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Mortgage Points Typically Don't Pay Off

UNIVERSITY PARK, PA (December 19, 2006) – Home buyers tend to purchase too many points when selecting a mortgage and end up paying more than they would have with no points and a higher interest rate, according to a new research report co-authored by a professor at Penn State's Smeal College of Business.

Abdullah Yavas, Elliott professor of business administration at Smeal, and Yan Chang, senior economist at Freddie Mac, found that home buyers who purchased points, on average, tended to pay off their mortgages about 37.5 months too early. In other words, the average mortgagor with points ended up defaulting, moving, or refinancing more than three years before reaching the break-even point from the purchase of the points.

The researchers examined the points paid, interest rates, and loan length of 3,785 individual mortgages originated from 1996 to 2003.

The results show that home buyers are significantly overestimating the amount of time that they will hold their loans. In fact, Chang and Yavas found that only 1.4 percent of borrowers held their loans long enough to make their decisions to buy points pay off.

Of the borrowers in the sample who did not buy points, the researchers found that only 1.5 percent would have been better off purchasing points.

Chang and Yavas also found that borrowers fail to treat points purchased as sunk costs when deciding whether to refinance and, as a result, are less likely to refinance—and when they do, they're often too late.

Rationally, once interest rates drop enough to make it beneficial to refinance, borrowers should do so, regardless of points paid initially. However, the results show that points previously paid do weigh on the decision, possibly because the borrowers don't want to admit they were wrong to purchase the points in the first place or they are waiting for rates to drop further to compensate for the points paid.

In any case, the consideration of the sunk costs of the points ends up costing borrowers more when refinancing.

Other results of the study include:
- Borrowers who are less likely to move or refinance take out mortgages with more points.
- Tax-related incentives do not appear to play a significant role in points selection.

Yavas is research director of the Institute for Real Estate Studies at Smeal, where he's been on the faculty since 1992. His research interests include financial contracting, agency problems, economics of uncertainty, and experimental economics.