

# U.S. Structured Finance Newsletter

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## REPRESENTATIONS & WARRANTIES

The Securities and Exchange Commission (SEC) is preparing to prescribe regulations on the use of representations and warranties (R&Ws) for the asset-backed securities (ABS) market. Under the Financial Reform Act signed into law on July 21, 2010, the SEC shall prescribe regulations relating to R&Ws within 180 days after enactment. These regulations require rating agencies to include, in any report accompanying a credit rating, a description of the R&Ws included in the transaction and how such R&Ws may differ from similar transactions.

In contemplation of these changes, DBRS has studied R&Ws in credit card master trusts. Typically, representations, warranties and covenants are meant to provide investors with comfort regarding the credit quality and eligibility of the assets being relied upon as collateral for a transaction, while also insuring that legal separation should be respected and ownership has been effectively transferred to the issuer.

The effect of a breach of R&Ws can be perilous if issuers are dependent on the ABS market for funding and the aggregate receivables balance is close to the minimum transferor interest for the trust. This can occur in most credit card master trusts if the transferor/seller is required to repurchase a material amount of receivables. Transferors/sellers have to repurchase a receivable within 30 days of notification or discovery of a breach. If the receivable is repurchased and the result is a failed minimum seller's interest, a trust wide early amortization will occur.

In practice, not many receivables have been repurchased from credit card master trusts due to breaches of R&Ws. The reasons for this include:

1. The originations are generated organically by most banks, through mailer campaigns and at bank branches. This is dramatically different than an acquisition of receivables from a different source.
2. The systems most credit card issuers rely on to generate, service, collect on and, if necessary, remediate, are robust.
3. Banks are highly regulated entities where compliance is typically approached more systemically and the business division normally builds that part of the bank as they are establishing or enhancing the credit card division.
4. Many times, additional receivables are not even transferred in order to issue a series. Maturing series, for example, could be re-issued with no new receivables added to the trust, assuming the re-issued series was issued in the same note size and all other important metrics (e.g. minimum transferor interest, credit enhancement, base rate triggers, etc.) were passed.
5. The continual nature of issuance makes the R&Ws aspects of a credit card master trust inherently different than a typical owner or grantor trust securitization.
6. Many credit card issuers have series that are either publicly issued or funded privately in the conduit market. The conduit administrators will also typically have the right to inspect the quality of receivables and the legal underpinnings of the Uniform Commercial Code filings. However, it should be noted that many conduit administrators do not typically rely on anything more than a due diligence review and the transaction legal opinions (which should also be available for term noteholders to rely upon).

Sponsors also have a good amount of incentive to repurchase receivables due to a breach of representations and warranties, especially if the trust is a primary source of funding for the bank. The flexibility to manage trust portfolios has also increased since many of the benefits of off-balance sheet treatment have been nullified by FAS 166 and 167. This goes beyond the breach of R&Ws themselves, and is instead a factor that may contribute to greater reliance on the R&Ws and related repurchase activity.

Consequently, it is likely that following the release of the expected regulations on R&Ws, DBRS will include more disclosure regarding R&Ws for various rated transactions.

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