Does It Make Sense to Pay Points?

Well...let us first define a "point". A point, often referred to as a "discount point" or "origination fee", is equal to one percent of the loan amount. Points are charged by the lender and are paid at closing. "Discount points" allow the buyer to "buy down" the interest rate for the loan. Initially, this may sound like a good idea, but you'll want to consider a couple things.

First, how low are current interest rates? If rates are fairly low (hovering around 6.5% at the time of this writing), there's really no need to pay points. Buying down your interest rate when rates are already low really only increases your up-front costs, rather than saving you money. Second, how long do you plan on staying in your home?

Let's look at an example.
In today's market, you might find a 30-year fixed rate loan for $170,000 at 6.00 percent with 2 points. This means, that for the life of the loan (all 30 years), you will have an interest rate of 6 percent. All that's required of you is $3400 ($170,000 x 2 percent) at closing for this example (this would be in addition to other closing costs). On the other hand, the same lender may offer you a rate of 6.5 percent with no points.

Now, which way is the better deal?

The monthly principal and interest (P&I) payment at 6.00 percent on $170,000 is $1,019.23. At 6.50 percent the P&I payment increases to $1,074.51 per month -- a difference of $55.28 per month. If we divide $3,400 by $55.28 (the cash for the 2 points paid at closing divided by the monthly savings in interest), we find that it takes just over 61 months (approx: 5 years, 1 month, 14 days) to recoup your points in the form of a lower payment. This is referred to as the "payback period."

In order to calculate a true payback period, we will assume that your $3,400 could make some kind of interest sitting in the bank. Let's assume your bank is paying three percent interest on a standard savings account. A balance of $3,400 balance would earn about $8.50 per month at the three percent. If you pay the two points, rather than sticking this money into a savings account at your bank, this is effectively interest you would never receive. So, we must subtract $8.50 from the $55.28. This leaves you with a figure of $46.78. To figure your true payback period, simply divide the $46.78 into the $3,400 and your payback period increases to just over 72 months (approx 6 years 19 days).

The answer?

Statistically speaking, many people don't hold onto their mortgages for six years before selling or refinancing. You must remember, points are never refundable. If you decide to sell or refinance your home before the payback period ends, you've actually lost money. For most people, the answer would be No...it doesn't make sense to pay points. You would be better off to take the higher interest rate and put that money to better use.

On the other hand, if you are absolutely positive that you are going to keep the mortgage beyond the payback period (preferably well beyond the payback period) then paying points may be an option worth considering. One would want to consider, however, just how positive we really are about anything.