Science & Technology

Fiscal Discipline

By
David J. Craig
|
Winter 2007-08

Congress is expected soon to draft tough new regulations for the mortgage industry, partly to ensure that lenders stop pushing complicated home loans on people who don't understand them. Lawmakers have even discussed banning a subprime loan called the "option-ARM" (for adjustablerate mortgage), which can send borrowers deeper into debt by letting them pay less than what they owe in interest, adding the excess to their principal.

But a new study by Tomasz Piskorski, a Columbia Business School finance and economics professor, and Alexei Tchistyi, a New York University finance professor, finds that the option-ARM is actually the best mortgage available — albeit only in an ideal world where borrowers show perfect discipline in making payments.

How could a mortgage aimed at people with shaky finances be the best? What makes the option-ARM dangerous, the researchers say, *should* be a big advantage: Its low monthly payments give borrowers maximum flexibility managing their debt so they're able to keep up with payments after losing a job, going through a divorce, or incurring unexpected medical bills. The trick to making an option-ARM work, they say, is to pay more toward the note whenever you can afford to, just as you'd pay off a credit card. The problem is that's not the way many Americans have used the option-ARM. Instead, they've chosen to pay only the minimum due every month, according to news reports. Then, the principal mushrooms, higher rates kick in, and foreclosure often looms.

Piskorski and Tchistyi demonstrate through mathematical modeling that the flexibility of the option-ARM should more than offset the costs of special stipulations lenders typically place on the loans - linking minimum payments to the federal interest rate, for instance, or including stiff prepayment penalties. (Their study assumes that borrowers, except in times of hardship, will make monthly payments large enough to pay off their mortgage in typical fashion.)

The current mortgage crisis, Piskorski said in a recent interview with *Columbia*, occurred partly because banks and lending agencies issued alternative home loans like the option-ARM to borrowers who simply couldn't afford them. Lenders hoped housing appreciation would enable borrowers eventually to pay off their debts by flipping their homes or by refinancing, he says.

But Piskorski insists that the federal government, rather than strictly regulate or eradicate option-ARMs, should instead require Americans to take training seminars and pass tests proving that they understand how the loans work before they obtain one. "Alternative mortgages have pumped tens of billions of dollars into our economy by extending credit to people who otherwise couldn't get a home loan," he said. "Anything we can do to keep borrowing restraints relaxed will be enormously beneficial."

Read more from
David J. Craig

Guide to school abbreviations

All categories >

Read more from
David J. Craig