



Is Securitization to Blame?

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Following the subprime mortgage crisis, much attention has been focused on the possible abuses of securitization, in which derivative securities are issued against a pooled and packaged collection of debt assets. Analysts have argued that the separation of “originate-to-distribute” via “conduit lending”, a process whereby mortgage lenders originated loans expressly for pass-through to securitization and derivative markets, was conspicuous among deconstructing forces, and it has contributed to the “lemons problem” in the mortgage markets.

The “lemons problem” was first highlighted by Nobel Prize-winning economist George Akerlof (1970) in his seminal paper: “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism”, where he explained how the information asymmetry between the seller and buyer may cause quality of goods to deteriorate due to “moral hazard” and “adverse selection”.

Critics claim that the process of securitization, i.e., the “originate-to-distribute” model, creates moral hazard as it diminished originator incentives to screen loans diligently, as well as adverse selection that bad loans drive out good ones because of asymmetric information between seller and buyer.

In a forthcoming paper to be published in the *Journal of Financial Economics*, Professor Yongheng Deng, Director of Institute of Real Estate Studies at NUS, with his co-authors, investigated the “lemons problem” in the commercial mortgaged-backed securities (CMBS) market. Prof Deng and his co-authors opined that conduit lending has a market role as it improves the allocative efficiency in the secondary mortgage market. Conduit lenders, unlike portfolio lenders, have less opportunity or incentive to develop private information on the loan quality, which mitigates the adverse selection concern investors have on portfolio loan sales. Thus, conduit loans can partially address the “lemons problem” and facilitate loan sales in the securitization market.

In this paper, An, Deng and Gabriel built an information economic model of loan sales in the securitization markets to examine the differences between conduit lending”, where mortgage lenders originated loans specifically for direct sales to the securitization market, and the “portfolio lending”, where mortgage lenders originate commercial mortgage loans with intent to hold those loans in their Investment portfolios. They provided a theoretical basis for the pricing puzzle observed in the CMBS markets, where conduit loans are priced higher than portfolio loans, notwithstanding the pervasive perception that conduit loans are originated with lower quality. Their empirical analysis is congruent with their theoretical predictions, demonstrating that the conduit loans have a 34 basis points (bps) premium over portfolio loans.

The authors find that for the portfolio loan sales only a fraction of the mortgage pool representing the lower quality loans (“lemons”) will be traded. In addition, the greater the information asymmetry between the buyer and seller of loans, the more severe is the “lemons problem”. That is, bad loans drive out good loans in the portfolio loan securitization market. Furthermore, the magnitude of the “lemons discount” of portfolio loan sales varies positively with the dispersion of loan quality in the mortgage pool and inversely with seller’s cost of holding the loans in the portfolio. Their theoretical results concluded that the total surplus associated with the securitization trade is higher for conduit loans than for portfolio loans, thus supporting their conjecture of the role conduit loans play in the market.

The empirical evidences of the study support their theoretical argument. The spread of the net coupon paid to the CMBS investors over the comparable maturity Treasury rate is the dependent variable, while the independent variables include a set of economic and debt market factors that affect the market- wide CMBS loan pricing, a vector of publicly observable CMBS loan characteristics, and an indicator “dummy” variable for taking the value of 1 for conduit and 0 for portfolio loans respectively. Thus, the coefficient associated with the indicator “dummy” variable would represent the presence or absence of the “lemons discount” in the pricing of conduit relative portfolio loans.

The empirical results suggest that conduit loans have a 33 basis points pricing premium over portfolio loans at deal level, and a 34 basis points premium at loan level. This pricing differential is consistent with their theoretical findings of a “lemons effect, where portfolio loan lenders utilize private information to sell low quality loans into the CMBS market.

In conclusion, this paper provides both a theoretical model and empirical evidence of asymmetric information and adverse selection in the market for CMBS.