

Explore the Possibilities to Get the Deal that Works for You

When home buyers begin to think about mortgages, invariably they get around to discussing "points", and whether or not to pay them on the new mortgage. To make a wise decision, they need to gain an understanding of what points are and how they affect rates.

A point is equal to one percent of the total amount of the mortgage. There are two types of points: "origination points" and "discount points." Lenders charge origination points in order to cover the expenses associated with underwriting the loan. Lenders charge discount points that are designed to reduce the loan's interest rate.

Discount points are actually prepaid interest that you give the lender when you take out a loan. Each point lowers your interest rate by one-eighth of a percentage point.

As a rule, the more discount points you pay, the lower the interest rate on your mortgage will be. On the other hand, the more points you pay, the more cash you will need because points are paid in cash at closing. This is why they are referred to as a "discount." You are actually paying for a discounted interest rate over the life of the loan with the advance of cash before the loan begins. Although points are usually paid at closing, some lenders may agree to finance points along with the rest of the loan. Be aware of the fact that lenders advertising low interest rates may charge more for their points.

Good advice for borrowers is to avoid the tendency of many to insist on a rule of thumb, such as "never pay points." Mortgage professionals say these rules are oversimplified and ignore beneficial strategies that can pay off well for borrowers, depending on their circumstances.

A better approach is to ask your loan officer to create a spreadsheet that shows upfront costs, rates, and payments with zero points, one point and two points.

Calculate the monthly savings with different options and find out where the points paid/break point is in terms of the number of monthly payments.

How should a home buyer decide whether or not to pay points?

Sometimes the answer to that question is decided for you by your financial situation. If you are short on up front cash, or your income is on the low side of the acceptable range, you will need to avoid points. If the amount of cash you have on hand is low, avoiding points will enable you to have enough money to fund your closing costs. If you have some extra cash on hand, but you are income-short, it is necessary to find the lowest rate available. This is so the mortgage payment won't be viewed as too large relative to your income level.

If you aren't affected by either of these conditions, then you should make your decision based on two factors. The first consideration is time. If you expect to hold the mortgage over the long-term, meaning seven to ten years, then paying points to reduce the rate is a good idea. If you plan on selling before seven years, then you are better served paying the higher rate.

The second factor to consider is how much paying points will cost you in terms of lost financial opportunities. For instance, will paying points mean tapping into money previously earmarked for other purposes such as saving for retirement? Do you have the time to compensate for the money that will not be used for retirement savings? Even if you live in your home a long time, are there other uses for that money that take priority over the long-term savings gained from a lower interest rate?

Before you make a final decision about points...

Find out what interest rate you will pay and what the points will cost on each mortgage you are considering. Then compare the loans side-by-side so you can get a true picture of which mortgage offers the better deal. Finally, evaluate if you will have enough available cash on hand to take advantage of opportunities or to meet unexpected emergencies if you pay for points. By investing the time in this two-step process, you will make an informed decision on whether or not purchasing points is right

In order to be able to answer the question of "what is my interest rate".....you need to know these three things:

- 1) Lender's Interest Rate
- 2) Lender's Origination Fee
- 3) Lender's Discount Points

The combined total effect of all three of these is what determines the Buyer's interest rate. Be informed before you sign.
