SECOND MORTGAGES: VALUATION AND IMPLICATIONS FOR THE PERFORMANCE OF STRUCTURED MORTGAGE PRODUCTS.

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Abstract. Many homeowners cash-out refinanced to extract equity from their properties during the recent run-up in U.S. house prices. We demonstrate that the risk characteristics of first lien mortgages are systematically altered when second liens are behind them. Subsequent borrower financing activity also effectively correlates homeowners' default decisions so that a drop in house prices can result in almost all of these homeowners defaulting together. In this case, even the most senior tranches of asset backed securities (ABS) collateralized by first lien mortgages with a second lien behind them may no longer be protected from default losses. Accordingly, the subordination levels of these ABS should increase to reflect this second lien risk. However, using data on all first-lien subprime ABS originated in 2005 and 2006, we find no evidence that credit rating agencies nor investors took this risk into account when rating and pricing these deals.

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