

## **Does Junior Inherit?**

### **Refinancing and the Blocking Power of Second Mortgages**

#### **ABSTRACT**

In most states, the law grants seniority to the oldest mortgage on a house, unless that mortgagee subordinates its claim. We show that this practice significantly impedes the refinancing of first mortgages by imparting blocking power to junior mortgagees. We identify the effect by building a database showing all mortgages of a large panel of homeowners, identifying those whose combined loan-to-value makes them candidates for refinancing their first mortgages, and contrasting the incidence of refinancing between the states following this standard and the states following an alternate standard by which a mortgage inherits the seniority of the mortgage it replaces.

JEL: D12, G18, H73, K11

## 1. Introduction

Homeowners across the U.S. could benefit greatly from reducing their debt service. Low rates provide a benefit not just to homeowners, who can thereby significantly increase their disposable income, but also to society, as lower payments may encourage borrowers to continue paying their mortgages.<sup>1</sup> But to realize this debt-service reduction a homeowner must overcome several obstacles. How many obstacles depends on how many mortgages she has: all homeowners must satisfy income, collateral and creditworthiness requirements, but those with multiple mortgages must also negotiate legal barriers specific to refinancing. Because many homeowners have multiple mortgages, these barriers can pose a significant economy-wide threat, and because the barriers vary across states, we can identify their impact in the variation of refinancing across states. This impact is the subject of this paper.

Second mortgages are widespread. As of December 2012, 22% of homes with a mortgage had more than one; as of December 2008 it was 36%.<sup>2</sup> In these cases, the mortgages' relative seniority, i.e. the order in which they are paid upon sale, foreclosure or similar event, is generally by age. The mortgage taken out first is the most senior, followed by the next mortgage taken out, and so on. This principle, which we label *time priority*, is convenient and easy to follow, but it has a potentially perverse effect on refinancing the first of multiple mortgages. This is because a replacement is newer than, and so by this principle junior to, mortgages that the original first mortgage was senior to. The originally junior mortgagees can waive this windfall of seniority with *subordination agreements*, i.e., documents affirming their subordination to the replacement mortgage, but they don't have to. Thus, a second mortgage can impede a welfare-

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<sup>1</sup> See, for example, Fuster and Willen (2012), who show that interest rate reductions that lower monthly payments are associated with decreases in mortgage default rates.

<sup>2</sup> Federal Reserve Bank of New York/Equifax Consumer Credit Panel.

increasing refinancing, either actively, because the second mortgagee aims to extract rents, or passively, because the additional logistical hurdle of obtaining his permission is difficult to clear. We refer to this potential to impede as *blocking power*.

We can identify the effect of the blocking power through its variation across states. This is because a subset of states follows a legal principle known as *equitable subrogation* that largely eliminates the perverse effect. Subrogation is the inheritance by a new creditor of the seniority of the creditor it paid off; equitable subrogation provides that this inheritance occurs when the new mortgage does not disadvantage junior mortgagees, relative to the old mortgage. So if the new mortgage has principal and interest no higher, and maturity no shorter, than the mortgage it extinguished, then it enjoys the old mortgage's seniority, despite the violation of time priority. By eliminating the second mortgagee's role in refinancings that do not disadvantage it, equitable subrogation removes its blocking power, which means we can observe the effect of this power in the contrast in refinancings between those in states that have adopted this principle and those in states sticking with time priority.<sup>3</sup>

Because state economies and laws vary on other dimensions as well, the variation across states of successful refinancing may not cleanly identify the effect of the laws in question. Thus, we combine this difference with two additional salient sources of variation. First, subrogation law should affect borrowers with multiple loans, but not borrowers with a single loan. Second, among borrowers with multiple mortgages, subrogation law should affect only those with a combined loan-to-value (CLTV) ratio in an intermediate range: one would expect borrowers with a low CLTV to be able to refinance all mortgages regardless of subrogation law, and borrowers with a high CLTV to be unable refinance any mortgage, again regardless of subrogation law.

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<sup>3</sup> We are grateful to Dale Whitman for assembling and providing the database showing the variation of the legal environment across states.

Consequently, the identification is a triple difference: the difference across states' treatments of equitable subrogation, of the difference between medium-CLTV refinancings and low- or high-CLTV refinancings, of borrowers with and without multiple mortgages.

A primary goal of this identification strategy is to separate the effect of interstate variation in subrogation law from other potentially important interstate variation, including variation in foreclosure law, recourse, mortgage-market competition, and economic conditions such as the unemployment rate. These variations may affect refinancing possibilities, and may even affect refinancing possibilities differentially for borrowers with high and low CLTVs; all our estimation requires is that they not differentially impact borrowers with one vs. multiple existing mortgage lenders but the same CLTV.

We identify the effect by building a database of recent mortgages, starting with 3.9 million mortgages originated between 2003 and 2007 from the Lender Processing Services (LPS) Mortgage Dataset. The LPS data show only one mortgage at a time, but we need all mortgages of each borrower, so we combine senior mortgages with any junior mortgages by matching through credit bureau data. We also need the current CLTV, so we update both the current balance of all mortgages, and also update home values by applying zip-code-level house-price indices to the home value at origination. Our database of state laws is current as of September 2008, so we focus on refinancing in 2009. This is a period of significant financial distress, which introduces other issues into refinancing, so to focus on the effect of the legal environment, we limit our sample to mortgagors who were current on all mortgages as of December 2008. Despite the general distress, 2009 saw frequent refinancing, likely encouraged by a plunge in mortgage rates, as Figure 1 illustrates.<sup>4</sup>

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<sup>4</sup> The refinancing originations are from the HMDA data, and the mortgage rates are the 30-year mortgage rates from the FHLMC primary mortgage market survey.

Our main finding is that the legal environment significantly affects refinancing: in states which eliminate the second mortgagee's blocking power, homeowners who have second mortgages and are in the middle range of CLTV refinance significantly more often. For multiple-mortgage borrowers in this range, the easier legal environment increases the probability of refinancing in 2009 by 1.2%,<sup>5</sup> which is 10% of the unconditional refinancing probability of 12% (see Table 2). By contrast, there is little or no effect when CLTV is too high or low.

## 2. Background and Literature

Junior mortgages figure heavily in both pre-crisis borrowing and in the subsequent distress. There is an accordingly large and growing literature on the role of junior mortgagees in the resolution of distress. The focus of this literature is not on refinancings that potentially alter seniority, but rather on modifications of already-distressed mortgages that preserve seniority while forgiving principal. The main concern this literature addresses is the weak incentive of junior mortgagees to forgive and the resulting difficulty in reducing prohibitive indebtedness. Relevant studies include Agarwal et al. (2011b), Cordell et al. (2011), Goodman (2011), and Mayer et al. (2009).

The principle of time priority that we focus on is summarized in this passage from Schmudde (2004):

“The first mortgage on a property, being the first recorded, has first priority. All later recorded mortgages applying to a single property are called “junior” mortgages. The basic rule of mortgage priority is that it is set by the time of recording. Earlier recording grants earlier priority. This can only be changed when a mortgagee who has earlier recorded agrees to subordinate her interest.”<sup>6</sup>

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<sup>5</sup> In Panel B of Table 5, the marginal effect of a second mortgage on the refinancing probability is 3.0% for those in the middle range and an easy state, whereas it is 1.8% for those in the middle range and a not-easy state.

<sup>6</sup> Schmudde (2004), p. 113.

The problem arising from this principle is that it ties a potentially deal-breaking wealth transfer to a run-of-the-mill refinancing. If a borrower refinances the senior of two mortgages, the replacement mortgage is newer than the old junior mortgage, making the old junior mortgage now the senior one. So this principle hands the old junior mortgage a large transfer from the entering mortgage without regard to whether the entering mortgage would make the old junior mortgage better off, for example by lowering the first mortgage's coupon.

Countervailing the time-priority principle is the principle of equitable subrogation. It is articulated in §7.6(a) of American Law Institute (1997), a document generally referred to as the *Restatement*, an abbreviation of its title:

One who fully performs an obligation of another, secured by a mortgage, becomes by subrogation the owner of the obligation and the mortgage to the extent necessary to prevent unjust enrichment. Even though the performance would otherwise discharge the obligation and the mortgage, they are preserved and the mortgage retains its priority in the hands of the subrogee.<sup>7</sup>

By this principle, which is explicated in depth in Nelson and Whitman (2006), Yoo (2011), and Been, Howell and Willis (2012), the refinancing mortgage inherits the refinanced mortgage's seniority, with or without subordination agreements from any intervening liens, provided the replacement of the old mortgage with the new does not disadvantage other lienholders.

The principle of equitable subrogation is not automatically incorporated into the laws of individual states. State legislatures and judiciaries choose whether to incorporate this and other elements of the Restatement. An example of a state that chooses not to adopt this principle is Minnesota. This is spelled out in, for example, an Appeals Court decision filed July 26, 2005:

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<sup>7</sup> American Law Institute (1997), p. 508.

Jurisdictions around the country have adopted three different approaches in determining whether to apply equitable subrogation under circumstances in which a third party holds a lien on the property at the time the second lender pays off the former encumbrance. The first approach reasons that actual knowledge of an existing lien precludes the application of equitable subrogation, but constructive knowledge does not. *See, e.g., Osterman v. Baber*, 714 N.E.2d 735, 739 (Ind. Ct. App. 1999). The second approach bars the application of equitable subrogation when the party seeking subrogation possesses either actual or constructive notice of an existing lien. *See, e.g., Harms v. Burt*, 40 P.3d 329, 332 (Kan. Ct. App. 2002).

The third approach, adopted by the Restatement, disregards actual or constructive notice and concentrates on whether the junior lienholder will be prejudiced by subrogation. *See* Restatement (Third) of Property: Mortgages § 7.6 (1997). Under the Restatement, a mortgagee will be subrogated when it pays the entire loan of another as long as the mortgagee "was promised repayment and reasonably expected to receive a security interest in the real estate with the priority of the mortgage being discharged, and if subrogation will not materially prejudice the holders of intervening interests in the real estate." *Id.*

Minnesota has adopted the second approach (actual or constructive notice of an existing lien bars equitable subrogation) with the added criterion that when a sophisticated party – such as a professional lender – is seeking subrogation, it will be held to a higher standard for the purpose of determining whether it has acted under a justifiable or excusable mistake of fact in failing to duly investigate prior liens.<sup>8</sup>

In the language of the court, actual notice of a lien means a lender actually knew of it, whereas constructive notice means the lien was properly and promptly registered, so the lender could have known about it. So in Minnesota, a refinancing lender does not inherit the seniority of the refinanced mortgage with respect to an intervening mortgage he knew or could have known about, unless the holder of the intervening lien agrees.

The complete distribution of relevant state law, as of September 17, 2008, is reported in Table 1. In this table, "Restatement" indicates that the state courts have effectively adopted the principal of equitable subrogation as spelled out in the Restatement (American Law Institute (1997)), excerpted above. As the table indicates, states that have not adopted the Restatement

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<sup>8</sup> State of Minnesota in Court of Appeals A04-1962, available online at: <http://www.lawlibrary.state.mn.us/archive/ctappub/0507/opa041962-0726.htm>.

wholesale exhibit various nuances in the positions they do take. In our empirical tests we do not attempt to capture these nuances; instead we simply contrast the Restatement states with the others.<sup>9</sup> As a shorthand representation of the hypothesis that refinancing the first of several mortgages is easier in a Restatement state, we denote the Restatement states as “easy”, and the other states as “not easy.”<sup>10</sup> The geographic distribution of these states is presented as Figure 2, which shows them to be widely dispersed across the country. Note that when a state precludes the application of equitable subrogation in the case of actual knowledge of an existing lien, but not when there was constructive knowledge, we code this state as “not easy”. The reason is that since it is routine today for lenders to perform a title search prior to a refinancing, “actual” vs. “constructive” knowledge appears to be a distinction without a significant difference.

Although our three-way identification strategy is designed to rule out other sources of cross-state variation, it is useful to note that cross sectional correlation between these other sources and subrogation laws is low. This is apparent in Figure 3, which shows low correlation of subrogation law with the three legal-environment variables in Ghent and Kudlyak (2011), i.e. recourse to the borrower for deficiency judgments, judicial vs. non-judicial foreclosure, and the optimal foreclosure timeline recommended by the GSEs (see that paper for details). It also shows low correlation with state-level average mortgage rates in December 2008 (from the LPS data described below), which reflect, among other things, the competitiveness of the local mortgage market,<sup>11</sup> and home-price appreciation since mortgage origination (from our matched sample described below). Thus, the variation of subrogation law is a largely independent source of variation in the refinancing environment.

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<sup>9</sup> We show below that the results do not change if one drops those states for which the law is uncertain.

<sup>10</sup> We include the District of Columbia as an easy subrogation state, but our results are robust to this coding.

<sup>11</sup> See Scharfstein and Sunderam (2013), who show that increases in banking-sector concentration reduce refinancing activity.



The empirical question we address is whether the blocking power imparted to the second lienholders by the absence of equitable subrogation reduces the incidence of refinancing. It is worth noting that this reduction could occur several ways. It could result from frictions when second lienholders with limited information bargain for rents. For example, a lender unable to distinguish between the various borrowers asking for subordination might make them all the same take-it-or-leave-it offer, which some would leave. Similarly, lenders or borrowers with some information might yet overplay their hands. Alternatively, failure could result from borrowers struggling to contact or even identify their current lenders or from lenders being willing but unable to subordinate due to contractual restrictions or complications, perhaps arising from securitization agreements. A servicer might also simply have too much paperwork or other time-consuming labor to pay it the proper attention. So it is some combination of these and related hazards peculiar to states without equitable subrogation that we hypothesize to reduce the incidence of refinancing.

### **3. Data Description**

The dataset consists of mortgages originated between 2003 and 2007, from the LPS Mortgage Dataset. The LPS dataset consists of mortgages serviced by most of the top ten servicers and covers about two-thirds of all mortgages currently outstanding or originated in recent years. Approximately four million of these loans were matched to the Federal Reserve Bank of New York/ Equifax Consumer Credit Panel, a database of consumer credit bureau records, based on loan characteristics at origination. The matching procedure is described in more detail in Elul et al. (2010). The importance of this matching for evaluating the effect of equitable subrogation laws is two-fold: it provides information on the other (second) mortgages

held by the same borrower, because these mortgages appear in bureau records, and it also allows us to identify refinancings.

From the LPS data, we obtain first-mortgage characteristics such as origination FICO score, interest rate, LTV ratio, etc. From the consumer credit bureau data, we obtain the borrower's updated Equifax risk score and information about second mortgage balances.<sup>12</sup> We calculate updated CLTVs as of 12/08 with the most current mortgage balances in the numerator and the home price at origination, updated with the Corelogic zip-code level house-price index, in the denominator. The second mortgages include both closed-end seconds and revolving home-equity lines.

The following procedure is used to identify refinancings.<sup>13</sup> We first identify the first mortgages that terminate in the LPS data; these make up approximately 55% of the sample. We then use the bureau data to identify which terminations are refinancings. A terminated mortgage is identified as a refinancing if the borrower did not move in a one-year window spanning the mortgage termination date (based on the address in credit bureau records) *and* a new mortgage account appears in the bureau data with an opening date that is within three months of the mortgage termination date.<sup>14</sup> For our final sample, approximately one-half of all terminations are identified as refinancings, which is consistent with the findings of Clapp et al. (2001).

We restrict the sample to those residences that had active and non-delinquent first mortgages as of December 2008 (and if a second mortgage exists, it must also be current). In

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<sup>12</sup> We include all second mortgages reported to the credit bureau.

<sup>13</sup> Haughwout et al (2011) use a similar procedure to identify refinancings.

<sup>14</sup> The new mortgage must further have a balance that is at least 90% that of the old mortgage just before termination; we also allow the refinancing mortgage to be a second mortgage in case the legal environment affects how the bureaus code the mortgages. We tested this algorithm out-of-sample on mortgage originations in LPS (for which there is a refinancing flag) and found that it identifies approximately 80% of all refinancings at origination. Conversely, we correctly identify about 75% of all purchase loans at origination.

order to create a more uniform dataset, we also restrict attention to prime, owner-occupied conventional first mortgages, with balances greater than \$100,000, and to “primary” Equifax panel members (for whom data are available in every quarter).<sup>15</sup> Table 2 summarizes the matched database along a number of dimensions. It also provides the same statistics for a random sample of mortgages from the LPS data that were not matched to the FRBNY/Equifax data, to help gauge whether the matching procedure biases the sample in any way.

The comparison between mortgage refinancings in easy and not-easy states drives the identification in the empirical tests. To document how the mortgages themselves compare, Table 3 separates the matched sample into easy vs. not-easy states and reports borrower and mortgage characteristics, and local conditions, in each. The columns show some small differences, with different and potentially offsetting implications for the likelihood of refinance. The easy states show slightly more fixed-rate, fewer jumbo and fewer second mortgages, which all support more refinancing, as does the lower unemployment rate, but they also show newer mortgages, higher CLTV and lower scores, which support less refinancing. That the net effect on refinancing in the easy states is negative is suggested by the realized rate of refinancing in 2009, 11% in the easy states vs. 13% in the others. We control for all of these covariates in our estimations.

#### **4. An Illustrative Model of Refinancing**

We now present a simple model to illustrate how the effect of subrogation law varies across CLTV regions. Assume that a homeowner has a first and second mortgage, with balances  $F_1$  and  $F_2$  and gross interest rates  $R_1$  and  $R_2$ , respectively, and that they mature on the same future date. So mortgage  $i$  can be paid down for  $F_i$  today or  $F_i R_i$  at maturity. Assume also that the

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<sup>15</sup> See Lee and van der Klaauw (2010) for further detail on the FRBNY/Equifax Consumer Credit Panel.

home's market value is currently  $V_0$  and that its value at maturity will be  $V = V_0 + \varepsilon$ , where  $\varepsilon$  is a random variable, and furthermore that the homeowner's valuation is and will be identical to the market valuation, which implies that the home goes into foreclosure on the future date if the combined repayment exceeds the market valuation. Assume finally that if a home goes into foreclosure, any current lender suffers a cost  $c$  in addition to any losses from recoveries falling short of the balance owed. This cost represents both labor and legal costs and any regulatory attention attracted by the loan's failure.

Suppose a new lender enters this economy, one willing to lend to refinance one or both mortgages at a lower rate, provided he at least breaks even in expectation. As we show in Appendix A, the effect of the subrogation regime on this potential refinancing is in one parameter region, the region where the lender would earn an expected profit from refinancing the first mortgage at its current rate  $R_1$  (assuming the second mortgagee allows it), but an expected loss from refinancing both mortgages at their collective current rate  $(F_1R_1+F_2R_2)/(F_1+F_2)$ . In this region, the only gains from trade are from refinancing just the first mortgage, with the second mortgagee's cooperation.

Figure 4 presents the solution to this model, where we assume for illustration that  $(F_1, R_1, R_2, V_0, c) = (80, 1.10, 1.12, 150, 10)$ , and that  $\varepsilon$  follows a normal distribution with a mean of 0 and standard deviation of 50. On the horizontal axis,  $F_2$  ranges from 10 to 100 to capture the effect of rising CLTV, while the vertical axis shows the lender's maximum possible expected return, i.e. the expected return from refinancing the existing mortgages at their current rates, thereby leaving the borrower indifferent to refinancing. When CLTV is low, we see that refinancing either the first mortgage or both at current rates is profitable, so the first mortgage will be refinanced, one way or another. When CLTV is in the middle, refinancing only the first mortgage is profitable, so this is the region where the second's cooperation, if the law requires it,

adds value. When CLTV is high, neither refinancing is profitable, so the first mortgage will not be refinanced, with or without cooperation. The figure illustrates the dynamics defining the middle range: The line representing the first mortgage hits zero at a higher CLTV than does the line representing both, since the former bends down due to the rising expected foreclosure cost, whereas the latter bends down due to *both* the rising expected foreclosure cost *and* the falling expected recovery, and thus hits zero sooner.

The model is too stylized to identify the lower and upper bounds of CLTV where subrogation laws would matter, but it does provide some intuition: The lower bound reflects the recovery and foreclosure risks of the combined mortgages, and the upper bound reflects just the foreclosure risk, given the prevailing uncertainty over future house prices. Such uncertainty was high in our sample period, so we set the lower bound a little below the standard 80% cutoff, at 75%, and the upper bound close to zero home equity at 95%, although as a robustness check we also consider other bounds.

## 5. Empirical Tests

To motivate our analysis, we begin by presenting the incidence of refinancing in 2009 in Table 4, sorted by the presence of a second mortgage and by CLTV range. This table gives a sense of the relevant three-way interaction, i.e., whether residing in an easy state makes refinancing more likely when there is a second mortgage and the CLTV ratio is in the middle range.

The table shows an interaction in the predicted direction. In the low and high CLTV ranges, there is little marginal impact from being in an easy state on the effect of a second mortgage on the likelihood of refinancing. That is, in the low range, the presence of a second

mortgage associates with a 0.53 percentage point higher probability of refinancing in the not-easy states and 0.89 percentage point higher in the easy states. Similarly, in the high CLTV range, it associates with a 1.16 percentage point decrease in the refinancing probability in not-easy states and a 0.41 percentage point decrease in the easy states. By contrast, in the middle CLTV range, the effect of being in an easy state on the impact of a second mortgage on refinancing is strongly positive (2.1%), whereas in the not-easy states it is actually slightly negative.

For a formal hypothesis test, we specify a logit model.<sup>16</sup> Each observation is a homeowner with a first mortgage and the dependent variable indicates whether the homeowner's first mortgage was refinanced in 2009. More formally, for homeowner  $i$ , let  $D_{ij}$  be a dummy variable indicating whether homeowner  $i$  lives in state  $j$ .  $Easy_j$  is a dummy variable taking the value 1 if state  $j$  is an "easy" state that facilitates equitable subrogation, i.e., one listed as having adopted the Restatement in Table 1, and 0 otherwise. So  $Easy_j \cdot D_{ij} = 1$  if borrower  $i$  lives in an easy state and 0 otherwise.  $2_i$  is equal to 1 if the homeowner also has a second mortgage. Recall that the homeowner's combined CLTV can be in the low, medium, or high region. Let  $CLTV_{L,i}$  be a dummy variable indicating whether homeowner  $i$  falls in the low CLTV region,  $CLTV_{M,i}$  whether he falls in the medium CLTV region, and  $CLTV_{H,i}$  the high CLTV region.  $X_i$  is a vector of other characteristics (for example, credit score, interest rate, etc., as described below). Since there are potentially other cross-state variations that could affect the likelihood of refinancing (including, for example, other state laws), we include state fixed effects in each regression, and also interact these with the other variables in some of our regressions.

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<sup>16</sup> We obtain similar results with a Probit regression.

Then under the most general logit model, the probability of homeowner  $i$  refinancing satisfies:  $\Pr(\text{refinance}) = \frac{e^Z}{1+e^Z}$ , where

$$\begin{aligned}
Z = & \sum_j [(CLTV_{L,i}\beta_{Easy \times CLTV,L} + CLTV_{M,i}\beta_{Easy \times CLTV,M} + CLTV_{H,i}\beta_{Easy \times CLTV,H}) \\
& + 2_i(CLTV_{L,i}\beta_{Easy \times 2 \times CLTV,L} + CLTV_{M,i}\beta_{Easy \times 2 \times CLTV,M} \\
& + CLTV_{H,i}\beta_{Easy \times 2 \times CLTV,H})] \cdot Easy_j \cdot D_{ij} \\
& + \sum_j [X_i\beta_{X \times j} + (CLTV_{L,i}\beta_{CLTV,L \times j} + CLTV_{M,i}\beta_{CLTV,M \times j} + CLTV_{H,i}\beta_{CLTV,H \times j}) \\
& + 2_i(CLTV_{L,i}\beta_{2 \times CLTV,L \times j} + CLTV_{M,i}\beta_{2 \times CLTV,M \times j} + CLTV_{H,i}\beta_{2 \times CLTV,H \times j})] \cdot D_{ij}
\end{aligned}$$

Here, the coefficients  $\beta_{Easy \times CLTV,M}$ , etc. capture the incremental effect of the law being “easy”. We wish to estimate

$$\delta_M = \beta_{Easy \times 2 \times CLTV,M} - \beta_{Easy \times 2 \times CLTV,L}$$

$$\delta_H = \beta_{Easy \times 2 \times CLTV,H} - \beta_{Easy \times 2 \times CLTV,L}$$

which together give the marginal effect of moving from the low CLTV region to the middle/high region, for borrowers who both have a second mortgage and live in an easy subrogation state. Observe that, under this general model, we allow every covariate to interact with the state fixed effects  $D_{ij}$ .

Since the subrogation law varies only at the state level, however, the above regression is not identified without further assumptions. For example,  $\beta_{Easy \times CLTV,M}$  cannot be separately estimated from  $\beta_{CLTV,M \times j}$ . We make the identifying assumption that if all states were “not easy,” then the effect of an increase in the CLTV on the incremental effect of a second mortgage on

refinancing would be constant across states. That is, other types of state-level variation (foreclosure procedures, mortgage-market competition, unemployment, etc.) may influence the effect of CLTV or the effect of second mortgages on refinancing, but only subrogation law influences the effect of their interaction. As motivated above, this is exactly the margin where one would expect subrogation law in particular to have an effect.

Formally, we assume that there exist  $\gamma_{CLTV,M}$  and  $\gamma_{CLTV,H}$  such that for all states  $j$ ,

$$\beta_{2 \times CLTV, M \times j} - \beta_{2 \times CLTV, L \times j} = \gamma_{CLTV, M}$$

$$\beta_{2 \times CLTV, H \times j} - \beta_{2 \times CLTV, L \times j} = \gamma_{CLTV, H}$$

Then we define

$$\gamma_{CLTV, L \times j} = \beta_{Easy \times CLTV, L} \cdot Easy_j + \beta_{CLTV, L \times j}$$

$$\gamma_{CLTV, M \times j} = \beta_{Easy \times CLTV, M} \cdot Easy_j + \beta_{CLTV, M \times j}$$

$$\gamma_{CLTV, H \times j} = \beta_{Easy \times CLTV, H} \cdot Easy_j + \beta_{CLTV, H \times j}$$

so that, under the identifying restrictions, the expression for  $Z$  becomes (see Appendix B for details):

$$\begin{aligned} Z = & 2_i \cdot (CLTV_{M,i} \cdot \gamma_{2 \times CLTV, M} + CLTV_{H,i} \cdot \gamma_{2 \times CLTV, H}) \\ & + \sum_j [2_i \cdot (CLTV_{M,i} \cdot \delta_M + CLTV_{H,i} \cdot \delta_H)] \cdot Easy_j \cdot D_{ij} \\ & + \sum_j [X_i \beta_{X \times j} + (CLTV_{L,i} \gamma_{CLTV, L \times j} + CLTV_{M,i} \gamma_{CLTV, M \times j} + CLTV_{H,i} \gamma_{CLTV, H \times j}) \\ & + 2_i \cdot \gamma_{2,j}] \cdot D_{ij} \end{aligned}$$

This last regression model, which we denote model A, is fully identified.



The illustrative model predicts that the marginal effect of the subrogation law should be apparent only in the middle CLTV region. So in terms of the notation, the first hypothesis is:

*Hypothesis 1:*  $\delta_M$  is significantly greater than zero.

And we also have:

*Hypothesis 2:*  $\delta_H$  is zero.

Another implication of the theoretical model is that the subrogation law should not affect the probability of refinancing in the low CLTV region, as borrowers in this region could replace both mortgages with a new first mortgage. Thus, we have:

*Hypothesis 3:*  $\beta_{Easy \times 2 \times CLTV, L} = 0$ .

To identify this coefficient, we add the restriction that for low CLTV borrowers, the only state-level determinant of how a second mortgage affects refinancing is through subrogation law. More formally, we assume that  $\beta_{2 \times CLTV, L \times j}$  is independent of state  $j$  and equals  $\gamma_2$  for all  $j$ . Under this identifying restriction,  $\gamma_{2,j} = \gamma_2 + \beta_{Easy \times 2 \times CLTV, L} \cdot Easy_j$ , and we obtain model B:

$$\begin{aligned}
Z = & 2_i \cdot (\gamma_2 + CLTV_{M,i} \cdot \gamma_{2 \times CLTV, M} + CLTV_{H,i} \cdot \gamma_{2 \times CLTV, H}) \\
& + \sum_j [2_i \cdot (\beta_{Easy \times 2 \times CLTV, L} CLTV_{L,i} + CLTV_{M,i} \cdot \delta_M + CLTV_{H,i} \cdot \delta_H)] \cdot Easy_j \cdot D_{ij} \\
& + \sum_j [X_i \beta_{X \times j} + (CLTV_{L,i} \gamma_{CLTV, L \times j} + CLTV_{M,i} \gamma_{CLTV, M \times j} + CLTV_{H,i} \gamma_{CLTV, H \times j})] \\
& \cdot D_{ij}
\end{aligned}$$

To identify the influences of the standard mortgage-related variables likely to affect refinancing, we also estimate models where we assume that these covariates all affect

refinancing in the same way across states, i.e. that  $\beta_{X \times j} = \beta_X$  for all  $j$ . When we apply this restriction to model A, we obtain model C, and when we apply it to model B, we obtain model D. The hypotheses testable on models A and B are also testable on C and D, respectively.

Regarding the other independent variables, they include standard mortgage and borrower characteristics from the LPS dataset (e.g., initial LTV, FICO score and term) observed at origination. We control for several other likely influences on refinancing, all dated December 2008: the county-level unemployment rate (from the BLS), the current mortgage interest rate (from LPS), the updated Equifax credit score (from the bureau data), the vintage year of the mortgage, the fixed period of a fixed/floating mortgage, the current coupon and loan amount, the type of investor holding the mortgage, and whether it qualified, as of 12/08, as a Jumbo mortgage.

Finally, we also estimate model E, which includes state fixed-effects, but leaves out all their interactions with the other covariates. This allows us to also estimate the impact of CLTV on the incidence of refinancing.

We now estimate the logit models. The results are in Panel A of Table 5.

First consider the three-way interactions between the CLTV category, the second mortgage indicator, and easy subrogation laws that are at the heart of our analysis. For each model, our estimates are consistent with the predictions. The interaction  $\delta_M$  with the middle CLTV region is positive and statistically significant, as predicted by Hypothesis 1, while the interaction  $\delta_H$  with the high CLTV region is statistically insignificantly different from zero, consistent with Hypothesis 2. This shows that the impact of subrogation law on borrowers with second mortgages is indeed concentrated on borrowers in the middle CLTV ranges. Finally, the three-way interaction  $\beta_{2 \times Easy \times CLTV, L}$  captures the effect of subrogation law on borrowers with

second mortgages in the low CLTV region. This coefficient is identified in models B, D and E and is statistically insignificantly different from zero in each case, consistent with Hypothesis 3.

To help interpret these results, in Panel B of this table we use the Panel A interaction results for model E to compute the marginal effect of a second mortgage on the probability of refinancing for each combination of CLTV region and state-law regime. Note that it is only in the middle CLTV region that there is a significant difference in the impact of a having a second mortgage between the easy and not-easy states: In the easy subrogation states, borrowers with second mortgages are 3.0 percentage points more likely to refinance in 2009, whereas in the not-easy states the marginal effect of a second mortgage on the refinancing probability is only 1.8 percentage points. The  $3.0\% - 1.8\% = 1.2\%$  difference is a 10% increase in the probability of refinancing, relative to the average refinancing probability for 2009, in Table 2, of 12%.

In addition, the uninteracted second-mortgage indicator and the coefficients capturing the effect of CLTV also have the expected signs. Higher CLTV ranges associate with a lower refinancing probability, relative to the omitted category of  $CLTV < 75\%$  (this coefficient is identified only in model E, the one with no state-fixed-effect interactions). Borrowers with second mortgages refinance more than those without, potentially to roll both mortgages into a single, new loan (this coefficient is only identified under the additional restrictions of models B, D and E).

Finally, we can see from the results for models C, D and E that the other variables capturing the benefit of refinancing to the homeowner have the expected signs.<sup>17</sup> Loans with higher interest rates are more likely to be refinanced, as are mortgages with larger balances. Fixed-rate loans, as well as ARMs with long fixed periods, are more likely to be refinanced than

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<sup>17</sup> See Elul (2012) for further discussion of the determinants of refinancing and how they have changed over time.

ARMs with short fixed-rate periods. Other explanatory variables generally enter as expected: borrowers with higher credit scores (either the FICO score at origination or the Equifax score as updated in December 2008) are more likely to be refinanced, and subprime loans are less likely to be refinanced, as are higher-LTV loans.<sup>18</sup> Loans with balances above the conforming loan limit as of December 2008 (i.e., \$417,000) are less likely to be refinanced, reflecting the tighter underwriting conditions since the financial crisis began. Loans with prepayment penalties are also less likely to be refinanced. Finally, portfolio loans and private securitized loans are refinanced less often, intuitively because these borrowers are less likely to meet conventional underwriting criteria.

To check the robustness of these results to the boundaries of the CLTV regions and to the interpretation of the legal regimes, we run some alternate specifications. Regarding the boundaries, the theoretical model does not dictate the precise bounds of the middle-CLTV region where subrogation law would matter, so to run the test we choose 75% and 95%. To gauge the robustness of the result to this choice, we re-run the test with a range of lower and upper bounds. Panel A of Table 6 shows the results from varying the lower bound from 70 to 80, and the upper bound from 90 to 100, where for brevity we report only the key statistic, i.e. the coefficient on the triple difference in the middle CLTV region, and its statistical significance. The results show statistical significance with eight of the nine alternate choices. Regarding the legal regimes, Panel B of Table 6 drops ten states (CO, DE, HI, MI, MT, OH, RI, SD, VT, WV) where the distinction between easy and not easy is cloudy because there is no case law, the law is unclear, or the cases are “conflicting.” As the result shows, this alteration also had little effect on our results.

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<sup>18</sup> In addition, 40-year mortgages are less likely to be refinanced, as these loans were typically taken out by riskier, liquidity-constrained borrowers. By contrast, 30-year mortgages are more likely to refinance (relative to the omitted category, 15-year) reflecting the borrower benefit.

## 6. Summary and Conclusion

This paper addresses the conflicting legal principles at stake when a homeowner wishes to refinance the senior of multiple mortgages. It does so by relating the incidence of refinancing to both the cross section of state legal environments and mortgage circumstances. The key finding is that those states that resolve the conflict by allowing the second mortgage to block the refinancing show significantly less such refinancing. The economic significance of this result is heightened by today's historically low rates, and by the fragile state of the housing market.

The test results identify a negative effect of time priority, and also identify the remedy. States can prevent second lien holders from blocking refinancings that don't impair them by adopting the principle of equitable subrogation. This adoption has already begun. If mortgage lenders value this blocking power, they might respond to adoption with higher rates: first-mortgage lenders, because they lose when homeowners gain from refinancing, and second-mortgage lenders, because they get rents from blocking. Whether these effects on origination are near the order of magnitude of the effects upon refinancing that we identify is an interesting area for future research.

There has been widespread recent concern that borrowers and mortgage lenders fail to implement mutually beneficial mortgage modifications,<sup>19</sup> a failure that implies inefficient renegotiation. The related literature has focused on modifications of loans that are already severely distressed, but the results here indicate inefficient renegotiation even when the loans are performing and above water. The inefficiency arises from the initial distribution of rights, as assigned by state law. So while market participants are free to contract around this distribution

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<sup>19</sup> See Piskorski, Seru and Vig (2010), Adelino, Gerardi and Willen (2009), and Agarwal, et al. (2011a) on securitization and the efficiency of mortgage modifications. See also Kroszner (2008) for evidence on the existence of mutually beneficial loan modifications in a different context.

with resubordination agreements, and many do, the barriers they face are often too high. Consequently, our results provide further evidence that laws affect financial outcomes: see, e.g., La Porta et al (1998), and others. Which barriers are the most important, whether this reflects intentional rent-seeking by the second mortgagees, and the best mechanisms by which to enhance the efficiency of the refinancing outcome, are important questions for future research.

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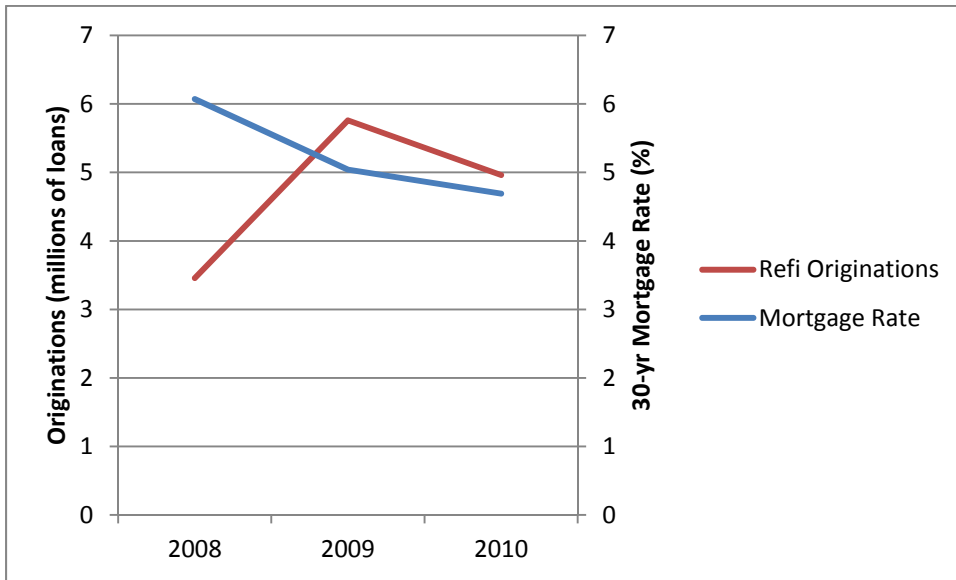
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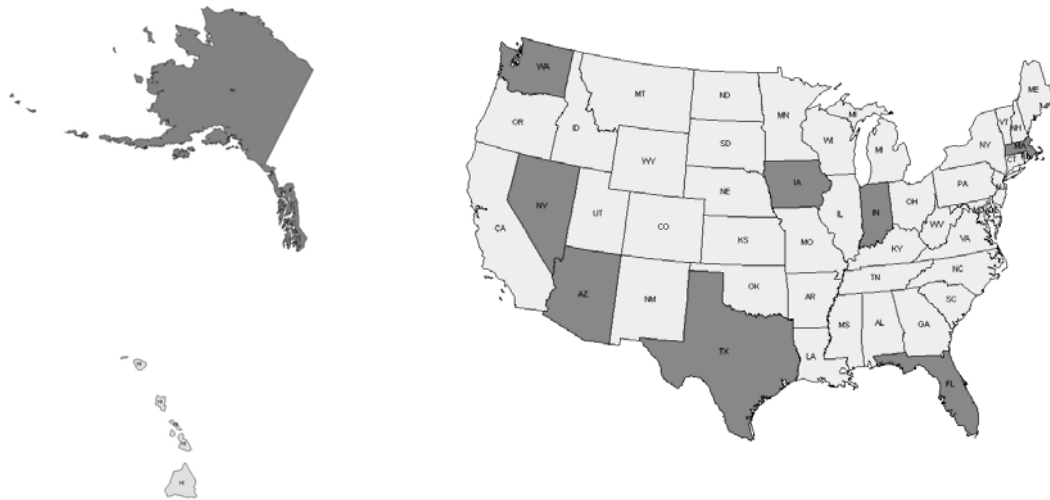
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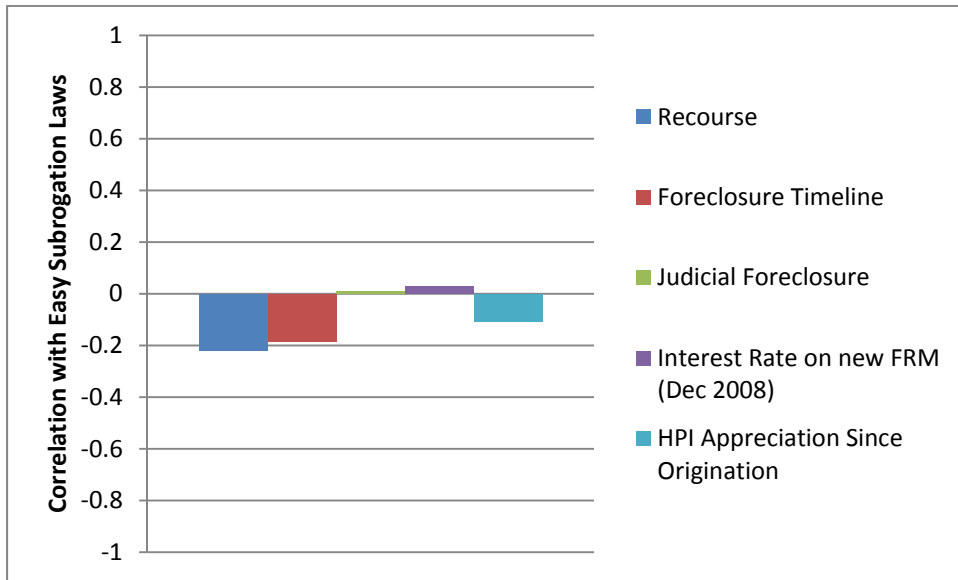


**Figure 1. Mortgage rates and new refinancings, 2008-10.** The refinancing originations are from the HMDA data, and the mortgage rates are the 30-year mortgage rates from the FHLMC primary mortgage market survey.

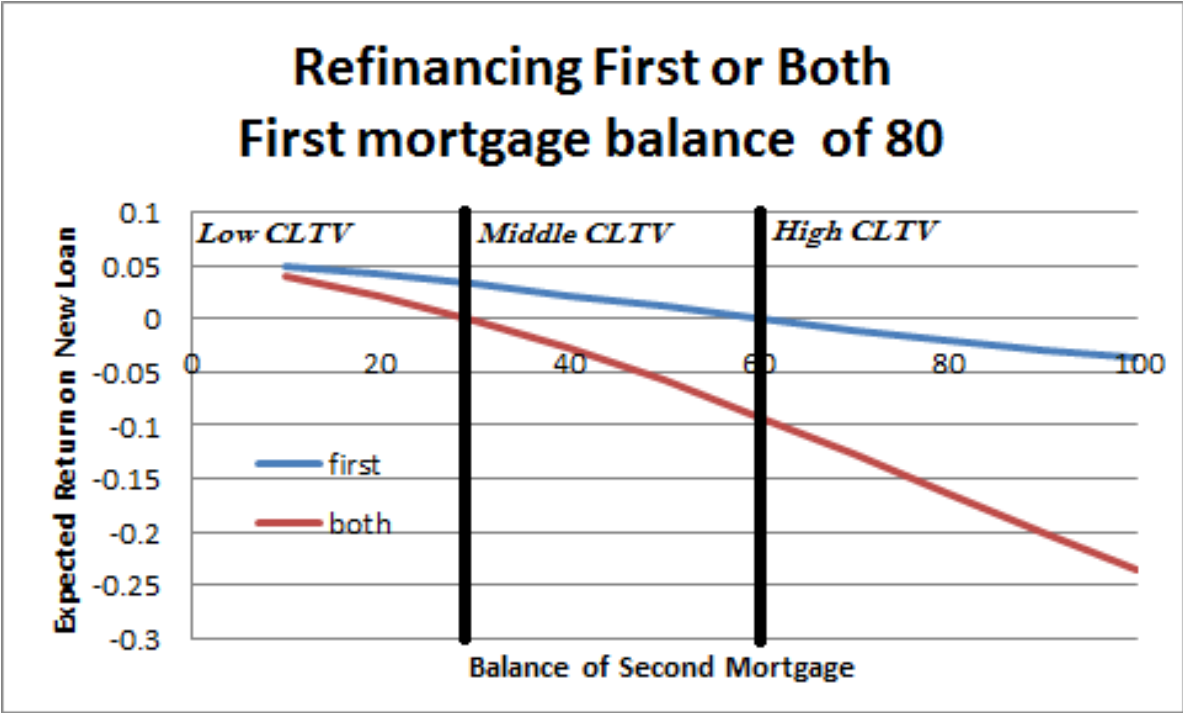
# States With Easy Subrogation Laws



**Figure 2. Geographic Distribution of Easy Subrogation States.** Easy Subrogation states are dark grey; Not-easy states are light grey.



**Figure 3. Correlation of easy subrogation laws with other state-level factors.** The figure plots the correlation of easy subrogation laws with other state laws affecting mortgages, and also with state-level average interest rates and HPI appreciation. The state laws are from Ghent and Kudlyak (2011). The interest rates are for fixed-rate mortgages originated in the LPS dataset in December 2008. The HPI appreciation is from our matched dataset.



**Figure 4. Model of mortgage refinancing: Numerical Example.** The figure assumes a first mortgage with interest rate 10% and balance 80, a second mortgage with interest rate 12% and the balance indicated on the horizontal axis, a home whose future value has mean 150 and standard deviation 50, and a cost of foreclosure, as experienced by any current lender, of 10.

**Table 1****Cross Section of State Law Pertaining to Subrogation of Mortgages**

This table was compiled by Dale Whitman and was current as of September 17, 2008. The following notes were included with the table: "Restatement" indicates the court would grant subrogation even if the refinancing lender had actual knowledge of the intervening lien. "Yes if constructive notice, no if actual knowledge" indicates the court would grant subrogation if the refinancing lender had only constructive notice from the recording of the intervening lien but would not do so if the refinancing lender had actual knowledge of it. "No if actual or constructive notice" indicates that the court would not grant subrogation if the refinancing lender had either actual knowledge of the intervening lien or constructive notice from the recording of the intervening lien. The rightmost column indicates how the laws were coded for our analysis: an easy subrogation state is indicated by "E" and not-easy by "NE".

State	Legal position	Controlling case	Notes and comments	Our Coding
Alabama (AL)	Yes if constructive notice, no if actual knowledge.	In re Hubbard, 89 B.R. 920 (Bankr.N.D.Ala.1988)		NE
Alaska (AK)	Restatement	Rush v. Alaska Mortg. Group, 937 P.2d 647 (Alaska 1997)	Technically not a subrogation case, since prior lender and refinancing lender were the same.	E
Arizona (AZ)	Restatement	Lamb Excavation, Inc. v. Chase Manhattan Mortgage Corp., 95 P.3d 542 (Ariz.App.2004)		E
Arkansas (AR)	Yes if constructive notice, no if actual knowledge.	United States v. Hughes, 499 F.2d 322 (8th Cir.1974)		NE
California (CA)	Yes if constructive notice, no if actual knowledge.	Lawyers Title Ins. Corp. v. Feldsher, 42 Cal.App.4th 41, 49 Cal.Rptr.2d 542 (1996)		NE
Colorado (CO)	Restatement (?)	Hicks v. Londre, 125 P.3d 452 (Colo. 2005); AmeriquestMortg. Co. v. Land Title Ins. Corp., 2007 WL 2128203 (Colo.App. 2007).	Ct indicated it might not grant subrog under Rest. to a sophisticated commercial lender	NE
Connecticut (CT)	No if actual or constructive notice	Independence One Mortg. Corp. v. Katsaros, 43 Conn.App. 71, 681 A.2d 1005 (1996)		NE
Delaware (DE)	Unclear; probably yes if constr. Notice, no if actual knowledge	Stoeckle v. Rosenheim, 10 Del.Ch. 195, 87 A. 1006 (Del.Ch. 1913)		NE
Dist. Of Columbia (DC)	Restatement (?)	Eastern Savings Bank, FSB, v. Pappas, 829 A.2d 953 (D.C.2003);	The ct. cited Rest. favorably but did not decide whether to follow the Rest. in an actual knowledge case, as there was none here.	E
Florida (FL)	Restatement	Suntrust Bank v. Riverside Nat'l Bank of Florida, 792 So.2d 1222 (Fla. App.2001)	Technically not a subrogation case, since prior lender and refinancing lender were the same.	E

Georgia (GA)	Not if actual or constructive notice	McCollum v. Lark, 187 Ga. 292, 200 S.E. 276 Ga. 1938		NE
Hawaii (HI)	Unclear; court's analysis is too cursory.	Strouss v. Simmons, 66 Haw. 32, 657 P.2d 1004 (Hawaii,1982)		NE
Idaho (ID)	Yes if constructive notice, no if actual knowledge.	Metropolitan Life Ins. Co. v. First Security Bank, 94 Idaho 489, 491 P.2d 1261 (1971)		NE
Illinois (IL)	No if actual or constructive notice	Mortgage Electronics Registration Systems, Inc. v. Phylactos, 2005 U.S. Dist. LEXIS 6295 (N.D. Ill. 3/30/05)	But Illinois has been extremely liberal in finding an agreement, leading to "conventional subrogation."	NE
Indiana (IN)	Restatement	Bank of New York v. Nally, 820 N.E.2d 644 (Ind.2005)		E
Iowa (IA)	Restatement	Klotz v. Klotz, 440 N.W.2d 406 (Iowa App.1989)		E
Kansas (KS)	No if actual or constructive notice	National City Mortg. Co. v. Ross, 117 P.3d 880 (Kan.App.2005)		NE
Kentucky (KY)	Unclear (but it is clear that court would not allow subrog. if refi lender had actual knowledge)	Minix v. Maggard, 652 S.W.2d 93 (Ky.App.1983)		NE
Louisiana (LA)	No subrogation in favor of a refinancing mortgagee	Pelican Homestead Ass'n v. Security First Nat. Bank, 532 So.2d 397 (La.App.1988)	Louisiana will not grant subrogation if the old first mortgage has been discharged of record.	NE
Maine (ME)	Yes if constructive notice, no if actual knowledge.	United Carolina Bank v. Beesley, 663 A.2d 574 (Me.1995)		NE
Maryland (MD)	Yes if constructive notice, no if actual knowledge.	Citibank Federal Savings Bank. v. New Plan Realty Trust, 748 A.2d 24 (Md.App.2000)		NE
Massachusetts (MA)	Restatement	East Boston Sav. Bank v. Ogan, 428 Mass. 327, 701 N.E.2d 331 (1998)		E
Michigan (MI)	No subrog.in absence of fraud, mistake, or misconduct by the lender being subordinated.	AmeriquetMortg. Co. v. Alton, 271 Mich.App. 660 (Mich.App.2006)	The Michigan cases are a conflicting mess. Other recent MI cases reject Restatement; see Washington Mut. Bank v. ShoreBank Corp., 703 N.W.2d 486 (Mich.App.2005). No Sup.Ct. case.	NE
Minnesota (MN)	No if actual or constructive notice	Ripley v. Piehl, 700 N.W.2d 540 (Minn.App.2005) (based on much older Sup.Ct. cases.)		NE
Mississippi (MS)	Yes if constructive notice, no if actual knowledge.	Home Owners' Loan Corporation v. Moore, 185 So. 253 (Miss.1939)		NE

Missouri (MO)	No if actual or constructive notice	184 Miss. 283, 185 So. 253		NE
Montana (MT)	No case law	Miss. 1939.		NE
Nebraska (NE)		American National Bank v. Clark, 660 N.W.2d 530 (Neb.App.2003)	Ostensibly based on "conventional subrogation."	NE
Nevada (NV)	Restatement	Houston v. Bank of America, 78 P.3d 71 (Nev.2003)		E
New Hampshire (NH)	Unclear; probably yes if constr. notice, no if actual knowledge	Hammond v. Barker, 61 N.H. 53, 1881 WL 4658 (N.H. 1881)	No modern case law.	NE
New Jersey (NJ)	Yes if constructive notice, no if actual knowledge.	First Union National Bank v. Nelkin, 808 A.2d 856 (N.J. Super. App. Div. 2002)		NE
New Mexico (NM)	Yes if constructive notice, no if actual knowledge.	In re Beltramo, 367 B.R. 825, 2007 WL 1307917 (Bkrcty.D.N.M.2007)	A bankruptcy court predicting NM law.	NE
New York (NY)	Yes if constructive notice, no if actual knowledge.	Gerenstein v. Williams, 23 N.Y.S.2d 257 (N.Y. App.Div.2001)		NE
North Carolina (NC)	No if actual or constructive notice	First Union Nat'l Bank v. Lindley Laboratories, Inc., 510 S.E.2d 187 (N.C.App.1999)		NE
North Dakota (ND)				NE
Ohio (OH)	Unclear	First Union Nat. Bank v. Harmon, 2002 WL 1980705 (Ohio App.2002) follows Rest.; contra, see IndyMac Bank v. Bridges, --- N.E.2d ----, 2006 WL 3095774 (Ohio App. 2006); Washington Mut. Bank, FA v. Aultman, 876 N.E.2d 617 (Ohio App.2007)	Unclear whether actual knowledge by lender would have denied subrogation.	NE
Oklahoma (OK)	Yes if constructive notice, no if actual knowledge.	Mortgage Electronic Registration Systems, Inc. v. U.S. ex rel. Internal Revenue Service, 134 P.3d 913 (Okla.Civ.App.2006)	Remanded for determination as to whether refinancing mortgagee exercised due diligence in determining existence of intervening lien.	NE
Oregon (OR)	Yes if constructive notice, no if actual knowledge.	Rusher v. Bunker, 99 Or.App. 303, 782 P.2d 170 (Or.App.1989); Dimeo v. Gesik, 993 P.2d 183 (Or.App.1999)	In Dimeo, ct remanded for finding as to whether lender's reliance on erroneous final title report was negligent.	NE
Pennsylvania (PA)	No subrogation in favor of a refinancing mortgagee	1313466 Ontario, Inc. v. Carr, 954 A.2d 1 (Pa.Super.2008)	The Superior Ct. likes the Rest. but can't adopt it because of old precedent, which treats all refi lenders as "volunteers."	NE

Rhode Island (RI)	No case law			NE
South Carolina (SC)	Yes if constructive notice, no if actual knowledge.	Pee Dee State Bank v. Prosser, 367 S.E.2d 708 (S.C. 1988)		NE
South Dakota (SD)				NE
Tennessee (TN)	Apparently no subrog.in absence of fraud or mistake by the lender being subordinated	Bankers Trust Co. v. Collins, 124 S.W.3d 576 (Tenn.Ct.App.2003)		NE
Texas (TX)	Restatement	Farm Credit Bank v. Ogden, 886 S.W.2d 305 (Tex.App.1994)	There are several earlier Texas cases taking the same view as early as 1969.	E
Utah (UT)	No if actual or constructive notice	Richards v. Security Pacific Nat. Bank, 849 P.2d 606 (Utah App.1993)		NE
Vermont (VT)	Unclear	No modern cases		NE
Virginia (VA)	No if actual or constructive notice	Centreville Car Care, Inc. v. North American Mortg. Co., 559 S.E.2d 870 (Va.2002)		NE
Washington (WA)	Restatement	Bank of America v. Prestance Corp., 2007 WL 1631420 (Wash. 2007)		E
West Virginia (WV)	No case law			NE
Wisconsin (WI)	Yes if constructive notice, no if actual knowledge.	Pierner v. Computer Resources & Technology, Inc., 577 N.W.2d 388 (Wis.App.1998)(unpub); Ocwen Loan Servicing, LLC v. Williams, 305 Wis.2d 772, 741 N.W.2d 474 (Wis.App.2007)	The <i>Pierner</i> court does not discuss the effect of actual knowledge, as there was none. The opinion is very liberal, and the ct. may yet adopt the Rest.	NE
Wyoming (WY)	Yes if constructive notice, no if actual knowledge.	Countrywide Home Loans, Inc. v. First Nat'l Bank of Steamboat Springs, 144 P.3d 1224 (Wyo.2006)		NE



**Table 2**  
**Data Description and Comparison with Unmatched Sample**

The column labeled “Matched Sample Mean” characterizes the mortgages in the sample resulting from the match of LPS data with FRBNY/Equifax data. The column labeled “Unmatched Sample Mean” characterizes a random sample of mortgages drawn from the LPS data, but not matched to the FRBNY/Equifax data.

<u>Variable</u>	<u>Matched Sample Mean</u>	<u>Unmatched Sample Mean</u>
Refinanced in 2009	0.12	
Easy Subrogation State	0.24	0.25
<b><u>First Mortgage Characteristics (at Orig.)</u></b>		
FICO Score @ Origination	722	725
Loan Amt.	\$246,692	\$251,736
LTV @ Orig.	73.34	72.13
First Mortgage Origination Yr.		
	2003	0.12
	2004	0.15
	2005	0.22
	2006	0.20
	2007	0.31
Fixed rate	0.85	0.82
ARM		
24-mon. fixed period	0.00	0.01
36-mon.	0.01	0.01
60-mon.	0.08	0.10
84-mon.	0.03	0.03
120-mon.	0.03	0.03
Term		
180-mon	0.09	0.09
360-mon.	0.90	0.90
480-mon.	0.01	0.01
"Investor"		
Portfolio	0.07	0.07
GSE	0.75	0.75
Private Securit.	0.18	0.18
<b><u>As of Dec 2008</u></b>		
Second Mortgage	0.35	
Second Mortgage Balance (conditional on having a second)	\$50,522	
Combined LTV	85.48	
Cty Unemp. Rate (%)	7.00	7.09
First Mortgage Int. Rate (%)	6.02	6.03
Updated Equifax Risk Score	741	
Jumbo Principal Bal. on 1st (Dec. 2008)	0.10	

**Table 3**  
**Mortgage Statistics: Easy vs. Not-Easy States**

The column labeled “Not-Easy State” reports the average for the portion of the matched sample representing mortgages of properties in not-easy states, as defined in the text. The column “Easy State” addresses the easy states.

		<b>Not- Easy State</b>	<b>Easy State</b>
Refinanced		0.13	0.11
FICO @ Orig.		722	719
LTV @ Orig.		72.92	75.31
Prepayment Penalty		0.04	0.04
Origination Year	2003	0.12	0.11
	2004	0.15	0.14
	2005	0.22	0.22
	2006	0.20	0.21
	2007	0.30	0.32
FRM		0.84	0.87
ARM fixed period (months)	24	0.00	0.00
	36	0.01	0.01
	60	0.08	0.07
	84	0.03	0.03
	120	0.03	0.02
Term (months)	180	0.09	0.08
	360	0.90	0.91
	480	0.01	0.01
Investor:	GSE	0.75	0.78
	Private Securitization	0.19	0.15
	Portfolio	0.07	0.06
Cty. Unemployment Rate		7.02	6.91
Jumbo		0.11	0.07
Balance (\$)		253,009	228,040
Updated Equifax Risk Score		743	735
Second Mortgage		0.36	0.32
Interest Rate (%)		6.01	6.06
CLTV $\leq$ 75		0.36	0.31
CLTV $\in(75,95]$		0.32	0.31
CLTV $>$ 95		0.32	0.38
N		599,944	187,104

**Table 4**  
**Refinancing Rate by CLTV, State Law, and Second Mortgage (2009)**

This table reports the 2009 refinancing rate for first mortgages in our matched sample that were current and had not terminated as of December 2008. The CLTV includes balances on all mortgages in the borrower's credit bureau file as of December 2008, and the house price is updated using the Corelogic ZIP-code-level house price index, as described above. We split the sample by whether the borrower has a second mortgage in his credit bureau file as of December 2008, and the states are grouped (Easy vs. Not Easy) by whether or not they permit equitable subrogation, i.e. have adopted the restatement.

**Low CLTV Range (CLTV<75)**

	Not Easy	Easy
No Second	16.82%	15.33%
Second	17.35%	16.22%
Second-No Second	0.53%	0.89%

**Middle CLTV Range (75≤CLTV<95)**

	Not Easy	Easy
No Second	13.77%	11.46%
Second	13.46%	13.56%
Second-No Second	-0.31%	2.1%

**High CLTV Range (CLTV≥95)**

	Not Easy	Easy
No Second	8.31%	6.24%
Second	7.15%	5.83%
Second-No Second	-1.16%	-0.41%

**Table 5**  
**Logit Model of Refinancing in 2009**

This table reports the output from a Logit model in which each observation is a residence with a first mortgage and the dependent variable indicates that the first mortgage was refinanced in 2009. There are 601,272 observations, and “\*\*” indicates statistical significance at the 5% level. State fixed effects (and their interactions, depending on the model) are included but not reported. Panel A contains the Logit results, showing coefficients for each model. Panel B uses the Panel A interaction results to report the marginal effect of the presence of a second mortgage on the probability of refinancing for model E.

**Panel A**

<i>Explanatory Variable</i>	<i>Model A</i>		<i>Model B</i>		<i>Model C</i>		<i>Model D</i>		<i>Model E</i>	
	<i>Coef.</i>	<i>SE</i>	<i>Coef.</i>	<i>SE</i>	<i>Coef.</i>	<i>SE</i>	<i>Coef.</i>	<i>SE</i>	<i>Coef.</i>	<i>SE</i>
FICO @ Orig.					0.003**	0.000	0.003**	0.000	0.003**	0.000
12/08 Equifax Score					0.008**	0.000	0.008**	0.000	0.008**	0.000
LTV @ Orig.					-0.003**	0.000	-0.003**	0.000	-0.004**	0.000
Orig. Year:										
2004					0.204**	0.017	0.206**	0.017	0.199**	0.017
2005					0.120**	0.017	0.121**	0.017	0.102**	0.017
2006					0.491**	0.019	0.492**	0.019	0.467**	0.019
2007					0.561**	0.018	0.562**	0.018	0.555**	0.018
Investor:										
Priv. Sec.					-0.252**	0.015	-0.252**	0.015	-0.236**	0.015
Portfolio					-0.444**	0.022	-0.445**	0.022	-0.424**	0.021
ARM fixed period										
2 years					-0.680**	0.121	-0.678**	0.121	-0.730**	0.121
3 years					-0.376**	0.060	-0.376**	0.060	-0.394**	0.060
5 years					0.204**	0.017	0.205**	0.017	0.183**	0.017
7 years					0.251**	0.024	0.252**	0.024	0.232**	0.023
10 years					0.179**	0.025	0.180**	0.025	0.166**	0.024
Term										
30 years					0.171**	0.016	0.170**	0.016	0.193**	0.016
40 years					-0.112*	0.059	-0.115*	0.059	-0.131**	0.059
Prepay Penalty					-0.393**	0.028	-0.391**	0.028	-0.398**	0.028
Coupon (12/08)					0.411**	0.010	0.412**	0.010	0.429**	0.010
ln(loan amt) (12/08)					0.678**	0.013	0.677**	0.013	0.629**	0.012
Jumbo (12/08)					-0.983**	0.021	-0.981**	0.021	-1.004**	0.021
Unemp (12/08)					-0.029**	0.003	-0.029**	0.003	-0.039**	0.003
CLTV $\in$ (75,95]									-0.419**	0.015
CLTV>95									-1.297**	0.023
CLTV $\in$ (75,95]&Easy									-0.055**	0.027
CLTV>95&Easy									-0.042**	0.040
2			0.090**	0.014			0.109**	0.014	0.142**	0.014
CLTV $\in$ (75,95]&2	0.073**	0.022	0.079**	0.022	0.072**	0.022	0.061**	0.022	0.034	0.021
CLTV>95&2	0.120**	0.029	0.118**	0.028	0.137**	0.029	0.121**	0.027	0.147**	0.027
CLTV $\leq$ 75&2&Easy			-0.024	0.034			-0.035	0.033	-0.016	0.033
CLTV $\in$ (75,95]&2&Easy	0.114**	0.051	0.099**	0.038	0.125**	0.050	0.109**	0.036	0.101**	0.036
CLTV>95&2&Easy	0.043	0.063	0.023	0.052	0.048	0.062	0.023	0.050	0.028	0.049

**Panel B**

	<b>Marginal</b>
CLTV $\leq$ 75&Not Easy Subrog.	0.019
CLTV $\leq$ 75&Easy Subrog.	0.017
CLTV $\in$ (75,95]&Not Easy Subrog.	0.018
CLTV $\in$ (75,95]&Easy Subrog.	0.030
CLTV $>$ 95&Not Easy Subrog.	0.016
CLTV $>$ 95&Easy Subrog.	0.018

**Table 6**  
**Robustness**

This table reports the results from model E for differing constructions on some key explanatory variables. In Panel A we report the coefficient on the three-way interaction between the middle CLTV region, the second mortgage indicator, and the easy subrogation state indicator as we vary the cutoff for the low CLTV region from 70 to 75%, and that for the high CLTV region from 9 to 100%. In this panel “\*\*\*” indicates statistical significance at the 1% level, “\*\*” at the 5% level, and “\*” at the 10% level. The sample size and specification are otherwise the same as in Table 5; other coefficients are not reported. In panel B we report the coefficients on the three-way interactions where we drop those ten states which are listed as having ‘no case law’, ‘unclear’ subrogation law, or ‘conflicting’ cases in Table 2 (CO, DE, HI, MI, MT, OH, RI, SD, VT, WV).

**Panel A:**

		Upper Boundary		
		90	95	100
Lower Boundary	70	0.096***	0.093***	0.090***
	75	0.105**	0.101***	0.098***
	80	0.072	0.080*	0.082**

**Panel B:**

	<i>Coeff</i>	<i>SE</i>
CLTV $\leq$ 75&2& Easy	-0.020	0.033
CLTV $\in$ (75,95]&2&Easy	0.100***	0.037
CLTV $>$ 95&2&Easy	0.028	0.050

## Appendix A: Illustrative Model

Because the borrower's valuation is identical to the market valuation, the borrower will repay his mortgage or mortgages in full on the maturity date if the market value  $V$  is greater than the balance due, and will otherwise give up the house to foreclosure. So absent any refinancing, there are three cases:

- If  $V > F_1R_1 + F_2R_2$ , the first and second mortgagees are paid in full.
- If  $F_1R_1 < V < F_1R_1 + F_2R_2$ , the first mortgagee is paid in full, the second mortgagee suffers a recovery loss, and both mortgagees pay the foreclosure cost  $c$ .
- If  $V < F_1R_1$ , the first mortgagee suffers a recovery loss, the second mortgagee is wiped out, and both mortgagees pay the foreclosure cost  $c$ .

The first mortgagee's expected repayment, net of foreclosure costs, which we denote  $E_1$ , is

$$E_1 = Pr(V \geq F_1R_1)F_1R_1 + Pr(V < F_1R_1)E(V | V < F_1R_1) - Pr(V < F_1R_1 + F_2R_2)c$$

For specificity, assume now that  $\varepsilon$  follows a normal distribution with mean 0 and standard deviation  $\sigma$ . Under this assumption,  $E_1$  can be written explicitly as:

$$E_1 = \left(1 - \Phi\left(\frac{F_1R_1 - V}{\sigma}\right)\right)F_1R_1 + \Phi\left(\frac{F_1R_1 - V}{\sigma}\right)\left(V_0 - \frac{\sigma\varphi\left(\frac{F_1R_1 - V}{\sigma}\right)}{\Phi\left(\frac{F_1R_1 - V}{\sigma}\right)}\right) - \Phi\left(\frac{F_1R_1 + F_2R_2 - V}{\sigma}\right)c$$

where  $\Phi$  and  $\varphi$  are the cdf and pdf, respectively, of the Standard Normal distribution. Since the new lender needs only to break even in expectation, it follows that if  $E_1 > F_1$ , there exists an  $R < R_1$  such that the lender would refinance the first mortgage at rate  $R$ , and this would make the borrower better off, since his repayment at maturity would be lower. It would also make the

second mortgagee better off, since the balance senior to him would be lower, and the probability of foreclosure would be lower.

We can similarly determine whether the new lender would refinance both mortgages. Let  $R_B = (F_1R_1 + F_2R_2)/(F_1 + F_2)$ , i.e., the interest rate on both mortgages put together. If the new lender refinanced both mortgages at this rate, the borrower's repayment at maturity would be unchanged, and the new lender's expected repayment, which we denote  $E_B$ , would be

$$E_B = (1 - \Phi\left(\frac{F_1R_1 + F_2R_2 - V_0}{\sigma}\right))(F_1R_1 + F_2R_2) + \Phi\left(\frac{F_1R_1 + F_2R_2 - V_0}{\sigma}\right)\left(V_0 - \frac{\sigma\varphi\left(\frac{F_1R_1 + F_2R_2 - V_0}{\sigma}\right)}{\Phi\left(\frac{F_1R_1 + F_2R_2 - V_0}{\sigma}\right)} - c\right)$$

If  $E_B > F_1 + F_2$ , then there exists an  $R < R_B$  such that the lender would refinance both mortgages at  $R$ , and the borrower would be better off.

Therefore, the lender's maximum possible expected returns from refinancing the first mortgage or refinancing both mortgages are  $E_1/F_1 - 1$  or  $E_B/(F_1 + F_2) - 1$ , respectively. Thus the parameter region where the first mortgage is refinanced if and only if the second mortgage cooperates is where  $E_1 > F_1$  and  $E_B < F_1 + F_2$ . To illustrate this parameter region, Figure 4 plots  $E_1/F_1 - 1$  ("first," the blue line) and  $E_B/(F_1 + F_2) - 1$  ("both," the red line) for the parameter vector indicated in the text.



## Appendix B: Identification

Substituting in for  $\gamma_{CLTV,M}$ ,  $\gamma_{CLTV,H}$ ,  $\delta_M$  and  $\delta_H$ , the argument of the original cdf above becomes

$$\begin{aligned}
& \sum_j (CLTV_{L,i} \cdot \beta_{Easy \times CLTV,L} + CLTV_{M,i} \cdot \beta_{Easy \times CLTV,M} + CLTV_{H,i} \cdot \beta_{Easy \times CLTV,H} \\
& + \mathbf{2}_i \cdot CLTV_{L,i} \cdot \beta_{Easy \times 2 \times CLTV,L} + \mathbf{2}_i \cdot CLTV_{M,i} \cdot \beta_{Easy \times 2 \times CLTV,L} + \mathbf{2}_i \cdot CLTV_{M,i} \cdot \delta_M \\
& + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \beta_{Easy \times 2 \times CLTV,L} + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \delta_H) \cdot Easy_j \cdot D_{ij} \\
& + (X_i \cdot \beta_{X \times j} + CLTV_{L,i} \cdot \beta_{CLTV,L \times j} + CLTV_{M,i} \cdot \beta_{CLTV,M \times j} + CLTV_{H,i} \cdot \beta_{CLTV,H \times j} \\
& + \mathbf{2}_i \cdot CLTV_{L,i} \cdot \beta_{2 \times CLTV,L \times j} + \mathbf{2}_i \cdot CLTV_{M,i} \cdot \beta_{2 \times CLTV,L \times j} + \mathbf{2}_i \cdot CLTV_{M,i} \cdot \gamma_{CLTV,M} \\
& + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \beta_{2 \times CLTV,L \times j} + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \gamma_{CLTV,H}) \cdot D_{ij},
\end{aligned}$$

which using  $CLTV_{L,i} + CLTV_{M,i} + CLTV_{H,i} = 1$  and  $\sum_j D_{ij} = 1$ , equals

$$\begin{aligned}
& \mathbf{2}_i \cdot CLTV_{M,i} \cdot \gamma_{CLTV,M} + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \gamma_{CLTV,H} \\
& + \sum_j (CLTV_{L,i} \cdot \beta_{Easy \times CLTV,L} + CLTV_{M,i} \cdot \beta_{Easy \times CLTV,M} + CLTV_{H,i} \cdot \beta_{Easy \times CLTV,H} \\
& + \mathbf{2}_i \cdot \beta_{Easy \times 2 \times CLTV,L} + \mathbf{2}_i \cdot CLTV_{M,i} \cdot \delta_M + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \delta_H) \cdot Easy_j \cdot D_{ij} \\
& + (X_i \cdot \beta_{X \times j} + CLTV_{L,i} \cdot \beta_{CLTV,L \times j} + CLTV_{M,i} \cdot \beta_{CLTV,M \times j} + CLTV_{H,i} \cdot \beta_{CLTV,H \times j} \\
& + \mathbf{2}_i \cdot \beta_{2 \times CLTV,L \times j}) \cdot D_{ij}.
\end{aligned}$$

Substituting in for  $\gamma_{CLTV,L \times j}$ ,  $\gamma_{CLTV,M \times j}$ ,  $\gamma_{CLTV,H \times j}$  and  $\gamma_{2,j}$ , this simplifies to

$$\begin{aligned}
& \mathbf{2}_i \cdot CLTV_{M,i} \cdot \gamma_{CLTV,M} + \mathbf{2}_i \cdot CLTV_{H,i} \cdot \gamma_{CLTV,H} \\
& + \sum_j [\mathbf{2}_i (CLTV_{M,i} \cdot \delta_M + CLTV_{H,i} \cdot \delta_H)] \cdot Easy_j \cdot D_{ij} \\
& + \sum_j [X_i \beta_{X \times j} + (CLTV_{L,i} \gamma_{CLTV,L \times j} + CLTV_{M,i} \gamma_{CLTV,M \times j} + CLTV_{H,i} \gamma_{CLTV,H \times j}) \\
& + \mathbf{2}_i \cdot \gamma_{2,j}] \cdot D_{ij},
\end{aligned}$$

which coincides with the expression in the text.