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Dodd-Frank’s Risk Retention Requirement: the Incentive Problem

Amy L. McIntire

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Dodd-Frank’s Risk Retention Requirement: the Incentive Problem

By: Amy McIntire

Introduction

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law (Dodd-Frank). Promulgated by Congress to “promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial service practices, and for other purposes,”¹ the bill represented an almost complete overhaul of the entire United States financial system regulation. Since the bill attempted to serve as a quick and forceful reaction to the recent financial collapse, it directed substantial regulatory reform toward the subject that many scholars and experts believed to be the main cause of the financial collapse— the failure of securitized debt. Thus, the bill generally mandated that securitizers “retain not less than five percent of the credit risk for any asset.”² This requirement, contained in Section 941 of Dodd-Frank and added into the Securities Exchange Act of 1934 as Section 15G, became known as the “risk retention requirement.”³ The legislature hoped that, by forcing securitizers to hold onto a percentage of the risk attached to the securities that they created, the securitizers would exercise more prudent judgment in creating and distributing these securities.

While this regulation did work towards correcting the misalignment of incentives that is inherent in the securitization chain, its uniform application of a five percent retention requirement, subject to a few delineated exceptions, to all types of asset-backed securities is problematic. By forcing a singular requirement onto different classes of asset-backed securities which have varying characteristics and may react uniquely in their respective market, the five percent risk retention requirement creates an entirely new risk – the potential effect of “chilling” the credit market by imposing a five percent retention requirement on securities that cannot feasibly retain such an amount. Therefore, while successful in making sure that securitizers and originators keep some “skin in the game,” the risk retention requirement is not a complete solution. This Article argues that any proposed solution must balance the interest of correcting the misaligned incentives of parties in the securitization process with the interest of maintaining a healthy credit market. Furthermore, leaving too much discretion as to retention restraints in the hands of the securitizers and originators themselves fails to correct the underlying incentive problem. Therefore, this Article proposes that the Securities and Exchange Commission, in conjunction with the federal agencies, prepare a set of rules that specify individualized retention requirements for each class of asset-backed security.

The scope of this Article is limited to the macroeconomic implications of the risk retention requirement on the United States financial market.4 In order to understand the macroeconomic implications of the risk retention requirement, one must understand the nature of “shadow banking” industry that was a key component in the recent financial crisis. Part I of this

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Article gives an overview of the origins of the shadow banking industry, and it illustrates the ways in which the shadow banking industry, through the combined effects of the securitization process and the repurchase agreement market, contributed to the recent financial crisis. Part II of this Article proceeds to analyze Congress’s response to the recent collapse of the financial markets – a comprehensive regulatory reform known as the Dodd-Frank Wall Street Reform and Consumer Protection Act. This analysis focuses specifically on the “risk retention requirement” contained in Section 941 of the Act and also provides an overview of the main critiques of the regulation. Finally, Part III of this Article responds to those critiques of the risk retention requirement, and after taking into account the interests of the market as well as the purpose of the regulation, proposes a solution to the shortcomings of the current regulation.

I. The Emergence of the Shadow Banking Industry

A. An Overview

The term “shadow banking” refers to the industry that emerged as a result of regulatory and market changes in the financial system over the last thirty to forty years.\(^5\) Also known as the “parallel banking system”\(^6\) since it acts as an alternative to many traditional banking functions, the shadow banking system began to emerge in the 1970s as a way to “circumvent the existing regulations” of the traditional banking industry.\(^7\)

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\(^5\) Gary Gorton and Andrew Metrick, *Regulating the Shadow Banking System*, September 1, 2010, at 6 (“Shadow banking is the outcome of fundamental changes in the financial system in the last 30 to 40 years, as a result of innovation and regulatory changes that led to the decline of the traditional banking model; in the face of competition from nonbanks and their products; the traditional banking business model became unprofitable.”).

\(^6\) Gary Gorton, *Questions and Answers about the Financial Crisis*, February 20, 2010, at 7. The shadow banking system or parallel banking system is also known by a third, more descriptive name – the securitized banking system.

Since its inception in the nineteenth century, the traditional banking industry has been heavily regulated by the United States government. Unlike other areas of commerce and business, the traditional banking industry has always presented unique impositions upon the public. Financial experts and scholars have long argued that banks are “special” and should be looked at as different from other industries because: (1) virtually all other financial markets and institutions are directly or indirectly dependent upon banks as a source of back-up liquidity and credit and (2) banks act as the “transmission belt” through which actions of the central bank have their effect on financial market conditions. Given traditional banks’ relationships with the overall economy, any types of problems - bank panics, runs, and failures - can seriously affect the economy and impose burdens on the public. Likewise, shortages in bank credit, caused by the aforementioned bank problems, may prevent small and medium-sized businesses from obtaining working capital and therefore cause systemic problems to the economy. Therefore, the United States bank industry has “always been a concern of public policy, and governments have always been involved in their regulation.”

In order to protect depositors and minimize the risks imposed upon the public, the government imposes a variety of prudential regulations. At a minimum, traditional banks are

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8 Meir Kohn, Financial Institutions and Markets 594 (2d ed. 2003)
9 E. Gerald Corrigan, Are Banks Special?, Federal Reserve Bank of Minneapolis 1982 Report (1982) reprinted in The Law of Banking and Financial Institutions 56–58 (Wolters Kluwer 4th ed. 2009). For a counter-argument as to why banks should not be viewed as “special,” see Richard C. Aspinwall’s On the ‘Specialness’ of Banking, 7 Issues in Bank Regulation 16 (1983) reprinted in The Law of Banking and Financial Institutions 58–60 (Wolters Kluwer 4th ed. 2009). Aspinwall argues that (1) banks are not special based upon any criteria that would justify the extent of heavy regulation and (2) improvement of financial markets and entities actually requires fewer restrictions and regulations. Id. at 59. Specifically, as counter-points to Corrigan’s argument that banks are unique, Aspinwall points out that banks “are not the only source of [back-up liquidity]” and that interest rates and non-banks, such as Goldman Sachs, can act as “transmission belts” for monetary policy. Id. at 60.
10 Kohn, supra note 8, at 594.
11 Id.
12 Id.
13 Id. at 595.
usually subject to both chartering and disclosure requirements.\textsuperscript{14} Since setting up a federal or state bank first requires the acquisition of a government charter, government regulators can choose to provide charters only to those banks that they deem to be “fit and proper.”\textsuperscript{15} After granting a bank charter, regulators also generally require traditional banks to disclose certain financial information to the public, and these banks are subject to government inspection to ensure that the disclosed financial information is accurate.\textsuperscript{16} These chartering and disclosure requirements comprise the minimum standard of regulation. Traditional banks are also generally subject to regulation that limits the type of assets a bank can hold and the types of activities in which a bank can engage.\textsuperscript{17} Additionally, regulators may also require that a bank maintain a certain level of reserves or capital, and since competition among banks encourages risk taking activities, regulators may restrict competition by setting caps on deposit rates.\textsuperscript{18}

Given the imposition of this heavy, and thus costly, regulation, traditional banks began to look for alternative means to operate.\textsuperscript{19} In searching for these “workarounds” to avoid the costs of regulated lending, “banks have taken a large part of their commercial lending off their balance sheets by helping their customers issue commercial paper or by selling syndications and participations to nonbanks.”\textsuperscript{20} Consequently, any savings that the bank realizes by avoiding regulatory costs are passed down to the customers through lower borrowing rates.\textsuperscript{21} Essentially, the shadow banking system “reflected regulatory arbitrage, [or] the opportunity and the propensity of the financial sector to adopt organizational forms and financial innovations that

\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{18} Id.
\textsuperscript{19} See Gorton and Metrick, supra note 5, at 6.
\textsuperscript{20} Kohn, supra note 8, at 424.
\textsuperscript{21} Id.
would circumvent the regulatory apparatus designed to contain bank risk taking.” The system allowed financial firms to perform all the basic functions of traditional banking, while operating outside the heavily regulated, and thus less profitable, system of traditional banking.

The shadow banking system consists of several financial operations that offer alternative, unregulated means to traditional banking functions. For instance, money market funds which collect uninsured short-term deposits and then fund other financial firms essentially replicate the maturity mismatch created by short-term demand deposits and long-term investments in the traditional banking business. Similarly, investment banks are able to offer many of the services of traditional banks. However, the most important component of the newly emerged shadow banking system is securitized debt, or a debt secured by underlying assets such as commercial paper, corporate bonds, mortgage-backed securities, or even other debt securities. Essentially, the shadow banking industry is a system of securitized banking that is comprised of (1) the securitization process and (2) the repurchase agreement market.

B. The Securitization Process

Securitization, the process by which consumer and business loans are pooled and

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22 Acharya et al., supra note 7, at 3. Regulatory arbitrage appears to be an inevitable consequence of any regulation of the banking industry. Banking companies will continually try to find ways to maximize their profits and minimize their costs, and since unregulated sectors impose less costs than regulated sectors, these companies will inevitably look for loopholes and exemptions to regulation. For an example of regulatory arbitrage see CitCorp. v. Board of Governors of the Federal Reserve System, 936 F.2d 66 (2d Cir. 1991), in which a bank holding company restructured in order to allow its insurance subsidiary to engage in more activities than it could engage in if it remained a subsidiary of the bank holding company.

23 Morgan Ricks, Shadow Banking and Financial Regulation, August 30, 2010, at 10, available at http://ssrn.com/abstract=1571290 (“Various components of the shadow banking system arose over the course of several decades. However, only in the most recent decade did that system achieve full bloom. The shadow banking system came to perform all the basic functions of ‘banking,’ but outside the terms of the social contract.”).

24 Acharya et al., supra note 7, at 3.

25 Id.

securities backed by these pools are issued, emerged as a new form of banking in the 1980s.\textsuperscript{27} When an originating firm decides to lend its assets, or cash, to borrowers, it selects a portfolio of loans for the purpose of securitization.\textsuperscript{28} Traditionally, banks tend to select their most unprofitable mortgages. This selection process results in the “pooling” of loans into a portfolio.\textsuperscript{29} The portfolio is then sold to a special purpose vehicle (SPV), a separate legal entity which finances the purchases of the portfolio by selling rated securities in the capital markets.\textsuperscript{30} By pooling and bundling these unprofitable mortgages together, the SPV creates “asset backed securities.” The SPVs create a “tranching” structuring in which they develop securities of different classes or levels of risk, in other words different qualities of collateral. These securities may then be sold to investors or sold to another SPV, in a process that creates a collateralized debt obligation (CDO) and essentially turns banks into intermediary parties. Agencies then “grade” the credit and assign ratings according to their seniority.\textsuperscript{31} Essentially, the securitization process “takes loans that traditionally would have been held on-balance sheet by the originating

\textsuperscript{27} Matthew Richardson, Joshua Ronen, and Marti Subrahmanyam, \textit{Securitization Reform}, in Regulating Wall Street 469 (2011). The first use of securitization occurred in June 1983 when Freddie Mac issued a collateralized mortgage obligation. This novel form of banking was then quickly replicated by others within the financial services industry. \textit{Id.} at 470.

\textsuperscript{28} \textit{See} Gorton and Metrick, \textit{supra} note 5, at 7.

\textsuperscript{29} \textit{Id.}

\textsuperscript{30} \textit{Id.} SPVs are separate legal entities created to carry out a specific, limited purpose. They have no physical location and no employees. Most importantly, SPVs cannot act beyond the transaction for which they were specifically created, and thus, SPVs are not involved in any substantial decision making process. \textit{Id.} at 8.

\textsuperscript{31} \textit{Id.} at 7; AAA is the highest credit rating and indicates the lowest risk that investors will lose their money. Equity investments are the most risky so they demand the highest interest rate. However, research almost unanimously suggests that, prior to the recent financial crisis, that the models used by Moody’s and Standard and Poor to assign credit ratings was seriously flawed. For a colorful and illustrative description of the flaws of the ratings systems, see Michael Lewis’s \textit{The Big Short: Inside the Doomsday Machine} (2010). In his book, Lewis notes that “everyone on Wall Street knew that the people who ran the [Moody’s and Standard and Poor’s] models were ripe for exploitation.” \textit{Id.} at 98. Investors on Wall Street were aware of the key fact that the ratings staffers did not actually evaluate individual loans, but instead relied upon general characteristics of loan pools, and this reliance seriously manipulated their ratings models. \textit{Id.} at 99.
firm and creates marketable securities that can be sold and traded via the off-balance sheet SPV.\textsuperscript{32}

Over the past twenty-five years, securitization has played an expanding role in the United States financial system and has rapidly grown to be an important source of credit for both businesses and private citizens.\textsuperscript{33} The benefits created by securitization include the development of financing products that are able to match industry-specific needs of issuers, increased efficiency, and reduced cost of financing.\textsuperscript{34} Furthermore, the securitization process became essential to the industry of securitized banking as the repurchase market relied on the collateral provided by these securities.

C. Repurchase Agreement Market

Securitized debt typically comes in the form of a repurchase agreement (repo) in which one party borrows cash from another party in return for pledging a financial security known as collateral.\textsuperscript{35} In the United States market, most repo loans are single day transactions. These “overnight repos” comprise roughly half of all repo transactions and most of them automatically roll over until either party chooses to exit the agreement since most depositors do not demand their money the very next day.\textsuperscript{36} Other repos are called “term repos.” These types of repos have terms longer than a day but shorter than a year.\textsuperscript{37} Finally, “reverse repos” are typical repos

\textsuperscript{32} Id.
\textsuperscript{33} See Richardson, Ronen, and Subrahmanyam, supra note 27, at 470 (“Between 1990 and 2006, issuance of mortgage-backed securities (MBSs) grew at an annually compounded rate of 13 percent, from $259 billion to $2 trillion a year; and asset-backed securities (ABSs), secured by auto loans, credit cards, home equity loans, equipment loans, student loans, and other assets, grew from $43 billion to $753 billion.”)
\textsuperscript{34} Id.
\textsuperscript{35} See Acharya and Oncu, supra note 26, at 320.
\textsuperscript{36} Id. at 322.
\textsuperscript{37} Id.
viewed from the buyer of the securities rather than the seller. The actual transaction in a repo agreement consists of several actions between a lender and a borrower. Typically, the borrower sells a bundle of securities to a lender, but the borrower actually agrees to repurchase, or buy back, that bundle of securities in the future. The price agreed upon for the buy-back transaction is at a higher price.

Repos were first introduced into the United States financial market in 1917 by the Federal Reserve, in order to allow the Federal Reserve to extend credit to its member banks after wartime tax on interest payments on commercial paper had made it difficult for banks to raise funds in the market for commercial paper. Regulatory and market changes in the 1970s made this type of transaction attractive for institutional investors that needed short-term, primarily overnight, financing. High inflation rates in the late 1970s led to rising short-term interest rates, and thus, short-term investors started depositing their cash into repo banks rather than commercial banks in order to earn higher interest. Additionally, the United States Treasury began to heavily borrow in 1974 which eventually transformed the country from a creditor into a debtor nation, and this increased “volume of marketable Treasury debt . . . led to a parallel growth in government securities dealers’ positions and financing, and the repo market grew by leaps and bounds.” Combined, the repo market and the securitization process make up the sale of securitized debt that is at the heart of shadow banking.

39 See Acharya and Oncu, supra note 26, at 323.
40 Id. at 320.
41 Id. at 323.
42 Id.
D. Role in the Recent Financial Crisis

Although the shadow banking system is a relatively new form of banking, there is widespread agreement among legal scholars that it played a key role in the financial crisis of 2007 to 2009.\(^{43}\) Specifically, academics and scholars point to the “originate-to-distribute” model of securitization, as well as the “lack of skin in the game” for lenders and securitizers.\(^{44}\)

The fall of Lehman Brothers, Inc. (Lehman), which eventually collapsed on September 15, 2008 and filed for the largest bankruptcy ever in the history of the financial market, vividly illustrates the role of shadow banking in the recent financial crisis.\(^{45}\) As reported by the *Wall Street Journal*:

Six weeks before it went bankrupt, Lehman Brothers Holdings Inc. was effectively out of securities that could be used as collateral to back the short-term loans it needed to survive. The bank’s subsequent scramble to stay alive exposed the murky but crucial role that short-term lending, done in the corner of Wall Street known as the repo market, plays in the financial world.\(^{46}\)

Before its collapse, Lehman Brothers was treating some of its repo transactions as outright sales, even though for accounting purposes ownership of repo securities technically belongs to the debtor.\(^{47}\) Using a loophole in the Financial Standards Accounting Board rules that stated that

\(^{43}\) See Gorton, *supra* note 6, at 7; Richardson, Ronen, and Subrahmanyam, “Securitization Reform,” *supra* note 27, at 469.

\(^{44}\) See Simpson Thacher Memorandum *supra* note 3; Richardson, Ronen, and Subrahmanyam, *supra* note 27, at 469.

\(^{45}\) See Acharya and Oncu, *supra* note 26, at 325.


\(^{47}\) See Acharya and Oncu, *supra* note 26, at 326. The Financial Standards Accounting Board issued a rule in 2000 known as FAS 140 that “allowed securitized debt to be removed from the issuer’s balance sheet so
“the issuer could report the securities as assets on its balance sheet as long as the issuer agreed to buy the securities back for a price between 98 percent and 102 percent of the sale price . . . [meaning that] [i]f the repurchase price was outside this band, then the securities could not be reported as assets until the repurchase date,” 48 Lehman was removing the securities from the asset side of the balance sheet and using the borrowed cash to pay off some of its debt temporarily. Through this activity, the company was able to “spiff up” its financial picture since it was able to portray its reported leverage at a lower point than it actually was. 49 At the height of its repo business, Lehman had roughly $200 billion in overnight repos, and this heavy reliance on its repo business contributed to its ultimate downfall. 50

Additionally, Bear Sterns’ activity throughout the 2000s exemplifies misuse of the repo market. By March 2008, the company was beginning to experience serious financial trouble. Its balance sheet had an asset side exposed to the housing market, and its liability side was fragile and extremely vulnerable to bank runs. On average, Bear Stearns was rolling over more than $75 billion of repo-contracts in mortgage-backed securities every night. 51 Although these securities were mostly AAA-rated, they were anticipated to have losses in the future and were feared to be illiquid. 52 When the company’s primary financers refused to roll over the repos, due to a fear of having to liquidate the underlying collateral in an illiquid market as a substantial fire-sale

48 Id. at 327.
49 Id.
51 See Acharya et al., supra note 7, at 24.
52 Id.
discount, Bear Stearns had to draw from its own $20 billion pool of liquidity. Within a week, the company was reduced to having zero assets on its balance sheet that could be pledged into markets with no fear of risk of rollover, and by mid-March 2008, Bear Stearns faced bankruptcy.

Thus, securitization, which was intended to be a method to transfer credit risk, actually increased the fragility of the whole financial system by allowing banks and financial intermediaries to increase their leverage by buying each other’s securities. However, once the investors began to lose faith and confidence in the repo market, their hastened withdrawals led to a contagion that culminated in a run on the repo market. Similar to “bank runs” on traditional deposit banks, these “runs” on the repo market played a significant role in the financial collapse of 2007 to 2009.

II. Dodd-Frank Wall Street Reform and Consumer Protection Act

In the aftermath of the 2007 to 2009 financial crisis, the federal government enacted the most sweeping regulatory reform since the New Deal. The 2,300-plus page reform known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law on

53 Id. at 25.
54 Id. For more information on the collapse of Bear Stearns, see Heidi N. Moore’s Can What Happened at Bear Happen to Other Banks?, The Wall Street Journal (March 18, 2008, 9:21 AM) available at http://blogs.wsj.com/deals/2008/03/18/repos-just-where-do-the-other-banks-stand/ (“The credit crunch has exposed vulnerabilities of investment banks that no one knew they had. Bear Stearns, we now know, was highly dependent on the kind of short-term loans called ‘repos,’ or short-term repurchase agreements. And those repos led to the downfall of the firm.”).
56 In the traditional banking system, banks are subject to a phenomenon known as “bank runs” which can then lead to systemic “bank panics.” If depositors in traditional banks become unsure about a bank’s solvency, regardless of whether this belief is well-founded or not, then these depositors may rush to withdraw their funds. If enough depositors all make bank runs, a banks’ liabilities will exceed its assets, and the bank may be unable to borrow the funds it needs to replace the withdrawn deposits. An inability to borrow replacement funds will lead to the failure of a bank. Through a phenomenon known as “contagion,” the failure of a single bank may then lead to runs on other banks, and thus, a loss of confidence in all banks is known as a “banking panic” and has serious economic implications. See Kohn, supra note 8, at 600–01.
July 21, 2010. While this lengthy reform addresses a variety of matters that contributed to the financial crisis, this Article shall focus specifically on the risk retention requirement imposed by Section 941 of Dodd-Frank.

A. The Risk Retention Requirement

Pursuant to Section 941(b), Dodd-Frank requires securitizers to “retain not less than five percent of the credit risk for any asset” subject to certain specified exemptions. In order to anticipate the potential effects of the new risk retention requirement and assist regulatory agencies in preparing to implement it, certain provisions of Dodd-Frank call for the conduction of studies on the effects of the regulation. Specifically, Section 941(c) requires that the Board of Governors of the Federal Reserve System conduct a study on the potential effects of the risk retention requirement, and Section 946 requires the Chairman of the Financial Stability Oversight Council (FSOC) to conduct a study on the macroeconomic effects of the requirement. Accordingly, in October 2010, the Board of Governors of the Federal Reserve System issued its Report to the Congress on Risk Retention (Risk Retention Report), and in January 2011, Timothy F. Geithner, Chairman of the FSOC issued a Report on the Macroeconomic Effects of Risk Retention Requirements (Macroeconomic Effects Report).

58 Dodd-Frank Section 941 defines a “securitizer” as “(A) an issuer of an asset-backed security; or (B) a person who organizes and initiates an asset-backed security transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuer.” 15 U.S.C. § 78o-11(a)(3).
In the FSOC Chairman’s Macroeconomic Effects Report, Geithner suggests examples of different forms which the five percent risk retention requirement can take.\(^{62}\) First, the § 941(b) could take the form of a vertical risk retention requirement which would require the retention of a pro rata economic interest in the credit risk of the securitization.\(^{63}\) Each retained economic interest would be equivalent to retaining a pro rata portion of each tranche, and this method essentially allocates the risk of loss throughout the entire securitization.\(^{64}\) Second, § 941(b) could potentially take the form a horizontal risk retention requirement. This form typically involves “the allocation of all losses on the securitized assets until the par value of the first loss position is reduced to zero.”\(^{65}\) Applied to securities, the securitizer is placed in the “first loss position,” and all losses beyond those projected or originated will first affect the subordinate tranche holder up until the losses exceed the subordination of the horizontal risk retention requirement.\(^{66}\) Third, the risk retention requirement could take the form of a representative sample requirement. This form involves the “securitizer retaining on its balance sheet a representative sample of all the assets that are transferred to the issuing entity.”\(^{67}\) By selecting at random from the pool of assets to be securitized, the retained risk will likely have characteristics very similar to those of the eventually securitized assets.\(^{68}\) Although Dodd-Frank does not specify what form the five-percent risk retention requirement must take, the three options, as proposed by the Chairman of the FSOC, appear to be the primary choices.

\(^{62}\) Id. at 19.  
\(^{63}\) Id. at 20.  
\(^{64}\) Id.  
\(^{65}\) Id.  
\(^{66}\) Id. at 21.  
\(^{67}\) Id. at 20.  
\(^{68}\) Id.; The 2013 proposal removed this option that would have enabled sponsors to satisfy the risk retention requirement by retaining a randomly selected representative sample of the securitized assets. Comments on this proposal are due later in 2013, and any final decision is yet to be determined.
On March 29, 2011, the Securities and Exchange Commission (SEC) and five federal agencies released a set of proposed rules which implemented Dodd-Frank’s risk retention requirement. On August 28, 2013, these organizations issued a revised proposal which reinforced the five percent retention requirement for all types of asset-backed securities, although the revision did propose to provide flexibility by allowing the combination of an eligible horizontal retained interest with an eligible vertical interest that together met a five percent retention requirement, as opposed to holding to an all horizontal or all vertical interest, or an equal combination of horizontal and vertical interests as required in the 2011 proposal. Regardless, both versions of the proposed rules generally applied the five percent risk retention requirement to all types of asset-backed securities. However, pursuant to section 15G(e)(1) of the Securities Exchange Act of 1934 which permitted the SEC, in co-ordination with the federal agencies, to jointly issue exemptions or adjustments to the risk retention rule, the proposed rules set forth a limited list that exempt certain types of asset-backed securities from the five percent requirement.

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69 The five agencies are: the Board of Governors of the Federal Reserve System, the Department of Housing and Urban Development, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Office of the Comptroller of the Currency. For the purposes of this Article, these agencies shall simply be referred to as “the federal agencies.”

70 Specifically, the section 15G(e) of the Securities Exchange Act of 1934 provides:

EXEMPTIONS, EXCEPTIONS, AND ADJUSTMENTS.—

(1) IN GENERAL.—The Federal banking agencies and the Commission may jointly adopt or issue exemptions, exceptions, or adjustments to the rules issued under this section, including exemptions, exceptions, or adjustments for classes of institutions or assets relating to the risk retention requirement and the prohibition on hedging under subsection (c)(1).

(2) APPLICABLE STANDARDS.—Any exemption, exception, or adjustment adopted or issued by the Federal banking agencies and the Commission under this paragraph shall—

(A) help ensure high quality underwriting standards for the securitizers and originators of assets that are securitized or available for securitization; and

(B) encourage appropriate risk management practices by the securitizers and originators of assets, improve the access of consumers and businesses to credit on reasonable terms, or otherwise be in the public interest and for the protection of investors.

First, the proposed rules exempt “any residential, multi-family, or health care facility mortgage loan asset, or securitization based directly or indirectly on such an asset, that is insured or guaranteed by the United States or an agency of the United States.” However, section 15G of the Securities Exchange Act of 1934 expressly specified that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not “agencies of the United States,” and thus, this exception to the rule does not apply when the issuer of the security is any of those three entities. Second, the proposed rule exempts, totally or partially, for the securitization of any assets that are issued or guaranteed by the United States or an agency of the United States. 

Third, the proposed rules exempt re-securitization transactions that meet the following two requirements:

First, the transaction must be collateralized solely by existing ABS issued in a securitization transaction for which credit risk was retained as required under the rule or which was exempted from the credit risk retention requirements of the rule (hereinafter 15G-compliant ABS). Second, the transaction must be structured so that it involves the issuance of only a single class of ABS interests and provides for the pass-through of all principal and interest payments received on the underlying ABS (net of expenses of the issuing entity) to the holders of such class. Additionally and perhaps most prominently, issuers of securities that are “transferred, sold, or conveyed through the issuance of ABS [asset-backed securities] by the securitizer, if all of the

74 See SEC Proposed Rules, supra note 71, at 104.
75 Id. at 106.
76 For the purposes of this Note, only a basic overview of qualified residential mortgages is necessary to understand that this particular type of asset-backed security is one of the few listed exemptions to the five percent risk retention requirement. For a more comprehensive analysis on the qualified residential mortgage exemption, a topic which has been the subject of much research and academic literature, see
assets that collateralize the ABS are qualified residential mortgages,” are not subject to the risk retention requirement.\footnote{77 SEC Proposed Rules, supra note 71, at 10 (emphasis added).} In the proposed rules, the agencies defended this exemption based on the fact that “certain product features that . . . contribut[ed] to the high levels of mortgage delinquencies and foreclosures since 2007” are not present in “qualified residential mortgages.”\footnote{78 Simpson Thacher Memorandum, supra note 3.} In the 2011 proposal, the SEC and federal agencies recommended a definition for “qualified residential mortgages” that ensured that underwriting standards are of a very high credit quality,\footnote{79 See SEC Proposed Rules, supra note 71, at 15.} and pursuant to section 15G of the Securities Exchange Act of 1934, the individual agencies’ definitions of a qualified residential mortgage were to be “no broader than” the definition of a “qualified mortgage” as defined in section 129C(b)(2) of the Truth in Lending Act.\footnote{80 See 15 U.S.C. § 1639C(b)(2). The exact provision of 15 U.S.C. § 1639C(b)(2) defines “qualified mortgages” as follows:}

\begin{enumerate}
\item The term “qualified mortgage” means any residential mortgage loan—
\item (i) for which the regular periodic payments for the loan may not—
\item (I) result in an increase of the principal balance; or
\item (II) except as provided in subparagraph (E), allow the consumer to defer repayment of principal;
\item (ii) except as provided in subparagraph (E), the terms of which do not result in a balloon payment, where a “balloon payment” is a scheduled payment that is more than twice as large as the average of earlier scheduled payments;
\item (iii) for which the income and financial resources relied upon to qualify the obligors on the loan are verified and documented;
\item (iv) in the case of a fixed rate loan, for which the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
\item (v) in the case of an adjustable rate loan, for which the underwriting is based on the maximum rate permitted under the loan during the first 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments;
\item (vi) that complies with any guidelines or regulations established by the Bureau relating to ratios of total monthly debt to monthly income or alternative measures of ability to pay regular expenses after payment of total monthly debt, taking into account the income levels of the borrower and such other factors as the Bureau may determine relevant and consistent with the purposes described in paragraph (3)(B)(i);
\item (vii) for which the total points and fees (as defined in subparagraph (C)) payable in connection with the loan do not exceed 3 percent of the total loan amount;
\item (viii) for which the term of the loan does not exceed 30 years, except as such term may be extended under paragraph (3), such as in high-cost areas; and
\end{enumerate}
mortgages” are to have the same meaning as the term “qualified mortgage,” as defined by the
Consumer Financial Protection Bureau.

Finally, the proposed rules acknowledge that, consistent with section 15G of the
Securities Exchange Act of 1934, the SEC and federal agencies may jointly issue additional
exemptions for any securitized transaction that would further the public interest and protect
investors. Thus, while Dodd-Frank imposes a general five percent risk retention requirement,
regulators have proposed a very specific set of exemptions. However, in the complex world of
securities regulation, are these specified exemptions enough to prevent a burdensome imposition
of the risk retention requirement on all asset-backed securities?

B. Critique- One Size Fits All

While a uniform application of the five percent risk retention requirement would likely
provide greater transparency and certainty of enforcement, critics of it have argued that a
standardized application is not best suited to all types of assets. Pointing to the fact that the
risk retention requirement of Dodd-Frank was drafted primarily in response to the view that

(ix) in the case of a reverse mortgage (except for the purposes of subsection (a) of this section, to the extent
that such mortgages are exempt altogether from those requirements), a reverse mortgage which meets the
standards for a qualified mortgage, as set by the Bureau in rules that are consistent with the purposes of this
subsection.

81 See SEC Proposed Rules, supra note 71, at 109, 199.
82 See e.g., Risk Retention Report, supra note 60, at 83 (“In light of the heterogeneity of asset classes and
securitization structures, practices and performance, the Board recommends that rule makers consider
crafting credit risk retention requirements that are tailored to each major class of securitized assets.”);
David Line Batty, Dodd-Frank’s Requirement of “Skin in the Game” for Asset-Backed Securities May
Scalp Corporate Loan Liquidity, 15 N.C. Banking Inst. 13, 25 (2011) (“Because many capital markets
products share characteristics and structures, it is almost inevitable that laws and regulations targeted at one
product or structure will have unintended effects on other unrelated capital market products. The only way
to avoid these unintended effects is to carefully refine the broad scope of omnibus legislation like Dodd-
Frank through well-crafted regulations implementing such laws.”); FSOC Chairman’s Report, supra note
61, at 24 (“[S]ome metrics that adjust to reflect expected performance may not apply appropriately to all
asset classes, and may be difficult to measure with confidence ex ante.”); Sabry, supra note 4, at 6 (arguing
against a one-size fits all model and stating that “there is no economic basis for the particular choice of five
percent as the amount or risk retained”).

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subprime residential mortgage backed securities were the cause of the recent financial collapse, critics argue that a retention requirement tailored to a specific type of asset should not be forced to fit entirely different types of assets. These critics advocate the “adjust[ment] [of] the amount of risk retention for different quality assets, as adjustments can more appropriately align risk retention with expected loss.” By adjusting the amount for different assets, the under- and over-inclusive nature of the uniform standard may be avoided. Specific requirements for classes of assets would also address the incentive problems that are characteristic of specific to different types of assets. Arguing from a practical standpoint, these critics argue that this “approach is consistent with the flexibility provided in the statute and would recognize differences in market practices and conventions, which in many instances exist for sound reasons related to the inherent nature of the type of asset being securitized.”

Furthermore, some critics have even advocated the exclusion of certain classes of assets from the risk retention requirement entirely. For instance, in “Dodd-Frank’s Requirement of ‘Skin in the Game’ for Asset-Backed Securities May Scalp Corporate Loan Liquidity,” Professor David Line Batty contends that collateral loan obligations (CLOs) should be altogether excluded from Dodd-Frank’s risk retention requirement. Although CLOs are an asset-backed security class under Dodd-Frank and thus are subject to the five percent risk retention requirement, Professor Batty argues that a risk retention requirement upon CLOs will seriously disrupt the secondary loan trading market and formation of new CLOs, thereby limiting the amount of credit

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83 See Batty, supra note 82, at 44.
84 FSOC Chairman’s Report, supra note 61, at 21.
85 As Geithner illustrates, a risk retention rate of five percent may be highly unnecessary when applied to high quality assets. However, that same five percent requirement may be insufficient when applied as an incentive to securely underwrite standards for pools with higher expected loss. Id. at 21.
86 See Risk Retention Report, supra note 60, at 83.
87 Id.
88 See Batty, supra note 82, at 25.
available in the economy.\textsuperscript{89} Specifically, classifying CLO managers and structuring banks as “securitizers” under the definition of Dodd-Frank would likely have the unintended effect of “chilling” overall market liquidity. Because structuring banks of CLOs are not compensated to hold a piece of the assets that they purchase under the direction of a CLO manager and because it is not economically practical to begin compensating the structuring banks for the risk, banks would be unable or unwilling to act as structuring banks for the creation of CLOs.\textsuperscript{90}

Still other academics and critics argue that Dodd-Frank in general and specifically the requirement upon securitizers to hold five percent interest of transactions creates serious practical difficulties. In his analysis of the risk retention requirement for the National Economic Research Associates, Dr. Faten Sabry is critical of the entire retention proposal and argues:

> The process of hedging exposures to changes in interest rates and other risks is already quite complicated. Adding the complication of modeling and hedging exposure to account for a retained interest net of hedging will present additional hurdles for the sponsors given the different types of securities they usually hold and the current freeze in many securitization activities.\textsuperscript{91}

\textsuperscript{89} \textit{Id.} at 30–33.  
\textsuperscript{90} Additionally, Professor Batty notes that the potential impact of the risk retention requirement on the CLO market according to a survey of existing CLO funds. 87% of CLO Managers who were surveyed stated that they could not retain a five percent vertical slice of their CLOs, and only 13% of those surveyed indicated that they would be able to retain a five percent horizontal slice. \textit{Id.} at 31–32 (citing Loan Syndications and Trading Associations, The Impact of Risk Retention on CLOs and Other Means of Aligning Incentives 1–2 (2010), available at http://www.lsta.org/WorkArea/showcontent.aspx?id=11904).  
\textsuperscript{91} See Sabry, \textit{supra} note 4, at 6.
The practical barriers attached to the five percent risk retention requirement, combined with the serious practical concerns of implementing a piece of legislation that is as comprehensive and broad as Dodd-Frank, creates realistic difficulties.

Other critics focus less on the bright-line rule of a five percent risk retention requirement and instead point to the shortcomings of any regulation imposed generally by Dodd-Frank. In “Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight,” Professor John C. Coffee, Jr. makes the point “not that regulation is futile, but that it is insufficient for policymakers to rely on preventative, ‘safety and soundness’ regulation alone . . . [since] such regulation will be predictably outflanked, relaxed, or rendered obsolete by later developments.” Although not specifically focusing on the risk retention requirement, Professor Coffee focuses on the underlying incentives of the players in the financial market and argues that the entire regulation proposed in Dodd-Frank is lacking. He notes that with the presence of federal deposit insurance and the mentality of certain large institutions being “too big to fail,” shareholders may have “rational incentives to exploit the implicit subsidy in interest rates by taking on what is undue risk from the perspective of social optimality.” This preference for risk by shareholders is then complemented by creditors’ continuing expectation that a failing financial institution will be rescued by the federal government. Additionally, shareholder pressure often influences managers, and this pressure leads managers to make the

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94 Id. at 813.
95 Id. Even if Dodd-Frank eliminates the possibility of a future federal bail-out for failing financial institutions, the federal government could still arrange “shotgun marriages through mergers” in which creditors could still be protected if the institution fails. This type of “shotgun marriage through mergers” was prevalent during the recent financial crisis, as evidenced by Bear Stearns, Merrill Lynch, and Wachovia. Id.
riskier decisions.\textsuperscript{96} As a result of these incentives to take excessive risks, Professor Coffee predicts that Dodd-Frank’s rule-based regulations alone will be ineffective in preventing another systemic failure of financial institutions.\textsuperscript{97} Instead, he advocates a solution that, in addition to rule-based regulation, will also correct the perverse incentives of financial players and “counteract the excessive shareholder tolerance for risk in the case of major financial institutions.”\textsuperscript{98}

Regardless of whether critics of the risk retention requirement believe that the nature of regulation should be consistent with a fluid market, that certain classes of assets should be entirely excluded, that the five percent requirement will create practical difficulties to implement, or even that Dodd-Frank as a whole is ineffective unless accompanied by non-rule-based regulation, these critics and academics firmly believe that a one-size-fits-all approach does not properly align incentives. In his economic analysis of the risk retention requirements, Dr. Faten Sabry of the National Economics Research Associates (NERA) points to academic research that suggests that the “business cycle risk impacts various retention mechanisms in different ways . . . [and that] the retention of the equity tranche may lease to lower screening efforts by the originator if a downturn in the business cycle is likely to occur following such retention.”\textsuperscript{99} Consequently, these critics believe that it is impractical and even impossible to pre-determine a singular optimal amount of retention since any optimal amount will likely differ depending upon the type of transactions and markets involved.\textsuperscript{100} In fact, Kathleen L. Casey, the Commissioner

\textsuperscript{96} Id. at 807 (“In truth, shareholder pressure usually influences managerial preferences, and modern corporate governance has increasingly reduced the ‘agency costs’ that once enabled managers to resist or disdain shareholder pressure.”).

\textsuperscript{97} Id. at 815.

\textsuperscript{98} Id. at 813.

\textsuperscript{99} Sabry, supra note 4, at 6.

\textsuperscript{100} Id. (citing Ingo Fender and Janet Mitchell, Incentives and Tranche Retention in Securitization: A Screening Model (September 2009) available at http://ssrn.com/abstract=1481663 which argues that a one size fits all approach would be ineffective and may even raise costs and hinder markets).
of the SEC, best summed up the difficulties of a one size fits all approach in her speech before the Forum for Corporate Directors:

Overly prescriptive, static, one-size-fits-all rules in a dynamic system run the risk of design failure, and promoting homogeneity that can lead to greater systemic risk. They burden investors to the degree that they do not meaningfully enhance decision-useful information or protection. They increase regulatory costs, discriminate disproportionately against smaller firms, and can act as barriers to entry minimizing the disciplining effect of competition.

To the degree this results in greater consolidation, you have greater concentration of risk. To the degree the rules hardwire structures and outcomes, they stymie innovation, capital formation and growth.¹⁰¹

Therefore, critics of the five percent risk retention requirement, and of Dodd-Frank in general, focus on what they believe to be the true problem with the proposed regulation—its failure to correct the misaligned incentives of parties that is inherent to the securitization chain.

III. Confronting the Problem

A. Incentives in the Securitization Chain

In looking back at probable causes of the recent financial collapse, scholars have increasingly begun pointing to incentive issues embedded in the securitization chain. Inherently,

the process of securitization “put[s] some distance between originators and investors . . . [which] can weaken incentives for proper screening and due diligence along the chain.”

Decreases in effort devoted to proper screening and due diligence can then lead to lower lending standards and a deterioration in the quality of assets used to collateralize the asset-backed securities. This propensity towards the misalignment of incentives between securitizers and investors is not a new phenomenon. Participants in the market have long used provisions in contracts and institutional arrangement between parties to address issues of perverse incentives, but as the financial crisis proved, these private market efforts alone are not sufficient to prevent the accumulation of incentive problems within the securitization chain. It was for this reason that the writers of Dodd-Frank proposed the risk-retention requirement, based on the belief that a uniform five percent retention requirement would force the originator or securitizer to keep “skin in the game” or have some personal investment in the quality of the risk. However, as the critics of the risk retention requirement have argued, a uniform retention provision alone does not assure the risk exposures are properly retained and even that such a retention may be detrimental to the overall financial market. Thus, academics who criticize the one-size-fits-all model of Dodd-Frank argue, either implicitly or explicitly, that “it may be desirable to keep any retention requirements flexible.” However, any argument for flexibility also contains incentive problems since “if the choice of how much to retain and in what form is left up to the originator, the retention mechanism chosen may well lead to suboptimal screening effort,” which is the very problem that Dodd-Frank’s risk retention requirement attempts to address.

103 *Id.* at 3.
104 *Id.*
105 *See supra* Part II.B.
106 Fender and Mitchell, *supra* note 102, at 32.
107 *Id.*
Therefore, the inherent problem of misaligned incentives is a complex one that cannot easily be solved by imposing either uniform requirements or purely discretionary-based regulation.

B. Proposed Solution

Any potential solutions to the shortcomings of Dodd-Frank’s risk retention requirement must attempt to properly align the varying incentives of parties along the securitization chain, while still ensuring that the process of securitization can effectively provide credit to the marketplace. As illustrated by the scholars and academics who criticize the current uniform five percent retention approach, a one-size-fits-all model, imposed forcefully unto all types of asset-back securities, presents serious problems to the market. By failing to provide “the proper economic design of retention requirements that are catered to the specifics of the different securities classes,” the uniform five percent risk retention requirement could impair the credit market and raise the costs of providing securitized products. However, advocates of potential solutions must also keep in mind the risks presented by leaving the amount of retention for different types of asset-backed securities in the hands of the very originators and securitizers whose poor screening efforts epitomized the incentive problems of the recent financial crisis. The risk retention form that is likely to provide the highest screening efforts and thus most effectively address the problems of misaligned incentives “is likely to depend crucially on the specific nature and characteristics of the securitisation [sic] in question, as well as the state of the

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108 See supra Part II.B.
109 Sabry, supra note 4, at 7. See International Monetary Fund, Restarting Securitization Markets: Policy Proposals and Pitfalls (August 7, 2009), at 3 available at www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap2.pdf (“While many incentive problems in securitization remain to be resolved, without the replacement of maturing securitized products, banks face a contraction of their funding sources, which may exacerbate already tight credit conditions. At the same time, as banks continue to repair their balance sheets in the current environment, the absence of a risk transfer mechanism is likely to perpetuate deleveraging pressures rather than alleviate them.”)
Therefore, in order to minimize the risks associated with the securitization process and to find a middle ground between a uniform retention requirement and an entirely discretionary amount that is left to the judgment of the perhaps mis-incentivized securitizers, this Article advocates that the SEC and federal agencies should amend its proposed rules to provide specific, delineated retention requirements for each type of asset-backed security.

Much like how Dodd-Frank directed the FSOC and the Board of Governors of the Federal Reserve System to conduct studies on the potential macroeconomic effects of the five percent risk retention requirement,\(^\text{111}\) this Article proposes that these agencies conduct economic analysis of the probable effects of different amounts of retention as applied to specific classes of asset-backed securities. These reports should explore the percentages of risk that would be optimal for each individual type of asset-backed security. Any optimal percentage should be restrictive enough to ensure that securitizers and originators exercise sound judgment and care in their screening efforts but also broad enough that the regulation does not completely “chill” the credit market. While an elimination of the effect of any imposition or burden on the credit market could be impractical, a top priority of any regulation should be to facilitate the credit market which is so vital to businesses and even individuals in the current economy.\(^\text{112}\)

Additionally, these economic studies should determine which, if any, of the forms of risk

\(^{110}\) Fender and Mitchell, supra note 102, at 33 (“In other words, there is no ‘one size fits all’ solution.”).
\(^{111}\) See supra notes 58–59 and accompanying text.
\(^{112}\) By making this a goal of any proposed risk retention regulation, one can avoid the fears mentioned by Professor David Line Batty in “Dodd-Frank’s Requirement of ‘Skin in the Game’ for Asset-Backed Securities May Scalp Corporate Loan Liquidity.” See supra note 82 and accompanying textual argument in Part II.A. Recall that Professor Batty’s main criticism of the five percent risk retention requirement was that its uniform applicability would essentially “kill” the credit market created by collateral loan obligations. He based this conclusion on the surveyed responses of the majority of collateral loan obligation managers who stated that they could not retain a five percent slice of the risk, either in horizontal or vertical form. Id.
Retention would best apply to each class of asset-backed security.\footnote{113} Again, any optimal determination should balance the goals of aligning the incentives of the parties (through optimal screening by the securitizers and originators) and minimizing the negative effects of regulation on the credit market.

While this proposed solution that the SEC and federal agencies undertake further economic study and draft a more detailed set of risk retention rules is certainly burdensome on the regulators, this Article argues that it is necessary. Since the potential unintended effects of a uniform retention requirement include a total “freezing” of the credit market, critics generally agree that any regulation must have an aspect of flexibility.\footnote{114} However, if the amount and form of risk retention is left entirely to the discretion of the securitizers and markets whose suboptimal screening efforts and misaligned incentives substantially contributed to the recent financial crisis to begin with, then any regulation runs the risk of being entirely ineffective in correcting the incentive problem inherent in the securitization process. Therefore, although this proposed solution is burdensome on the regulators and will likely be a long, arduous process, it is necessary for the SEC and federal agencies to draft a set of proposed rules that specifies the exact form and amount of risk retention that each type of asset-backed security must take in order to properly balance the minimization of negative effects on the credit market and also align the incentives of the parties to the securitization chain.\footnote{115}

\footnote{113} For an illustrative list of the different forms that a risk retention requirement could take (e.g. horizontal slice, vertical slice, etc.) see supra notes 60–66 and accompanying text. For additional potential forms of risk retention, beyond the three proposed in the FSOC Chairman’s Report, see Simpson Thacher Memorandum, supra note 3, at 2–5.

\footnote{114} See supra Part II.A and accompanying textual argument against the uniform one size fits all requirement.

\footnote{115} For additional and/or alternative solutions proposed by academics, see Fender and Mitchell, supra note 102. In their working paper, Fender and Mitchell use a “model [that] provides support for initiatives that are currently under discussion to modify banks’ remuneration systems and to adjust regulatory and accounting measures that have the effect of making securitisation [sic] artificially more attractive than other sources of funding.” Id. Options include changes to the current standards of accounting that could eliminate the immediate recognition of gain on sale by originators at the inception of asset-backed securities.
Conclusion

In conclusion, the current five percent risk retention requirement imposed by Section 941 of Dodd-Frank is a step in right direction toward correcting the misaligned incentives of parties in the securitization chain that ultimately led to the financial crisis of 2007 to 2009. However, it does not present a complete solution. Rather than stabilize the credit market and national economy by ensuring that all parties involved have some “skin in the game,” the risk retention requirement of Dodd-Frank actually imposes a new problem – the risk of “chilling” the credit market by imposing a five percent retention requirement upon asset-backed securities that cannot feasibly retain such an amount. Thus, by forcing a uniform requirement upon different classes of asset-backed securities, classes which have individual characteristics and may react differently in the market, the Dodd-Frank regulation presents an incomplete solution.

After examining the critiques of Dodd-Frank’s one size fits all approach posed by academics and scholars, this Article advocates a solution that would balance the interest of correcting the misaligned incentives of parties in the securitization process with the interest of the public in sustaining a healthy credit market. While admittedly burdensome on the regulators, this Article proposes that the SEC and federal agencies work in conjunction to establish individualized risk retention requirements for each class of asset-backed security, tailored to the specific needs and characteristics of the classes. To leave intact the uniform five percent risk retention requirement would pose serious problems to the current credit market, which plays such a vital role in the economy, and to leave individualized retention requirements in the hands

Additionally, the two academics consider the possibility that capital regulation might be adjusted to reduce the incentive to sell securitized debt to vehicles that have “implicit recourse to originators.” Id. For a broader solution to the problems in the shadow banking industry, beyond a focus limited to the risk-retention requirement, see Professor Morgan Ricks’ “Shadow Banking and Financial Regulation,” supra note 23. In his paper, Professor Ricks examines the efficiency implications of three potential policy interventions: (1) ex ante risk constraints, (2) ex post liquidity support, and (3) an insurance regime for short-term creditors. Id. He concludes that an insurance regime, aided by ex ante risk constraints, offers the most efficiency-maximizing solution. Id.
of the securitizers and originators in the market would defeat the entire purpose of the regulation which is to correct the misaligned incentives of the parties. Therefore, as argued in this Article, to be optimally effective, the SEC and federal agencies should tailor the risk retention requirement of Dodd-Frank to suit the interests of each type of asset-back security.