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How U.S. Credit Card ABS Can Withstand Today's Credit Challenges

Credit card asset-backed securities (ABS) transactions exhibit several key strengths that should help sustain positive performance in this sector. The main strengths include the following: generally strong sponsors/servicers, favorable fundamental characteristics of the asset class, relatively favorable performance in the asset class to date and robust protections within transaction structures.

Financially Strong Sponsors/Servicers

Over the years, the competitive landscape in the credit card industry has markedly changed. The market has undergone significant consolidation, resulting in a stronger, more stable industry, leaving the top remaining players better capitalized. At year-end 2006, the top five credit card issuers comprised 70.3% market share, up from just 37.3% at year-end 1995.[1] Credit card issuers today have more diversified business lines since many of the monoline issuers (e.g., MBNA and First USA) and subprime-only issuers (e.g., Metris and Providian) have been acquired by large banks. Economies of scale are crucial to the operating dynamics of the industry because competition is intense and creates ongoing pressure on profit margins. Credit card issuers use sophisticated technology to manage underwriting, collections activities and risk management.

In credit card securitizations, the originators (sponsors) and servicers are typically either the same entity or affiliated. The benchmark Visa/MasterCard issuers are generally highly rated, well-capitalized banks and therefore are not solely reliant on securitization as a funding source. This diversified funding base gives these issuers more financial flexibility to obtain the best execution across multiple sectors and markets, depending on market conditions. Moreover, the ability to tap multiple sources of liquidity provides competitive advantages, especially in down credit cycles. In addition, since the major credit card issuers are banks, they are highly regulated, and the regulatory agencies have broad authority to ensure sound underwriting and risk management practices within the banking system.

Favorable Characteristics of Asset Class

Credit card receivables have fundamental characteristics that make this asset class attractive for securitization. The key features are summarized below.

Issuer Ability to Change Terms and Conditions at Any Time

Credit card issuers are able to actively manage accounts based on purchase and payment behavior or credit bureau information. If an issuer deems that the credit risk of a cardholder has increased, it can change the terms, such as decreasing credit limits or increasing annual percentage rates (APRs) on the account. In addition, credit card issuers can change terms to boost their yields by increasing fees (e.g., over-the-limit fees and late fees) and can mitigate interest rate risk by changing APRs on accounts from fixed rates to variable rates.

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[1] The top five credit card issuers at year-end 2006 were Bank of America (19.3% market share), JP Morgan Chase (18.8%), Citigroup (13.9%), American Express (10.6%) and Capital One (7.6%). Source: The Nilson Report.

Relatively Easy Transfer of Servicing

Credit cards are a commodity asset class. Therefore, in the event that an issuer becomes insolvent, servicing can be readily transferred, particularly to the larger issuers who have established servicing platforms.

Fast-Turning Receivables

Credit card receivables have short average lives. The current industry monthly principal payment rates of 19% would translate into an average life of five to six months. Consequently, if an early amortization event were to occur in a credit card securitization, investors would be exposed to performance deterioration for a relatively short period of time before being repaid by principal collections.

Diversification

Credit card master trusts generally are geographically diversified, which should minimize the risk that an economic downturn in a particular region would have an impact on performance. In addition, trusts have broad FICO score diversification.

Product Innovation Attracts Higher Credit-Quality Obligors

Credit cards as a lending product have evolved over time. Today, many cardholders use credit cards for "everyday" purchases (e.g., gas, groceries and utilities), making cards a virtual substitute for cash. Also, rewards programs encourage more convenience usage. Consequently, many prime obligors use credit cards, and credit card trusts in general have a large component of prime obligors.

Weathering the Storms since 1987

Long and Established Track Record

After the first credit card ABS transaction was issued in 1987, the industry has endured various credit cycles in addition to legislative and regulatory scrutiny and accounting changes. A major exogenous event that had an impact on the industry was bankruptcy reform. Consumers rushed to file bankruptcy before the October 2005 effective date of the bankruptcy reform legislation, causing a spike in credit card losses in late 2005. Credit card losses dropped off precipitously post-reform and while losses have climbed since then, they are still lower on an absolute basis relative to historical levels.

Tracking Trends in Collateral Composition

Updated collateral composition and distribution (e.g., aging, credit limits, geographic concentrations, FICO scores and account balances) are published in the offering document for each new transaction issuance. Since established issuers are frequently in the market, investors can track trends and monitor changes in trust composition over time.

Standardized Reporting

Credit card ABS transactions have standardized monthly reporting of performance measures such as portfolio yield, losses, monthly payment rate, delinquencies and excess spread. While other asset classes often have charge-off policies that vary by issuer, bank credit card issuers are governed by Federal Financial Institutions Examination Council (FFIEC) guidelines, which give an "apples-to-apples" comparison among issuers. These guidelines require uniform charge-off and re-aging policies.[2]

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[2] For example, an account is charged off at 180 days delinquent or within 60 days after bankruptcy notification. Re-aging of a delinquent account can occur (1) no more than once in a 12-month period or (2) no more than twice in a five-year period. For more details, see www.ffiec.gov/press/pr021099.htm.

Robust Structural Features

Credit card securitizations have various structural mechanisms in place to protect investors. These core features are summarized below.

Master Trust Structure

Credit card securitizations are typically issued out of a master trust. The master trust structure (compared with a discrete trust structure) creates efficiency for the issuer as it eliminates the cost of setting up a new trust with each new issuance as well as allows for a larger pool of receivables, which can benefit from more diversification. Each series issued out of a master trust shares an undivided interest in the collateral pool. Under normal circumstances, collections on credit card receivables are first allocated pro rata between the seller (originator/sponsor) and the investors. Each trust requires a minimum seller's interest (typically at least 4%), which provides an incentive for the seller (originator/sponsor) to maintain performance. The seller's interest is intended to cover dilutions (non-cash reduction in receivable balances, such as merchandise returns), fraud and seasonal fluctuations of receivables balances and does not serve as credit enhancement for the benefit of noteholders.

Investor collections are further allocated between finance charge collections and principal collections. Finance charge collections are used to pay transaction expenses (e.g., servicing fees, interest coupons, reimbursement of investor charge-offs and fund-up of reserve accounts), with any excess flowing back to the originator. This excess spread (in the 7% to 9% range for the industry) further incentivizes originators to maximize collateral performance. Principal collections are used to repay noteholder principal in an amortization period; in the revolving period, principal collections are used to purchase newly generated receivables.

Shared Excess Spread and Shared Principal

Typically, credit card trusts, particularly those with de-linked structures,[3] benefit from shared excess spread and shared principal collections. For those trusts with shared excess spread, finance charge collections are allocated based on need (rather than pro rata). Therefore, a higher coupon series will receive a higher allocation of finance charge collections; conversely, a lower coupon series will receive a lower allocation of finance charge collections. To the extent that excess finance charge collections are available after a particular series has paid its allocable expenses, they can be applied to cover shortfalls for other series. For those trusts with principal sharing, a series that is in its amortization period can receive allocations of principal from those series that are in their revolving periods (which do not have principal repayment requirements).

Discount Option

If excess spreads decline, many trust documents permit the use of discounting, subject to certain conditions, which would enable an originator to sell receivables into the trust at a discount. Since the discounting of receivables recharacterizes principal collections to interest collections, it has the effect of "artificially" increasing portfolio yield and, in turn, excess spread. Issuers would utilize discounting in order to avoid the breach of certain triggers (e.g., reserve account fund-ups or early amortization) based on excess spread. However, issuers may be limited in their use of discounting since selling receivables at a discount is viewed by regulators as implicit recourse, which would generally require higher capital requirements for the bank sponsosr.

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[3] De-linked master trust structures enable an originator to issue senior classes at different times from subordinated classes. A senior class may only be issued if the issuance trust has required minimum subordination that matures within the legal final maturity of the proposed senior class.

Ability to Add Accounts

Credit card originators can also manage trust performance by adding eligible (presumably better performing) accounts to the master trust. Typically, trust documents dictate a maximum percentage of account additions (e.g., 20% of aggregate trust receivables) within a 12-month period and a three-month period (e.g., 15% of aggregate trust receivables) without rating agency confirmation.

Fixed Allocation of Principal Collections after Early Amortization

After an early amortization event, investors' principal collections are allocated based on a fixed percentage[4] calculation. Therefore, as the deal amortizes, investors get an allocation of principal that is larger than pro rata (and therefore the seller gets a smaller share than would occur if allocations were made pro rata). In addition, the Discover trust has a unique fixed finance charge allocation structure, wherein upon an early amortization event, investors' finance charge collections along with principal collections are allocated based on a fixed percentage. This "overallocation" of finance charge collections provides additional credit enhancement as investors are repaid in an early amortization situation.

Conclusion

Given the strength of the sponsors/servicers, the characteristics of the asset class, the good track record and transaction structural features, the credit card sector has sound fundamentals to weather consumer stress.

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[4] Fixed percentage is a calculation where the numerator is the invested amount (i.e., the note balance) as of the end of the revolving period and the denominator is the aggregate amount of principal receivables in the trust. Although investors are receiving principal payments during the amortization period, the numerator of the fixed allocation of principal remains constant. This fixed allocation method has the effect of accelerating payments to noteholders.

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