

# BATTLING WITH “LEMON PROBLEM”: INVESTORS PROTECTION IN CHINESE ABS MARKET

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A breakthrough reform is undergoing in Chinese capital market: a proposal to modify the current security law is under the review of the National People's Congress, which attempts to the current offering system from approval system to the registration system.<sup>1</sup> If such proposal is approved by the National People's Congress, then China's security regime will enter a new post- registration time. In the post-registration time, the securities regulators would not focus on keeping the gate and the offering and play the role as the allocator of financial resources. Instead, they need to focus on the investors' protection, which should be the center of the regulation of Chinese capital market. The core issue of the investors' protection would be the information asymmetry problem, which haunts over the relation of the issuers and the investors. The asset back security (ABS) business is an emerging business in China. The information asymmetry problem is significant in ABS market due to the complexity and the opacity of securitization. This article will take ABS as an example to explore the information asymmetry problem in Chinese ABS market and seek for solutions. The first part of this article provides a snapshot of ABS market in China. The second part discusses the functions, benefits and concerns of ABS *via* the lens of Lemon Market Theory. Then, the article comments on the CSRC's rules of the disclosure regarding the underline assets, which is apparently pioneering but unfortunately still a platitude. Part Four analyzes the dilemma of signaling and screening and explores possible alternative solutions by allocating risks to originators. The last part concludes.

### I. A SNAPSHOT OF ABS MARKET IN CHINA

Securitization is a pool of homogeneous financial cash flow by producing illiquid assets and issuing claims on those assets in the form of marketable securities.<sup>2</sup> The securitization began in China at

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<sup>1</sup> See “Zhengquan Fa” Tijiao Renda Shenyi (“证券法”提交人大审议) [Security Law submitted to People's Congress for Review], NETEASE (May 21, 2015), <http://news.163.com/15/0421/01/ANMIOLOK00014AED.html>.

<sup>2</sup> The securitization of credit assets refers to an activity of structured finance, under which the banking financial institutions (the originator) will entrust the credit assets to the trustee institutions, and then such trustee institutions will issue and sell the beneficiary securities to the investment institutions in the form of asset-backed security (the “ABS”) and will use the cash derived from such credit assets to pay the returns on the ABS.

the end of 2004 when the Chinese Securities Regulatory Commission (CSRC) issued the rule of the pilot for the securitization.<sup>3</sup> The blueprint of regulators is to test the risks of securitization business in some pilots under the close supervision by regulators. If the risks of securitization are acceptable for market and regulatory regime to afford, then the regulators would expand the entry for more participants to get into the market. However, the experiment of securitization was suspended in 2008 in China due to the panic of global financial crisis.<sup>4</sup> The securitization was restarted in 2012.<sup>5</sup> The market of ABS gained a fast growth in 2014. Beginning from the end of 2014, the offering system of ABS was changed from the approval system to the registration system: the Chinese Banking Regulatory Commission (CBRC) issued a notice that the ABS of credit assets needed to be registered with the CBRC and CBRC would not review the quality of the underline assets any more.<sup>6</sup> The People's Bank of China (PBOC)<sup>7</sup> and CSRC also issued a similar rule to replace the approval system with the registration system.<sup>8</sup> In post-registration time, the ABS market is expected to expand fast and the next decade may the golden decade for ABS in China.<sup>9</sup> As the estimation by Moody's, the total asset of the ABS market will reach around 500 billion in 2015.<sup>10</sup>

<sup>3</sup> See Guanyu Zhengquan Gongs Kaizhan Zichan Zhengquan Hua Yewu Shidian Youguan Wenti de Tongzhi (关于证券公司开展资产证券化业务试点有关问题的通知) [Notice on some issues of the pilots of the Securitization Business of Securities Companies] (promulgated by China Sec. Reg. Commission., Oct. 21, 2004, effective Oct. 21, 2004) (Chinalawinfo).

<sup>4</sup> See Mudi Yuze 2015 Zhongguo Zichan Zhengquan Hua Chanpin Guimo Chao 500 Yi (穆迪预测 2015 中国资产证券化产品规模超 5000 亿) [Moody's Estimate that the Securities Products in China Would Be More Than 50 Billion], SINA FINANCE (Mar. 4, 2015), <http://finance.sina.com.cn/money/bond/20150304/011921636864.shtml> [hereinafter Moody].

<sup>5</sup> See Wang Xiaoqiao (王小乔), ZiChan Zehngquan Hua Jiannan Chongqi (资产证券化艰难重启) [Restarting the Securitization with Hardship], NANFANG ZHOUMO (南方周末) [SOUTH WEEKEND], (Oct. 27, 2012), available at <http://www.infzm.com/content/82279>.

<sup>6</sup> See Guanyu Xindai Zichan Zhengquan Hua Beian Dengji Gongzuo Liucheng de Tongzhi (关于信贷资产证券化备案登记工作流程的通知) [The notice of the Procedures of Registration of the Credit Asset Securitization] (promulgated by China Banking Reg. Commission, Nov. 20, 2014, effective Nov. 20, 2014) art. 2 (Chinalawinfo).

<sup>7</sup> See Zhongguo Renmin Yinhang Gonggao Diqi Hao (中国人民银行公告第 7 号) [The No.7 Notice by People's Bank of China] (promulgated by People's Bank of China, Mar. 26, 2015, effective Mar. 26, 2015) (Chinalawinfo).

<sup>8</sup> See Zhengquan Gongs Ji Jijin Guanli Gongs Zigongs Zichan Zhengquan Hua Yewu Guanli Guiding (证券公司及基金管理公司子公司资产证券化业务管理规定) [Provisions for the Administration of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies] (promulgated by China Sec. Reg. Commission, Nov. 19, 2014, effective Nov. 19, 2014) (Chinalawinfo).

<sup>9</sup> See Feng Guanghua, Zhongguo Zichan Zhengquan Hua Shichang Youwang Yinglai "Huangjin Shinian" (冯光华：中国资产证券化市场有望迎来“黄金十年”) [Guanghua Feng, The Chinese Securitization Market May have the golden Decade], EASTMONEY NET (Apr. 22, 2015), <http://finance.eastmoney.com/news/1353,20150422499766961.html>.

<sup>10</sup> Moody, *supra* note 4.

In China, there are two types of asset securitization businesses which are operated by different companies and subject to different regulatory regimes. One is the securities companies' asset-backed securitization business, using special purpose vehicle (SPV) and subject to the supervision of CSRC.<sup>11</sup> The companies' asset-backed securitization products are mainly traded on the fixed income platform of Shanghai Stock Exchange and the comprehensive protocol platform of Shenzhen Stock Exchange. Another is (banks') credit asset securitization business supervised by the CBRC and the PBOC.<sup>12</sup> This kind of products is mainly traded on the asset-backed commercial paper platform, the purchasers in which are institutional investors. The trust companies are in the center of securitization of credit assets as trustee institutions.

The securitization is an invention and innovation in financial world. The securitization make the greatest utility of the assets, which are lack of liquidity but capable of generating predictable and stable cash flows. The underlying assets for the securitization business include the existing assets and the future assets. The existing assets means that the amount of assets are fixed by the existing contracts, such as receivables by the BOT projects of infrastructure construction, by the acquisitions of assets or mortgage loans. Such kind of assets exists in the form of debt-credit relationship. In contrary, the securitization of future assets involve the title or right to a particular property, such as the rights to claim highway tolls and the right to claim the proceeds generated by the disposal of urban construction sewage. This kind of securitization is a form of "securitization of rights of remuneration". In China, the eligible assets of for the credit are limited the credit (existing assets) generated by the financial institutions (like the mortgages or the car loans),<sup>13</sup> while the corporate asset securitization allows a wide scope of existing or future assets held by the companies.<sup>14</sup>

For those like securitization, it is an innovation in contracting to provide the low cost of financing.<sup>15</sup> For those dislike securitization, it is a sedan directly connected to the subprime financial crisis in

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<sup>11</sup> Xindai Zichan Zhengquan Hua Shidian Guanli Banfa (信贷资产证券化试点管理办法) [Primary Rule for the Measures on Administration of Pilot Credit Asset-backed Securitization] (promulgated by People's Bank of China & China Banking Reg. Commission, Apr. 20, 2005, effective Apr. 20, 2005) (Chinalawinfo).

<sup>12</sup> *Id.*

<sup>13</sup> See Qin Wei (秦伟), *Zhongguo Xindai Zichan Zhengquan Hua Yewu Jianjie* (证券公司资产证券化业务简介) [A Brief on Securities Companies' Asset-backed Securitization Business], 6 HUANQIU FALU PINGLUN (环球法律评论) [GLOBAL LAW BULLETIN] 1, 3 (2013).

<sup>14</sup> *Id.*

<sup>15</sup> See Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 136 (1994).

2008.<sup>16</sup> The next section will discuss the functions, the benefits and the concerns of the securitization so as to see whether it is a good boy, a bad boy or a combination of good and bad.

## II. FUNCTIONS, BENEFITS AND CONCERNS OF ABS

### *A. The Function of Securitization*

Securitization is like a factory line.<sup>17</sup> Mortgage brokers and banks generate material (loans), and they sell it to investment banks who package the material in the factory producing the final product: special purpose vehicles (or SPV).<sup>18</sup> Professor Steven L. Schwarcz, the most leading scholar in Securitization Law in the U.S., called the process of securitization as “alchemy”.<sup>19</sup> Whether the underline assets is existing assets or future assets, the basic structure of securitization involves inputs, structures, and outputs.<sup>20</sup> The inputs refer to the materials (assets) that put into the securitization pipe. The assets may be payment rights(existing or future) and may also be other assets, like the securities or the whole business. The entity, which holds the assets from the beginning till the end of the securitization pipe is the called the originators. The alchemy demonstrated in the process of structure, which is the core of securitization. Structure involved the isolating input from the credit risks from originators to a “special purpose entity” (“SPE”) by the “true sale”. Form the legal perspective, the SPE is remote from the bankruptcy risk of the originator and is immune from the claim of the originators’ creditors. In China, the trust companies are the center of securitization of credit assets. The banking financial institutions (the originator) entrust the credit assets to the trustee (usually the trust companies), and then these trustees will issue and sell the beneficiary securities to the investment institutions in the form of asset-backed security (the “ABS”) and will use the cash derived from such credit assets to pay the returns of the ABS. The process of the securities companies’ asset-backed securitization is similar to that of credit

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<sup>16</sup> See Dwight Jaffee, Anthony Lynch, Matthew Richardson & Stijn Van Nieuwerburgh, *Mortgage Origination and Securitization in the Financial Crisis*, 18 FINANCIAL MARKETS INSTITUTIONS & INSTRUMENTS 141, 141-43 (2009), available at <http://whitepapers.stern.nyu.edu/summaries/ch01.html>.

<sup>17</sup> See FEDERAL DEPOSIT INSURANCE CORPORATION, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 102 (Financial Crisis Inquiry Commission ed., 2011) (interview with Charles O. Prince by FCIC on Mar. 17, 2010).

<sup>18</sup> See *Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing Before U.S. Senate Comm. on Banking, Housing, and Urban Affairs* (2007) (statement of Kurt Eggert, Professor of Law, Chapman University School of Law).

<sup>19</sup> See Schwarcz, *supra* note 15, at 134.

<sup>20</sup> Jonathan C. Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229, 1229 (2013).

asset securitization. The securities companies work in a role similar to trustees in credit asset securitization. The securities companies set up the special scheme (the SPE), create and sell the asset-backed security to investors.

### *B. The Benefits of Securitization*

Theoretically, securitization process is not a zero-sum game. Instead, it is a win-win game. It will reduce the net financing costs for the companies. For those companies having high liquidity assets, they can use assets to raise funds in the capital market. The securitization provided a lower cost for the companies to raise funds compared with issuance of debts or equities directly. For issuers, they have good channel to get the off-balance sheet funding. This is especially meaningful for the financial institutions (banks, thrifts, depository institutions and insurance companies), which actually have lower capital requirement.<sup>21</sup> For investors, securitization can diversified the risks compared with buying a single pool of assets.<sup>22</sup> The investors do not need to concern about the insolvent risk of the originator since the payment rights has been isolated from the originators.

## III. THE DOWNSIDE RISKS OF SECURITIZATION

Securitization lowers the cost of financing and diversifies the investment products in the financial market. Although the benefits it brings to the market, securitization has significant downside risk since it change the incentive of the originators, which may induce them to become more irresponsible. Securitization changes the model of originating from originating-to-holding (OTH) to originating-to-distributing (OTD). Such model change would materially influence the incentive of the originators since they will not burden the risks of the future cash flow (which has been sold out and moved off balance sheet) and they would like to generate assets as many as they can. As the critique by Economist in 2008 that "old-fashioned mortgage lending is like a marriage: both the bank and the borrower have an incentive to make things work. Securitization...involve[s] lots of participates in fleeting

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<sup>21</sup> See, e.g., Shangye Yinhang Fa (商业银行法) [Commercial Bank Law] (promulgated by the Standing Comm. Nat'l people's Cong., Dec. 27, 2003, effective Dec. 27, 2003) art. 39 (Chinalawinfo) ("The rate of capital sufficiency shall be no less than 8%; the proportion of balance of loan to balance of deposit shall not exceed 75%.").

<sup>22</sup> See Sunil Gangwani, *Securitization 101*, 3 DELOITTE & TOUCHE 5 (July 20, 1998) ("For a securitization, assets are isolated into a bankruptcy remote entity, separate accounts have been set up for collection so cash is not commingled for an unreasonable period of time with other funds of the issuer.").

relationships.”<sup>23</sup> In the fleeting relationships, no one will take the game seriously and be responsible. The originators only care about creating more underline assets to put into the securitization pipe whether it is good or bad. The investment banks only care about producing more securities and sell to the market.

If the securitization is transparent, it would be easy for the investors to identify the garbage assets. However, the securitization is complex and opaque. There is significant information asymmetry problem between the investors and the originators and the issuers. The Information asymmetry problem<sup>24</sup> associated with the securitization can be interpreted via the lens of Lemon Market Theory, which is the coinage of Prof. Akerlof in “Market for Lemons: Quality Uncertainty and the Market Mechanism”<sup>25</sup>.

#### *A. Information Asymmetry Problem via the Lens of Lemon Market Theory*

The quality uncertainty of the used car is the example for demonstrating the information asymmetry problem in this article. In his paper, Prof Akerlof used the example of selling a used car to explain the problem caused by quality differences in situations characterized by uncertainty, and then he proposed a structure for determining the economic costs of dishonesty. The cars in used market have different qualities: some may be good while some may be bad. The cars in bad quality have a nickname of “*lemon*” since “handing (someone) a lemon is to pass off a sub-standard article as good” in American English,<sup>26</sup> while a good car has a sweet name of “*cherry*” in this paper. To distinguish between bad cars and good cars in the used car market is not so easy as to distinguish lemons and cherries in the fruit store for the buyers. Because of information asymmetry, the buyer is unable to correlate the price of the used car with their quality. Therefore, the bad cars and the good cars will be sold at the same price, which reflects the average quality in the used

<sup>23</sup> See *Ruptured credit*, THE ECONOMISTS (May 15, 2008), <http://www.economist.com/node/11325452>.

<sup>24</sup> See Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941 (1963) (first describing asymmetry information situation on health care, which assumes that the sellers have more relevant information about assets quality than buyers, which leads to more transaction cost and even results in unrealizable trade).

<sup>25</sup> See George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON 488, 495 (1970) (winning George Akerlof a Noble Prize of Economics in 2001). See also *George Akerlof-Biological*, Nobel Prize Official Website, [http://www.nobelprize.org/nobel\\_prizes/economic-sciences/laureates/2001/akerlof-bio.html](http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2001/akerlof-bio.html) (last visited May 14, 2015).

<sup>26</sup> See Barry Popik, *Lemon ("Hand someone a lemon")*, Barrypopik (Mar. 18, 2009), [http://www.barrypopik.com/index.php/new\\_york\\_city/entry/lemon\\_hand\\_someone\\_a\\_lemon](http://www.barrypopik.com/index.php/new_york_city/entry/lemon_hand_someone_a_lemon) (stating that “lemon” is a slang originated from American English, and “to hand (someone) a lemon” means “to pass off a sub-standard article as good; to swindle (a person), to do (someone) down”).

car market.<sup>27</sup> This phenomenon is called pricing distortion, which will decay the used car market since the bad cars cannot get sufficient compensation as both of them are sold at the same price.<sup>28</sup> The bad cars are more likely to be selected under the price distortion, which is called as “adverse selection”.<sup>29</sup> The bad cars will tend to drive out the good and the average quality of used cars fall correspondingly.<sup>30</sup>

Facing information asymmetry and the price distortion, the buyers has no other options but set price as a screening mechanism to reflect the average quality in the used car market. The seller knows all information about the car but without strong incentive to disclose, especially those have “lemon” cars. The market will gradually become a market of lemons.<sup>31</sup> Then, it will lead to “a sequence of events that no market exists at all.”<sup>32</sup>

### *B. Lemon Market Problem in Securitization*

Like the purchasers of the used cars, the investors of the securitized products cannot distinguish the good securitized products from the bad ones. Asset back backed security (ABS) is an extremely complex, structured asset-backed security where debt obligations represent claims to the cash flows from pools of various assets. Like the used car, ABS varied greatly in quality due to the opaque risk associated with the underline assets. The value of the securities is derivative from the cash flow of underline assets, while the risk of the cash flow held by the originators is not accessible for the investors unless there is sufficient disclosure. Also, the complexity of the securitization prevents investors to understand the full meaning of the information even it is mandatorily disclosed.

Securitization is like a factory line.<sup>33</sup> The information of the risks associate with the underline assets was withheld, evaporated and hidden in the process of securitization. The originators hold the

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<sup>27</sup> Akerlof, *supra* note 2, at 489 (“[B]ut good cars and bad cars must still sell at the same price—since it is impossible or a buyer to tell the difference between a good car and a bad car.”).

<sup>28</sup> Akerlof, *supra* note 2, at 490.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 493.

<sup>31</sup> See Ted Bergstrom, *Adverse Selection*, UCSB ECONOMICS (April 15, 2004), <http://www.econ.ucsb.edu/~tedb/Courses/Ec100C/lemonsexperiment.pdf> (outline for Lemon’s Experiences).

<sup>32</sup> *Id.* at 490 (“[T]he bad driving out not-so-bad driving out medium driving out not-so-good driving out good in such a sequence of events that no market exists at all.”).

<sup>33</sup> See FCIC, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 102 (2011) [hereafter Final Report] (particularly the interview of Charles O. Prince, former CEO for Citigroup on March 17, 2010).



information of the underline assets.<sup>34</sup> Research showed that “the most complete information concerning individual pool prepayment efficiency is likely to be held by informed originators because only they know both the level of points paid by borrowers at origination and other difficult to quantify characteristics of credit worthiness.”<sup>35</sup> The originators are supposed to tell the investment banks (the issuers) all the information about the underline assets. However, originators will not have an incentive to tell all truth if telling the truth does not increase their payoffs.<sup>36,37</sup> In another word, the information transferred from the originators to the issuers is not one hundred percentage of the information they have about the underline assets and some information has evaporated intentionally or unintentionally. This phenomenon is “information evaporation.” Information evaporation potentially exists in every stage of securitization. Not only mortgage issuer, but also the investment bank, SPV, servicer and rating agency all have an incentive to hide some information for their own benefit. Moreover, the information evaporation does not only exist in the stage of offering but also is continuous since the risks associated with the underline assets are changing.

The complexity of securitization also undermines efficiency of the disclosure. Let us see how the risk hides in the complex process of the securitization factory line. After the investment bank purchases the inputs, it transfers them into a SPV, which pools together various assets. The pool is then sliced into many tranches. New “pools” are set up by bundling some of the tranches, which then may be further divided into other new tranches, and so on. The risks of each underline assets are submerged in the composition and division, which not easy to discern. Since the information of unique risks is completely hidden by the process of “pooling” and “trenching,” the investors can only assess the risks by referring to the securities rating. Therefore, the obligor of the information disclosure in the securitization may hide the risk using complexity despite mandated disclosure requirements.

<sup>34</sup> Peter Demarzo & Darrell Duffie, *A Liquidity Based Model of Security Design*, 67 *ECONOMETRICA*, 65, 67 (1999).

<sup>35</sup> Chris Downing, Dwight Jaffee & Nancy Wallace, *Is the Market for Mortgage-Backed Securities a Market for Lemons?*, 22 *REV. FIN. STUD.* 2457, 2464 (2009).

<sup>36</sup> Such effect is called “cheap talk”. See Vincent P. Crawford & Joel Sobel, *Strategic Information Transmission*, 50 *ECONOMETRICA*, 1431 (1982). See also Joseph Farrell & Matthew Rabin, *Cheap Talk*, 10 *J. ECON. PERSP.* 103, 104 (1996).

<sup>37</sup> Menglin Cao, *Essays On Information Asymmetry in the U.S. Residential Mortgage Market: Incentives And Estimations* (2005) (unpublished Ph.D. dissertation, University of Maryland) (on file with the University of Maryland Library system).

### C. Why Information Problem Cannot be Solved by Market Force?

Some people may argue that the market force can cure the information asymmetry problem. However, information asymmetry is a kind of market failure, which cannot be cured by market force. The following section will raise some responses to the possible counter arguments.

Will the market force disclosure? The economist assumed that in a world where knowledge is valued, market forces should induce disclosure.<sup>38</sup> However, it is not always right. The issuers of the underline assets do not have the incentive to disclose if such disclosure will bring adverse consequences to them. Research showed that more information might reduce liquidity<sup>39</sup> and only “less information can increase liquidity”<sup>40</sup> for securitization. Therefore, the issuers have no incentive to disclose.

Some people may argue that most investors in the ABS market are sophisticate investors (the institutional investors)<sup>41</sup>, who may have higher capability to discern the real quality of the ABS than the common investors. However, evidence shows that “sophisticated investors and qualified institutional buyers (QIBs) are the very investors who lost the most money in the subprime financial crisis”<sup>42</sup>. Investors lost confidence and fled away, which led to market distress.

Prof. Akerlof stated that licensing and guarantees could reduce the quality uncertainty and further mitigate the information asymmetry.<sup>43</sup> How about the rating agencies that are working as gate keepers? The CSRC rules require the securitization products to be rated in application.<sup>44</sup> CBRC also requires the rating to be updated every year to reflect the changes of the conditions of underline assets.<sup>45</sup> To ensure that the consistency of the rating, the information

<sup>38</sup> Edward L. Glaeser & Hédi D. Kallal, *Thin Markets, Asymmetric Information, and Mortgage-Backed Securities*, 6 J. FIN. INTERMEDIATION 64, 64 (1997).

<sup>39</sup> *Id.* at 65-66, 85 (“limited private information decreases the returns to market makers, causing them to exit and thus decreasing liquidity”).

<sup>40</sup> *Id.* at 66.

<sup>41</sup> For example, the investors of Chinese ABS market are mainly sophisticate investors at current stage.

<sup>42</sup> Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. R. 211, 243 (2009).

<sup>43</sup> Akerlof, *supra* note 25, at 499-500 (stating licensing and guarantee could reduce the quality uncertainty and further mitigate the information asymmetry).

<sup>44</sup> Zhengquan Gongsijijin Guanli Gongsizigongsizichan Zhengquan Hua Yewu Guanli Guiding (证券公司及基金管理公司子公司资产证券化业务管理规定) [Provisions for the Administration of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies] (promulgated by China Sec. Reg. Commission, Nov. 19, 2014, effective Nov. 19, 2014) art. 3(6) & art. 5(2) (Chinalawinfo).

<sup>45</sup> *Id.* art. 4 (7).

regarding the change of the rating agency shall be disclosed.<sup>46</sup> Will the rating agencies help investors to identify the quality of the securitization products? Theoretically it shall be, but the reality is not so optimistic. Firstly, the ex-ante model used by rating agencies is too simple to measure “observably high-risk deals”.<sup>47</sup> Information asymmetry undermined the capability of rating agencies to accurately evaluate the value of the ABS. Ratings agencies had difficulty in estimating the risk for mortgages with low-documentation.<sup>48</sup> Some scholars criticized that the rating agencies in the U.S. shall be partially responsible for the 2008 crisis because the rating agencies created the rating inflation.<sup>49</sup> Beside complexity, information asymmetry and rating shopping also significantly led to rating inflation.<sup>50</sup> Rating shopping is the drive force of the rating inflation.<sup>51</sup> Security originators shop for more favorable credit ratings.<sup>52</sup> This phenomena is depicted as “rating shopping” by Sangiorgi *et al.*<sup>53</sup> With the concern of losing market share, rating agencies competed with each other by inflating ratings and ignoring the true credit quality of the ABS.<sup>54</sup>

The stock price cannot accurately reflect the real quality of securities. In an efficient market, stock prices virtually reflect all publicly available information relevant to the value of traded stocks. However, the ABS market is not an efficient market due to the significant information asymmetry.<sup>55</sup> The market relied on the rating agency to identify the real quality. The rating, however, disappoints

<sup>46</sup> *Id.* art. 4 (9).

<sup>47</sup> Adam Ashcraft, Paul Goldsmith-Pinkham & James Vickery, *MBS Ratings and the Mortgage Credit Boom*, in FED. RES. BANK OF NY STAFF REPORTS, at 32 (Staff Report No. 449, 2010), available at [http://www.newyorkfed.org/research/staff\\_reports/sr449.pdf](http://www.newyorkfed.org/research/staff_reports/sr449.pdf).

<sup>48</sup> See Ashcraft, *supra* note 45, at 32 (“Deals with a high share of low-documentation mortgages also perform disproportionately worse compared to other types of risky deals.”).

<sup>49</sup> See Joseph Stiglitz, *Testimony on Restoring Financial Stability Act 2010* (May 13, 2010) (“[I] view the rating agencies as one of the key culprits ... They were the party that performed the alchemy that converted the securities from F-rated to A-rated. The banks could not have done what they did without the complicity of the rating agencies”, quoted by Sen. Charles E Schumer, script of which available at <http://www.c-spanvideo.org/videoLibrary/clip.php?appid=598136964>).

<sup>50</sup> See Skreta, Vasiliki & Laura Veldkamp, *Rating Shopping and Asset Complexity: A Theory of Ratings Inflation*, 56 J.MONETARY ECON. 678, 679 (2009).

<sup>51</sup> *Id.* at 679.

<sup>52</sup> Elliot Blair Smith, “Race to Bottom” at Moody’s, S&P Secured Subprime’s Boom, Bust, BLOOMBERG (Sept. 25, 2008), [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya\\_Vtdo](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ax3vfya_Vtdo).

<sup>53</sup> Francesco, *supra* note 48, at 4; See also Roger Lowenstein, *Triple-A-Failure*, N.Y. TIMES, Apr. 27, 2008 (“The banks choose the agency that can deliver the desired rating. This process is known as ratings shopping.”).

<sup>54</sup> Schumer, *supra* note 49.

<sup>55</sup> Steven L. Schwarcz, *Disclosure’s Failure in the Subprime Mortgage Crisis*, 2008 UTAH L. REV. 1109, 1116 (claiming that the complexity of the financial transaction would take the market “more time to understand and reach price equilibration”).

the market in the end. The rating inflation is possible to leads to the price distortion in the ABS market, which is likely to become a lemon market: bad assets will drive off good assets. Thus, more and more bad assets are attracted to the market while more and more goods are leaving. In the U.S., “assets sold to SPVs will be of lower quality compared to assets that are not sold to SPVs” according to some statistics.<sup>56</sup>

#### IV. INFORMATION DISCLOSURE APPROACH IN CSRC’S RULE

In Chapter Five of the Provisions for the Administration of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies (证券公司及基金管理公司子公司资产证券化业务管理规定), it requires the trustee and other obligors to disclose the information of securitization.<sup>57</sup> The provisions also delegate the quasi-regulators (like the stock exchanges, the Securities Association of China) to implement the guideline.<sup>58</sup> The essential requirement of the disclosure is just copy from the Article 63 of Securities Law of the PRC,<sup>59</sup> which shall be “authentic, accurate and complete and shall not have any false record, misleading statement or major omission”.<sup>60</sup> Any information that has material influence on the value or price of the asset back securities shall be disclosed.<sup>61</sup> CBRC also promulgates the implementation of the guideline on information disclosure (hereafter Guideline). The other obligors including but not limited to the custody and the rating agencies according to the guideline.<sup>62</sup> The

<sup>56</sup> Downing et al., *supra* note 35, 2459 (2009) (studying the sales of mortgage-backed securities (Freddie Mac Participation Certificates, or PCs) to SPVs over the period 1991 through 2002 which shows that PCs sold to SPVs are “on average valued \$0.39 lower per \$100 of face value relative to PCs not so sold”).

<sup>57</sup> Zhengquan Gongsi Ji Jijin Guanli Gongsi Zigongsi Zichan Zhengquan Hua Yewu Guanli Guiding (证券公司及基金管理公司子公司资产证券化业务管理规定) [Provisions for the Administration of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies] (promulgated by China Sec. Reg. Commission, Nov. 19, 2014, effective Nov. 19, 2014) art. 41 (Chinalawinfo).

<sup>58</sup> *Id.*

<sup>59</sup> Zhengquan Fa (证券法) [Securities Law] (promulgated by the Standing Comm. of the Nat’l People’s Cong., Dec. 29, 1998, effective Jul. 1<sup>st</sup>, 1999) (2014) art. 63 (Chinalawinfo).

<sup>60</sup> Zhengquan Gongsi Ji Jijin Guanli Gongsi Zigongsi Zichan Zhengquan Hua Yewu Guanli Guiding (证券公司及基金管理公司子公司资产证券化业务管理规定) [Provisions for the Administration of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies] (promulgated by China Sec. Reg. Commission, Nov. 19, 2014, effective Nov. 19, 2014) art. 42 (Chinalawinfo).

<sup>61</sup> *Id.* art. 44.

<sup>62</sup> Zhengquan Gongsi Ji Jijin Guanli Gongsi Zigongsi Zichan Zhengquan Hua Yewu Xinxin Pilu Zhiyin (证券公司及基金管理公司子公司资产证券化业务信息披露指引) [Guideline of Information Disclosure of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund

guideline also requires the loan level disclosure<sup>63</sup>: the ownership, burden of collateral, and the isolation of the risk. If the underline asset is composed of a pool of various credit loans, then the trustee shall also disclose the components, criteria of the components, the overall characteristics of the asset pool and the debtors' credit situation if single debtors get default up to the amount of 15% of the debtors and their affiliated parties get default up to 20%.<sup>64</sup> The idea of loan level disclosure is pioneering and reflects the lessons from 2008 financial crisis.<sup>65</sup> The information of each tranche is essential for valuing the asset pool because the asset back security market is model-driven instead of trade-driven. However, the requirement of the guideline regarding the loan-level disclosure is too simple, which only covers categories of tranches and the default of them. Although the guideline aims at using such disclosure to lead the investors to make an informed decision and burden all the risks of their investment decisions, the rule is too general to achieve this end.<sup>66</sup> The disclosure under this rule is not sufficient to facilitate investors to identify different tranches and to perform their own due diligence regarding both the underlying assets and their origination process. At least two kinds of loan-level information need to be disclosed. The first one is the fixed information as the offering stage, such as original balance, maturity date, interest rate, the original loan to the value rate of the single assets instead of an aggregated pool.

Also, because the risks of the underline assets keep changing, continuous disclosure may be needed. However, the existing rules

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Management Companies] (promulgated by China Security Regulatory Comm'n, Nov., 19, 2014, effective Nov. 19, 2014) art. 2 (Chinalawinfo).

<sup>63</sup> *Id.* art. 9.

<sup>64</sup> *Id.*

<sup>65</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 942(b), 124 Stat. 1376, 1897 (2010) ("Section 7 of the Securities Act of 1933 (15 U.S.C. 77g) is amended by adding at the end the following: '(c) DISCLOSURE REQUIREMENTS. – (1) IN GENERAL. – The Commission shall adopt regulations under this subsection requiring each issuer of an asset-backed security to disclose, for each tranche or class of security, information regarding the assets backing that security.(2) CONTENT OF REGULATIONS. – In adopting regulations under this subsection, the Commission shall —(A) set standards for the format of the data provided by issuers of an asset-backed security, which shall, to the extent feasible, facilitate comparison of such data across securities in similar types of asset classes; and (B) require issuers of asset-backed securities, at a minimum, to disclose asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including-(i) data having unique identifiers relating to loan brokers or originators;(ii) the nature and extent of the compensation of the broker or originator of the assets backing the security; and (iii) the amount of risk retention by the originator and the securitizer of such assets.'")

<sup>66</sup> Zhengquan Gongsi Ji Jijin Guanli Gongsi Zigongsi Zichan Zhengquan Hua Yewu Xinxi Pilu Zhiyin (证券公司及基金管理公司子公司资产证券化业务信息披露指引) [Guideline of Information Disclosure of the Asset Securitization Business of Securities Companies and the Subsidiaries of Fund Management Companies] (promulgated by China Security Regulatory Comm'n, Nov., 19, 2014, effective Nov. 19, 2014) art. 8 (Chinalawinfo).

only require the loan-level disclosure at the offering stage without continuous reporting requirement.<sup>67</sup> Some information, such as the paid amount, delinquency or the foreclosure status, the prepayments, and the interest rate adjustments need to be disclosed.

Of course the disclosure of the underline assets shall not include the personal identity. Otherwise, it may violate the law of privacy protection. For example, the U.S. Federal privacy law restricts the release of consumers' "personally identifiable financial information" of consumers unless exceptions apply.<sup>68</sup> However, it does provide an exception for disclosure in connection with "a proposed or actual securitization, secondary market sale (including sales of servicing rights), or a similar transaction." With the concern of the threat of privacy, the originators or issuers shall remove any personally identifiable financial information.

The disclosure on asset back securities can inherently be incomplete, considering that asset back securities is a combination of cash flow rights from thousands of underline assets, whose cash flow streams are dependent on numerous actors, and thus innately too complex to be effectively disclosed by the current disclosure regime. Therefore, we need some new solutions. The following section will discuss the inherent defects of the traditional signaling and screening paradigm and raised some possible alternative solutions.

#### V. DILEMMA OF SIGNALING AND SCREENING AND POSSIBLE ALTERNATIVE SOLUTIONS

The signaling-screening game may work around the problem of information asymmetry. The signaling-screening game works in this way: the party with less information (uninformed party) announces offers (or intents to investment). The party with more information (informed party) will signal themselves by providing the credential of their quality.<sup>69</sup> On the other hand, the uninformed party may use the screening to identify the quality.<sup>70</sup>

##### *A. Signaling, Disclosure and Misrepresentation*

In the lemon market, the price distorted to match the average quality of the products in the market. The sellers of above-average quality products could "signal" this fact by taking some costly actions. On the other side of the market, could the uninformed buyers

<sup>67</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 942(a), 124 Stat. 1376, 1896.

<sup>68</sup> See Privacy Of Consumer Financial Information, 16 C.F.R. § 313.10, [http://cfr.regstoday.com/16cfr313.aspx#16\\_CFR\\_313p10](http://cfr.regstoday.com/16cfr313.aspx#16_CFR_313p10) (last updated May 24, 2000).

<sup>69</sup> See Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355, 355-74 (1973).

<sup>70</sup> *Id.*

use the costly action as a way to “screen” for quality? The problem of signaling is that the senders burden the cost of sending information. And also the candidates pay the cost to get the credentials though the good quality candidates pays less cost than the bad quality candidates to get the credentials. Signaling can maximize the utility of resources by reducing information acquisition. It can also “[enable] individuals to make informed choices to maximize their own utility.”<sup>71</sup> It also brings benefits to the securities originators and issuers if they send the signals to the market about the good quality and can attract more investors and increase the liquidity of companies.<sup>72</sup> In order to increase liquidity, firms would like to signal to increase the investors’ confidence in their assets.<sup>73</sup> Then, it looks like that the signaling is a win-win game. However, the selection effect of signaling is associated with the assumption that the uninformed party can identify the quality from the candidates’ signaling: for example, the employees’ the education background is a strong signal of having a good working force. This assumed that the informed parties are honest (or should be honest) in signaling and no “inverted signaling.”<sup>74</sup> It also assumes that only the good quality products can get the credential. Questions are raised here: first, if the credential can also be attained by the bad quality products, will the signaling be a strategic lying? Second, will the sellers disclose every essential information about the products for the buyers to make informed decision or may conceal some information or even misrepresent?

The answer is that credential does not always be credible in the case of the ABS. For example, the rating from the rating agencies is the credential for the quality of the assets. However, the rating inflation seems significant in the ABS market in the U.S. as I discussed above. The poor quality assets may be possible to be rated as AAA, which turned out to be trash.<sup>75</sup>

Will the originators and other obligors disclose everything? Maybe not, especially for the bad news. The more information about how poor the quality is the lower the price it will get. The obligors

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<sup>71</sup> Alan Schwartz T & Louis L. Wilde, *Intervening In Markets on The Basis of Imperfect Information: A Legal And Economic Analysis*, 127 U. PA. L. REV. 634, 635 (1979).

<sup>72</sup> *Id.* at 1325.

<sup>73</sup> See Douglas W. Diamond & Robert E. Verrecchia, *Disclosure, Liquidity, and the Cost of Capital*, 46 J FIN., 1325, 1325 (1991).

<sup>74</sup> See Vincent P. Crawford, *Lying for Strategic Advantage: Rational and Boundedly Rational Misrepresentation of Intentions*, 93 AM. ECON. REV. 133, 134 (2003).

<sup>75</sup> See Lowenstein, *supra* note 53 (“93 percent of AAA-rated subprime mortgage-backed securities issued in 2006 have been downgraded to junk status”).

actually are facing the moral hazard of *Cheap Talk*.<sup>76</sup> The originators have strong incentive to cash out the assets while there is serious information asymmetry in ABS market. The investors can only rely on the disclosure (including the rating agencies) to get information.<sup>77</sup> If the assets are of high quality, then the obligors will be happy to tell the investors. However, if the assets are not very good, then the problem will become complicated. The obligors can choose to tell the truth, which may lower the price of securities. Here, the obligors burden the cost of their honest disclosure. Otherwise, the obligors may only disclose good news and hide the bad news. In this way, the ABS can get higher price. Which one looks better? Ignoring the possibility of getting penalty, the second one is definitely better for obligors. Of course, there is a risk of penalty, if the misrepresentation has been detected. However, the chance is comparatively low due to the veil of complexity.

Therefore, disclosure is really not a win-win strategy in the case where the quality of underline asset is not good. What determine the amount of information disclosed by the obligors? Assuming no penalty for misrepresentation, the amount depends on their buyers' acquaintance with product quality.<sup>78, 79</sup> Considering the penalty, the higher the penalty is and the higher risk of being detected, the larger amount and more accurate the disclosure will be. However, in a lemon market, the information asymmetry disables the buyers to be acquainted with the asset quality and to detect the misrepresentation easily. Therefore, the obligors may like to bet on their fortune by misrepresenting information that is against their interests.

### B. Screening Approach

The concept of screening was a coinage by Michael Spence as decision-making strategy against information problem.<sup>80</sup> The "screener" is the party with less information, attempting to rectify this asymmetry by learning as much as he can about his counter party.<sup>81</sup>

<sup>76</sup> See, e.g., FINANCIAL CONCEPT MORTGAGE, <http://www.fcmortgageloans.com/LoanApplicationInfo> (providing an example of essential information for apply financial mortgage).

<sup>77</sup> Assuming that the rating agencies face the rating shopping pressure and have the incentive aligned with the originators and the issuers.

<sup>78</sup> See Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosures*, 24 J. L. ECON., 461,483 (1981). See also Paul R. Milgrom, *Good News and Bad News: Representation Theorems and Applications*, 12 BELL. J. ECON. 380, 391 (1981).

<sup>79</sup> See Ginger Zhe Jin, *Competition and Disclosure Incentives: An Empirical Study of HMOs*, 36 RAND. J. ECON. 93,112 (2005) ("HMOs use voluntary disclosure to differentiate from competitors, with lower disclosure rates in highly competitive markets").

<sup>80</sup> See Spence, *supra* note 69.

<sup>81</sup> *Id.*



Theoretically, investors in the ABS market are not passive players and can only wait for the obligors to disclose. Many investors in ABS market are the institutional investors, which usually have risk and data analysis professionals. Therefore, the investors may use the screening approach to get the alternative information. The uninformed players may collect more information from the informed players to have more information to make a decision. In the case of ABS, the screening ability on the buying side may be theoretically enhanced through the following ways: they may rely on the long-term relationship to capture the information since the repeated game may reduce the possibility of cheating and also the acquaintance provides more available information; enhance the risk analysis capability of purchasers by collecting more information and using advanced technology; promoting due diligence of risk analysts; relying on rating agencies to screening; or devising a mechanism (e.g. price) which induces the sellers to sort their goods out.

Those mechanisms look practical, however, may not be both practical and efficient. The originator holding information and generating inputs to the securitization pipe does not have a direct connection and transaction with the investors. Therefore, the investors may not be acquainted with the originators and get advantages of information screening. Especially, the risks of underline assets will only emerge after a long time or will associate with economic distress. Since the information of many underline assets is not open to public (such as the borrower's credit scores and default history), the risk analysts lack sufficient data to estimate the risks.

Because "[i]n the case of asymmetric information, the risks generated by the bad behavior of one player...are generally borne by the other,"<sup>82</sup> we cannot get the appropriate amount of information using either screening approach or the disclosure doctrine. Therefore, we need a new device to cure such a moral hazard problem using the risk allocation paradigm.

### *C. Skin in the Game Paradigm*

Information asymmetry cannot be cured with the signaling and screening paradigm. The pricing mechanism (offering prices according to the average quality of products in ABS market) also cannot protect the investors; it may attract the bad quality ABS and drives off the high quality products. The moral hazard vested in the

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<sup>82</sup> Andre de Palma, Luc Leruth & Guillaume Prunier, *Towards a Principal-Agent Based Typology Of Risks in Public-Private Partnerships* 15 (IMF Working Paper, Paper No. 09/177, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1475518](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1475518).

context of information asymmetry is that investors will burden the cost of dishonesty of obligors of disclosure. The risk allocation paradigm may solve the moral hazard problem by asking the disclosure obligors to share some risks of the securities. The higher the risk shared by the disclosure obligors, the more information they would like to disclose. The risk allocation paradigm is originated from the doctrine of strict liability in torts, based on the ground that manufacturers know the risk of products while the consumers lack the information to evaluate the risks.<sup>83</sup> China also uses the strict liability in torts.<sup>84</sup> Another example is the famous “Lemon Law” (Magnuson–Moss Warranty Act) in the U.S.A.<sup>85</sup>, which provides a remedy for purchasers if the goods they buy fail to meet certain standards of quality and performance.<sup>86</sup>

The risk allocation paradigm in ASB is to change the originating-to-distributing model to a combination of originating-to-distributing and originating-and-hold. In other words, it requires the originators to have skin in the game. Without skin in the game, the originators have great incentive to lend out more, which will bring them only benefit and no risks. As Eric Thompson comments that “Securitization itself has many benefits, but one downside in the OTD model is that it gives banks incentives to generate as many mortgages as possible, sell them and repeat, a process that will hereinafter be referred to as churning”.<sup>87</sup> They also have strong incentive to cheat in the information disclosure. The skin in the game would align the interest of obligors and investors to make sure that obligors be responsible for their behaviors. This design will make the securitization become a real win-win game instead of zero-sum game that one gains means another losses.

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<sup>83</sup> See Calabresi & Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1062 (1972).

<sup>84</sup> See Qinquan Zeren Fa (侵权责任法) [Tort Law] (promulgated by Standing Comm. Nat'l People's Cong., Dec. 26, 2009, effective July 1, 2010) art. 41 (Chinalawinfo) (“Where a defective product causes any harm to another person, the manufacturer shall assume the tort liability.”).

<sup>85</sup> Magnuson–Moss Warranty Act, 15 U.S.C. § 2301 (1975) (called as Lemon Act because it tends to solve “Lemon Problem” of information asymmetry).

<sup>86</sup> See Jonathan Eddy, *Effects Of The Magnuson-Moss Act Upon Consumer Product Warranties*, 55 N. C. L. REV. 835 (1977) (stating missions of Magnuson–Moss Warranty Act as (1) attempts to improve the clarity of warranty terms in consumer sales through rules governing disclosure of terms and pre-sale availability of warranties; (2) attempts to increase the substance of warranties given by inducing warrantors to comply with “minimum federal standards for warranty”; and (3) attempts to improve the remedies available to consumers, especially by encouraging “informal dispute settlement mechanisms”).

<sup>87</sup> See Eric Thompson, *Dodd-Frank And Basel III, Skin In The Game Divergence And Why It Is Good For The International Banking System*, 2 GLOBAL BUS. L. REV. 159, 160 (2012).

### 1. U.S. model in Dodd-Frank Act (Dodd-Frank)

As a response of the subprime mortgage loan crisis, Dodd-Frank suggests a solution to the moral hazard problem regarding the information asymmetry in securitization. Section 941 of Dodd-Frank has a rule called “credit risk retention” requirement. This rule requires the issuers to retain “not less than five percent of the credit risk for any asset.”<sup>88</sup> This requirement was added into the Securities Exchange Act of 1934 as Section 15G.<sup>89</sup> The purpose of this legislature is to increase the incentive of the securitizers to have a “more prudent judgment in creating and distributing these securities” by forcing them to share the risks of securitization.<sup>90</sup> The five percentage requirement is applied to all the asset-back securities, which is not exempted from the by the U.S. Securities and Exchange Commission’s (SEC) proposed rule.<sup>91</sup>

The model in Dodd-Frank provides a mechanism against the irresponsible behavior in a fleeting relationship. However, the credit risk retention requirement in Dodd-Frank still looks conservative due to the lobbying pressure from the industry: first, the credit risk retention rule only requires the issuers to retain five percent of the assets. This requirement does not apply to the originators, which hold the information of the underline assets. Just putting the issuers on the hook is not enough. The originators, the parties, who have the greatest incentive of being irresponsibility, do not have a skin in the game. Secondly, five percent may not be material for preventing the irresponsibility on the obligors’ behalf, since the five percent of risks of the securities can easily be hedging by holding diversified securities. However, if the regulators require a way too high percentage of retention, then it may cause liquidity problem for the issuers.

### 2. Proposal for Skin-in-the Game

The first question need to answer is why the ABS needs to have risk retaining requirements. Some people may think that the underline assets in ABS market usually have collateral, which provides adequate protection for investors; hence, retaining the ownership equity requirement is redundant. For example, the mortgage-backed securities have the real estate as the collateral,

<sup>88</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, § 941, 124 Stat. 1376, 1897 (2010).

<sup>89</sup> Securitization After Dodd-Frank: A Look at the Proposed Risk-Retention Rules, memorandum from Simpson Thacher (Apr. 7, 2011) (on file with author), available at <http://www.stblaw.com/content/Publications/pub1185.pdf>.

<sup>90</sup> Amy McIntire, *Dodd-Frank’s Risk Retention Requirement: the Incentive Problem*, 33 BANKING & FINANCIAL SERVICES POLICY REPORT 5, 6 (2014).

<sup>91</sup> *Id.* at 20.

which is over the value of the underline assets.<sup>92</sup> However, since the price of the collateral is not fixed, but may sharply decrease when during the economic distress. For example, the housing collateral does not have adequate protection for investors to avoid losses, especially after a market collapse. Thus, retaining some portion of ownership equity is one possible solution that puts the originator's skin in ABS games. For example, the original version of financial reform bill in the U.S. suggests that the seller of the mortgage backed securities should be required to keep a material portion of credit risk exposure to "ensure they won't sell garbage to investors, because they have to keep some of it for themselves."<sup>93, 94</sup>

One counter argument of the risk may say that it is improper to require that banks to retain some portion because "retention is costly since there are investment opportunities and because the issuer will have to post capital against the retained proportion of security."<sup>95</sup> This opinion is correctly reflecting one side of the issue, but it ignores the other side: can the banks benefit from retention? Yes. Banks would incur a cost by retaining some portion of the asset. But this cost is compensated by the reduced cost of getting liquidity. The retention of risks will send a signal of credential to investors that the securities have comparatively high quality. The investors would believe that "the issuer puts her money at stake with the investors and consequently this should constitute an incentive to issue higher quality securities."<sup>96</sup> Such belief will increase the liquidity of the ABS market.

The retention of risks should not only apply to the ABS issuers but also to the ABS originators, who generate the materials for

<sup>92</sup> See Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 34 MINN. L. REV. 373, 388 (2008) ("Retaining the equity ownership is not always done in mortgage securitization because mortgage loans are inherently over-collateralized by the value of the real-estate collateral, and thus investors can effectively be over collateralized even if the originator bears no risk of loss.").

<sup>93</sup> See U.S. Senate Comm. on Banking, Housing & Urban Affairs, *Summary: Restoring American Financial Stability* 1, 10 (2010), available at [http://banking.senate.gov/public/\\_files/FinancialReformSummary231510FINAL.pdf](http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf) ("Requires companies that sell mortgage back securities to retain a material portion (generally 5%) of credit risk of securitized exposures and prohibits the originator or sponsor from directly or indirectly hedging or otherwise transferring this risk.").

<sup>94</sup> But see S. 3217, *the Restoring American Financial Stability Act of 2010*, DPC.SENATE.GOV, [http://dpc.senate.gov/dpcdoc.cfm?doc\\_name=lb-111-2-64](http://dpc.senate.gov/dpcdoc.cfm?doc_name=lb-111-2-64) (the final version of the Financial Reform Act 2010 opening an exception of the retaining provision that "the underlying loans meet standards that reduce riskiness"). The standard of exception is too vague and open large space for MBS sellers to escape the requirements of retaining. The new version of Financial Reform Act only apply to the seller but not to the servers, sponsors and the lenders which are actually participate the process of production but remote from risks.

<sup>95</sup> See Mario Cerrato, *The Rise and Fall of the ABS Market*, 10 (Univ. of Glasgow Working Paper, 2010), available at [http://www.gla.ac.uk/media/media\\_179593\\_en.pdf](http://www.gla.ac.uk/media/media_179593_en.pdf).

<sup>96</sup> *Id.* at 13.

securitization and have the information of underline assets. For the originators, we can use another risks retention mechanism to guarantee the price of assets. If the underline assets are worth substantially less than the investors had paid and the originators misrepresent, the originators need to compensate the price difference.<sup>97</sup> Of course, only the substantially decrease of the price will trigger the compensation. The compensation penalty is better than the retention of securities since it will not reduce the liquidity.

## VI. CONCLUSION

The problem of bad driving off the good is not very significant at the current stage in China since the ABS market is emerging China and the products which get approval from the CSRC usually has a high quality. However, it is hard to say that China will not have similar problem when the market booms. Especially, the approval system for offering securities has been replaced with the registration system at the end of last year. Without the approval review by the CSRC, it is more possible that both good and bad quality assets will be mingled into the securitization pipe. According to the report, the cash flow of the underline real estate may become unstable due to the new policy in housing market.<sup>98</sup> Saving for a rainy day is always the traditional wisdom in China. It would also be wise for the regulator to consider new solutions for the information asymmetry problem and the investors. As I have discussed that the rule of disclosure by CSRC is not panacea; instead, it is just platitude, which cannot solve the lemon problem in disclosure. Due to inherent dilemma of traditional signaling and screening paradigm, risk allocation to the disclosure obligors may be fundamental solution. To have the obligors skin in the game; we can require the issuers to have material risk retention of the securities and the originators to compensate the material price difference of the underline assets due to the misrepresentation. Of course, as an innovative financing channel, the charm of securitization is to provide liquidity to illiquid assets. Therefore, the retaining portion shall be set at a reasonable level: too high portion will cause liquidity problem while too low may easily be hedging by holding diversified assets and cannot produce the deterrence effect. The price guarantee may be better than risk retention since it will not cause any liquidity problem. However, how to measure the price difference is a spiny problem faced by

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<sup>97</sup> *Id.*

<sup>98</sup> See Jichu Zichan Zhiliang Jueding Zhengquan Hua Chengbai (基础资产质量决定证券化成败) [*The Quality of the underline assets determines the success of the securitization*], Zhengquan Shibao (证券时报) [CHINESE SECURITY NEWS], Aug. 9, 2013, available at [http://www.csrc.gov.cn/pub/shenzhen/xxfw/mtzs/201308/t20130830\\_233354.htm](http://www.csrc.gov.cn/pub/shenzhen/xxfw/mtzs/201308/t20130830_233354.htm).

regulators. Therefore, those issues are still open for further discussion.