

# Implicit recourse and credit card securitizations: What do fraud losses reveal? <sup>☆</sup>

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## Abstract

In this paper, we develop and test a model of implicit recourse in asset-backed securitizations. Fraud losses on securitized assets are generally incurred by the bank and do not affect the performance of securitization trusts, while credit losses do affect the trust's performance and are potentially borne by the owner of the securitized assets. Thus, the classification of losses as either fraud or credit losses provides a potential avenue of implicit recourse to manipulate the performance of securitization trusts. Using annual data from 2001 to 2006, we find that the performance of the credit card securitization portfolio is negatively related to fraud losses reported by the bank. We examine these results in light of the proposed Basel II capital rules and argue that a bank's incentive to provide implicit recourse will increase under the anticipated regime.

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## 1. Introduction

In credit card asset-backed security (CC-ABS) deals, credit losses are borne by the trust (and thus potentially borne by investors), while fraud losses are borne by the originating bank. Thus the (mis)classification of losses as either credit or fraud losses affects trust performance. Banks could use this distinction to provide implicit recourse in CC-ABS markets. By nature, implicit recourse can be difficult to see and quantify. However, by develop-

ing empirical tests to analyze the classification of credit losses and fraud losses in the US CC-ABS market, we can examine whether banks use a particular type of implicit recourse to protect securitized credit card receivables. We focus on CC-ABS because, on average, fraud losses are far higher for credit cards than other types of lending.

The expectation that banks may provide implicit recourse is common in the industry. For example, Gregory (2002) reported that in response to poor performance on the Chase Credit Card Master Trust, a Barclays Capital analyst said, "It would behoove them to do whatever they have to do to keep the deals going". The academic literature has also noted the existence of implicit recourse in CC-ABS markets. In the two papers most closely related to this work, Higgins and Mason (2004) document several well-defined instances of implicit recourse in CC-ABS deals and analyze the market's reaction to these events. Gorton and Souleles (2007) provide an indirect test of implicit recourse by showing that market prices of CC-ABS reflect an originator's ability to provide recourse.

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The market for CC-ABS has expanded and developed in banks and other lending institutions since the first deals were introduced in the early 1980s. As reported in the first column of Table 1, there was over \$361 billion in securitized credit card receivables outstanding in US commercial banks as of year-end 2006. This amount is concentrated in a few very large banks.

Our study contributes to the academic literature in several ways. We are the first to specify a process and test for implicit recourse directly. Further, this paper examines the proposed treatment of securitized assets under the proposed Basel II bank capital rules. We argue that a bank's incentive to provide implicit recourse will be greater under Basel II capital rules than under the current regulatory regime.

## 2. Securitization mechanics

### 2.1. Accounting and regulatory treatment of securitizations

In order to remove assets from the balance sheet through securitization, accounting rules state that the assets must be a “true sale” to a third party. According to Financial Accounting Standards Board Statement 140 (FASB 140), to constitute a true sale the assets must be sold to a legally remote third party (typically the special purpose entity or trust), and the originating bank cannot retain the benefits and risks of owning the assets. Recourse refers to guarantees promised to ABS investors allowing the transfer of losses to the bank if the performance of the underlying portfolio of receivables deteriorates. Therefore, if explicit recourse terms are present, the transaction is not considered a “true sale” under FASB 140, since some risk remains with the seller, and the protected assets would remain on the bank's balance sheet.

Recourse may not be stated explicitly, but could be implicit if a bank maintains credit support beyond contractual obligations to the securitized assets. Sometimes referred to as moral recourse, the originator may choose to provide support to distressed asset pools, although this behavior would violate the true sale conditions.

US federal bank regulators have rules stating that assets must be brought back on-balance sheet if a bank engages in implicit recourse. In fact, federal bank regulators have issued a series of policy statements clarifying rules that prohibit implicit recourse, including statements in 1996, 1998, and 2002. In 2002, the FFIEC released a document (see SR 02–15 for the Federal Reserve's version of this release) to assist regulators in identifying cases of implicit recourse. The guidance lists four major actions that signal possible implicit recourse, including (1) selling assets to a trust at a discount, (2) purchasing assets from a trust at a premium, (3) exchanging performing assets for nonperforming assets in a trust, and (4) funding credit enhancements beyond what is explicitly contracted.

Implicit recourse can also be more subtle than the events listed above. In 2002, regulators found that NextBank had provided implicit recourse by misclassifying certain credit losses as fraud losses. According to the OCC, by classifying the losses as fraud, NextBank was able to protect the trust, reducing the risk of early amortization (OCC, 2002). In the NextBank case, the bank had supported the trust by providing implicit recourse, and regulators determined that the securitized assets had to be brought back on the balance sheet because the “true sale” definition had been violated. As a result, NextBank was undercapitalized and closed.

As this paper describes a potential method for banks to provide implicit recourse in CC-ABS markets, some detail on securitization mechanics is necessary. In particular, there are two features of CC-ABS that are important to this paper: clauses within ABS contracts that define “qualified assets” and early amortization provisions. Excellent discussions of the broader mechanics of CC-ABS and the economics of securitization can be found in Fitch (1998) and Gorton and Souleles (2007).

### 2.2. Qualified assets within CC-ABS structures

The issuer is responsible for ensuring that assets transferred into the SPE are “qualified assets”. The definition of a “qualified asset” is deal-specific and can include

Table 1  
Credit card securitizations in 2006 for selected large financial institutions

Institution	Credit card securitizations (mil. \$)	Credit card securitizations as % of managed credit card portfolio	Tier 1 capital ratio (%)	Tier 1 capital ratio if credit card securitizations were put back on-balance sheet (%)
Citigroup	101,434	57.5	8.6	7.8
Bank of America Corp.	98,306	57.6	8.6	7.9
JPMorgan Chase & Co.	66,950	45.5	8.7	8.1
Capital One FC	42,785	66.7	10.2	7.5
American Express Centurion Bank	13,842	43.8	9.6	6.1
All Insured Commercial Banks	361,100	48.2	N/A	N/A

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