

## Discussion

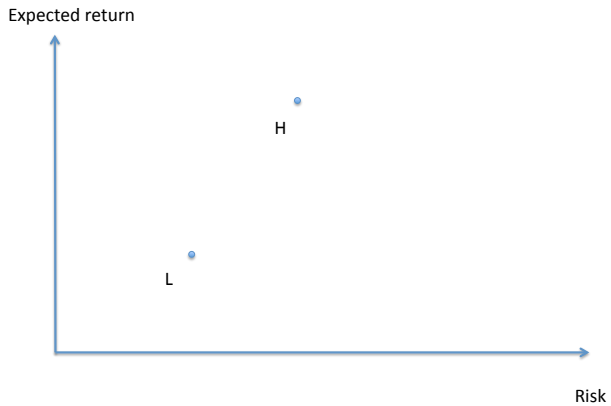
# “Servicing Securitisation through Inefficient Foreclosure” by Kuong and Zeng

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Sciences Po

- Description of the paper
- Comments

- Suppose an issuer seeks to sell the future cash flows from a project to relatively more patient investors
- The project may be of two types  $H$ ,  $L$  and the issuer privately observes the type of his project



## Separating equilibrium

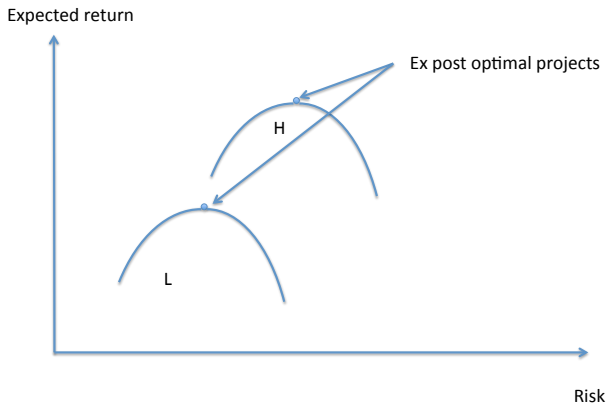
- If the  $H$ -type issuer issues a security  $S$  and retains the residual cash flow  $R$ , then by mimicking him the  $L$ -type issuer pockets

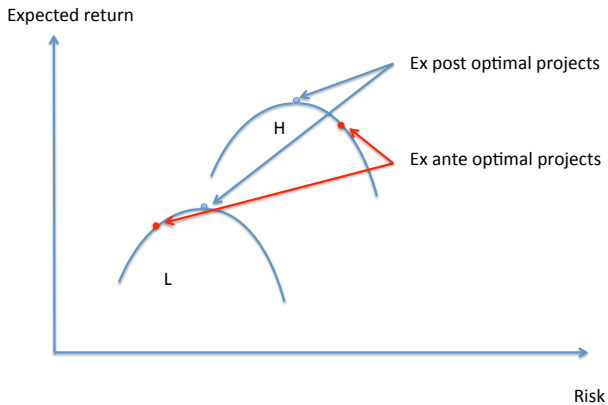
$$E_H[S] + E_L[R]$$

- Issuing  $S$  =debt and retaining  $R$  =equity is the optimal (monotonic) security design because it maximizes the cost of mimicking for a given retention
  - Debt makes high risk on the  $H$ -project most costly
  - Equity makes the low risk on the  $L$ -project most costly

## Endogenous project choice

- Suppose now that the issuer raises funds first and then chooses the risk-return profile of his project
- He can announce a contingent project choice before he learns his type and commit to it — but he cannot commit to a security design before learning his type (otherwise he would just commit to sell his whole cash flows)







- In the paper, “reducing the risk of the project” means **foreclosing a larger fraction of a mortgage portfolio**
- The paper also studies the case in which the issuer cannot commit himself to an *ex ante* efficient foreclosure policy
- He uses delegation to a third-party servicer as a commitment device

- ① Perfect commitment
- ② Third-party servicing

# Perfect commitment

- Here the paper takes the view that foreclosures reduce the risk on a mortgage portfolio at some cost
- Do foreclosures really reduce uncertainty or merely accelerate the resolution of uncertainty, which would not be valuable here?
- The view underlying the model is one in which portfolios differ along the labor income profile of the borrowers, but in which housing collateral is a **commodity for which there is a type-independent demand curve**

# Perfect commitment

- The value of a mortgage is driven by the value of the borrower's future labor income and by the market value of the home
- But since the foreclosed home will presumably be sold to somebody with similar socioeconomic characteristics as that of the defaulting borrower, both the outcomes of foreclosure and that of forbearance should depend on the risk associated with each portfolio type
- In other words, with endogenous liquidation values, and segmented housing markets, foreclosure merely accelerates the resolution of uncertainty but does not affect the level of uncertainty
- Given that foreclosure as a risk-reduction device is central to the argument, a serious discussion of endogenous liquidation values is in order

# Limited commitment

- The issuer cannot commit to a foreclosing policy vis-a-vis investors but he can commit to a contract vis-a-vis the third-party servicer
- Two issues:
  - Partial commitment. The issuer can commit not to sell retained equity after his type is revealed, but he cannot commit to a foreclosure policy? Why is committing along one dimension more difficult than along the other dimension?
  - Why is it more difficult to renegotiate with a single sophisticated party than with a diffuse investor base?
- It would be great if the paper endogenized the organizational frictions that make outsourcing servicing a commitment device rather than just assume it

# Conclusion

- Important and under-researched question
- Reasonable model, some interesting insights
- Would be great to make a stronger case about foreclosure as a risk-reduction device
- Would be great to explain why third-party servicing is a commitment device — maybe contract versus internal bank policy