Financial Planning Insights

Is Refinancing the Right Solution?

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Many people have taken advantage of the historically low interest rates to refinance their mortgages over the past few months. If you're thinking about what to do with your mortgage, know that you have more choices than refinancing, including making additional payments, recasting, or—if COVID-19 affects you—modifying a loan. How might each strategy affect your finances? Each approach has pros and cons.

Refinancing provides you with a current benefit by decreasing payments.

After refinancing, monthly payments typically shrink—not only because of the lower rate, but also because of the longer repayment period. Closing costs generally apply, which borrowers may be able to roll into the financing, but will add to the loan amount. Also, keep in mind that refinancing requires funding a new loan with its own terms, but we have heard from news sources that individuals with complicated cases may have a harder time refinancing. Lenders may require higher credit scores, lower loan-to-value ratios, and not allow cash-out refinance due to uncertainties related to the pandemic.

Increasing payments provides a future benefit by paying off the mortgage early.

You can choose to make extra principal payments with an existing mortgage rather than refinancing into a lower rate. The principal amount and the interest rate don't change, but the extra principal payments reduce the number of payments needed. This strategy is flexible—payments can be large or small, or made only when extra cash is available. However, it requires discipline and patience. You won't have lower payments or see a current benefit, but you will own your home sooner than you would have otherwise, and will save on interest.

"Recasting" requires a large lump-sum payment.

Recasting involves making a lump sum payment to the lender and setting up a new amortization schedule. The term of the mortgage and mortgage interest rate remain the same. Not all lenders allow recasting. But this strategy can reduce the monthly payment amount without extending the life of the loan, as would be the case with refinancing. You could also reduce total interest payments compared to refinancing with an extended loan term, or making additional payments. To recast, lenders may require a few hundred dollars in fees. Veterans Affairs (VA) and Federal Housing Authority (FHA) loans typically are not eligible.

Modifying a loan can help people who no longer can afford their mortgage. Borrowers who are struggling with their usual monthly payments can work with their loan servicer to modify their mortgage. Loan servicers can lower monthly payments by extending the term, by reducing the interest rate, by changing the type of mortgage, or by having a portion of the loan forgiven (this last one will have tax implications). If you fit into this situation, before considering a loan modification, check to see if the lender can pause your payments to give you time to figure out your financial situation—the CARES Act allows up to 360 days of forbearance on federally backed loans. Generally, loan modifications may be a last resort before a lender proceeds with foreclosure proceedings.

Consider these factors before pursuing one of these strategies:

- What's the primary goal for refinancing? Reducing payments? Paying off debt faster?
- What are your immediate liquidity needs? Do you have an emergency fund?
- Do you have high-interest consumer or non-deductible debt you could repay first?
- Are you already saving enough to achieve a 401(k) match, if eligible?
- How long do you expect to live in the home?
- Do you want to pay off your loan before retirement?
- Can you afford the current mortgage payments?

What should you consider next?

Refinancing, making additional payments, recasting and modifying a loan are four ways to help change an existing mortgage. Understanding the differences can help you manage the liability side of your balance sheet, and save for and achieve your financial goals. Don't go it alone when a professional advisor can help guide you to a better future.

Mortgage Strategy	Lowers monthly payments	Reduces number of payments	Lowers interest rate	Reduces total interest	Credit score required	Costs to execute strategy*
Refinance	Yes	No	Yes	Depends on new loan terms	Yes	Closing costs
Make extra payments	No	Yes	No	Yes	No	Prepayment penalties normally don't apply
Recast	Yes	No	No	Yes	No	Requires lump sum payment and fee
Modify	Yes	No	Maybe	Maybe	No	Minimal admin fees

Source: Schwab Center for Financial Research
*Verify with lender for specific rules of the loan

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