

Modigliani, Miller and Mortgages

Dr. Krzysztof Ostaszewski, FSA, CFA, MAAA

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Abstract

The Modigliani-Miller Theorem about irrelevance of the mode of financing in its effect on the value of a firm has been simultaneously extensively used and spectacularly ignored in modern finance. Yet its significance cannot be understated. If we do know that change of financing of an activity alone cannot produce new value, why then are so many economic agents so involved in such financing activities? Is it because they believe that they can create value, or is it because they believe that they can get away with subtracting value?

This paper asks the Modigliani-Miller question regarding the mortgage markets. More specifically:

- Do mortgage-backed securities and mortgage derivatives add or subtract value and why?
- Do reverse mortgages add or subtract value and why?

The most general and most important question addressed is:

- How do financing activities revolving around real estate affect taxes, default cost and agency cost of the economic agents involved?

The answer proposed is simple: We must no longer allow practice of risk without actuarial supervision.

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