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# Scenario Analysis: U.S. Credit Card ABS Ratings Will Likely Survive A Severe Recession Without Payment Defaults

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# Scenario Analysis: U.S. Credit Card ABS Ratings Will Likely Survive A Severe Recession Without Payment Defaults

(Editor's note: This article, part of a series produced by Standard & Poor's Structured Finance Group, provides insight into the circumstances under which ratings may change, or notes default, in an asset class given a particular set of macroeconomic circumstances. These articles are being produced as a result of the New Actions initiative we announced recently (see article titled "A Listing Of S&P's New Actions Aimed At Strengthening The Ratings Process," published Feb. 7, 2008). These New Actions incorporate the intent to provide "what if" scenario analyses to allow investors to better understand the risk profile of a particular transaction.)

Credit card asset-backed securities (ABS) have historically been one of the most stable sectors of the securitization market. In the 20 years since Standard & Poor's Ratings Services has been rating credit card ABS, only nine of the over 2,800 tranches that we've rated to date have defaulted, all of which resulted from the insolvencies of just three credit card lenders.

Still, U.S. credit card securitizations have been a matter of concern lately, thanks to a variety of factors that are combining to test the performance of credit card portfolios. Among these forces are a recent rise in card losses and delinquencies, a decrease in alternative financing sources for card obligors, weaker consumer confidence due to higher food and oil prices, and a general weakening of the housing market and the overall U.S. economy.

Investors, therefore, have questions about how Standard & Poor's ratings on credit card ABS might hold up under current and future performance and macroeconomic conditions. To provide some answers, we've done a study on an aggregate sample of U.S. credit card ABS transactions in the prime, nonprime, and retail categories that tests them under Standard & Poor's Chief Economist David Wyss' latest forecast for a pessimistic-case recession in the near future (called our "severe recession" scenario). Our goal was to see how credit card ABS would perform under such conditions and to see how likely it would be for these securities to default. Prime refers to bankcards whose holders typically have stronger credit and lower losses than nonprime bankcards. Retail refers to store-branded credit cards.

This study follows up on an earlier one we did that examined the potential performance of some specific U.S. credit card ABS transactions in a recession (see "U.S. Credit Card ABS Is Expected To Withstand Higher Losses In A Recession," published Jan. 31, 2008, on RatingsDirect).

In our latest study, we compare our chief economist's most recent projections for peak card losses in a severe recession scenario with two other analyses, our "break-even losses" at the 'BBB' level and our "peak loss" rating assumptions for higher rating categories. Our chief economist's severe recession scenario uses a peak unemployment rate of 7.5% and a credit card loss rate that rises over 20 months to a peak of 8.1% in the fourth quarter of 2009. Under this scenario, loss rates would average about 7.7% in 2010. We currently feel that there's a 20% likelihood of this scenario occurring.

When we compare the severe recession losses to our break-even losses at the 'BBB' level, we test how high losses can get before credit support runs out and a 'BBB' rating defaults.

We chose to do our break-even tests on 'BBB' rated notes because these securities have lower credit support than the senior classes that they support under a typical credit card capital structure. Hence, 'BBB' rated securities are less insulated and have the ability to withstand a lower level of increased losses than senior tranches in most transactions, and tend to have more rating changes over time than higher-rated classes.

We also compare the severe recession scenario to our standard rating peak loss assumptions at the higher rating categories, specifically, the 'A' and 'AAA' levels. Higher rating categories are more insulated in typical card ABS structures and are assumed to withstand higher losses than lower rated tranches. Therefore, the break-even loss results at the 'BBB' level are lower than our peak loss assumptions when we rate 'A' and 'AAA' tranches. By peak losses, we mean the highest annualized loss level in our rating assumption that can be supported by available credit enhancement—as part of our original ratings process. During the credit card ABS ratings process, we first determine the transaction's base case scenario. We do this by looking at the historical performance of key variables, including yield, losses, excess spread, payment rate, purchase rate, servicing fee, and bond coupon, and we analyze how they change in various economic scenarios, including in prior recessions. Based on the best available data, we then determine our base case assumptions for each variable and use them as starting points to simulate a deteriorating credit environment. We stress all variables simultaneously and apply the stresses progressively to the base case assumptions until the maximum stress level is reached (for losses, the peak loss). We then maintain the stress until the notes' legal final maturity. The stresses vary based on the rating categories.

Table 1 summarizes our findings.

**Table 1**

Summary Results	
Question	Answer
What is our expected case going forward?	Our Chief Economist David Wyss has developed an econometric model to forecast changes in our credit card quality index charge-off rates. In April 2008, our base line (expected case) forecast is for credit card losses to rise from the current 5.7% to a peak of 6.9% by the first quarter of 2009, based on a 5.9% unemployment rate. We expect loss rates to average about 5.6% in 2010. Our (pessimistic case) severe recession assumes that the credit card loss rate will rise over 20 months to a peak of 8.1% in fourth-quarter 2009 based on a 7.5% unemployment rate and loss rates will average about 7.7% in 2010. We currently feel this scenario is 20% likely.
What would cause the downgrade of a 'BBB' tranche?	In the current environment, it is possible that losses might rise beyond historical experience, and so our base case assumptions would need to be revised. Currently, our base case assumption for prime banks averages about 6.5%. This is above the current loss rate of about 5.7% for our total rated bankcard index and about 5% for prime banks. If card losses for prime banks increase by about 30%-40% over current rates, reaching a range of 6.5%-7.0%, we may reexamine our current base case loss assumptions and downgrade the bonds. We would analyze the drivers behind the rise in losses and consider the change in context of other key variables that influence our assessment of credit quality. We would also consider qualitative factors, such as changes in portfolio composition and the servicing and collection strategies of the issuer. Similarly, if an issuer's payment rate declines by about 10%-20% from current levels, (and such a decline was not already factored into our base case assumptions), we may reexamine our current base case payment assumptions and downgrade the bonds. Again, we would consider issuer-specific drivers behind the change in performance and evaluate the likelihood that the negative trend would continue. It is important to understand that a downgrade and the magnitude of downgrade of a 'BBB' rated security depend on the combined performance of the following key variables: yield, excess spread, loss rate, payment rate, purchase rate, servicing fee, and bond coupon. Because we apply simultaneous stresses to base case assumptions for all these variables that incorporate historical experience (including prior recessions), the deterioration in any one variable may not necessarily result in a potential downgrade. For example, an increase in losses could be offset by stronger payment rates by the obligors. Generally, for prime banks, an increase of about 1.0% in our loss base case assumption could be offset by about 1.25% increase in our payment rate base case assumption. In addition, if losses rise and excess spread falls to a level that would cause spread account triggers to be breached, 'BBB' rated securities might not be at an increased risk of downgrade, if the trapping of cash in the spread accounts is at a sufficient rate to maintain the rating. Spread account triggers and trapping refer to conditions that require excess spread to be set aside as extra credit support rather than the originator using it for other purposes allowing it to leak out of the transaction or the master trust. A downgrade to a card issuer's unsecured credit rating is an indication of an increased risk to its ability to fund future card purchases and transfer new receivables to the trust, which could result in longer pay-out and loss horizons. A weakened financial and operational position could, thus, adversely affect credit card ABS ratings. Our purchase rate assumptions depend on card lenders' ability to extend credit and transfer new receivables to the trust, and a material change in these banks' unsecured credit rating could thus affect credit card ABS ratings, especially if this occurs at the same time as performance variables have deteriorated.

**Table 1**

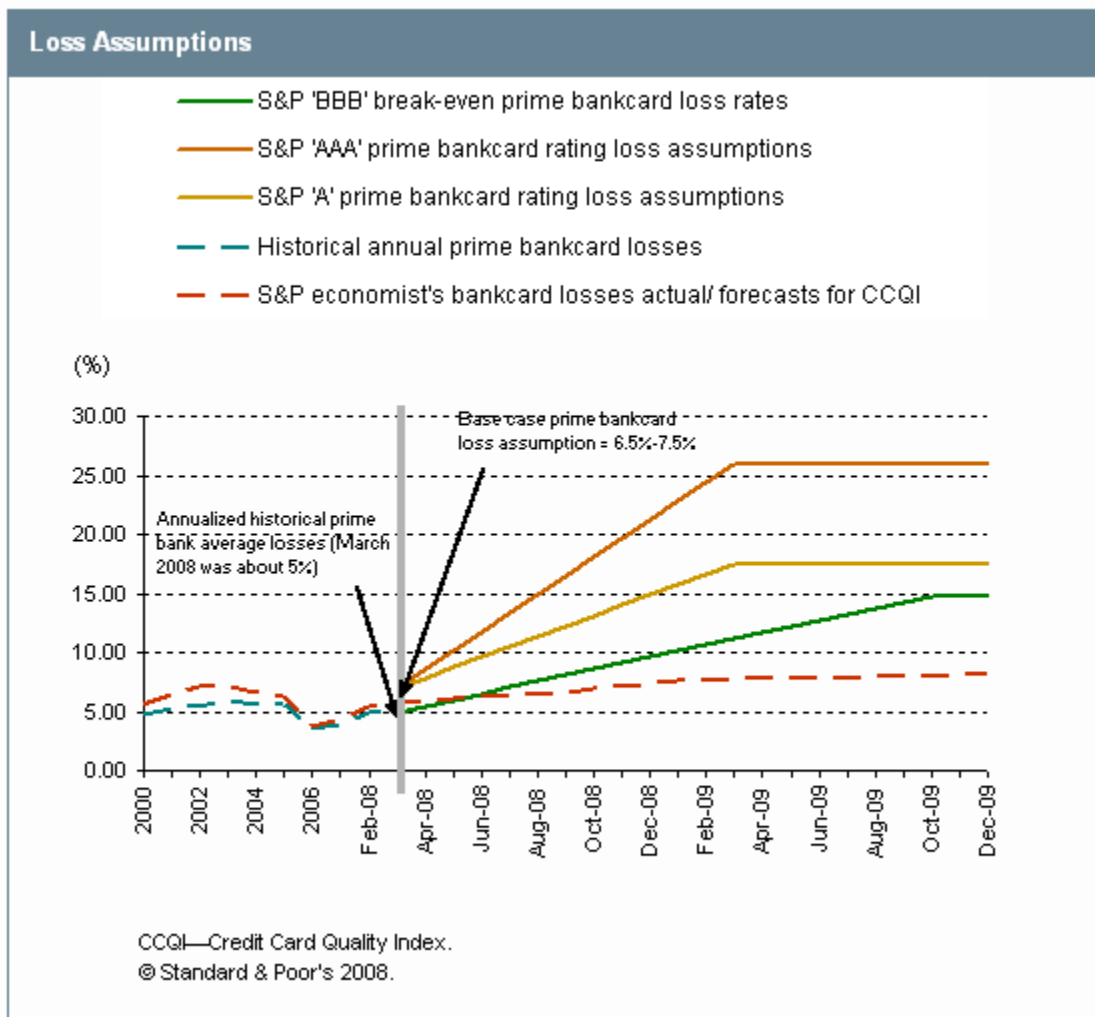
Summary Results(cont.)	
What would cause the default of a 'BBB' tranche?	Before suffering a default in interest payment or principal payment at the legal final maturity payment date, our 'BBB' break-even peak loss rate for the prime bankcard sector averages about 14.7%, which is approximately 82% more than the severe recession peak loss projection of 8.1%. The prime bankcard sector is most comparable here because it makes up about 92% of the total credit card quality index (a monthly index that aggregates performance data across our rated bankcard transactions). Cash flow models are used to evaluate the effect of deterioration in key performance variables. The break-even loss rate will vary based on the model inputs for all the variables and the rate of deterioration. The 14.7% 'BBB' average break-even loss result used in this article is higher than the 10% break-even cash flow model result discussed in our January publication, because the "what if" scenario assumptions were different. Our most recent April 2008 econometric peak loss projections in the severe recession scenario were assumed to occur over a longer time horizon of 20 months instead of 15 months. A longer time period allows a slower deterioration of variables in our simulations, resulting in higher payments and yield allocated to pay monthly transaction expenses and bond principal.
What would cause the downgrade of a 'AAA' tranche?	'AAA' rated classes are subject to the same performance-related risk factors as 'BBB' rated classes. Nevertheless, senior notes are relatively well insulated in card transaction structures and benefit from the diversion of principal cash flows from subordinate classes, if necessary, should performance deteriorate. In addition, there are certain structures that benefit senior notes, especially in delinked structures. The delinked program documents allow issuers to change enhancement levels retroactively for existing notes outstanding. If the collateral performance deteriorates, issuers have the option of increasing credit enhancement for the senior notes and avoid rating action. Issuers can do this by either issuing more subordinate notes or reducing the capacity to issue more senior notes. Both options protect existing senior notes with additional credit enhancement. If the issuer chose to take advantage of this option, 'AAA' rated tranches could benefit when unprecedented performance deterioration would cause us to examine potential ratings action and additional credit support is required. A downgrade of a 'AAA' note could mean a significant deterioration in a key performance variable, a simultaneous deterioration of more than one performance variable at the same time, or a material downgrade or insolvency of the originator.
In a 'BBB' default, what would happen to the 'AAA' tranche?	We believe that downgrades of 'AAA' rated notes are likely in scenarios that would cause 'BBB' notes to default. A 'AAA' rated security would likely remain investment-grade in a scenario that would begin to cause a 'BBB' note to default. Nevertheless, we believe these senior tranches would not experience payment defaults of timely interest or principal by the legal final maturity dates.
What historical data are we basing our analysis on?	We generally review a minimum of 3-5 years of issuer-specific historical data in determining our analysis. However, most issuers provide us a significantly longer range of historical data. We also meet with management to discuss changes in underwriting standards that may make past portfolio performance less indicative of future performance and adjust stress factors accordingly. Some questions have been asked whether there are risks that an unprecedented decay in performance of the variables could cause unexpected defaults or rating changes. This risk exists to some degree, but we attempt to minimize this by stressing credit card ABS variables beyond historical experience and incorporating prior recession experiences in our stress case assumptions.

## Break-Even Loss Rate Scenario Results Show 'BBB' Note Survival

Our findings suggest that 'BBB' rated notes would not experience defaults for timely payment of interest or ultimate repayment of principal by their legal final payment dates. Our model results indicate that break-even losses at the 'BBB' level exceed our severe recession scenario forecasted by our Chief Economist. Our severe recession economic forecast of 8.1% for credit card losses is about 50.0% higher than the actual loss rates in the first quarter of 2008 and about 8.0% more than the highest rolling three-month average loss rate since 2000. Our 'BBB' break-even peak loss rate for the prime bankcard sector averages about 14.7%, which is approximately 82.0% more than the severe recession peak of 8.1%. The result shows that the projected peak of 8.1% credit card losses in the fourth quarter of 2009 is about 45% lower for the prime bankcard sector than the break-even losses our 'BBB' rated transactions could withstand based on their current credit support.

Chart 1 illustrates our severe recession scenario for credit card losses and our break-even loss rate results showing the total losses 'BBB' rated notes can withstand in the same 20-month period based on their current credit support. The chart also shows that our peak loss rate assumptions at the 'AAA' and 'A' rating categories are about 221% and 116% higher than our pessimistic forecast of losses in the above severe recession scenario.

Chart 1



## Our Break-Even Loss Scenario Analysis

This section compares our April 2008 severe recession forecast with break-even loss rate results at the 'BBB' level for three categories: prime, nonprime, and retail.

We use a 20-month period for the break-even losses because this period coincides with the severe recession peak of 8.1% losses, forecasted for the fourth quarter of 2009. Under this scenario analysis, we start all credit card variables at their current rates at March 2008 and stress each of them simultaneously over 20 months until the current credit support is exhausted. In our break-even loss rate analysis, the cash flow runs for each pool test how high losses can get over a 20-month period without causing a default to a 'BBB' note based on current credit support in prime, nonprime, and retail card transactions.

For the nonprime bankcard pools and retail card pools, we show the magnitude of break-even losses compared with current rates and the respective three months' average highest loss rates since 2000 for each subsector.

### Prime, nonprime, and retail categories

Table 2 lists examples of master trusts in each of the credit card subsectors. We excluded some of our rated pools from this analysis because they don't fall into any of the subsectors.

**Table 2**

Examples Of Master Trusts	
Subsector	Master trusts
Prime	American Express Credit Account Master Trust, Citibank Credit Card Master Trust I, Chase Credit Card Master Trust, Bank of America Master Trust, Discover Master Trust, and Capital One Master Trust
Nonprime	Washington Mutual Master Trust, Metris Master Trust, and some of our confidentially rated portfolios
Retail	GE Master Trust, HSBC Private Label Master Trust, Citibank Omni Credit Card Master Trust, WFN Master Trust, and Charming Shoppes Master Trust

## Break-Even Loss Rates

The following sections list the approximate break-even loss rates that 'BBB' rated transactions should withstand over 20 months based on their current credit support for each subsector.

### Prime bankcard break-even loss rates

Our break-even loss scenario testing shows that our 'BBB' rated prime notes are currently supported by about 8.70% excess spread on average and an additional 0%-0.5% initial hard credit support. Our break-even results show that prime bankcard pools should withstand peak losses averaging 14.75%, which is about:

- 1.8 times our severe recession loss projection of 8.1% for the card industry in the same 20-month period from now;
- 2.3 times higher than the highest three-month average loss rate of 6.50% from January 2000 to March 2008, excluding the effect of the 2005 change in the bankruptcy code\*; and
- 2.9 times higher than the current loss rate of 5.12% as of March 2008.

### Nonprime bankcard break-even loss rates

'BBB' rated nonprime notes are currently supported by about 8.92% excess spread and an additional 6.5%-9.0% initial hard credit support. Our break-even results show that the low end of the range of peak loss rates that nonprime bankcard pools should withstand is about 38%, which is approximately:

- 1.6 times higher than the highest three-month average loss rate of 19.45% from January 2000 to March 2008, excluding the effect of the 2005 change in the bankruptcy code\*; and
- 2.8 times higher than the current loss rate of 13.52% as of March 2008.

### Retail card break-even loss rates

'BBB' rated retail notes are currently supported by about 16.57% excess spread and an additional 4.25%-9.50% initial hard credit support. Our break-even results show that the low end of the range of peak loss rates that retail card pools should withstand is about 33%, which is approximately:

- 3.1 times higher than the highest three-month average worst-case loss rate of 10.72% from January 2000 to March 2008, excluding the effect of the 2005 change in the bankruptcy code\*; and
- 4.0 times higher than the current loss rate of 8.09% as of March 2008.

\*The effect of the bankruptcy code change in 2005 was an increase in loss rates from 5.7% in September 2005 to about 7.0% in October, November, and December 2005. Following this rush to file for bankruptcy, losses declined to artificially low levels of about 3.0% in the first half of 2006.

The multiples vary by sector because the risk profile, loss volatility, and vulnerability to an economic downturn are different for prime, nonprime, and retail pools. Lower credit support will be able to withstand lower break-even loss rates than higher credit support that nonprime banks and retail transactions have.

In general, the higher credit enhancement levels in securities backed by subprime and retail card receivables are a function of higher base case loss assumptions and more severe stresses on assumed payment and purchase rates. (For a more detailed explanation, please see "Credit Card Criteria," published June 1, 1999, on RatingsDirect and Standard & Poor's Web site at [www.standardandpoors.com](http://www.standardandpoors.com).)

## Our Rating Scenario Analysis

Our standard rating scenario assumptions stress performance variables beyond historical experience.

We benchmark our base case assumptions against historical data in unfavorable economic times, such as the three months' average highest loss rates since 2000, excluding the bankruptcy spike effect in 2005. We chose this time period because card losses were highest after the last recession in 2001-2002. We look at historical data to gauge trends and volatility, incorporate prior recessions, and focus on incremental and consistent risk management changes by originators/sellers, over and above any macroeconomic factors.

For example, we generally did not adjust our base case assumptions for card losses between 2003 and 2006, when credit losses decreased to 3.66% from 7.27%, due mainly to industrywide policy changes and economic factors, including low unemployment, affordable financing alternatives, house appreciation, and the Bankruptcy Reform Act of October 2005. When loss rates were at historically low levels in 2006 following the bankruptcy reform that caused artificially low levels of losses due to a spike before the law was implemented, base case assumptions were generally maintained. We assumed that loss rates would return to higher, more normalized rates, which we are starting to see materialize, although later than originally expected.

## Potential Rating Actions

Credit card ratings can and do change when circumstances warrant a revision. Should portfolio performance variables deteriorate and current base case assumptions become inappropriate, the card ABS transactions would be subject to review for potential negative rating action. For example, an increase in losses or transaction expenses, or a decline in a portfolio's yield, payments, or purchase rate could result in a downgrade.

In another example, we might consider taking rating actions on a credit card ABS transaction if its excess spread-trapping trigger is breached and the outlook for the economy remains negative. Excess spread that would otherwise be returned to the card issuer is typically trapped when yield, losses, certificate rate, and servicing costs have deteriorated to the point that the portfolio's excess spread is less than a specified level, commonly 4.5% for most prime credit card transactions.

We also evaluate other factors unrelated to the spread-trapping trigger breach when determining rating actions, such

as portfolio payment and purchase rates and the issuer's ability to fund new purchases. Furthermore, our review of the ratings considers the magnitude, speed, and potential duration of the performance deterioration and compares them with our current performance expectation and the available credit enhancement to determine the ultimate rating impact.

The rate of deterioration of any of these variables and its interaction with the other variables makes scenario testing more complex. For example, the effects of deterioration in one variable could be offset by stability or improvement in another.

It is important to understand that potential performance-related rating actions will likely depend on the combined performance of key variables, including losses, yield, payment, and purchase rates. For example, potential downgrades would be unlikely if losses were to rise to a level that would cause the breach of an excess spread-trapping trigger but other variables were still improving from their current rates, or if the spread account reached a level that was sufficient to maintain the current rating.

Potential rating actions can also occur if the unsecured credit rating on the originating bank declines. When the affected bank is the originator and servicer of the underlying credit card receivables in the master trust, we consider, among other key factors, the originator's ability to continue generating and transferring receivables to the trust, which is partly dependent on the credit rating on the originator. Credit card charges and the subsequent transfer of receivables affect the level of principal receivables in the trust and the monthly collections available to repay the outstanding principal balance of the notes.

The stressed purchase rate assumptions also reflect concerns that a bankruptcy or insolvency of the loan originator could adversely affect the allocation of collections. Currently, the general framework for our purchase rate stress is to assume a declining pool of assets during the payout period for transactions rated 'A' and above. Traditionally, for credit card-backed securities, the purchase rate assumption varies between 0%-6% based on the originator's unsecured credit rating, business and performance characteristics, the utility of the credit card accounts, and the quality and transferability of the pool upon the originator's insolvency. A lowering of the originator's unsecured credit rating could lead to a decrease in the purchase rate we assume in our cash flow analysis.

Recent acquisitions of small nonprime banks by highly rated, diversified entities imply that the merged entities have a greater ability to generate new receivables. For example, more diverse funding sources enable the originator/servicer to continue generating and transferring receivables to the trust and provide added liquidity to finance receivables on an ongoing basis. A greater breadth of resources with extensive experience in account origination, management, and servicing improves the strength of the current servicer/originator and the quality of receivables in the related pool.

## Ratings Transitions

Credit card ABS transactions experienced one of the lowest number of rating transitions since we started rating bonds for this sector more than 20 years ago. Annual downgrades averaged about 1% from 1982 through March 2008, and most of the downgrades initiated in 2002 and 2003 were related to four issuers: Metris Master Trust, Providian Gateway Master Trust, NextCard, and First Consumer National Bank. The only defaults to date coincided with the insolvencies of three credit card issuers: Heilig Meyer, NextCard, and First Consumer National Bank.

Two NextCard series had defaults on classes initially rated 'BBB' and 'BB'. However, all of the NextCard classes in those two series that had initial ratings of 'AAA' and 'A' paid off without default, and the classes initially rated 'AAA' had their ratings lowered to 'BBB-' before principal was paid in full.

First Consumer National Bank had two series that experienced significant downgrades, including a default on a class that was initially rated 'A'. The senior classes of those two First Consumer National Bank series that were initially rated 'AAA' were downgraded to 'BB' and 'B' before principal was paid in full. Securities backed by Heilig Meyers retail store cards experienced defaults on classes that were initially rated as high as 'AAA'.

Table 3 includes our key rating variables as of March 2008, our assumptions in a break-even loss scenario, and our standard rating assumptions for the 'AAA', 'A', and 'BBB' rating categories. In credit card ABS, we consider two types of variables:

- Pool performance variables, which result from the behavior of the underlying card obligors, including losses, delinquencies (past due amounts not yet deemed uncollectible are not a rating variable; we incorporate delinquencies in our loss and yield assumptions), yield, and principal payment rate; and
- Event variables, which result from market events, including purchase rate, bond coupon, and servicing fee.

**Table 3**

<b>Glossary Of Key Variables And Assumptions</b>						
	<b>Definitions</b>	<b>March 2008 average prime bank rate</b>	<b>Rating scenario base case assumption</b>	<b>Stress applied in 'AAA' rating scenario assumption</b>	<b>Stress applied in 'A' rating scenario assumption</b>	<b>Stress applied in 'BBB' rating scenario assumption</b>
Losses	Payment defaults on principal receivables. Typically, receivables that are deemed uncollectible due to 180 day delinquency, bankruptcies, or death	5.1%	6.50%-7.50%	From 3.5x-4.0x the base case assumption over 12 months	From 2.5x-3.0x the base case assumption over 12 months	From 1.5x-2.0x the base case assumption over 18 months
Payment rate	Aggregated payments collected from cardholders to repay debt due	20.5%	14.50%-17.50%	Immediately declines to 45%-55% of the base case assumption	Immediately declines to 55%-65% of the base case assumption	Immediately declines to 70%-75% of the base case assumption
Bond coupon	An expense that depends on the cost of funds, not the performance of the card obligors	—	Stressed assumption	Starts at current rates and increases by 1% increments each month until it reaches about 14%-15%	Starts at current rates and increases by 0.80% increments each month until it reaches about 14%-15%	Starts at current rates and increases to about 14%-15% over 18 months. For highly rated banks, we assume the bond coupon will likely be 3%-4% lower than yield
Yield	Income flowing into the trust, including cardholder interest payments and fees, interchange, recoveries, and other miscellaneous income	18.9%	14.50%-19.00%	Immediately declines to 30%-45% of the base case assumption	Immediately declines to 35%-50% of the base case assumption	Declines to 75% of the base case assumption over 18 months
Excess spread	Yield over transaction expenses, including losses, servicing fee, bond coupon and other transaction related fees	8.7%	Stressed assumption	Immediately declines to negative 5%	Immediately declines to negative 3%	We assume the lower of spread account trapping trigger, typically 4.5%, or current excess spread

**Table 3**

Glossary Of Key Variables And Assumptions(cont.)						
Purchase rate	New receivables generated during the reporting period resulting from cardholder purchases and cash advances	20%	Stressed assumption	Immediately declines to 0%-6%, depending on corporate rating of the originator entity	Immediately declines to 0%-6% depending on corporate rating of the originator entity	Immediately declines to 0%-6%. For highly rated banks, we assume that new principal receivables will equal principal payment collections
Servicing fee	An expense that is driven by the current market rate of servicing a pool of credit card assets	2%	Stressed assumption	For prime bankcard receivables, we assume market value rate of 2%	For prime bankcard receivables, we assume market value rate of 2%	For prime bankcard receivables, we assume market value rate of 2%. We assume that highly rated banks will receive some of the servicing fee from interchange

To help readers have a better understanding of our standard rating scenarios, we illustrate how we stress our key variables compared to historical performance. Charts 2-5 show how our 'AAA', 'A', and 'BBB' stresses compare with the historical credit card quality index (CCQI) performance of card variables.

**Chart 2**

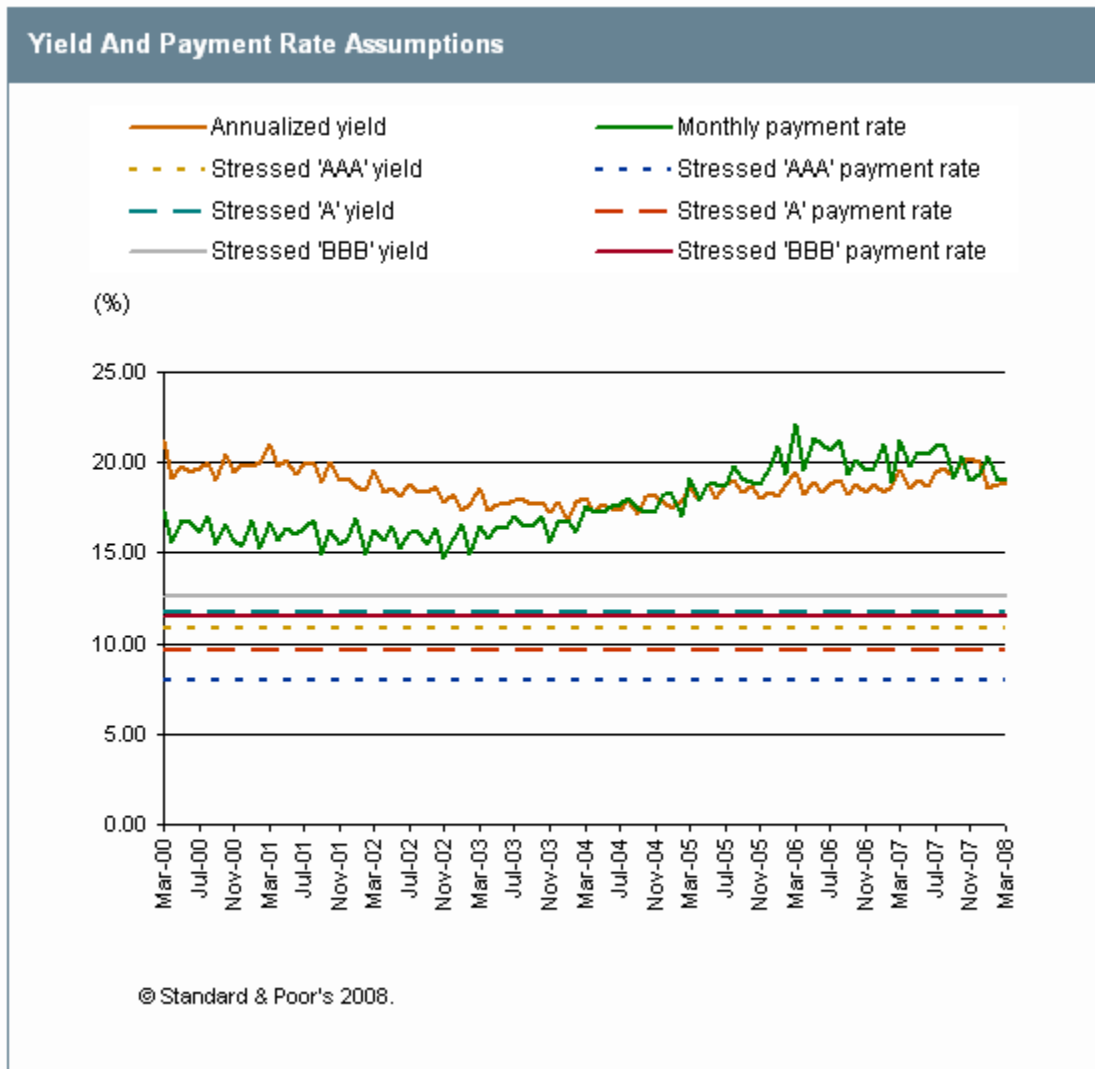


Chart 3

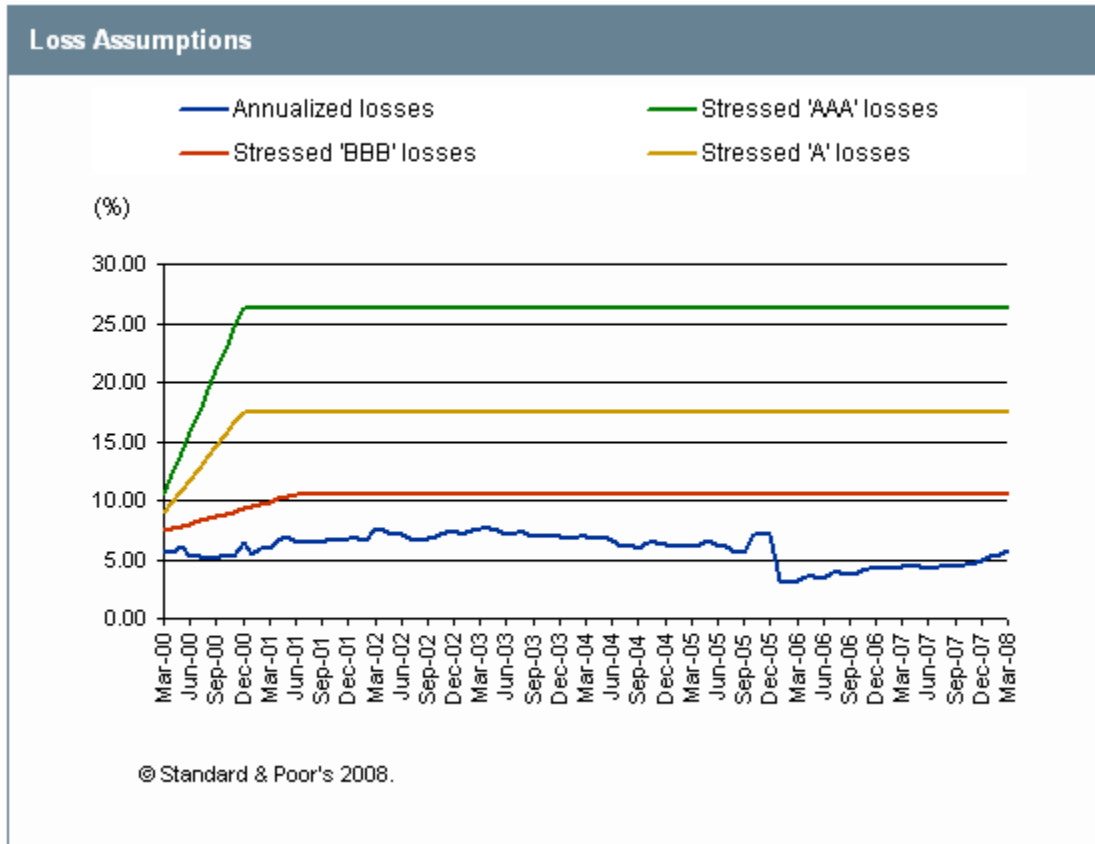


Chart 4

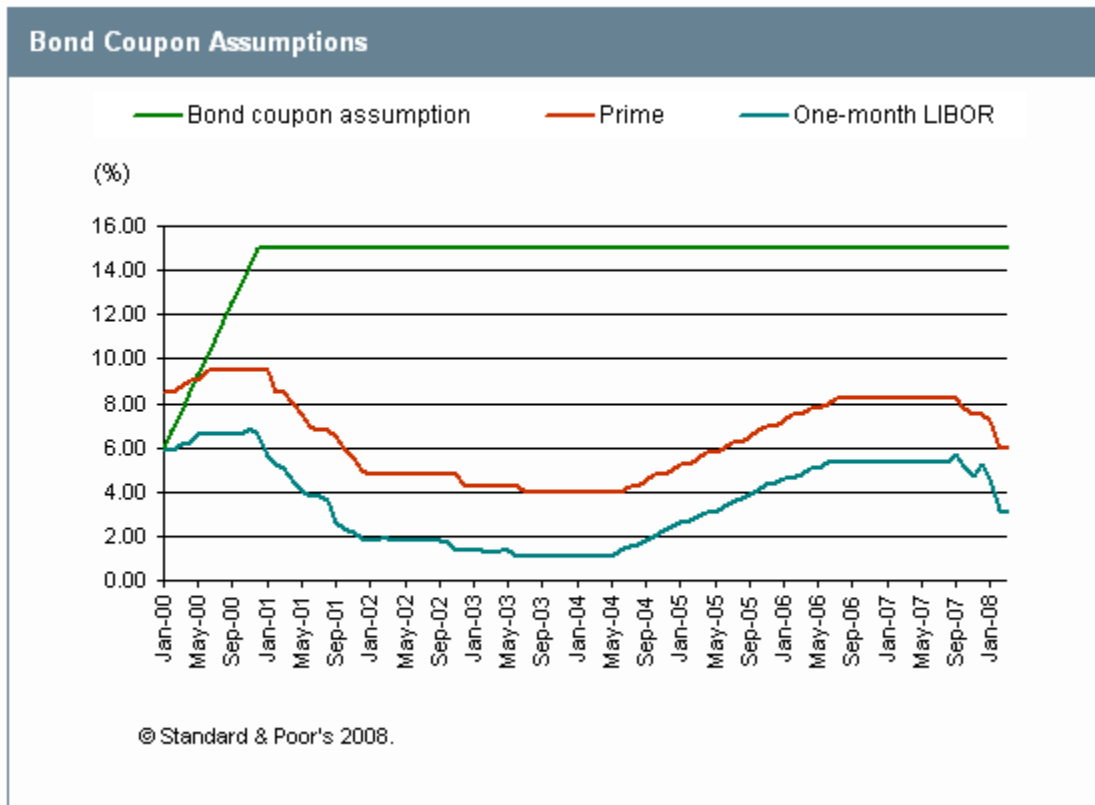
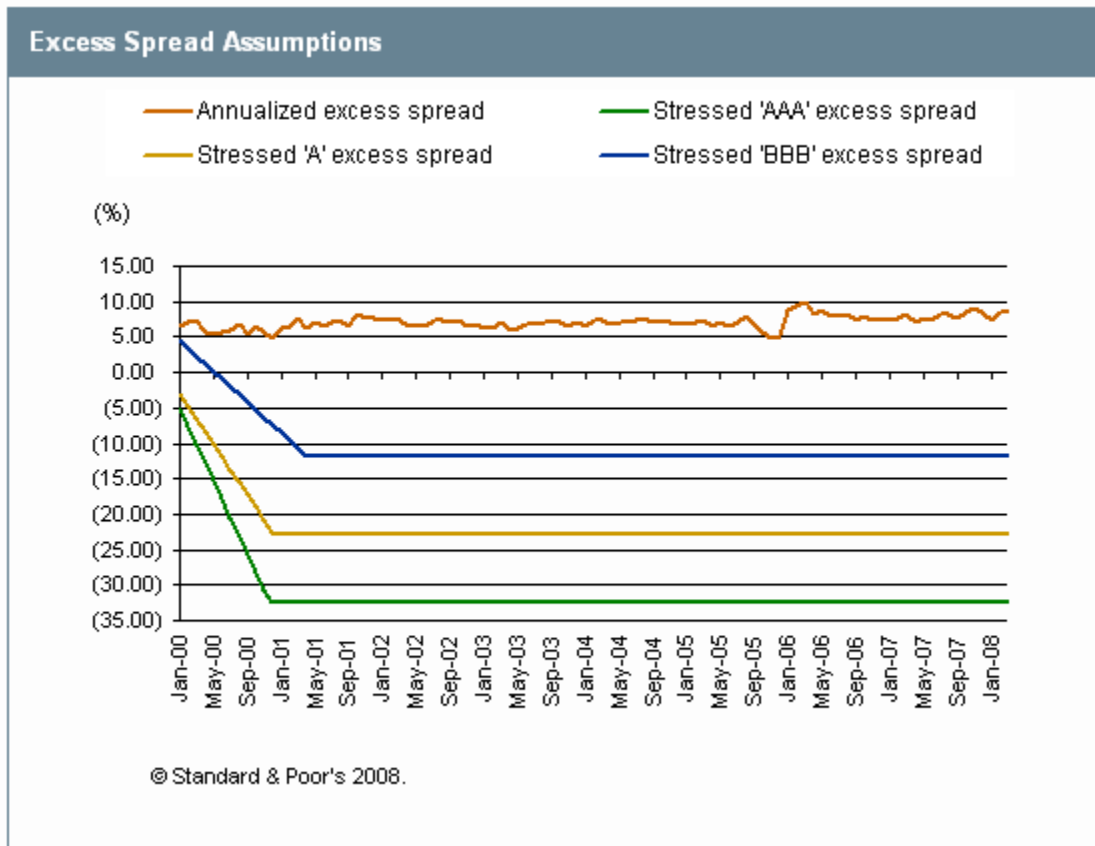


Chart 5



## Related Publications

The following articles are available on RatingsDirect. The criteria can also be found on our Web site at [www.standardandpoors.com](http://www.standardandpoors.com).

- "U.S. Credit Card ABS Is Expected To Withstand Higher Losses In A Recession," published Jan. 31, 2008; and
- "A Listing Of S&P's New Actions Aimed At Strengthening The Ratings Process," published Feb. 7, 2008; and
- "Credit Card Criteria," published June 1, 1999.

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