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ADVERSE SELECTION IN CREDIT CARD MASTER TRUSTS

The risk stemming from adverse selection in credit card asset-backed securities (ABS) has traditionally been ignored due to the significantly large and diverse volume of obligors underlying master trusts, the relatively small balances of the accounts, a high volume of convenience users that characterize most major trusts and the revolving nature of the receivables' pools. However, this risk, associated with increased concentrations of higher risk obligors, can emerge when a trust enters early amortization and no new accounts are added into the trust.

When early amortization is triggered, principal allocation percentages are locked and credit enhancement levels are frozen at the pre-early amortization levels. Therefore, following early amortization, in the event card holders remaining in the trust cease using their cards, or even transfer balances out of the program, without the ability to add new accounts credit card trusts are susceptible to performance declines during the early amortization period.

Card holders who cease using their cards may still pay off or revolve their balances and incur finance charges, which continue to support the yield on the trust. However, lower credit quality borrowers are more inclined to stop entirely from paying off their balances and eventually charge-off. Higher credit quality borrowers may be inclined to transfer their balances out of the trust altogether. Regardless of the degree to which of the latter two events happens, the result of such behavior increases the risk of adverse selection in the trust, which would have an increasingly negative effect on the future performance of the trust.

In the case of a balance transfer, a cardholder uses funds borrowed from another card program to pay down the existing balance carried on the master trust program. Since balance transfers are traditionally offered to higher quality obligors, following early amortization, higher credit quality, low risk obligors may be lured by offers from competing card programs to transfer their balances and do so to avoid the stigma of remaining with the program whose trust is in early amortization. As a result of such balance transfers, the credit profile of the existing master trust will decline more rapidly, exacerbating the effect of adverse selection in the trust and leading to higher potential losses.

The credit card market most recently saw the phenomenon occur in 2002, in connection with the NextCard Credit Card Master Note Trust. On February 7, 2002, NextBank, N.A., an internet bank, was closed by Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) was named Receiver. The bank maintained a credit card subsidiary, NextCard, which sponsored the credit card trust and also ended up under federal regulatory control. In short order following the bank seizure, regulators cut-off the credit card customers' accounts. This action caused customers to stop making payments on their balances and for many of the higher quality obligors to transfer balances out of the trust. Eventually, the trust entered early amortization due to rapidly declining performance. Since that time, performance has continued to decline.

The market may also experience the effect of adverse selection in the credit card ABS sector in the case of the Advanta Business Card Master Trust (ABCMT), which entered early amortization in June due to the tripping of a base rate trigger. Although there are significant differences between the NextCard and Advanta situations, there are enough similarities between the two that a comparable outcome is possible. As is typical in a credit card trust, ABCMT will not fund new accounts subsequent to the date in which the early amortization event was declared. Advanta has also stopped funding new credit card charges on existing accounts. Advanta has promoted balance transfers away from the trust to other credit card issuers and some customers have acceded. However, as expected, the transferred accounts have tended to be associated with higher quality obligors—a trend that is expected to continue. The result will most certainly be a significant increase in losses on the trust. The Advanta situation is still emerging, but its story and that of NextCard tell a cautionary tale regarding the hidden risk of adverse selection in credit card ABS.

For questions or comments, please contact Chris O'Connell at coconnell@dbrs.com.