

Asset-Backed
Criteria Report

**Rating U.S. Credit Card ABS
Seller/Service**

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Related Research

- “Rating U.S. ABS Seller/Service,” dated April 20, 2006

■ **Summary**

This credit card asset-backed securities (ABS) criteria report is supplemental to Fitch Research on “Rating U.S. ABS Seller/Service” (dated April 20, 2006, available on Fitch’s web site at www.fitchratings.com) and summarizes the principal factors considered in Fitch Ratings’ review of credit card seller/service. This report also outlines how ABS seller/service ratings are incorporated into the credit card ABS rating process.

Fitch’s seller/service review process determines the quality and effectiveness of an organization’s origination and servicing platform, as well as its compliance with stated guidelines, operational and financial stability, and soundness of internal control procedures. While Fitch’s credit card ABS ratings always have included a seller/service evaluation, the seller/service ratings formalize and standardize this information, providing a clear indication of both origination and servicing capabilities based on standard benchmark assessments.

The seller/service ratings are used to augment Fitch’s credit card collateral analysis and cash flow modeling when evaluating credit enhancement levels, serving as an added measure of any risk or benefit associated with the transaction. Credit card ABS transactions with highly rated seller/service are likely to benefit from credit-given or reduced loss coverage levels. On the other hand, seller/service rated below the ‘3’ category could receive a negative adjustment to enhancement levels, which could be mitigated by an alternative servicing arrangement. In some cases, the adjustments noted above have been taken into consideration already as part of Fitch’s seller/service review process. Fitch’s expanded and more detailed reviews also will allow for better communication to the market of these adjustments, as well as the potential for further modifications to enhancement calculations.

Fitch’s credit card seller/service rating criteria focus on three principal factors — corporate performance, originations, and servicing — each with various subcategories. Corporate performance analysis focuses on the quality of the company’s management, its financial strength, and its ability to manage operational risks at a corporate level. Evaluation of origination activities covers the origination and sourcing procedures and underwriting integrity, as well as quality control and operational risk management in the loan origination function. The servicing review focuses on account maintenance, customer service, investor reporting and remittance, collection and loss mitigation, default management, and operational risk management of various servicing functions. This report discusses these key rating factors and related subcategories that make up Fitch’s rating methodology and offers insights on the qualitative factors and quantitative metrics that will influence their evaluation.

Fitch will refine its seller/servicer rating criteria regularly to keep it reflective of the credit card origination and servicing landscape by including observations noted during annual servicer reviews, as well as issues arising within the ABS market.

Credit card seller/servicers are able to make portfolio management decisions that affect yield and monthly payment rate, in addition to losses, because the terms on credit card products are dynamic, unlike those for many other consumer loan products. The annual payment rate, fees, payment due date, credit line, interest calculation method, and minimum payment due calculation can all be changed quickly. In some cases, the initial terms will provide for adjustment of these features at the discretion of the issuer, while in others, the customer may opt out upon receipt of a change in terms notice.

Due to the contingent liability associated with many accounts, credit card seller/servicers develop early warning systems at both the account and portfolio level. The ability of the servicing team to identify problems and resolve them quickly or, in the case of newly identified problems, to develop mitigating strategies and then implement them, is what distinguishes one seller/servicer from another. As a result, some seller/servicers may be able to withstand and react to unfavorable economic conditions and changes in consumer behavior more rapidly than others. This will result in a higher seller/servicer rating and therefore allow the seller/servicer to benefit from a reduction in overall credit enhancement levels. This is achieved by using the adjustment factors, such as those in the sample matrix table below, and applying them to the output of Fitch's cash flow model during the development of credit enhancement levels.

Since the class C notes in most credit card trusts derive credit enhancement from spread accounts, Fitch gives additional consideration to how these are evaluated for highly rated seller/servicers.

Additionally, Fitch evaluates spread accounts for prime trusts by measuring how much can be trapped over a 12-month decline scenario. However, a 15- or 18-month decline scenario may be used for highly rated seller/servicers to give credit to their ability to react rapidly to changing market conditions.

■ **Rating Process**

Fitch's credit card ABS seller/servicer rating reviews are one factor included in the ABS rating process. Fitch expects these reviews to be completed, whenever possible, in conjunction with either financial institutions or ABS group visits, to make them as efficient as possible. Although the review formats can vary depending on several factors and objectives, a description of the steps generally taken in the servicer review and rating process is explained below.

To make the process efficient and focused, Fitch requests advance documentation from the seller/servicer, such as corporate and operating structures, organization charts, audited financial statements, and select portfolio statistics. Fitch may request additional documentation, such as policy and procedure manuals, quality control reviews, compliance reports, and internal audits that may only be available either during the visit or immediately thereafter. Also prior to the on-site review, Fitch reviews the seller/servicer's agenda to determine that the relevant topics are covered, the appropriate personnel are present, and the time allocated for each topic is adequate.

During the on-site review, Fitch meets with senior management and functional managers to discuss origination and servicing operations, tours the facilities, and reviews system demonstrations. Fitch expects the duration of on-site reviews to range from one to three days, depending on the seller/servicer review type(s), product(s), and number of platform sites.

Sample Factors: Credit Card ABS Seller/Servicer Credit Enhancement Adjustments

(%)

Bond Rating Category	Seller/Servicer Rating								
	'1/1-'	'2+'	'2'	'2-'	'3+'	'3'	'3-'	'4'	'5'*
'AAA'	90	92	94	96	98	100	100	108	NR
'AA'	88	90	92	94	97	100	100	110	NR
'A'	86	88	90	93	96	100	100	112	NR
'BBB'	82	86	89	91	94	97	100	115	NR
'BB'	75	80	85	90	93	96	100	115	NR

*Fitch Ratings will not rate transactions from seller/servicers rated '5'. ABS – Asset-backed securities. NR – Not rated.

Fitch assesses the information gathered through the review process, along with Fitch surveillance data and industry statistics. Results of this analysis are entered into the credit card seller/servicer scorecard, consisting of both quantitative and qualitative measures, generating a recommended servicer rating. The rating recommendation is then presented to a credit committee consisting of operational risk, ABS, and financial institutions analysts. Additional qualitative input is solicited from members of the rating committee, especially for comparative analysis.

The seller/servicer rating is published in the marketplace and may be followed by publication of a report detailing Fitch's evaluation of the seller/servicer and the rationale for the rating. Seller/servicer ratings and reports are available on Fitch's web site at www.fitchratings.com.

Fitch seller/servicer ratings are valid for one year from issuance; however, Fitch continues to monitor the organization's operating characteristics, performance, and status of key personnel for the one-year tenure of the rating. For a servicer with an existing rating, the annual review focuses on changes that have occurred over the prior 12 months or since the prior review.

■ Rating Criteria

As discussed in Fitch Research on "Rating U.S. ABS Seller/Servicers," (dated April 20, 2006, available on Fitch's web site at www.fitchratings.com), seller/servicer ratings are based on criteria that commonly fall into three areas — corporate performance, originations, and servicing. In addition, two areas are common to both origination and servicing — staffing and training and technology. The following sections describe more specific criteria, arranged within these general areas, that apply to credit card seller/servicers.

Corporate Performance

Company Management

Fitch pays close attention to the stability of the company and its capacity for and capability of meeting its business objectives, together with its ability to deal with changes proactively. Fitch views management adaptability/resiliency and effective strategic planning as necessary factors to remain viable in the highly competitive credit card industry.

Fitch will evaluate management's commitment to providing strategic direction and developing operational

tactics used to fulfill the organization's loan origination and servicing objectives. Factors considered include:

- Corporate structure and ownership.
- Management stability and depth.
- Operating history and portfolio characteristics.
- Operating experience (years in business, product, and securitization).
- Growth strategy (organic or acquisitions).

Management is measured individually and as a team. At the individual level, industry experience, tenure with the company, and time in the current position are evaluated. Fitch also assesses management collectively for overall breadth and depth and to gauge the tenure and diversity of experience of the core management team. Additionally, Fitch reviews management's participation in industry roundtable conferences, forums, or other associations that can shape industry standards or best practices.

Fitch also reviews historical portfolio growth to understand volume fluctuations and assess the company's ability to meet growth objectives. As part of this evaluation, Fitch reviews merger/acquisition activity, expansion plans, or intentions to exit or scale back specific businesses that could influence operating performance. Aggressive growth objectives involving portfolio acquisitions require greater scrutiny of the seller/servicer's volume capacity and resources, as well as integration planning and execution.

It is critical that the company demonstrate overall integrity in corporate governance (for details, see Fitch Research on "Evaluating Corporate Governance: The Bondholders' Perspective," dated April 12, 2004, available on Fitch's web site at www.fitchratings.com). However, in this seller/servicer evaluation, Fitch focuses on elements of corporate governance that are particularly relevant for loan origination and servicing, such as the integrity of audit process and regulatory compliance.

Financial Condition

Fitch believes that the financial condition of a company has a direct impact on the stability of its operation platform and ultimately on credit card ABS transaction performance. A credit card seller/servicer with limited financial flexibility may not be able to support its various originations and servicing functions appropriately, resulting in weaker collections, higher delinquencies, and, ultimately, higher losses. In Fitch's view, this dynamic requires an evaluation of the seller/servicer's financial condition, as well as active monitoring. The following are several factors and

quantitative metrics considered by Fitch in its seller/servicer financial condition evaluation:

- Unsecured debt rating/credit assessment.
- Capitalization.
- Funding diversity and liquidity.
- Operating performance.
- Receivable growth rate.
- Operating expenses to managed receivables.

The purpose of the seller/servicer financial condition review is to assess the seller/servicer's business viability. Public credit ratings assigned by Fitch's Financial Institutions group, where available, serve as the main component of the seller/servicer financial condition review. When an explicit debt rating is absent, Fitch will assign a shadow rating, which will entail a review of the seller/servicer's financial statements, with a focus on liquidity, profitability, capitalization, and leverage trends. A shadow rating assigned specifically for the seller/servicer process is limited in scope and is not meant to substitute for a credit rating, which offers an opinion on an institution's ability to meet its debt obligations.

Credit card ABS transactions commonly include early amortization triggers associated with trust and deal collateral performance metrics, as well as the financial viability of the seller/servicer. However, card transactions wind down when the seller/servicer defaults on its obligations or in the event of bankruptcy or receivership. Fitch has observed that it is sometimes difficult to accomplish a timely and efficient servicing transfer that could benefit investors. Recent card programs that were subject to a servicing transfer included NextCard and First Consumers.

Due to the considerations noted above, Fitch's financial condition assessment has a significant impact on a credit card issuer's seller/servicer rating. For example, it is difficult for credit card seller/servicers with a non-investment-grade financial condition profile to achieve a seller/servicer rating in the top categories.

Corporate Operational Risk Management

In addition to looking at the internal control systems, processes, and procedures at each of the functional levels, Fitch also reviews an issuer's corporate risk management infrastructure to ensure that the system of internal controls in place is consistent with the organization's size and scope of operations. Fitch reviews how operational risk is monitored and managed through compliance, quality assurance

programs, and the internal audit function. Examples of key ratings factors include:

- Corporate risk management strategy.
- Internal audit.
- Compliance performance and tracking.
- Litigation risk management.

Operational risk refers to the risk of incurring a loss due to insufficient development or execution of procedures, policies, or systems. Failure to manage operational risks affects the credit card portfolio performance in multiple ways. For example, a failure to test changes to the billing system may result in lost fee revenue. An inadequate audit of the automated credit line increase process may result in the extension of credit to an undesired cohort of accounts. A failure to adequately review the terms and legal disclosures on a new account application may result in the need to reprint the applications, leading to increased marketing expenditures and legal challenges, which could prove costly. Regulatory noncompliance (for example, unlawfully aggressive collection) may result in fines, account closures, forced changes to the business model, and even suspension of servicing activities in extreme cases.

Given the scope of credit card operations, Fitch believes issuers should employ an integrated approach to operations risk management that transcends functional and departmental boundaries. This may be accomplished through risk oversight committees, formal compliance and operations risk management programs, or enterprise risk management programs. Regardless of the system in place, Fitch expects operations risk management oversight to be given a high priority in the organizational structure, with adequate dedicated staff and appropriate resources for monitoring and reporting.

In addition to well-defined and clearly documented policies and procedures, Fitch believes companies should have formal procedures for documenting operational loss events, tracking open items, and validating the adequacy of resolutions. These procedures keep management informed, improve its ability to identify future risks, and enable it to determine where enhancement to the existing risk controls is needed.

Fitch views the internal audit function as a critical component of an effective operations risk management program. Fitch expects issuers and servicers to maintain an independent internal audit group, supported by an appropriately staffed

department in terms of experience and number of employees. Functional responsibilities generally include determining adherence to established policies and procedures and risk management policies, measuring the seller/servicer's compliance with laws and regulations, and testing the internal control environment. Fitch evaluates the responsibilities and resources available to the internal audit function, as well as its position in the organizational structure. Fitch also samples internal audit reports for key operations functions. Some companies outsource their internal audit functions. In such a case, Fitch will apply the same standards of evaluation as for an audit conducted by internal auditors.

Additionally, for public companies, Fitch evaluates management and auditor assessments of internal controls and disclosures relating to the Sarbanes-Oxley Act of 2002, Section 404 – Management Assessment of Internal Controls. While private companies are not covered by this section legally, Fitch expects well-managed private companies to achieve the minimum standards stipulated by this provision.

In addition to discussing current compliance efforts, Fitch asks senior management about any events of noncompliance with applicable laws, rules, and regulations. The credit card industry is regulated heavily by U.S. federal, state, and local consumer protection laws that affect how credit card loans are made, enforced, and collected. The most prominent federal laws include: the Truth in Lending Act; the Equal Credit Opportunity Act; the Fair Credit Reporting Act; the Fair Debt Collection Practices Act; and the financial privacy laws, as outlined by the Graham-Leach-Bliley Act. These statutes impose disclosure requirements, limit accountholder liability for unauthorized use, prohibit discriminatory practices in extending credit, impose limitations on types of account-related charges, and regulate collection practices. Fitch reviews litigation with which the seller/servicer has been involved, as well as the extent of settlements paid by the company.

Origination

Origination, Underwriting, and Risk Management

New account originations are vital for the stability of a credit card portfolio due to account and balance attrition caused by competition, chargeoffs, and principal repayments. As such, an issuer must

maintain an account maintenance infrastructure that can digest easily the quality and volume of accounts booked. For credit card ABS, issuers must continuously add receivables to their trusts to ensure that sufficient collateral is available to support outstanding ABS transactions. For issuers with significant securitization programs, this process generally involves adding relatively new or unseasoned accounts to their respective trusts. Due to these factors, Fitch's seller/servicer review process includes an assessment of the account origination process and strategies. The following are some factors and quantitative metrics considered in Fitch's review process:

- Effectiveness of contact strategy.
- Sophistication of marketing and testing.
- Account scoring and pricing.
- Response and activation rates.
- Average campaign cycle time.
- Cost per account.

The focus of the originations review is on the ability of the seller/servicer to devise and execute an approach to originations that is complementary to the company's core competencies and strategic objectives, which should include maintaining adequate long-term profitability. Credit characteristics of securitized pools are analyzed when credit enhancement levels are evaluated and ratings assigned and continuously surveilled thereafter. As such, the Fitch seller/servicer review is not specifically concerned with the credit quality of the accounts booked.

The prospect universe should be segmented to allow for some differentiation of offers and enable closer management of the risk/reward tradeoff. The card industry is very competitive; hence, seller/servicers must develop compelling offers and target the appropriate prospect segment to mitigate the risk of adverse selection. Since the market changes frequently, Fitch evaluates issuers' ability to reassess core offers regularly and to quickly adjust the terms of the offer based on competitive analysis and test/control results from prior mailings.

Fitch expects the execution of the account originations process to be efficient and reasonably accurate. The deployment of sophisticated contact management strategies, such as the allocation of resources based on the likeliness of response, the use of multichannel methods (such as direct mail followed by telemarketing or e-mail), and conversion of cross-sell opportunities, improves efficiency.

Acquisition methods and operational practices should be reviewed regularly and modified as required.

Underwriting a new credit card account consists of three decisions — whether to grant the credit request; if granted, how high a credit line should be assigned; and what pricing should be applied. Synchronization of these decisions is essential to managing a profitable portfolio, as mismanagement of one element can have an adverse effect on performance. Fitch reviews the underwriting area to determine what credit scoring, line assignment, and pricing methods are being used, whether they are customized, and if they are employed effectively and validated regularly. The ability to incorporate prior program results and vintage data as part of an iterative process is also evaluated. Best-in-class seller/servicers have integrated credit-scoring segmentation schemes, in which multiple scores (for example, chargeoff, bankruptcy, profit, and attrition scores) are considered in conjunction with one another rather than applying discrete score cutoffs. This approach enables the underwriting team to depict a multidimensional view of the applicant in which negative attributes can be offset by positive ones.

Fitch also reviews the ability of the seller/servicer to furnish the applicant with a suitable credit product. Some seller/servicers are quick to reject applicants that have blemished credit records, while others have instituted downsell processes, which enable the seller/servicer to approve the applicant by providing a product with appropriate terms. In addition, these processes may entail a request for more information and judgmental review by credit analysts. While downsell may seem like a simplistic concept, it can become especially effective when continuously refined. A set of well-developed downsell processes can allow the seller/servicer to increase the return on its investment by increasing approval rates, boosting profitability, and developing customer loyalty.

Thorough and timely reporting facilitates forecasting and responsiveness to market changes. While a certain proficiency in generating management information system (MIS) reports is necessary for compliance reasons, best-in-class seller/servicers are able to use their in-house data to improve the management and growth of their portfolios. Fitch evaluates samples of management reports, such as vintage analysis and responder characteristics, as well as the underlying reporting system, in its analysis.

When an issuer is engaged in acquiring or servicing portfolios originated by third parties, Fitch evaluates

the portfolio integration process. In standard cases, the integration process encompasses initial contact with the client company and due diligence to new account setup, data conversion, and post-implementation arrangement. The acquirer's responsibility generally includes the transition of acquired accounts from the conversion implementation group to the account maintenance group, as well as notification of new loan terms to cardholders.

Fitch's review of an issuer's origination platform also focuses on the safeguards or risk management processes governing portfolio acquisitions. Fitch expects acquirers to evaluate purchased accounts against acquisition criteria and take actions where necessary, including immediate closure of accounts, suspension of purchase of cash advance activity, modification of credit lines, and pricing adjustments where appropriate.

Servicing and Account Maintenance

Account Maintenance/Management

Fitch views account management as a critical component/function in a credit card issuer's operation. Credit cards are revolving products that must be continuously underwritten by the seller/servicer to reduce not only the number of accounts charged off but also the balances associated with them. Alternatively, issuers must continue to offer existing accountholders competitive terms or risk losing them to competitors. This balancing act is accomplished through the account management infrastructure, which allows the seller/servicer to reset product terms periodically, including account pricing, credit line adjustments, or to prohibit further usage. The following are several factors and quantitative metrics considered in Fitch's account management review:

- Product life cycle management.
- Account activation and retention.
- Pricing and yield management.
- Credit line management.
- Authorization strategy.
- Frequency of scorecard validation.

Account management policies rely heavily on risk and marketing segmentation schemes. A comprehensive approach to customer segmentation will incorporate behavioral attributes and various scores, including credit bureau, behavior, bankruptcy, profit, and attrition scores, and enable the seller/servicer to make both proactive and reactive decisions for each account. Additionally, account management policies and scoring considerations differ from credit screening at

origination, with issuers placing greater emphasis on an account's historical performance. Fitch reviews the use of these scores to determine the level of integration, their maintenance and validation schedules, and the frequency with which the scores are updated at the account level.

Management of a revolving credit facility requires vigilant efforts to retain balances and accounts. As with the initial underwriting decision, it is possible to create adverse selection within the portfolio as a result of uncompetitive account management practices. Fitch reviews the strategies for balance growth and retention, such as rewards programs and incentive and promotional pricing, as well as customer relationship management activities, such as cross-selling and account linking.

As credit cards have become more attainable, customers have become more price sensitive. Revenue is derived from interest and non-interest income, such as late fees, overlimit fees, and annual fees, among others. As competition and a low interest rate environment have depressed interest yield, seller/servicers have become more reliant on fee income. In addition to fee schedules and annual percentage rate distributions, Fitch reviews the seller/servicer's approach to yield management regarding penalty pricing, payment hierarchies, and minimum payment calculations, as well as its compliance with Federal Financial Institutions Examination Council (FFIEC) guidelines.

Credit lines must be monitored to ensure that they are high enough to service the customer's needs while low enough to facilitate repayment. Most seller/servicers employ sophisticated automated decision models to make credit line adjustments. Fitch expects seller/servicers to monitor available credit and reduce lines for deteriorating accounts. On the other hand, measured line increases should be given to customers with good credit profiles over time.

It is important for the seller/servicer to have proper safeguards in place to prevent additional usage of the card by cardholders with deteriorating credit profiles. The authorizations policy should be very highly automated; some seller/servicers have implemented scores that are updated after each transaction to improve both credit and fraud losses. Fitch believes the overlimit authorizations policy should make provisions for cardholder emergencies and hardship but otherwise not be too accommodative. Regulators are increasing scrutiny on seller/servicers with

chronically overlimit accounts, whereby the customer incurs an overlimit fee (generally \$25–\$35) each month. Proposals requiring structured repayment of the overlimit amount over a short period have been made. Overlimit fees are an important revenue component for some seller/servicers, and Fitch will continue to monitor the situation to determine the impact of any regulatory change that occurs.

As in originations, well-executed program tracking and portfolio MIS reports can create a competitive advantage. Fitch reviews sample reports from each area of account management and determines how the results are incorporated into strategy and policy changes.

Customer Service

Fitch views customer service operations as a key servicing component, as it represents a valuable direct link with customers that can either enhance an issuer's relationship with an accountholder or damage it and drive high levels of voluntary account attrition. While this function is largely engaged in handling inbound customer inquiries and disputes with a goal of maintaining customer satisfaction, in recent years, it has also grown into a valuable marketing and risk management platform. In evaluating customer service operations, Fitch focuses on the quality, efficiency, and consistency of processes, as well as supporting information technology (IT) and human resources in place and whether customer service functions are undertaken internally or outsourced. The following are several factors and quantitative metrics considered by Fitch in its customer service evaluation:

- Customer service strategy.
- Management and reporting infrastructure.
- Overall customer service technology.
- Correspondence and dispute handling.
- Average hold time.
- Percentage of calls resolved by voice response unit (VRU).

Fitch believes the effective use of automation and real-time decision-making tools is critical in achieving customer satisfaction in today's credit card marketplace. Most customer service operations are supported by an automated call routing/distribution system that effectively routes incoming calls to available customer service representatives (CSRs). Once the call reaches the CSR, customer inquiries and transactions are processed with the help of graphical user interfaces. These applications present CSRs with information in a logical flow and user-

friendly manner, thereby eliminating the need to hunt for account data across IT platforms. In addition to reducing call-handling times, this automation provides for greater consistency in interacting with the account holder and assists in controlling/managing compliance with stated policies and procedures.

Automation also has allowed customer service platforms to take on growing marketing and risk management activities. For marketing, CSRs in many operations are not only expected to satisfy a customer inquiry but also to cross-sell financial, insurance, or reward products to defined customer populations. On the other hand, issuers have also added special skill groups to manage inquiries by higher risk groups, and most CSRs can take payments by phone.

With expense control and efficiency as growing considerations, many credit card issuers are expanding their use of VRUs and dedicated internet web sites to handle most routine inbound customer service calls. These technologies are available 24 hours per day, seven days per week and allow customers to receive balance, payment, and credit information, to request statements, and even to make a payment without human interaction. Additionally, when CSR interaction is required, VRUs have been enhanced to more efficiently route inbound calls to the appropriate departments and skill levels.

Fitch expects issuers to maintain a formal framework to monitor customer service performance and evaluate standards. At most credit card operations, this is accomplished through the use of multiple tracking and reporting systems, which are employed to ensure that service quality and efficiency standards are achieved and maintained. Compliance with established standards should be measured at regular intervals with a goal of continuous improvement.

Fitch also evaluates the customer service management structure and staffing levels, as well as processes used to monitor CSR compliance with internal policies and procedures and legal and regulatory requirements. A consideration in this review is the IT security environment — how CSR data access is governed, system security clearance requirements, and other safeguards against internal fraud. Monitoring CSR calls in real time or through call-recording applications (for example, Witness or E-Talk) and focused audits is also an integral part of the compliance/management process for most issuers.

While customer service operation sites often are managed separately, Fitch expects customer service strategies to be centralized. At the site level, monitoring and reporting systems should track timing and call volume used in adjusting capacity.

Fitch also reviews issuers' third-party correspondence and dispute resolution strategy, operations, reporting, and performance. Areas of focus include issuer tracking of complaints/disputes, historical volume, and trends, as well as average response times. In recent years, many issuers have established dedicated units to handle customer disputes and complaints and inquiries from third parties, including the Better Business Bureau, Federal Reserve, Federal Deposit Insurance Corporation, U.S. Department of Consumer Affairs, and state attorney general offices. In such cases, Fitch reviews the composition of these units and formal processes employed to achieve a final resolution with the customer/agency, as well as the documentation requirements involved.

Billing and Payment Processing

Processing operations encompass many behind-the-scenes but vital functions for credit card issuers. These functions include processing and authorization of transactions, processing credit card applications, embossing cards for new and existing customers, preparing/printing cardholder billing statements and promotional material at mail facilities, and processing payments and posting them to cardholder accounts. Issuers handle these functions in-house, outsource them to third parties, or employ some combination of the two strategies. As part of the review process, Fitch focuses on the efficiency and effectiveness of processes and policies in place governing these various functions, as well as supportive IT and MIS reporting. The following are several rating factors and quantitative metrics considered in Fitch's review:

- Efficiency of payment processing.
- Exception processing.
- Bank statement reconciliation.
- Process and control environment.
- IT, MIS reporting, and outsourcing.

Most credit card issuers are members of VISA and MasterCard (together, the associations) and are subject to the rules of those associations, including a capital requirement based on the merchant credit card processing volume. Each time a credit card is submitted for payment, the information is transmitted to the associations and routed to the issuing bank to obtain an authorization decision. The details of the transaction are captured by the system so they can be

included on the billing statement. The association sets performance standards and benchmarks for efficiency and accuracy for the credit authorization tasks. Fitch requests and reviews performance and compliance reports but expects to find largely homogeneous results.

In addition to gauging the timeliness, efficiency, and accuracy of the statement-generation process, Fitch examines it to determine how marketing opportunities are being incorporated, potential customer service issues are addressed, and cardmember benefits are communicated. To improve cost efficiency, some seller/servicers are devising ways to issue a comprehensive customer statement (i.e. just one statement for several accounts or products). A sophisticated approach to statement generation can enable a seller/servicer to transform what traditionally has been a cost center into a revenue-producing section. Some seller/servicers include cross-sell offers for other products, can print customized messages on the statement, and derive additional revenue from products advertised via statement inserts.

Payments may be received in person (for example, submitted at a branch or a retail store), by mail, by internet, or by wire transfer. Fitch evaluates the operations flow for payment submission, mail collection, and processing. Fitch explores whether the billing and payment receipt platform is viable under certain failure scenarios. Potential for concern may arise from a lack of geographic dispersion (for example, sending all payments to a single post office) or a high dependence on in-person payment submission.

The automation required for the rapid and efficient creation, processing, handling, storage, and retrieval of information has become increasingly complex. These capabilities require significant development efforts, capital expenditures, and processing expertise and have caused many credit card issuers to outsource processing functions. The third-party processing arena is dominated by two large data processing companies: First Data Resources, a unit of First Data Corporation; and Total Systems. Both companies offer a wide array of services, including transaction authorizing and posting, statement generation and printing, card embossing, fraud and risk management services, and settlement.

Benefits to outsourcing include reduced costs, efficiency gains, and improved portfolio portability or transferability. However, outsourcing challenges

include a lower level of customization and flexibility relative to in-house platforms, particularly for smaller operations, and the need for an outsource oversight function to ensure the continued quality and effectiveness of the tasks.

Investor Reporting and Remittance

Fitch also recognizes the importance of the financial reporting function, as it represents a critical link between the seller/servicer, investors, and the trustee. As a result, Fitch focuses on the policies, systems, and controls that govern the investor reporting and remittance functions. Performance is measured for accuracy and timeliness. Fitch queries its own Performance Analytics team to obtain its perspective on the quality and timeliness of servicer reports. The following are several factors and quantitative metrics considered by Fitch in its review process:

- Compliance monitoring.
- Trustee monitoring and dialogue.
- Accounting and cash management.
- Supportive IT and automation.
- Accuracy of servicer reports and waterfall distribution.

When reviewing this area, Fitch examines its position within the organizational structure, reporting lines, management oversight, and functional responsibilities. Fitch also reviews the risk management or control environment in place, including the segregation of responsibilities, internal audits, securitization-related compliance audits, and IT security requirements.

While acknowledging the valuable role trustees play in ABS transactions, Fitch recognizes that the ability to administer and manage trust accounts is more significantly influenced by the process and control environment for seller/servicers than for trustees. As such, Fitch reviews the policies, processes, and procedures for each function, including account reconciliation and investor report generation and distribution. Fitch also examines reporting and remittance handling/tracking and occurrences of late investor reporting. Additionally, the quality of communication with the trustee is evaluated, including the discrepancy resolution process.

Fitch also assesses the level of automation employed in the cash management and investor reporting functions. Varying levels of automation may be present related to gathering internal data, distributing reports, data modeling, and utilization of verification, management, and manipulation tools. While not a requirement for solid performance, Fitch believes the

proper use of automation can benefit reporting accuracy by reducing human error substantially. Similarly, issuers can boost reporting timeliness by filing reports electronically or making them available to investors on dedicated web sites.

Collection, Loss Mitigation, and Default Loan Management

The effectiveness of a servicer's collection and default management operations is one of the key determinants of the performance of any ABS portfolio. While it cannot eliminate or cure weak performance of poorly originated collateral, Fitch recognizes that a well-organized collection strategy that employs effective loss mitigation tools certainly can reduce loss severity. Consequently, Fitch assigns significant weight to a servicer's effectiveness in loss mitigation, collections, and recovery. The following are several factors and quantitative metrics considered in Fitch's collections and loss mitigation review process:

- Effectiveness of contact and collection strategy.
- Use of specialized collection programs.
- Collections IT.
- Management and reporting infrastructure.
- Delinquency roll rates.
- Treatment and payment plan recidivism.
- Recovery rate.

The seller/servicer must decide how best to deploy its collection resources to obtain the maximum return. Most shops are subdivided into teams handling early-, middle-, and late-stage delinquencies, as well as post-chargeoff and bankruptcy cases.

Given that some cardholders inadvertently miss a monthly payment, prioritizing early-stage delinquencies is important from a cost and resource perspective. As such, in constructing calling campaigns, lenders use account management segmentation, prior behavior, and customized collections scores. Through these and other tools, they can distinguish the low-risk slow payers from accounts with either an inability or unwillingness to pay and prioritize them in the collection queue. Early-stage delinquency collection activities generally include statement messages, automatic letter dunning, and direct calls.

Collection efforts cannot begin in earnest until the servicer is assured of customer contact. Fitch expects seller/servicers to make use of contact management tools and methods to improve their efficiency. Most card issuers have boosted productivity by integrating predictive dialer technology with internal collections

systems and other third-party applications. These applications allow delinquent accounts to be segmented according to various risk assessments — for instance, by delinquency bucket, dollar amount due, or internal risk score — queued and automatically dialed in order of priority.

When a right-party contact is made, the collector is automatically connected and the account information displayed. Predictive calling software enables servicers to categorize accounts and devise staffing levels for each shift. Call-blending technology lets agents manage both inbound and outbound calls, limiting downtime by forwarding calls to available agents. There are new developments within skip tracing, which help collectors find debtors who have moved and have not provided current contact information. As part of its review process, Fitch reviews issuer automated contact management solutions and other supportive technology in place.

Not surprisingly, collection efforts generally escalate in intensity as an account cycles into a more advanced delinquency category. For middle- to late-stage delinquencies, the collections representative may be able to provide a modified payment plan to help the cardholder become current. The plan may include a reduction in the interest rate and waiver of certain fees, in addition to a structured payment schedule. If the delinquent balance is fully or partially repaid, the cardholder may be re-aged, which is defined as a manual or systematic adjustment to an account's delinquent status or past due amount that results in a lessened state of delinquency. Credit card issuer re-aging policies are well defined and generally governed by FFIEC guidelines (which also govern chargeoff, bankruptcy, fraud, and deceased accounts). Fitch reviews the issuer's automated and manual re-aging process, as well as compliance with established policies and procedures.

The effectiveness of the payment plans can be gauged by examining the unit and dollar loss rates compared with rates for a control group and weighing the results against the cost and effort involved in extending the payment plans. In some situations, the cardholder will be unable to pay the entire amount owed. In this case, the lender may settle for a portion of the amount, close the account, and write off the unpaid amount. As part of its review, Fitch assesses the use and performance of re-aging practices, payment plans, and settlements.

If a cardholder does not pay and does not declare bankruptcy, lenders usually will write off the debt within 180 days. After that time, collections efforts will cease and recovery efforts will begin. Recovery focuses on getting all or some portion of the debt from the consumer using legal and other means. Fitch reviews the account assignment policy and the use of specialized recovery agencies. Many companies outsource a portion of their collection and recovery efforts to agencies or attorney networks, while others sell accounts that conform to a certain profile. Fitch discusses with the servicer how companies are selected for outsourcing, how agency performance is monitored, and how accounts are selected to be sold.

Reporting and MIS reports are essential to collections due to the number of test strategies that are usually deployed. Fitch expects the seller/servicer to provide timely and thorough analysis for all collection areas and will specifically review roll rate reports. Delinquency data should be reviewed by collection staff on a daily basis, with aggregate portfolio reporting provided to senior managers via performance-tracking reports, audit reports, production reports, and online policy manuals. The relative success of different collection strategies that are performed simultaneously should be measured by issuers actively through champion/challenger strategies.

Fitch reviews the quality control processes in place to track collector activities. At most operations, collectors are monitored regularly through a combination of methods, including: silent monitoring; side-by-side sitting; random call recording; or focused group audits.

Topics Common to Origination and Servicing

Staffing and Training

Maintaining a stable and efficient work force is a critically important challenge for the credit card industry. Many credit card operation sites are concentrated geographically, which creates competition for the best employees. Recruitment and hiring of staff depend on the type of position being filled. The marketing, credit risk management, credit policy, and finance areas typically consist of salaried employees, while in the operations areas, such as account solicitation, underwriting, customer service, and collection, credit card issuers typically employ thousands of hourly staff. The human resources group

must select candidates with a proper skill set and ability to fit in to the work environment.

To assess the relative success of the recruitment and hiring process, Fitch reviews the number of open positions, length of staff vacancies, and average tenure and turnover rates for different areas. The following are several qualitative factors and other quantitative metrics considered by Fitch as part of its staffing and training evaluation:

- Hiring and retention strategies.
- Performance-monitoring systems.
- Turnover rates.
- Supervisor-to-staff ratios.
- Staffing composition, including full-time equivalents, part-time equivalents, and seasonal.

For comparative purposes, Fitch examines the seller/servicer's training plan and how effectively it integrates various types of training to maintain a viable work force. Training consists of skills-based training, as well as compliance training. Much of it may be done on the job, but for new employees in the operations area, usually there is an orientation program that must be completed before a new employee begins to work with customers. Fitch also inquires about the prevalence and success of internal management development programs. Development activities are provided by in-house programs, vendor-delivered programs, or tuition reimbursement programs. Fitch reviews the duration and content of the orientation training, frequency of follow-up training development, and average amount of training and development each employee receives per year by functional area.

Fitch expects seller/servicer compensation structuring to be competitive and protect against adverse selection of employees. Compensation varies for different geographical areas and different job functions; as such, Fitch may inquire about compensation studies and employee satisfaction studies to determine management's attention to this area. Fitch also reviews collector incentive compensation structures to ensure they are prudent and properly aligned with collection strategies.

Performance management programs should provide a framework for each employee for job requirements, specific objectives and goals, formal assessment, and feedback. The goal is to quantify and categorize employee performance while giving employees the feedback necessary for them to improve their contributions. Fitch reviews the performance

management system to determine the frequency of reviews, the way employees are rated, and the effectiveness in identifying both good and bad performers.

An emerging trend in the industry is to outsource, in some cases offshore, certain functions that traditionally have been performed in-house, such as customer service and collections. While outsourcing may provide a cost benefit to the company, operational risks unique to such an arrangement may arise. In Fitch's opinion, excessive reliance on third-party vendors may introduce incremental elements of risk to an organization and, therefore, requires additional scrutiny. Fitch's review of seller/servicer outsourcing practices will focus on the following:

- Functions outsourced.
- Vendor concentrations.
- Quality control systems in place.
- Training of offshore staff.
- MIS reporting.
- Contingency planning.

Technology

Effective use of technology is essential to the success of credit card operations. Sophisticated loan-servicing systems, credit scoring and modeling, automated decision support systems, and web-based applications are available readily and utilized by most credit card seller/servicers. Fitch's review includes determining the primary functionality of all systems that are critical to the core origination and servicing functions, such as solicitation, underwriting, account maintenance, collections, and loss mitigation. To evaluate the effective use of technology in the larger corporate context, Fitch considers management's strategic policy on IT, as well as the experience of technology staff and

timeliness of updates and enhancements. Other issues reviewed include:

- Degree of automation and integration.
- Report-writing capability.
- Disaster recovery plans.
- Internet and web site availability for related parties.
- Quality control of outsourced or offshore operations.

The use of the internet is becoming increasingly important in the credit card business. The web site can be used not only as a marketing tool but also as a means to disseminate pertinent information to cardholders and investors. Fitch assesses the robustness, versatility, and interactive capabilities of a servicer's web site.

Because of the high reliance on technology involved in credit card origination/servicing, a seller/servicer must have a strong plan in place to curtail the amount of time critical systems are offline. Fitch reviews disaster recovery plans and test results and business resumption plans to ensure adequacy and completeness.

■ Scorecard and Weightings

Fitch's credit card seller/servicer rating evaluation is divided into three broad segments: corporate performance; origination; and servicing. Within each segment, there are category groupings that pertain specifically to the segment. In turn, these criteria groups each contain several individual components, or rating factors. Each rating factor is scaled from 1 to 5, with 1 being the highest. Each factor is assigned a relative weight to generate a category score. Additionally, these category scores are assigned relative weights to determine the overall credit card seller/servicer ratings.

■ **Appendix: Fitch Seller/Servicer Rating Scale**

The ABS seller/servicer rating scale is designed to provide investors and other market participants with a tool to differentiate between various seller/servicers, as well as many best practices in the industry. The ratings are based on Fitch’s review, evaluation, and analysis of the company’s ability to manage operational risks in accordance with regulatory guidelines, industry standards, and origination/servicing agreements.

Level One — Fully Acceptable (With Overall Superior Performance)

- ‘ABPS/S1 (Seller/Servicer)’
- ‘ABPS/S1 (Seller)’
- ‘ABPS/S1 (Servicer)’

ABS seller/servicers receiving rating level one have achieved high scores in all areas of assessment. Specific origination/servicing requirements and market environments differ by product type, but level one-rated companies have an established and successful business record. These ABS sellers/servicers commonly have experienced management and company history of successful operations over a period of time, demonstrating their ability to deal with market and regulatory changes. They demonstrate proactive and comprehensive management of operational risks, including compliance with all major industry-related regulations. These companies have a strong and stable financial standing, supported by an investment-grade debt rating for the company (or its parent) and/or sound financials for at least three years. In addition, level one-rated companies have attained high assessments in all other areas of evaluation.

Level Two — Fully Acceptable (With Noted Strengths)

- ‘ABPS/S2 (Seller/Servicer)’
- ‘ABPS/S2 (Seller)’
- ‘ABPS/S2 (Servicer)’

ABS seller/servicers that receive Fitch’s level two rating have demonstrated satisfactory performance for all rating criteria. In addition, this designation indicates that the seller/servicer has noted strengths in several of these criteria. Such companies are generally successful, stable, and efficient, with a solid management and employee base, supported by successful training programs and strong financial resources. The company’s inability to attain a level one rating may be due to a short history or other factors that may need further refining or enhancement to fully develop. However, these seller/servicers have demonstrated that they have accomplished a

high level of performance, risk mitigation, and operational excellence.

Level Three — Fully Acceptable

- ‘ABPS/S3 (Seller/Servicer)’
- ‘ABPS/S3 (Seller)’
- ‘ABPS/S3 (Servicer)’

Level three ratings represent Fitch’s full acceptance as an ABS seller/servicer, with overall acceptable levels of performance in Fitch’s evaluation scheme. The seller/servicer receiving this rating has demonstrated an adequate capacity to originate and service portfolios in accordance with industry standards and investor and securitization agreements.

Level Four — Qualified Acceptance

- ‘ABPS/S4 (Seller/Servicer)’
- ‘ABPS/S4 (Seller)’
- ‘ABPS/S4 (Servicer)’

ABS seller/servicers at level four have shown originating/servicing proficiency comparable to level three standards. However, some area of operation requires continued surveillance. Servicers at this rating level may not be acceptable for ABS transactions, unless additional support or structural features are incorporated. Situations that could cause a level four rating for an otherwise fully acceptable servicer include: limited time originating/servicing a particular product type; or a recent event, such as a merger, acquisition, management change, and/or system conversion. Other issues are high management or staff turnover or major litigation relating to operational risks. A level four seller/servicer may be upgraded to level three, if the circumstances in question are positively resolved, as long as all other features of the operation remain consistent.

Level Five — Not Acceptable

- ‘ABPS/S5 (Seller/Servicer)’
- ‘ABPS/S5 (Seller)’
- ‘ABPS/S5 (Servicer)’

Seller/servicers that receive a level five rating have failed to meet commonly accepted industry standards and benchmarks. Fitch has concerns with some aspects of their operation, operational risk management, personnel, or financial condition. They have not demonstrated sufficient performance capabilities in origination or servicing to meet investor and/or securitization requirements. Seller/servicers at this level are considered not acceptable for ABS by Fitch.

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