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Paying Points on a Refinance Loan - Probably Not the Best Option

If you are considering a refinance loan, in addition to paying for closing costs, your lender may also require you to pay points. Or you may simply be offered the chance to pay points in exchange for a lower interest rate on your new mortgage. Either way you need to what points are and how they will affect your loan.

One point is equal to one percent of the loan total. So with a $200,000 refinance home loan, one point would equal $2,000. Points are a few paid to your lender (not toward the principal of your loan) in order to “buy down’ or decrease the interest rate you receive on your mortgage. (These are also known as discount points or as origination fees.) The more points you pay, the lower your interest rate will be. For example, a lender may allow you to pay zero points and give you an interest rate of 6.25 percent, but if you pay him two points, your interest rate may be lowered to something like 5.6 percent. Decreasing your interest rate will mean less interest paid in the long run and lower monthly payments from the beginning.

Paying some points on a refinance loan seems like a good idea, right? Well, unfortunately there is plenty of evidence to suggest it really does not make sense for many American homebuyers. The main reason is that these borrowers do not stick with their refinance loans long enough to make the savings worth the upfront costs.

A recent study was conducted at Penn State by Professor Abdullah Yavas and by Freddie Mac senior economist Yan Chang. While the two concentrated on points paid on original mortgages, the same principles generally apply for refinance loans. They found that only 1.4 percent of homebuyers who paid mortgage points stayed with their loans long enough to realize the interest rate savings. In fact, the study reported that those borrowers paying points upfront paid ended their loans an average of 37.5 months too early. That means that these homebuyers need to wait three more years before refinancing again or selling (or defaulting, in some cases) in order to make the points worthwhile.

Consider you pay $4,000 in points on a $200,000 30-year fixed rate for a 0.5 reduction in your interest rate. Your monthly savings equal about $63.50. You would have to stay in your new refinance loan for at least 63 months (just over five years) in order to break even between the money paid upfront and the money you have saved from the lower interest rate. In order to really save anything, you have to stay in the loan even longer. The longer you stick with it the more you save. So unless you are absolutely sure you will stay with your new refinance loan past your break-even point, the points will not be worth the price.

And remember the points are not paid toward your loan balance, but to your lender. If you do not plan to stay in your refinance loan for more than a few years, you may save more money by putting what you might have paid in points into a savings account for retirement or for the closing costs on your next home loan! Save your money; think hard before you pay mortgage points on your refinance loan!

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