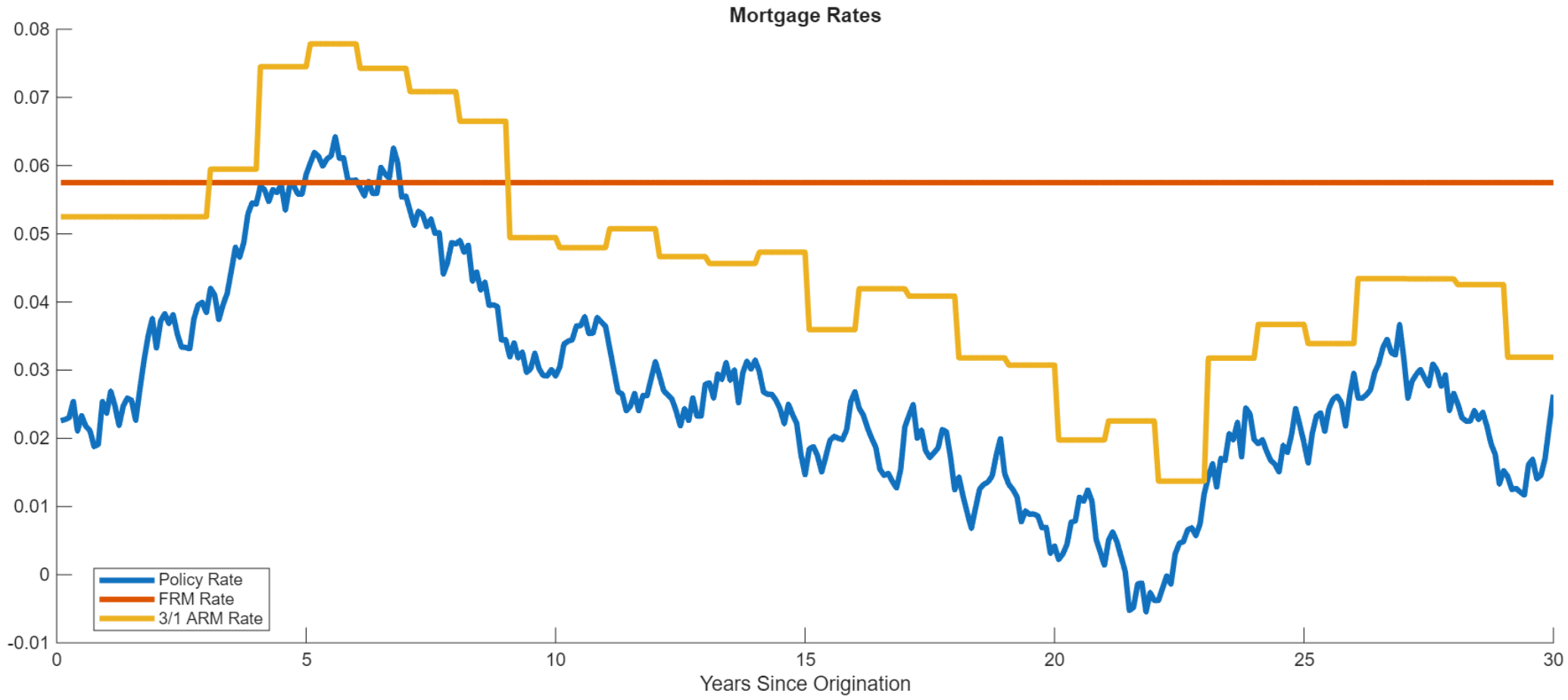
Discussion of

“The Value of Mortgage Choice: Payment Structure and Contract Length”

by Michael Boutros, Nuno Clara, Katya Kartashova

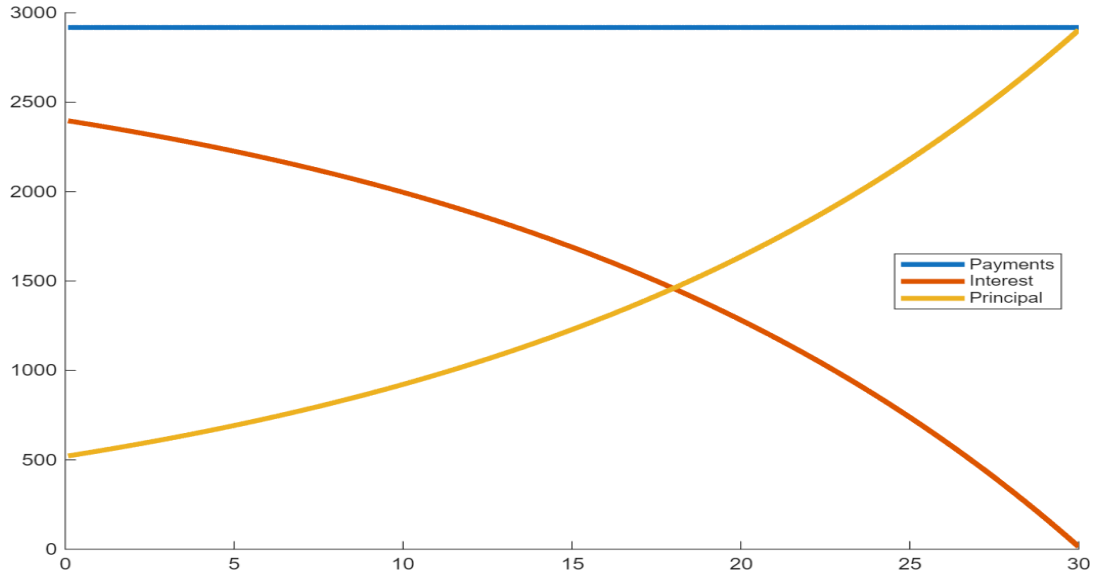
Vadim Elenev
Johns Hopkins Carey
EFA| August 2025

Mortgage Choice in the U.S.: Sample Path

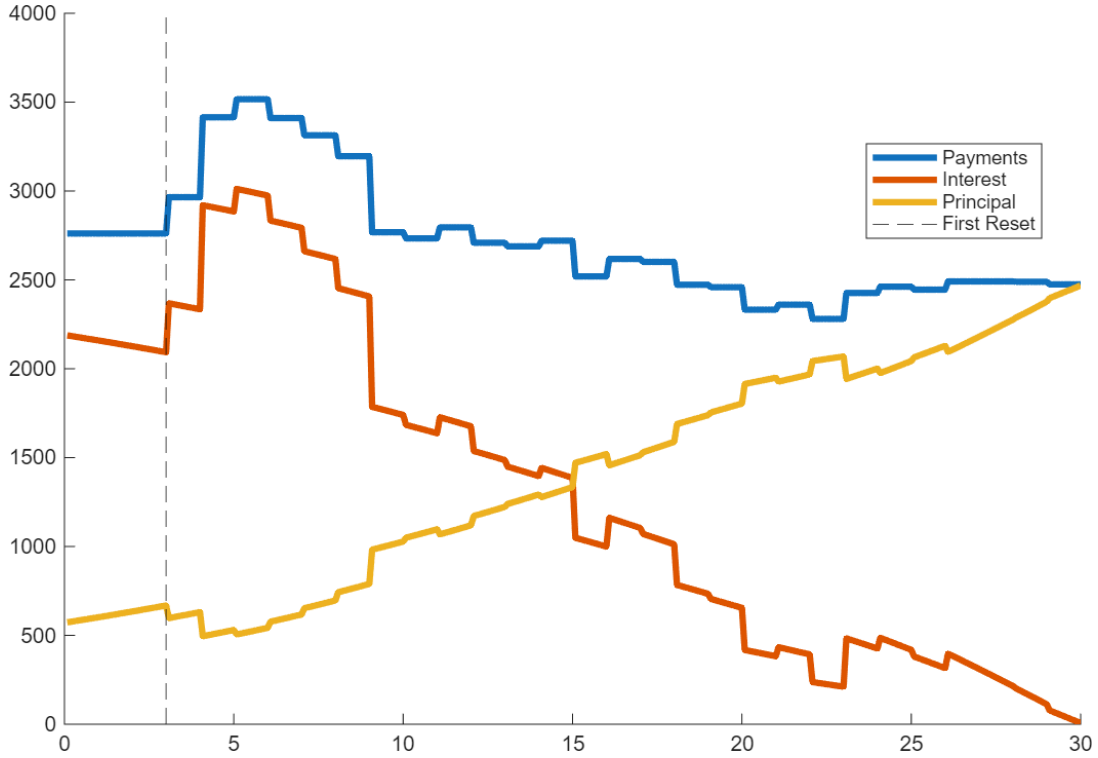


Mortgage Choice in the U.S.: Amortizing a $500K Loan

FRM

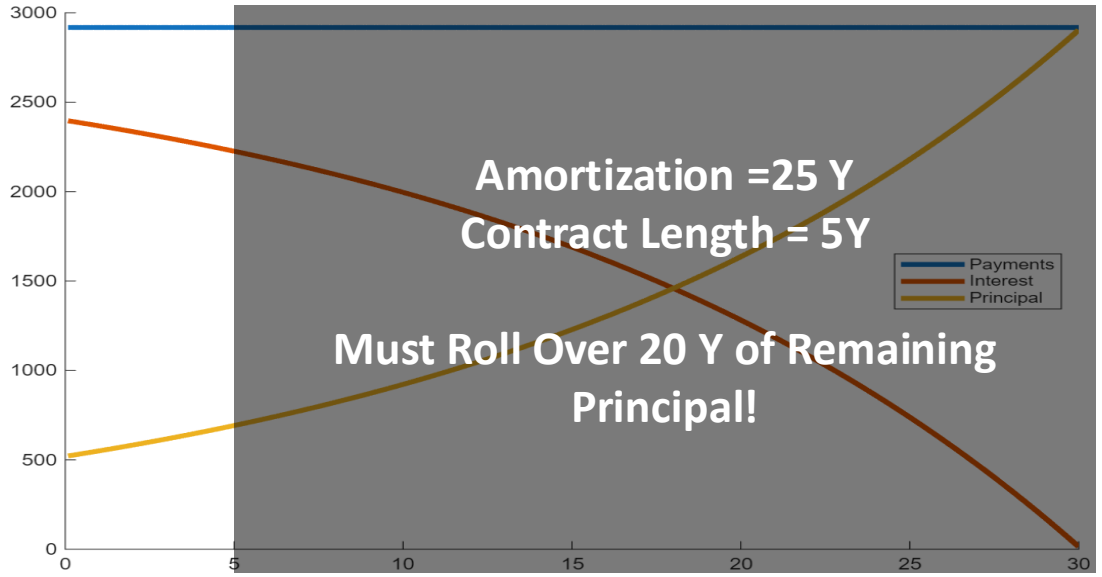


3/1 ARM

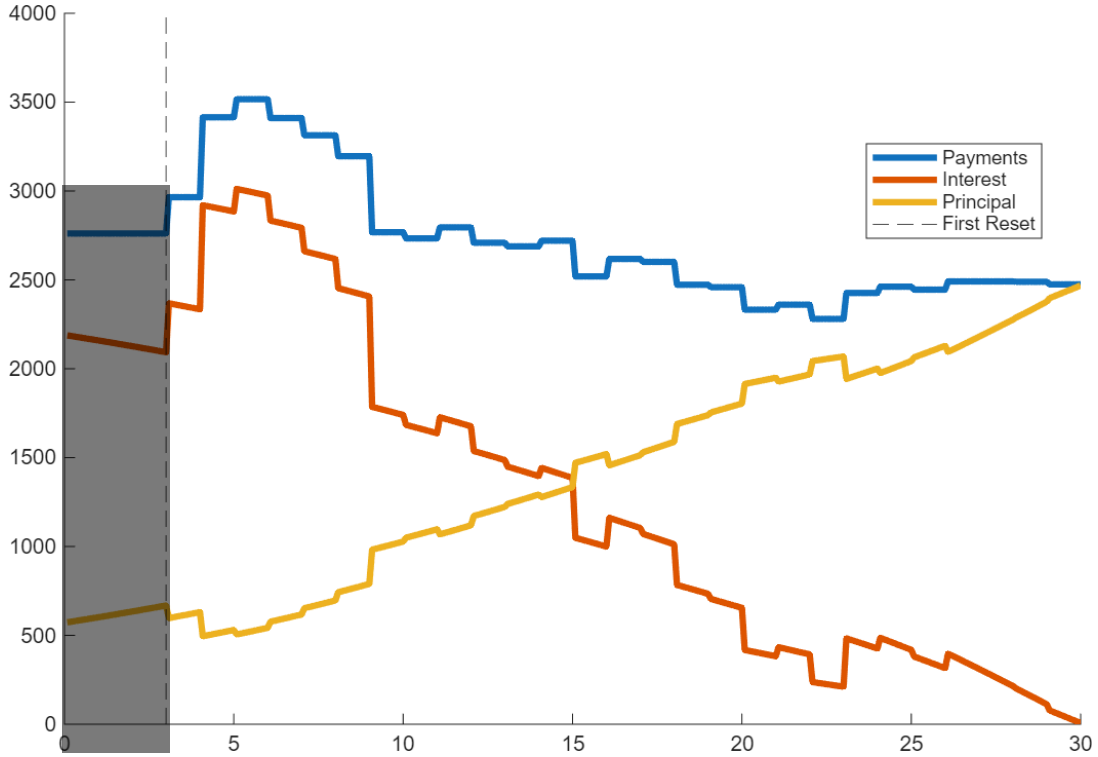


Not How Things Work in Canada!

Fixed Rate



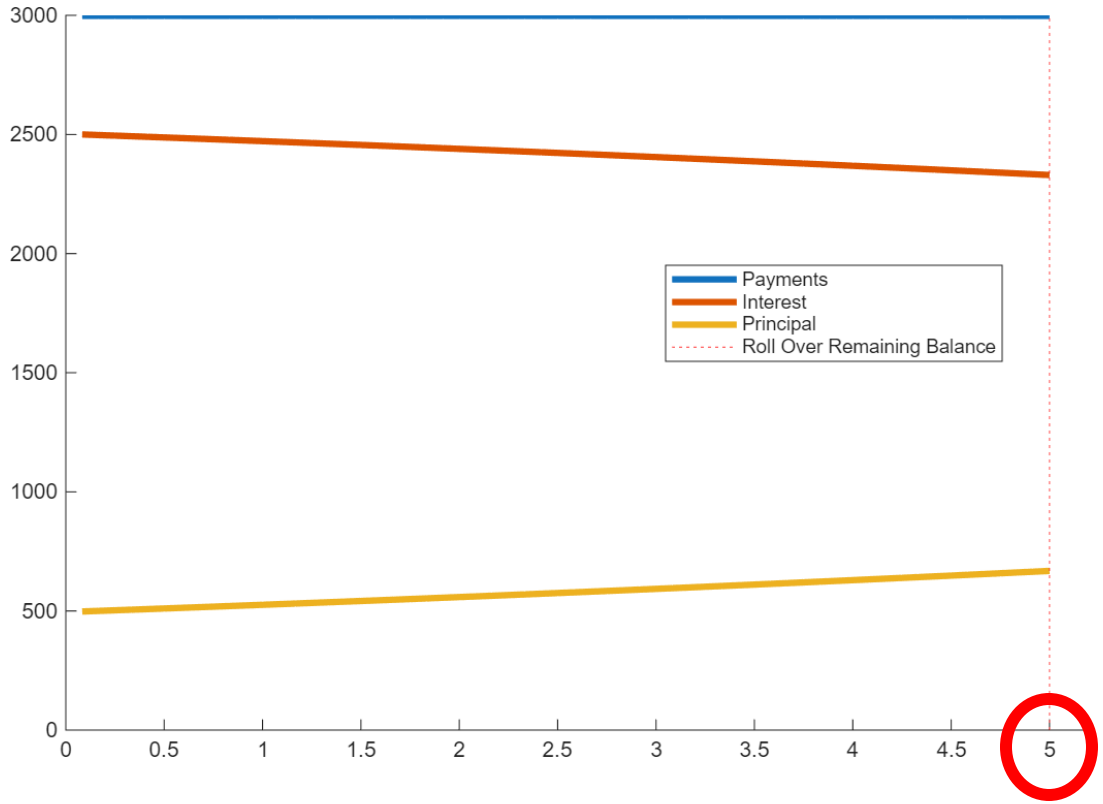
Variable Rate



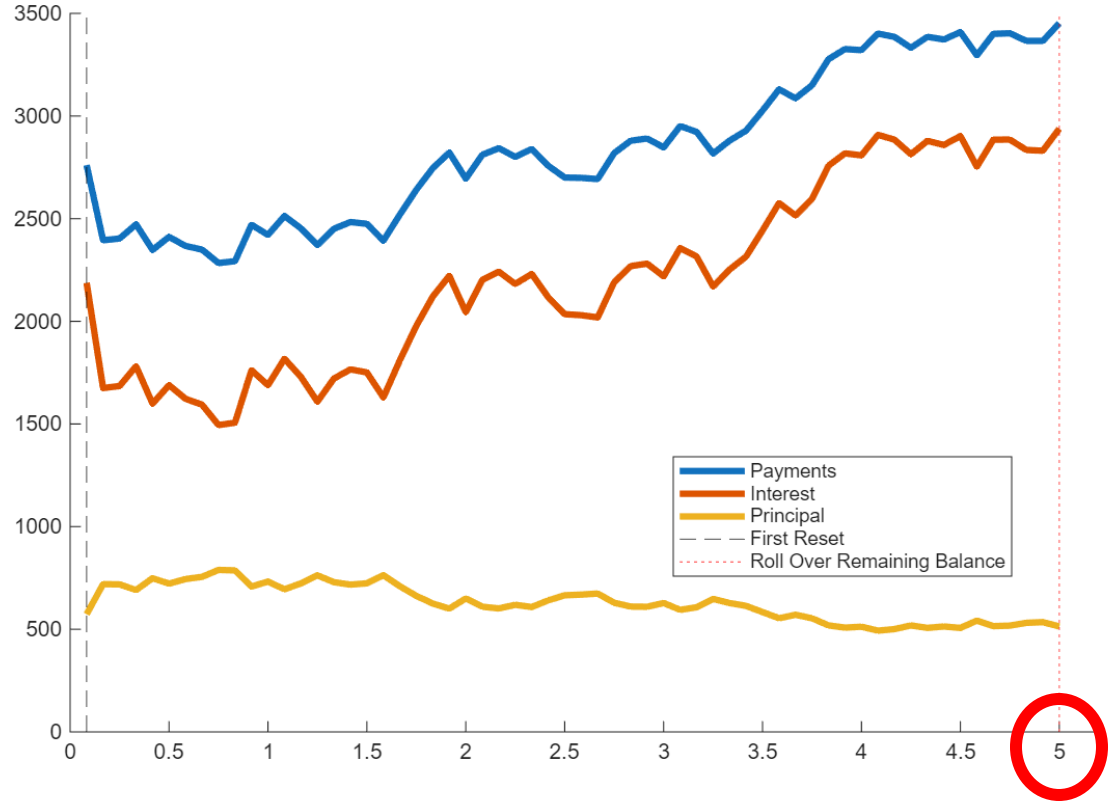
No initial fixation/"teaser" stage in variable-rate loans

Not How Things Work in Canada!

Fixed Rate

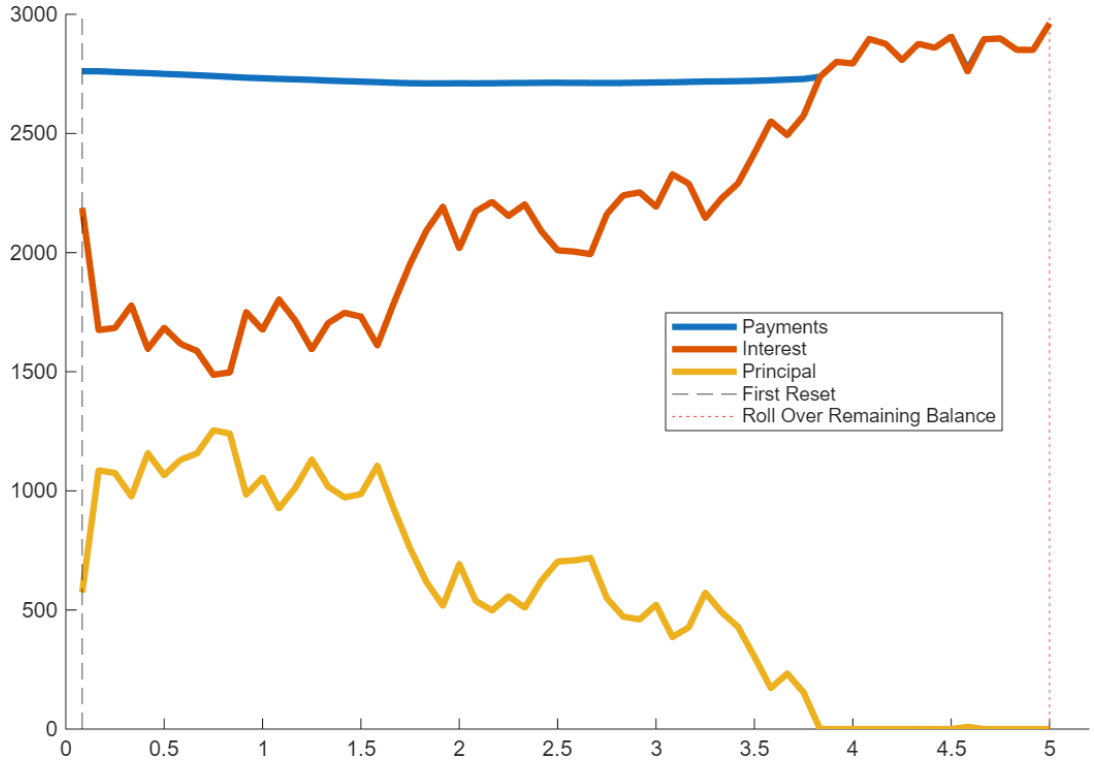


Variable Rate

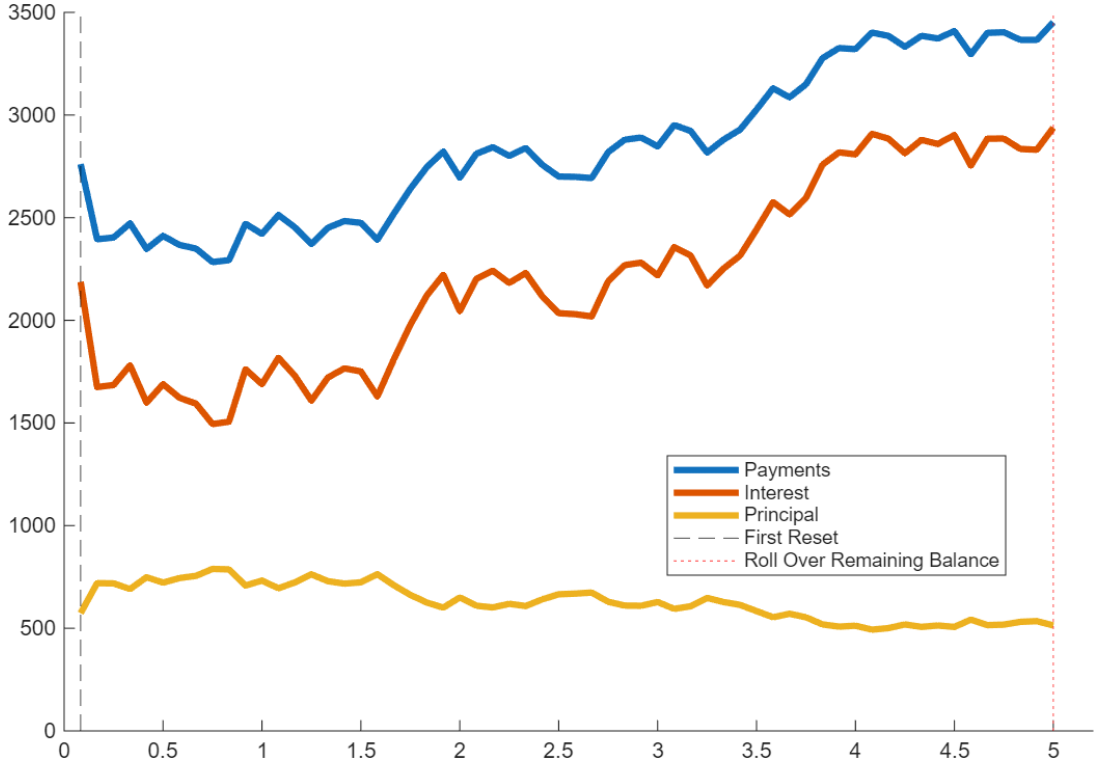


Not How Things Work in Canada! 3rd Option

Variable Rate & Fixed Payment



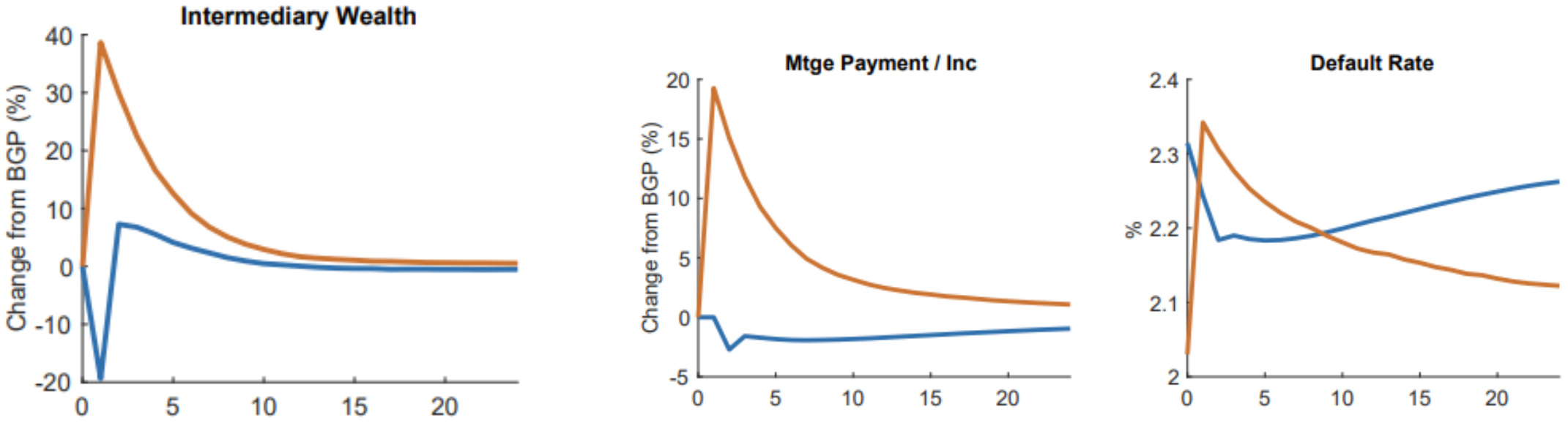
Variable Rate & Variable Payment



What Problem is VF trying to solve? Consider an Interest Rate Increase

FRMs are Costly for Lenders (Blue)

ARMs Expose HHs to Liquidity Risk



From Elenev and Liu (2025) “Mortgage Structure, Financial Stability, and Risk Sharing”

What Problem is VF trying to solve?

FRMs are Costly for Lenders (Blue)

whether individuals or fiduciaries — show by their behavior that they want speculation.

Now let's look at mortgage debt, which plays a big role in today's discussions of derivatives. All mortgage borrowers could use floating-rate debt with no floors or ceilings, but with fixed payments and variable maturity. Thus an interest rate change leaves the payment unchanged but affects its allocation between interest and principal.

With the right index used in floating the rate, the value of a mortgage loan would be stable. Since both the value and the payment would be stable for this type of debt (assuming a high-quality borrower), it would be close to riskless for both borrower and lender.

Homeowners could have this kind of mortgage, but they don't want it. They want fixed-rate callable debt, or floating-rate debt with caps on the rates. Thus they create risks for themselves and for lenders that are quite unnecessary.

ARMs Expose HHs to Liquidity Risk

Key Insight due to Black (1995):

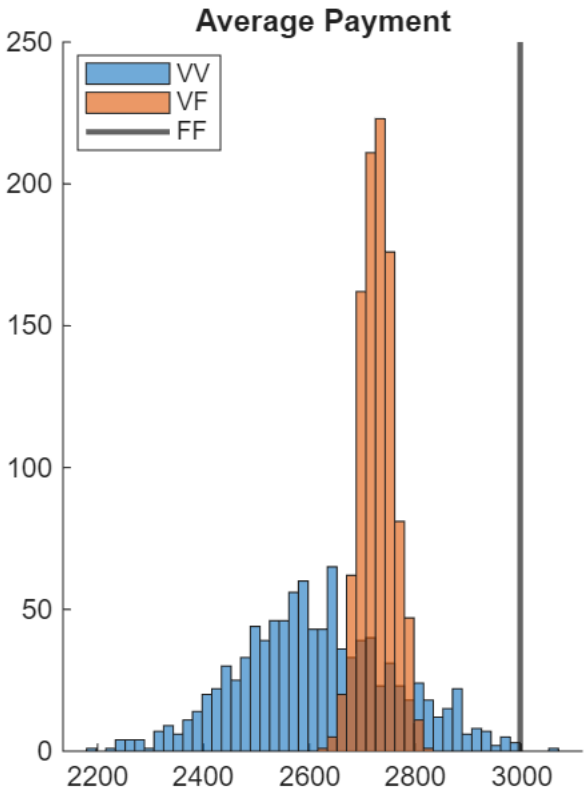
Lenders don't care about when they get paid as long as the PV of cash flows remains the same

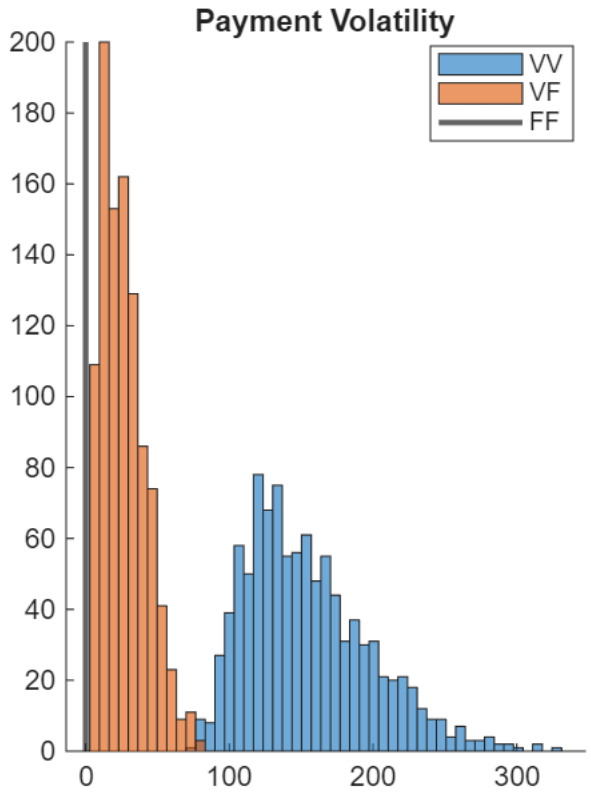
Households prefer to smooth payments over time

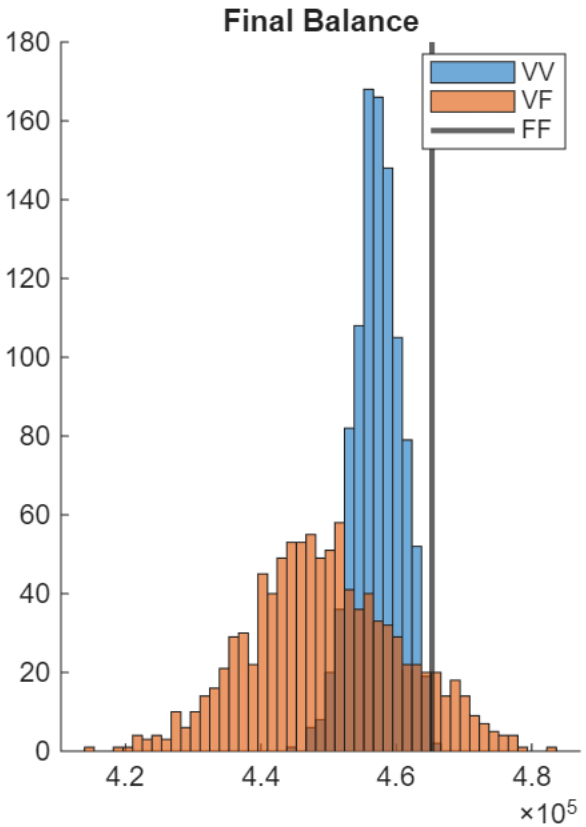
➔ Compensate lenders for rising discount rates, but defer that compensation so HHs can save up

From Elenev and Liu (2025) "Mortgage Structure, Financial Stability, and Risk Sharing"

Trade-Offs: Payments vs. Risk & Timing of Risk



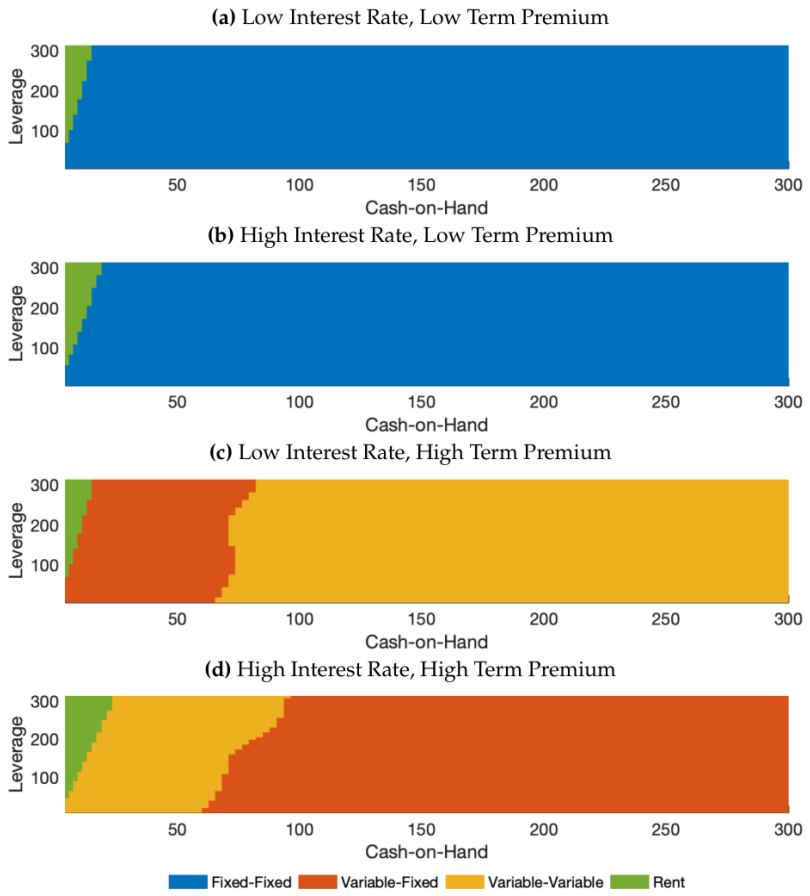




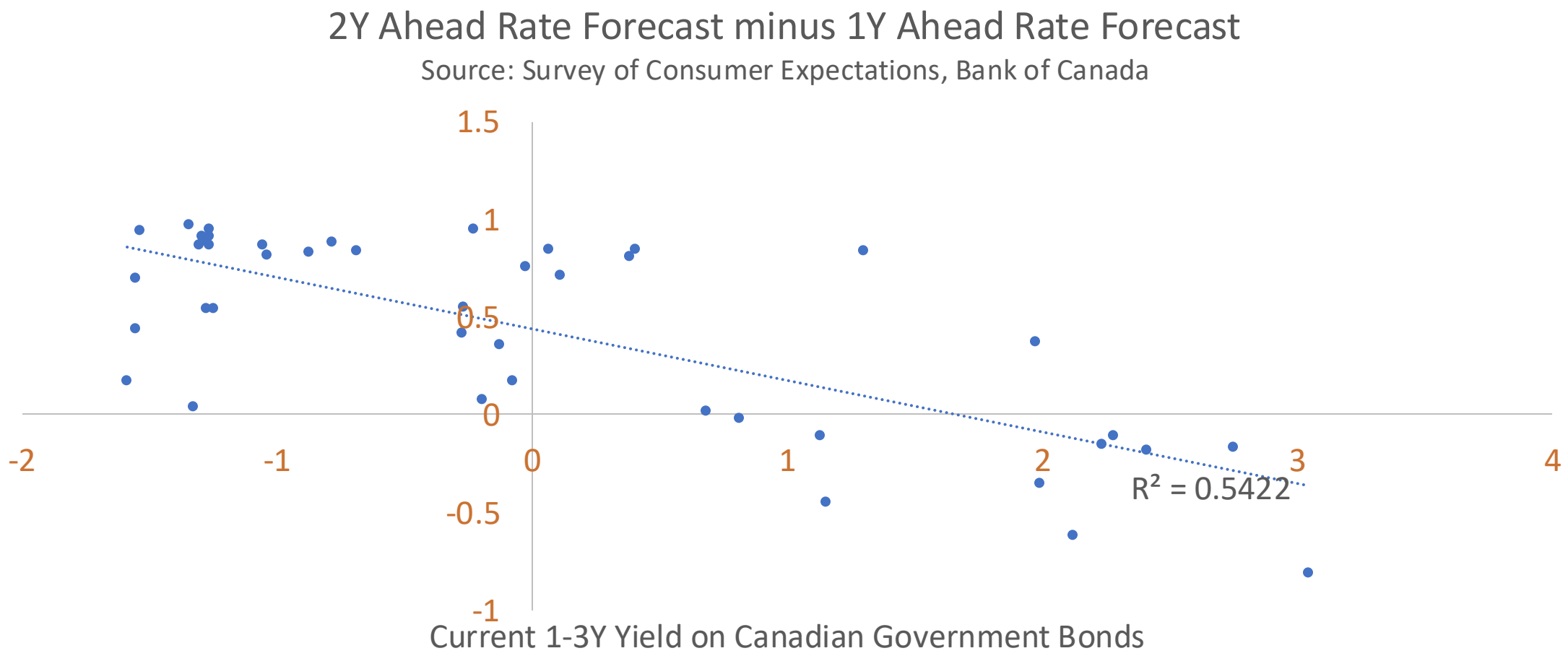
This paper: who makes which choices and when? Drivers:
Level of Rates | Level of Term Premia | Borrower Age | Borrower Cash-on-Hand | Borrower Leverage

Takeaways

- Everyone chooses FF when they're relatively cheap
- Liquidity-constrained HHs minimize payments
  - Low rates today → rising rates → choose VF to lock in low payments
  - High rates today → decreasing rates → choose VV to benefit
- Unconstrained HHs care about cost of future rollover



Do Households Expect Rates to Mean Revert? Yes!



Counterfactuals

- Choice is valuable: forcing everyone into one of the three types has large welfare costs
- U.S. borrowers would be better off in the Canadian system
  1. U.S. prepayment option is very costly ex-ante
  2. Choice is better than no choice
  3. Switching contract types every 5 years is a form of insurance
  4. VF is a particularly attractive contract to some borrowers in some environments

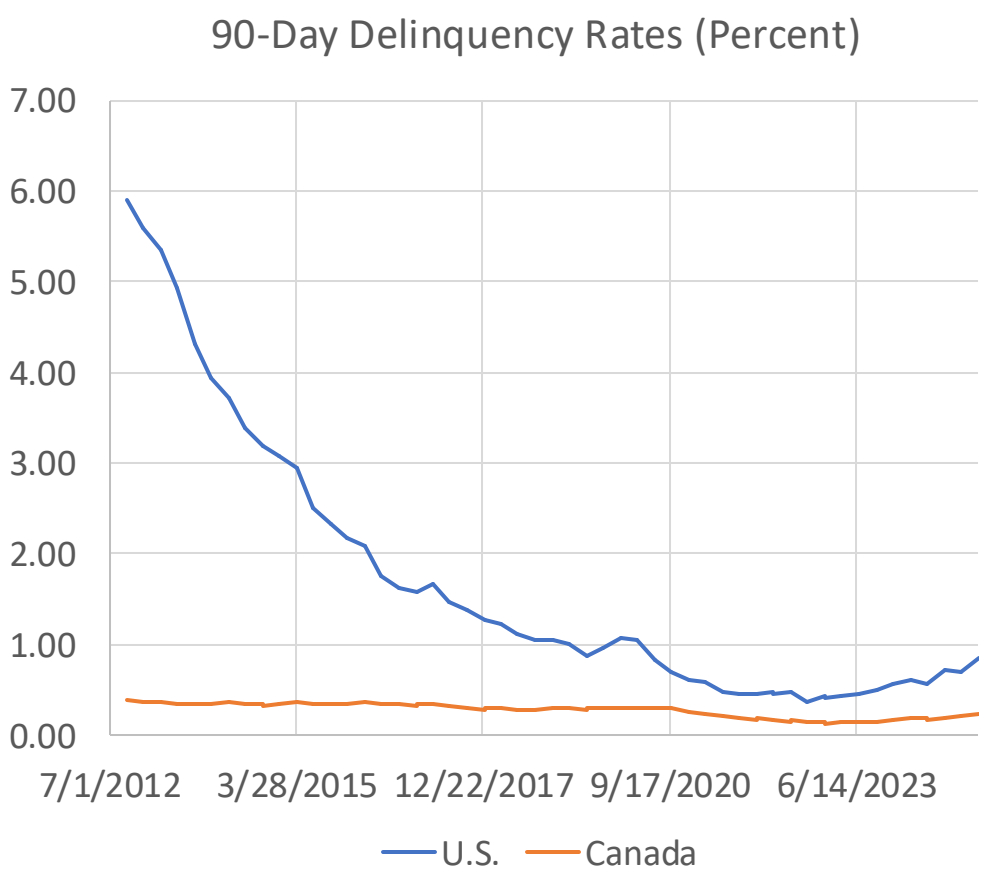
➢How much of the benefit comes from [1] vs. from [4]?

- Main new thing in the paper is [4],
- U.S. 30y FRM leads to 7% welfare gain without pricing in prepayments, 4% loss with

What about Default?

- Not in the model
- Not in the [Canadian] data
- Very much in the U.S. data!

- Why does it matter? VF leads to more volatile remaining balances at rollover
  - More volatile rollover LTVs
  - More volatile rates if credit risk is priced



Concluding Thoughts

- Really interesting paper
  - Quantifying [in **Canadian** data] the benefit of decoupling two features typically packaged together into an ARM: (1) a hedge for lender's duration, (2) payment volatility
  - Identifying which households value each decoupled component, and when
  - Arguing that the lack of this choice substantially hurts **U.S.** borrowers
- I enjoyed reading it, and highly recommend you read it too!
- It would be nice if the next version
  - Quantified the specific value of the new (to the literature) VF contract
  - Wrestled with other institutional differences between Canada and U.S. that may limit the benefits of switching to the Canadian system