I – INTRODUCTION

BACKGROUND

Generally defined, the **securitization** of credit card receivables is the process by which these financial assets are transformed into securities. Credit card issuers rely on this type of funding to manage liquidity and capital, to reduce exposure to interest rate risk, and to generate fee income. Because investors look to the securitization structure of underlying assets and credit enhancements rather than to the credit card issuer (selling bank) as a source of repayment, unrated or low-rated credit card issuers may be able to obtain triple-A ratings on the securitized credit card receivables. Thus, a credit card issuer may be able to sell securities with lower coupon rates, and thereby, reducing its funding costs.

The benefits of securitizing credit card receivables can be substantial; however, securitization activities are susceptible to economic influences and present other risks that need to be managed and controlled. Weak underwriting standards, poor servicing, or inadequate liquidity planning are examples of risks, which, if poorly managed can damage a credit card issuer's reputation and cause serious financial problems. This manual is intended to assist examiners in understanding and evaluating the credit card securitization process. The discussions contained in this manual focus on a bank's role as the loan originator and servicer, rather than as an investor, in credit card receivable-backed securities.

Benefits of Credit Card Securitizations

Securitizations, when used properly, provide financial institutions with a useful funding, capital, and risk management tool. By using securitizations, a credit card issuer may be able to obtain lower cost funding, diversify its funding sources, improve financial indices, potentially lower regulatory costs, and increase its ability to manage interest rate risk. In addition, securitizations may allow banks to reduce asset-class concentrations in the overall portfolio, create underwriting and pricing discipline (provides market feedback regarding asset value), and leverage origination skills and systems capacity by increasing the volume of transactions that pass through the bank. In addition, servicing is often retained by the originator which minimizes customer disruption and enhances fee income.

Securitizations are the largest funding source for credit cards, representing over 50 percent of the industry's funding. Even un-rated or low-rated institutions can obtain investment grade ratings on their asset-backed securities (ABS) since investors look to the securitization structure of underlying assets and credit enhancements rather than the institution for repayment. In contrast, the unsecured corporate bond market is typically a less attractive and less cost-effective funding source as the ratings on the bonds reflect the strength of the institution, which is typically lower, therefore, requiring higher spreads.

Investor acceptance of the credit card ABS has grown considerably as the market has matured. While there are several reasons for increased investor confidence, the use of more sophisticated monitoring and effective credit risk management techniques have and continue to enhanced investors' comfort with these products. Investors are also more attracted to the more subordinated certificates, particularly the triple-B rated issues, often referred to as the Class C market. This increased marketability of the subordinated bonds, particularly during lower interest rate environments and narrower spreads, has resulted in the credit card ABS market being a primary funding tool even more attractive to credit card issuers.

Risks of Credit Card Securitizations

Realization of the benefits of credit card securitizations, however, requires appropriate risk management processes. The key to a bank's success with using securitizations lies in the quality of the underlying receivables, which is directly related to the underwriting and credit risk management techniques employed. Poorly performing receivables may hinder the bank's access to the securitization market, require higher **credit enhancements** to achieve investment grade ratings, and significantly increase the cost of this funding source.

As a result of securitizing its credit card receivables, a bank creates an accelerated or "paper" earnings and capital under current accounting rules. At the time of the sale, a bank is able to recognize its right to future excess cash flows generated by the sold receivables. In general, this right is reflected immediately in the income statement with the corresponding balance sheet asset presented in the form of a **credit-enhancing interest-only strip (CE IO strip).** The accounting chapter discusses the mechanics of the gain-on-sale accounting and related interests that continue to be held by the **transferor** in the transferred assets. The CE IO strip is probably the riskiest, most volatile asset on the credit card issuing bank's balance sheet.

Other risks can develop if management is too focused on earnings which may lead to poor origination decisions. In addition, management's incentive to ensure the performance of the securitization may result in "**cherry-picking**," which could eventually lead to a lower quality balance sheet. Banks that have an excessive dependence on securitizations for funding could present significant liquidity issues if this funding source becomes unavailable. Plus, a significant reliance on securitizations may result in a bank outgrowing other alternatives, such as traditional borrowing facilities. These are just a few of the major risks associated with securitizations. These risks, as well as several others, are discussed throughout this manual.

Banks involved in securitization activities, **subprime** credit card securitizations in particular, have experienced a multitude of problems, including some failures. Regulatory agencies have increased oversight of banks involved in credit card lending and securitizations, issued interagency guidance, amended regulatory capital rules, and enhanced examiner training and guidance.

PRINCIPALS AND THEIR ROLES

The securitization process involves various participants at the inception of the transaction and throughout the life of an issue. Participants include the **seller**, servicer, trustee, investors, investment bankers, third-party guarantors, accountants, attorneys, rating agencies, and underwriters. This section focuses on the roles of the parties typically involved in the securitization process.

Seller

The seller of credit card receivables is usually a larger financial institution, although there are certain entities that have **Rent-a-Bank Identification Number (BIN)** relationships with insured financial institutions that also sell and securitize credit card receivables. The seller generally retains a small portion of the securitized pool of receivables. The seller is also responsible for selecting an investment banker, establishing the securitization trust, appointing a trustee, and obtaining legal and accounting opinions.

Servicer

The servicer receives a fee for administering the assets held by the securitization trust. The **pooling and servicing agreement** details the specific duties and responsibilities of the servicer. It also sets forth the fees available to the servicer. The servicer is often the seller but, under certain circumstances, the trustee or an unrelated third party may be appointed as the servicer.

Trustee

A **Qualified Special Purpose Entity (QSPE)** is established to hold the underlying assets securing the issuance of certificates, and a trustee is appointed by the selling financial institution. The trustee's duties and responsibilities include:

- Ensuring that cash collections (generally daily) forwarded by the servicer to the securitization vehicle's trustee are invested in eligible investments.
- Determining the appropriate certificate rate for variable-rate issues at each repricing date.
- Ensuring that the seller and servicer are in compliance with all legal documents governing each transaction.
- Serving as the collateral agent for the benefit of the certificate holders.

Investors

The primary investors in credit card ABS are pension funds, insurance companies, foreign banks, large domestic banks, and other investment managers who require predictable cash flows. Credit enhancements and favorable bond ratings tend to eliminate credit quality concerns so investors typically focus on the timing of principal and interest payments of the issue when making investment decisions.

Investment Bankers

Investment bankers perform two key roles for the seller. First, they assist the seller in obtaining the most efficient funding. Second, they make sure that potential investors have sufficient information to make a sound investment decision.

Third-Party Guarantors

Third-party guarantors provide credit enhancements such as **cash collateral accounts**, letters of credit, and **surety bonds**. Credit enhancements are intended to assure rating agencies and investors of the likelihood of repayment. Third-party guarantors may be P-1 rated[1] commercial banks or affiliates of the credit card issuing bank.

Accountants

Accountants are responsible for issuing a comfort letter before the securities go to market. A comfort letter includes information on account selection; their historical performance, including three years of delinquency; and credit loss experience. It also includes the eligibility criteria used for account selection, the number of accounts, the principal dollar amount outstanding, the weighted average **finance charges**, and other composition statistics. The accountants often provide a further break down of the information on credit card receivables, such as by geographic location, account balance, payment rate and status, and credit limit. The accountants also furnish an annual report to the rating agency, the trustee, and the servicer stating that, based on the review of certain documents and based on agreed-upon procedures and Statement on Auditing Standards 70 (SAS 70), a system of internal controls is in effect and that the servicer is adhering to the representations and warranties made in the pooling and servicing agreement. In addition, the accountant attests to the mathematical accuracy of each amount on the monthly investor certificate forwarded by the servicer during the previous year.

[1] Moody's short-term debt rating, which reflects a bank with superior ability for repayment of short-term debt.

Rating Agencies

Rating agencies assign a rating to the issue based on their assessment of the quality of the credit card receivables, the underwriting standards, the collection and servicing processes, and the type and level of credit enhancements. Their assessment includes stress-testing the credit card receivables under different scenarios, including simultaneously decreasing the portfolio yield and the monthly payment rate by a certain percentage and increasing monthly charge offs by some multiple. The rating typically does not address the likelihood of principal and interest being paid by the expected final maturity date or the likelihood of an <u>**early amortization**</u>.

Rating agencies are responsible for monitoring the credit quality and performance of the issues pool of credit card receivables over the life of the security. If deterioration is detected, the rating agencies determine the cause and the seller's ability to correct the problem before downgrading the series' rating.

Underwriters

Underwriters are typically a syndicate of banks (the lead-managers) that underwrites the transaction, which means they have taken on the risk of distributing the securities. The underwriters typically have the primary role of structuring the transaction and finding investors. If they cannot find enough investors, then they may end up holding some securities themselves. Underwriters make their income from the price difference, or underwriting spread, between the price they pay the issuer for the securities and what they collect from investors who buy portions of the offering. The underwriters are also typically the primary document preparer.

MANUAL STRUCTURE

This manual describes a typical securitization structure, accounting requirements, cash flows and cash flow structure, designation of receivables, credit enhancement facilities, early amortization triggers, <u>**residual interest**</u> valuation and modeling, regulatory capital, risk management and examination issues, and regulatory reporting. Many of these sections include guidance to assist examiners in evaluating securitization activities. This manual should be used in conjunction with the Risk Management Examination Manual for Credit Card Activities. A variety of terms and industry language is used throughout this manual. The first use of each term included in the glossary is noted in bold and underlined.