Discussion of “Structural Modeling of Loan Pool Choice in the CMBS Market,” by Sean Chu

Ron Borzekowski
Office of Research

Consumer Financial Protection Bureau

Background

Empirical Fact

- Commercial Real Estate (CRE) loans in securitizations underwritten by the loan originator perform better, ceterus paribus, than loans sold and then securitized by a third party.

Question

- Is this a case of adverse selection where the originator takes advantage of private information and sells 'bad' loans to others?

Thoughts

- This was the 'obvious' answer to many before the crisis.
- However, not to economists – for better or worse.
- In this paper, goal is to disentangle different effects: unobservable ex ante loan quality vs. some ex-post action by originator
- Note: All loans in this study are securitized!

Approach

Estimation

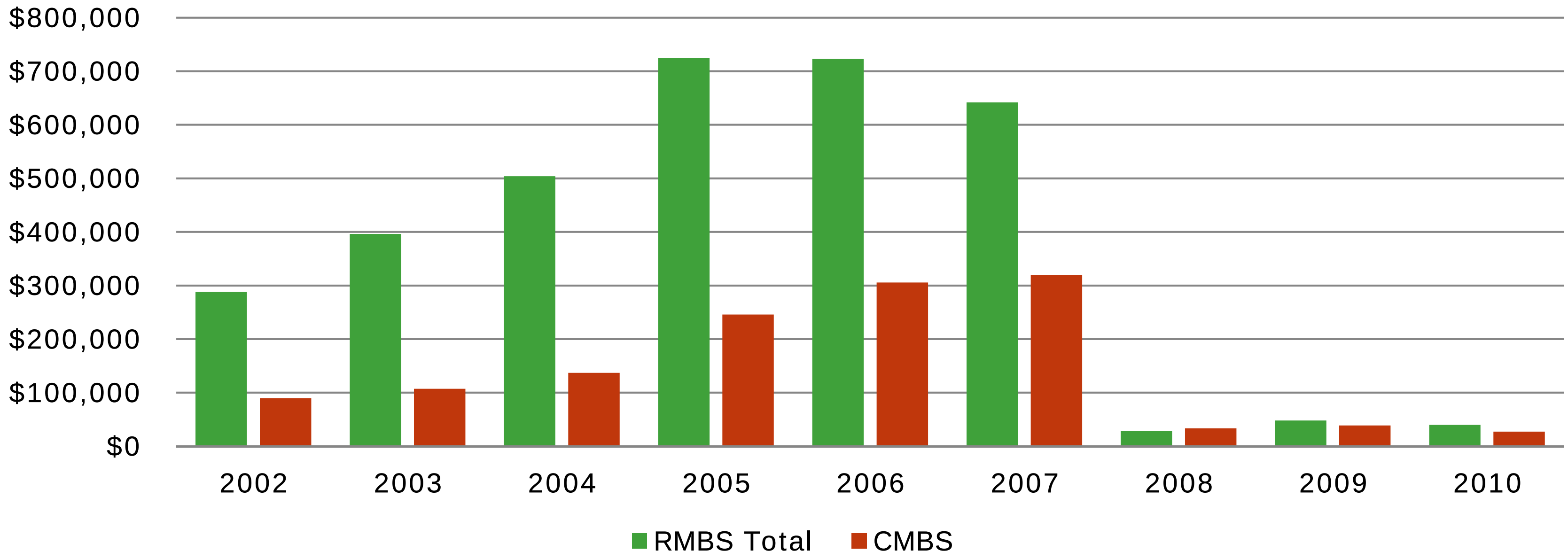
- Estimate hazard function for default of each loan assuming unobserved quality
- Use time to default for each loan to model returns for each deal (collection of loans) as function of unobserved quality
- Structural model: Identify parameters of interest by assuming that adding or subtracting a deal is profit reducing. Do this under two information sets, one with no private information, the other where originator's valuation and buyer's diverge.

Results

- Ex-post value to loans originated by the securitizing firm.
- However, it appears that the ex-ante quality of these loans is weaker
  - ⇨ Hold them for diversification reasons
  - ⇨ Couldn't sell em'

CMBS market and the crisis

Bubble and Collapse



Patterns

- More deals, bigger deals, more complex deals, weaker covenants, less subordination etc.

Secondary market

- CMBS CDOs and the issue of credit risk

Aftermath – Bear Stearns and Hilton; Lehman and Archstone

Discussion

Model

- Simplified but not simple.
- Very rich in many dimensions – can capture salient market features

Nature of the Firm

- Are vertically integrated really integrated e.g. Citigroup

Drivers of Default

- Vintage and region – are these adequate controls

Secondary Market Changes and Identification

- The market changed as the crisis neared
- Spreads narrowed, particularly in the lower tranches e.g. Merrill
- Holders of lower rated tranches changed – correlation trade
- Hold vs. buy decisions changed e.g. Wamu