Discount Points

Discount points are the most variable of all closing costs. One discount point equals 1% of your loan amount. Although discount points are paid as a fee at closing, try to think of discount points as part of the interest cost for your loan.

What are the options?

If you elect to pay discount points, you are, effectively, prepaying interest at the closing table. In exchange for this pre-payment of interest, you receive a reduction (discount) on your interest rate.

Another option (the flip side of the coin, really) is to choose a higher interest rate in exchange for a reduction in your discount points. And at a high enough interest rate, your discount points can drop to zero or even become a credit, paid to you, rather than a cost.

Although exceptions abound, typical discount points on a typical loan range from a 2% cost to a 2% credit. Converted into dollars that's a pretty doggone huge variable (a $4k swing in costs for every $100k you borrow). And it's up to you to choose what you pay.

Should you or shouldn't you buy them?

As soon as you are eligible to lock your interest rate, we'll be in touch. Typically, we will provide an array of options—loans with lower rates and higher points to loans with higher rates and lower points. We'll usually have 3 to 6 scenarios available for you to consider. This can be a lot to take in, so we'll do our best to offer some guidance and advice.

We are all a little like magpies when it comes to interest rates. A lower rate can be a shiny object that's hard to resist. It's just counter-intuitive that a loan with a higher rate might save you money. But it might.

The combination of interest rate and discount points you should choose depends on two things: 1) the length of time you anticipate keeping the loan and 2) the amount of money you can spend.

If you have unlimited funds to spend on discount points (lucky you!), your decision should be all about the length of time you estimate keeping the loan. Prepaying a chunk of interest at closing can be a money-saver if you plan to keep your loan for a long time. The lower rate and payment will pay you back, and then some, over a period of many years.

If, on the other hand, you imagine you'll sell or otherwise pay off your loan in a shorter number of years, you may be better off at a higher rate. Remember that a higher rate could save you thousands of dollars in closing costs. Your payment will be a little bit higher at a higher rate, sure. But if you're not going to pay the higher payment all that many times, the extra monthly amount could add up to far less than what you save at closing.

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How do I assess my options?

Assessing things is pretty simple. Pick a pair of loan options to compare.

1. What is the difference in the cash you need to bring to closing?
2. What is the difference in the monthly payment?
3. Divide the difference in cost by the difference in monthly payment.

You've just figured a very simple "break-even" calculation— the number of months it would take to get back your up-front investment in points.

Think you'll keep the loan longer than this timeframe? The lower rate/higher cost is your better bet. Think you'll keep the loan less than this period of time? Go for the higher rate/lower cost. (We can muddy the waters with time-value-money and income tax considerations, but for most cases this simple math is perfectly serviceable.)

And there's money to consider, too

For those of us without unlimited funds, there is the matter of, well, money. You can't spend money you don't have, can you? So we need to keep the costs in line with your budget. Discount points can play a big role. Think of discount points as a tool we can employ to manage your cash due at closing.

Exactly how much a given amount of discount points will reduce your interest rate is quite variable — dependent on market conditions, your loan type and even what rate you choose. The cost to buy a rate that is .125% lower can be as little as .25% of your loan amount to as much as 1% (or more), making "normal" hard to define. Pressed for an answer, we could say that "normally" (for a 30 year fixed rate loan), a .125% reduction in your note rate should cost .5% in discount points. When that is true, your break-even point (using the math above) is between 5 and 6 years. Meaning, it will take 60-70 months of payments at the lower rate for you to save back the up-front cost.

One other thing

Although most of our conversations about discount points will focus on picking the right combination of discount points and interest rate, there may be another component to what you pay in discount points. Lenders have gotten quite sophisticated about assessing the risk of default presented by different types of loans. Your credit score, loan amount, percent of down payment, the type of property you are buying, your occupancy status and the type and term of your loan combine to present a risk profile.

Where lenders see added risk they often offset this risk by charging extra fees in the form of discount points. If you are subject to any risk premiums we'll let you know what they are and strategize with you to minimize them.

It is worth noting that not every loan offers variable discount points or risk premiums. Notable exceptions to one or the other include the Oregon Bond loan, Oregon VA home loan and some jumbo loans.

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