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## What's the Problem with Recourse?

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Previous commentaries have suggested that the main problem facing financial markets today is information difficulties. The story should be familiar by now. Investors, knowing there has been a shock to asset values but not knowing the distribution of that shock among investments, rationally pull back from the market as a whole to decrease their probable exposure. A good example of such behavior is currently being manifested in the Florida state money market fund offered to local municipalities. That fund has experienced withdrawals amounting to approximately 30% of the original \$28 billion since it revealed less than two weeks ago that the fund held substantial exposures to defaulted SIVs and watchlisted RMBS.

The sources of information in today's markets are sparse. The meaning of bond ratings has been arbitrated to a two-step process, where investors have to know the investment sector before interpreting ratings. Furthermore, structured products are overly complex, in that risk has been sliced and diced too finely to be supported by the statistical estimations of underlying collateral risk: the financial engineers got too tricky.

Another element of information difficulties that investors are just beginning to learn about is the nature of "true sale." True sale lies at the heart of securitization, as that is the reason that securitizations can be considered "off-balance sheet."

The concept of true sale is easy to demonstrate. Suppose I sell you my car. It breaks down as you drive away. Too bad. True sale. Now suppose I offer you a money-back guarantee for two weeks. I should probably not spend the money I receive for the sale until the two week period expires. Until that, it is not a true sale.

The concept is being demonstrated this week at Citi and HSBC this week. Both issued SIVs in a form that contain triggers and other elements that allow the financial instruments at the heart of the SIV to be sold back to the banks if certain events occur. Those triggers violate the spirit of true sale, even if the banks have the capacity to absorb the losses (HSBC probably does, Citi probably doesn't).

Such terms are not new in structured finance. In particular, even RMBS allow the loans to be returned to the issuer in the event of loan fraud. Hence, the industry's insistence early this year that most of the current mortgage difficulties were due to loan fraud. Similar terms apply to other ABS. In the credit card sector, in particular, credit card issuers that securitize a lot tend to report more

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fraud than others. (See Todd A. Vermilyea, et. al, “Implicit Recourse and Credit Card Securitizations: What do Fraud Losses Reveal?”)

But even where those terms do not apply, securitized pools have been repaired by issuing banks without consequence – an action termed “explicit recourse” – even though such actions clearly violate FAS140 and explicit regulatory rules. In some cases, the regulators excused the recourse by reasoning that if recourse was *not* allowed, the bank at issue would be rendered critically undercapitalized. Hence, bank regulators have used recourse as a form of explicit forbearance, similar to the way bank regulators allowed insolvent banks to continue operating in the Thrift Crisis in the 1980s and the way Countrywide is currently being supported by Federal Home Loan Bank advances. (See Joseph Mason and Eric Higgins, “What is the Value of Recourse to Asset Backed Securities? A Study of Credit Card Bank ABS Rescues,” *Journal of Banking and Finance*, April 2004 (28:4), pp. 857-874.)

In any of those situations, bank regulators and FASB have been reluctant to see a “third way” of approaching true sale. In particular, regulatory capital and the contingent liability do not have to be absolute. My research with Charles Calomiris (“Credit Card Securitization and Regulatory Arbitrage,” *Journal of Financial Services Research*, August 2004 (26:1), pp. 5-27 (lead article)) goes so far as to suggest that well-functioning banks routinely hold additional capital against their securitizations, despite lacking regulatory requirements to do so. The UK also does not provide full capital relief for securitizations, which has allowed UK banks to support securitized pools while previously having reserved capital for that contingency.

The point is that if investors believe that issuers will support securitizations as has happened in the past, they will discount current performance except in cases where the firm is not expected to be a going concern. If, instead, securitizations are treated as true sales that cannot be bailed out, they will be priced according to fundamentals. Not knowing which value to use is confusing. Hence, regulators have a lot of work to do to redefine true sale and removing a great many points of confusion from markets and financial statements.