Discussion of


by

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Overview

1) *Time priority: At first blush, seems odd*
   - Why should 2nd mortgagee get to move up in priority with a refi of the 1st?

2) *In fact, in non-easy states, 2nd mortgagees effectively have the power to block a refi on the 1st, which might impose costs on the homeowner*

3) *But reflection suggests something more is going on*
   - Ex post reallocations that negatively effect 2nd mortgagee are the concern
     - Sneak in a new, more senior mortgage
     - Replacing 1st with higher credit risk mortgage based on observables
     - Replace 1st with higher credit risk mortgage based on unobservables
Example

Time 0: \( P_0=150, \sigma_p=.15 \)
\( M_1=100, M_2=20 \)

Time 1: \( \sigma_p=.20 \)

or increase in unobserved credit risk

1) 2\textsuperscript{nd} position is now less secure, but the effect is subtle

2) Should the 2\textsuperscript{nd} mortgagee be allowed to “block” a refi?

3) If not, something fundamentally unfair about the game
So, What is Fair?

1) Pareto Principle?
   • Contract law outside of bankruptcy tends to follow this standard
   • Mitigates ex post hold-up and risk shifting behavior
   • If economic/financing pie is really bigger, then borrower can for example simply pay off
     the two mortgagees and create a newer-better financial structure (that is, the Coase
     theorem applies)

2) Kaldor-Hicks argues ok for there to be losers if welfare-
   increasing transaction would not otherwise get done
   • Cramdown and bankruptcy judgement reallocations follow this principle
   • But implicit assumption is that losing happens idiosyncratically rather than
     systematically
   • Inherent adverse selection problem: Welfare increasing transactions can more easily
     follow Pareto principle, whereas borrower in welfare decreasing transaction will want to
     apply Kaldor-Hicks to systematically damage the 2nd mortgagee

3) But coordination problems and aggressive 2nd mortgagees
   can be a problem (inefficient blocking)
   • Why there is nuance in state laws
   • Also be careful what you wish for – ex ante lending effects with respect to cost and
     availability of mortgage finance
1) Takes on this priority issue

2) Use a good quality massive data set, and does a lot of work matching to 2nd mortgage data. Also update certain variables after origination

3) Identification: Triple interaction of easy refi state, 2nd mortgage, CLTV in middle range
A (very) few comments

1) I learned a lot – Table 1 is great
2) I believe the main result
3) But why is this finding important?
   – More motivation on why blocking leads to large welfare losses
4) More work on characterizing borrowers that are blocked
   – If many/most blocked borrowers are relatively well endowed with more expensive houses, then I am skeptical of welfare loss but more inclined to believe in risk-shifting
   – In fact, finding may actually be evidence of a good thing going on
5) More balanced discussion of the law and economics underlying time-based priority
6) More on characteristics of 2nd mortgagee
   – Identity known?