

Discussion of “The Value of Mortgage Choice”

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Relevance of the Paper

- Mortgages are the biggest debt for most households → Mortgage contract design matters greatly for household welfare and financial stability
- However, mortgage contracts are largely shaped by history and institutions, leading to large cross-country differences (Badarınza–Campbell–Ramadorai 2018)
- This paper:
 - First to incorporate VF (variable IR - fixed pymt) with rich endogenous choice.
 - Very clear, intuitive risk-management results
 - Rich counterfactuals & strong policy relevance

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 - Rich counterfactuals & strong policy relevance
- Recent U.S. debate on 50yr mortgages has even heightened relevance!

Summary

1. Mortgage contract choice is driven by managing two risks

- Payment risk: matters most for *low* liquidity households
- Balance risk: matters most for *high* liquidity households

Type	Payment Risk	Balance Risk	Chosen when
FF	X	X	Low term premium (TP) (dominant)
VF	X	O	Low IR & low liq. / high IR & high liq.
VV	O	X	Low IR & high liq. / high IR & low liq.

2. Value of mortgage choice is significant

- Restricting contract choice reduces households' ability to manage risks.
- Welfare loss (consumption-equivalent): **1.8–3.8%**.
- U.S.-style FRM-only (long-term fixed contract): welfare loss **3.2–4.1%**.

Comment 1: Sensitivity to Counterfactual Premiums

- Welfare loss from restricting contract choice is expected, but its *magnitude* depends crucially on two objects: **the term premium** and **the loan premium**.
- Especially in the U.S. counterfactual, the welfare loss shifts dramatically with different loan premium assumptions (from -4% to $+7\%$).
- **Proposal:** A robustness check on **premium sensitivity** would greatly strengthen the results.
 - Controlling for term premium, showing model-generated FRM-ARM spread can replicate the data
e.g., Regressing the FRM-ARM spread on the term premium and comparing the model's residual to the data's.
- Incorporating the U.S. institutional structure—where lenders do **not** bear most mortgage risks—could lead to more realistic implications.
 - GSEs absorb default risk, while MBS investors bear interest-rate & prepayment risk
 - Large loan-premium swings in the model may not fully align with the actual system

Comment 2: Independence of State Variables

- The model's **independence assumption** (e.g., $r_t \perp \text{income} \perp \text{term premium}$) is crucial for generating the “**clean**” **policy functions**.
- However, this assumption **abstracts from** key correlated risks that could fundamentally alter these choices.
- **Example: Inflation Risk**
 - **FRM vs. ARM:** Misses the **inflation-hedging role** of FRMs—a key driver of choice beyond the term premium (Campbell-Cocco 2015, Guren-Krishnamurthy-McQuade 2021)
 - **VF vs. VV:** Misses the “double shock” risk, where an inflation spike can cause **higher payments** ($i \uparrow$) just as **real income falls** ($w \downarrow$).

→ This makes VV far riskier and VF more attractive, even for high-liquidity households.
- **Proposal:** A valuable **scenario analysis** would be to introduce correlations to proxy these dynamics and see if the clean policy functions hold.
 - e.g., $\text{Corr}(\text{income}, r_t) < 0$ and $\text{Corr}(\text{term premium}, r_t) > 0$ to mimic house price-driven inflation scenarios.

Comment 3: HELOCs and the Payment Risk Channel

- A central finding of the model is the “intuitive” separation:
 - **Low Liquidity** → **Aversion to Payment Risk**
- However, **HELOCs could mitigate a key mechanism** of the model: :
low-liquidity households' aversion to **payment risk**
 - As noted in the paper, HELOCs are prevalent in Canada (30-35% of homeowners).
- This, in turn, may blur the policy function and complicate the model-data fit
 - e.g., It may **further underestimate** VF in 2017-19, where interest rates were expected to increase ($1.0 \sim 1.75\% < \bar{r} = 2.9\%$) as low-liq. households **shift to VV**.
- **Proposal:** It would also be constructive to test the **quantitative importance** of this payment risk channel.
 - e.g., Re-run the simulation assuming a fraction (say, 30%) of “low-liq.” households are **insensitive to payment risk** (as a HELOC proxy).
 - This would clarify how much the model's aggregate fit truly *depends* on this specific mechanism.

Closing Remarks

- This is a **timely and highly policy-relevant** paper.
 - Mortgage contracts determine households' largest debt position, and thus have wide-ranging and important implications for their welfare.
- The model provides **clean and intuitive insights** into mortgage choice by elegantly focusing on a key trade-off:
 - The balance between **payment risk** and **balance risk**.
- The model's "clean" separation is achieved by **deliberately abstracting from** other real-world elements (e.g., HELOCs, correlated inflation risks).
- A natural next step, which would **greatly strengthen** the quantitative policy implications, would be to test the **robustness** of these findings against those elements.
- Overall, a very insightful and thought-provoking paper!