10 Errors to Avoid When Refinancing

I just refinanced from a 3.625% to a 3.375% 15 year fixed mortgage with Rate One (No financial relationship, but highly recommended.) If you are paying above 4% and have less than 15 years left on your mortgage or you’re paying above 5% on a longer mortgage, get off your duff and go get a “no-cost” refinance. That’s where you get an above market rate where the lender takes some of the extra money he makes for giving you that higher rate and applies it to your closing costs. As long as you keep the same term you currently have (easy to do just by taking your savings and applying it to principal, i.e. keeping the payment the same) you’ll pay the mortgage off faster and spend less on interest. The lender makes a few bucks, the appraiser gets a few bucks, the title insurance/closing agent earns a commission, and you save some money. It’s a win-win for everyone but your current mortgage holder, but don’t feel too badly, especially if you gave them a chance to have your refinance business.

In the past 12 years, I’ve had three different mortgages, refinanced three separate times, and had a home equity loan. In fact this is my third closing in a year. I’ve made plenty of mistakes but learned something new every time. Let me
share some of the lessons learned.

Lessons Learned From My Refinances

# 1 Shorten the term on the mortgage

If you have been paying on a 30-year mortgage for a couple of years, and now you refinance to a new 30-year mortgage, you’ll end up paying for your house for 32 years instead of 30, and you might just pay more in interest than you would have if you hadn’t refinanced. Your goal should not necessarily be a lower payment, but rather owning your home free and clear sooner.

Let’s use figures from my recent refinance to illustrate. I refinanced after 13 payments into a 15-year mortgage. My old principal and interest payment was $2809.16. My new principal and interest payment is $2613.20, or a savings of $195.96 a month. But if I still want to be mortgage-free after 15 years in the house, I now need to pay an extra $157 a month. So my real savings are only about $39 a month, or about $6500 over the next 13 years and 11 months. Not a huge savings, but I had a pretty good mortgage rate to start with. One benefit aside from the savings on interest is that if I get into a tight spot financially, I can default back to the lower payment and increase my cash flow by $196 a month.

# 2 Realize that there is a difference between a no-cost refinance, and no-cash refinance

Lenders are tricky folks, and sometimes what they do is just add the closing costs to the loan amount. You don’t have to bring cash to closing, but instead of owing $200,000, you find after the refinance that you owe $205,000. Sure, you have a lower rate, but was it worth it? Maybe, maybe not. Be very
Pay close attention to the amount of principal you owe on the old mortgage and the amount of the new loan. For example, the amount of principal I owed on my old mortgage was ~ $368,000. The loan amount for the new loan is $368,700, which is within $50 of the payoff amount. Remember that the payoff amount is the sum of principal owed and the interest for the part of the month prior to the closing, so $700 for about half a month’s interest is about right. But if the new loan balance had been something like $371,000, that would mean I was now adding some closing costs onto my loan balance AKA a “no-cash” refinance.

We were burned this way on at least one of the two refinances we did back in medical school. You’re hardly paying anything toward principal in the first few years of a 30-year mortgage anyway. Once you start adding costs back onto the loan, you’ll really be rowing upstream.

# 3 Recognize the “skipped payment” fallacy

Lenders and closers love to talk about it, but what does it mean really? There are a couple of things they may be referring to. First, I closed my loan in the first half of December. My old mortgage payment, due on December 1st has a
15 day grace period to pay it. If my loan is closed and funded before that grace period is up, technically I don’t have to make the payment. But you better believe the bank isn’t going to make the payment. That principal, as well as the interest, will just be added onto the loan (and your payoff amount will be higher.)

The second thing the lender may be referring to is the fact that I won’t make a January payment. While it is true that I don’t have to write a check in January, there really isn’t any savings going on. Again, no one else is going to make the payment for me. The reason I don’t make a payment in January is that I made it at closing. That’s right. Not only do you not skip a payment, you have to make it IN ADVANCE. That’s because interest is collected in arrears. So at closing, you pay the interest for the first part of the month as part of the payoff amount (it’s usually added onto the loan, like in my case, but you could pay it with cash at closing if you like.) You also pay the interest for the second part of the month as part of your closing costs. If I paid the interest for December at closing, so I obviously won’t have to pay it again at the first of January. **Interest never sleeps.** From the day you take out a mortgage, until the day you pay it off, you’ll never stop accumulating interest on the amount owed, no matter how many times you refinance.

Now, what about the principal? I don’t HAVE to pay the principal in January. I can if I want, but I don’t HAVE to. So in reality, I CAN skip a principal payment. But do you think someone else pays it for me? Not hardly. It just gets added on to the end of the loan. So if I didn’t increase my payment after the refinance, it would take me another 15 years, plus another month to pay off the loan. Again, if I want the loan paid off after 15 total years in the house, I’d better pay the principal for January.
# 4 Understand the escrows

An escrow account is an account, usually held by your bank, that pays your insurance and property taxes. It’s helpful for those without the discipline to save up money for those large expenses themselves, and many lenders require you to have one, or at least make you pay a fee if you want to do it yourself. (Although you can often cancel your escrow account without a fee after you start making payments.) With an original mortgage, you usually need to put 2 months worth of pro-rated insurance and taxes in the escrow account. With a refinance, you’ll almost surely need to put in more, sometimes much more. For example, I paid both my taxes and insurance in November, and so I only have 3 months of escrows in my old account (2 from the original buffer, plus the amount that was paid with my December mortgage payment.) The bank, however, wanted 5 months worth of pro-rated insurance payments, and four months of pro-rated property tax payments. That’s the two buffer months, plus December and January for the taxes, and plus November, December, and January for the insurance (insurance was paid in early November, taxes in late November.) I’ll get 3 months worth of escrows back from the old bank a few weeks after closing, but 4-5 months of escrows had to fronted for the new escrow account at the new bank. Again, there is no skipped payment for interest OR escrows, and a skipped principal payment doesn’t help you.

# 5 Recognize that all no-cost refinances are not the same

The theory behind a no-cost mortgage is great. It puts all the fees on the lender, who is better at negotiating them than you anyway, so all you theoretically have to do is shop based on the rate. In typical mortgage shopping the lenders play a constant game of moving pieces. If you shop by rate, they nail you with points. If you only shop zero points to
eliminate that, they’ll start varying their fees. You can minimize the lender’s advantage by doing a no-cost refinance, but there are a few places here where the new lender can still take advantage of you.

First, make sure you know what happens with the old escrow account. If the lender makes you pay it to them (“because we paid for your new escrow account”) that isn’t as good a deal for you as if you get your old escrows back. How bad of a deal depends on how much you had in there. I seem to remember falling for this trick with one of my refinances.

Another place you can get burned is with the new escrows. Some no-cost refinances will fund your new escrow account AND let you keep the old one. However, you might not get as good a rate. For example, Rate One offered me two options. They would pay for my new escrow account (and interest which we’ll get to next) for a 3.5% refinance, but not for 3.375%. They wanted me to cover those expenses for 3.375%. I figured since I would be paying those expenses myself if I didn’t refinance (remember nobody else will pay your interest, taxes, or insurance), I might as well take the lower rate.

Watch the interest too. With some refinances the lender will cover the interest for the part of the month after closing. That works out great if you refinance the first week of the month, but isn’t worth much if you close the last week. If they’re paying, try to negotiate a closing early in the month!
Another place a lender tried to burn me in the past was changing my loan from one without a pre-payment penalty to one with a pre-payment penalty. The only difference is a little tiny checked box. If you don’t read the paperwork carefully at the closing, remember that by law you have 3 days to cancel the refinance if you find out someone has pulled a stunt like that on you.

Finally, be aware of costs paid outside of closing. For example, I had to pay for the new appraisal, an origination/lender fee, and a credit report charge. That was all credited back to me at closing, but if I hadn’t closed the loan I would have had to eat those costs. If you’re concerned the loan won’t close for some reason (sketchy credit etc), try to get your lender to pay these expenses. The appraisal is usually the most expensive part ($300-500 is common), so try to delay that at least until you’ve been approved.

So my “no-cost refinance” covered all the fees, but didn’t cover any of the interest or escrows. Yours may be different. But when shopping around, you need to understand who is going to cover the fees, the interest, and the escrows. You also need to be clear that you don’t want any of those expenses added on to the loan total. Sometimes, it might be better to have the lender pay everything, then you can take your old escrow account and apply it to the principal. This might give you better bang for your buck than
bringing cash to the closing and getting a little lower rate. It was close to a wash in my case, so we decided to go with the lower rate to save the hassle factor of another refinance in a few months or years. But if rates drop further and I refinance again soon, I might have been better off taking the 3.5% and having the lender pay ~$1900 in interest and escrows. So in essence, I had 3 options, and chose the middle one.

- A) True no-cost refinance to 3.5%. Lender pays interest for last half of month ($500), funds new escrow account ($1400) and all fees ($1900).
- B) No-fee refinance to 3.375%. Lender just pays the fees ($1900).
- C) Standard refinance to 3.25%. I pay fees, interest, and escrows.

# 6 A no-cost mortgage might not be the best deal for you

If you’re going to be in the house for a long time, you might be better off paying the fees and possibly even points to buy the rate down even further. Of course, there’s nothing that says you can’t do another no-cost refinance in a year or two if rates continue to fall, but realize you’ll always be paying 1/8 to 1/2 a percent higher for your no-cost mortgage than a
“market-rate” mortgage where you pay the fees.

# 7 Don’t worry so much about your credit score

You only need a score of 740 to get the best rates on mortgages. We were getting some sweet offers in the mail for credit card freebies a month or two ago (you know, $300 with your first purchase, or 25,000 miles to sign up with another 25,000 after putting $2K on the card) so we actually applied for 5 credit cards just two weeks before initiating our refinance. It dropped our score a little, down into the 770s, but that was still plenty high to refinance. We had to give a quick explanation and show a couple of statements, but no big deal. Now, I don’t recommend applying for credit cards the same month you try to get a mortgage, but if you pay your bills, your credit score will take care of itself.

# 8 Shop around for your mortgage

This is a major purchase and it is easy to save a few hundred dollars in fees and can be quite easy to save thousands in interest over the course of the loan. It’s amazing that we’ll go to another store to save 50 cents on bread but won’t look at multiple lenders for a purchase where it may cost thousands of dollars less at one bank than another. Remember to check with all lenders on the same day, and look at rate, points, AND fees.

I recommend you first check with a mortgage broker to see what he can do for you. Then look up the rates/fees/points on Amerisave (takes 2 minutes online). Take a look at lenders/banks who have traditionally had great rates like Rate One or Pentagon Federal Credit Union or perhaps your local credit union. Finally, approach the bank who currently owns your mortgage and let them know about your best offer. Ask for a loan modification. They might just knock the rate down
on your loan with no hassle and no expense. Probably not, but it’s worth a try. What they will usually do is give you a significant discount on the closing costs. US Bank offered me a 1/4 point discount (about $900) which almost beat out Rate One.

# 9 The best mortgage for you might not be the same type of mortgage you had before

Many times it will make sense to refinance into a 15 year or even a 10 year mortgage after paying on a 30 year mortgage for a few years. Perhaps your income increased, or you simply paid down enough principal that you can now afford the higher payments. You may save up to 1/2% on a 15 year over a 30 year. If you’re just a few years from paying off your mortgage, you could even get a 3/1 or a 5/1 ARM. It’s fixed for 3-5 years, and if that’s all the longer you’ll be paying the mortgage, that’s good enough. You might also be able to get out of jumbo mortgage, or get rid of PMI when you refinance depending on how much you still owe.

# 10 The biggest mistake is probably not
refinancing at all

The little errors I’ve made from time to time pale in comparison to the most common one, and that is to not refinance at all. Some people go for years paying rates that are 2, 3, even 4% higher than the market rate. My first mortgage in 1999 was 8%. We refinanced it to 7.75%, then to 7.25%. The mortgage on my next house was 6.25%. We later took out a home equity loan at 5.3% and paid off that mortgage with it. My mortgage on this house was 3.625%, now refinanced to 3.375%. [Update: I refinanced again a year after this article to 2.75%.] The difference between 3.375% and 8% on a $400,000 mortgage is $18,650 A YEAR. That’s more than enough to max out a 401K.

But there are millions of people in this country still paying 6-8% on the mortgages they got just a few years ago. Some of those are trapped in their mortgage by being underwater. But many are simply too ignorant or too lazy to get a no-cost refinance. Don’t be “that guy.”

What do you think? When was the last time you refinanced? What mistakes have you made in the process? Comment below!