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Risk retention in the European securitization market: skimmed by the skin-in-the-game methods?

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purpose is to create a better alignment of the interests held by the originator and the investor by incentivizing originators to 'do their jobs better', for example by improving their screening and monitoring standards.

The rule allows the originator to select one of the different regulatory risk retention methods to hold their portion of *skin-in-the-game*. This means that the intention behind all methods is to align the incentive on both the originator and the investor in an equal manner. The four regulatory risk retention methods analyzed in this paper work as follows. First, there is what is known as the first loss tranche (FLT) method, where a portion of the equity tranche, corresponding to at least 5% of the total nominal value of the securitized exposures, is retained. Second, there is the first loss exposure (FLE) method, where at least 5% of the credit risk at the level of every securitized exposure is retained. Third, we distinguish the vertical slice (VES) method, where the originator retains a portion of each tranche of a minimum 5%. Finally, we have the on-balance sheet (OBS) method, where the originator keeps a randomly selected portion of the exposures of at least 5% of the nominal value from the envisaged asset pool in their books.

The starting point of our study was the fact that the European risk retention rules do not distinguish between the degree to which a particular risk retention method aligns the incentive between the originator and the investor. Hence, all methods are treated by regulation as optimizing the incentive in an equal manner, and the originator is free to use whatever option suits best. This seems surprising, given that these methods differ in terms of risk and return profiles for both the retainer and the investor as well as in terms of the way in which their incentives align, as is also highlighted in previous literature (cf. Bektić & Hachenberg, 2021; Kiff & Kisser, 2014; Malekan & Dionne, 2014). This led us to formulate three research questions. First, as it is not the investor but the originator who has the freedom to select one of the risk retention methods, we investigated whether or not investors perceive these methods to be equally risky. We did so by analyzing if investors differentiate in their pricing (measured by issuance spread) between the different risk retention methods. Second, we explored whether investors were informed, via the credit rating, about the differences in risk profiles of securitizations with the different retention methods. We scrutinized the credit rating methodologies, and we also analyzed the credit ratings (and their discrepancy) of securitization tranches based on different risk retention methods. Finally, as it is up to the originator to choose a particular method, we attempted to assess the motives of originators for selecting a specific risk

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