V DESIGNATION OF RECEIVABLES

INTRODUCTION

This section provides information on the selection of credit card receivables, the purpose of seller's interest, the rational for **account additions**, the types of account additions, the general criteria for removing accounts, and the possible existence of **implicit recourse**. It makes many references to account additions or adding accounts. Accounts are not actually added to a securitization trust; rather the credit card receivables arising from additional accounts are added. However, to be consistent with industry terminology, the addition of receivables on added accounts is considered account additions.

At the inception of a securitization of credit card receivables, the bank as the seller selects receivables arising from specific accounts and sells the entire balance of these receivables to the securitization vehicle. The transfer of credit card receivables represents a sale (if the criteria are met for sales treatment under FAS 140) of an undivided interest in the receivables, not the accounts. Ownership of the accounts is retained by the credit card issuing bank. After the initial transfer, all newly-generated receivables from the selected accounts are also sold to the securitization vehicle so that it maintains 100 percent of the receivable balances owed by the cardholders on these designated accounts.

The selling bank first identifies the pool of accounts, from which the initial accounts are selected, based on the eligibility and other specified criteria in the pooling and servicing agreement. Some banks that securitize both prime and subprime receivables establish two separate master trusts, one for the prime receivables and one for the subprime receivables. A master trust containing prime receivables generally issues bonds that contain lower credit enhancement requirements and lower coupons on the investor certificates than a master trust containing subprime receivables. Banks, however, typically include different types of receivables within one master trust. Some banks include all types of credit card receivables in one master trust; prime, subprime, secured, and unsecured.

Since each new series issued out of a master trust has an undivided interest in the pool of receivables in the master trust, the receivables selected for a new series must not significantly alter the credit characteristics of the pool of receivables in the master trust. Once the pool of accounts has been identified, the receivables selected for a securitization should be based on a random or statistical sampling procedure for the applicable pool. Examiners should review the selection process to determine whether it is appropriate. Random selection of receivables is required to ensure that, among other things, there is no systematic selection of higher-quality assets for inclusion in the securitization pool, to the benefit of the investors' interests in the pool and the relative detriment of the seller's interest. However, pools of securitized credit card receivables are generally comprised of thousands of credit card accounts, carrying relatively small balances, and originated in accordance with standard credit underwriting procedures and documentation requirements.

The bank may exclude a portion of its newly-solicited and accepted accounts from the selection process but should not engage in cherry-picking. Each series' prospectus furnishes a description of the receivables, their selection process, and any segment or segments of the loan portfolio that was excluded in the process. Examiners should review this document to determine whether the bank's selection process is consistent with the requirements.

The ownership interest in the pool of receivables transferred to the securitization vehicle is divided between the seller's interest, which is generally retained by the credit card issuing bank, and the investors' interests. All risks and benefits attributable to the receivables are shared on a

pro-rata basis, and, with the exception of a senior/subordinated structure, the seller's interest is not subordinated to the investors' interests. As explained in the next section, the seller's interest serves the following purposes:

- Absorbs monthly fluctuations in the pool of credit card receivables.
- Protects the investors from breach of representation or warranties.
- Insures that the transaction (sale) will be treated as a debt issuance for tax purposes.

ABSORBING MONTHLY FLUCTUATIONS

Monthly fluctuations in the balance of the underlying receivables occur due to factors such as cardholder principal payments, additional cardholder charges, **attrition**, and dilution. Since all newly-originated credit card receivables arising from the accounts selected for securitization are transferred to the securitization vehicle, the total receivables held by it also fluctuates. The seller's interest is designed to absorb minor receivable fluctuations. The following example illustrates this point:

A bank initially transfers $1 million of credit card receivables into a securitization trust. The investor's interest is 90 percent, or $900,000, and the seller's interest is 10 percent or $100,000. Assume that in the subsequent month, total cardholder principal payments equal total cardholder charges; however, due to attrition and dilution, the total outstanding balance of the receivables falls by $20,000 to $980,000. Since the investor's interest is fixed at $900,000, the seller's portion must absorb the $20,000 decrease in the pool of receivables. The seller's interest is reduced to $80,000, which now represents 8 percent ($80/$980) of the remaining pool of receivables.

The seller's interest in the securitization trust will equal the difference between the total credit card receivables held by the trust and the amount of the investors' certificates outstanding. Most pooling and servicing agreements require the seller to maintain a minimum interest (generally 5 to 10 percent) in the pool of receivables. Consequently, any factors that decrease the pool of receivables beyond the maximum amount that can be absorbed by the seller's interest require the credit card issuing bank to provide additional accounts to the trust.

REPRESENTATIONS AND WARRANTIES

In addition to absorbing monthly fluctuations in the pool of receivables, the seller's interest also absorbs declines in receivables as a result of breaches in the credit card issuing bank's representations and warranties. Any breach of representation or warranty results in the removal of all receivables arising from those accounts triggering the breach. The bank's representations and warranties should be the only recourse provision associated with the sale.

Representations or warranties provided by the selling bank typically include the following:

- That the bank was duly incorporated and in good standing and has the authority to consummate the transactions contemplated in the pooling and servicing agreement.
- That the pooling and servicing agreement constitutes a legal, valid, and binding obligation on the bank.
- That the transfer of credit card receivables under the pooling and servicing agreement constitutes either a valid transfer and assignment to the securitization vehicle of all rights, title, and interest of the bank or the grant of a first priority perfected security interest in the receivables.
- That each credit card receivable is an "eligible receivable."

Eligible Accounts

An "eligible account" is typically defined as any account owned and maintained by the credit card issuing bank that is payable in U.S. currency and has not been identified as either sold, pledged, lost, or stolen. The cardholder must not be involved in bankruptcy proceedings and must have an address located in the U.S., U.S. territories, or U.S. possessions.

Eligible Receivables

An "eligible" credit card receivable typically must meet the following criteria:

- Arise from an "eligible account."
- Be created in compliance, in all material respects, will all requirements of law applicable to the credit card issuing bank.
- Have all authorizations, consents, orders or approvals of or registrations or declarations with any governmental authority that are required to be obtained, effected, or given by the bank in connection with the conveyance by the bank of receivables to the trust.
- Have good and marketable title, free and clear of all liens and security interest, at time of creation.
- Have a cardholder payment obligation that is legally enforceable against the cardholder in accordance with the terms of the agreement.
- Constitute an account under Article 9 of the Uniform Commercial Code (UCC).

TAX CONSEQUENCES

The seller's interest also serves as a mechanism to allow the sale to be accounted for as a debt issuance for tax purposes. Special tax counsel to the credit card issuing bank generally recommends that the institution maintain, at a minimum, between a 5 percent and 10 percent seller's interest to sustain this special tax treatment.

ACCOUNT ADDITIONS

Accounts are added to the securitization vehicle to maintain the investors' interests in the underlying assets at the prescribed level, establish new series within the master trust, or change the existing credit quality on the aggregate pool of receivables.

The average life of a credit card receivable is generally much shorter than the life of a particular series. The principal payment rate varies month to month, but on average, for the past few years, approximately 15 to18 percent of cardholder principal balance is paid down each month in a "normal" economy. Accordingly, an average cardholder's receivable balance turns over about every five to seven months. Investor certificates issued in each series are typically interest only with maturities ranging from three to ten years. Therefore, the pooling and servicing agreement must allow for account additions to ensure that the underlying receivables do not shrink to a level below the amount required for the investors' certificates. Credit card receivables represent open-end, revolving credit, and monthly outstanding balances on the designated accounts may vary from month to month due to seasonal spending patterns, changing principal payment rates, dilution, and attrition.

The creation of a master trust allows the bank the flexibility to originate new securitizations without the establishment of a new trust. The pooling and servicing agreement for new series issued under the master trust agreement specifies the amount of additional accounts that must be sold to the securitization vehicle.

The bank can also add accounts to change certain characteristics within the pool of credit card receivables. For instance, the bank may decide to add accounts during periods of high

delinquency rates, low cardholder usage rates, and high cardholder debt repayment rates. However, changes made after the original sale that are designed to improve the performance of the credit quality on a deteriorating pool of credit card receivables may constitute implicit recourse, and, as such, these types of changes should be carefully scrutinized. Implicit recourse is discussed later in this chapter and in the Regulatory Capital chapter.

Types of Additions

The pooling and servicing agreement determines the extent of additions and mechanisms available to the bank when adding accounts. Common types of account additions are lump-sum additions, required additions, and automatic additions.

- *Lump-Sum Additions* allow the bank to freely add accounts to a securitization vehicle; however, the rating agencies must agree that the addition of accounts will not result in a withdrawal or downgrade in a rating on any outstanding series.
- *Required Additions* are designed specifically to protect the investors from asset shrinkage and allow for the addition of accounts when the pool of receivables decline below the level established in the pooling and servicing agreement. The level required is usually based on the current or the initial amount in relation to all series within the master trust.
- *Automatic Additions* allow the bank to add a limited number of accounts to the securitization trust within a given period of time. The period may be designated as a specific time period (monthly, quarterly, annually), or may be a revolving period. Unlike lump-sum additions, the rating agencies are not required to notify the bank of the effect such additions may have on the ratings assigned to previously issued series.

Risk of Account Additions

Account additions can alter credit and early amortization risk within a securitized pool of credit card receivables. The pooling and servicing agreement, therefore, includes conditions with respect to the types of account additions allowed. Provisions may include, but are not limited to, allowing only accounts of the same nature as those included as initial accounts, delivery to the securitization vehicle's trustee copies of UCC filing statements covering the new accounts, notification by the rating agencies that the additions do not reduce or withdraw the initial rating assigned, or allowing additions consisting only of eligible accounts as defined in the purchase and sales agreement.

Credit risk is largely determined by the bank's underwriting and servicing standards, its target market, its financial health, and other internal or external factors. Pooling and servicing agreements that allow for automatic account additions, therefore, pose the greatest potential for increased credit risk because such additions are generally limited only by amount and time constraints, with no requirement to consider credit quality implications. On the other hand, lump sum and required additions are less likely to increase credit risk because they must consider the effect additions will have on other outstanding series and because they are made only in response to declines in the level of underlying assets. Lump sum and required additions are generally small in relation to the entire pool of receivables.

In some circumstances where account additions will result in a downgrade of a rating, a bank may prevent the downgrade by increasing the credit enhancement facility of that series. However, this may be considered implicit recourse.

REMOVAL OF ACCOUNTS

The bank may remove accounts from the securitization trust only as specified in the pooling and servicing agreement and are usually only allowed once a month. The criteria for account removals are unique to each series, but criteria commonly include the following:

- That the removal of accounts will not cause an early amortization event.
- That the removal of accounts will not cause the seller's interest to fall below a specific percentage of the aggregate amount of principal receivables outstanding as specified in the pooling and servicing agreement.
- That the principal receivables of removed accounts will not exceed a specified percentage of the aggregate amount of principal receivables. Clean-up calls that are 10 percent or less of the original pool balance and that are exercisable at the option of the credit card issuing bank are usually not viewed as recourse.[31]
- That the rating agencies be notified of the intent to remove accounts and agree that the removal of accounts will not result in a downgrade of the rating for any series.
- That accounts will not be removed if the delinquency rate within the securitized credit card portfolio is material, with materiality generally defined in the prospectus.

All receivables must be sold without recourse in order for the transaction to qualify as a sale and be afforded favorable tax treatment. Therefore, examiners should be concerned if the bank removes accounts that would ordinarily be considered a repurchase under a normal recourse agreement, such as accounts with high delinquency rates and charge offs. While banks occasionally weed out problem loans from a securitization vehicle in order to avert an early amortization, the practice is discouraged and would warrant critical comment in the report of examination. In general, accounts should be removed only if an inordinate amount of receivables exist in the securitization vehicle or if a bank is exercising a clean-up call option.

IMPLICIT RECOURSE

Implicit recourse arises from an institution providing post-sale support to a securitization beyond the contract. Banks deemed to be providing implicit recourse are generally required to hold capital against the entire outstanding amount of assets sold, as though the sold assets remained on the books, for risk-based capital purposes. Banks that engage in securitizations have an incentive to avoid early amortization because once an early amortization event occurs a bank may have difficulty accessing the securitization market as a funding source. Examiners should be alert for securitizations that are approaching early amortization triggers, such as a decreasing excess spread below a certain threshold or increasing delinquencies beyond a certain rate.

Examiners should review the pooling and servicing agreement to determine whether the bank limits any post-sale support to that specified in the terms and conditions in the documents. They should also review a sample of receivables transferred between the seller and the securitization vehicle to ensure these transfers were completed in accordance with the contractual terms of the securitization, particularly when the overall credit quality of the underlying receivables has deteriorated. Banks may attempt to improve the credit quality of a securitized credit card portfolio by selling receivables to the securitization trust at a discount from the price specified in the pooling and servicing agreement, exchanging performing receivables for non-performing receivables, or purchasing receivables from the securitization trust at an amount greater than fair value. While banks are not prohibited from providing implicit recourse, such support will generally result in higher capital requirements. The Regulatory Capital chapter provides more information on what constitutes implicit recourse and the ramifications a bank may face if implicit recourse is deemed to exist.

[31] "*Interagency Questions and Answers on the Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interest in Asset Securitizations*" issued in FIL-54-2002 on May 24, 2002.