

Should You Buy Points or Not?...Back to Math Class

Discount mortgage points seem to confuse a lot of people. Many folks aren't sure what they are, when they should buy them, or if they actually did buy points when they got their mortgage. The truth is, points aren't that complicated. In fact, some simple math can make it really easy to determine if you will benefit from purchasing points.

First things first. Make sure you understand what points are. Points (or discount points) are simply pre-paid interest. One point amounts to 1% of the total mortgage. If you have a \$100,000 mortgage, one point costs \$1,000. That's pretty much all there is to it.

Now, why would anyone pre-pay interest? Good question!

You pre-pay interest to get a lower interest rate for the life of your loan. And because points are pre-paid interest, you can, in some cases, deduct them from your taxes in the year that you pay the points. That can be a nice one-time tax benefit!

So, if you want the lowest interest rate possible on any given day, buying points may certainly be an option, which is also called "buying down your rate." Every day, when rates are issued, a certain amount of points are tied to certain interest rates. For example, if you've heard the term "zero point rate," that means that rate has no points attached to it. You get that rate without pre-paying any interest. A one-point rate would have one point attached to it and a two-point rate, two points attached to it, etc.

If you want a rate below the zero point rate, you have to pay points to your lender. If you are willing to accept a rate above the zero point rate, you can actually get money back or a credit on your closing costs. This is often how "no closing cost" options are created — you typically get a loan with the highest interest rate available and a lender will credit back all your normal closing costs.

To find out if buying points will pay off for your situation, here's some simple math you can do (go ahead, whip out the calculator):

Okay, let's assume you are considering two options on the day you want to lock your mortgage interest rate:

- a 5.25% mortgage interest rate that costs you one point.
- vs.
- a 6% mortgage interest rate that costs you zero points.

In this scenario, you would pay 0.75% (3/4 of 1%) less interest on your mortgage each year with the 5.25% option. To get this rate, you have to buy one point up front.

Now that you have your basic numbers, it's time for some basic math. To figure out if buying points makes sense, divide the total points paid (one, in the example above) by the difference in rate (0.75) which, in this example equals 1.33 (one divided by 0.75). This is the number of years it will take you to break even from your investment in points. In months, this would be 16.

To summarize, it would take you 16 months to recoup your pre-paid interest money (regardless of your mortgage amount — it's the same whether you have a \$100,000 or a \$500,000 mortgage) and from then on you would enjoy your low 5.25% for the duration of your remaining mortgage.

If you think you will be in your home more than 16 months, you're saving money from that point forward. Now that's a good investment!

To find out more about the home buying process contact our office today.

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Not for Reprint



What To Do Before You Start Shopping For a New Home!

Looking for a home can be stressful and daunting. But there are things you can do to decrease your stress level and make the home buying process easier.

Before you even think about what kind of home you want, you have to decide on what kind of home you need. Doing this will help narrow down the number of houses you look at and will save you valuable time. At the same time, you should make a list of things you don't want in a home so that you don't waste time looking at houses that don't fit your needs or your budget. To help set your priorities, ask yourself these questions.

Where do you want to live?

Location is one of the most important elements to choosing the right home. So, not only are you looking for the right home, you're looking for the right neighborhood. Among all your decisions, you should consider things like: how far or near do you want to live to your other family members? If you have your own family, what kind of schools you want your children to go to? How important is it to you to be close to the highway or public transportation, shopping, work, hospitals, entertainment, community amenities?

How long do you expect to live in your new home?

Most people end up moving within seven to nine years of living in a home and move for several reasons: job transfers, starting a family, needing a bigger home, don't like the area, etc. If you

plan on living in your new home for only a few years, or if you don't have children, then proximity to schools may not be an issue, but resale value may be. On the other hand, if you have a family and plan on staying in the home for ten years or more, schools, as well as size of the home, will be priorities. How long you expect to stay in your home can have a large impact on which home you choose as well as what type of mortgage you choose.



Consider your lifestyle

As you make a list of your wants and needs (as well as what you don't want), it may also be important to consider the type of lifestyle you have. If you like to entertain a lot, then you'll want a spacious home that lends itself to that. If you work from home, or have your own business that you run out of your home, you'll need space for a home office. If you're a gardener, then lot size may be your priority.

Put these items on your list in order of importance. And remember, your list should be somewhat flexible in case you can't find a home in your price range with all the amenities you need or want.

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How Mortgage Interest Rates Are Affected

When the Fed raises interest rates, rates for short-term mortgages such as home equity loans and adjustable rate mortgages raise too. Long-term rates are affected by inflation concerns, which the Fed tries to keep in check.

Generally speaking, interest rates are influenced by supply and demand. When the economy is robust and borrowing is strong, interest rates rise. When the economy softens and there is less borrowing, interest rates tend to go down.

But interest rates are also influenced by what the Federal Reserve,

also known as "the Fed," does and where the fed funds rate is set. The federal funds rate, also known as the "fed funds" rate, is the interest rate charged when banks lend funds to one another. This is a short-term rate, or a rate that is two years or less in maturity. When the Federal Open Market Committee (FOMC) raises or lowers the Fed funds rate, it affects mortgage rates that are tied to short-term interest rates, such as home equity rates and adjustable rates. When short-term rates fall, borrowing and spending usually increase. This can cause inflation, something the Federal Reserve wants to keep in control.

Long-term interest rates, or rates that are 10 years or more in maturity such as for 30-year mortgages, are influenced by short-term rates in a round-about way because they can rise when concerns about inflation increase. To keep inflation under control, the Fed started raising short-term interest rates in 2004. Because of this, people who have adjustable rate mortgages have been refinancing into longer-term fixed-rate mortgages to avoid the rising rates, especially since long-term rates have remained historically low for quite some time.

The Fed Funds Rate has the ability to change at every Federal Reserve meeting. However, it's almost impossible to accurately predict the future of something as complex as the U.S. economy, so no one is ever really sure if or when the rate will change. In any case, it is important to understand some of these market dynamics because a lack of understanding can sometimes cost you a lot of money.

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