The Financial Stability Oversight Council Chairman's Study on "Risk Retention"

"Skin in the Game" to Help Ensure a Safe and Strong Securitization Market

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Chairman of the Financial Stability Oversight Council (FSOC) to issue a study on the Dodd-Frank Act's risk retention requirements within 180 days of enactment. This risk retention study was delivered to Congress on January 18, 2011 and examines the ways that risk retention, also known as "skin in the game," can help reform the securitization market, protect the public and the economy against irresponsible lending practices, and facilitate economic growth by allowing for safe and stable credit formation for consumers, businesses, and homeowners.

Preserving the Benefits of Securitization for the Economy by Keeping "Skin in the Game"

- The study notes that asset-backed securitization provides important economic benefits by improving the availability and affordability of credit to a diverse group of consumers, businesses, and homeowners.
- However, as the recent financial crisis demonstrated, without reform, risks in the securitization process can detract from these benefits. Leading up to the recent crisis, originators and securitizers made loans, bundled them together, and then sold them off to a broad array of outside investors, often without retaining a meaningful share of the risk. Because originators had little interest in whether the borrowers would be able to repay the loans, underwriting standards deteriorated and excessively risky mortgages flooded the market. This helped fuel the financial crisis.
- To address this serious flaw in the pre-crisis securitization market, the Dodd-Frank Act generally requires that securitizers or originators have "skin in the game" by retaining at least 5 percent of the credit risk of an asset sold to investors through the securitization process, which should allow market participants to price credit risk more accurately and allocate capital more efficiently.
- By putting in place such safeguards, the Dodd-Frank Act can help ensure that securitization is a stable and reliable source of credit for consumers, businesses, and homeowners in the United States.

Employing a Tool to Help Mitigate Flaws in Securitization

- The FSOC Chairman's study states that risk retention serves as an important tool that, if properly structured, has the potential to mitigate some of the risks that we've seen in the past and promote safe and efficient lending.
- The study indicates that a risk retention framework should seek to:
    - Align incentives without changing the basic structure and objectives of securitization transactions;
    - Provide for greater certainty and confidence among market participants;
    - Promote efficiency of capital allocation;
    - Preserve flexibility as markets and circumstances evolve; and
    - Allow a broad range of participants to continue to engage in lending activities, while doing so in a safe and sound manner.
- In doing so, there are a number of design choices that regulators must address.
    - The form of risk retention, allocation of risk retention to various participants in the securitization chain, amount of risk retention, allowances for risk management, and exemptions from risk retention are all important variables in the design of any such framework.

Utilizing a Comprehensive Approach to Reform

- While risk retention offers many potential benefits, it cannot by itself address all of the challenges in this market. That's why the Dodd-Frank Act includes a comprehensive set of reforms to help improve the health and sustainability of the financial system, including:

    - Credit rating agency reform;
    - Improved transparency and issuer due diligence;
    - The ability-to-pay requirements for mortgages;
    - Critical new consumer protections; and
    - Improved monitoring of risks throughout the financial system.
- Additionally, accounting and prudential capital standards are also being reformed to address problems that became apparent during the financial crisis.

Moving Forward in an Ongoing Rulemaking Process

- This study is issued by the Secretary of Treasury, as Chairman of the FSOC, as mandated by Section 946 of the Dodd-Frank Act.
- Separately, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Securities and Exchange Commission (SEC), must jointly prescribe rules to implement the risk retention requirements under Section 941. The study is independent of the Section 941 rulemaking process.
- In addition, the Federal Housing Finance Agency (FHFA) and the Department of Housing and Urban Development (HUD), along with the foregoing agencies must jointly prescribe rules on risk retention with respect to residential mortgages.

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