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# Refinancing a mortgage: What it means and how it works

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Refinancing your mortgage means replacing the property's existing mortgage loan with a new one. Homeowners typically refinance when mortgage interest rates have dropped, in order to get a lower rate than they currently have.



While this can result in significant savings over time, it's important to remember that securing this new loan will incur closing costs — so homeowners will need to calculate their breakeven point and stay in the home long enough to reap the savings.

Most homeowners refinance to lower their rate, but you can also refinance to a loan with a shorter or longer term, or refinance from an adjustable-rate loan to a fixed rate.

The process of refinancing a mortgage is similar to the process you completed to purchase your home. You can refinance with your current lender if you like, and you may be eligible for discounts or waived fees as an existing customer. But you're not required to stick with the same company, and just like with your initial purchase loan, it's smart to shop around for the best deal.

## Types of mortgage refinances

There are many types of refinancing, so consider each within the context of your unique financial situation. Here are some of the most common types:

- Rate and term: A rate-and-term refinance changes either the loan's interest rate, the loan's term or both. This is the most common type of mortgage refinancing.

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- Cash out: With a cash-out refinance, you use your home equity to withdraw cash to spend. This increases your mortgage debt but gives you money that you can invest or use to fund a goal, like a home improvement project.
- Cash in: Conversely, with a cashin refinance, you make a lump sum payment to reduce your loan-to-value (LTV) ratio. This cuts your overall debt burden, potentially lowers your monthly payment and could also help you qualify for a lower interest rate.
- No closing cost: A no-closing-cost refinance does not require you to pay closing costs upfront. Instead, those expenses are rolled into the loan — which lowers your upfront costs but means a higher monthly payment and, likely, a higher interest rate.
- Streamline: A streamline refinance accelerates the process for borrowers by eliminating some refinance requirements, such as a credit check or appraisal. It's available for FHA, VA, USDA and Fannie Mae and Freddie Mac loans.

### How does refinancing work?

What happens when you refinance your home? Refinancing is similar to the purchase mortgage application process, in that the lender reviews your finances to assess your risk level and determine your eligibility. Here's a step-by-step guide to what you can expect:

Step 1: Set a clear financial goal There should be a good reason why you're refinancing your mortgage, whether it's to reduce your monthly payment, shorten your loan term or pull out equity for home repairs or debt repayment.

- What to consider: Take into account both the rate and the length of the new loan. If you reduce your interest rate but restart the clock to another 30 years, you might pay less every month, but you'll pay more in interest over the life of your loan.

Step 2: Check your credit score and history

You'll need to qualify for a refinance just as you needed to qualify for your original home loan. The higher your credit score, the better rates lenders will offer you, and the better your chances of underwriters approving your loan. For a conventional refinance, a credit score of 620 or higher is generally needed for approval.

### How does it affect your credit?

- What to consider: While there are ways to refinance your mortgage with bad credit, spend a few months boosting your credit score if you can before contacting lenders. If you're concerned about hurting your score while comparing refinance offers, try to shop for a refinance within a single 45-day window. Any credit pulls in this timeframe will only count as one inquiry.

Step 3: Determine how much home equity you have

Your home equity is the total value of your home minus the amount you still owe on your mortgage. Check your latest mortgage statement to see your current balance; then, check home search sites or have a professional appraisal to estimate your home's value. Your home equity is the difference between the two. For example, if you still owe \$250,000 on your home, and it's worth \$325,000, your home equity is \$75,000.

- What to consider: You'll get better rates and fewer fees (and won't have to pay for private mortgage insurance) if you have at least 20 percent equity in your home. The more equity you have in your home,

the less risky the loan is to the lender.

#### Step 4: Shop multiple mortgage lenders

Getting quotes from at least three mortgage lenders can help you maximize your savings when refinancing a mortgage. Once you've chosen a lender, discuss when it's best to lock in your rate so you won't have to worry about rates climbing before your refinance closes.

- What to consider: In addition to comparing interest rates, pay attention to the various loan fees and whether they'll be due upfront or rolled into your new mortgage.

#### Step 5: Get your paperwork in order

Gather recent pay stubs, tax returns, bank/brokerage statements and any other financial documents your lender requests. Your lender will also review your credit score and net worth, so be sure to disclose all your assets and liabilities upfront.

- What to consider: Keep your documentation organized and at-the-ready throughout the refinancing process — being able to find things easily and answer questions quickly helps things run more smoothly.

#### Step 6: Prepare for the home appraisal

Mortgage lenders typically require a home appraisal (just like when you bought your house) to determine its market value. A professional appraiser will assess your home based on criteria and comparisons to similar homes in your area.

- What to consider: A refinance appraisal will run you a few hundred dollars. Let the lender and appraiser know of any improvements, additions or major repairs you've made since purchasing your home, as they will likely affect the final valuation.

#### Step 7: Come to the closing table

You'll receive a closing disclosure and loan estimate itemizing the closing costs that must be paid to finalize the loan. These payments will be made at closing and typically require cashier's checks or money orders.

- What to consider: You may be able to finance these costs, which can amount to several thousand dollars, to save on your upfront outlay. But you will likely eventually pay more by doing so. If you can afford to, it makes more financial sense to pay closing costs upfront.

#### Step 8: Keep tabs on your loan

Some lenders are willing to offer you a lower rate if you sign up for autopay, but you'll still want to keep an eye on things just in case. Store copies of your closing paperwork in a safe place.

What to consider: Your lender or servicer might resell your loan on the secondary market either immediately after closing or years later. This is common and nothing to be concerned about, but it means you'll owe mortgage payments to a different company, so keep an eye out for mail notifying you of such changes. The loan terms themselves shouldn't change, though.

#### Pros, cons of mortgage refinancing

Pros • You could secure a lower interest rate.

- You could lower your mortgage payment and create more space in your monthly budget.
- You could decrease your loan's term and pay it off sooner.
- You could tap into your home's equity.
- You could consolidate debt, such as student loans or credit card bills, into one payment.

- You could change from an adjustable-rate to a more predictable fixed-rate mortgage.
- You might be able to cancel private mortgage insurance premiums.

### Cons

- You'll have to pay closing costs. • You might have a longer loan term, increasing your interest costs and delaying your payoff date.
- You could have less equity in your home if you take cash out.
- Your credit score will take a (temporary) hit.
- Most refinances won't affect your property taxes, but completing a remodel with a cash-out refinance can increase your home's assessed value, which could mean a higher tax bill.
- If you've paid off a significant chunk of your mortgage, refinancing might not make financial sense.

### When to consider mortgage refinancing - Note

Refinancing your mortgage is a significant financial decision, and knowing when to refinance is key. If you're planning to remain in your home for years to come, there are many instances in which a refinance can make sound financial sense — including lowering your interest rate, extending your loan term to lower monthly payments or using the equity you've built to finance home improvements.

“The general rule of thumb is that you need to cut at least a full percentage point from your rate for refinancing to make sense. But the decision varies depending on your situation,” says Jeff Ostrowski, writer and housing market analyst at Bankrate. “Maybe you have an FHA loan and refinancing would let you get out of mortgage insurance — that savings could nudge you toward a refi. Or perhaps you live in a state that taxes refinances — that could push the costs to a point that it doesn't make sense.”

Knowing when to consider a refinance also depends on the general financial climate. If refinancing will mean getting a significantly higher interest rate on your mortgage, it's probably not a good idea.

“For the small group of homeowners who took loans at 8% in 2023, now is a great time to refinance,” says Ostrowski. “For most homeowners, though, the moment has yet to arrive.”

### FAQs

- What does it cost to refinance a mortgage? Closing costs on a mortgage refinance can run between 2% and 5% of the loan amount. These line items often include discount points, your lender's origination fee and an appraisal fee to evaluate your home's worth. You'll need to calculate the break-even point of all these expenses and decide whether you plan to stay in your home long enough to recoup them and benefit from the refinance savings.
- Is a second mortgage the same as refinancing? No, a second mortgage and a refinance are not the same thing. A refinance replaces your current mortgage with a new one, and you'll still only have a single loan — and a single payment — on the property. A second mortgage, however, typically involves taking out equity you've built up in your home and using it elsewhere, such as with a home equity loan. A second mortgage adds a second monthly payment you'll need to budget for.
- How soon after closing can I refinance? Once you close on a new home, you can't refinance right away — there is a seasoning period that you must wait out first. The exact amount of time will usually depend on your loan type: FHA loans require you to wait six months, for example. Another limiting factor when refinancing a mortgage is the amount of equity you've built. In general, you'll need at least 20 percent equity before being able to refinance.