

Paying Points for a Lower Interest Rate on Your Mortgage:

Does it make sense?

by Dave Muti

You hear and see all of these advertisements on the radio and in the newspaper that say “no cost loans” or “no points”. You also see a rate quoted in the paper that seems too good to be true. Then, when you call or read the fine print, you find out that you must pay a point or two in order to get that rate. The problem is that no one really explains what a “point” is, or if they do, they usually don’t advise you on whether you should consider paying these points. In this article I will explain what a point is and then lay out a formula that you can use to determine if it makes sense for you to pay one with your next mortgage. So let’s start with the basics.

A point or a fraction thereof is simply a fee that you pay in order to get your interest rate discounted* below what the rate would be if there were no points paid. Simply put, “a point” is one percent (1.00%) of the loan amount for which you are applying. Two points would be two percent (2.00%) of the loan amount. Let’s say you are applying for a \$300,000 mortgage and you are quoted a rate of 6.25% with one point in order to get that discounted rate. This means that you will have a fee due at the closing in the amount of \$3,000 ($\$300,000 \times 0.01$) payable to the lender or broker. If you are quoted a rate with $\frac{1}{2}$ point or $\frac{3}{8}$ of a point it is again simply a fraction of your loan amount. For a \$300,000 mortgage these would be \$1,500 (for $\frac{1}{2}$ pt) or \$1,125 (for $\frac{3}{8}$ pt). If you are not



sure how to calculate three eighths of a point, it is easy. Every $\frac{1}{8}$ is one eighth of one percent ($1.00 \div 8 = 0.125$) so you would just multiply 0.125 times 3 to get the answer of 0.375%. The formula for determining the fees above would be $\$300,000 \times 0.005 = \$1,500.00$ or $\$300,000 \times 0.00375 = \$1,125.00$.

Now that we know what a point is and how to calculate it, we need to understand how to determine if it makes sense to pay a point or fraction of one for your loan. There used to be an old rule of thumb that if you planned on living in your home for more than 5 years then it made sense to pay points. Today however that rule does not really apply. The *real question* is “how long do you plan on having this mortgage?” If you have been reading my column you know that due to life changing events a mortgage does

not really last as long as you stay in a home. (See my 30-Year Fixed article in the August 2006 issue). So, should you pay points on your next loan?

Assuming that you have the additional funds to pay for the point(s) at the closing you have to determine if it makes sense for you to do so. We will be using an example of a \$300,000 mortgage for a 5/1 ARM that is amortized as well as an interest only example. The rates used in this article are for illustrative purposes only and they are not to be interpreted as current interest rates. The choices you may be presented with might be:

An Amortized loan consisting of both principal and interest

6.375% interest rate with zero points =
monthly payment of \$1,871.61

- vs -

6.125% interest rate with a $\frac{1}{2}$ point =
monthly payment of \$1,822.83

Although the rate is one quarter percent lower, it does not have the effect on the monthly payment that you might think. The monthly savings is only \$48.78, or \$585.36 a year. *The focus should be on the monthly payment and not the rate.* The name of the game is cash flow. If you choose the discounted rate, it will come with the expense of \$1,500.00 due at the closing. You now have to figure out how long it will take before you make back this cost to get the lower rate. After this time frame, any savings are gravy.

*certain loans such as those for investment properties, points are usually the norm. These types of loans are beyond the scope of this article.

The formula for this is very simple. You take the total cost of the point(s) and divide that by the monthly savings of the lower rate. For this example, it would be $\$1,500 \div \$48.78 = 30.75$. What this means is that it would take you just under 31 months to make back the cost you incurred to get the lower rate and payment. After that you would be ahead of the game with the monthly savings. So, if you plan on having this mortgage for 3 years or longer it makes sense to pay the $\frac{1}{2}$ point up front to get the lower rate. This basic formula can be used no matter how many points you choose to pay to get a lower rate. The formula is:

$$\text{Cost of point(s)} \div \text{monthly savings} = \text{number of months to make the cost back.}$$

In addition, with the amortized loan used in the above example you would also be \$429.79 ahead of the game as far as you loan balance is concerned. At the higher rate you would have a balance of \$290,663.36 after 31 months whereas with the lower rate your balance would be \$290,233.57. Although under this illustration there is not much of a difference, it is still a number of which you should be aware.

If we were applying for an interest only mortgage the calculation would be the same. Again assuming a \$300,000 mortgage for a 5/1 Interest Only ARM. The choices you may be presented with might be:

$$\begin{aligned} &6.5\% \text{ interest rate with zero points} = \\ &\quad \text{monthly payment of } \$1,625.00 \\ &\quad \text{- vs -} \\ &6.25\% \text{ interest rate with a } \frac{1}{2} \text{ point} = \\ &\quad \text{monthly payment of } \$1,562.50 \end{aligned}$$

Under this illustration your monthly savings would be \$62.50 with the discounted rate and again here you would have \$1,500.00 due at the closing. The formula to determine if this makes sense for you is exactly the same as above: $\$1,500 \div \$62.50 = 24$. As you can see, under the interest only example it only takes 24 months to make back the cost you incurred to get the lower rate.

The savings in both examples are what I refer to as the "gross savings", without considering other factors that should go into the formula. One factor to consider that is beyond the scope of this article is the tax deductibility of the point. You should seek the advice of a CPA to determine the affect for you. Another factor would be the "opportunity cost" of not having the \$1,500.00 in our example to invest. If you were able to earn 6.00% on this money, it might grow to \$1,786.52 after three years. Having this money to invest may or may not be a good thing depending upon your savings and investing history. If you, like most people, are not good at saving then it may

make sense for you to pay the point.

The purpose of this article is not to advocate one choice over the other. It is simply to educate you on what YOU need to know before you make a decision to pay points. If you are in the market to purchase a new home or refinance your existing loan make sure the person you are dealing with is able to provide you with a detailed explanation of the program they are offering you. Take the time to research, read and then sit down to discuss different options available with a qualified Mortgage Planner to make sure you are in the right program for YOUR circumstances.



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