

Abstract: Incentives and Tranche Retention in Securitisation: A Screening Model

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This paper examines the power of different contractual mechanisms in securitisation, and how these influence a loan originator's choice of costly effort to screen borrowers. The analysis focuses on three potential retention mechanisms: the originator holds a "vertical slice", or share of the portfolio; the originator holds the equity tranche of a "tranching" transaction; the originator holds a mezzanine tranche, rather than the equity tranche. These retention mechanisms will result in differing levels of screening, and the differences arise from varying sensitivities to a systematic risk factor. The form of retention thus has an impact on the loss distribution for the portfolio of securitised loans.

Equity tranche retention is not always the most effective mechanism, and the equity tranche can be dominated by either a vertical slice or a mezzanine tranche if the probability of a downturn is high and if the equity tranche is likely to be depleted in a downturn. Hence, there is no one-size-fits-all retention rule. Yet, if the originator is allowed to choose the form of retention, the chosen mechanism may lead to very low screening effort, suggesting a potential rationale for government intervention. One example is mandatory disclosure of the amount and form of retention by the originator, which would allow an assessment of the impact of retention on portfolio losses.