Anatomy of a Mortgage Loan

How Points Really Work

There are few things less well disclosed in the mortgage industry than how points work. That "mystery" is the single best tool some salesmen use to obscure the truth from borrowers.

This Chapter will cover:

- How points really work.
- What a loan officer's rate sheet reveals, and what that means to you.
- How to determine if a "no points" or "no fee" loan is a good idea or not.

Holly's Definition of "Points" :

One point equals 1% of the loan amount. "Points" cover the lender's and broker's overhead and profit. They are considered pre-paid interest because paying points corresponds to a lower rate, and therefore less interest paid over the life of the loan.

Here is the scoop in plain, simple English. There are 3 ways a loan officer (either a broker or a banker) is paid:

1. **By you directly** in the form of an **Origination Fee** or **Broker Fee** (which is plainly labeled on the estimate of fees)

2. **By you directly** in the form of **other fees under various names** (which may not be plainly disclosed)
3. **By the investor or bank** who keeps the loan after it closes, in the form of a "**rebate**." (Honestly, this is ultimately paid by you, indirectly, in the form of a higher interest rate.) The rebate is disclosed on the closing statement if the loan officer is a broker. It is not disclosed if the loan officer is a banker.

Holly's Definition of "Rebate":

A rebate is a percentage of the loan amount that is paid by the lender to the loan officer, either the loan officer within the bank, or the loan officer who brokers the loan to the bank.

I tell my clients plainly that they can pay me, the bank can pay me, or we can do a combination of the two. It makes no difference to me. We simply need to determine the breakeven point if they want to pay for a lower rate. We will discuss that in detail later in this chapter.

Following are examples of wholesale pricing and the retail price you would be offered if the loan officer is making 1 point for his services.

This is an example of pricing on a wholesale rate sheet that the mortgage broker or banker sees, that you do not see. (Percentages are of the loan amount. Our example uses a $400,000 loan.)

5.875%	Costs the broker 0.5%	Cost of $2,000 to broker
6.000%	0.00 ("Par")	No cost, no rebate
6.125%	0.5% rebate	$2,000 rebate
6.25%	1.0% rebate	$4,000 rebate
6.50%	1.5% rebate	$6,000 rebate
6.75%	2.0% rebate	$8,000 rebate

Here are the "retail" choices you would see for the same rate sheet if the bank or broker charges 1 point for his services

5.875%	1.5 points cost
6.000%	1 point cost
6.125%	0.5 point cost
6.25%	No points cost, you pay fees
6.50%	No points cost, with ½ point credited toward fees
6.75%	No points cost, with 1 point credited toward fees

Explanation of these charts:

- If you are quoted **6.75% at "no points"** that means the lender is paying the broker 2% of the loan amount for the broker's services. If he wants to make 1 point for his service, he can use the other point to pay some—or all—of your other closing costs.

- If you are quoted **6.5% at "no points"** that means the lender is paying the broker 1.5% of the loan amount for the broker's services, and the broker has a half point available to help with your fees.

- If you are quoted **6.25% at "no points"** that means the lender is paying the broker 1% of the loan amount for the broker's services. In this example, you would pay your own fees.

- If you get **6.125% at 0.5 point cost**, you are splitting the broker's fee with the bank.

- If you are quoted **6% at 1 point cost**, the broker is getting all of his payment from you, none from the bank.

- If you want **5.875%**, you will have to pay the 0.5 point fee the bank charges the broker as well as the 1 point fee for the broker, or 1.5 points.

If you want **a "no points, no fee" loan**, the broker will have to get enough rebate to cover his fee, plus enough to pay the other fees (third party fees). Guess who pays in the end? Correct–you do!! This translates to a higher rate for your loan than you would get if *you* paid your fees.

Third Party Fees

Closing Agent (Escrow/Attorney)
Title
Appraiser
Credit Report
Underwriting and Other Lender Fees

The third party fees have to be paid by someone. **Either you pay the third party fees directly, or the broker pays them for you.** There is no way to get around the fact that *somebody* has to pay them. However, if the broker pays them, you pay a higher interest rate than you would receive if you paid them. That may not be a bad thing. **If you are not planning to keep**

the loan very long, it may make sense to get a higher rate and not pay fees. However, if you plan to keep the loan past the "breakeven point" (discussed next), then it makes more sense for you to pay your own fees.

Do the Math[1]

There is a very simple way to determine whether or not you should pay points and/or fees. Some people do not like math and will tend to go "bleary-eyed" on me immediately after I begin talking about it. Do not despair! It's really easy. First, you need to get the information you need about the options available in order to do the math.

If the loan officer is nice, he will do these calculations for you. But below are the calculations, in case you want to do them yourself.

Information you need from the loan officer to do the math:

1. What is the rate if you pay no points, but pay fees?
2. What is the rate if you pay the points *and* the fees?
3. Is it possible to do a no points/no fee loan? If so, what is that rate?

In the following example, you would pay 1 point for a 6% loan and no points for a 6.25% loan.

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1 I have deliberately simplified the math to determine the breakeven. Technically, if you have an "amortized loan" (a loan whose payment includes principal and interest, as opposed to interest only) you pay a little bit less interest each month than you do if you have an interest only loan. However, that amount is small the first few years of the loan period, which falls in the 'break even' period. Also, a financial planner may argue that we have to account for the "return on investment" you would get if you invested the points instead of paying them, and got a return on your investment. Then, to get really complicated, you have to consider tax consequences because points on a purchase are tax deductible in the year of purchase. However, my goal is to help as many people as possible. If I get into all that stuff, I risk boring you into a stupor. Then you won't read the rest of my book. If that happens, I haven't helped you at all.

Calculate the interest portion of your monthly payment for each option

Loan Amount x Interest Rate ÷ 12 = Interest paid monthly

So, for a loan of $350,000 at **6.25%** interest, your calculation would be:

$350,000 x 0.0625 ÷ 12 = **$1,822.92**

The payment at **6%** would be:

$350,000 x 0.06 ÷ 12 = **$1,750.00**

Calculate the "Breakeven" point

(Remember, in this example, you would pay 1 point if you got 6%, and pay no points if you chose 6.25%)

1 point = 1% of the loan amount
For our example the definition of 1 point is
$350,000 x 0.01 = $3,500

Calculate the difference in interest paid for the 2 rates

Larger payment – (minus) smaller payment = Difference in Interest Paid

$1,822.92 - $1,7500.00 = **$72.92**

$72.92 is the interest you save *each month* by paying 1 point up front.

Breakeven point

Points paid up front ÷ Amount saved monthly = Breakeven point (in months)

$3,500 ÷ $72.92 = **48 months**

Conclusion from the above scenario: If you expect to keep the loan longer than 48 months, then it makes sense to pay one point and get the lower rate. If there is a good chance you will sell or refinance within 4 years time, then it does not make sense to pay one point.

There is one more thing I would like to point out: **Some lenders try to obscure the fact that you are paying points** by saying it is a "no points" loan, and then **charging thousands of dollars in fees. Do not fall for it!**

Remember this:

Points are tax deductible because they are pre-paid mortgage interest

Fees are not tax deductible![2]

So if you have the choice of paying one or the other, choose points over fees.

Chapter Summary:

The choice of whether or not to pay points is not a difficult decision. There is nothing mysterious about points and fees. Assuming you have a loan officer who is up front and honest with you, the choice is based in simple math. To determine the best choice for your situation, you can do the math yourself, or ask your loan officer to do it for you. When you calculate the breakeven point, you will want to ask yourself if you are likely to keep the loan long enough so that buying down the rate will pay off in the long run.

2 Please consult your tax preparer for details of when and how you may deduct points.