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What are points on a mortgage loan, and what are their pros and cons?

To begin with, a point is simply an up front interest fee (better known as pre-paid interest) that a mortgage lender charges the borrower which is equal to one percent of the loan amount. For example, one point on a $100,000 loan would be $1,000. The lender determines how many points are charged on any given loan.

Many lenders allow customers the option of paying points in exchange for a lower interest rate on a loan. But will this up front interest payment save you money in the long run? That’s difficult to say since each case is different.

When you are shopping for a loan, don’t automatically assume that one carrying no points is the best loan for you. They generally carry a higher interest rate, often one-quarter of a percentage point higher or more. Here’s an example:

Let’s look at a $100,000 loan. One lender is offering a 30-year, fixed-rate loan at 7 3/4 percent interest with no points. Another lender is offering a 30-year, fixed-rate loan at 7 1/4 percent interest with 2 1/8 points, or an up front interest payment of $2,125.

Monthly principal and interest payments on the first loan amount to $716, compared with $682 on the second loan. Per year, payments on the first loan add up to $8,592; the second loan totals $8,184. And over the 30-year life of both loans, payments on the first loan would total $257,760, while payments on the second loan would total $245,520. That’s a savings of $12,240 over the lifetime of the loan, or a savings of $10,115 if you then subtract the up front interest charged to buy the lower percentage rate on the second loan. Plus, the amount you paid in points is probably tax deductible -- check with your CPA or tax advisor on this.

So, points are a good thing, right? Not necessarily. Points can be beneficial to home buyers who can afford the cash and plan to stay in the home long enough to see some of the above-mentioned return on their investment (generally 7 - 10 years). This is particularly the point (pardon the pun) when interest rates are low, as they are today. In that case, buyers are often more willing to pay the points.

On the other hand, there are several scenarios where a homebuyer would want to strictly avoid paying points on a loan. The first and most obvious is the lack of up front cash. Most first-time buyers today have plenty of income to qualify for a mortgage loan, but have trouble clearing the down payment hurdle, let alone the cost of points.

Another situation where a no-point loan would be beneficial is if you don’t plan on staying in the home for an extended period of time. If you move around a lot, or if you plan to move within the first five years of purchasing your home, paying points may not necessarily be a wise choice. Remember to keep your personal and career paths in mind when making such a decision.

People refinancing their homes should opt for no-point loans as well. The reason: Unlike a purchase, on a refinance, the amount paid in points is probably NOT tax deductible. Again, it is recommended that you consult your CPA or tax advisor concerning your particular situation.

To sum it all up, the primary factor in determining whether or not you should pay points on a mortgage loan is how long you plan to keep paying on the loan. The longer you pay on it, the more beneficial points can be. But if you are anticipating a quick turnover, paying points is ill advised.

The concept of points is often misunderstood, and the mathematics involved can be quite cumbersome. That’s why it’s a good idea to contact your REALTOR® to help you determine if paying points will be to your benefit.