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Adjustable-Rate Mortgages, Economic Fluctuations, and Lender Portfolio Change

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Abstract

In this study we examine the effects of economic fluctuations on the repayment behavior of a portfolio of adjustable-rate mortgages (ARMs). Because the U.S. experience with ARMs is quite recent, we have used data on a form of ARM used in Canada, the rollover mortgage. The results of our analysis suggest that use of ARMs similar to the rollover mortgage may reduce but not eliminate interest-rate risk for lenders, as borrowers, albeit constrained, prepay above-market-rate loans. In addition, we find that the periodic payment change inherent in the rollover mortgage does not lead to higher default rates and, therefore, credit risk.

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