Issues in Securitization

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Common Theme

• Securitization
  – Originate and distribute

• Around in different forms for a long time
  – Credit Cards, Auto, Freddie/Fannie in mortgages
  – Stable structures

• 2000s different: Growth and underperformance
  – Residential Mortgages
  – This session
    • Commercial Real Estate
    • Corporate Loans
Common Theme

• Is there an effect on performance?
  – Yes
  – Bord and Santos

• What changed?
  – “Incentives”
  – Bord and Santos, Black et al., Furfine

• Why was there a change?
  – Furfine
Bord and Santos

• Compare performance of securitized and non-securitized loans
  – Securitized loans underperform
  – Similar to residential mortgages: Agarwal et al. (2010), Keys et al. (2010)...

• Heterogeneity
  – Skin in the game seems to matter
  – Concentrated in boom period: Keys et al. (2011)

• Pricing
  – Priced “differently” (perhaps mispricing by investors)
Bord and Santos: Questions

- Heterogeneity across participants?
  - Monitoring incentives vary (e.g., hedge funds)

- Decision to securitize exogenous?
  - Hard to interpret
    - Selection on unobservables: Adverse selection/cherry picking etc.
    - Time to securitize affects which loans end up on books: Keys et al.

- Is this really mispricing?
  - Risk aversion heterogeneity/ LGD/Mapping (model)?

- Why did this change over time?
  - Different clienteles?, Cost of capital went down?...
Performance of securitized loans varies depending on “organizational form” of issuer

- Conduits (worst), Commercial banks (best)

Heterogeneity

- Skin in the game matters
  - Internal funds
  - Warehousing risk
  - Do both “originate and hold” and “originate and sell”

- Similar to several papers in residential mortgage literature (e.g., Agarwal et al. (2011))
Black, Chu, Cohen and Nichols: Questions

• What is the ex-ante prediction?
  – Fragility of capital structure could discipline: Diamond and Rajan, Calomiris and Kahn
  – Diversified/large business could make one more lax
    • In a narrow range of very comparable loans banks underperformed independent sellers: Keys et al.

• What could be the differences?
  – Screening technology?
  – Cost of capital?
  – Time to securitize?
  – Investors?
Furfine

• “Complex” deals consist of worse loans
  – Large pools, Fusion pools, # of tranches and Rating disagreements

• Skin in the game matters
  – Aligned interests matter

• Complexity effect accentuates over time

• Some evidence of mispricing
Furfine: Questions

• What causes what?
  – More complexity => risky collateral Or Risky collateral => “complexity”? (Amromin et al, Barlevy and Fisher)
  – More tranches in complex deals: Demarzo
    • Assuming complex deals have more asymmetric information
    • Lower cost of capital over time => riskier loans

• Is this really mispricing?
  – Risk aversion heterogeneity/LGD/Mapping (model)?
  – Actual versus model generated investor yields?

• Why did this change over time?
  – Different clienteles?, Cost of capital went down?...
Going Forward

• What can be generalized? Can we learn from other securitization markets/history?
  – If it works in one market doesn’t mean always works
  – Incentive provision varies dramatically across markets
    • GSE (exclusion threat) vs. Credit Cards (reps and warranties)
  – Direct incentives/Reputation/Disclosure/Market structure/Internal governance/Capital structure fragility?

• What should and should not be securitized?
  – Is this innovation efficient for all assets? (hard vs. soft)
Going Forward

• What are “benefits” and “costs” of securitization?
  – Value added by banks in screening and monitoring?
    • For what sorts of assets?
    • How much “ease of securitization” leads to change in behavior of agents?
  – What is the right security design?
    • What are investors after?

• Beyond mispricing...a bigger question: why did regulators/rating agencies not pick this?
  – What information do they see? When do they see it?
    What do they do with it? Lucas critique?
  – Regulatory distortions have real outcomes