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Should You Pay Points on Your Refinance Loan?

You have decided that now is the time to refinance. You sit down with your lender and she presents several different rate and point schedule to you. How do you know how many points you should pay? Is it even a good idea to pay discount points at all? The answers to these questions are varied, depending on your financial situation and your future plans. There are many great reasons though why paying a few points may be your best option.

First, do you understand what points are? Points (and in this case we mean discount points) are fees paid to your lender in exchange for a certain interest rate on your mortgage refinance. The more points you pay the lower the interest rate you will get. The reasoning behind points is that you are paying your lender interest upfront rather than simply spreading it out over the course of the loan. And for many lenders a bird in the hand is worth two in the bush - they would rather have the guarantee of money now rather than the promise of more money in the future.

One point is equal to one percent of the loan total. So, one point on a $100,000 loan would equal $1,000. Here is an example of how a rate-point schedule might look: If you pay no points, your lender will offer you an interest rate of 6.25percent. If you pay one point, your rate could be 5.875 percent, and if you pay two points your lender offers you a rate of 5.6 percent.

Advantages
While the difference in interest rates above may seem small, they actually can make a significant difference in the amount of interest you pay in the long run. If you applied for a $100,000 30-year fixed loan with the above schedule and chose the zero points/6.25 percent rate combination you would pay $121,659.20 in interest over the course of the loan. If you paid one point for a 5.875 percent rate, you would pay $112,954.40 in interest, a savings of $7,704.80 (after accounting for the $1,000 in points paid.) If you paid two points for a 5.6 percent interest rate, you would pay $106,668.80 in interest, saving you a total of $12,990.4 over the no-points schedule. Surely you can think of a better way to spend $13,000 than on mortgage interest!

Along with the benefit of paying less interest, you will also have a reduced monthly mortgage payment by paying some points up front. Using the same figures from above, with the zero point/6.25percent combo, your monthly payment would be $615.72. By paying one point, your monthly payment would be lowered to $591.54 (a $24.18 savings) and two points would further decrease your monthly payments to $574.08 (a $41.64 savings.) The savings may not seems so huge from month to month, but with careful use of those unused funds you can really see the savings add up over time.

The savings will be even greater because any mortgage points you pay will be tax deductible. You may have to spread the deductions out over the life of the loan, but you still save money.

Finally, paying points makes the most sense if you plan to stay in your home for a substantial amount of time. It often takes several years for the savings on your monthly mortgages to equal the amount of money you paid up front, so you should figure out how long it would take for the savings to kick in.

