Competition in Securitization

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Abstract

In an economy with incomplete markets, financial intermediaries have market power. By choosing the terms of marketed contracts, they influence risk sharing and production decisions of consumers. This paper identifies the set of marketed contracts that arises from oligopolistic competition between profit-maximizing intermediaries in a model of the mortgage market. Intermediaries offer mortgage loans and resell these in the form of mortgage-backed securities. The resulting transfers enable the construction of houses, and the need to put up collateral imposes financial constraints. In equilibrium, intermediaries make extensive use of second mortgages and tranching, tend not to pool mortgages across neighborhoods, and offer the largest possible set of risk sharing possibilities. Such extensive risk sharing need not be socially optimal: If consumers are financially constrained, competition may lead to suboptimally low down payments, overproduction of houses, and price drops in the future.

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