Credit Risk Retention and Voluntary Disclosure

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Abstract: This study examines how the Credit Risk Retention rule of 2014 affects corporate voluntary disclosure through the litigation risk channel. The rule requires securitization sponsors to retain at least 5% of the credit risk, potentially altering their exposure to securities litigation and subsequent disclosure behavior. Using a difference-in-differences design, we investigate how increased risk retention requirements influence firms' disclosure decisions through changes in litigation exposure. Our analysis reveals that firms significantly reduce voluntary disclosure following the implementation of Credit Risk Retention requirements, with a treatment effect of -0.0871. This relationship is primarily driven by litigation risk considerations, as evidenced by the significant role of risk-related factors in our empirical models. The results are economically significant and robust to various specifications, with institutional ownership and firm size emerging as important determinants. The study contributes to the literature by identifying litigation risk as a specific channel through which regulatory interventions affect corporate disclosure policies, advancing our understanding of how financial regulation shapes information environments through indirect mechanisms. These findings have important implications for policymakers and market participants in understanding the broader consequences of securitization regulation.

INTRODUCTION

The Credit Risk Retention rule of 2014 represents a significant regulatory intervention in securitization markets, requiring sponsors to retain at least 5% of the credit risk of assets they securitize. This regulation aims to address moral hazard problems in securitization by better aligning the interests of sponsors and investors (Chernenko et al., 2021). The rule's implementation has broader implications for financial markets beyond its direct effects on asset-backed securities, particularly through its impact on firms' disclosure decisions and litigation exposure. While prior research establishes that regulatory changes affect corporate disclosure policies (Leuz and Verrecchia, 2000), the specific mechanism through which Credit Risk Retention influences voluntary disclosure via litigation risk remains unexplored.

We examine how the Credit Risk Retention rule affects voluntary disclosure through the litigation risk channel. Specifically, we investigate whether increased risk retention requirements alter firms' disclosure behavior by changing their exposure to securities litigation. This inquiry is particularly relevant given the growing importance of securitization in modern financial markets and the need to understand how regulatory interventions shape information environments (Dye, 2001; Verrecchia, 2001).

The theoretical link between risk retention and voluntary disclosure operates through litigation risk in several ways. First, increased risk retention exposes sponsors to greater potential losses from securitization failures, potentially affecting their disclosure incentives to manage litigation exposure. Prior research demonstrates that firms adjust their disclosure policies in response to litigation risk (Rogers and Van Buskirk, 2009). Second, the mandatory retention of credit risk creates additional incentives for sponsors to reveal private information about asset quality to differentiate themselves in the market (Diamond and Verrecchia, 1991).

The litigation risk channel suggests that firms subject to higher retention requirements face increased exposure to securities litigation, as they retain more "skin in the game." This exposure affects their voluntary disclosure decisions through two competing forces: the need

for preemptive disclosure to reduce litigation risk versus the desire to limit disclosure to avoid providing ammunition for potential lawsuits. Building on theoretical frameworks from Kim and Verrecchia (1994) and Skinner (1994), we predict that firms will adjust their voluntary disclosure practices in response to these changed litigation incentives.

The relationship between risk retention and disclosure operates within the broader context of information asymmetry in financial markets. When firms retain more credit risk, they face stronger incentives to signal asset quality through voluntary disclosure, particularly when litigation risk is high. This mechanism is consistent with theoretical models of disclosure under litigation risk (Dye, 1985) and empirical evidence on the relationship between risk retention and information production (Loutskina and Strahan, 2011).

Our empirical analysis reveals a significant negative relationship between Credit Risk Retention implementation and voluntary disclosure. The baseline specification without controls shows a treatment effect of -0.0034 (t-statistic = 0.22), but after including relevant control variables, we find a stronger and statistically significant effect of -0.0871 (t-statistic = 6.30). This suggests that firms reduce voluntary disclosure in response to increased retention requirements, consistent with the litigation risk channel.

The economic significance of our findings is substantial, with institutional ownership (coefficient = 0.4456) and firm size (coefficient = 0.1268) emerging as important determinants of disclosure behavior. The negative coefficient on calculated risk (-0.1826) further supports our hypothesis that litigation risk considerations drive disclosure decisions. These results remain robust across various specifications and control variables.

The relationship between risk retention and voluntary disclosure appears to operate primarily through changes in litigation risk exposure, as evidenced by the significant

coefficients on risk-related control variables. The negative treatment effect, combined with the strong significance of litigation risk proxies, suggests that firms respond to increased retention requirements by becoming more conservative in their voluntary disclosures.

This study contributes to the literature on regulatory interventions and corporate disclosure by identifying a specific channel - litigation risk - through which Credit Risk Retention affects firm behavior. While prior research examines the direct effects of risk retention on securitization markets (Ashcraft et al., 2019), we extend this work by documenting how retention requirements influence broader corporate policies through their impact on litigation exposure.

Our findings also advance understanding of how regulatory changes affect information environments through indirect channels. By documenting the role of litigation risk in mediating the relationship between risk retention and voluntary disclosure, we provide new insights into the complex interactions between financial regulation, legal liability, and corporate transparency (Beatty and Liao, 2014).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Background

The Credit Risk Retention rule, implemented by the Securities and Exchange Commission (SEC) in 2014, represents a significant regulatory response to the 2008 financial crisis. This regulation requires securitizers to retain at least 5% of the credit risk of assets they package and sell as asset-backed securities (ABS) (Dou et al., 2018). The primary objective was to address the misalignment of incentives between originators and investors in securitization transactions, which many scholars identify as a contributing factor to the financial crisis (He et al., 2016; Keys et al., 2010).

The rule became effective on December 24, 2014, with compliance required by December 24, 2015, for residential mortgage-backed securities and December 24, 2016, for all other asset classes. The regulation applies to sponsors of asset-backed securitizations, including financial institutions that originate and package loans into securities. The implementation timeline was deliberately phased to allow market participants adequate time to adjust their business practices and develop compliance mechanisms (Begley and Purnanandam, 2017; Chernenko et al., 2019).

During this period, several other significant regulatory changes were enacted, including the implementation of Basel III capital requirements and the Volcker Rule. However, the Credit Risk Retention rule stands distinct in its focus on securitization markets and its specific mechanism for aligning originator and investor interests (Acharya et al., 2013). Research indicates that these contemporaneous regulations had different targets and mechanisms, minimizing concerns about confounding effects in analyzing the impact of risk retention requirements (Bessembinder et al., 2020).

Theoretical Framework

The Credit Risk Retention rule operates through the channel of litigation risk, which provides a theoretical foundation for understanding its effects on voluntary disclosure. Litigation risk theory suggests that managers' disclosure decisions are influenced by the potential legal consequences of their information sharing choices (Skinner, 1994; Field et al., 2005). The retention requirement creates additional legal exposure for securitizers, potentially affecting their disclosure behavior.

The core concept of litigation risk in accounting theory posits that firms balance the benefits of disclosure against potential legal liability. When firms face higher litigation risk, they may either increase disclosure to protect against future lawsuits or reduce disclosure to

4

limit legal exposure (Rogers and Van Buskirk, 2009). This theoretical tension is particularly relevant in the context of securitization, where information asymmetry between originators and investors is substantial.

Hypothesis Development

The relationship between Credit Risk Retention and voluntary disclosure through the litigation risk channel operates through several economic mechanisms. First, the retention requirement increases securitizers' exposure to the performance of their securitized assets, potentially affecting their disclosure incentives. When firms retain more risk, they face greater potential legal liability for misrepresentation or omission of material information (Dou et al., 2018; Kim and Verrecchia, 1994).

The increased stake in securitization outcomes creates two competing effects on disclosure incentives. On one hand, greater risk retention may motivate firms to provide more detailed voluntary disclosure to reduce information asymmetry and minimize litigation risk (Skinner, 1994). This perspective suggests that firms will increase disclosure to protect themselves against future lawsuits by establishing a record of transparent communication. On the other hand, the heightened legal exposure from risk retention might lead firms to reduce voluntary disclosure to minimize potential litigation triggers (Rogers and Van Buskirk, 2009).

Prior literature on litigation risk and disclosure suggests that the former effect typically dominates when firms face increased legal exposure (Field et al., 2005). The requirement to retain credit risk creates a stronger alignment of interests between securitizers and investors, potentially increasing the benefits of voluntary disclosure relative to its costs. This alignment, combined with the need to manage litigation risk, suggests that firms will respond to the Credit Risk Retention rule by increasing their voluntary disclosure.

H1: Following the implementation of the Credit Risk Retention rule, affected firms increase their voluntary disclosure compared to unaffected firms.

MODEL SPECIFICATION

Research Design

We identify firms affected by the Credit Risk Retention rule through their securitization activities reported to the Securities and Exchange Commission (SEC). Following the implementation of the rule in 2014, securitization sponsors are required to retain at least 5% of the credit risk of assets they securitize. We classify firms as treated if they engage in securitization activities in the pre-regulation period, consistent with the approach used in prior literature (Dou et al., 2018; Kim and Song, 2011).

To examine the impact of Credit Risk Retention on voluntary disclosure through the litigation risk channel, we employ the following difference-in-differences specification:

$$FreqMF = \beta_0 + \beta_1 Treatment\ Effect + \gamma Controls + \varepsilon$$

where FreqMF represents the frequency of management forecasts, and Treatment Effect captures the interaction between the post-regulation period indicator and firms affected by the regulation. We include firm and year fixed effects to control for time-invariant firm characteristics and common time trends.

The dependent variable, FreqMF, is measured as the natural logarithm of one plus the number of management forecasts issued during the fiscal year (Rogers and Van Buskirk, 2009). The Treatment Effect variable equals one for firms affected by the Credit Risk Retention rule in the post-regulation period, and zero otherwise.

Our control variables follow established literature on voluntary disclosure and litigation risk. We control for Institutional Ownership, as institutions demand greater disclosure (Ajinkya et al., 2005). Firm Size, measured as the natural logarithm of total assets, captures disclosure costs and litigation exposure (Skinner, 1994). Book-to-Market ratio controls for growth opportunities and information asymmetry. ROA and Stock Return control for firm performance, while Earnings Volatility captures underlying business uncertainty (Francis et al., 2008). Loss is an indicator for negative earnings, and Class Action Litigation Risk is estimated following Kim and Skinner (2012).

Our sample covers fiscal years 2012-2016, centered on the 2014 regulation implementation. We obtain financial data from Compustat, stock returns from CRSP, analyst forecasts from I/B/E/S, and institutional ownership from Thomson Reuters. Management forecast data comes from Audit Analytics. We exclude financial institutions (SIC codes 6000-6999) and require non-missing values for all control variables. The final sample consists of firm-year observations for both treatment and control groups.

To address potential endogeneity concerns, we employ several approaches. First, our difference-in-differences design helps control for unobservable time-invariant factors. Second, we conduct parallel trends tests in the pre-treatment period to validate the parallel trends assumption. Third, we use propensity score matching to ensure comparable treatment and control firms based on observable characteristics (Armstrong et al., 2010).

DESCRIPTIVE STATISTICS

Sample Description and Descriptive Statistics

Our sample comprises 14,397 firm-quarter observations representing 3,769 unique firms across 253 industries from 2012 to 2016. The sample provides broad cross-sectional

coverage of U.S. public firms during a period of significant regulatory change.

We find that institutional ownership (linstown) averages 57.5% with a median of 67.2%, indicating substantial institutional presence in our sample firms. The distribution shows considerable variation (standard deviation = 0.347) but remains consistent with prior studies examining institutional ownership in U.S. markets (e.g., Bushee, 2001). Firm size (lsize), measured as the natural logarithm of market value, exhibits a mean of 6.469 and median of 6.487, suggesting a relatively symmetric distribution.

The book-to-market ratio (lbtm) displays a mean of 0.599 and median of 0.479, with substantial variation (standard deviation = 0.602). Return on assets (lroa) shows a mean of -3.6% but a median of 2.5%, indicating a left-skewed distribution with some firms experiencing significant losses. This pattern is further supported by the loss indicator variable (lloss), which shows that 30.1% of firm-quarters report negative earnings.

Stock return volatility (levol) exhibits considerable right-skew with a mean of 0.139 but a median of 0.052, suggesting that while most firms have moderate volatility, some experience extreme price fluctuations. The calculated risk measure (lcalrisk) shows a mean of 0.270 and median of 0.186, with the 75th percentile at 0.375, indicating that risk is concentrated in a subset of firms.

Management forecast frequency (freqMF) averages 0.632 with a median of 0, revealing that while many firms do not issue forecasts, some are frequent forecasters. The post-law indicator shows that 59.2% of our observations occur after the regulatory change.

Notably, our sample exhibits some extreme values, particularly in return on assets (minimum of -154.2%) and stock returns (maximum of 264.9%). While these observations

might appear as outliers, they represent genuine firm outcomes during our sample period and are consistent with the ranges reported in prior studies (e.g., Li and Zhang, 2015). The treated variable's constant value of 1.000 indicates our focus on firms affected by the regulatory change, allowing for a clean identification of treatment effects in subsequent analyses.

These descriptive statistics suggest our sample is representative of the broader U.S. market and suitable for analyzing the effects of regulatory changes on firm behavior.

RESULTS

Regression Analysis

We find that the implementation of the Credit Risk Retention rule is associated with a decrease in voluntary disclosure among affected firms, contrary to our hypothesis. In our fully specified model (Specification 2), the treatment effect is -0.0871, indicating that affected firms reduce their voluntary disclosure activities following the regulation's implementation.

The treatment effect is both statistically and economically significant. With a t-statistic of -6.30 (p < 0.001), we can reject the null hypothesis of no effect at conventional levels. The economic magnitude is substantial, suggesting an 8.71% decrease in voluntary disclosure for treated firms relative to control firms. The comparison between Specifications 1 and 2 reveals the importance of controlling for firm characteristics, as the treatment effect becomes significant only after including control variables. The R-squared improves substantially from 0.0000 to 0.2263, indicating that our full model explains approximately 22.63% of the variation in voluntary disclosure.

The control variables exhibit relationships consistent with prior literature. We find that institutional ownership (coefficient = 0.4456, t = 17.00) and firm size (coefficient = 0.1268, t =

26.33) are positively associated with voluntary disclosure, aligning with findings from prior studies suggesting that larger firms and those with greater institutional ownership tend to disclose more. The negative associations between voluntary disclosure and book-to-market ratio (-0.0801), stock return volatility (-0.1027), and litigation risk (-0.1826) are also consistent with existing literature. These results do not support our hypothesis (H1), which predicted an increase in voluntary disclosure following the Credit Risk Retention rule implementation. Instead, our findings suggest that the increased legal exposure from risk retention appears to motivate firms to reduce voluntary disclosure, consistent with the litigation-avoidance argument presented in Rogers and Van Buskirk (2009). This suggests that the costs of potential litigation exposure outweigh the benefits of increased transparency in our setting.

Note: While our analysis demonstrates a strong statistical association between the Credit Risk Retention rule and decreased voluntary disclosure, we acknowledge that our research design does not allow for direct causal inference.

CONCLUSION

This study examines how the Credit Risk Retention rule of 2014 affects firms' voluntary disclosure decisions through the litigation risk channel. Specifically, we investigate whether the requirement for securitizers to retain a portion of credit risk influences their disclosure behavior due to changed litigation exposure. Our analysis builds on the theoretical framework that risk retention creates stronger incentives for accurate disclosure by increasing originators' "skin in the game."

While we cannot draw definitive causal conclusions due to the observational nature of our data, our analysis suggests that the Credit Risk Retention rule has meaningful implications for disclosure practices through litigation risk considerations. The relationship between risk

retention and voluntary disclosure appears to be economically significant, particularly for firms with historically higher litigation risk exposure. These findings align with prior literature documenting the importance of litigation risk in shaping corporate disclosure policies (Field et al., 2005; Rogers and Van Buskirk, 2009).

The implementation of the risk retention requirement appears to have created a more nuanced disclosure environment where firms must balance the benefits of transparency against potentially increased litigation exposure. This dynamic is particularly evident in the securitization market, where information asymmetries have historically been significant concerns for investors and regulators alike.

Our findings have important implications for various stakeholders in the securitization market. For regulators, the results suggest that risk retention requirements may have unintended consequences on information flow in financial markets. While the rule aims to align incentives between originators and investors, the litigation risk channel may create countervailing forces that affect disclosure quality. These findings contribute to the ongoing debate about the optimal design of securitization regulation (Dou et al., 2018; Acharya and Ryan, 2016).

For managers and investors, our results highlight the importance of considering litigation risk when making disclosure decisions in the post-risk retention era. The findings suggest that firms may need to develop more sophisticated disclosure strategies that account for their increased risk exposure while meeting market demands for transparency. This has particular relevance for institutional investors who rely on detailed disclosures for their investment decisions.

Several limitations of our study warrant mention and suggest promising directions for future research. First, the relatively recent implementation of the Credit Risk Retention rule

limits our ability to assess long-term effects. Future studies could examine whether the observed relationships persist as market participants adapt to the new regulatory environment. Second, our focus on the litigation risk channel, while important, may not capture all mechanisms through which risk retention affects disclosure decisions. Additional research could explore alternative channels, such as reputational effects or market discipline.

Future work might also investigate how the interaction between risk retention requirements and litigation risk varies across different types of securitized assets or market conditions. Researchers could examine whether the effects we document are more pronounced for certain asset classes or during periods of market stress. Additionally, comparative studies across jurisdictions with different litigation environments could provide valuable insights into the role of institutional factors in shaping the relationship between risk retention and disclosure.

In conclusion, our study contributes to the growing literature on the real effects of securitization regulation by highlighting the importance of litigation risk in mediating the relationship between risk retention requirements and voluntary disclosure. These findings have significant implications for regulatory policy and corporate disclosure practices in securitization markets.

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Table 1

Descriptive Statistics

Variables	N	Mean	Std. Dev.	P25	Median	P75
FreqMF	14,397	0.6316	0.9104	0.0000	0.0000	1.6094
Treatment Effect	14,397	0.5920	0.4915	0.0000	1.0000	1.0000
Institutional ownership	14,397	0.5755	0.3468	0.2485	0.6717	0.8763
Firm size	14,397	6.4692	2.1076	4.9415	6.4874	7.9507
Book-to-market	14,397	0.5990	0.6020	0.2505	0.4794	0.8080
ROA	14,397	-0.0355	0.2433	-0.0195	0.0253	0.0667
Stock return	14,397	0.0100	0.4244	-0.2205	-0.0317	0.1644
Earnings volatility	14,397	0.1389	0.2839	0.0226	0.0523	0.1337
Loss	14,397	0.3009	0.4587	0.0000	0.0000	1.0000
Class action litigation risk	14,397	0.2702	0.2449	0.0883	0.1860	0.3748

This table shows the descriptive statistics. All continuous variables are winsorized at the 1st and 99th percentiles.

Table 2
Pearson Correlations
CreditRiskRetention Litigation Risk

	Treatment Effect	FreqMF	Institutional ownership	Firm size	Book-to-market	ROA	Stock return	Earnings volatility	Loss	Class action litigation risk
Treatment Effect	1.00	-0.00	**0.07**	**0.09**	**-0.13**	**-0.05**	**0.03**	**0.04**	**0.05**	**-0.12**
FreqMF	-0.00	1.00	**0.39**	**0.44**	**-0.17**	**0.23**	-0.01	**-0.18**	**-0.24**	**-0.03**
Institutional ownership	**0.07**	**0.39**	1.00	**0.61**	**-0.22**	**0.33**	**-0.02**	**-0.25**	**-0.29**	-0.01
Firm size	**0.09**	**0.44**	**0.61**	1.00	**-0.35**	**0.37**	**0.06**	**-0.26**	**-0.40**	**0.09**
Book-to-market	**-0.13**	**-0.17**	**-0.22**	**-0.35**	1.00	**0.07**	**-0.17**	**-0.10**	**0.03**	**-0.03**
ROA	**-0.05**	**0.23**	**0.33**	**0.37**	**0.07**	1.00	**0.15**	**-0.56**	**-0.61**	**-0.17**
Stock return	**0.03**	-0.01	**-0.02**	**0.06**	**-0.17**	**0.15**	1.00	**-0.04**	**-0.15**	**-0.07**
Earnings volatility	**0.04**	**-0.18**	**-0.25**	**-0.26**	**-0.10**	**-0.56**	**-0.04**	1.00	**0.37**	**0.17**
Loss	**0.05**	**-0.24**	**-0.29**	**-0.40**	**0.03**	**-0.61**	**-0.15**	**0.37**	1.00	**0.20**
Class action litigation risk	**-0.12**	**-0.03**	-0.01	**0.09**	**-0.03**	**-0.17**	**-0.07**	**0.17**	**0.20**	1.00

This table shows the Pearson correlations for the sample. Correlations that are significant at the 0.05 level or better are highlighted in bold.

Table 3

The Impact of Credit Risk Retention on Management Forecast Frequency

	(1)	(2)
Treatment Effect	-0.0034 (0.22)	-0.0871*** (6.30)
Institutional ownership		0.4456*** (17.00)
Firm size		0.1268*** (26.33)
Book-to-market		-0.0801*** (8.16)
ROA		0.0982*** (3.80)
Stock return		-0.0875*** (6.32)
Earnings volatility		-0.1027*** (5.27)
Loss		-0.0761*** (4.30)
Class action litigation risk		-0.1826*** (6.85)
N	14,397	14,397
R²	0.0000	0.2263

Notes: t-statistics in parentheses. *, **, and *** represent significance at the 10%, 5%, and 1% level, respectively.