Discussion: Strategic Opaqueness: A cautionary tale on securitization (Babus and Farboodi)
BDF-FRBC conference on Endogenous Financial Networks

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July 9, 2015

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Outline

1. Summary

2. Discussion
Contribution: Link securitization and financial stability

- 10 years (and one financial crisis) later, limited theoretical understanding of the role played by securitization
  - Loutskina and Strahan (2009), Keys, Mukherjee, Seru and Vig (2010)
  - Demarzo (2005); Dang, Gorton and Holmstrom (2015), Breton (2011)
- Contribution: framework to understand the link between securitization and financial crises
Timing

0

- Investor $I$ lends $D$ to bank $i$
- Banks invest
- Bank chooses whether to securitize fraction $1 - \phi$ of assets

1

- Investor $I$ observes project quality $\theta = \{L, M, H\}$ of bank $i$

2

- Chooses whether to liquidate its investment $s_I(\theta_i)$ and get $r$
- Project payoff
  - $0 (p_L)$
  - $R_M (p_M)$
  - $R_H (p_H)$
- Debt $D$ matures
- If $V_i < D$, default and payoff of 0
Solution

- **Step 1:** fix $s_I$ and $\phi$, derive $D$
  - Takeaway: debt value lower with $\phi = K > 0$
- **Step 2:** fix $\phi$, derive $s_I$
  - $\phi = 1$: if $r$ is small, continue for $H$, $M$
  - $\phi = K > 0$: continue for $H$ (in a nutshell)
- **Step 3:** compare bank payoff
  - Bank prefers $\phi = K$
Securitization decreases welfare

The banks always have an incentive to securitize and set \( \phi \in (0, 1) \)

There exist equilibria in which securitization increases the probability of financial crises
Outline

1. Summary

2. Discussion
On the definition of securitization

- In paper, securitization is redistribution of risk among financial intermediaries
- Can we compare it to bank mergers? Lessons for e.g. universal banks?
- However, aren’t banks supposed to “spin-off” their securitization? (originate to distribute)
  - E.g. many buyers of AAA RMBS were Chinese investors who considered them substitutes to Treasuries
  - Role of excess liquidity in European securitization
Can financial engineering cure cancer?

- Fagnan, Fernandez, Lo and Stein (2013) describe the challenges of funding research in biotech
- Key challenge: high risk, capital intensive
- Solution: pool projects, securitize and allow long term, deep pocket but risk averse investors to participate
Risk aversion and Welfare

- Key trade-off for securitization in your model:
  - Diversification $\rightarrow$ less risk
  - Opaqueness $\rightarrow$ investors liquidate more often
- However the “less risk” is not really priced in welfare
- Role for risk averse investors?
  - $\rightarrow$ key motivation for securitization is to cater to different investor tastes
Bargaining power

- A key motive for securitization is that it increases the bargaining power of the bank
- Seems a central assumption
  - Contrasts with e.g. Holmstrom-Tirole (2011), limited pledgeability leads to credit constraints
- Would banks still have an incentive to securitize if they had the bargaining power?
- What are the alternative options for the bank to regain market power?
- Evidence of link securitization and market power?
Incomplete contracts

- Why can’t the investor force the bank not to buy securitization?
- Seems related to e.g. rise of banking giants
  - But why did investors favour these deals?
- Policy conclusions:
  - “Government interventions are inefficient”