ABCs of Credit Card ABS

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Fitch IBCA

Over the past several years, competition in the U.S. credit card industry has been fierce. This competition has led many banks, including large, full-service institutions, to lose customers to issuers that are aggressively expanding their card portfolios. Some of the more visible winners of this competition are Capital One Bank, Citibank, First USA Bank, N.A., Fleet Bank (formerly Advanta), Household Bank, N.A., MBNA America Bank, N.A., and Universal Card (formerly AT&T). The tremendous volume of card loans generated has created an equally immense need for inexpensive, reliable funding. For many of these institutions, securitization has fulfilled this need.

I. CREDIT CARDS

The credit card market has grown significantly in the last eight years, increasing from $234 billion of total receivables outstanding in 1990 to $356 billion outstanding as of May 31, 1998. This growth came from continual reliance on credit cards by consumers, along with more acceptance of cards by merchants and service providers, such as doctors and grocery stores. In addition to growth of outstanding receivables, a wide diversity in the types of cards being issued has developed.

A. Affinity Cards

Affinity programs target members of groups sharing common interests. For example, associations of medical professionals, fans of auto racing, or alumni of the same university can have the logo of their association, a picture of their favorite driver, or their school seal on credit cards. This group loyalty builds a bond to the card. MBNA is the standout issuer of affinity cards, followed by First USA Bank.

B. Low-Price Cards

This issuer's strategy is to attract an interest ratesensitive borrower with a low "teaser" rate offer, run up the borrower's balance quickly by offering instant and easy transfers of existing credit card balances from other banks, and keep the cardholder with competitive "go to" rates after the introductory period has ended.

To be successful in the low-price business, an issuer must have sophisticated risk-based pricing computer models to determine the rate it can offer to a particular market segment based on that segment's risk profile. Fleet Bank, Capital One, and First USA Bank have grown their portfolios dramatically using this strategy.

C. Co-Branded Cards

Many companies, especially automobile manufacturers, airlines, and telephone companies, have allied with card-issuing banks to jointly market cards. The intent is to promote the company's product and increase receivables for the bank. These co-branded cards reward...
the cardholder for usage. The rewards may be rebates on new car purchases, free airline tickets, or discounts on long distance telephone calls. This program also provides an incentive for cardholders to pay their bills on time, since the reward benefits will be revoked if the cardholder becomes delinquent. Household and General Motors Corp. (GM), Citibank, N.A. and American Airlines, and Chase Manhattan and Shell Oil Co. are several joint ventures in the co-branded arena. Each program has different arrangements for expense and revenue sharing.

D. Discover Card

Discover is the only significant issuer of general purpose credit cards to successfully break into the U.S. market without relying on Visa or MasterCard associations. Discover developed its own merchant network across the U.S. 13 years ago and, since then, has achieved notable market penetration. The barriers to entry into this arena are high due to significant start-up costs and intense competition. Discover's card has been extremely successful because of the company's cash rebate for purchases strategy and clear, simple pricing structure.

E. Retail Cards

Many retail stores offer their customers the choice of using a national credit card or the store's own card. An advantage to cardholders of using store cards is that available credit on the customers' other cards is not used up, allowing cardholders to "compartmentalize" their debt burden. For example, a consumer might use a Sears, Roebuck and Co. card to purchase a new refrigerator and pay it off evenly over time without using up a Visa or MasterCard line. The retailer benefits by building customer loyalty and increasing the profitability of its lending operation.

F. Other Cards

Travel and entertainment cards, such as American Express and Diners Club, and full-service cards, like Citibank and Chase Manhattan Bank, round out the spectrum of card types.

II. SECURITIZATION

As with credit cards, the use of securitization as a financing tool has increased in volume and importance. The first deals were done in 1987 to diversify sources of bank funding. As the banks came under pressure to free up on balance sheet capital in 1990 and 1991, securitization filled that need. (Bank regulators treat securitization as asset sales.) More recently, securitization has been the primary funding source for specialized credit card banks. These banks, such as Fleet Bank, Capital One, First USA Bank, and MBNA, benefit from funding at 'AAA' rates and low capital charges and, in some cases, rely on off balance sheet treatment to meet....
regulatory requirements. Without securitization, some of these banks could not have grown as rapidly. As of May 31, 1998, more than $216 billion in credit card securities had been issued.

A. Stand-Alone vs. Master Trust

A vast majority of card securitizations have been completed using two different vehicles – the stand-alone trust and the master trust. The former is simply a single pool of receivables sold to a trust and used as collateral for a single security, although there may be several classes within that security. When the issuer intends to issue another security, it must designate a new pool of card accounts and sell the receivables in those accounts to a separate trust. This structure was used from the first credit card securitization in 1987 until 1991, when the master trust became the preferred vehicle.

The master trust structure allows an issuer to sell multiple securities from the same trust, all of which rely on the same pool of receivables as collateral. For example, an issuer could transfer the receivables from one million accounts (representing $1 billion of receivables) to a trust, then issue multiple securities in various denominations and sizes. When more financing is needed, the issuer transfers receivables from more accounts to the same trust. It can then issue more securities. The receivables are not segregated in any way to indicate which series of securities they support. Instead, all the accounts support all the securities.

This structure allows the issuer much more flexibility, since the cost and effort involved with issuing a new series from a master trust is lower than creating a new trust for every issue. In addition, credit evaluation of each series in a master trust is easier since the pool of receivables will be larger and not as subject to seasonal or demographic concentrations. For example, if an issuer transferred only receivables from accounts originated in 1989 into a stand-alone trust and the next year transferred all the receivables from 1990 accounts into a different trust, the two would perform differently based on the underwriting standards used, the terms (annual payment rate [APR] and minimum monthly payment) offered, and the competing offers available at that time.

If a master trust had been used in the same example, both series would depend on the same pool of accounts, one-half of which were originated in 1989 and one-half of which were originated in 1990. Credit differences between the two series would be contained in the structure of the deal, rather than the receivables. Investors must keep in mind, however, that the makeup of accounts in a master trust pool may change dramatically over time as new accounts are added and as some existing cardholders cancel or stop using their accounts.

Other efficiencies can be included in a master trust, including sharing of principal and sharing of excess spread (see Master Trust Features, Exhibit 9). In addition to issuing investor securities, every seller is required to maintain an ownership interest in the trust. This participation performs several critical functions. It acts as a buffer to absorb seasonal fluctuations in credit card receivables balance, is allocated all dilutions (balances canceled due to returned goods) and fraudulently generated receivables that have been transferred to the trust, and ensures that the seller will maintain the credit quality of the pool since the seller owns a portion of it. To ensure that the certificate holders’ invested amount is always fully invested in credit card receivables, the size of the seller’s participation must remain at or above a minimum percentage of the trust receivables balance, usually 7%. The seller’s participation does not provide credit enhancement for the investors.

The seller is obligated to add credit card accounts to the trust if the amount of its participation falls below the required minimum. If the seller cannot provide additional accounts, an amortization event will occur (see Amortization Triggers, Exhibit 5). In most circumstances, the seller must receive rating agency approval before any accounts can be added. Sellers do not need approval when the addition is a small percentage of the trust (10%-15%) or when the minimum seller’s participation level has been breached. Of course, rating agencies will receive notification of these events.

III. STRUCTURES

Regardless of whether the trust is a stand-alone or a master trust, the same general structure is used for every deal. The typical setup has three different cash flow periods: revolving, controlled amortization (in some cases, controlled accumulation), and early amortization. Each period performs a different function and allocates cash flows differently. This structure is designed to mimic a traditional bond, in which interest payments are made every month and principal is paid in a single “bullet” payment on the maturity date.

Since the average life of a credit card receivable is a short five to 10 months, an amortizing structure, like the ones used in automobile and mortgage deals, does not work very well. In this type of structure, the principal and interest collections on the pool of loans are passed directly through to investors on a monthly basis. An amortizing structure for credit card-backed securities would result in a short average life and lumpy, unpredictable repayment to investors. Use of a revolving
Exhibit 2. Controlled Amortization

- Senior Investor
- Subordinate Investor
- Seller

Exhibit 3. Controlled Accumulation

- Senior Investor
- Subordinate Investor
- Seller

structure gives the issuer medium- to long-term financing, and it gives the investor a predictable schedule of principal and interest payments.

All collections on the receivables are split into finance charge income and principal payments. Each of the three periods treats finance charge income in the same manner. Monthly finance charges are used to pay the investor coupon and servicing fees, as well as to cover any receivables that have been charged off in the month. Any income remaining after paying these expenses is usually called excess spread and is released to the seller. Principal collections, however, are allocated differently during each of the periods.

A. Revolving Period

During the revolving period, monthly principal collections are used to purchase new receivables generated in the designated accounts or to purchase a portion of the seller’s participation if there are no new receivables. If there are not enough new receivables to reinvest in, an early amortization will be triggered because the seller’s participation has fallen below the required minimum, or, in some cases, the excess principal collections will be deposited in an excess funding account and held until the seller can generate more credit card receivables. The risk of early amortization gives the seller adequate incentive to maintain the seller’s participation at a level well above the minimum. The revolving period continues for a predetermined length of time, which has ranged from two to 11 years. Investors will receive only interest payments during this period.

B. Controlled Amortization/Accumulation

At the end of the revolving period, the controlled amortization or controlled accumulation period begins. In the case of controlled amortization (see Exhibit 2), which typically runs for 12 months, principal collections are no longer reinvested but are paid to investors in 12 equal controlled amortization payments. The payments are sized at exactly one-twelfth of the invested amount so investors can be repaid on a predetermined schedule. (Some series may have longer or shorter controlled periods and, thus, will have smaller or larger controlled amortization payments.) Any principal collected in excess of the controlled amount will be reinvested in new receivables, as in the revolving period. Interest will be paid only on the outstanding amount of securities as of the beginning of the monthly period.

Controlled accumulation follows a similar procedure, except that the controlled payments are deposited into a trust account, or principal funding account (PFA), every month and held until the expected maturity date. At the end of the accumulation period, the full invested amount will have been deposited into the PFA and investors will be repaid their principal in a single payment (see Exhibit 3). Of course, interest payments will be made each month on the total invested amount. With this structure, investors will not see any difference in monthly payments when the deal converts from revolving to accumulation.

C. Early Amortization

Severe asset deterioration, problems with the seller or servicer, or certain legal troubles can trigger early amortization at any point in the deal, whether it is
to insulate investors from fluctuating payment patterns and cardholder chargeoffs. Common forms of credit enhancement are excess spread, a cash collateral account (CCA), a collateral invested amount (CIA), and subordination. Most recent transactions use a combination of enhancements, the most common being senior/subordinate/CIA.

A. Excess Spread

The yield on credit cards, which is high relative to other types of consumer loans, should cover the payment of investor interest in addition to the servicing fees and still be sufficient to reimburse the trust for any receivables charged off during the month. The remaining yield, or excess spread, provides a rough indication of the financial health of a transaction.

Available excess spread may be shared with other series, used to pay fees to credit enhancers, deposited into a spread account for the benefit of the enhancers, or released to the seller.

If the deal is performing as expected, the cash flow from the pool of credit cards will be sufficient to make all principal and interest payments to investors and to pay all expenses, with plenty of excess remaining. In the example of Exhibit 4, the 4% excess spread would have to be depleted (i.e., decrease in yield, increase in coupon, and/or increase in chargeoffs) before there would be a cash shortfall. If, however, excess falls below zero, other credit enhancement must be available to make up the shortfall.

B. Cash Collateral Account

A CCA is simply a segregated trust account, funded at the outset of the deal, that can be drawn on to cover shortfalls in interest, principal, or servicing expense for a particular series if excess spread is reduced to zero. The account is funded by a loan from a third-party bank, which will be repaid only after all classes of certificates of that series have been repaid in full. Cash in the account will be invested in the highest rated short-term securities, all of which will mature on or before the next distribution date. Draws on the CCA may be reimbursed from future excess spread.

C. Collateral Invested Amount

The CIA represents an uncertificated, privately placed ownership interest in the trust, subordinate in payment rights to all investor certificates. Acting like a layer of subordination, the CIA serves the same purpose as the CCA; it makes up for deficiencies if excess spread is reduced to zero. The CIA is traditionally placed with banks, which may require investment-grade ratings on

**Exhibit 4**

<table>
<thead>
<tr>
<th>Gross Portfolio Yield</th>
<th>18%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor Coupon</td>
<td>7%</td>
</tr>
<tr>
<td>Servicing Expense</td>
<td>2%</td>
</tr>
<tr>
<td>Chargeoffs</td>
<td>5%</td>
</tr>
<tr>
<td>Excess Spread</td>
<td>4%</td>
</tr>
</tbody>
</table>

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Exhibit 5. Amortization Triggers

<table>
<thead>
<tr>
<th>Seller/Servicer</th>
<th>Covered by</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Failure or inability to make required deposits or payments.</td>
<td>1, 2, and 3</td>
</tr>
<tr>
<td>2. Failure or inability to transfer receivables to the trust when necessary.</td>
<td>4</td>
</tr>
<tr>
<td>3. False representations or warranties that remain unremedied.</td>
<td>5 and 6</td>
</tr>
<tr>
<td>4. Certain events of default, bankruptcy, insolvency, or receivership of the seller or servicer.</td>
<td></td>
</tr>
</tbody>
</table>

**Legal**
5. Trust becomes classified as an investment company under the Investment Company Act of 1940.

**Performance**
6. Three-month average of excess spread falls below zero.
7. Seller’s participation falls below the required level.
8. Portfolio principal balance falls below the invested amount.

Fitch IBCA believes these basic triggers address all possible worst-case scenarios as well as any unforeseen events applicable to the seller/servicer, trust, or portfolio. Some sample scenarios are outlined below.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Covered by</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller/Servicer Fraud</td>
<td>1, 2, and 3</td>
</tr>
<tr>
<td>Default of Seller/Servicer</td>
<td>4</td>
</tr>
<tr>
<td>Taxation of Trust</td>
<td>5 and 6</td>
</tr>
<tr>
<td>Rapidly Rising Chargeoffs</td>
<td>6</td>
</tr>
<tr>
<td>Federally Imposed Interest Rate Caps</td>
<td>6</td>
</tr>
<tr>
<td>Whipsaw Interest rate Scenarios</td>
<td>6</td>
</tr>
<tr>
<td>Economic Recession/Depression</td>
<td>6</td>
</tr>
<tr>
<td>Spikes in Dilution and/or Fraudulent Charges</td>
<td>7 and 8</td>
</tr>
<tr>
<td>Declining Pool Balance due to Competition</td>
<td>7 and 8</td>
</tr>
<tr>
<td>Reduction in Credit Card Usage</td>
<td>7 and 8</td>
</tr>
</tbody>
</table>

*All credit card transactions contain deal- and issuer-specific amortization events. The following events are basic, common triggers that are necessary for most transactions.

the CIA as a condition to purchase. The CIA itself is protected by a spread account (not available to any other investors) and available monthly excess spread. If the CIA is drawn on, it can be reimbursed from future excess spread.

This class of enhancement also goes by other names - CA investor interest, collateral interest, enhancement invested amount, or “C” tranche.

**D. Subordination**

A senior/subordinate structure offers two different types of investor ownership in the trust - senior participation in the form of class A certificates and subordinate participation in the form of class B certificates. Class B will absorb losses allocated to class A that are not already covered by excess spread, the CCA, or the CIA. Like the CCA and CIA, draws on the subordinate certificates may be reimbursed from future excess spread. Principal collections will be allocated to the subordinate investors only after the senior certificates are fully repaid.

**E. Letter of Credit**

From the inception of credit card securitization until 1991, the letter of credit (LOC) was a common form of enhancement. It is an unconditional, irrevocable
Exhibit 6. Performance Variables

- Underwriting standards
- Cardholder credit scores
- Card type—retail, low-price, affinity, and co-branded, among others
- Fixed- or floating-rate annual percentage rate
- Flexibility of issuer to reprice and rates
- Frequency of floating-rate resets
- Use of teaser rates
- Attrition
- Geographic and demographic diversification
- Interchange
- Convenience usage
- Seasoning
- Servicing
- Competitive position
- Management
- Discounting of new receivables into trust
- Other structural features

commitment from a bank to provide cash payments, up to the face amount of the LOC, to the trustee in the event that there is a shortfall in cash needed to pay interest, principal, or servicing. Usage as a form of enhancement was discontinued when a number of banks providing LOCs were downgraded and the transactions they enhanced were downgraded as a result. The CCA was developed to remove downgrade risk caused by enhancer credit quality, and this marked the end of the use of LOCs in credit card transactions.

V. STRESS SCENARIOS

Under the most severe depression scenarios, properly structured ‘AAA’ credit card asset-backed securities (ABS) should repay investors 100% of their original investment plus interest. Securities rated in the ‘A’ category (subordinated certificates) are subject to less severe recessionary scenarios than those used for ‘AAA’; however, they are considered to be investment grade and of high credit quality. The trust’s ability to pay interest and repay principal to class B is strong, but it may be more vulnerable to adverse changes in economic conditions and circumstances than class A.

Credit card ABS performance can be influenced by many variables, with both positive and negative effects. Fitch IBCA develops stress scenarios at every rating level for each ABS issuer and structure by evaluating the performance variables described in Exhibit 6.

Current/historical performance or, if the portfolio is unseasoned, a conservative projection of performance is used as a benchmark by which to assess future performance. The stress scenarios applied to a transaction are determined on a case-by-case basis and compared to a hypothetical industry benchmark. The major variables influencing credit enhancement levels are chargeoffs, portfolio yield, monthly payment rate (MPR), and investor coupon.

A. Chargeoffs

Credit cards are unique among loans in that the credit quality of each cardholder is reflected in the cardholder’s credit limit and APR, which are based on the cardholder’s ability to meet debt payments (i.e. the higher the risk, the lower the credit limit and the higher the APR). Many issuers use sophisticated credit scoring models, or well trained credit analysts, to determine the cardholder’s probability of default. This probability dictates what credit limit should be granted, and at what APR.

Examining the credit limits and APRs of a portfolio, however, does not always give a true picture of the issuer’s total risk. Some issuers might be more aggressive in assigning high limits to lower credit quality borrowers. Some might not have well developed scoring models. Finally, some may try to gain market share by offering very low interest rates, possibly at the expense of credit quality.

All these factors must be analyzed when determining the appropriate chargeoff stress to apply to a portfolio. The stress level shown in Exhibit 7 indicates that one in every four or five cardholders defaults on their obligation to pay.
B. Portfolio Yield

Yield is made up of periodic APR charges, annual fees, late payment fees, overlimit fees, and, in some cases, recoveries on charged-off accounts and interchange. Interchange is income from the card associations (Visa, MasterCard, and Novus, among others) that is paid to the issuing bank as compensation for taking credit risk and funding receivables, the amount of which varies from 1%-2% annually. Most of these components are relatively stable and only comprise a small percentage of the yield. APR, on the other hand, accounts for a large majority of the yield and is the most volatile.

In stressing a portfolio’s yield, competitive position is a critical factor, since a highly priced portfolio will be under pressure to reduce rates to maintain market share. Another important factor is the possibility of a federally imposed interest rate cap on credit card APRs. In November 1991, the U.S. Senate proposed a measure to lower credit card interest rates to a cap of 14%. If the measure had been enacted, some portfolios would have suffered a reduction in yield of more than 30%.

C. Monthly Payment Rate

The MPR includes monthly collections of principal, finance charges, and fees paid by the cardholder and is stated as a percentage of the outstanding balance as of the beginning of the month. Reductions in MPR may come from a decrease in the number of cardholders who pay off their entire bill every month and from cardholders making smaller monthly payments.

D. Fitch IBCA Credit Card Default Model

When run through Fitch IBCA’s default model, the benchmark scenario in Exhibit 7 gives a generic ‘AAA’ level for a portfolio. However, since every credit card is not created equal, more attention must be paid to the dynamics of each variable stressed in context with that portfolio and Fitch IBCA’s benchmark. For example, the stress test outlined in Exhibit 8 applies to the Household Affinity Credit Card Master Trust, which is made up solely of GM co-branded cards.

Household’s underwriting criteria is strong, and, to date, the trust’s performance has been better than expected. However, since Household’s portfolio is not heavily seasoned and has not been tested during a recessionary environment, Fitch IBCA imposes a slightly more conservative chargeoff multiple. As the average age of the accounts increases, Fitch IBCA will revisit this stress and adjust it accordingly.

The payment rate stress on this portfolio is also very conservative. Since all the accounts are under the GM

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Exhibit 7. Benchmark Stress Scenarios

<table>
<thead>
<tr>
<th></th>
<th>AAA</th>
<th>A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chargeoffs</td>
<td>4.5x–5.0x Multiple</td>
<td>3.0x Multiple</td>
</tr>
<tr>
<td>Portfolio Yield</td>
<td>35% Decline</td>
<td>25% Decline</td>
</tr>
<tr>
<td>Monthly Payment</td>
<td>50% Decline</td>
<td>35% Decline</td>
</tr>
</tbody>
</table>

Exhibit 8. Household Affinity Credit Card Master Trust — Stress Scenarios

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Benchmark</th>
<th>Household Affinity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chargeoffs</td>
<td>7.27%</td>
<td>4.50-5.00x Multiple</td>
<td>5.25x Multiple</td>
</tr>
<tr>
<td>Portfolio Yield</td>
<td>18.07%</td>
<td>35% Decline</td>
<td>40% Decline</td>
</tr>
<tr>
<td>Monthly Payment Rate</td>
<td>23.90%</td>
<td>50% Decline</td>
<td>65% Decline</td>
</tr>
<tr>
<td>As of May 31, 1998</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Exhibit 9. Sears Credit Card Master Trust — Stress Scenarios

<table>
<thead>
<tr>
<th></th>
<th>Current</th>
<th>Benchmark</th>
<th>Sears</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chargeoffs</td>
<td>8.57%</td>
<td>4.5-5.0x Multiple</td>
<td>4.5x Multiple</td>
</tr>
<tr>
<td>Portfolio Yield</td>
<td>19.22%</td>
<td>35% Decline</td>
<td>35% Decline</td>
</tr>
<tr>
<td>Monthly Payment Rate</td>
<td>7.28%</td>
<td>50% Decline</td>
<td>35% Decline</td>
</tr>
<tr>
<td>As of May 31, 1998</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
relationship, it is important to keep in mind what would happen if the co-branding agreement were canceled. Many cardholders using their cards to generate GM rebate points would cease making purchases, and payment rates would fall dramatically.

As another example of customizing stresses, Exhibit 9 shows a scenario applied to the Sears Credit Card Master Trust.

Since more than 60% of Sears’ accounts are greater than five years old, portfolio statistics are very consistent. Even during the 1990-1991 recession, Fitch IBCA gives Sears credit for stable underwriting and reduces the company’s worst-case multiple. In addition, payment rates cannot fall much farther, even under severe economic stress.

E. Investor Coupon

For fixed-rate ABS, Fitch IBCA uses the expected pricing level of the securities as the transaction’s investor coupon expense. For floating-rate ABS, Fitch IBCA assumes that the investor coupon will increase dramatically. The interest rate environment of the early 1980s—specifically, the second half of 1980—is used as a stress scenario, since that was the most volatile period of the last 20 years.

Additional credit enhancement is needed to cover the potential basis risk and interest rate risk between a rapidly rising investor coupon and lagging floating-rate or low fixed-rate credit cards, where trust expenses increase faster than trust earnings. This risk is issuer—and deal—specific and is estimated based on credit card interest rates, frequency of credit card floating-rate resets, investor coupon index, frequency of investor coupon resets, and, to a limited extent, the issuer’s ability to change credit card interest rates. The amount of additional enhancement required may vary from 2.5% to more than 4.0%.

For example, if the ABS investor’s coupon floats off the one-month London Interbank Offered Rate (LIBOR), a deal with credit cards that are priced off the prime rate and reset monthly would be exposed to less interest rate risk than a deal with cards that are fixed rate or reset quarterly. Therefore, the monthly reset portfolio would require less additional credit enhancement than the portfolio with fixed-rate cards.

F. Receivables Balance

An additional variable that must be examined is the pool’s receivables balance. If the outstanding principal receivables of the portfolio decline, especially during early amortization, the amount of principal collections reallocated from the seller’s participation would be drastically reduced. This results in a longer payout period and increased exposure to a deteriorating pool. The primary concern is how cardholders will behave with regard to the solvency of the seller.

For credit cards issued by small, regional retailers, Fitch IBCA believes that if the retailer files bankruptcy under Chapter 7 of the U.S. Bankruptcy Code, consumers would no longer be able to use their cards since all the stores have been closed or sold, and the principal receivables balance of the trust will decline in lockstep with the amortization of the securitization. Exceptions may be made if the retailer is unlikely to file under Chapter 7.

For well underwritten, geographically diverse, general-purpose card portfolios, insolvency of the seller will not have such a dramatic effect. Most consumers probably will not even know that their bank has gone into insolvency and will continue to use their cards. With the profitability of the card business, the heavy premiums at which pools of accounts are bought and sold, and the aggressive competition for market share, Fitch IBCA believes that portfolios such as these should continue to remain active, with consumers continuing to charge and the portfolio continuing to be serviced, even if not by the original servicer.

Some issuers fall between these two extremes. For
Exhibit 10. Series Structures

The following are examples of structures used in recent credit card master trust securitizations. Please refer to series-specific reports for the structure of any transaction that is not shown in this exhibit.

ACSE – Alternative credit support election.
ASA – Available subordinated amount.
example, a portfolio that is heavily concentrated in a single co-branding relationship or affinity group may experience heavy runoff if that relationship is canceled or becomes less a value to cardholders. It is unlikely, however, that all cardholders would simultaneously cease using their cards, as they would for a bankrupt retailer.

VI. MASTER TRUST FEATURES

Master trusts may be set up with one or several reallocation groups. For example, Universal Card Master Trust currently has several groups: Group I for series with fixed-rate coupons and Group II for series with floating-rate coupons; other groups accommodate variable funding series. Most other trusts have only one group, in which all series are included. Depending on the structure of the trust, series within the same group may share principal and/or excess spread, have the ability to discount, or fix allocations of finance charges.

A. Principal Sharing

For all series in the same group, the trust allows distribution of excess principal collections to any series in its accumulation or amortization period. Since a series in its revolving period has no principal payment requirements, principal collections allocated to that series are available for reallocation. In addition, principal collections in excess of a series’ controlled amount are available for reallocation. The principal reallocation feature provides investors with more assurance of timely principal repayment, with no additional risk to other series.

B. Excess Spread Sharing

There are several ways excess spread may be shared within series of a group. Some groups may be set up as a “socialized” group, whereby finance charge collections are allocated to each series based on need. The interest expense for all series in the group will be the weighted average expense for each series. Thus, the highest coupon series will receive the largest allocation, and the lowest coupon will receive the smallest allocation. The excess spread for each series will be the same, since each has the same coupon expense. In effect, socialized groups share excess spread at the top of the cash flow waterfall. Universal Credit Card Master Trust, Household Affinity Credit Card Master Trust, and Citibank Credit Card Master Trust are examples of socialized trusts.

Other trusts may allocate finance charge collections on a pro rata basis, based on size. Thus, each series will receive the same proportionate amount of finance charges, and the series with the lowest coupon expense will have the largest amount of excess spread. This amount will be available for reallocation to other series, particularly high-coupon series, if their excess spread is reduced to zero.

C. Discount Option

Many trusts permit the transfer of receivables to the trust at a discount, which increases the portfolio’s yield by including principal collections as finance charge collections. This allows an issuer to artificially increase excess spread. A potential risk of discounting is that a deteriorating pool of assets can continue to revolve with deeper discounts, which increases potential economic exposure during early amortization. The issuer must obtain rating agency approval prior to discounting or changing the discount rate.

D. Fixed Allocation of Finance Charges

This innovative feature permits a larger percentage of finance charge collections to be allocated to investors after an amortization event, when cash is needed most. Before early amortization, investors receive their pro rata share of finance charge collections, and the seller receives its pro rata share. After an event is triggered, a portion of the seller’s share will be made available to cover shortfalls in interest or servicing expense, or chargeoffs, in the investors’ share. Cash flow simulations show that, even under stressful scenarios, this overallocation of finance charges provides a significant amount of support, thus reducing the need for credit enhancement.

VII. EARLY AMORTIZATION RISK

Fitch IBCA ratings address the likelihood of repayment of all principal and interest in a full and timely manner as promised. Credit card transactions, however, do not promise repayment of principal on any specific date. Instead, they define an expected payment date, and caveat that principal may be paid earlier or later than that date. The circumstance that would lead to earlier payment would be commencement of an early amortization. Later repayment could be caused by very low payment rates, which would mean that controlled amortization or controlled accumulation payments would not be made in full, and extra months of collection would be needed to pay off the entire invested amount. Every series defines a termination date, which is usually set 24-36 months after the expected payment date. All
principal must be paid on or before this date. It is extremely unlikely that MPR would be so slow that principal would not be repaid by the series termination date.

The amount of enhancement any deal has does not affect the probability of early amortization. And investors must keep in mind that ratings do not reflect the likelihood of this occurrence. In fact, it is possible that a deal's 'AAA' rating would be affirmed if an early amortization commenced.

Early amortization risk is not a focus of investors when deals perform strongly. However, before consumer delinquencies and chargeoffs increase, portfolio yields come down dramatically, or interest rates shoot up, investors should look very closely at their investments to determine their exposure to prepayment risk. Several topics should be considered when evaluating early amortization risk, including:

- Variability of chargeoffs.
- APR pricing position (competitive or not).
- Fixed- or floating-rate investor coupon.
- Seller/servicer strength.
- Ability to discount new receivables into trust.
- Sharing of excess spread.
- Percentage of total bank receivables that have been securitized.
- Existence of variable funding, extendible, or commercial paper series.