

U.S. Structured Finance Newsletter

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Claire Mezzanotte

Managing Director, ABS/RMBS
U.S. Structured Finance,
+1 212 806 3272
cmezzanotte@dbrs.com

Jan Buckler

Senior Vice President,
Research and Modeling
U.S. Structured Finance
+1 212 806 3925
jbuckler@dbrs.com

David Hartung

Senior Vice President, ABS
U.S. Structured Finance
+1 212 806 3269
dhartung@dbrs.com

Quincy Tang

Senior Vice President, RMBS
U.S. Structured Finance
+1 212 806 3256
qtang@dbrs.com

Kathleen Tillwitz

Senior Vice President,
Operational Risk
U.S. Structured Finance
+1 212 806 3265
ktillwitz@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

THE DEPARTMENT OF EDUCATION'S DOUBLE-EDGED SWORD

The U.S. Department of Education (the ED) offers student loan lenders who participate in the Federal Family Education Loan Program (FFELP) two loan-purchase facilities that provide temporary liquidity to meet loan commitments for the 2008–2009 academic year and to help weather the current credit crisis. Over the next 12 months, these facilities could have a negative impact on the volume of student loan asset-backed securities (ABS) issued as lenders turn to the ED for funding rather than to the more-costly term capital markets. DBRS expects future loan-backed issuance to primarily emanate from refinancings of outstanding auction-rate securities and, in the longer term, from the repurchasing of loans from the ED (an option described below). A number of prominent lenders, including Sallie Mae and Nelnet, have already taken advantage of the ED's programs to the tune of several billions of dollars and many other lenders have indicated their intent to participate. The two programs offered by the ED are the Loan Purchase Commitment Program (the Purchase Program) and the Loan Participation Purchase Program (the Participation Program).

Under the Purchase Program, lenders can sell FFELP loans outright to the ED at any time (but no more frequently than weekly) at a price equal to (1) the outstanding principal amount of the loan plus (2) any accrued and unpaid interest plus (3) \$75 to cover ancillary fees and servicing de-conversion costs minus (4) the 1% origination fee initially paid by the lender to the ED. Following the loan sale, servicing of the loan will transfer to the ED. There is no minimum loan amount required for a lender to sell loans through the Purchase Program. A lender must notify the ED of its intent to sell a loan by August 14, 2009, and all sales must be completed by September 30, 2009.

Under the Participation Program, lenders can sell the ED participation interests in facilities backed by FFELP loans (but no more frequently than weekly). Specifically, the lender sells to the ED a Class A interest in a facility that consists of a 100% beneficial interest in the principal portion of the loans and the right to receive quarterly interest payments on the loans in an amount equal to the 90-day commercial paper rate plus 0.50%. The lender retains a Class B interest, which consists of the right to redeem the loans or to sell them to the ED through the Purchase Program plus the right to receive collections on the loans net of the quarterly interest paid on the ED's Class A interest and any loan principal payments. Servicing of the loan can be maintained at the original servicer during the participation period, which can last no longer than September 30, 2009. To take part in the Participation Program, a lender must commit to selling at least \$50 million of interests over the course of the program. The deadline for a lender to sign up for the Participation Program is July 1, 2009. In the Participation Program, the lender must arrange for a custodian to maintain title of the loans in the participation facility and perform a variety of other duties during the participation period, including preparing or arranging for the servicer to prepare monthly trust reports.

Common features of the two programs include the following: (1) lenders in both programs must state their intention to remain active in the FFELP; (2) only subsidized and unsubsidized Stafford and PLUS (both parent and graduate) loans are eligible; (3) the only borrower benefits affecting loans can be (a) upfront borrower fee reductions accrued and paid for or made prior to the sale and (b) interest rate reductions of no more than 0.25% for payment via automatic debit; (4) loans must have (a) a payment period beginning on or after July 1, 2008, (b) a first disbursement occurring between May 1, 2008, and July 1, 2009, and (c) a final disbursement by September 30, 2009; and (5) the servicing agreement covering the loan must be able to be terminated with 30 days' notice.

A lender may choose the Participation Program over the Purchase Program to maintain control of the servicing of the loans during the participation period and to have the option of repurchasing the loans at a later date – possibly for securitization. However, the added administrative burden of the Participation Program, including the costs associated with retaining a custodian, can be undesirable. Also, conditions in the debt capital markets have not improved, which may lead some issuers to go straight to the Purchase Program and bypass the participation option, forsaking the hope of successfully issuing student loan ABS in the next 12 months. Only time will tell whether the ED's programs will be able to help FFELP student loan lenders, but for now the programs are serving their purpose for some prominent lenders, while at the same time leaving student loan ABS investors wondering if and when the next transaction will come to market.

For questions or comments, please contact David Hartung at dhartung@dbrs.com.