



FEDERAL RESERVE BANK OF PHILADELPHIA



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A newsletter published by the Payment Cards Center, providing meaningful insights into developments in the payment card industry

From the Director *Peter Burns, Vice President & Director*

An important element of the Payment Cards Center's mission is to support dialogue that leads to new insights into critical industry issues. Toward that end, the Center's agenda includes an active program of conferences and forums that bring together representatives from industry, academia, and the policy community to consider topics of current import. This special conference edition of our newsletter, *Update*, provides highlights from one such recent event.

In December 2003, the Payment Cards Center sponsored the conference *Asset-Backed Securities and Credit Cards* to focus attention on this increasingly important financial market and to explore emerging risks and challenges. Providing a wide range of perspectives, an invited audience of some 75 professionals participated in the event. Indeed, it was in large part the participation of this diverse mix of credit card issuers, rating agency and securities analysts, investment bankers, attorneys, economists, and regulators that contributed to the high quality of the dialogue that ensued.

While the conference benefited from this broad participation, the discussion moderators played critical organizational roles. Karen Weaver from Deutsche Securities, Mark Adelson from Nomura Securities, Bill Lang from the Philadel-

phia Fed, and Kathy Dick from the OCC were all helpful in defining the right questions and in assembling knowledgeable subject matter experts for their panels. The guidance and counsel of Vernon Wright from MBNA also enhanced the quality of this event. Vernon not only set an effective tone for the conference with his keynote address, but he also provided valuable contacts through his leadership role in the American Securitization Forum. The collaborative relationships that helped to structure this event are central to the Center's broader goal of developing programs and activities that are informed by those closest to the markets.

What follows are highlights from the conference proceedings, including summaries of the keynote address from Vernon Wright and opening remarks from the Bank's president, Tony Santomero. This and other Payment Cards Center newsletters are available on our web site: www.phil.frb.org/pcc.

The Payment Cards Center at the Federal Reserve Bank of Philadelphia has just completed its third year of activities. As always, I welcome your thoughts and suggestions as to how we can better serve the needs of market participants and others interested in this dynamic financial sector. □

Mission Statement

The mission of the Payment Cards Center is to provide meaningful insights into developments in the payment card industry that are of interest not only to the Federal Reserve but also to the industry, other businesses, academia, policymakers, and the public at large. The Center will carry out its mission through an agenda of research and analysis as well as forums and conferences that will encourage a dialogue that includes industry, academic, and public-sector perspectives.

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Securitization: Finally a Mature Market

Keynote address by Vernon H. Wright

Vernon Wright, executive vice chairman and chief finance officer, MBNA Corporation, and chairman of the American Securitization Forum, delivered the conference keynote address, providing background and context for the program agenda. He began by noting that in just 19 years,

the asset-backed securities (ABS) market has grown and matured to become “a mainstay of the capital markets as we know them today.” Interestingly, Wright’s own professional career has been intertwined with these developments as he directly participated in the market’s evolution and growth.

In his view, a compelling indication of the market’s maturity is its sheer size, scale, and liquidity. Today, asset-backed securities comprise almost one-third of the U.S. private debt market. Furthermore, market growth has accelerated. In

the last eight years alone, outstanding asset-backed securities have increased from \$300 billion to \$1.7 trillion. While there are now a myriad of asset types that make up the broader market, the lion’s share is composed of consumer-based receivables, including credit cards.

In large part reflecting consumers’ increasing preference for cards as their payment vehicle of choice, credit card asset-backed securities have been an important factor in the market’s growth. In the current year, U.S. credit and debit

card purchases are expected to reach \$2.1 trillion, with over 70 percent of this total billed to credit cards.

Of course, all of this growth in credit card receivables has to be funded, and increasingly, card issuers and other consumer lenders have turned to the ABS markets. Importantly, Wright noted, companies’ access to broader funding sources has also provided increased choice and availability of credit for consumers. He emphasized the overall benefits to the economy, arguing that “the severity of the [recent] recession was mitigated to some degree due to the increased liquidity provided by the securitization markets.”

Another characteristic that affirms the new mainstay status of securitization is its importance as a viable alternative funding source. Securitization has provided a wide range of issuers with alternatives to traditional debt markets, facilitating business growth while expanding the base of funding and reducing short-term financing risks.

As Wright emphasized in describing the impact of expanded funding alternatives, “It is [the] investor base that lies at the heart of securitization’s success.” Drawn by the comparative stability of the ABS market, investors have driven widespread acceptance of securitization. This, he noted, is true worldwide and means that “many who would not buy a company’s direct debt are happy to invest in its asset-backed securities.” This is truly a global market, since MBNA’s experience shows that many of its ABS investors are based abroad.

Along with the benefits afforded securitization in reaching maturity comes increased scrutiny from regulators, accountants, lawyers, and investors. As Wright noted, this added attention provides further evidence of the



Vernon H. Wright, Executive Vice Chairman and Chief Finance Officer, MBNA Corporation, and Chairman, American Securitization Forum



market's size and importance. In fact, he argued that "this sort of scrutiny and the debate that it engenders only makes the industry stronger."

Alluding to a number of topics on the conference agenda, he described several current issues facing the industry. These include bank capital adequacy, accounting standards related to the transfer of assets to securitization vehicles, and

the risk of impact from poorly structured transactions spilling over into the broader markets.

Wright closed by emphasizing the need for dialogue, asserting that "it is this sort of discourse that allows all of us to discuss, debate, and determine the appropriate course of action that we must take to continue the robust development of the securitization process." ■

President Santomero's Opening Remarks

Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, welcomed conference speakers and participants. In his remarks, he outlined the Bank's motivation for hosting this forum on asset-backed securities and credit cards.

As he explained, the Philadelphia Fed has developed a special focus on the payment cards industry through its Payment Cards Center and a related initiative, a Federal Reserve System effort to expand the Fed's knowledge of advanced approaches to quantifying retail credit risk. With credit card loans totaling nearly \$700 billion, balance-sheet-management technologies and innovative funding strategies have become increasingly important factors in supporting industry growth and profitability. As Vernon Wright made clear in his keynote address, development of the

asset-backed securities market for credit card receivables has been a critical innovation in addressing these challenges.

Nevertheless, as Santomero went on to say, "Few outside of industry and regulatory specialists have a broad grasp of the range of opportunities and risks posed by these securitization processes...Indeed, it is with the intent of shedding new light on these issues that we have convened this group of qualified experts today."

In closing, Santomero suggested that "over the course of this day, our goal should not necessarily be to reach conclusions but perhaps, more realistically, to use these discussions to develop broader understanding and insight into those factors needed to support stronger and healthier markets."

The Investors' Perspective

The first panel session focused on investors' perspectives. *Karen Weaver*, Deutsche Securities, Inc., moderated the discussion with *Robert Franciscus*, Merrill Lynch Investment Management; *Paul Grillo*, Delaware Investments; and *Susan Troll*, T. Rowe Price. Among the topics discussed, three major themes emerged: asset-backed securities (ABS) investment strategies, credit card issuer consolidation, and the special importance of issuers' business models.

The panelists discussed general approaches to incorporating credit card ABS in fixed-income portfolio strategies. As they noted, the asset class can serve as short-term cash substitutes, provide portfolio diversification, and generally present yield spread opportunities. Panelists acknowledged, however, that they make an important distinction between low-risk AAA-rated securities and higher-risk BBB tranches. All three firms noted that they are less active in the more risky BBB-rated portions of credit card ABS.

AAA-rated credit card asset-backed securities provide higher yields for lower perceived risk than similarly rated corporate bonds. The relatively high yields make AAA asset-backed securities useful as cash substitutes or as short-term investments in common fixed-income barbell investment strategies (where portfolio holdings are concentrated in very short-term and very long-term maturities).

The panelists indicated, however, that risk management policies in most firms generally limit portfolio concentrations of any one issuer's ABS to about 2 percent of assets under management. An interesting discussion ensued about how that 2 percent is computed. Panelists noted that some firms treat investments in ABS and corporate debt of the issuing firms as separate exposures,

while others aggregate the two. It appears that the practice of consolidating the corporate debt of the issuer and the ABS for portfolio limits is becoming more common as investors have come to better understand that the performance of ABS – especially revolving ABS such as credit

AAA-rated credit card asset-backed securities provide higher yields for lower perceived risk than similarly rated corporate bonds.

cards – is not entirely uncorrelated with the credit conditions of the issuing firm.

Consolidation in the credit card industry has given rise to a number of new investor concerns. On the bright side, industry consolidation has often resulted in weak pools being purchased by stronger firms. After the purchase, better servicing facilitates performance recovery.

The larger pools underlying ABS sold by the large credit card acquiring banks are now more diverse than ever, resulting in better performance predictability. On the other hand, there are fewer issuers' ABS to choose from; therefore, creating customized diversification (i.e., fine tuning the correlations of the portfolio's components using ABS) is increasingly challenging.

The panelists also noted that their firms restrict investments in ABS to liquid securities from well-established issuers. Hence, these firms tend to be less active in BBB-rated securities issued by well-established firms but also generally avoid untested sectors, such as subprime lending.

The topic of avoiding subprime and other specialty lending sectors led to the discussion of

issuers' business models. While in practice credit card asset-backed securities have performed very well, the panelists noted that proprietary (issuer-specific) underwriting practices make credit card

formula”), no comparable loans can be revolved into the pool. In the best case scenario, the ABS will then amortize, and investors will be repaid earlier than expected.* As noted in the next

panel's discussion, a number of recent examples suggest that failed issuer business models can also lead to loss of principal.

An important thread ran through the panelists' comments: They were less concerned with the sort of collateral underlying the ABS, per se, and more concerned about how one issuer's business model (or way of originating and managing that collateral) differs from the industry norm. As such, disclosure and transparency around business practices become important analytical tools.

Investors also noted that some firms even avoid pools that contain blends of loans originated from different business models, such as prime and subprime loans. The concern is that the pool's composition could change adversely during the

revolving period — the important point being that because of the revolving structure and the importance of a good servicing platform, what you're buying today may not be what you get tomorrow. If different quality loans are revolved into the pool or if servicing practices change, investors may find themselves with substantially different pool performance over the life of the security. U



Susan Troll, Vice President, Credit Analyst, T. Rowe Price (left), and Lisa Capuano, Director, Capital Structure and Global Securitization, Citigroup

ABS susceptible to the issuer's business model risk.

While business models are a concern for all collateral types, the revolving nature of credit card ABS (where new loans must continually be added to the collateral pool to facilitate an investment maturity longer than the average underlying collateral maturity) carries with it a risk that the business model could change over the life of the investment, affecting pool performance over time. In a revolving structure, if the issuer's business model fails (and therefore cannot originate any more loans using its “secret

* For a more complete description of early amortization in credit card ABS, see “ABCs of Credit Card ABS,” New York: Fitch Investors Service, April 1, 1996.

What Can Go Wrong? What Have We Learned?

The morning's second panel session examined lessons learned from risky business models and differences in deal structure that led to investor losses. The session was led by *Mark Adelson*, Nomura Securities, with participation from *Alexander Dill*, Moody's Investor Services, and *C. Thomas Kunz*, Skadden, Arps, Slate, Meagher & Flom.

Panel members reviewed several important "case studies" of asset-backed securities (ABS) transactions that ultimately led to investor losses. While the examples used were not specific to credit card ABS, the intent was to generally illustrate the importance of previously unforeseen elements, such as the risk of fraud or misappropriation, business model risk, and servicing risk. Among the failed structures examined were ABS issues from LTV Steel; Heilig-Meyers; NextCard; DVI, Inc.; Spiegel-First Consumers National Bank (Spiegel-FCNB); and National Century Financial Enterprises (NCFE).¹

The cases of NCFE, Spiegel-FCNB, and DVI were examples where fraud or misappropriation resulted in substantial losses. In each case, better oversight and monitoring of the issuers might have prevented or reduced the harm to investors.

In the case of NCFE, the monitoring failure was particularly significant because ratings agencies did not act on a series of three increasingly stern anonymous letters detailing fraud and other improprieties. Only years later, when the

company was in financial distress, did the true character of the securitized pools come to light. While other cases may have been less dramatic, investors have learned that without regular audits or third-party oversight, an ABS issuer in financial distress may misrepresent the character (or even the existence) of securitized assets, manipulate amortization triggers, divert cash flows from deals, or otherwise misappropriate assets.

Investors are "buying as much into the servicer as the receivables."

Even without misappropriation or fraud, financial distress presents acute problems for certain business models. Problems typically arise because the ABS issuer is generally also hired as the servicer.² Hence, as one conference participant commented during the session, investors are "buying as much into the servicer as the receivables."

Heilig-Meyers and DVI, Inc. were cases in which changes to idiosyncratic servicing and collection practices strongly affected the performance of the securitized receivables and resulted in investor losses.

The classic case of how idiosyncratic servicing and collection practices affect investor losses is that of Heilig-Meyers. Heilig-Meyers was

¹ Details of many of these cases can be found in Alexander Dill and Letitia Accarrino, "Bulletproof Structures Revisited: Bankruptcies and a Market Hangover Test Securitizations' Market Mettle," New York: Moody's Investors Service, August 2002.

² The servicer is hired by investors to send out billing statements and collect revenues from borrowers and recover payments from slow or nonperforming borrowers.

a chain of furniture stores that sold on credit, collecting monthly payments at its store locations. When the chain closed its stores in bankruptcy, payment collections were significantly interrupted, resulting in defaults on Heilig-Meyers' previously triple-A-rated ABS. Investors have learned that idiosyncratic servicing and collection procedures may directly link the performance of the securitized assets to the issuer's business fortunes.

Recent experience with securitizations from failed issuers has also pointed out the risk pre-

The problem is that contractual servicing fees, in distressed situations, are rarely sufficient to cover costs.

sented when servicing fees are priced too low. This was a primary factor in investor losses in NextCard and Spiegel-FCNB.

In general, issuers have an incentive to price servicing fees low so that more cash can flow through to investors and hence more money can be raised from selling ABS. Aggressive issuers may set their servicing fees too low or subordinate the fees.

If the issuer fails, someone else must service the loans, even if only to provide a smooth amortization (to wind down the deal for investors). Thus, a deal's servicing fee must be large enough to attract a successor servicer. If it is not, bank regulators might order an increase in the servicing fee. That is just what happened in the Spiegel-FCNB case. In the NextCard case, bank regulators were unsuccessful in trying to find a buyer for the portfolio.

The problem, of course, is that contractual servicing fees, especially in distressed situations, are rarely sufficient to cover costs. Without adequate compensation, the quality of servicing for a securitized pool will suffer. With no one diligently sending out late notices and collecting payments, it is not surprising that delinquency rates skyrocket and recovery rates on the collateral — the safety net for investors — plummet.

How far the recovery rates plummet, however, is also related to an ABS issuer's business model. Unusual or flawed business models greatly exacerbate challenging servicing environments.

In the case of DVI, Inc., the issuer leased medical equipment to health-care providers and securitized the leases. The issuer regularly repurchased delinquent leases from its securitization pools and also routinely substituted leases to allow lessees to upgrade their equipment. When the issuer failed, the performance of the securitized pools deteriorated because the issuer no longer repurchased delinquent leases and because customers could no longer upgrade their equipment.

Similarly, in the case of NCFE, many health-care providers relied on National Century to provide working capital by selling future receivables for cash. NCFE relied heavily on securitization markets for their own funding. When financial difficulties precluded NCFE from financing its customers, many health-care providers also failed.

Such round-trip financing and heavy reliance on a single entity that funds itself almost exclusively through securitization were singled

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Risk-Based Capital & Basel II

The third panel session considered how Basel II capital standards are being applied to retail credit in general and credit card asset-backed securities (ABS) in particular. *William Lang*, of the Federal Reserve Bank of Philadelphia, moderated the discussion; panelists *Marc Saidenberg*, Federal Reserve Bank of New York; *Randy White*, Bank One Corporation; and *Hugh Van Deventer*, Citicorp, presented alternative perspectives on calibrating ABS capital requirements for Basel II.

balance sheets. Basel II breaks these risks down into direct exposures to privately placed ABS residuals, direct exposures to the rated investment-grade tranches, and capital risk arising from early amortization.

The most obvious risk that ABS issuance poses to banks' balance sheets lies in direct exposures to residuals and other lower-level noninvestment grade tranches of the securities that remain on balance sheet. Hence, Basel II currently provides that banks hold 100 percent capital against exposures to ABS pieces that have credit enhancement levels lower than the bank's own internal risk-based capital requirement.

As mentioned earlier, however, publicly issued asset-backed securities have experienced far fewer downgrades than corporate debt. Thus, Basel II generates risk weights for investments in "thick, granular pools"* that are very different from those required for commercial loan pools. Capitalization of these asset-backed securities is based on the initial ratings of the tranches, and required capitalization increases with lower initial credit ratings.

Last, as described in the previous session, ABS can become riskier if the pool of loans underlying the ABS begins to perform poorly and becomes manifest only when the asset-backed securities (and possibly the issuer) default. Hence, Basel II proposes that banks hold increasing capital against their ABS issues as the deals approach early amortization triggers. If



Kathryn Dick, Deputy Comptroller for Risk Evaluation, Office of the Comptroller of the Currency (left), and Elisabeth Levins, Assistant Vice President, Supervision, Regulation and Credit, Federal Reserve Bank of Philadelphia

Saidenberg began the session by describing the current Basel approach toward risk-based capital allocation to ABS issuers and discussing the recent decision to apply the Basel II internal ratings-based (IRB) framework to calibrating capital only on unexpected loss. Basel II seeks to capitalize ABS exposures that pose risk to banks'

* Where the underlying pool contains 100 exposures or more and the tranche is a significant size relative to the pool.

excess spread is less than 450 basis points away from an early amortization trigger, the bank begins to hold nonzero capital against the securities. If excess spread on a typical U.S. credit card ABS is less than 112.5 basis points away from its early amortization trigger, the bank will be required to treat the pool underlying the ABS as if it were on the bank's balance sheet.

At the heart of this debate is a fundamental difference in risk measurement and management for retail and commercial credit.

Other panelists' comments (and a great deal of the discussion that ensued) focused on the accuracy of estimated internal ratings-based capital requirements that form the baseline for capitalizing direct exposures to privately placed ABS and residuals. At the heart of this debate is a fundamental difference in risk measurement and management for retail and commercial credit.

Basel II seeks to establish capital for both retail and commercial credits based on the probability of default and the loss given default for the loan type (commercial loans and four types of retail consumer loans). This approach is more commonly used for commercial loans, as most proprietary commercial loan default models work with these parameters.

Randy White, of BankOne, noted that because of the granularity of retail portfolios, banks manage retail loan risk differently from commercial loan risk. Credit card lenders typically estimate expected loss — the *product* of probability of default and loss given default — for their retail loan portfolios. Of course, expected loss may be high either because of high prob-

ability of default and low loss given default *or* low probability of default and high loss given default. Hence, White argued for more analysis of the correspondence between retail expected loss calculations and the simulated decomposition of probability of default and loss given default currently proposed under Basel II.

Of course, even if a high correspondence existed between the two estimation processes, panel members noted that certain parameters of relative risk used in Basel II remain to be accurately quantified. Three parameters were discussed at length: the correlation of within-asset credit risk across different quality borrowers; the correlation of credit risk across assets; and the appropriate threshold for capitalizing early amortization exposures.

Some argue that the correlation of within-asset credit risk across borrowers of different

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Richard Lang, Executive Vice President, Federal Reserve Bank of Philadelphia (left), and Marc Saidenberg, Assistant Vice President, Federal Reserve Bank of New York



Examiners' View of Credit Card Asset-Backed Securities

The last session of the day introduced participants to measures that bank supervisors are taking to address balance-sheet risks associated with asset-backed securities (ABS). *Kathryn Dick*, Office of the Comptroller of the Currency, served as moderator for the panel, which included *Kelly Ballard*, Office of the Comptroller of the Currency; *David Kerns*, Board of Governors of the Federal Reserve System; *Keith Ligon*,

between 1997 and 2002 issued ABS, losses at those four banks amounted to \$1.7 billion, or 78 percent of the total losses accruing to the FDIC during that period. Loss rates at those banks were the highest among the 34 failures, averaging well over 50 percent. Hence, the difficulties associated with banks' issuing ABS, although few in number, have been costly.

Drilling deeper into these cases, Ligon noted that in addition to these banks' over-reliance on securitization as a funding source, other warning signs were also often present, including large amounts of brokered deposits, high-growth business strategies, and poor corporate governance.

Brokered deposits are known to be related to large loss rates even in banks that do not securitize because brokered deposits are usually added to satisfy funding needs of high-growth institutions and can present moral hazard concerns. Brokered deposits are "hot money," often paying above market rates to rate-sensitive customers, and they can be withdrawn from the institution at the first sign of trouble.

High-growth business strategies contribute to losses because the aggressive business models used by these banks relied crucially upon aggressive accounting – adhering to the letter rather than the principles behind accounting rules. An important component of failed bank losses in the early part of the 1997-2002 period was "gain-on-sale" accounting, wherein valuation gains on the residual were required to be booked at the time of the sale (even though cash flows arising from these purported gains may lie far in the future). Sometimes managers not only distorted but also concealed information to meet financial targets, hoping the firm could "grow out" of its problems.



David A. Kerns, Supervisory Financial Analyst, Board of Governors, Federal Reserve System (left), and Joseph Mason, Assistant Professor, Drexel University, and Visiting Scholar, Payment Cards Center

Federal Deposit Insurance Corporation; and *Richard Westerkamp*, Federal Reserve Bank of Richmond. The panelists offered their perspectives of how regulators are addressing new risks posed by ABS.

Ligon provided a baseline for the discussion by reviewing the relationship between ABS issuance and recent bank failures. He noted that although only four of the 34 banks that failed

Failed banks issuing ABS usually demonstrated poor corporate governance practices. Those failed banks often lacked independent directors, showed evidence of weak internal

The four major bank regulatory agencies have developed a flexible system of coordination to deal with fast-moving policy developments related to ABS.

controls, and often wielded *de facto* control over third-party vendors.

As a result, failed banks that issued ABS often became repositories of “toxic waste”: high-risk residual interests. Failed banks often valued these risky investments using scenarios that included aggressive cash flow assumptions with especially unrealistically low pool losses. In two well-publicized cases, these residuals were a major component of bank capital at the time of failure, totaling over 634 percent of tangible capital for Keystone and almost 400 percent of core capital (over 2,000 percent of tangible capital) for Superior.

As discussed previously, risky business models based on securitization as a major funding conduit are easily manipulated. As such, the panel participants noted that all of the bank supervisory agencies emphasize the need for a proactive focus and quick action when improprieties are first detected.

In response to the difficulties and actual losses experienced so far, examiners from the four major bank regulatory agencies have developed a flexible system of coordination to deal

with fast-moving policy developments related to ABS. An interagency working group now convenes at least once a month to focus solely on ABS surveillance policy. Furthermore, this working group has developed a number of interagency guidance documents that are less formal than regulatory rules but effective in addressing new risks quickly as they become evident. The interagency working group has developed guidelines applicable to accrued-interest receivables, interpretations of implicit recourse,* and covenants tied to supervisory actions in securitization documents. The group has weighed in on the proposed rulemaking for additional capital standards for early amortization.

The bank supervisory community will also be responsible for monitoring compliance with Basel II capital requirements, as discussed in a panel earlier in the day. In this regard, Basel II is just the “C” in CAMELS, and regulatory risk-based capital measurements are minimums. Hence, there is still a lot of work to be done evaluating bank ABS risks and enforcing compliance related to ABS issuance and related investments, which, in the end also includes risky business models, funds concentration, and other risk factors noted earlier. U

* Ligon offered the following example of the working group’s proactive focus and prompt response. When, earlier this year, a major bank announced a restructuring of its ABS program, the interagency working group immediately conducted its own review. In this case, the group concluded that the restructuring did not constitute a recourse event, allowing the bank to proceed expeditiously with its business plan.

What Have We Learned? *continued from page 7*

out as important elements of flawed business models in that the sources of investor payments were not independent of operations elsewhere in the business.

In summary, while credit card ABS markets are considered mature (in the sense of Wright's keynote address), the experience of NextCard illustrates that even that sector is not immune to business model and servicing risk. It is important to remember that no ABS transaction is re-

ally "bankruptcy proof" and that the declining pool scenario (where new loans cannot be re-rolled into a deal) can really happen. As noted in the discussion period, however, the ABS markets in general have experienced far fewer debt downgrades than corporate debt markets, and credit card asset-backed securities have experienced the fewest downgrades of any major ABS sector. ■

Capital and Basel II *continued from page 9*

quality is too high, particularly in the case of credit card portfolios. White showed results from simulations suggesting that it takes substantially lower correlations than those assumed by Basel II to align regulatory risk-based capital with his bank's required economic capital estimates. On the other hand, White noted that Basel II understated the required capital for off-balance-sheet credit card exposures and suggested that a more appropriate approach would be a lower correlation applied to on- and off-balance-sheet receivables.

White also argued that the simulations of appropriate within-asset correlations are significantly influenced by the level of correlation of credit risk *across* assets. White asserted that his simulations equate his own economic capital measurements and Basel II internal ratings-based estimates only by assuming dramatically higher cross-asset correlations than those in simulated bank portfolios.

Hugh Van Deventer and some audience members who are issuers of ABS also commented that well-managed banks may have different across-asset correlations than others and should receive capital credit for managing the quality of their portfolios. However, most agreed

that the whole point of Basel II is to generate a better quantitative *benchmark* for capital adequacy decisions, and the resulting model would not be a complete substitute for discretionary supervisory judgment.

Furthermore, other conference participants suggested that capitalizing early amortization risk might well be a significant potential source of procyclicality, wherein banks will be required to raise capital in periods of distress. Forcing banks to raise capital during periods of distress is widely believed to choke off lending at precisely the time when the credit is needed to fuel economic recovery.

Overall, participants seemed to agree that more work is necessary to better understand retail credit portfolio risk and more accurately parameterize Basel II provisions. The regulatory comment period on Basel II's third Quantitative Impact Study closed just before the conference date; more than 400 comments were received. An important conclusion of the session, echoed in Wright's message in his keynote address, was that there are significant benefits from regulators and issuers working together to better address retail credit risk issues in Basel II. ■

Conference Speakers and Moderators

Keynote

Vernon H. Wright, MBNA America Bank, NA

Welcome

Dr. Anthony M. Santomero, Federal Reserve Bank of Philadelphia

Peter Burns, Federal Reserve Bank of Philadelphia

Credit Card ABS: The Investor Perspective

Moderator: **Karen Weaver**, Deutsche Securities Inc.

Panelists: **Robert Franciscus**, Merrill Lynch Investment Management

Paul Grillo, Delaware Investments

Sue Troll, T. Rowe Price

What Can Go Wrong? What Have We Learned?

Moderator: **Mark Adelson**, Nomura Securities

Panelists: **Alexander Dill**, Moody's Investor Services

C. Thomas Kunz, Esq., Skadden, Arps, Slate, Meagher & Flom

Risk-Based Capital and Basel II

Moderator: **William Lang**, Federal Reserve Bank of Philadelphia

Panelists: **Marc Saidenberg**, Federal Reserve Bank of New York

Randy White, Bank One Corporation

Hugh Van Deventer, CitiBank

The Examiner's View of Credit Card ABS

Moderator: **Kathryn Dick**, OCC

Panelists: **Kelly Ballard**, OCC

David Kerns, Board of Governors of the Federal Reserve System

Keith Ligon, FDIC

Richard Westerkamp, Federal Reserve Bank of Richmond



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03-05

Credit Card Securitization and Regulatory Arbitrage

Charles W. Calomiris and Joseph R. Mason

April 2003

This paper explores the motivations and desirability of off-balance-sheet financing of credit card receivables by banks. We explore three related issues: the degree to which securitizations result in the transfer of risk out of the originating bank, the extent to which securitization permits banks to economize on capital by avoiding regulatory minimum capital requirements, and whether banks' avoidance of minimum capital regulation through securitization with implicit recourse has been undesirable from a regulatory standpoint. We show that this intermediation structure could be motivated either by desirable efficient contracting in the presence of asymmetric information or by undesirable safety net abuse. We find that securitization results in some transfer of risk out of the originating bank but

that risk remains in the securitizing bank as a result of implicit recourse.

Clearly, then, securitization with implicit recourse provides an important means of avoiding minimum capital requirements. We also find, however, that securitizing banks set their capital relative to managed assets according to market perceptions of their risk and seem not to be motivated by maximizing implicit subsidies relating to the government safety net when managing their risk. Thus, the evidence is more consistent with the efficient contracting view of securitization with implicit recourse than with the safety net abuse view. Concerns expressed by policymakers about this form of capital requirement avoidance appear to be overstated.

03-04

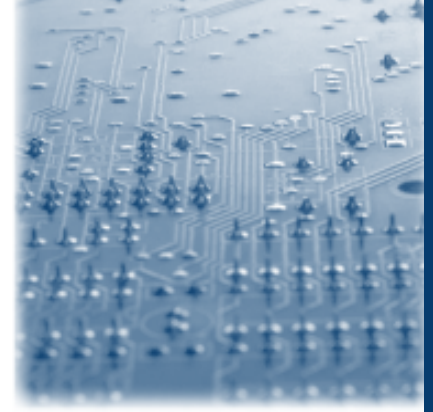
What Is the Value of Recourse to Asset-Backed Securities? A Clinical Study of Credit Card Banks

Eric J. Higgins and Joseph R. Mason

April 2003

This paper uses data from revolving credit card securitizations to show that, conditional on being in a position where implicit recourse has become necessary and actually providing that recourse, recourse to securitized debt may benefit short- and long-term stock returns and long-

term operating performance of sponsors. The paper suggests that this result may come about because those sponsors providing the recourse do not seem to be extreme default or insolvency risks. However, sponsors providing recourse do experience an abnormal delay in their normal



Special Thanks to Joe Mason

The Payment Cards Center is grateful for the assistance of Professor Joseph Mason in preparing the conference summaries for this special issue of *Update*. Joe is an assistant professor of finance at Drexel University's LeBow College of Business and a Visiting Scholar in the Payment Cards Center. His research interests include analysis of default risk, bankruptcy costs, and the factors associated with economic distress. His two recent papers related to credit card asset-backed securities are "Credit Card Securitization and Regulatory Arbitrage" and "What Is the Value of Recourse to Asset-Backed Securities? A Clinical Study of Credit Card Banks." Both papers are available on the Philadelphia Fed's web site: www.phil.frb.org.

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. Therefore, although in violation of regu-

latory guidelines and FASB 140, recourse may have beneficial effects for sponsors by revealing that the shocks that made recourse necessary are transitory.

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An Overview of Credit Card Asset-Backed Securities

Mark Furletti

December 2002

On Friday, October 25, 2002, the Payment Cards Center held a workshop that focused on credit card asset-backed securities. Mark Adelson, head of structured finance research at Nomura Securities International, led the workshop. A veteran analyst of the ABS market, Adelson has written numerous articles and special reports on securitization. During the workshop, Adelson

explained the growth, pricing, and mechanics of credit card asset-backed securities. He also discussed some key issues currently facing ABS markets. This paper supplements material from Adelson's presentation with additional information on the development of credit card ABS and the securitization process.



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Payment Cards Center Newsletter

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The Payment Cards Center was established to serve as a source of knowledge and expertise on this important segment of the financial system, which includes credit cards, debit cards, smart cards, stored-value cards, and similar payment vehicles. Consumers' and businesses' evolving use of various types of payment cards to effect transactions in the economy has potential implications for the structure of the financial system, for the way that monetary policy affects the economy, and for the efficiency of the payments system.

"The Philadelphia Reserve Bank will be broadly recognized as an important center of central bank knowledge and capability."

*Anthony M. Santomero
President*