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SAFE Finance Blog

How to Make Asset Backed Securities Safer

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ABS originators should be obliged to reveal how much of the transaction's risk they share / Current regulation gives too much leeway



Jan Pieter Krahn (<https://safe-frankfurt.de/de/forschung/wissenschaftler/details/showauthor/14-krahn.html>), Director of the Research Center SAFE at Goethe University Frankfurt, calls for more transparency in the regulation of asset backed securities (ABS). Current regulation both in the EU and the US gives too much leeway in the crucial aspect of retention: Although it obliges ABS originators to keep a small part of the securitization on their books, they do not specify exactly which part. As these parts correspond to different risk classes, it remains totally unclear to what extent an originator is involved in the potential losses. "In order to assess the overall risk of an ABS transaction, investors need to know whether issuers have sufficient 'skin in the game'," Krahn states. "The more originators participate in the potential losses, the better they will monitor the securitized loans. And the regular monitoring of the

borrowers is crucial for the risk of the whole transaction.”

In a new SAFE White Paper (<http://safe-frankfurt.de/policy-center/policy-publications/policy-publicationname/skin-in-the-game-in-abs-transactions-a-critical-review-of-policy-options.html>), Krahn and co-author Christian Wilde present a way to fill this regulatory gap. They suggest a method to calculate the real level of risk retained by the issuer. “The legislator should oblige ABS originators to inform investors about this figure,” Krahn demands. “This would make the entire ABS market safer and more attractive.”

An ABS transaction is constructed of a portfolio of loans which is divided into tranches with different risk quality: usually a large, rather safe senior tranche, several mezzanine tranches and a rather small first loss piece that contains most of the portfolio’s risk. A major lesson from the 2007 subprime crisis was to make a minimum level of retention held by the originator mandatory for all ABS deals. By having sufficient “skin in the game” originators should be incentivized to thoroughly assess the borrowers’ risks, to monitor them during the repayment term and to insist on collecting the money. As a consequence, the Dodd-Frank-Act in the US as well as the Capital Requirements Regulation (CRR) in the European Union introduced a minimum retention level of 5% of the nominal transaction size.

However, both regulations offer several options to fulfill the 5% threshold. In their paper, the authors analyze a real world example and show that the originator’s true share of the overall potential losses of the transaction ranges from 5% to 99.9%, dependent of the chosen option of the CRR. “A nominal share of 5% of the securitized loans, as the regulation requires, says nothing about the level of retained risk,” Krahn says. “The important issue is whether the originator keeps risk-poor or risk-rich parts of the transaction – that is: a part of the senior tranche or the first loss piece.” As a consequence of the unprecise regulation, investors – but also rating agencies – lack the essential information to correctly evaluate the risk of the ABS transaction and to calculate an adequate price for it. The ensuing uncertainty is likely to impair the functioning of the securitization market and to decrease the attractiveness of this class of instruments, the authors write.

To solve this problem, Krahn and Wilde recommend that originators should be obliged to report their share of the overall potential losses of a given ABS transaction. In their paper, they provide a method to calculate this figure. “The reporting of this figure would make ABS transactions comparable and more transparent,” Krahn says. “This could help to achieve a better implementation of the current regulation and to exploit the full potential of an active securitization market.”

SAFE White Paper No. 46: "Skin-in-the-Game in ABS Transactions: A Critical Review of Policy Options" (<https://safe-frankfurt.de/policy-center/policy-publications/policy-publicationname/skin-in-the-game-in-abs-transactions-a-critical-review-of-policy-options.html>)


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