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Dodd-Frank and Basel III's Skin in the Game Divergence and Why it is Good for the International Banking System

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By Eric Thompson

Table of Contents

ABSTRACT

The recent financial collapse has illuminated many problems with the global financial system. One of these problems was that the financial system developed in a way that allowed banks to profit by simply making more loans instead of quality loans. After the financial collapse, regulators scrambled to enact new legislation to better manage the financial system and avoid the problems that caused the collapse. One way in which regulators attempted to improve the system was to remove the ability of banks to generate limitless loans in which the banks had no stake. Two such pieces of regulation, the Dodd-Frank Wall Street Reform and Consumer Protection Act and the new provisions in the Basel Accords (Basel III), attempted to limit the ability of banks to make endless loans. Although the Dodd-Frank Act's risk retention requirement does a better job in this respect, having diverging systems of international regulation may prove to be beneficial.

INTRODUCTION

The Originate to Distribute (OTD) system of banking changes the incentives of the banking system from that of traditional banking. By originating the mortgages and selling the income streams from them, banks generate large amounts of revenue from the fees associated with the transactions.[1] Although there are caveats, this basic structure allows banks to divorce their success from that of the mortgages themselves.[2] Securitization itself has many benefits, but one downside in the OTD model is that it gives banks incentives to generate as many mortgages

[1] *See* Berndt, Antje and Gupta, Anurag, *Moral Hazard and Adverse Selection in the Originate to Distribute Model of Bank Credit*, pg.2, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1290312 (Nov. 2008).
[2] *See* Keys, Benjamin J., et al., *Financial Regulation and Securitization: Evidence from Subprime Loans*, pg. 1, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346131 (Feb. 2009).

as possible, sell them and repeat, a process that will be referred to as "churning" hereinafter.[3] Churning led to banks producing many bad loans such as subprime loans, NINJA loans, and liar loans, and when these bad loans defaulted in and around 2007, the financial industry collapsed.[4] A lot of the new regulation targets capital and reserve requirements. However, capital and reserve requirements do not greatly inhibit a bank's ability to churn because a bank can sell its mortgage payment streams and return capital to its balance sheets, meeting regulatory requirements.

In response to the recent financial collapse, two prominent pieces of regulation have been passed: The Dodd-Frank Wall Street Reform and Consumer Protection Act[5] (Dodd-Frank Act) and the 2010 revisions to the Basel Accords (Basel III).[6] Both of these pieces of legislation attempt to address the new financial challenges in different ways. In response to the OTD model, the Dodd-Frank Act requires firms that securitize to retain a portion of the risk of the mortgages.[7] This requirement is commonly referred to as "skin in the game" because it forces banks to retain an interest in the mortgages.[8] This forces banks to retain some of the risk of the loans defaulting, aligning the interest of the originators and investors.[9] Basel III has no such provision and instead attempts to control the OTD model through capital requirements and other techniques.[10] The Dodd-Frank Act's skin in the game provision appears to do a better job of solving the problems created by churning by aligning originator and investor interests while

[3] *See id* at 3.
[4] *See id* at 1.
[5] Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).
[6] Basel Committee on Banking Supervision, Consultative Documents, available at http://www.bis.org/list/basel3/index.htm (2010).
[7] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. §516 Sec 15(g)(c)(1)(B)(i) (2010).
[8] *See* Jackson, Howell, E. *Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions*, Moving Forward: The Future of Consumer Credit and Mortgage Finance, A National Symposium, pg. 3 available at http://www.jchs.harvard.edu/moving_forward_symposium/conference_drafts/3-2_jackson.pdf (2010).
[9] *See id*.
[10] *See generally* Basel Committee on Banking Supervision, Consultative Documents, available at http://www.bis.org/list/basel3/index.htm (2010).

leaving the actual investment decisions to the market. However, a growing body of literature suggests that by having different regulatory systems, financial innovators cannot game the systems as easily, and risk and downturns will be less systemic.[11] Additionally, by having separate systems, regulators can attempt different strategies to see which allow for the greatest growth while still maintaining trust and solvency in the market.[12]

THE ORIGINATE TO DISTRIBUTE MODEL[13]

Securitization is a complex process that can have many variations. Although the description below does not hold for all securitization transactions, the basic structure of the deal will be relatively similar.

The process begins with banks making loans to borrowers.[14] The loans are purchased by intermediaries that design and create the securitization (this step will be the focus of this paper, and as such, it is discussed in more detail below).[15] Originators pool the loans which are then transferred to an entity called a Special Purpose Vehicle (SPV).[16] Ideally, the transfer will be a true sale in which the originating bank no longer holds a stake in the receivables, and this step is necessary to protect investors in the SPV should the originator go bankrupt.[17] Collateral and other credit enhancement techniques are usually used to help prevent the risk of default for the

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[11] *See* Romano, Roberta, *Against Financial Regulation Harmonization: A Comment*, pg. 2, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 414 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 (Nov. 2010).
[12] *See id* at 16 – 17.
[13] For a model of a basic originate to distribute model, please see Appendix A.
[14] *See* Frankel, Tamar, *Securitization: Structured Financing, Financial Asset Pools, and Asset Backed Securities*, 2nd ed. Vol. 1 §2.1 (2005).
[15] *See id* at §3.3 – 3.4.
[16] *See id* at §2.1.
[17] *See* Frankel, Tamar and Fagan, Mark, *Law and the Financial System: Securitization and Asset Backed Securities: Law, Process, Case Studies, and Simulations*, Vandeplas Publishing pg. 232, (2009).

receivables.[18] The SPV segments its receivables into tranches which have different levels of risk and payout.[19] The SPV then issues the securities and market intermediaries sell them.[20] For a diagram of a basic securitization transaction, see Appendix A.

As noted earlier, the part of the securitization transaction where the loans are purchased from the by bank intermediaries in exchange for capital is an important part of the transaction.[21] When it receives the liquid capital, the bank will record the transaction as a gain or a loss.[22] In addition to the capital they receive, the banks receive a fee for the transaction.[23] Because banks now have liquid capital on their books, they are able to use these assets to make more loans.[24] This process can be repeated over and over again and the capital is simply churned through the bank while the bank makes its profits from the fees.[25] For a diagram of the process of churning, see Appendix B.

BENEFITS AND HARM FROM SECURITIZATION

BENEFITS

Securitization is a complex financial transaction, and although it has received a lot of bad press lately, investors, borrowers, and originators can still realize many benefits from its use.

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[18] *See* Frankel, Tamar, *Securitization: Structured Financing, Financial Asset Pools, and Asset Backed Securities*, 2nd ed. Vol. 1 §2.1 (2005).
[19] *See id.*
[20] *See id.*
[21] *See id* at §3.3 – 3.4.
[22] *See* Dechow, Patricia M., Myers, Linda A., and Shakespeare, Catherine, *Fair Value Accounting and Gains from Asset Securitizations: A Convenient Earnings Management Tool with Compensation Side-Benefits*, pg. 2, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111594 pg. 2 (Feb. 2009).
[23] *See* Frankel, Tamar, *Securitization: Structured Financing, Financial Asset Pools, and Asset Backed Securities*, 2nd ed. Vol. 1 §3.3 – 3.4 (2005).
[24] *See id.*
[25] *See id.*

Securitization provides originators access to cheaper capital than debt or equity markets.[26] Securitization allows lenders to make more loans than they otherwise would.[27] This allows the banks to earn more money[28] and provides access to loans for those who otherwise would not have access.[29] Securitization also gives more investors access to the mortgage market. Normally, small investors would not be able to vet individual mortgages, nor would they be able to meet individual clients without becoming a specialist.[30] Securitization removes these barriers by creating easily tradable securities.[31] Finally, securitization gives borrowers access to cheaper capital as the reduced transaction costs are passed on to the borrower.[32]

HARMS

With the aforementioned benefits, securitization has shown its ability to incur substantial harm. Securitization contributed largely to the subprime mortgage crisis which propelled the recent financial collapse.[33] The process of securitization caused the moral hazard whereby banks had an incentive to generate as many mortgages as possible, and, therefore, generated many low quality mortgages on which the borrowers later defaulted.[34] Because the mortgage lenders did not have to live with the credit consequences of their loans and the lenders were able to churn

[26] *See* Schwarcz, Stephen, *The Future of Securitisation*, pg. 4, Leverhulme Lectures, University of Oxford, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707053 (Nov. 2010).
[27] *See id*.
[28] *See* Frankel, Tamar, *Securitization: Structured Financing, Financial Asset Pools, and Asset Backed Securities*, 2nd ed. Vol. 1 §3.3 – 3.4 (2005).
[29] *See* Frankel, Tamar and Fagan, Mark, *Law and the Financial System: Securitization and Asset Backed Securities: Law, Process, Case Studies, and Simulations*, Vandeplas Publishing pg. 24, (2009). referencing Kolev, Ivo, *Primer: Mortgage Backed Securities*, Financial Policy Forum: Derivatives Study Center, available at http://www.financialpolicy.org/fpfprimermbs.htm (July 2004).
[30] *See* Frankel, Tamar, *Securitization: Structured Financing, Financial Asset Pools, and Asset Backed Securities*, 2nd ed. Vol. 1 §1.3 (2005).
[31] *See id.*
[32] *See id.* at §5.3.
[33] *See* Schwarcz, Stephen, *The Future of Securitisation*, pg. 4, Leverhulme Lectures, University of Oxford, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707053 (Nov. 2010).
[34] *See id.*

loans, their standards fell.[35] Because securitization is such a complex process with many parties, and many underlying assets, investors heavily, if not overly, relied on rating agencies to assess the risk of the securities.[36] Unfortunately, the rating agencies did not succeed in accurately assessing the risk of many of these loans, and the unknowing investors incurred large losses.[37] There were also problems with servicing the loans when the loans were securitized because the servicers typically did not have power to renegotiate the loans, but it would have been in everyone's interest for the loans to be renegotiated.

When a bank holds loans, if a problem arises, the bank can simply renegotiate with the borrower and come to a compromise to optimize the income.[38] With securitization, servicers generally are supposed to have limited duties, and are not in a position to renegotiate.[39] Among the many reasons why the servicers are only given limited duties, one is that the securitization is based off of the original terms of the loans, and changing the cash flow and value of the loan changes the value of the securitization. The original bank may have the ability to renegotiate, but has no stake in the loan anymore.[40] The original bank may be unable or unwilling to conduct a negotiation.[41] The end investor in the SPV's securities has no ability to renegotiate individual loans, and is unlikely to have the resources to do so anyway.[42] Although it might be beneficial for all parties with a vested interest for the terms of a loan to be renegotiated, there is no reasonable way in which to do so.[43]

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[35] *See id* at 7.
[36] *See id. at 5.*
[37] *See id*.
[38] *See id* at 9.
[39] *See id.*
[40] *See id.*
[41] *See id.*
[42] *See id.*
[43] *See id.*

<u>HOW THE OTD MODEL ALLOWS BANKS TO MEET CAPITAL REQUIREMENTS</u>

Many commentators have stated that the OTD model of banking makes firms more risky by making them more leveraged. Blair claims that "banks could invest in mortgage backed securities on a more leveraged basis than by directly investing in them."[44] Ojo states that "in response to the recent Financial Crisis and to the realization that capital levels (which banks operated with) during the period of the Crises were insufficient and also lacking in quality."[45] Hannoun similarly claims that "such a lack in high quality capital resulted in the raised levels of capitals [sic] and de leveraging of trading books (by many banks) amidst the Crisis."[46] However, this understanding fails to comprehend what occurs in the OTD method of lending. Although banks may have been overleveraged in the time leading to the financial crisis, it was not a result of the OTD model. The OTD model allowed banks to easily increase their capital by selling the interest in the receivables for cash or some other liquid capital.[47] If anything, the OTD model allows banks to be less leveraged and circumvent capital requirements by churning.[48] By raising capital requirements, as many regulators have proposed, banks may have an incentive to churn a greater amount of loans because they will be even further restricted from making profits using traditional banking methods. For a graphical representation of how the OTD model allows firms to use securitization to increase their capital, see Appendix B.

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[44] Blair, Margaret, *Financial Innovation, Leverage, Bubbles the Distribution of Income*, pg.11, Law and Economics Working Paper No. 10-31 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1693913 (Oct. 2010).
[45] Ojo, Marianne, *Basel III and Responding to the Recent Financial Crisis: Progress Made by the Basel Committee in Relation to the Need for Increased Bank Capital and Increased Quality of Loss Absorbing Capital*, pg. 3, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1680886 (Sept. 2010).
[46] Hannoun, Hervé, *Towards a Global Financial Stability Framework*, pg. 10, Bank for International Settlements Publications, available at http://www.bis.org/speeches/sp100303.pdf (Feb. 2010).
[47] *See* Dechow, Patricia M., Myers, Linda A., and Shakespeare, Catherine, *Fair Value Accounting and Gains from Asset Securitizations: A Convenient Earnings Management Tool with Compensation Side-Benefits*, pg. 2, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1111594 pg. 2 (Feb. 2009).
[48] *See* Berndt, Antje and Gupta, Anurag, *Moral Hazard and Adverse Selection in the Originate to Distribute Model of Bank Credit*, pg. 2, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1290312 (Nov. 2008).

SKIN IN THE GAME

DESCRIPTION OF SKIN IN THE GAME

A general definition of skin in the game is the concept of creating a situation to ensure that corporations are managed by like minded individuals who share a stake in the company.[49] In the securitization context, skin in the game refers to a requirement that originators or sponsors retain a portion of the loans and securities they create, thus also retaining some of the risk.[50] In theory, this would align the incentives of the banks with the goals of the investors of the SPVs because the banks also are invested in the final outcome.[51] By forcing the bank to retain an interest in the loans it securitizes, the bank will be less likely to create a bad loan because any failures of the loans will affect the end securities issued by the SPV, and, therefore the bank that is required to hold some of them.

There are different ways to structure the skin in the game retention. One way is for the banks to retain an interest in each individual loan that they issue.[52] Howell E. Jackson believes that this is not an optimal method because it complicates the valuation exercise for investors in the loan pools.[53] This would also give two entities an interest in each loan and would complicate the renegotiation process.[54] Another method of requiring skin in the game is to require the banks to retain an interest in the securitization pool itself.[55] The most likely method of doing this would be for the bank to hold a pro-rata share of all of the tranches issued by the SPV so that it is

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[49] *See* Skin in the Game Definition INVESTOPEDIA.COM, (last visited December 19, 2010). http://www.investopedia.com/terms/s/skininthegame.asp.
[50] *See* Jackson, Howell, E. *Loan-Level Disclosure in Securitization Transactions: A Problem with Three Dimensions*, Moving Forward: The Future of Consumer Credit and Mortgage Finance, A National Symposium, pg. 5 available at http://www.jchs.harvard.edu/moving_forward_symposium/conference_drafts/3-2_jackson.pdf (2010).
[51] *See id.*
[52] *See id* at 17.
[53] *See id.*
[54] *See id.*
[55] *See id.*

exposed to all of the levels of risk that are issued.[56] This method more directly aligns the interests of the originators and sponsors to the interests of the investors in the SPV.[57] For a graphical representation of a bank's assets when there is skin in the game, see Appendix B.

BENEFITS OF SKIN IN THE GAME

In theory, skin in the game is a good way to prevent the bad loans that can originate from securitization. Although it is hard prove this empirically, many authors have investigated the effects of having skin in the game and have found that it aligns incentives and interests in practice. Keys, et al., found that the current system of broker compensation based on fees encourages brokers to maximize the volume of the loans they originate instead of the quality.[58] This is compared to regulations that require brokers to have skin in the game, which were found to curb this moral hazard problem.[59] Berndt and Gupta found that loans that are securitized underperform similar loans that are not securitized.[60] The authors believe that this underperformance is due to the diminished relationship between the borrowers and the banks.[61] Purnanandam came to a similar conclusion in his study which found that loans made in the OTD model were of inferior quality because banks that heavily used OTD created loans with higher default rates than banks that did not use the OTD model.[62] Finally, Hildebrand, Puri, and Rocholl found that online lending networks work better when the person recommending the loan

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[56] *See id.*
[57] *See id.*
[58] *See* Keys, Benjamin J., et al., *Financial Regulation and Securitization: Evidence from Subprime Loans*, pg. 3, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346131 (Feb. 2009).
[59] *See id* at 21.
[60] *See* Berndt, Antje and Gupta, Anurag, *Moral Hazard and Adverse Selection in the Originate to Distribute Model of Bank Credit*, pg. 23, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1290312 (Nov. 2008).
[61] *See id.*
[62] *See* Purnanandam, Amiyatosh, *Originate-to-Distribute Model and the Subprime Mortgage Crisis*, pg. 3 – 4, AFA 2010 Atlanta Meetings Paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1167786 (April 2010).

has a stake in a fraction of the loan.[63] Through these studies, the authors show how skin in the game regulations appear to lead to the generation of higher quality loans.

DESCRIPTION OF THE REGULATIONS

DODD-FRANK

The Dodd-Frank Act is binding legislation that applies to all US banks.[64] The Act is an in depth bill that attempts to restore accountability and responsibility in the financial sector through multiple avenues.[65] The Dodd-Frank Act created a new independent watchdog to ensure consumers get clear and accurate information.[66] Furthermore, the Dodd-Frank Act created a safe way to liquidate failed financial firms by imposing tough new capital and leverage requirements that make it undesirable for a bank to get too large.[67] The Dodd-Frank Act created a council to identify and address systemic risk posed by large, complex companies, products, and activities before they threaten the stability of the economy.[68] The Dodd-Frank Act eliminated loopholes that allow risky and abusive practices to go unnoticed and unregulated.[69] The Act provides shareholders with a say on pay and corporate affairs with a non-binding vote on executive compensation and golden parachutes.[70] The Dodd-Frank Act provides tough new rules for transparency and accountability for credit rating agencies to protect investors and businesses.[71]

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[63] *See* Hildebrand, Thomas, Puri, Manju, and Rocholl, Jörg, *Skin in the Game: Evidence from the Online Lending Market*, pg. 25, Conference on Financial Economics and Accounting, available at http://www.rhsmith.umd.edu/feaconference/docs/Session3PuriSkinintheGame.pdf (Oct. 2010).
[64] *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).
[65] *See* Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 111th Cong. 1 (2010).
[66] *See id.*
[67] *See id.*
[68] *See id.*
[69] *See id.* at 2.
[70] *See id*.
[71] *See id.*

The Dodd-Frank Act also strengthens oversight and empowers regulators to aggressively pursue financial fraud, conflicts of interest, and manipulation of the system.[72]

In addition to the aforementioned provisions, the Dodd-Frank Act has a requirement that the originators retain five percent of the credit risk in securitized assets.[73] This requirement is subject to many qualifications, but will hold for many mortgage backed securities. This provision is important because it requires originators to retain skin in the game. Whether or not five percent is an optimal retention is beyond the scope of this paper, but what is important is that the act requires some retention.

BASEL III

The Basel III reforms are a set of non-binding financial regulations written by the Basel Committee's Group of Central Bank Governors and Heads of Supervision that are, in practice, followed by many banks throughout the world.[74] Basel III contains both micro-policy measures and macro-policy measures, but it is less comprehensive than the Dodd-Frank Act.[75]

Basel III's micro-policy measures attempt to regulate the actions of individual banks. Basel III requires a substantial increase in the quality of the capital held by banks.[76] Banks must hold appropriate capital for less liquid, credit sensitive assets with much longer holding periods. Basel III claims that securitization exposures will be subject to capital charges more consistent

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72 *See id.*
73 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. §516 Sec 15(g)(c)(1)(B)(i) (2010).
74 *See generally* Basel Committee on Banking Supervision, Consultative Documents, available at http://www.bis.org/list/basel3/index.htm (2010); *see also* Klein, Ezra, *Why You Should Care About Basel III*, http://voices.washingtonpost.com/ezra-klein/2010/07/why_you_should_care_about_base.html (last visited Dec. 19, 2010).
75 *See* Stefan Walter, *Basel III and Financial Stability*, Speech at the Fifth Biennial Conference on Risk Management and Supervision, pg. 2, (Nov. 3 – 4, 2010) (transcript available at http://www.bis.org/speeches/sp101109a.htm.
76 *See id.*

with those for the banking book.[77] Basel III requires high capital levels to absorb the types of losses associated with crises, similar to the one recently experienced.[78] It requires a global liquidity standard to supplement capital regulations.[79] Specifically, there will be a requirement for banks to be able to withstand a thirty day system-wide liquidity shock as well as maintain a more robust structural liquidity profile.[80] Also included are stronger supervision, risk management, and disclosure standards.[81]

Basel III's macro-policies attempt to make economies less sensitive to risk. Basel III introduces a leverage ratio that will help to contain the compression of the risk based requirement.[82] Basel III also adds measures to raise the capital levels of banks in good times so that they can be drawn down in periods of stress to reduce procyclicality.[83] It also will require global systemic banks to have additional loss absorbency capacity beyond the base Basel III requirements.[84]

For the purposes of this paper, it is instructive to note that nowhere in Basel III is there a risk retention requirement.[85] As a result, Basel III does not require banks to have any skin in the game when securitizing.[86]

[77] *See id*.
[78] *See id*.
[79] *See id* at 3.
[80] *See id.*
[81] *See id*
[82] *See id.*
[83] *See id*. at 4.
[84] *See id*.
[85] *See generally* Stefan Walter, *Basel III and Financial Stability*, Speech at the Fifth Biennial Conference on Risk Management and Supervision, (Nov. 3 – 4, 2010) (transcript available at http://www.bis.org/speeches/sp101109a.htm.; *see also See generally* Basel Committee on Banking Supervision, Consultative Documents, available at http://www.bis.org/list/basel3/index.htm (2010).
[86] *See generally* Stefan Walter, *Basel III and Financial Stability*, Speech at the Fifth Biennial Conference on Risk Management and Supervision, (Nov. 3 – 4, 2010) (transcript available at http://www.bis.org/speeches/sp101109a.htm.; *see also See generally* Basel Committee on Banking Supervision, Consultative Documents, available at http://www.bis.org/list/basel3/index.htm (2010).

DIVERGENCE ON SKIN IN THE GAME REGULATION

There are many differences between the Dodd-Frank Act and Basel III regulations that could be compared and contrasted, but the presence of, or lack of, risk retention is an important difference between the two. One major problem in the recent financial downturn was that mortgages with an active secondary market systemically underperformed.[87] Many actors and factors have been blamed for this. Rating agencies are blamed for failing to identify the risks associated with the loan pools.[88] Mortgage brokers are blamed for abusing the system and either purposefully or negligently arranging loans for unqualified individuals lacking proper paperwork.[89] The insufficiency of, or complexity of, the information is also blamed for preventing investors and the market from independently evaluating the investments in asset backed securities.[90]

One way that the problems associated with securitization could be avoided is to align the market incentives so that all parties have the same objectives and then allowing the market to take care of the transactions. As discussed above, some authors have indicated that introducing skin in the game incentives will be effective in increasing the quality of loans and would prevent poor performance practices. It also makes intuitive sense that skin in the game would work. If an originator is required to bear some of the risk of the loan defaulting, the originator will have a greater incentive to make sure its processes will generate profitable loans instead of as many loans as possible.

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[87] *See* Berndt, Antje and Gupta, Anurag, *Moral Hazard and Adverse Selection in the Originate to Distribute Model of Bank Credit*, pg. 5, working paper available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1290312 (Nov. 2008).
[88] *See generally* Reiss, David J., *Ratings Failure: The need for a Consumer Protection Agenda in Rating Agency Regulation*, Brooklyn Law School Legal Studies Research Paper No. 154 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1439748 (June 2009).
[89] *See* Havard, Cassandra, *'Goin' Round in Circles' . . . And Letting the Bad Loans Win – When Subprime Lending Fails Borrowers: The Need for Uniform Broker Regulation*, Neb. L. Rev. Vol. 86, No. 4, 747, 742 – 743 (2008).
[90] S*ee generally* Schwarcz, Steven, *Disclosure's Failure in the Subprime Mortgage Crisis*, Utah L. Rev., p. 1109 (2008).

THE DODD-FRANK ACT

The Dodd-Frank Act takes into consideration the need to align market incentives by requiring a five percent risk retention. This aligns the bank's motives with that of the investors. There are exceptions to the five percent retention rule, but it is unclear whether or not five percent is an optimal retention amount.[91]

Despite all of the benefits involved with requiring risk retention, there is a downside to the rule. Just as securitization helped free bank assets and aided many people in receiving loans, requiring risk retention may lead to reduced lending in the future. Additionally, the fees associated with securitization may compensate banks enough that even a complete loss of five percent of their investment would not be a disincentive.

BASEL III

Basel III lacks a five percent risk retention requirement. Basel III focuses on capital requirements and regulating the banks, but it does not address the benefits of requiring skin in the game. Non-U.S. banks issuing securities will not have the same motivations to issue quality securities because of their lack of skin in the game.[92] The lack of originator incentives will require the investors to conduct more costly investigation to assure that the securities they are purchasing are good investments.[93]

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[91] At the time of writing, the author could not find the motivation for choosing five percent risk retention, and any insight into where this percentage came from would greatly enrich the analysis.
[92] *See* Purnanandam, Amiyatosh, *Originate-to-Distribute Model and the Subprime Mortgage Crisis*, pg. 3 – 4, AFA 2010 Atlanta Meetings Paper, available at http://papers.ssrn.com/sol3/papers.cfm?abstract-id=1167786 (April 2010); *see also* Schwarcz, Stephen, *The Future of Securitisation*, pg. 7, Leverhulme Lectures, University of Oxford, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1707053 (Nov. 2010).
[93] *See generally* Schwarcz, Steven, *Disclosure's Failure in the Subprime Mortgage Crisis*, Utah L. Rev., p. 1109 (2008).

Despite the harms that a lack of skin in the game can bring, there are benefits as well. Without the need to have skin in the game, banks can make more loans which not only allow them to earn more money, but allow more people to receive loans. This will free up capital markets that have been chilled as a result of the recent financial collapse.

INTERNATIONAL CONVERGENCE

There exists a clear divergence between Basel III and the Dodd-Frank Act with regard to whether banks should be required to maintain risk retention. With this divergence in regulatory framework, some commentators believe that it is optimal for regulatory frameworks to converge.[94] In light of this, it is important to ask whether the two frameworks should converge, and if so, which regulation should be chosen.

BENEFITS OF INTERNATIONAL REGULATORY CONVERGENCE

International regulatory convergence would lead to simplified communication and information sharing because less investigation would be necessary in order to invest in a jurisdiction with identical rules.[95] Where there is convergence on securitization regulation, the transaction costs of US investors are reduced.[96] When there is not convergence, investors must hire lawyers and bankers to investigate business operations, disclosure documents, and the regulatory environment of the jurisdictions in which they intend to invest.[97] Investors will find it

[94] *See generally* Jordan, Cally and Majnoni, Giovanni, *Financial Regulatory Harmonization and the Globalization of Finance*, World Bank Policy Research Working Paper No. 2919, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636281 (Oct. 2002).
[95] *See* Jordan, Cally and Majnoni, Giovanni, *Financial Regulatory Harmonization and the Globalization of Finance*, pg. 2, World Bank Policy Research Working Paper No. 2919, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636281 (Oct. 2002).
[96] *See* Andreas M. Fleckner, *Stock Exchanges at the Crossroads*, 74 FORDHAM L. REV. 2541, 2593 note 21 (2006).
[97] *See id.*

easier to invest across borders and diversify their portfolios where regulations have converged. By having international financial regulatory convergence, investors and borrowers benefit through increased and cheaper credit. To some extent, regulatory convergence is a precondition for financial market integration, and as finance continues to flow across borders, there is a growing need for financial regulators in different jurisdictions to collaborate.[98]

When international regulatory convergence occurs, multiple regulators from different backgrounds and jurisdictions can discuss and work together to develop best practices.[99] This, theoretically, would lead to the most efficient investor protection regimes.[100] Compliance with two or more sets of disclosure requirements makes it harder and more costly to comply with both when investing across borders.[101] If jurisdictions do not work together to some extent, investors will be able to expose gaps and differences in systems and conduct regulatory arbitrage.[102] From the regulators' perspective, some countries may not have the resources to regulate and supervise a complex financial system.[103] By having international regulatory convergence, these smaller countries can utilize the frameworks already in place and adopt the sophisticated frameworks to adequately regulate and encourage complex financing.[104]

[98] *See* Jordan, Cally and Majnoni, Giovanni, *Financial Regulatory Harmonization and the Globalization of Finance*, pg. 2, World Bank Policy Research Working Paper No. 2919, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636281 (Oct. 2002).
[99] *See id*. at 1
[100] *See* Brummer, Chris, *Post American Securities Regulation*, Forthcoming Cal. L. Rev., pg. 10, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1441508 (2010).
[101] *See id.* at 11
[102] *See* Romano, Roberta, *Against Financial Regulation Harmonization: A Comment*, pg. 2, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 414 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 (Nov. 2010).
[103] *See* Jordan, Cally and Majnoni, Giovanni, *Financial Regulatory Harmonization and the Globalization of Finance*, pg. 2, World Bank Policy Research Working Paper No. 2919, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=636281 (Oct. 2002).
[104] *See id*.

BENEFITS OF INTERNATIONAL REGULATORY DIVERGENCE

The new regulatory frameworks show that there is a divergence relating to the requirement of risk retention in securitization transactions. However, this may not be a bad thing. There is uncertainty as to what is the best method to regulate banks.[105] This problem is unlikely to ever be solved fully due to the constant change of financial markets and products.[106] Prior to the recent financial collapse, the Basel Accords facilitated bank regulation harmonization.[107] This resulted in nearly all large banks following similar strategies with regard to international securitization.[108] Banks and other financial institutions adopted bad strategies, such as the OTD model, because there was precedent, and until the collapse, the strategy appeared to be working. Additionally, gaps in international regulation exposed more investors to the risks of fraud.[109] When these business strategies failed, the failure was not restricted to investments in one state. Rather, the failure was felt throughout the world and the global economy suffered.[110] By having different regulatory regimes, there is a greater likelihood that not all of the regulators will make the same mistake.[111] This will help reduce international systemic risk and help test different strategies in the pursuit to find the best practices.[112]

[105] *See* Romano, Roberta, *Against Financial Regulation Harmonization: A Comment*, pg. 19, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 414 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 (Nov. 2010).
[106] *See id.*
[107] *See id.* at 16.
[108] *See id.*
[109] *See* Brummer, Chris, *Post American Securities Regulation*, Forthcoming Cal. L. Rev., pg. 10, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1441508 (2010).
[110] *See* Romano, Roberta, *Against Financial Regulation Harmonization: A Comment*, pg. 18, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 414 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 (Nov. 2010).
[111] *See id.* at 19
[112] *See id*.

SHOULD THERE BE CONVERGENCE?

When asking whether there should be international convergence in rules, it is important to determine what the rules would converge to. For the purposes of this paper, we will focus on the concept of risk retention and simplify the examination as to whether regimes should require risk retention. For the reasons noted above, requiring risk retention in securitization appears to be a better policy than not requiring risk retention. A large body of literature has been written describing how requiring originators to bear a proportion of the risk of the assets they create is beneficial.[113] However, there is no way to be sure that the upside to aligning banks' interests with that of investors outweighs the disadvantages. With all the benefits of requiring risk retention, there are also benefits to not requiring risk retention.[114] There is also little to no literature showing that five percent is an optimal retention amount. The lack of risk retention allows more access to credit for investors in a tough market. Banks would also be able to make more profits in a time where they are hurting. The divergence in possible best practices makes it more favorable that the two systems do not converge, at least initially, until one of the regulations is shown to work better in practice.

There are benefits to not having international convergence on financial regulation in general as discussed above. Because of the benefits, Basel III's position to not require risk retention may benefit the overall financial industry. By allowing different regulatory regimes, local jurisdictions can tailor rules to best meet their needs and desires.[115] By having multiple systems and rules, different regimes can be tested in practice. Best practices can then be

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[113] *See* Hildebrand, Thomas, Puri, Manju, and Rocholl, Jörg, *Skin in the Game: Evidence from the Online Lending Market*, pg. 25, Conference on Financial Economics and Accounting, available at http://www.rhsmith.umd.edu/feaconference/docs/Session3PuriSkinintheGame.pdf (Oct. 2010).
[114] *See* Blinder, Alan S, *It's Broke, Let's Fix It: Rethinking Financial Regulation*, International Journal of Central Banking, Vol. 6, No. 4, 277, 303 (2009).
[115] *See* Romano, Roberta, *Against Financial Regulation Harmonization: A Comment*, pg. 15, John M. Olin Center for Studies in Law, Economics, and Public Policy Research Paper No. 414 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1697348 (Nov. 2010).

discovered and utilized by jurisdictions as they are proven. In the present case, if the risk retention leads to better asset backed securities being issued, and this creates a better banking system than in countries that lack the risk retention, the Dodd-Frank Act will be vindicated, and other countries will likely adopt the regulation. If countries that do not have a risk retention requirement generate high quality asset backed securities, and lead to a more fluid and profitable financial system, then Basel III will be vindicated and the US can remove the risk retention requirement.

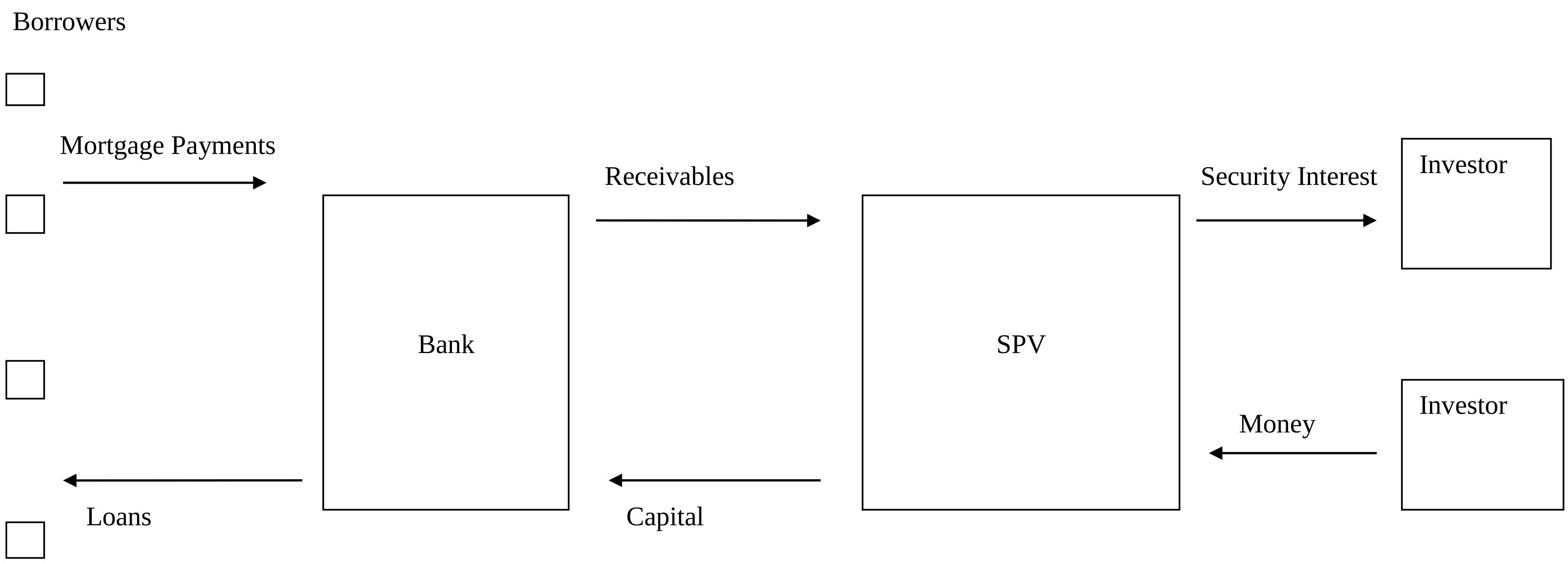
Even though risk retention appears to be the better policy, it has yet to be tested, and as such, uncertainty exists whether it is a preferable policy in practice. Further, there are benefits to not having international convergence that will help avoid another international financial collapse. In light of these two considerations, the different policies between the Dodd-Frank Act and Basel III with regard to risk retention appears to be a beneficial divergence.

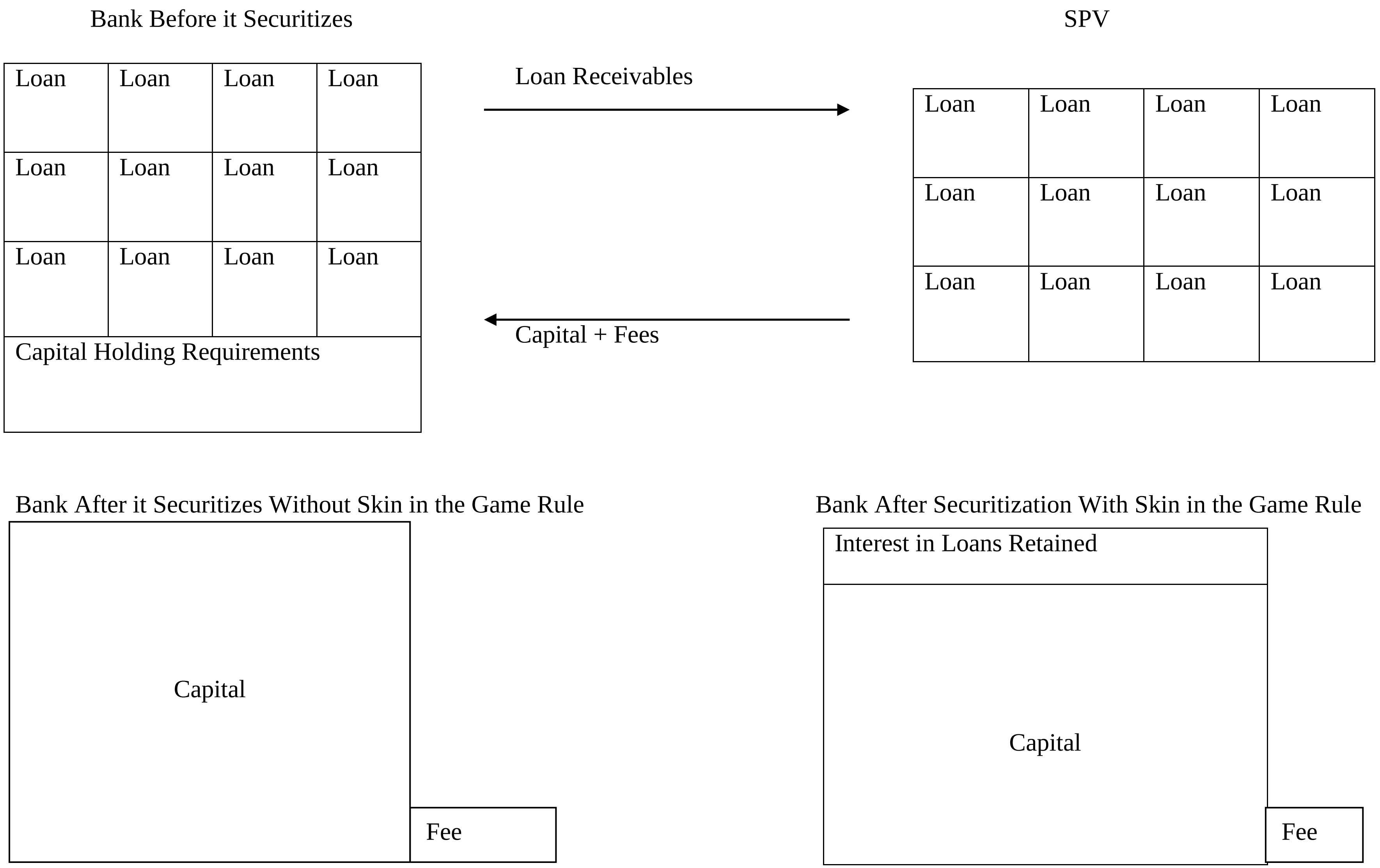
CONCLUSION

The OTD model of banking led to significant securitization and the creation of many poorly performing loans. The poor performance of these loans was a major cause of the recent financial collapse. In response, both the Dodd-Frank Act and Basel III were passed to better regulate banks. Notably, the Dodd-Frank Act contained a provision that required banks to maintain five percent risk retention in securitizations whereas Basel III has no such risk retention requirement. Although both regulations require banks to maintain higher capital levels, without requiring the banks to hold skin in the game, the raised capital levels will do little to prevent banks from securitizing their loans. Banks are able to circumvent the system because churning loans allows banks to sell their receivables in exchange for capital, thereby meeting their capital requirements. As a result, the Dodd-Frank Act does a better job of addressing the problems inherent in the OTD model of banking.

There are still drawbacks to the Dodd-Frank Act's risk retention requirement. Securitization was a useful financial tool that allowed banks to be more profitable, allowed borrowers better access to loans, and allowed non-institutional investors to invest in the mortgage market. By requiring risk retention, the Dodd Frank Act will inhibit the securitization market. Banks will likely be unable to churn loans as much as they would without the risk retention. Since the financial market is still reeling from the recent collapse, this could further inhibit an economic rebound. A divergence in regulatory regimes can prevent a systemic downturn. Additionally, having the two regimes test the two different regulations will prove, in practice, which is actually the better policy. As one regulation proves itself, the other regulatory framework can adopt it. The lack of convergence between Basel III and the Dodd Frank Act with regard to risk retention can be beneficial for international banking.

Eric M. Thompson
Appendix A




Bank Before it Securitizes
SPV
Loan Loan Loan Loan
Loan Loan Loan Loan
Loan Loan Loan Loan
Capital Holding Requirements
Loan Receivables
Capital + Fees
Loan Loan Loan Loan
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Bank After it Securitizes Without Skin in the Game Rule
Capital
Fee
Bank After Securitization With Skin in the Game Rule
Interest in Loans Retained
Capital
Fee