

Discussion of 'Securitization, Disclosure and Liquidity' By Marco Pagano and Paolo Volpin

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- ▶ General theme:
How to get **funding** from **unsophisticated investors**.
- ▶ Narrow topic:
Timing of the impact of **adverse selection** on initial **price** and **liquidity**.

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- ▶ Policy: Social vs Private returns of **mandating full disclosure**.
- ▶ Security design: **tranching**.

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- ▶ **Market Makers**:
 - buy securities from investors in period 3 (when liquidity is needed).
 - have NO private info.

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- ▶ A fraction π of investors can use funds at time 3, to invest in a project with payoff Δ .
(**liquidity**)

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 - Secondary market is liquid, because price has revealed information.
- ▶ **Without disclosure, or NO transparency:**
 - No asymmetric information at time of issue.
 - Sophisticated investors find information later on.
 - Adverse selection in secondary market.
 - If price in secondary market is too low, unsophisticated investor may not take advantage of opportunity Δ (low liquidity).

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- ▶ **MM not a standard investor**: not present at issue of security, and not having investment opportunity Δ at time 3.

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- ▶ Why informed investors don't consider to acquire information about security at date 1, when it is issued?
- ▶ Perhaps the answer is that they are not interesting in acquiring info if there is no default, but it should be checked.
- ▶ Important for the model:
The **timing** the resolution of the adverse selection gives the **trade-off between liquidity and transparency**.

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- ▶ Term γ gained by society in period 3 when each of the π investor undertake the alternative project (liquidity shock).
- ▶ But this externality is NOT developed in the model.
- ▶ It is important (perhaps crucial) for the policy implications:
it is the reason why the equilibrium choice of transparent may not be socially efficient.

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- ▶ Explanation:
Effect of the choice of transparency into liquidity is completely internalized in the price at issue.
- ▶ Equilibrium is efficient even if secondary market freezes and there is no liquidity whatsoever.

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- ▶ See, welfare expression for social value of period 3 liquidity (top of pp 19): $(1 + \gamma)\Delta$
- ▶ See welfare expression (eq 10): $\gamma\Delta$.
- ▶ Yet, this seems different from the condition on Proposition 3 on mandating transparency.

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- ▶ Equilibrium has the **highest possible social value**: Ignorance is bliss!
- ▶ Alternatively, sophisticated investors have a negative effect on welfare.

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Is this reasonable?

- ▶ Intuitively, transparency should be better (socially and privately), since there is no cost for society.

What are the forces in the model that preclude that?

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- ▶ Good aspect: Result seem generally applicable to many cases.
- ▶ Bad aspect: Does not seem to be about securitization.
- ▶ But result on **tranching** used nature of payoffs.
- ▶ **Nice intuitive result on security design:**
Split the payoffs so that unsophisticated investors do NOT have to value sophisticated securities.