Originate-to-Distribute Model and UK Financial Institutions

PO YU LIN *(London South Bank University, United Kingdom, link5@lsbu.ac.uk)*
GURJEET DHESI *(London South Bank University, United Kingdom, dhesig@lsbu.ac.uk)*
LEE ROSE *(London South Bank University, United Kingdom, roselg@lsbu.ac.uk)*

The subprime mortgage crisis has brought attention to the business model, (namely the originate to distribute (OTD) model), that a vast majority of banks have adopted. In the OTD model the originator of a loan sells it to third parties through a securitisation process. The OTD model can be an efficient risk sharing tool for financial institutions to diversify their portfolio. However, the conflict of interest between different parties and potential incentive problem have eroded the original intention of the model. Furthermore, the financial contagion effect evolving from the OTD model of lending, contributes towards a significant proportion of the credit crisis in 2008. Because of data limitation we choose to examine the OTD business model of Lloys Banks and Northern Rock.We adopt Purnanandam (2008)'s approach using the difference-to-difference method to analyse the participation of UK OTD mortgage market pre-subprime crisis and post-subprime crisis periods. We show the difference of two UK commercial banks' participation in mortgage market prior to the credit crisis and post-disruption period. We find that the ability of the transfer of credit risk through the OTD model encouraged the origination of inferior quality loans by the banks. We also find that the OTD model affects banks' attitude towards risk from risk aversion to risk taking investment behaviour. We conclude that the OTD model is a postive financial innovation. However the screening incentive needs to be revised and monitored.

Keywords: Originate-to-distribute, OTD model, financial contagion, risk management, subprime crisis