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What is the value of recourse to asset-backed securities? A clinical study of credit card banks

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Abstract

The present paper uses credit card securitization data to show that recourse to securitized debt may benefit short- and long-term stock returns and long-term operating performance of sponsors. Therefore, although recourse violates regulatory guidelines and FASB140, recourse may have beneficial effects for sponsors by revealing that the shocks that made recourse necessary are transitory. Sponsors providing recourse do, however, experience an abnormal delay in their normal issuance cycle around the event. Hence, it appears that the asset-backed securities market is like the commercial paper market, where a firm's ability to issue is directly correlated with credit quality.

JEL classification: G21; G28
Keywords: Asset-backed; Bank regulation; Credit cards; Recourse; Securitization

1. Introduction

Commercial banks have a strong incentive to sell assets in order to increase liquidity, reduce interest rate risk, and avoid burdensome regulations. However, most bank assets are high-asymmetric-information financial instruments and, as a result,

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are fundamentally illiquid. Hence, commercial banks have become increasingly reliant upon securitization as a means of selling assets.

Business strategies that revolve around securitization are accompanied by a host of incentive conflicts. At various times during the 1990s, securitization has been associated with financial difficulties arising from fictitious financial ratios (gain-on-sale provisions), understated leverage (Enron), and hidden risks (Enron, PNC, and other commercial banks). The present paper concerns itself with the last of these, that is, the propensity for securitizations to mask risks to the sponsor, [1] whether the sponsor is a bank originating loans or a non-bank firm posting other collateral for securitization (Calomiris and Mason, 2003; Jones, 2000).

Risks often remain with the sponsor because securitization – and the removal of assets from the sponsor's balance sheet – relies on a "true sale" to a legally remote third party. If the assets are not truly sold or the sale is not to a legally defined third party, the assets must be reported on the sponsor's balance sheet. One important condition that determines whether a true sale has taken place is whether the sale agreement provides *recourse*, or performance guarantees, to the buyer. If recourse terms are present, the assets pose a contingent risk to the seller, which, under FASB140, prohibits the removal of the assets from the seller's balance sheet.

While few loan sales contracts contain explicit terms that provide recourse, many loan sales (particularly those involving revolving collateral such as credit card loans) hinge upon an *implicit* understanding that recourse may be provided by the sponsor. Such understandings exist because sponsors wish to maintain their reputations for consistent credit quality over repeated sales (while still taking advantage of the ability, under a true sale, to remove the assets from the balance sheet). Losing a good reputation (and the ability to sell loans economically) may expose the sponsor to decreased liquidity, increased interest rate risk, and burdensome regulatory supervision. By providing recourse in cases where none is explicitly required, the sponsor demonstrates the presence of de facto recourse and therefore previously unreported contingent liabilities.

This paper examines 17 discrete recourse events that support securitized credit-card receivables sponsored by 10 different credit-card banks. We examine the market response to the support announcement, the pre- and post-recourse performance of the sponsoring firms, and the pre- and post-recourse deal characteristics of the sponsoring firms' credit-card-backed securities. We find that, conditional on being in a position where honoring implicit recourse has become necessary and conditional on actually providing that recourse, the sponsors, on average, exhibit improved short- and long-term stock price performance and improved long-term financial performance. The only penalty that recourse-providing sponsors face is an increase in the issuance time post-recourse provision. Otherwise, deal characteristics remain unchanged after recourse provision. Hence, it appears that the market

[1] The sponsor originates the assets and sells them to a bankruptcy-remote third-party trust that funds the purchase by issuing asset-backed securities.