The unexpected benefits of adjustable rate mortgages

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Using loan level data matched to consumer credit records, researchers have been able to determine that a reduction in mortgage payments of as little as $150 a month spurred a reduction in mortgage defaults and an increase in consumer spending (particularly the financing of automobile purchases), while improving household credit ratings.

University of Chicago Booth School of Business Professor Amit Seru, together with Benjamin J. Key of UChicago's Harris School of Public Policy, Tomasz Piskorski of the Columbia Business School and Vincent Yao of Fannie Mae authored "Mortgage Rates, Household Balance Sheets and the Real Economy," which is available at the *Social Science Research* Network.

As would be expected during a time of consumer deleveraging, households applied more than 70 percent of their mortgage savings to reducing outstanding credit card debts. Not only did the lower payments reduce mortgage defaults but credit card delinquencies fell. "These choices had significant impact on foreclosures, house prices and employment in regions that were more exposed to interest rate declines," the researchers concluded.

Mortgage securitization and other bank organizational features stood in the way of post-Crisis renegotiation. Because of that, adjustable rate mortgages (ARMs), the bete noire of the housing bust, became useful transmitters of the U.S. Federal Reserve's low interest rate policies. "In that sense," the professors wrote, "by reducing the mortgage rates of

ARM borrowers, low interest rate policies may achieve similar effects to mortgage modification programs for these borrowers more quickly (at least in the near term)."

Another benefit to the use of ARMs in mortgage refinancing is that the rate resets are automatic, so that borrowers do not have to do through the difficult and often arduous process of refinancing their mortgages. Also, borrowers with dodgier credit, who might most benefit from a refinancing but be least able to obtain it, automatically benefit from the lower interest rate environment.

As much of the savings went, at least initially, towards paying down consumer debt balances, the low interest rate policies of the Fed served to help shore up bank and lender balance sheets. The researchers suggest at the end of the paper that if the government sees a need to spur more consumer spending, particularly on durable goods like automobiles, that it might consider directly targeting consumer debt burdens.

That said, while they have cataloged numerous benefits to households from low interest rate policies, they remain agnostic about the economy-wide effects of the Fed's decision, suggesting an avenue for further research.

Provided by University of Chicago

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