Modigliani, Miller and Mortgages

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Comments on Ostaszewski

The paper, its title notwithstanding, is about the genesis of the credit crisis, which the author attributes to a confluence of factors. However, the basic cause is that recent financial innovations created an incentive for mortgage lenders to take excessive risk.

The paper makes some interesting points, but it also leaves too much out of the story. The author has a point about a lack of penalties for excessive risk-taking, but this was not the only factor behind the crisis. It is quite possible that the bubble in the U.S. housing market could have developed even without these financial innovations. In addition, certain derivatives were so complex that the people who should have recognized their dangers did not, and regulation was lax. The author errs when he implies that the derivatives involved in housing finance were effectively without any social utility. If derivatives, properly regulated lower the risk faced by lenders for a given expected return, they have some utility. The author tries to relate developments to the Modigliani-Miller theorem, and is partially successful.