

Understanding Rates, Points and Closing Costs

To successfully compare rate quotes and cost estimates from various lenders while shopping for the best deal you have understand the relationship between rates, points and closing costs. Without a thorough understanding you will be a the mercy of slick talkin' loan salesmen who knows just how to convince you that their deal's the best ... when it's nowhere close.

At least once a day I field a phone call from a loan prospect who asks, "What's your rate on the 30 year fixed-rate?" I politely answer that I have at least twenty "rates" on the conforming 30 year fixed-rate program. The fact is that on common loan programs most loan originators offer a wide range of rates (referred to as "coupons" in mortgage lingo) on the most common loan programs. Today, for example, most lenders can provide borrowers with quotes on coupons ranging from 5.000% to 7.500% in increments 1/8 of 1 percent (0.125%).

Each of these "coupons" has a "price". The lower the rate, the higher the "price". The price is stated in "points". Each point is 1 percent of the loan amount. If a particular rate or coupon has a price exceeding zero then those points are referred to as a "discount" or "discount points". If a particular rate or coupon is offered with zero points it referred to being priced at "par". At higher interest rates the lender may offer a CREDIT to the borrower to offset other costs. In this event the credit, still described in points, is referred to as "premium" or "premium points".

For example, the rate of 6.000% might be quoted with zero discount points. On the same day the coupon of 5.75% would typically be costing the borrower 1 discount point (1 percent of the loan amount). On a \$200,000 loan, for example, the borrower would be required to pay \$2,000 (1 point or 1 percent of the loan amount) at closing to obtain the 5.75% rate on the mortgage loan. And on the same day the lender might be quoting 6.25% with a "premium" credit of 1 point. Thus, with the \$200,000 loan, the borrower would receive a credit of \$2,000 paid by the lender to be applied toward other closing costs.

Historically, lenders also charged an "origination fee" that was also stated in points. The fee customarily earned by banks for originating a mortgage loan a decade or more ago was 1 point. Thus, the 5.75% rate would have been quoted at 5.75% at 1 plus 1, meaning that the lender was charging 1 discount point and 1 point origination fee for the 5.75% mortgage loan.

In today's highly competitive mortgage industry it is becoming more common for lenders to quote flat fees for their profit in a transaction rather than a fee stated as a percentage of the loan amount. But even these "flat fee" lenders may be receiving premium as profit that is not passed on to the borrower. Thus, in most cases, the profit of the lender is a combination of a flat fee and some amount of premium (paid by a purchaser in the secondary market) earned on the transaction.

Most lenders will also charge a variety of smaller flat fees charged for the purpose of compensating the lender for certain expenses incurred in the process of taking and processing a borrower's loan application. These fees are sometime referred to as "junk" fees since some originators attempt to increase their profit by charging higher than customary "junk" fees.

Thus, Lender A may quote the 6% rate with 1 discount point plus a 1 point origination fee but will charge no "flat" fees at closing. Lender B will quote the 6% coupon with a 1% origination fee but will tell the borrower there are no discount points. But later the borrower discovers that Lender B charges a \$2,000 "mortgage broker fee". Thus, on the \$200,000 loan both lenders were charging the borrower the same amount but one was quoting it as points and the other as a "flat" fee.

Based on this understanding of the relationship between rates, discount points, premium, and lender "flat" fees, the borrower must develop a strategy to compare the quotes of competing lenders that have a different method of style of pricing.

This will ultimately involve obtaining firm costs quotes from each lender at identical rates or coupons and then evaluating the costs paid to each lender at the particular coupon.

Possessing the knowledge of how rates and points (discount and premium) interact is essential when comparing the rate quotes from competing lenders.

Armed with this knowledge you should now gain knowledge of how to avoid the smoke and mirrors routine that many loan originators use to secure their customers.