

# U.S. Structured Finance Newsletter

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**Sharon McGarvey CFA, CPA**  
Senior Vice President, U.S.  
Structured Finance Research  
+1 212 806 3261  
[smcgarvey@dbrs.com](mailto:smcgarvey@dbrs.com)

**Michael Nelson**  
Managing Director, U.S.  
Structured Finance  
+1 212 806 3251  
[mnelson@dbrs.com](mailto:mnelson@dbrs.com)

**Toronto**  
DBRS Tower  
181 University Avenue  
Suite 700  
Toronto, ON M5H 3M7  
+1 416 593 5577

**New York**  
140 Broadway, 35th Floor  
New York, NY 10005  
+1 212 806 3277

**Chicago**  
101 North Wacker Drive  
Suite 100  
Chicago, IL 60606  
+1 312 332 3429

**London**  
1st Floor  
25 Cophthall Avenue  
London EC2R 7BP  
+44 (0)20 7562 5600

**Paris**  
27, avenue de l'Opéra  
75001 Paris  
+33 (0)1 7038 5214

**Frankfurt**  
Trianon Tower  
Mainzer Landstrasse 16  
60325 Frankfurt  
+49 (0)69 9716 8144

## BORROWER BENEFITS

In an increasingly competitive student loan market, lenders continue to use borrower benefits as an integral component of their marketing strategy. Common borrower benefits include the following:

- Reduction in the borrower's interest rate (generally 0.25% to 0.50%) when the borrower uses a direct-debit (ACH) method for payment.
- Additional interest rate reductions (generally 1% to 2%) when a borrower makes on-time payments for a qualifying time period.<sup>1</sup>
- Reduction in principal payments when the borrower makes on-time payments. Principal reductions can range from a set dollar amount (\$500 to \$700) or can be a percentage (3% to 5%) of the original or current outstanding balance at the time of qualification.
- Reduction or waiver of origination fees.

Although reductions or waivers of origination fees do not impact the cash flows in SLABS transactions since these benefits are applied prior to the loan being securitized, interest rate and principal reductions can present potential risks to collateral cash flows. However, the risks from these benefits are reduced by the following key factors:

- *Qualification hurdle.* Borrowers must be able to make consecutive on-time payments to continue to qualify for the benefit. Once a borrower misses a payment, the benefit is typically lost permanently or the qualifying status terminates. Overall, less than 15% of borrowers utilize ACH payment and less than 10% have historically qualified for the full term of the benefit.<sup>2</sup>
- *Ability of lenders to make changes to their program at any time.* Borrower benefits are typically not contractual and lenders can make changes to their programs at any time.<sup>3</sup>
- *Inclusion of credit enhancement* to cover the impact of borrower benefits in SLABS transactions.

Specifically, when evaluating SLABS transactions, DBRS will stress the issuer's historical utilization rate for borrower benefits. Under DBRS stress scenarios, a transaction must be able to withstand a level of borrower benefit utilization in excess of a multiple<sup>4</sup> of the issuer's historic rates. Additionally, the stressed utilization rate is assumed to be static, although practically, for SLABS transactions with discrete pools, the utilization rates will drop as borrowers miss payments and lose their qualifying status or benefit. Lastly, excess spread levels are fairly stable for SLABS transactions backed by FFELP collateral and provide additional protection.

While DBRS expects lenders to continue to use borrower benefits in their marketing strategies, particularly in light of the repeal of the single holder rule,<sup>5</sup> the credit risk they pose to SLABS transactions is expected to remain low. Additionally, the current proposed legislation to modify the FFEL program may motivate lenders to eliminate these programs, although historically their economic impact has been very low, approximately 10 basis points, or less than \$50 per borrower.<sup>6</sup>

For questions or comments, contact Sharon McGarvey at [smcgarvey@dbrs.com](mailto:smcgarvey@dbrs.com) or David Laterza at [dlaterza@dbrs.com](mailto:dlaterza@dbrs.com).

<sup>1</sup> Qualifying on-time periods can range from one month to 48 months. On-time payments are often defined as not past due more than ten to 15 days, although some programs allow for up to 30 days.

<sup>2</sup> Source: [www.finaid.org](http://www.finaid.org).

<sup>3</sup> Borrower benefits are not part of the promissory note between the borrower and lender and therefore are not contractual obligations of the lender.

<sup>4</sup> Stress multiples are applied based on the desired tranche rating, dispersion of the issuers' utilization rates and length of data series.

<sup>5</sup> This rule was repealed on June 15, 2006, and borrowers can now consolidate their loans with any lender.

<sup>6</sup> Source: [www.finaid.org](http://www.finaid.org).