Incentives to Issue Low-Quality Securitized Products in the OTD Business Model*

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Abstract

We consider an economy in which a lender finances loans to borrowers by issuing a securitized product to investors and in which the credit quality of the product can depend on whether the lender screens borrowers. In the presence of asymmetric information between the lender and investors regarding the credit quality of potential borrowers, overvaluation from the lender's perspective can occur for low-quality securitized products, which inefficiently induces the lender not to screen borrowers and hence to issue the securitized products of low credit quality. This is likely to occur when the probability of being in a bad state (i.e., the presence of low-quality borrowers) is low, or when the seeds of recession begin emerging in a booming economy.

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