Securitization bubbles: Structured finance with disagreement about default risk

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Abstract

An additional reason for the structured finance boom of the 2000s may have been disagreement about default risk of collateral assets. When risk-neutral investors disagree about average default probabilities, structuring collateral cash flow raises prices by concentrating optimists' demand on risky tranches. With disagreement about default correlation, low-correlation investors believe in diversification and pay high prices for senior tranches they deem riskless. High-correlation investors value junior tranches they expect to pay whenever aggregate conditions are good. Risk aversion and short selling through credit default swaps reduce the prices of both pass-through and structured securitizations but may increase the return to tranching.

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