Reputation and Securitization

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Abstract

We analyze a dynamic market with a seller who can make a one-time investment that affects the returns of tradable assets. The potential buyers of the assets cannot observe the seller's investment prior to trade, nor verify it in anyway after trade. The market faces two types of inefficiency: the *ex-ante* inefficiency, i.e., the seller's moral hazard problem; and the *ex-post* inefficiency, i.e., inefficient ex-post allocations due to the adverse selection problem. We analyze how the observability of information by the future buyers through which the seller builds a reputation affects the two types of inefficiency, and the interplay between them. Our conclusions are as follows. If the cost of investment is small, then the observability of such information mitigates both types of inefficiency. If the cost of investment is not small, however, then it may not have any effect on them. Moreover, even when the observability of such information improves the ex-post efficiency, it does so only at an offsetting cost in terms of the ex-ante efficiency. A simple regulation, which is based on prices observable in the markets, can enhance the role of such information and achieve the social welfare arbitrary close to the first best.

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