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## Are Credit Cards the Next Crisis?

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In the past several months some have predicted a spillover from home mortgage markets to credit card markets. Some claim that increased credit card defaults will lead credit card ABS structures to blow up similar to the mortgage industry. Despite those pressures, however, the credit card industry will remain profitable and the ABS structures will not blow up because the riskiest revolving credit borrowers were lured to the mortgage sector through products like home equity lines of credit (HELOCs) in recent years, credit card ABS structures are over-engineered compared to their mortgage counterparts, and credit card companies now make substantial profits as a payments medium, rather than through the credit function of the cards.

### HELOCs TOOK THE RISKIEST CREDIT CARD BORROWERS

In 2006 (the most recent year available) the Nilson Report showed some \$690b in general purpose credit cards outstanding, roughly another \$100b in oil and store cards outstanding, and about another \$100b in charge balances outstanding (American Express). But between 2000 and 2007 there were some \$200b in HELOC securitizations, representing competition for consumer revolving credit needs.

HELOCs were attractive to consumers, especially for riskier borrowers, usually offering twenty years of interest-only payments at lower rates than credit cards. As a result, from 2002-2006, oil and store card outstandings fell in 2003 and 2004, as HELOC products successfully bid away borrowers. General purpose card growth slowed in 2003 and 2004 in response to similar market pressures.

Now, HELOC expected losses are trending toward 15%, and even higher for more recent vintage deals, which is similar to the roughly 17% subprime credit card loss rate experienced in 2003.

### CREDIT CARD ABS STRUCTURES ARE OVER-ENGINEERED COMPARED TO HELOCs

JP Morgan recently analyzed differences between enhancement structures among Credit Cards and Subprime Mortgages. In their own words, "...BBB Credit Card ABS generally offers 2.25x loss coverage (Fitch) simultaneous with cuts in yield and payment rate. In comparison, while ABX.07-1.AAA loss coverage started originally at 5x [loss coverage], the dramatic change in [subprime mortgage loss] expectations, from approximately 6% to 20-30%,

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means that coverage ratio now range between 0.99x and 1.45x, with an average of 1.20x. Using Fitch's seasoned loss coverage ratios to estimate an appropriate rating for ABX, we find 1.20x loss coverage is consistent with a rating of BBB. The two originally AAA tranches in ABX.07-1 with loss coverage below 1.0x would be non-investment grade (i.e., HEAT 06-7 and LBMLT 06-6). (JP Morgan, Securitized Products Weekly, April 25, 2008)

BBB Credit Card ABS also benefit from early amortization triggers and spread account credit enhancement that protects investor interests in the event of deal underperformance.

Hence, while Credit Card performance has exposure to the performance of housing, "...underwriting did not deteriorate as significantly as in subprime mortgages (i.e., not underwritten to a +5% per annum [house price appreciation] scenario). (JP Morgan, Securitized Products Weekly, April 25, 2008)

Furthermore, HELOC issuers that are at worse risk than the Credit card issuers. Like Credit Cards, HELOC ABS deals contain rapid amortization features that can constrain investor risk. Unlike Credit Card lenders, riskier engineering (lower credit enhancements) mean that rapid amortization events are more likely than among Credit Card ABS. Furthermore, those events will create a massive funding commitment for lenders like Countrywide and ResCap (in the billions), both of which are already experiencing dire financial difficulties. In fact, both originators have sent letters to some borrowers suspending lines of credit due to property value declines, which will mitigate this risk. (JP Morgan, Securitized Products Weekly, April 25, 2008)

#### CREDIT CARD COMPANIES PROFIT FROM USE, AS WELL AS BORROWING

Credit card use is integral to consumer markets. Credit cards are not only used, but are necessary for a variety of consumer payments. Take, for instance, airline tickets. As we learned with the Frontier Airlines bankruptcy, if a credit card bank sees a risk that the merchant will not deliver the product, the bank will cut the merchant off from further ability to accept credit cards for payments. Since most airline customers use credit cards to pay for tickets, such a movement was a death knell to Frontier.

From the perspective of the industry, the credit card banks and associations earn interchange from using credit cards for those types of payments. Since credit card companies offer not only credit, but also payment services, credit card companies remain profitable despite the fact that a substantial majority of monthly credit card charges are paid in full each month. Hence, credit card companies can be expected to remain profitable despite a downturn in credit quality.

#### SUMMARY

Will there be losses in the credit card industry? Undoubtedly. Will those losses surprise investors that bought credit card ABS? Probably not. Will those losses break the industry? I seriously doubt it.

The credit card industry has been built around effective risk-based pricing, solid securitization vehicles, and sells more than just the "credit" function on the card. Those operational principals will continue to serve the industry well through the downturn.