Modigliani, Miller and Mortgages

Dr. Krzysztof Ostaszewski, FSA, CFA, MAAA

Comments on Ostaszewski

Mr. MacKenzie states, "… recent financial innovations created an incentive for mortgage lenders to take excessive risk." This is apparently Mr. MacKenzie's opinion, so let me state that it is not mine. The point I made could not be more clear, although it is largely ignored: derivative securities can, and in case of mortgage derivatives, often have, subtract value. This value subtraction has been accommodated by the Federal Government, at the great expense to our nation's wealth and economic well-being.

Mr. MacKenzie states, "The author errs when he implies that the derivatives involved in housing finance were effectively without any social utility." I merely said that derivative securities can, and indeed in this case, judging by the state of national economy, have subtracted value. But in scientific inquiry, propositions like this are not supposed to be judged by authoritative statements such as provided by Mr. MacKenzie, but by empirical studies.
Fannie Mae and Freddie Mac are effectively bankrupt. The market has passed a judgment on their economic viability. Investment banks are gone, or became banks supported by a lifeline thrown by the Feds. In my opinion, had any of these institutions paid attention to the housing wealth of their borrowers, they would still be in business today.

In terms of the impact on the actuarial profession, these institutions booked as profit what should have been booked into reserves. Actuaries were nice, silent and uncontroversial about this practice. If the profession would like its practitioners to be considered as risk management experts, they should understand their responsibility to alarm the public in such instances. Because they surely did not do this when risk was neither priced nor reserved properly in the U.S. housing markets.