

VI CREDIT ENHANCEMENT FACILITIES

INTRODUCTION

Credit card securitizations use various forms of credit enhancements to transform the risk return profile of the underlying receivables. Credit enhancements are intended to reduce the credit risk to the investors, thereby increasing the rating on the investor certificates and thus lowering the funding cost to the selling bank. The nature and the amount of credit enhancements are determined by the rating agencies and underwriters. One or more credit enhancement facilities are usually required in order to receive a high enough debt rating to make the certificates readily marketable. Some of the factors the rating agencies consider in determining the required credit enhancement are the expected performance of the specified pool of receivables typically based on credit scores, credit limits, average outstanding balances, portfolio seasoning, consistency of underwriting and collection practices, and historic performance; geographic diversification, and the legal and cash flow structure of the transaction. The types of credit enhancement facilities are then chosen by management after considering costs and market placement factors.

The ratings are assigned to each class in the series based on the credit quality of the pool of receivables, the types of credit enhancement facilities, the servicer's experience, and the legal and cash flow structure of the series. For the highest rating band (triple-A), rating agencies may stress the loss rate assumption to three to five times the expected rate (or some other multiple to create a severe stress environment), and the portfolio yield and payment rates to 30 percent to 50 percent below their respective expected levels to reflect a negative excess spread environment. Credit enhancements are then determined to ensure that the triple-A holders would receive timely and ultimate interest and principal payments even in these highly-stressed scenarios. Lower-rated classes are stress tested at incrementally lower severities. For issues that carry a floating-rate coupon on the investor certificates, the rating agencies stress the underlying index to reflect an increased coupon rate.

Aside from the coupon rate paid to investors, the largest expense in structuring a credit card securitization is the cost of credit enhancements. As a result, issuers are constantly trying to minimize the costs associated with providing credit protection, which can be either internally provided or externally provided. This section describes the internal and external credit enhancements found in most series of securitized credit card receivables.

INTERNAL CREDIT ENHANCEMENT FACILITIES

Credit enhancements provided by the cash flows generated by the underlying receivables and the securitization structure include excess spread, spread accounts, subordinated classes, and over-collateralization. Accrued but uncollected interest (AIR) serves as another form of internal credit enhancements but securitization documentations do not require a specified AIR amount nor do rating agencies consider AIR when determining total credit enhancement requirements. AIR is discussed in the Accounting, Residual Interest Valuation and Modeling, and Regulatory Capital chapters.

A typical security structure may contain any of the following internal enhancements, which are presented in the general order of priority that is, from the first to absorb losses to the last.

Excess Spread

Excess spread represents the first line of protection against credit losses and avoiding early amortization. As such, excess spread represents the primary internal credit enhancement facility

and is built into every securitization. The portfolio yield for a given month on the underlying receivables supporting the investor certificates generally exceeds the coupon paid on the investor certificates, servicing costs, and expected losses. Any remaining finance charges after the expenses are paid is called excess spread and generally reverts back to the seller. The amount of excess spread depends on several factors, including the following items:

- Finance charges collected on cardholder balances.
- The amount of annual membership charges and other fees collected.
- The amount of interchange income collected.
- The delinquency and net charge-off rates.
- Cardholder payment rates.
- The percentage of cardholders with revolving balances.
- Changes in investor coupon rates.

The pooling and servicing agreement establishes whether the excess finance charges from one series will be returned to the seller/servicer or whether they will be made available to other issues within the master trust. Sharing of finance charges is discussed in the Cash Flow and Cash Flow Structure chapter. However, in every instance, excess finance charges are first used to absorb the expenses of a particular series.

Finance charges collected each month after servicing and coupon expenses are paid are used to reimburse investors for their pro-rata share of monthly charge-offs, and as previously noted, provide the investors with the first line of defense against credit losses. To protect against the possibility of insufficient finance charges to cover all trust expenses, including charge-offs, in the future, the rating agencies require additional forms of credit enhancements as discussed next.

Spread Account

While finance charges generated from the underlying pool of receivables are available to cover credit losses in any given month (*current* losses), any excess spread generated each month generally reverts back to the seller/servicer. However, pooling and servicing agreements commonly require the funding of a spread account when certain performance ratios on the underlying receivables deteriorate to or beyond a specified level. Rather than the excess spread reverting back to the seller/servicer, the excess spread is instead captured or “trapped” in a spread account to provide the investor certificate holders protection against *future* credit losses. For series that allow for finance charge sharing, excess finance charges are usually made available to other series in the master trust only after the required spread account for the specific series is funded. At the series’ maturity, any unused portion of the spread account is released to the bank.

Senior/Subordinated Structure

A senior/subordinated structure establishes two or more classes of ownership within a series and is sometimes referred to as tranching. Senior/subordinated structures are layered so that each position benefits from the credit protection of all the positions subordinated to it. The junior positions are subordinated in the payment of both principal and interest to the senior positions. The more senior classes are usually sold to institutional investors and the most subordinated piece is typically retained by the selling bank. A common structure is a Class A that is triple-A rated, a Class B that is single-A rated, a Class C that is triple-B rated, and an unrated class. The selling bank may retain the unrated class and may retain one or more of the other rated subordinated classes. When the selling bank retains a subordinated class, this asset is reflected as another asset on the bank’s balance sheet and considered a residual interest for risk-based capital purposes. The Regulatory Capital chapter discusses how these assets are treated for regulatory capital purposes.

The size of the subordinated certificates or classes is determined by the rating agencies. The subordinated classes are smaller than each senior certificate but are in amounts that are sufficient to protect the holders of the most senior certificates from the possibility of future cash flow shortfalls.

Rating agencies may require some form of additional credit enhancement facility (besides the excess spread which is included in every deal) even when the series has a senior/subordinated structure. However, the amount of additional credit enhancement will be much smaller than would otherwise be required. A smaller additional credit enhancement facility is one of the advantages of a senior/subordinated structure, but disadvantages include fewer cash proceeds to the selling bank and a higher level of on-balance sheet assets when the bank retains one or more of the subordinated classes.

The senior/subordinated structure continues to evolve, and, as a result, examiners should stay abreast of changing industry structures.

Over-collateralization

Over-collateralization occurs when newly-generated receivables exceed monthly cardholder principal payments and accounts lost to attrition and dilution. From an investor's perspective, over-collateralization is represented by the seller's interest, which is subordinated for purposes of absorbing dilution but not for purposes of absorbing credit losses. Seller's interest ensures that the securitization trust has sufficient assets to generate adequate interest and fee income to maintain the coupon yield. Most cash flow structures do not allow for the subordination of seller's interest to the investors. Over-collateralization in credit card securitizations typically only provides a receivable base for declines in principal receivable balance on the investor certificates and is not a source of credit enhancement.

EXTERNAL CREDIT ENHANCEMENT FACILITIES

External credit enhancements insulate investors from credit risk, generally through mechanisms other than redirecting internal cash flows or the securitization's structure. The following section provides discusses the types of external credit enhancement facilities available to issuers.

Third-Party Letter of Credit

A third-party letter of credit is an unfunded commitment granted by a third-party provider that guarantees limited protection against losses, typically catastrophic losses, on the underlying assets. Issuers of letters of credit are obligated to honor demands for payment up to the amount specified in the pooling and servicing agreement. The credit enhancement is normally set at a fixed percentage of the investors' certificates and is usually determined by the perceived credit risk in the underlying assets. A letter of credit may also require a spread or reserve account.

The advantage of using a letter of credit is the additional analysis done on the originating bank and servicer by the third-party credit-enhancement provider. However, letters of credit expose investors to the risk that the investor certificates will be downgraded when the letter of credit provider is downgraded. A letter of credit is also more expensive than a cash collateral account or a collateral invested amount (both discussed next); therefore, its use as a credit enhancement facility is limited.

Cash Collateral Account

Some industry experts categorize cash collateral accounts (CCA) as internal credit enhancements, but for the purposes of this manual, they are viewed as external credit enhancements because they are typically not created from the cash flow of the underlying

receivables or as a result of the securitization structure. A CCA is a segregated trust account, funded at the time a series is issued, that can be used to cover shortfalls in interest, principal, or servicing expenses if the excess spread falls below zero. The account can be funded by the issuer, but is most often funded by a loan from a third-party bank (or an affiliate), which will be repaid only after holders of all classes of investor certificates of that series have been repaid in full. The loan is generally priced using a specified index plus a fixed spread. The pooling and servicing agreement dictates the amount of the CCA, which is typically based on a specified percentage of the investor certificates issued in a specific series.

CCA have evolved from the earlier transactions that used letters of credit as a credit enhancement. To eliminate the event risk of the letter of credit provider receiving a rating downgrade, which could cause the investor certificates to also be downgraded, the securitization vehicle's trustee borrows the required credit support amount from a commercial bank (or an affiliate) and places the funds in a CCA at closing. Under this type of enhancement, the securitization vehicle's trustee enters into a loan agreement with the third-party. Excess finance charges are used to pay interest on the CCA loan that was obtained to fund the CCA prior to being released to the seller.

Examiners need to be aware of the existence of a CCA when identifying the cash flow waterfall and assessing the valuation of any CE IO strips created from anticipated excess spread. Typically, the required interest payment to the CCA provider is near the bottom of the waterfall. If the securitization performs well, the cash collateral provider is repaid its principal from the CCA itself as the transaction amortizes and the need for this credit enhancement curtails. If the securitization does not perform well, the cash collateral provider will only be repaid after all holders of the investor certificates that are senior in priority are paid in full. CCA can be set up to support either all or only some of the classes in a series. For example, the CCA can be collateral for the rated classes, but may or may not serve as a credit enhancement for the un-rated, most subordinated classes. Again, the securitization documents will identify the exact payment priority and subordination.

Collateral Invested Amount

Similar to a CCA, the third-party credit enhancer lends money to the securitization trust, but instead of putting the funds into a CCA, the proceeds are used to purchase an undivided ownership interest in the securitization trust's assets (the underlying receivables). The collateral invested amount (CIA) is also referred to as the C tranche and is typically rated triple-B. Often, a Class C bond is issued instead of using a CIA and typically carries the same triple-B rating as the CIA. With a CIA, the cash flows allocable to the collateral invested holder are used to repay the interest and principal on the loan.

The CIA is an un-certificated, privately-placed ownership interest in the trust, subordinated in payment rights to all investor certificates. Like a layer of subordination, the CIA serves the same purpose as a CCA, making up for cash shortfalls if the excess spread is negative. The CIA itself is often protected by a separate cash collateral account and available excess spread. If the CIA absorbs losses, it can be reimbursed from future excess spread if available. Like the CCA, the CIA is usually a designated percentage of the investor certificates plus any cash collateral interest. The advantages of the CIA include a wide range of investors and no downgrade risk associated with a third-party provider.

Surety Bonds

Surety bonds are guarantees issued by third parties, usually triple-A rated, mono-line insurance companies. Surety bond providers generally guarantee (often referred to as a wrap) the principal and interest payments for specified investor certificate classes. The cost of this guarantee is determined by the insurance company's perceived credit risk in the underlying receivables. Surety Bonds are more prevalent in subprime credit card securitizations. The monthly premium

for this insurance can increase on subsequent series issued out of a master trust if the performance of the underlying receivables is deteriorating. Certain issuers have seen this premium more than double as credit quality deteriorated.

Reserve Account

A reserve account is established to ensure distribution of principal and interest on the certificates as required in the pooling and servicing agreement. The bank may have the option of funding the reserve account with an initial cash deposit or through the retention of specific periodic distributions of principal or interest otherwise payable to the investors. The amount required in a reserve account may be stated as either a percentage of the senior certificates or any other amount designated by the bank.

EARLY AMORTIZATION TRIGGERS

Revolving credit card securitizations use early amortization triggers as a way of protecting investors from deterioration in asset quality. Early amortization events and servicer default triggers are typically defined in the general prospectus and the prospectus supplement for each series issued, the pooling and servicing agreement, or the insurance agreement if a third-party insurance company guarantees the transaction. Early amortization triggers accelerate the repayment of the investor certificates' principal ahead of their scheduled maturity. This accelerated repayment method requires that the investors' share of all principal collections be returned immediately when they are received by the securitization vehicle's trustee.

A prospectus supplement typically discusses the terms and structure in greater detail and may use different terms and references than those specified in this manual. For example, terms including early redemption events, events of default, events of default remedies, and pay out events have been used to describe early amortization events.

Typically, early amortization events are tied to quantitative factors performance metrics. The following list provides examples of some early amortization triggers or events (the first one being the most common), but it is not all inclusive:

- If for any month, the average of the excess spread amount for the three preceding calendar months is less than the required excess spread amount for the month (e.g. excess spread falls below zero for three consecutive months).
- The triggering of an event of default or early amortization trigger in any series, class, or tranche issued out of the master trust (e.g. cross early amortization clause).
- Failure to pay the investors in full by the expected final maturity date.
- Default by the servicer (default would be defined in the pooling and servicing agreement).
- Seller's interest falling below a specified required amount (for example, 7 percent).
- Insolvency or bankruptcy of the seller or transferor.
- The trust is deemed to be an investment company for purposes of the Investment Company Act of 1940.
- Material breach of any seller representation or warranty.
- Third-party downgrade.
- Merger or acquisition.

Other possible early amortization event triggers could be based on the performance of the underlying receivables, such as a delinquency or charge-off rate trigger, a portfolio yield trigger, or a payment rate trigger.

The aforementioned early amortization or early redemption triggers are generally self-explanatory; however, the following discussion is offered as further explanation for a few of the triggers mentioned.

Since each series has an undivided interest in the pool of underlying receivables, the triggering of an early amortization event in any series signifies some degree of deterioration in the underlying collateral. An early amortization event triggered by the excess spread falling below zero for three consecutive months may occur in one series but not in others if the weighted average coupon rate paid on the one particular series is greater than rates paid on others. However, since the only difference in excess spread from one series to the next is typically the coupon rate or perhaps a third-party fee, all series backed by these same receivables will be experiencing the same deterioration in yield, losses, or a combination of both. As a result, most deals now require a cross early amortization clause in order to protect the investors of all series issued out of the master trust.

A servicer default typically refers to the servicer failing to perform its duties as dictated in the pooling and servicing agreement; specifically:

- Failing to make required payments or deposits on time.
- Failing to perform its required duties, and such failure causes a material adverse impact on the investor certificate holders for an extended period.
- Making non-permitted delegations.
- Conveying incorrect representations or warranties which cause a material adverse impact on the certificate holders for an extended period of time.
- Becoming insolvent or bankrupt.

A merger or acquisition trigger enables the investors to opt for an early amortization in the event the credit card issuing bank is acquired by another institution. A merger or acquisition trigger protects the investors from the prospects of adverse underwriting or servicing standards by the acquiring institution. Recent mergers, however, reveal that if these types of triggers exist, they are not always exercised.

Triggering Covenants Tied to Supervisory Actions

On May 23, 2002, the Federal banking agencies issued FIL-53-2002, *Interagency Advisory On The Unsafe And Unsound Use of Covenants Tied to Supervisory Actions In Securitization Documents*. This guidance was issued after examinations uncovered structures with early amortization or servicing transfer covenants tied to supervisory actions or thresholds, such as CAMELS ratings, capital category, and written enforcement actions. Any contractual provision that could result in early amortization or the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event are subject to this advisory.

Negative safety and soundness implications exist if covenants link supervisory actions or thresholds to the triggering of an early amortization or the transfer of servicing. Triggers related to supervisory actions can result in a bank experiencing an early amortization event at a time when its ability to access other funding sources is limited, thereby resulting in liquidity problems. Such triggers also could potentially inhibit supervisors from taking actions intended to cure problems at a troubled bank because those actions activate a trigger that could cause a worsening of the condition or failure of the bank. Also, triggers premised upon the action of banking supervisors could result in an early amortization event when the supervisory action is linked to events that have limited or no relevance to the performance of the underlying assets. Also, covenants related to supervisory actions may obligate bank management to disclose confidential examination information.

Examiners should review securitization documentation to determine if covenants related to supervisory actions or thresholds exist. Covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event should, under appropriate circumstances, be criticized as an unsafe and unsound banking practice.

Consistent with the FIL, most banks have modified existing documents to remove these covenants, and new securitizations typically do not contain these types of covenants. However, banks new to securitizations may not be aware of the interagency advisory.