

U.S. Structured Finance Newsletter

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YIELD FORMULA ON FFELP LOANS SAPS LENDERS

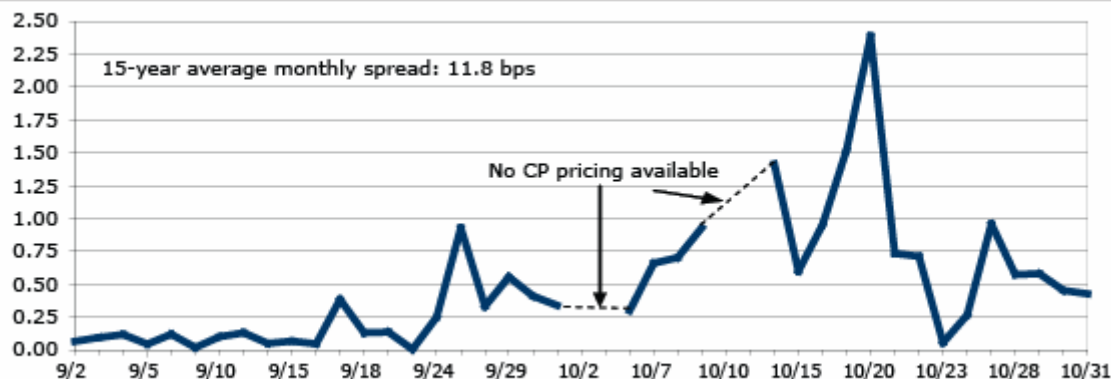
Holders of federally reinsured student loans originated under the Federal Family Education Loan Program (FFELP) earn a “market rate” of return determined through the special allowance payment (SAP) formula dictated by the *Higher Education Act* (the Act). This formula is tied to the three-month Financial commercial paper (CP) rate.¹ With the Act, the U.S. government wanted to set below-market rates on student loans in order to ease the financial burden on borrowers. To attract commercial lenders to the loan program, however, the government implemented the SAP formula to ensure lenders earned a market rate of return.

Recently, in response to the turmoil in the credit markets, the U.S. Treasury took action to allow the Federal Reserve to intervene in the asset-backed commercial paper (ABCP) markets in order to improve general market liquidity.² These actions have artificially depressed the CP rate versus LIBOR, which has had a detrimental effect on current FFELP loan holders, including trusts that issued asset-backed securities (ABS) backed by FFELP loans, whose liabilities are indexed to the monthly or three-month LIBOR.

As seen in the chart below, the differential between the CP rate and LIBOR increased sharply last month and shows little signs of stabilizing at or near historical levels. The CP-LIBOR spread has a direct impact on the yield earned by loan holders, which allows the securitization trusts to be able to pay full and timely interest and principal on their ABS. The widening of the CP-LIBOR relationship reduces excess spread and thus jeopardizes the excess cash flow in the trusts. As a consequence, FFELP student loan ABS may suffer deterioration in credit quality should the spread widening persist at elevated levels for the next several months.

At this time, DBRS has not taken rating actions on student loan ABS trusts affected by the CP-LIBOR spread widening, but continues to monitor market conditions and may take action in the event further deterioration of credit enhancement occurs to the detriment of certain classes of bonds.

CP-LIBOR Spread, September 2, 2008, to October 31, 2008



Source: Federal Reserve and Bloomberg.

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

1. The SAP calculation is equal to (1) the average of the bond equivalent rates of the quotes of the three-month CP rates in effect for each day in the quarter plus (2) a margin specified under the Act less (3) the borrower rate. The sum of this calculation, if positive, results in a payment to the loan holder by the U.S. government; if negative, it requires the loan holder to rebate the difference to the U.S. government. This mechanism effectively converts the loans to CP floating-rate assets, plus the predetermined margin.

2. On September 19, 2008, the Federal Reserve announced an initiative to extend non-recourse loans to U.S. banks to finance their purchases of ABCP from money market mutual funds that may look to sell such paper in order to meet demands for redemptions by their investors.