

Discussion of

*“Does Junior Inherit? Refinancing and the
Blocking Power of Second Mortgages”*

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) 2nd position is now less secure, but the effect is subtle*
- 2) Should the 2nd 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*

Paper

- 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?***