

Asset-Backed Special Report

1998 Student Loan Industry Wrap-Up

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■ Overview

This report summarizes the recent trends in student financial aid, the issuance of student loan asset-backed securities (ABS), the changes implemented in the most recent reauthorization of the Higher Education Act of 1965, the legal issues regarding 150 (d) conversions, and the introduction of expanded student loan servicer oversight.

■ Trends in Student Financial Aid

Based on the most recent statistics from the college board, the volume of student financial aid increased 6% in academic year 1998–1999 in constant dollars, to \$60.5 billion. Of that amount, 54% is composed of federal loans, including the Federal Family Education Loan Program (FFELP) and the Direct Loan Program, with FFELP volume constituting two-thirds.

The growth in unsubsidized loan volume, which was introduced in academic year 1992–1993, has been dramatic and represents about one-third of federal borrowings. Since that time, Parental Loans for Undergraduate Students (PLUS) volume rose 13%, with the average loan amount jumping 65%, to \$6,285. Nonfederally guaranteed student loan volume topped \$2 billion for 1998, remaining relatively flat compared to 1997.

■ Student Loan Asset-Backed Issuance Volume

Student loan ABS volume reached nearly \$15 billion for 1998, comprised of approximately 72% asset-backed and 28% municipal transactions. This represents an almost 15% decline from 1997. The number of ABS deals totaled 12 versus 47 in the municipal sector.

This decline is due primarily to recent events in the capital markets, most notably the widening of the Treasury Eurodollar (TED) spread. Over the last six months of 1998, the capital markets endured interest rate spreads that rendered many transactions uneconomical. As a result, the issuance of 91-day U.S. Treasury bill (T-bill) floating-rate notes has decreased markedly, from approximately 70% in 1997 to 44% in 1998. The volume of auction-rate London Interbank Offered Rate (LIBOR) floaters, in addition to fixed-rate debt, each as a percentage of total student loan debt issuance, increased in 1998.

■ Reauthorization

On Oct. 7, 1998, President Clinton signed into law the Higher Education Amendments of 1998, which amended and reauthorized the Higher Education Act of 1965 for the next five years and implemented changes that may affect the economics of student loan ABS. The most far-reaching are the changes to borrower and lender interest rates and special allowance payments.

Reauthorization has extended the interest rate savings to borrowers of new FFELP loans that went into effect on a temporary basis on July 1, 1998 as part of the Transportation Equity Act for the 21st century. The legislation includes an 80-basis-point (bp) reduction in the student loan borrowers' interest rate for Stafford loans disbursed after July 1, 1998 through July 1, 2003. This results in a new borrower rate of 91-day T-bill plus 1.70% for in-school, grace, or deferment status loans and 91-day T-bill plus 2.30% for loans in repayment status. The subsidy paid to lenders by the federal government was effectively decreased from 80 bps to 50 bps, resulting in a yield of 91-day T-bill plus 2.20% while students are in school, grace, or deferment status and 91-day T-bill plus 2.80% while students are in repayment. The interest rate on PLUS loans will be 91-day T-bill plus 3.1%, capped at 9.0%.

The interest rate for direct consolidation loans originated between Oct. 1, 1998 and Jan. 31, 1999 will be equal to the bond equivalent yield of 91-day T-bill rate of the last auction in May plus 2.30%. The interest rate on direct consolidation loans originated after Jan. 31, 1999 will be equal to the lesser of the weighted average interest rate of those loans being consolidated rounded to the nearest one-eighth of one percent and 8.25%.

The interest payment rebate fee, which is an annual fee lenders pay the government in relation to the origination of FFELP consolidation loans, will be reduced for the life of loans to 0.62% from 1.05% for loans originated from Oct. 1, 1998 through Feb. 1, 1999. On and after Feb. 1, 1999, the interest payment rebate fee will again increase to 1.05%.

The extension of the availability of the lower rate direct consolidation loan program through Jan. 31, 1999 could temporarily increase the number of students consolidating their loans, thus increasing prepayment speeds. The magnitude of this increase is unclear due to many factors, including the visibility of the direct loan program and the cost savings it may represent. Due to the short-term nature of the extension, Fitch IBCA expects prepayment speeds and consolidation rates to return quickly to historical norms.

Fitch IBCA has been closely monitoring the interest rate issue to gauge the effects on outstanding student loan ABS in addition to developing criteria regarding future transactions. Ostensibly, the effect of the 30-bp yield reduction for student loans acquired into existing rated transactions will vary depending on the weighted average yield of the total portfolio, the transactions' cost structure, and the amount of available credit enhancement.

Since the legislation would not affect loan yields for loans already disbursed, Fitch IBCA expects that the effects on existing transactions should be marginal and relate to the levels of unused prefunding moneys or recycled principal receipts that are used to purchase the lower yielding loans. For transactions that are contemplated in the future, Fitch IBCA expects that higher than current credit enhancement levels may be needed to achieve an investment-grade rating.

■ Repayment Plans

Prior to re-authorization, all repayment options offered under the Stafford loan program stipulated that loans must be repaid in 10 years, exclusive of any forbearance and deferments. For income-sensitive repayment plans, negative amortization is not permitted. Reauthorization allows Stafford borrowers with outstanding loans of more than \$30,000 the option of an extended repayment period not to exceed 25 years.

The maturity extension option, while giving borrowers more flexibility in dealing with their student loan debt, could substantially increase the average life of student loans and, at the same time, the average life of bonds collateralized by these loans. This potential increase could cause a shift in the investor base of student loan bonds issued in the future.

■ Alternative Lender Yield Calculations

The comptroller general of the General Accounting Office and the U.S. Secretary of Education shall convene a study to evaluate the use of alternative financial instruments for determining lender yield. It is proposed that the study will evaluate the 30- and 90-day commercial paper rates, as well as LIBOR. Fitch IBCA believes this study could provide additional flexibility for issuers of student loan asset-backed debt since many of the lenders and investors in the student loan industry have cost of funds denominated in LIBOR or commercial paper. A change in the lender yield could allow these institutions the flexibility to match their own internal liabilities with a comparable asset.

■ Changes Affecting Guaranty Agencies

The following changes were instituted under re-authorization:

- The origination fee paid to guarantors by lenders will be set at 0.65% for 1999–2002 and 0.40% for 2003 and later.
- A guarantor's risk associated with default was increased due to the decrease of the guaranty agency's reinsurance reimbursement for

defaulted loans from 98% of the loan balance to 95%.

- A loan maintenance fee of 0.12% of outstanding guaranteed loans for fiscal years 1999 and 2000, and 0.10% of outstanding loans in fiscal years 2001–2003 will replace the administrative cost allowance.
- A guaratee agency's share of collections on loans in default decreases from 27% to 24%. A further decrease to 23% will be enacted in September 2003.

■ Master Promissory Note

Reauthorization introduces the concept of a master promissory note (MPN), under which all Stafford loans to a particular borrower are made. Lenders are able to sell loans originated over the course of a borrower's education at different times and to multiple buyers. The buyers' ownership of the loan(s) will be evidenced by a copy of the MPN. Fitch IBCA is currently analyzing the potential perfection problems that an MPN might produce for future student loan securitizations.

■ Nondischargeability of Student Loans

Student loans will no longer be automatically dischargeable in bankruptcy after seven years of repayment. The provision allowing loans to be discharged after seven years of repayment if a student can prove undue economic hardship will remain in place. This change could have a significant positive impact on the net default rates of transactions backed by loans without insurance, as it allows for increased recoveries.

■ 150 (d) Conversions

In August 1996, Congress passed the minimum wage bill that contains language which allows tax-exempt student loan funding corporations — 150 (d) — to convert to a for-profit, taxable entity. Some of the factors that were considered in the creation and passage of the legislation include: 150 (d) corporations are limited to holding and financing student loans with tax-exempt debt subject to state tax-exempt volume caps; the desire of some not-for-profit corporations to create and participate in other lines of business beyond those allowed by law; and income generated from tax-exempt debt financings in excess of 200 bps plus reasonable administrative fees over the yield on the student loan pool is required to be remitted to the U.S. government.

According to the legislation, a new taxable, for-profit entity will be formed that will acquire all of the existing assets and liabilities at fair market value.

The nonprofit corporation will remain a nonprofit organization and will hold all of the senior stock of the new company. Tax-exempt debt that is transferred will remain tax-exempt; however, no further tax-exempt debt may be issued by the taxable entity.

In addition to the rationales for conversion cited earlier, another positive factor is the ability of the new entity to access the private or public equity markets. Some of the negative factors include the costs of corporate restructuring and the creation of an income tax liability, which would reduce retained earnings and lower capital formation until new equity was issued. In addition, there may be an inability to convert due to language in an outstanding bond indenture that makes conversion impossible.

Fitch IBCA believes that the legislation will result in an expansion to the student loan asset-backed market of issuers as previously tax-exempt entities will no longer be able to finance their debt on balance sheet but will need to turn to the securitization market. Generally speaking, Fitch IBCA evaluates on balance sheet transactions by 150 (d) corporations and off balance sheet structures similarly from a cash flow perspective; however, the bankruptcy analysis is different. In most cases, the 150 (d) corporations that convert will need to set up special purpose corporations to finance their assets. Tax-exempt debt outstandings will maintain their tax-exempt status after the conversion and Fitch IBCA expects to affirm the outstanding ratings.

Fitch IBCA has issued new and affirmed existing ratings for the four issuers who converted from a 150 (d) to a for-profit corporation since the legislation was enacted. The new structures generally include a parent and operating company and a debt issuing entity.

■ Expanded Student Loan Servicer Oversight

In response to numerous investor inquiries regarding student loan servicer quality and effectiveness, Fitch IBCA has initiated an expanded student loan servicer oversight program that evaluates operational effectiveness as it relates to the portfolio performance of securitized transactions. Within the next 12 to 18 months, Fitch IBCA expects to convert their findings into a student loan servicer rating product.

■ Conclusion

Due to the dynamic nature of the student loan industry, the recent events in the capital markets, and the complexity of the regulatory environment, Fitch

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