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The Safety Of Credit Card-Backed Investments What We Are Looking For Today

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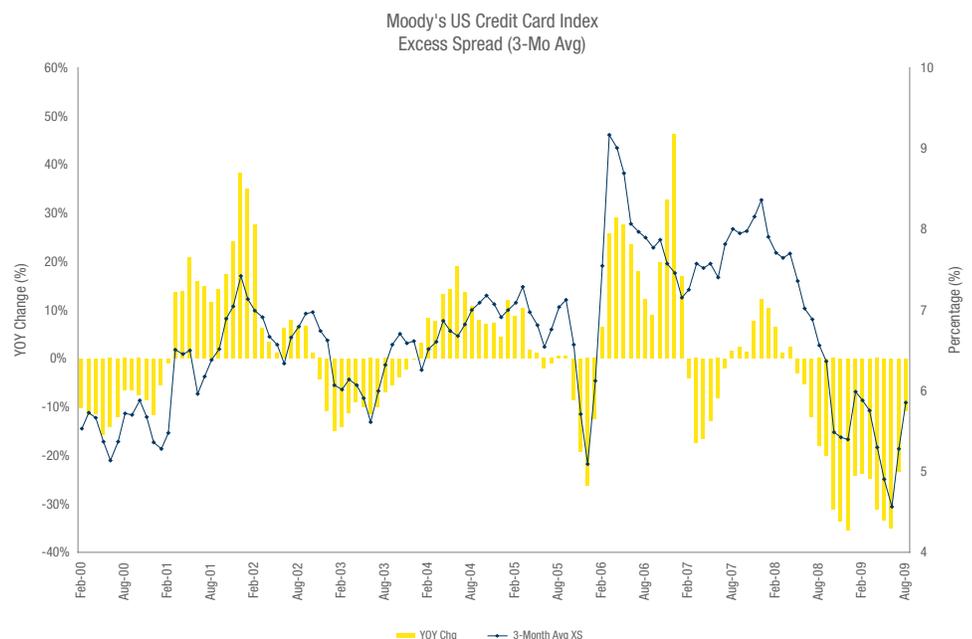
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Key Points

- The uncertainty today surrounding pending regulatory change, consumer behavior and accounting treatments prevents us from adding credit card asset-backed issuers to our approved list because of downgrade risk
- However, in terms of safety and given their performance year-to-date, we believe senior tranche credit card asset-backed securities (ABS) are potentially an attractive alternative to other structured products
- We are looking for major domestic issuers to demonstrate an ability to weather the current uncertainty in the months to come

Introduction

In the wake of the harsh spotlight thrown on structured finance's role in the 2007-2009 financial crisis, much of the securitization landscape has been altered. While many structured investments fell out of favor, particularly private label mortgage-backed securities and collateral debt obligations, credit card-backed securities avoided most of the severe credit and ratings downgrades. The AAA ratings for the senior tranches of the top five U.S. credit card issuers have been relatively stable to date. Based on Moody's credit card index data, credit card excess spread (a good proxy for the overall health of a trust) remains healthy and improved from 6.15 percent to 6.81 percent in September 2009 with three-



month average excess spread above 6 percent (see figure 1). Healthy excess spread has come from higher portfolio yields, which have helped offset higher charge-offs. We expect the senior tranches of credit card asset-backed securities to remain attractive in terms of safety, however the uncertainty surrounding pending regulatory changes means we remain neutral on this asset class. (We have currently one major ABS card trust on our approved list). Beyond new governmental regulation, new accounting rules and changing cardholder behavior are other major factors that prevent us from adding more credit card trusts into our approved list.

Overview of Credit Card Asset-Backed Securities

Credit card asset-backed securities are one of the oldest segments of the ABS market, representing 42.3 percent of ABS issuance in 2008. They are backed by payment streams from a pool of credit card receivables. From a credit standpoint, ABS have strong credit quality as they are secured by over-collateralization and credit enhanced with strong protection measures to ensure predictable, consistent repayments. Fast paydown of liabilities inherent in credit card debt has also contributed to the stability of ABS credit card ratings. ABS sectors offer investors the ability to diversify their fixed-income portfolios from government agencies, money market and corporate bonds, as well as protect against event-risk downgrades. Historically, AAA-rated credit card ABS have provided yields comparable to an A-rated financial corporate bonds.

Major Sponsors Have Supported Their Credit Card Trusts

Since the beginning of 2009, major credit card ABS sponsors have moved to support their credit card trusts to avoid rating downgrades as collateral performance sagged. Most credit card issuers have focused on structural improvements by exercising their discount options and adding subordination to improve the credit profile of their respective credit card ABS. The “Big 6” issuers in the U.S. are strongly motivated to bolster credit card trusts as the card business is important both from an earnings perspective

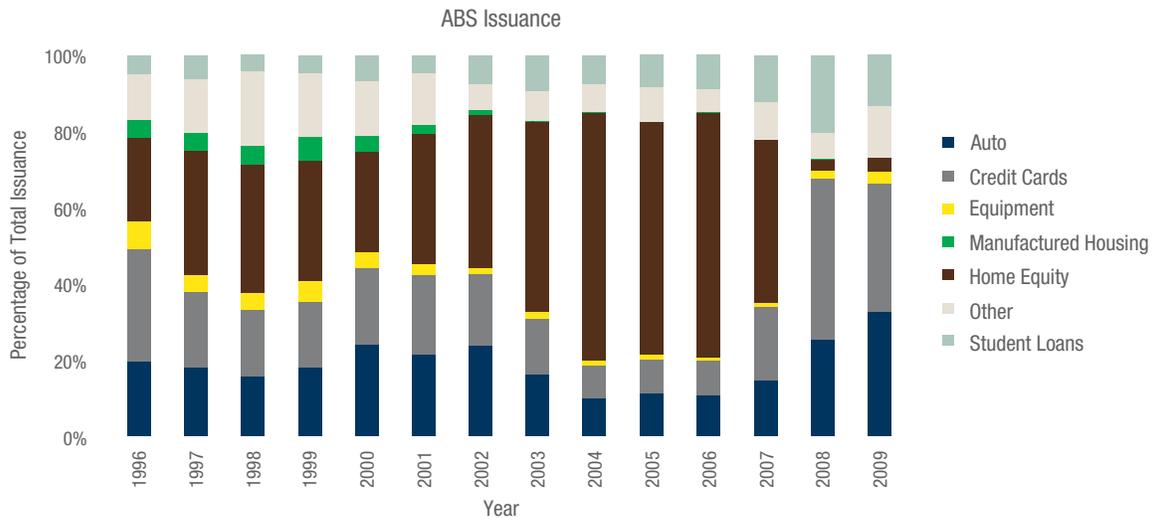
and as a funding source. In early 2010, securitized credit card portfolios are expected to be consolidated on the bank's balance sheet, which will require the issuers to hold more capital and reserves. From a cost perspective, this may make securitization less attractive as a funding alternative, but will remain an important funding source for card issuers.

The Macroeconomic Picture Matters to Underlying Collateral Performance

In terms of collateral performance, macroeconomic factors such as the increase in unemployment have correlated strongly with the increase in the charge-off rates. While the Emergency Economic Stabilization Act of 2008 has helped stimulate the economy, unemployment has increased dramatically from 6.2 percent in September 2008 to 9.8 percent in September 2009. Recently, there have been signs of improvement in the number of initial jobless claims as initial claims filed for the week ending October 3 reached 521,000, marking the lowest level since January 2009. Moody's continues to call for a recovery of the credit card sector to begin once industry average charge-offs peak in mid-2010 between 12 percent and 13 percent, based on macroeconomic indicators on a projected peak in the unemployment rate of 10 percent to 10.5 percent. Standard & Poor's base case scenario calls for charge-offs of 10.5 percent to 11 percent in 12 to 24 months based on an unemployment rate of 10.5 percent. Despite the forecast for rising charge-offs, excess spreads should widen in the months to come, especially for those trusts that exercise their discounting option.

Accounting and Regulation Changes Impacting Credit Card Issuers

New GAAP accounting standards FAS 166/167 are expected to bring certain off balance sheet activities back to the bank's balance sheet including credit card securitization. The new accounting rule will result in incremental credit risk to the securitization in the event of insolvency of the bank sponsor, due to closer linkage between the ratings of the sponsor banks and the related credit card ABS.



Currently, an existing FDIC rule provides a safe harbor against repudiation of a securitization by the FDIC so long as the related transfer of assets meets the standards for a sale under GAAP. This new accounting rule will eliminate sale accounting for credit card securitizations. There is still uncertainty over whether the FDIC will continue to grant “safe harbor” status to the securitizations.

If the safe harbor issue remains unsolved, Moody’s has stated that this could lead to many Aaa-rated U.S. credit card transactions being placed on review for possible downgrade due to the potential repudiation risk and stay risk by FDIC. The magnitude of any downgrade will depend on the credit strength of the bank sponsor.

Despite the uncertainty of FDIC future action, the likelihood of a downgrade to ABS sponsored by Aa3 or above-rated banks is low. The new accounting rule is expected to be implemented starting on the fiscal year beginning after November 15, 2009.

CARD Act

Credit card issuers must comply with some elements of the CARD Act, designed to increase protections to credit card holders and full adherence to the Fed’s new regulation. The latest legislation introduced in the House of Representatives on September 2009 could accelerate

the timeline of the changes mandated up to December 1, 2009 instead of February 2010 as originally scheduled. In response, card issuers have been tightening underwriting standards, employing more conservative risk management strategies as well as adjusting pricing in advance of enactment, with the effect of improving credit card trust performance. Lenders are charging off their bad credit card balances at a record pace while dramatically slowing down originations and curtailing existing lines of credit.

Government Intervention Into ABS Markets

Over the past year, the TALF (Term Asset Backed Securities Loan Facility) program supported the stability of the overall ABS market and helped tighten spreads. But despite this, issuance in securitization markets as a whole is markedly down compared to its 2007 peak. By comparison, credit card ABS issuance has been relatively stable, totaling approximately \$43 billion through 3Q09 including 60 percent issuance through TALF (See figure 2). On August 17, 2009, the Federal Reserve and the Treasury Department announced that the expiration date of the TALF program for non-mortgage ABS will extend to another three months through March 31, 2010. We expect that 4Q09 issuance will drop as long as concerns regarding FDIC’s safe harbor persist.

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