Accounts of the recent financial crisis claim that the practice of securitizing bank loans had led banks to be less vigilant in their lending habits. Securitization, the argument goes, gives the originators of the loans worse incentives to screen potential borrowers and monitor them as compared to traditional direct lending. But, unless investors are pricing securities irrationally, wouldn’t contract theory suggest that banks should always prefer the contract that allows them to commit to higher vigilance? This paper addresses this problem by introducing a model in which securitization leads to laxer lending standards, even though it is chosen optimally by banks and investors.

I construct a model where investment is performed through intermediaries (banks) that choose the volume of lending and a variable level of effort in screening potential borrowers, set the lending standards, and can finance their activities either by eliciting deposits or selling securities. Securitization allows the banks to credibly communicate to investors information about the borrowers, which depositors cannot access.

Securitization has two effects: at fixed leverage, securitization gives banks better incentives to screen borrowers and leads to higher lending standards; however, it also allows banks to choose a higher level of leverage, which in turn degrades the screening effort. In equilibrium, securitization leads to lower vigilance, but is still preferred because it allows the banks to intermediate more funds. Paradoxically, the method of finance that allows banks to better communicate information about borrowers leads in equilibrium to less information being produced.

A promise by the government to bail out security holders is demonstrated to have a positive welfare effect if the probability that a bailout is required is small. However, if the probability of a bailout is high, it leads banks to overextend, and degrades lending standards beyond what is socially desirable.

Abstract

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"Securitization, Bank Vigilance, and Bailouts"

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חדר ישיבות תקשורת (C228), בניין ארזי-שופר

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