Abstract
How much of a loan should a lender dynamically retain, and how does retention affect loan performance? We address these questions in a model in which a lender originates loans that it can sell to investors. The lender reduces default risk through screening at origination and monitoring after origination, but is subject to moral hazard. We show that the optimal lender-investor contract can be implemented by having the lender sell its stake in the loan over time, rationalizing loan sales after origination, and use the model to generate predictions linking loan characteristics to initial retention, sales dynamics, and loan performance.