Pointers on Home Mortgages

It's important to understand the effect of paying points on the long-term cost of a mortgage. The points paid on your home loan may substantially increase your effective annual mortgage rate. Each point equals one percent of the amount borrowed and is usually paid in cash at the time the loan is closed.

Home buyers must often choose between a *higher* mortgage rate with no points or a *lower* mortgage rate with one, two, or more points. To determine which is more cost-effective for you, calculate how much additional interest must be paid over the life of the loan in order to pay less money upfront. A general rule is to equate each point with one-quarter percent interest rate. Thus, an 8.75 percent loan with two points costs approximately the same as a 9 percent loan with one point.

However, the rule is only accurate for the first several years of the loan. The longer you plan to keep your home, the less effect points will have on the annual mortgage rate. In general, if you are buying a permanent home that you intend to own for five to seven years or more, you may wish to pay the higher points and take the lower rate. If you are contemplating a shorter length of residence, you may wish to consider paying the lower points or no points and take the higher rate.

Taxes must also be considered in any borrowing situation. While points for home purchase mortgages are typically fully deductible for the year in which they are paid, points on refinanced mortgages must be prorated over the life of the loan. It's important to evaluate your current circumstances in order to minimize your cost and to determine what effect paying points will have on your situation. The more knowledge you have, the more you may find yourself "home free."

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