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Leibniz Institute for Financial Research SAFE

Dear Marius Luta,

In this edition of SAFE Update, the digital newsletter of the Leibniz Institute SAFE, we present a research project on asset-backed securities (ABS) financing for low-emission vehicles. We also showcase a paper on European contract law as it relates to mortgage lending indexed to foreign currencies.

We hope you enjoy this newsletter and welcome your feedback at newsletter@safe-frankfurt.de.

Green Auto Asset-Backed Securities

In a joint research project, SAFE and the European Data Warehouse are analyzing how asset-backed securities (ABS) can transform the automotive sector

The monumental challenge posed by climate change demands innovative solutions, not least in the finance sector. In a new working paper, SAFE researchers Carmelo Latino, Loriana Pelizzon, and Max Riedel survey the literature on the auto loan securitization market, particularly with a view to the potential for introducing “green auto asset-backed securities,” i.e., low-emission vehicle financing instruments that are backed by a pool of underlying assets, such as auto loans or auto leases, and give investors a claim on the cash flows generated by these assets. The study identifies key participants in the securitization process, shedding light on their function in the value chain and respective motives. Special attention is devoted to the potential for introducing green auto ABS in light of recent regulatory changes, feasibility concerns, and options for sustainable ABS design.

One key finding of the study is that “captive banks” (that is, owned by a car manufacturer) and “non-captive banks” have disparate objectives during loan origination, and that these objectives depend in part on their access to vehicle-related information (where captive banks enjoy an advantage). Car dealerships emerge as pivotal in the vehicle purchase process, in part because dealerships leverage informational advantages they hold over buyers to enhance their profitability. The study thus points to the importance of reducing informational asymmetries between market participants. Public advertising of the financial incentives for green car purchase could boost consumer interest, while educating consumers about total cost of ownership differentials could nudge decisions toward low-emission vehicles. Anticipated strong investor demand awaits green auto exposure securitization, given the dearth of environmentally friendly financial products.

An additional finding of the study is that stakeholders strongly favor a transparent, uncomplicated design for green auto ABS. A primary concern in this regard is to ensure a level playing field among market participants, in order to prevent green auto ABS from being disadvantaged in relation to other instruments. One option for ensuring sustainability is to follow a “dual approach” in which generated cash flows are pledged to green causes and loans are securitized using green collateral. While the specifics in regard to sustainability criteria require clarification, both dimensions of the dual approach are compelling, as the former would ensure ABS issuers invest in future green projects, and the latter would immediately encourage increased origination of green auto loans and leases.

The authors emphasize that green auto ABS could mitigate climate risks for banks, enhance portfolio performance, and augment green asset ratios (GAR), thus attracting green investors. The authors also note the virtuous circle that could result given bank focus on improving GAR, investor demand for sustainability, and the EU’s sustainability goals for the transport sector.

The “Green Auto Securitisation” (GAS) project is being carried out in collaboration with the European Data Warehouse, with support from the KlimFi initiative of the German Federal Ministry of Education and Research.

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Sustainable Finance and Climate Protection

Read the full paper here

Notable Research: Strengthening Borrower Autonomy

Foreign Currency Loans and the Foundations of European Contract Law – A Case for Financial and Contractual Crisis?

By Nikolai Badenhoop, a postdoctoral researcher at SAFE's Law & Finance Cluster, and Stefan Grundmann, a professor at Humboldt University of Berlin

The authors of this paper, which was recently published in the *European Review of Contract Law*, discuss variable rate loans indexed to foreign currencies and the associated dual risk for borrowers – namely, interest rate fluctuations and adverse exchange rate movements. These loans have been permitted at both the EU and national levels, despite the significant problems they have triggered in Eastern and Central European mortgage markets. An unanswered question is how to design mutual restitution claims in cases where national courts find that standardized contracts are void because of unfair contract terms. The authors stress the importance of addressing these issues to avoid potential systemic risks in the Eastern European banking system, and they provide guidance for designing the restitution process.

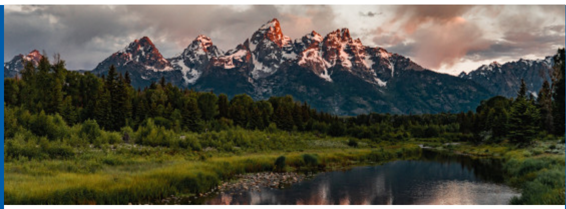
According to the authors, the Unfair Contract Terms Directive (UCTD) provides a suitable framework for remedy to achieve a fair balance of interests and meet “legitimate expectations” when it comes to consumer credit contracts and restitution claims following the ruling of a void contract. General principles of unjust enrichment and damages are recognized under EU law and require restitution to rectify gains or losses in relation to what could have been obtained in the market. In particular, Articles 23 and 24 of the Mortgage Credit Directive (MCD) provide an appropriate model for unjust enrichment claims, even for older cases. Moreover, windfall profits for borrowers must also be avoided, as fairness and legitimate expectations are critical benchmarks in the UCTD. Finally, a fair restitution regime can be achieved by allowing borrowers who were not properly informed at the time of contract signing to make an informed choice between different market offers.

Foreign currency loans to households are not prohibited by EU legislation or the EU Court of Justice as long as the terms are clear and not subject to discretion. However, problems may arise when discretion is involved, leading to potential banking crises and challenges to the restitution regime under EU law. The paper emphasizes that European consumer contract and restitution law aims at achieving fairness and preserving legitimate expectations without penalizing borrowers or redistributing wealth. Instead, it seeks to establish information equality and strengthen the autonomy of consumers.

The authors conclude the paper by recommending that borrowers who were not properly informed at the time of contract signing should be allowed to choose between the offers available on the market at that time, thus ensuring a fair and balanced contractual relationship. After the paper was published, the CJEU decided a landmark case on this very issue. Read Nikolai Badenhoop's comments in a SAFE Finance Blog post.

Read the full paper here

#SAFEHappenings



SAFE goes to Jackson Hole
At this year's Jackson Hole Economic Symposium, a prestigious event hosted by the US Federal Reserve, Yueran Ma, an assistant professor of finance at the University of Chicago, presented a research paper co-authored by then-SAFE postdoctoral researcher Kaspar Zimmermann. Their paper explores the impact of monetary policy on firm innovation activities, documenting how policy driven changes in aggregate demand influence the profitability of innovation. Read the full paper here.

Upcoming Events in September
SAFE will be co-organizing the 8th Conference on Global Insurance Supervision together with the International Center for Insurance Regulation (ICIR) and the European Insurance and Occupational Pensions Authority (EIOPA) on 6 and 7 September 2023. On 25 September 2023, SAFE will be hosting the 7th SAFE Market Microstructure Conference and, on 26 September 2023, the 10th SAFE Asset Pricing Workshop, which is co-organized by the German Bundesbank and the DFG Research Unit FOR 5230 "Financial Markets and Frictions." All events will be held at the House of Finance on the Westend Campus of Goethe University Frankfurt.

Handpicked Podcast

Florian Heider, Scientific Director at SAFE and Professor of Finance at Goethe University Frankfurt, recommends the podcast series *The Rest is Politics*:

"With podcasts proliferating rapidly these days, what does it take to stand out from the pack? *The Rest is Politics*, hosted by Alastair Campbell and Rory Stewart, has the right stuff, as each episode offers insights from a British perspective that go beyond the standard narratives, often unraveling layers of political intrigue. The hosts have a keen eye for European politics, highlighting aspects often overlooked by other media, and they regularly offer a new take on sensitive issues – which is particularly fascinating to me, given my British education. Plus, if you're a fan of the TV series *The Thick of It*, you're in for a treat. Podcast host Alastair Campbell served as the model for the show's unforgettable Malcolm Tucker. Remember those moments that captured the absurdity of politics? Well, *The Rest is Politics* taps into that spirit and runs with it. Campbell and Stewart astutely survey today's political landscape, frequently offering insights that are eerily prophetic. It's a podcast that informs and entertains, giving you a deeper understanding of European politics and a new sense of Britain's place on the world stage."

Listen to the podcast here

Further Content

- **News:** Europe’s Sustainable Finance Disclosure Regulation provides clearer separation for sustainable funds

- **SAFE Finance Blog:** Money distribution through scattergun approach does not buy real locational advantages (by Alfons J. Weichenrieder)

- All upcoming events and SAFE publications

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