Going for Broke: Underwriter Reputation and the Performance of Mortgage-Backed Securities

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Summary

- **Question:** can intermediaries reptuational concerns dampen booms and busts?
- **Approach:**
  - Assemble novel historical dataset with detailed info on MBS, intermediary, and investor characteristics
  - Compare origination characteristics and performance of high vs. low reputation banks
- **Main Findings:**
  - Low reputation banks origination **worse loans**
  - High reputation banks **retreated** during boom, but with limited aggregate impact
- **Comments:** framing and interpretation

(Additional) Motivation

- Investors, borrowers, and fin. intermediaries appear to value intermed. reputation
  Beatty and Ritter (1986); Nanda and Yun (1997); Dunbar (2000); Fang (2005); Lewellen (2006); Ivashina (2009); Drucker and Puri (2009); Becker and Milbourn (2011); Murfin (2012); Baghai and Becker (2020)
- Does financial intermediary reputational capital matter as much as financial capital?
  - Underwriter reputation $\Rightarrow$ substantial contagion in early sov. bond markets (Indarte, 2021)
- **This paper:** can a lack of reputation concerns exacerbate credit booms and busts?

Framing: What is the Null Hypothesis?

What is the Null Hypothesis?

- Intro framing: did banks *not* value their reputation or were they overly-optimistic?
- Why not both? Not mutually exclusive
- Alternative possible framing:
  - Does reputation incentivize good behavior? And does this mitigate credit booms/busts?
  - Was the boom driven by optimism or opportunism?
    $\Rightarrow$ Were low rep. banks worse at evaluating securities and deserving a weak rep?

Does a Good Reputation Incentivize Good Behavior?

- Another reason paper is interesting: answer isn't obvious!

- Economics here are similar to setting where firms make unobserved investments in product quality (Board and Meyer-ter-Vehn, 2013)
  - Incentives to maintain reputation depend on *how* buyers learn
  - With imperfect signals: can have either work-shirk equilibrium or shirk-work-shirk (i.e., slacking when reputation is very high)

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- Recent examples suggest competition can weaken desire to maintain reputation
  - Entry of Fitch in 1990s into corp. bond ratings $\Rightarrow$ Moody's and S&P issued higher ratings and became less predictive of bond yields (Becker and Milbourn, 2011)
  - Re-entry of S&P into set of ratings markets after procedural error $\Rightarrow$ overly-optimistic ratings in attempts ot regain market share (Baghai and Becker, 2017)

Interpretation

How Did Reputation Discipline Banks?

- Paper argues that investors ignored underwriter reputation by continuing to buy MBS from low reputation banks

- **Q:** if investors aren't attentive to reputation, why do banks exert effort to maintain it?

- Are there long-run costs from repeated interactions?
  - **Test:** possible to examine post-boom activity/prices? In other markets/activities?
  - **Test:** lower long-run wealth of bankers whose MBS performed worse ?

Establishing the Counterfactual

- Paper has a clever proxy for reputation
  - Evidence on how the loans differed between high/low rep. helps corroborate explanations for boom and bust
- Would the crisis have been more **severe** if high reputation banks didn't **retreat**?
  - **Test:** possible to partition bonds into groups that experienced differential exposure to retreating by high reputation banks? Perhaps sugar/coffee sample split is informative?
- How would high rep. banks have behaved without competition from low rep. banks?
  - Would high reputation banks have filled the gap? Creating the same loans?

Conclusion

In conclusion...

- Insightful and interesting paper tackling an important question!
- Sheds light on how fin. intermediary reputation matters for credit booms and busts
- Assemble valuable and unique datasets

Thanks!