

# MRRC RESEARCHER



*Frank Stafford discusses his MRRC supported research*

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## **Adjustable Rate Mortgages — “Armed and Dangerous”**

MRRC: At the April MRRC Research Workshop you presented a paper based on your current 2010 MRRC project with Elena Gouskova titled “Mortgage Contract Decisions and Mortgage Distress: Family and Financial Life-Cycle Factors.” You said that a better title might be *Adjustable Rate Mortgages -- “Armed and Dangerous.”* What did you mean by that?

FS: What we meant by “armed and dangerous” is that, at the time, the ARMs might not have looked risky because they were given to very credit-worthy people. Yet, ARMs were very prominent in housing markets with speculative run-ups in prices.

Data from the Mortgage Bankers Association shows that the so-called subprime mortgages have not had the highest increase in foreclosure rates. Instead, adjustable rate mortgages have had the greatest increase in foreclosure rates. The big problem with ARMs is that if someone signs a 5 percent ARM and then the mortgage rate resets to 10 percent, then they can’t make their payments. ARMs were very prevalent from 2004-2007, during the run-up in the hot real estate markets like California, South Florida, Arizona. Many people who saw their house appreciate were borrowing against it. It was very tempting to take out these ARMs and refinance in the 2004-2007 period to get more cash, using the housing equity based on the bubble price.

MRRC: Do you think the bubble prices increased the amount of ARMs?

FS: If you look at our data from 2007-2009, the markets where the Case-Shiller home price index fell by more than 35 percent were the ones where many of the mortgage problems arose.

MRRC: What percentage of income is safe to spend on housing?

FS: The Federal Reserve tracks the debt-service ratio -- it’s how much of a family’s income goes into servicing debt. The aggregate data from 2003 onward shows that the debt-service ratio went from 13 or 14 percent to 17 percent, which is a huge change. If we look at the PSID data, some families were spending up to 25 or 30 percent of their income on housing.

MRRC: How is the mortgage crisis affecting the elderly?

FS: In prior decades, those who were in their 60s and 70s were much less likely to hold a mortgage or even own a home. Whereas, in the mid 2000-2010 decade, those 65 and older were more likely to own a house, more likely to have a mortgage, and were spending a larger portion of their family’s income on housing. The PSID dataset has family data and we’ll be looking to see how many adult children needed help from their parents who were having mortgage trouble too.

MRRC: How have financial practices impacted the mortgage crisis?

FS: Before the Great Depression, there were shorter term contracts that got renegotiated every six years. When the Great Depression hit, they made the 30-year fixed rate mortgages the so-called standard. This put the banks

in the position of trying to determine what future interest rates and inflation would be instead of households. These practices have slowly eroded to much more tenuous loaning rules and the emergence of what I think is fairly careless lending by web-based lenders. The lending officers were paid on a commission basis and had incentives to exaggerate the housing prices and expeditiously loan to as many people as possible.

**MRRC:** Were the elderly hit the hardest by the mortgage crisis?

**FS:** Our data show that those having the most problems are younger people and people with less education. The elderly are not at-risk relative to younger people, but they are at risk relative to the elderly of 15-20 years ago. They're supposed to be the backstop for their adult children, who are, in many cases, themselves in a precarious financial position. ■

Frank P. Stafford is Director of the Panel Study of Income Dynamics (PSID), Senior Research Scientist at the Survey Research Center, and Professor in the Department of Economics at the University of Michigan. His current research interests include household saving and human capital formation, and the impact of monetary policy on home ownership, household spending, and portfolio adjustment.



**Michigan Retirement Research Center**

Institute for Social Research  
University of Michigan  
426 Thompson Street, Room 3026  
Ann Arbor, MI 48104-2321

Director: John P. Laitner  
Associate Directors: Daniel Silverman  
and Dmitriy Stolyarov  
Associate Director for External Relations:  
Ruth Shamraj  
Administrative Manager: Becky Bahlibi

Phone: (734) 615-0422  
Fax: (734) 615-2180  
E-mail: [mrrc@isr.umich.edu](mailto:mrrc@isr.umich.edu)  
Web: <http://www.mrrc.isr.umich.edu>

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