

Why Don't ARM Borrowers Understand their Interest Rates?



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What borrowers seem to understand

- i Borrowers understand basic mortgage terms, but appear to underestimate or not know the amount their interest rates can change (Bucks and Pence, 2006)
- i Why?

Borrowers appear to know basic mortgage terms

	Lender	Lender	Borrower
<i>Type of mortgage</i>			
Fixed	86	83	87
Variable	11	13	11
<i>Amortization period (years)</i>			
1–15	23	25	27
16–20	4	4	5
21–25	1	1	2
26–30	70	69	64

ARM borrowers underestimate how much their interest rates can increase

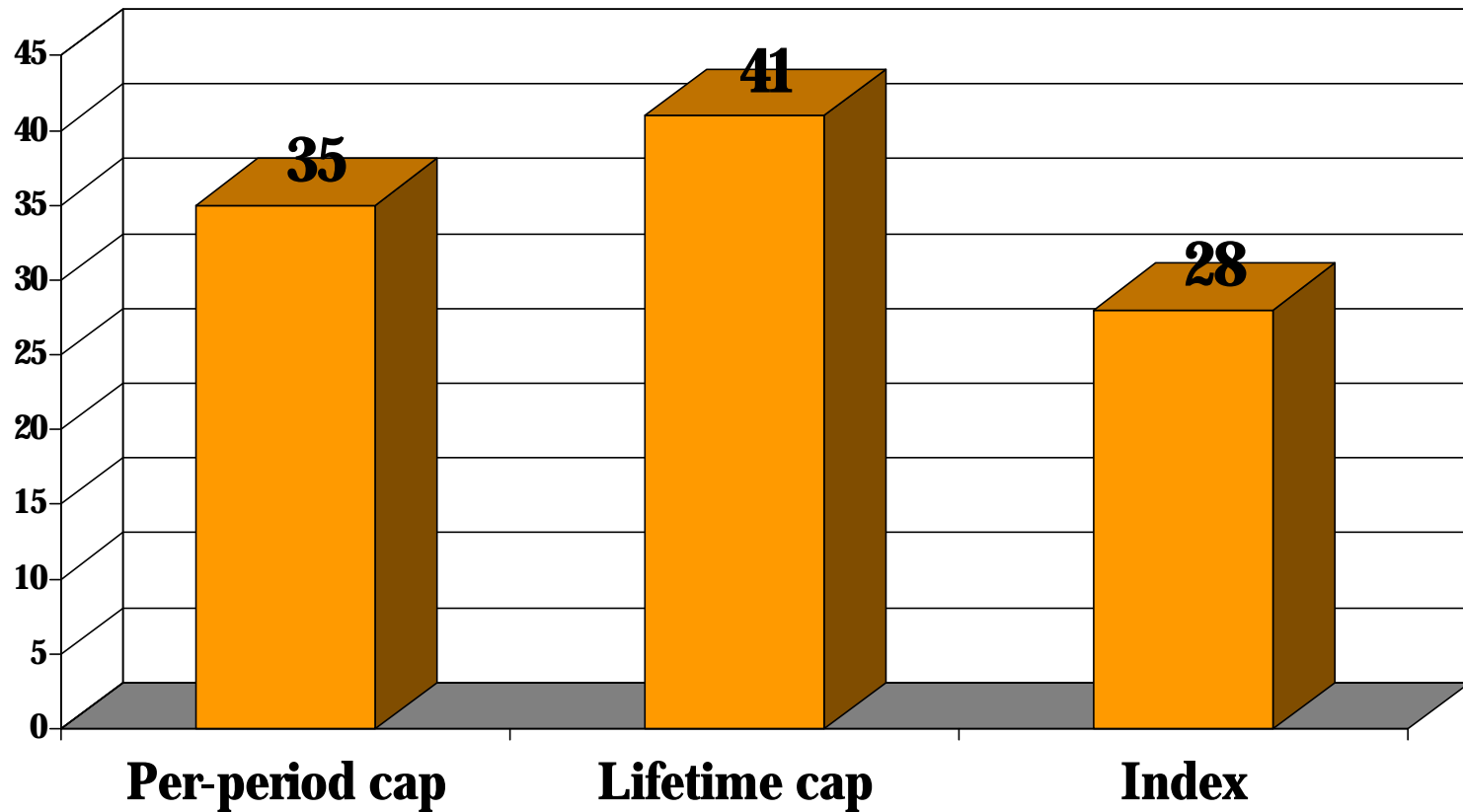
Lender data

Borrower data

Cap on interest rate change per period

1 ppt or less	1.5	40
Between 1 & 2 ppts	5	3
2 ppts	47	23
More than 2 ppts	28	26
No per-period cap	18	7

Share of ARM borrowers that don't know their...



Possibility One

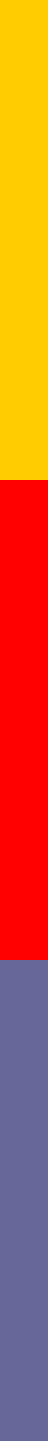


The benefit of acquiring the
knowledge is small

Overview

- i Borrowers may know that changes in interest rates will not have a big effect on their finances
- i Agarwal, Chomsisengphet, Liu, and Souleles (2006): as the financial penalty for choosing the wrong credit card contract increases, more borrowers choose the right contract.





Possibility two

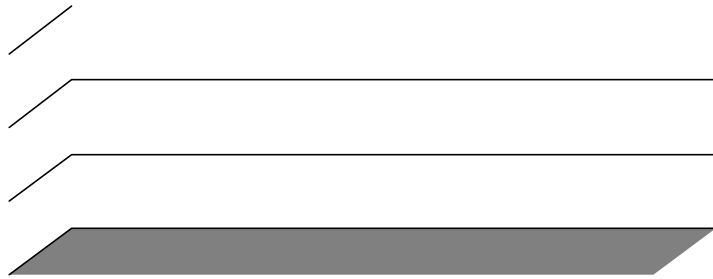


Understanding mortgage terms
is difficult

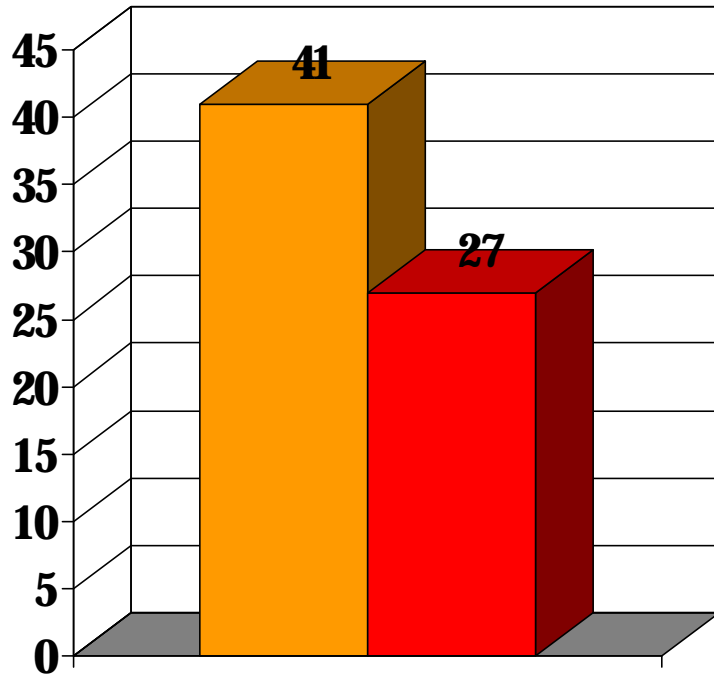
Overview

- i Some borrowers may have low levels of cognition or financial literacy
 - › Borrowers with less income and education and older borrowers appear to have more difficulty (Hilgert, Hogarth, and Beverly, 2003; Lusardi and Mitchell, 2006; Agarwal, Driscoll, Gabaix, and Laibson, 2007)
- i Interest rates appear to be particularly difficult for borrowers (Campbell, 2006; Stango and Zimmerman, 2006)

Share of ARM borrowers who don't know their per-period caps



Share of ARM borrowers who don't know their per-period caps



Possibility three



Borrowers are focused on short-term payments, not long-term financial consequences

Overview

- i Borrowers may consider only the near-term payment when choosing a mortgage
- i Borrowers may be impatient by nature, or may need money badly and have few good options
- i Many subprime borrowers report feeling desperate and powerless (Moore, 2003; Lacko and Pappalardo, 2007)

Conclusions

- i Financial literacy and short time horizons appear to be the main reasons why ARM borrowers don't know their interest rate caps
- i "It doesn't matter" seems to be a less plausible explanation
- i Consumer information and disclosures can help address financial literacy shortcomings, but not short time horizons