Asset-Backed Securities: Time to Reevaluate Their Place in Corporate Accounts?

Abstract

AAA-rated fixed rate credit card ABS may be viable investments for corporate treasurers. Transparent asset collateral, servicer quality, potential sponsor support, relatively short maturity schedule, and soft-bullet structure are some of the sector's advantages over other forms of ABS. The credit card ABS sector stood the test of time without significant ratings implications during the Great Recession. Recent delinquency and charge-off statistics confirm that the worst may be behind us in consumer credit quality.

AAA-rated credit card ABS returned 0.48% more in annual returns than short-duration corporate bonds in the last decade. The annual outperformance was even greater, at 2.1%, in the last three years that included the financial meltdown. Treasury investors should carefully evaluate the fundamental credit characteristics of ABS in deciding on the appropriateness of ABS in their cash portfolios. Proper credit surveillance should be in place to evaluate bond performance in a timely fashion.

Introduction

It has been nearly six years since we published a whitepaper (*Asset-Backed Securities: Do They Belong in Corporate Accounts*) on why asset-backed securities (ABS) may be an appropriate asset class in corporate cash portfolios[1]. However, for many treasury investors, the recent financial crisis was caused by, or related to, a number of financial assets that can be loosely categorized as ABS. It is no wonder why some corporate investors view the entire sector with a suspicious eye. Is this attitude justified? Should corporate treasury portfolios shun the entire asset class as the result of the crisis? With the economy improving and regulators demanding better transparency, is it time to reconsider ABS as a viable asset class? With this whitepaper, we hope to provide our perspective that not all ABS are alike and, with adequate due diligence, the credit card ABS sector may prove beneficial to corporate treasury investors.

Published: March 1, 2011

Lance Pan, CFA
Director of Investment Research
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

Safety First

In our 2005 paper, we compared investment returns and credit risks of AAA-rated asset-backed securities to those of AAA-rated corporate securities. Our analysis drew empirical data from the Merrill Lynch ABS Index and the Merrill Lynch AAA-Rated 1-3 Year Corporate Index between 1998 and 2003. Our conclusion was that, during this period, AAA-rated ABS provided comparable investment returns while incurring

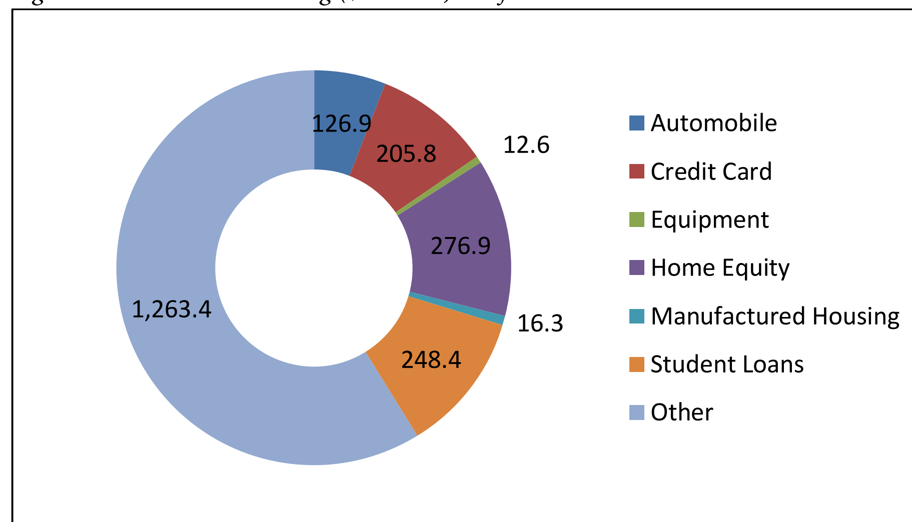
less return volatility. We think this approach is no longer applicable today for two reasons. One, despite comparable AAA credit ratings, the credit market views ABS less favorably than corporate securities because of their complexities. Two, the amount of AAA-rated corporate securities has shrunk dramatically in the Merrill Lynch index during this period, from 28 securities totaling $163.7 billion in market value in 2003 to just 12 securities totaling $9.1 billion in 2010.

In the post-credit crisis era, investors are rightfully more concerned with the fundamental risk characteristics of investments rather than relying on credit ratings. The financial crisis also serves as a real-life test case of how different asset classes performed during the financial meltdown and the ensuing Great Recession. In placing greater emphasis on safety, we think one should first establish which types of ABS may be appropriate for conservative corporate investors before relative value analysis can commence.

Why ABS Received Bad Publicity during the Credit Crisis

Similar to corporate securities from different industries with different credit characteristics, ABS are known by the financial assets that back up the bonds. While we advocate investing only in AAA-rated securities backed by prime quality credit card receivables (and occasionally auto loans,) they actually represent a small subset of the ABS market.

Figure 1: US ABS Outstanding ($ Billions) as of 12/31/2010

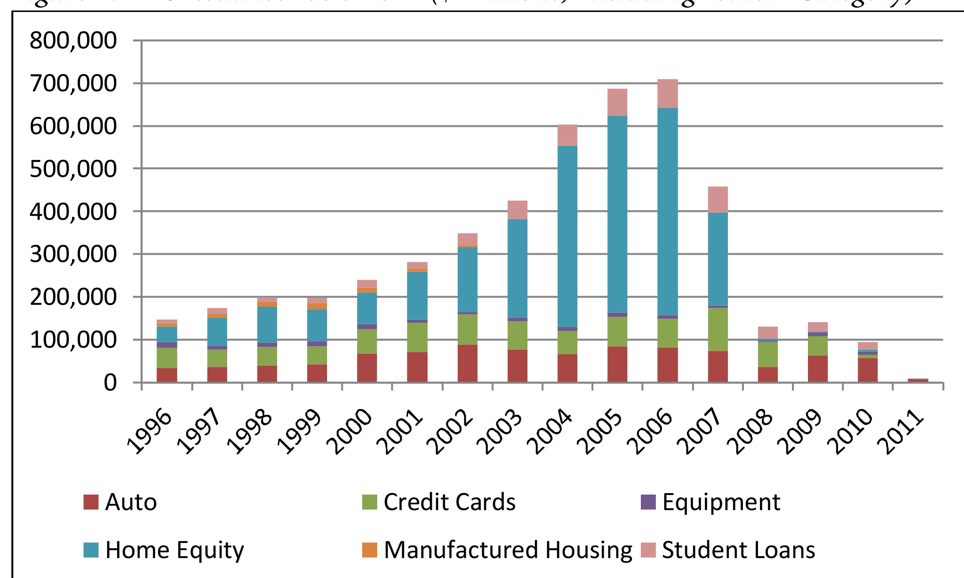


Source: SIFMA U.S. ABS Outstanding http://www.sifma.org/research/statistics.aspx.
"Other" includes CDOs.

As Figure 1 indicates, of the $2.1 trillion ABS outstanding as of the end of last year, about $1.2 billion, or 59%, were backed by obscure assets including the now infamous

collateralized debt obligations (CDOs). In contrast, cards and autos made up only 10% and 7%, respectively. We think one reason ABS received unfavorable publicity during the crisis was that many loans of questionable origins and credit worthiness were packaged into bonds generically called ABS. Further, as shown in Figure 2, the rapid growth of issuance in ABS backed by home equity loans, a code word for subprime mortgages, in the years leading up to the crisis, contributed directly to the collapse of the market. While a number of government programs helped stabilize the ABS market backed by credit cards, auto loans and student loans, the market for the other collaterals never recovered.

Figure 2: ABS Issuance 1996-2011 ($ Millions, Excluding "other" Category)



Source: SIFMA U.S. ABS Outstanding

Why AAA-rated Fixed Rate Credit Card ABS May be a Viable Choice

In our 2005 whitepaper, we cited the benefits of investing in ABS such as yield advantage over treasury and agency securities, high credit quality and low event risk. Relative to the other non-mortgage ABS, we think securities backed by prime quality credit card receivables may be worthy candidates for treasury investors for the following reasons:

a) Consumer credit statistics are more readily available from major credit card trusts than from other assets collateral pools. By monitoring the delinquency and charge-off statistics, card investors may have better insight into the credit quality of the revolving credit balances than in the long-dated assets in other ABS types.

b) Most of the major credit card trusts are serviced by well-known investment-grade bank servicers such as JPMorgan Chase and American Express. Servicer quality, Federal bank regulations, and potential parental support are important credit characteristics not common in other ABS types.

c) ABS backed by credit card receivables are generally shorter in their expected maturities, usually within three years of issuance. Furthermore, the so-called "soft-bullet" structure, which by design returns a lump sum principal payment to investors on a pre-determined date, is a feature only available to credit card ABS. ABS backed by other forms of collateral return principal in several smaller payments. These are important practical considerations given most treasury accounts' need to closely control liquidity.

Servicer Support during the Downturn

Without a doubt, as a form of unsecured lending to the American consumer, credit quality in credit card portfolios suffered during the Great Recession. As delinquencies and losses rose, major card sponsors chose to support the bonds with additional credit enhancement so that they would maintain credit rating stability. According to a Standard & Poor's study, 10 asset pools from nine different credit card ABS originators received support between January 1, 2008 and August 31, 2009[2]. These 10 pools represented 413 specific bonds originally rated from AAA to BBB. Support was typically in the form of posting additional collateral through new subordinated notes.

Table 1: Possible Ratings Transitions for Credit Card ABS

Rating category before	No. of Bonds	Possible rating category without support				
		AAA	AA	A	BBB	BB
AAA	188	143	45			
AA	14		14			
A	101			73	28	
BBB	110				6	104

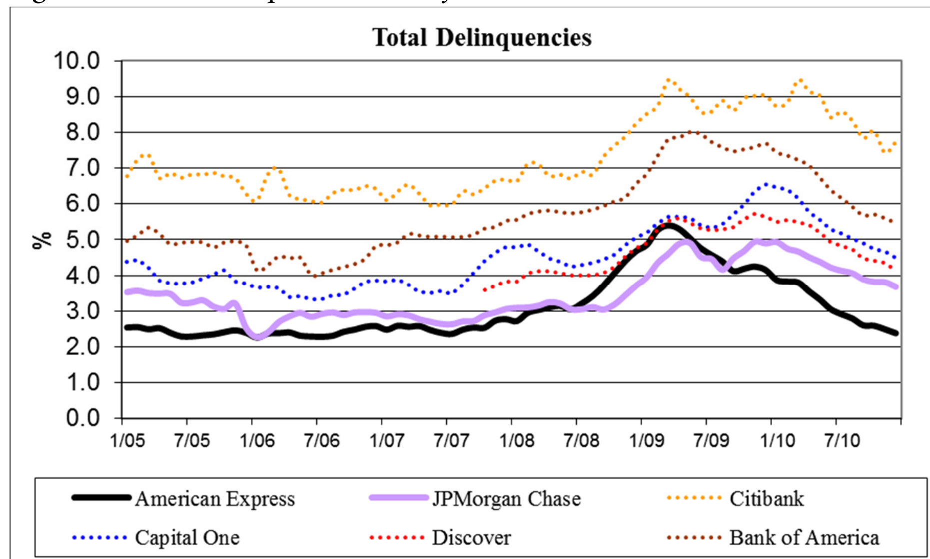
Source: Standard & Poor's

The fact that sponsors stepped in to provide credit enhancement to credit card ABS is an added comfort to ABS investors, although such support is not contractual and may not be repeated in the future. What is striking to us in this S&P study is the finding that, without sponsor support, 143 of the 188 AAA-rated bonds would have retained their AAA status, and none would have fallen below AA. These statistics are in stark contrast to many of the CDO varieties that quickly fell to junk status or default as the financial crisis deepened.

The Credit Cycle Supports ABS in Cash Portfolios

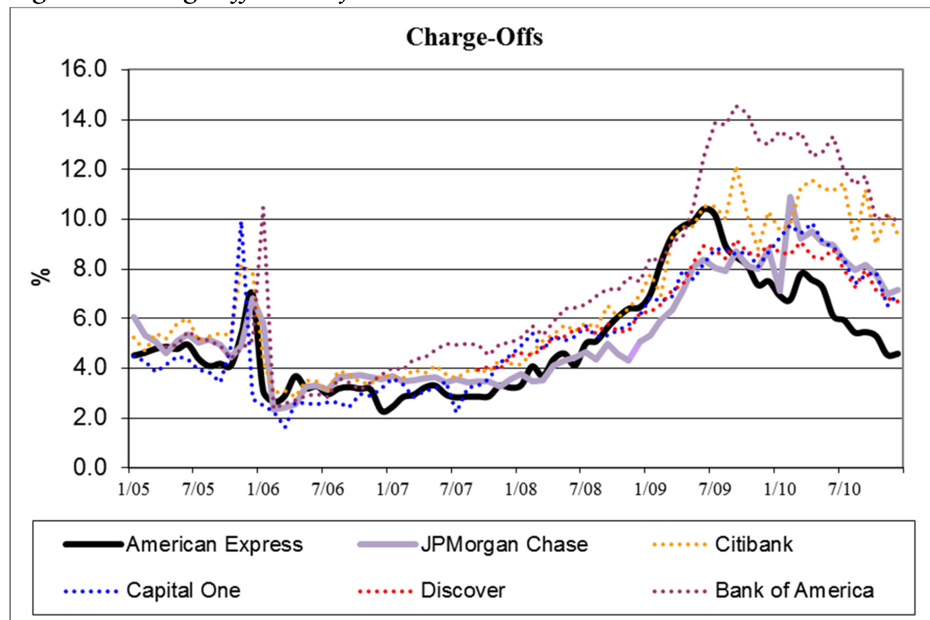
The credit cycle is an important factor in considering investments in credit card backed ABS, much as it is when considering investments in bank bonds. As a firm, we stopped purchasing credit card ABS in the spring of 2008 as we suspected the subprime mortgage crisis could spill over to the other consumer sectors.

Figure 3: Total Delinquencies in Major Credit Card Trusts



Source: CAG compilation of trust data from Bloomberg

Figure 4: Charge-offs in Major Credit Card Trusts



Source: CAG compilation of trust data from Bloomberg

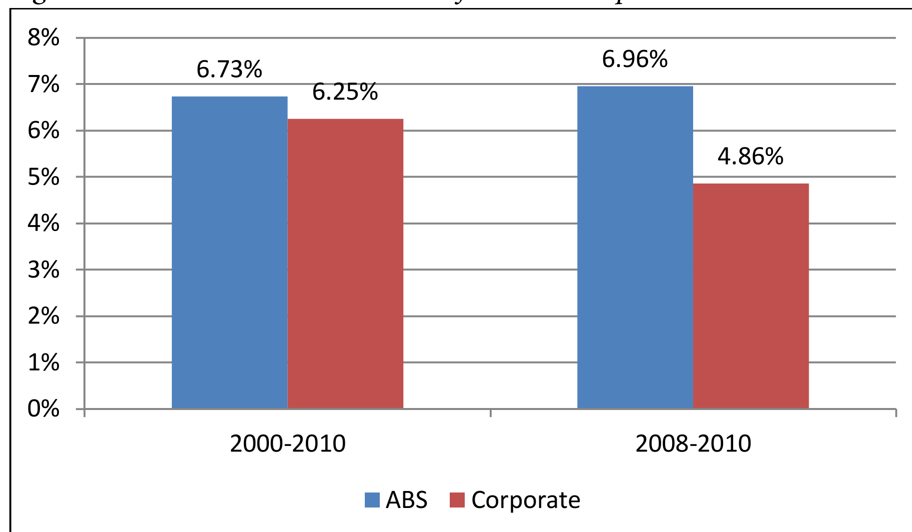
As Figure 3 and Figure 4 indicate, the consumer credit cycle clearly turned the corner in the summer of 2009 for the six major credit card trusts we monitor. Although the economic recovery in the U.S. remains tepid and the unemployment rate remains high, we think the likelihood of the delinquency and charge-off statistics revisiting the 2009 peaks is remote.

Based on the S&P analysis of strong unsupported AAA ratings performance during the Great Recession and the positive credit trends in the credit card sector, we believe credit card ABS now represents a favorable credit investment vehicle for treasury investors.

Investment Performance during the Crisis Was Favorable

We hope to have established that credit card backed ABS may be sound credit investments for treasury investors; but a discussion is not complete without a comparison of their total return performance relative to other eligible credit investments. We picked the Merrill Lynch Fixed Rate Bullet Credit Card ABS Index (Code R0CB) as the ABS proxy. We used the Merrill Lynch U.S. Corporate, A-AAA Rated 1-5 Year Index (Code CV10) as the corporate proxy. We used the A-AAA corporate group since we think the market tends to discount the AAA ratings in ABS. We used a longer corporate index to match its modified duration of 2.72 years at year-end 2010 to the ABS index's 2.77 years.

Figure 5: Annualized Total Returns of ABS vs. Corporate Indices



Source: Merrill Lynch Global Indices R0CB and CV10 via Bloomberg.

As Figure 5 indicates, for the last decade, the credit card ABS index returned 6.73% annually, compared to 6.25% for the corporate index. The return differential was even higher during the financial crisis. In the three years since 2008, the ABS index returned

6.96%, a pickup of 2.10% over the 4.86% earned by the corporate index. In short, AAA-rated fixed rate credit card backed ABS could have provided attractive returns while diversifying risk in a corporate treasury account during these periods.

Conclusion

Treasury investors are rightfully skeptical of the appropriateness of ABS in their cash portfolios today due to a wide range of ABS in existence and the credit deterioration of certain asset collateral. We think the bad publicity has fallen unfairly on non-mortgage related consumer ABS bonds. We continue to view AAA-rated fixed rate credit card ABS as viable investments for corporate treasurers. Their relatively transparent asset collateral, strong servicer quality, a history of sponsor support, relatively short maturity schedule, and soft-bullet structure are some of the advantages over other forms of ABS. They also seem to have stood the test of time in surviving the Great Recession without significant ratings implications. Now past the peak of the credit cycle, we think it is appropriate for treasury investors to consider using this asset class as a viable investment choice. In comparing the return history over the last decade and, in particular, the three years that included the financial market meltdown, we found AAA-rated fixed rate credit card bonds outperformed their corporate counterparts by 0.48% and 2.10% on an annualized basis.

In conclusion, we think treasury investors should carefully evaluate the fundamental credit characteristics of ABS, rather than relying on general market sentiment, in deciding whether ABS may be appropriate for their cash portfolios. Since investment performance of credit card ABS may follow the overall consumer credit cycle, proper credit surveillance procedures need to be in place to evaluate bond performance in a timely fashion.

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[1] Asset-backed Securities: Do They Belong in Corporate Accounts, by Lance Pan, was published by Capital Advisors Group on March 29, 2005. Contact us for a print copy of this article.

[2] U.S. ABS credit ratings would have remained relatively stable even without additional support, by Jason McCauley, Primary Credit Analyst et al., Global Credit Portal: Standard & Poor's, January 25, 2010.

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