Discussion: Strategic Opaqueness: A cautionary tale on securitization (Babus and Farboodi)

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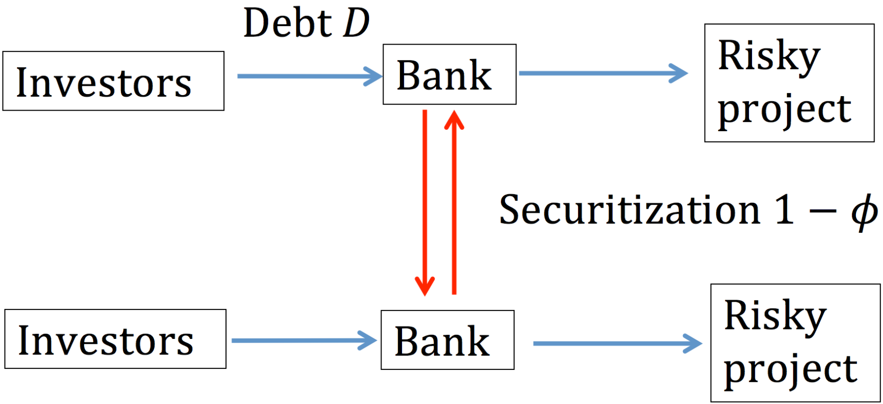
Outline

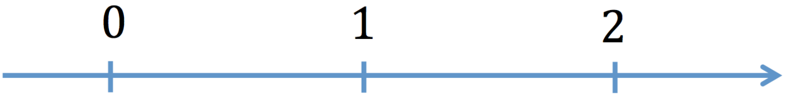
Contribution: Link securitization and financial stability

- R. Rajan (2005) "Has Financial Development Made the World Riskier?"
- 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

Setup


Debt D
Investors
Bank
Risky project
Securitization $1-\phi$
Investors
Bank
Risky project

Timing



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

- Investor I observes project quality $\theta = \{L, M, H\}$ of bank i
- 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 ϕ, derive D
  - Takeaway: debt value lower with $\phi = K > 0$
- Step 2: fix ϕ, 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 $\phi = K$

Results

- 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

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 -> less risk
  - Opaqueness -> investors liquidate more often
- However the "less risk" is not really priced in welfare
- Role for risk averse investors?
  - -> 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"