

2009-10-16

## PRESS RELEASE

---

### **Incentives and tranche retention in securitisation: a screening model**

*by Ingo Fender and Janet Mitchell*

NBB Working Paper No 177 - Research Series

The current financial crisis, whose origins in 2007 can be traced to large-scale losses in U.S. subprime mortgage-backed securitizations, has eroded confidence in all securitization markets. One issue of concern is the impact of securitization on the incentives of institutions participating in this activity; an institution which is originating loans and then selling them on to investors via securitization may not have the appropriate incentive to adequately screen potential borrowers. Lending standards may deteriorate, and investors in the securitizations may suffer greater losses than expected.

A proposal that has gained broad support is to require originators to retain a portion of their securitizations, in order to align their interests with those of the investors. Retention by the originator of the equity, or "first-loss", tranche has often been advocated in this regard, since the holder of the equity tranche bears the first losses in the portfolio. Legislation is currently being considered in Europe to require originators to retain five percent of their securitizations. Originators can choose the specific form of retention from a list of alternatives, which include holding a share (sometimes called "vertical slice") of the portfolio or the equity tranche.

This paper contributes to the policy discussion by examining the influence of different forms of securitization retention on an originator's choice of costly effort to screen borrowers. The question addressed is whether some forms of retention lead to more screening effort than others and under what conditions. Three potential forms are analyzed: the originator holds a share of the portfolio; the originator holds the equity tranche; the originator holds the mezzanine tranche instead of the equity tranche. The mezzanine tranche of a securitization resembles subordinated debt for a firm and lies just above the equity tranche in the priority of payments. Until now, it has not been common practice for originators to hold the mezzanine tranche of securitizations.

The analysis reveals that different forms of retention create differing incentives for the originator to conduct borrower screening. In particular, the equity tranche is not always the most effective in inducing the originator to choose a high level of screening effort. For example, if the probability of a downturn is likely and if the portfolio losses in a downturn would be high enough to "exhaust" the equity tranche — so that the equity tranche holder would receive no payment, then the originator holding the equity tranche will have lower incentives to screen borrowers. In this case retention of a mezzanine tranche or a share of the portfolio could result in greater screening, although the retained portfolio share would generally have to be rather large to dominate both the mezzanine tranche and the equity tranche. On the other hand, if an upturn in the business cycle is likely or if the size of the equity tranche is large enough not to be exhausted in a downturn, then the equity tranche will be more effective than the portfolio share or the mezzanine tranche.

These results demonstrate that the optimal amount and form of retention will depend crucially on the nature and characteristics of the specific securitization transaction and on the stage of the business cycle. In other words, there is no "one-size-fits-all" solution to securitization retention. Furthermore, the requirement for the originator to retain a particular amount of securitization can be too weak in some cases and too strong in others. An amount of retention that is too low will result in too little screening effort by the originator, while an amount that is too high may make securitization too costly to undertake, ultimately resulting in less lending. Finally, and independently of any official retention requirement, requiring disclosure by the originator of the amount and form of retention for each securitization transaction would allow investors and regulators alike to decide whether the choices are appropriate for any given transaction.