Mortgage Put Options and Real Estate Markets

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Abstract In this paper we offer direct evidence that financial intermediation does impact underlying asset markets. We develop a specific observable symptom of a banking system that underprices the put option imbedded in non-recourse asset-backed lending. Using a dataset for 19 countries and over 500 real estate investment trusts, we find that, following a negative demand shock, the “underpricing” economies experience far deeper asset market crashes than economies in which the put option is correctly priced.

Keywords Real estate bubble • Mortgage lending put options • Asian financial crisis

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Introduction

All non-recourse asset-backed mortgage loans contain a put option that allows the borrower, through default, to “sell” the asset to the lender for the outstanding mortgage balance. The default spread compensates the lender for this put option. If correctly priced, the imbedded put option has no impact on asset markets. If, however, the put is underpriced, efficient asset markets incorporate this mistake into