

Letter from the Editors

Vol. 4, No. 5

Securitization III

Banks and Finance companies are refinancing an increasing proportion of their credit card receivables via securitization. In a recent statement before the senate subcommittee on financial institutions and regulatory relief, Eugene A. Ludwig observed that "In September 1991, when we first started collecting data on assets of credit card loans securitized without recourse through the call reports, credit card loans securitized represented nearly 37 percent of credit cards held in portfolios by banks. By March 1996, that percentage had risen to 66 percent. The OCC is monitoring carefully the implications of this rising trend in securitizations."

In 1990 finance companies securitized 3.8 percent of their revolving consumer loans, in 1996 the percent was 13.6 percent. Since 1988 the share of consumer loans originated by banks which have been refinanced by means of securitization, has increased from less than 5 percent to close to 25%. This has led to a significant increase in the noninterest component of banks' income. "Other noninterest income" which includes fees generated from originating and servicing securitized assets has risen from \$22.45 billion in 1987 (.77% of average net consolidated assets) to \$56.812 billion (1.3% of average net consolidated assets) in 1996. As of December 17, 1997 there was \$274.7 billion in outstanding securities backed by interests in pools of credit card receivables. Nelson and Owen suggest that there is a substitution taking place between secured and unsecured consumer borrowing, home equity borrowing at the expense of credit card borrowing. As of December 31, 1996, forty-two banks met the Federal Reserve's two criterion for being categorized as a "credit card bank." A "credit card bank" is a bank that predominantly lends to consumers and 90% or more of this lending is via credit cards. These 42 banks accounted for roughly 77 percent of outstanding credit card balances on the books of commercial banks and in pools underlying securities backed by credit cards.

Typically, in a credit card securitization, the originator

of the credit card accounts transfers the current and future receivables generated by a group of designated accounts to a master trust. It is also common for credit card receivables to be securitized through asset backed commercial paper conduits. In exchange for the receivables, the originator receives a beneficial interest in the trust, referred to as the seller's interest, and the proceeds from the placement of asset backed securities issued by the master trust to investors. The trust's assets are allocated between the seller's beneficial interest and the investors' beneficial interest. The investors' beneficial interest in the trust constitutes a series of the master trust. The series may be composed of senior and subordinate interest and interests which differ with respect to repayment terms. Together all of the outstanding series of the trust have a claim on a specific value of the trust's assets (\$x billion). The seller's interest is a claim on the value of the trust's assets in excess of this amount. To preserve the investor's interest at \$x billion the size of the seller's interest will vary.

Additional series will be issued by the master trust to finance future exchanges as new accounts are designated for securitization and existing investor's interests in the trust are paid off. Since the balances of the credit card accounts fluctuate as borrowers draw and repay, the balance of the trust which is committed to buy all receivables generated by the accounts will also fluctuate.

Originators are interested in implementing a long term off balance sheet financing for the receivables generated by their portfolios of credit card accounts, and investors are interested in liquid securities that can be accurately valued relative to a standard benchmark. How can the objective of the issuer and the investors be satisfied when the underlying balance of the accounts are uncertain?

Briefly, the solution that has been applied to overcome these two sides of the same problem has been for the master trust to issue two classes of beneficial interests, a seller's interest and an investor's interest. The maturity

Exhibit 1. Asset Backed Securities Issued to Finance Pools of Credit Card Receivables	
1997 (as of 12/15/97)	\$46 billion
1996	\$55 billion
1995	\$33 billion
Source: Bloomberg L.P.	

of the investor's interest is disconnected from the maturity of the underlying receivables and from the perpetual nature of the credit card accounts. This has been achieved by creating a revolving structure. As receivables are repaid, the payments are reinvested by the trust in additional receivables generated by obligors who have made additional draws on the securitized portfolio of accounts. To balance the difference between the repayment of principal and drawing of principal, the seller's interest is designed to absorb fluctuations in the balance of the trust's assets, to allow the investor's interest to be designed as a bullet bond with relatively certain maturity. Maturities of the securities are managed by dividing the life of the investors' interest into three distinct periods. The first stage is a revolving period during which the trustee purchases new receivables with principal collections; during the second phase, principal payments are accumulated for the benefit of the investors so that by the time the amortization phase commences, sufficient principal has been accumulated to repay the investors. This is called the accumulation period during which funding the scheduled repayment for the investors takes priority over acquiring new receivables. The third period corresponds to the bullet payment.

Credit card master trusts typically have the provision that principal collections will be shared among all series to their required level. For example if a trust issues one series a year, each with a five-year maturity (the fifth year being the accumulation period), in a steady state, 20% of the series will be going through the accumulation stage and benefitting from the availability of shared principal from 80% of the series. The potential to draw on numerous series to assure that sufficient principal is accumulated to retire a series on schedule is an advantage offered by large and active trusts. Large active trusts in turn depend on having access to a steady stream of receivables. Intense marketing efforts to consumers and acquiring the credit card portfolios of other lenders generate the raw material for the trust. A factor that will contribute to further consolidation in the credit card in-

dustry is the lower cost of financing available to the large master trusts relative to the smaller trusts.

Exhibit 2 illustrates how one of the major originators of credit card accounts, Metris Companies Inc. uses securitization to refinance its credit card business and the value it extracts from the process. Metris Companies Inc. implemented Statement of Financial Accounting Standards No. 125 ("FAS 125") "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" in the first quarter of 1997. Statement of Financial Accounting Standards No. 125, (FASB 125) Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities was published by the Financial Accounting Standards Board in June of 1996 and became effective for transfers of servicing and financial assets and extinguishments of liabilities occurring after December 31, 1996. FASB 125 supersedes FASB Statements No. 76, *Extinguishments of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables With Recourse*.

FASB 125 is based on the concept of financial components: "Previous standards did not accommodate recent innovations in the financial markets. After studying many of the complex developments that have occurred in financial markets during recent years, the Board concluded that previous approaches that viewed each financial asset as an indivisible unit do not provide an appropriate basis for developing consistent and operational standards for dealing with transfers and servicing of financial assets and extinguishments of liabilities. To address those issues adequately and consistently, the Board decided to adopt as the basis for this Statement a *financial-components approach* that focuses on control and recognizes that financial assets and liabilities can be divided into a variety of components."

FASB 125 sets the criteria that must be met for a transfer of assets to qualify as a sale for accounting purposes. Briefly a transfer of assets will be considered a sale if control of the assets has been given up, and consideration other than beneficial interests in the transferred assets has been paid. FASB 125 specifies what conditions must be met for control to have passed from the transferee to the transferor. In summary, control of the transferred assets is foregone when the assets have been isolated from the transferor with respect to bankruptcy, and the rights to transfer and pledge the assets or in the case of a "qualified special purpose entity," beneficial interests in the assets, is controlled by the transferee and the transferor has not conditioned the transfer of assets upon an agreement that "entitles and obligates" it to repurchase essentially the same assets which constituted the original transfer at a predetermined price, prior to maturity, irrespective of whether the transferee is in bankruptcy.

Exhibit 2.

The Company securitizes and sells a portion of its credit card loans to both public and private investors through the Metris Master Trust (the "Trust") and a third party multi-seller conduit (the "conduit"). The Company retains participating interests in the credit card loans under "Retained interests in loans securitized" on the consolidated balance sheets). Although the Company continues to service the underlying credit card accounts and maintains the customer relationships, these transactions are treated as sales for financial reporting purposes and the associated loans are not reflected on the consolidated balance sheets. The Company has receivables from and payables to the Trust and Conduit as a result of securitizations, including amounts deposited in an investor reserve account held by the trustee for the benefit of the Trusts's certificate holders, the excess servicing asset, which represents the net gain recorded at any point in time for loans sold under the asset securitizations, net of recourse reserves for securities loans and normal excess servicing fee receivables...

The effect of securitization on the Company's consolidated financial statements is to remove credit card loans sold with limited recourse from the consolidated balance sheet and record a gain on a sale for the difference between the carrying value of the loans sold and the sales proceeds.

The securitization and sale of credit card loans changes the Company's interest in such loans from lender to servicer, with a corresponding change in how revenues and expenses are reported in the income statement. For securities and sold credit card loans, amounts that otherwise would have been recorded as net interest income, fee income and provisions for loan losses are instead reported in other operating income as net securitization and credit card servicing income...

The Company's managed loan portfolio is comprised of credit card loans held for securitization, retained interests in loans securitized and the investor's interests in securitized credit card loans. The investor's interests in securitized credit card loans is not an asset of the Company, and, therefore, is not shown on the Company's consolidated balance sheets... (Metris Companies Inc, Form 10-Q September 30, 1997)

"Revolving period securitizations" are explicitly addressed in FASB 125. The dissenting argument presented in FASB 125 (FASB was adopted by a vote of 6 to 1) sheds light on the intricacies and subtleties of "revolving period securitizations". Should the transferor be able to account for the receivables it refinances through a "revolving securitization structure" as a sale of assets? Are the accounting standards consistent with the true nature of these transactions and with the implications they have on the accounts of the transferor?

The argument that the control of the securitized assets remains with the transferor in a "revolving-

period" securitization because the transferor receives essentially all of the principal collections during the revolving period, is handled by FASB 125 by treating each purchase of receivables as a new and separate sale of assets. A Pooling and Servicing agreement that establishes the credit card master trust will typically obligate the transferor to sell and the trustee to purchase new receivables during a revolving period of a master trust series. The Board interprets this as a secured forward agreement that essentially removes the transferor's control over the securitized accounts. The Board also defends its logic regarding the true sale treatment of securitization trans-

actions with revolving period by noting that the benefits that the transferor receives during the revolving period derive not from its previous ownership of the receivables but in fact by its commitment to give up control through a transfer of the receivables to the trust during the revolving period. FASB 125 is a “standard for accounting standards”. The financial-components approach is a sound counterpart to the “financial building block approach” used to analyze complex financial instruments.

Charles A. Stone, *Université Paris Dauphine*
Anne Zissu, *Temple University*

REFERENCES

Statement of Eugene A. Ludwig, Comptroller of the Currency, before the Subcommittee on Financial Institutions and Regulatory Relief of the

Senate Committee on Banking, Housing and Urban Affairs, on consumer Credit, Washington, D.C., July 24, 1996.

Survey of Finance Companies, James D. August, Michael R. Grupe, Charles Luckett and Samuel M. Slowinski, Volume 83 Federal Reserve Bulletin Number 7, July 1997.

Profits and Balance Sheet Developments at U.S. Commercial Banks in 1996, William R. Nelson and Ann L. Owen, Federal Reserve Bulletin, June 1997.

The Profitability of Credit Card Operations of Depository Institutions, Federal Reserve Board, August 1997.

Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, Financial Accounting Standards Board of the Financial Accounting Foundation, June 1996.

Managing Financial Risk: A Guide to Derivative Products, Financial Engineering, and Value Maximization, by Charles W. Smithson, Clifford W. Smith, Jr. and D. Sykes Wilford, Irwin Professional Publishing, 1995.