three days of the application. This document sets out all the costs associated with the mortgage. Properly identifying the costs of closing a mortgage is a key prerequisite of any refinancing decision.

Mortgage lenders often tout recent Fed interest rate cuts as incentive to refinance in their marketing efforts. Despite this accommodative fed policy, the conventional mortgage market has been rather choppy over the past 12 months. The data in the preceding chart, compiled by Bankrate.com, describes a precipitous decline in the yield of a one year treasury bill. However, both adjustable and fixed rate mortgages, followed a more circuitous path over the same period.



Keep in mind that mortgages represent longer term lending. Implicit in these longer term interest rates are inflation expectations and liquidity concerns within the mortgage market. In short, the decline in the federal funds has not translated directly to lower mortgage rates.

There will be opportunities for families to refinance in 2008. In some cases, the opportunity will arise from an improved credit standing. Some folks will have seasoned mortgages from past years that might benefit by locking in a sub 6% interest rate available today.

The key factor in the refinancing analysis are the underlying costs. There are a number of fees associated with a new mortgage - many of which decline in importance with the size of the loan. That's where the GFE comes in.

The fees in the GFE are organized under numerical headings: the 800s, 900s, 1000s, 1100s, 1200s, and 1300s. For purposes of comparison-shopping, the most significant fees are listed in the 800s. Most of the items are within the control of the lender or broker, so the estimates should be accurate. A few of the items in the 800s are charged by third parties. These items may not be negotiable but, at least, the lender's estimates should not be far off from the actual charges.

The lender has direct control over origination and discount points and fees (listed in 801 and 802) and administrative, underwriting, processing, funding, document preparation, wire transfer, and other fees (listed in 810 and higher). These are the fees that are the best candidates for negotiation as they are set by the lender and are not contracted out. Keep this in mind as you are not strictly a price taker when it comes to borrowing – especially if you have good credit.

In short, the fees under headings 800, 1100, 1200, and 1300 represent real costs to the

borrower and are summed as ***Estimated Closing Costs***. This is probably the most important figure on the form.

Notably, items under the 900 and 1000 heading are prepaid expenses such as mortgage, hazard and flood insurance premiums, mortgage interest and taxes that must be paid up front or deposited into an escrow account. These should ***not*** be considered part of the cost to refinance as they effectively replace costs that will be borne under the current mortgage anyway. They are usually listed below the Estimated Closing Costs and can be ignored for the purposes of the cost analysis of the refinancing decision.

Only the Loan Origination fee (801) and loan discount (802) are tax deductible. The balance of the closing costs are not. This is an important consideration as the borrower is making an after tax investment in closing costs to obtain savings in mortgage interest – a tax-deductible expense for most.

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The GFE also lists the size, interest rate, and term of the loan. We can use this data to create the comparison with the existing mortgage. As a rule of thumb, it is not worth undertaking any breakeven analysis unless proposed interest rates are at least 0.50% lower than the current mortgage. There may be some jumbo mortgages that merit consideration earlier because many refinancing costs do not increase commensurately with the loan balance.

Here is a real world example. John and Jane Doe currently have a 6.75% mortgage with a $200,000 balance and 26 years remaining. Monthly principal and interest payments are $1362. The Does visit a mortgage lender and receive a CFE identifying $3200 in estimated closing costs. It’s a 30 year fixed rate at 6.00%. We’ll assume that they are taxed at a 30% marginal rate. Is this a good deal?

The first step is to estimate the annual interest savings each year. The mortgage is constantly amortizing but we can infer that the first year’s interest savings will be about (.0675 - .0600) * $200,000 = $1500. After taxes, that amounts to a savings of $1050. This rate will of saving will decline somewhat in successive years as the mortgage amortizes. We can conclude that the Does’ initial “investment” will be recouped after 3 years.

“As a general rule, every point paid lowers the borrower’s interest rate by 0.25%. More simply, every dollar paid up front saves almost $0.25 each year thereafter.”

If we factor in the time value of money, the real breakeven point moves out closer to five years - when they will earn a 17% return on investment. That is, the Does stand to benefit from refinancing if they plan to stay in their house at least another five years. The following table displays in greater detail the economics of the refinancing decision. The green rows at the bottom of the illustration indicate the holding periods over which the Does benefit from refinancing.

Estimated Closing Costs:	$ 3,200
Interest Rate of Proposed Mortgage	6.00%
Marginal Tax Rate of Borrower:	30%
"Converted" Monthly Payment with Proposed Mortgage	$1,267
Term to Maturity of Current Mortgage (months)	312
Interest Rate of Current Mortgage	6.75%
Balance of Current Mortgage	$ 200,000
Monthly Payment of Current Mortgage	$1,362

	Pretax	Aftertax
"Investment" or estimated closing costs	$ (3,200)	$ (3,200)
Annual Savings with lower rate (year 1)	$1,475	$1,033
Annual Savings with lower rate (year 2)	$1,449	$1,014
Annual Savings with lower rate (year 3)	$1,421	$995
Annual Savings with lower rate (year 4)	$1,392	$974
Annual Savings with lower rate (year 5)	$1,360	$952
Annual Savings with lower rate (year 6)	$1,327	$929
Annual Savings with lower rate (year 7)	$1,291	$904
Annual Savings with lower rate (year 8)	$1,254	$878
Annual Savings with lower rate (year 9)	$1,214	$850
Annual Savings with lower rate (year 10)	$1,171	$820

Estimated Return on Refinance after	1	year	-67.7%
Estimated Return on Refinance after	2	years	-25.3%
Estimated Return on Refinance after	3	years	-2.5%
Estimated Return on Refinance after	4	years	9.9%
Estimated Return on Refinance after	**5**	**years**	**17.0%**
Estimated Return on Refinance after	**6**	**years**	**21.3%**
Estimated Return on Refinance after	**7**	**years**	**24.1%**
Estimated Return on Refinance after	**8**	**years**	**25.9%**
Estimated Return on Refinance after	**9**	**years**	**27.1%**
Estimated Return on Refinance after	**10**	**years**	**27.9%**

The last topic to be addressed is perhaps the most significant choice variable for the borrower within the framework of the refinancing decision. Does the borrower pay points to buy down the loan interest rate? These “points” are considered tax deductible over the life of the loan and are represented under items 801 and 802 of the CFE. Borrowers can typically write off any unamortized points if the loan is paid off via another refinancing or sale. Thus, the tax treatment of points and mortgage interest is similar enough to be ignored for the purpose of breakeven analysis.

As a general rule, every point paid lowers the borrower’s interest rate by 0.25%. More simply, every dollar paid up front saves almost $0.25 each year thereafter. The value of the buydown, then, is governed by how long the new mortgage stays in place. When the time value of money is considered, the borrower should plan to stay at least six years to obtain a good return on the points paid.

The best mortgage to compare from a lender is one with no origination fee and discount. That’s the one to ask for first. It makes it easier to value the proposed loan against the current one. If the proposed loan passes muster, then the payment of points should be considered.

If a proposed loan grades as barely passable, it’s usually better to wait. Once you exercise the option to refinance, you are effectively precluded from refinancing again in the immediate future. Don’t pull the trigger unless you are getting an excellent return on investment.