The failure of the mortgage financing industry, a major part of the recent economic crisis, included clear examples markets that broke down due to information failures. There are two markets involved in this story.

The first market is the market for mortgages, loans that allow a borrower to buy a house. In this market banks lend to home buyers. One way to look at this market is to see the bank as the sellers of the funds and mortgagees the buyers. The price is the interest rate charged. A more credit worthy borrower pays a lower rate, a risky borrower a higher rate.

Product: A mortgage, an agreement in which one party gets money now and pays it back with interest over time. The house is the collateral.

The buyer: A borrower, a homeowner, who buys use of the money for the life of the mortgage by paying the “price” of interest for use of the money until he has paid it back.

The seller: The lender, a bank, who provides the money now and receives interest until the borrower pays the money back.

Price: The interest rate.

The second market is the market for mortgages as an investment. In this market the original lender of the mortgage, a bank, sells the right to the receive future interest and money payments that it is being paid by mortgagees. By transferring their rights to mortgage payments in this way the bank, in essence, gets paid off now and investor that buys mortgage becomes the lender instead. In this market the bank is again the seller but the investors are the buyer. Simplistically put, the price of the mortgage sold is quoted as a percentage of the original money the bank lent out. So, roughly speaking, an investor might pay 96% of the amount of the mortgage to the bank because, perhaps, the loan looks riskier now. In this case the bank would be selling the future loan income for less than the amount it originally lent and would be taking a loss of 4%. Alternatively, an investor might instead decide to pay 102% of the original mortgage amount because in current market conditions the interest rate being paid by the mortgagees is more than it should be. But the banks do not sell the loans one at a time. They sell investors pieces of large batches of loans, called pools. Each investor buys rights to part of a mixture of payments from a large group of mortgages.

Product: A mortgage obligation, the right to receive the future income buying paid by groups of mortgagees.

The buyer: An investor who gives money to the seller now in order to receive future income over time.

The seller: The bank who takes money now and gives up the right to receive future income.

Price: A bond price which roughly states the percentage of the original money that the bank lent to the homeowner that the investor is willing to give the bank for the future mortgage payments.

Your assignment is do sufficient research to explain the information failures that actually occurred in one of these market. You should have a bibliography of at least one article and attach a copy of the article. For one of the markets you must clearly describe

- the information advantage held by either (or both) parties in that market,

- why that information imbalance was valuable to the advantaged party,

- how market equilibrium was effected by the information imbalance.

Greater credit will be given for a piece that properly applies the terminology from the book to the circumstance (i.e. moral hazard, adverse selection). To make sure I am not missing your use of terminology from the book underline or otherwise highlight your use of the terminology.

You may work alone or in a group of two. Groups of two will receive a single grade.