Arbitraging the Basel Securitization Framework: Evidence from German ABS Investment*

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Abstract

I use data on bond holdings of banks residing in Germany to identify regulatory arbitrage under the Basel Securitization Framework. Within a group of asset-backed securities (ABS) with the same Basel II risk weight, banks buy the ABS with the highest yields, the worst collateral, and the most inflated credit ratings. The effect is more pronounced for banks operating with capital adequacy ratios close to the regulatory minimum requirement and for large banks. The evidence suggests that regulatory arbitrage considerations influence investment decisions and that ratings inflation reinforces regulatory arbitrage as Basel II risk weights depend mechanically on credit ratings.

Keywords: Regulatory arbitrage, asset-backed securities, risk-taking, ratings inflation

JEL classification: G01, G21, G24, G28.

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