

Asset-Backed
Special Report

Borrower Benefits in FFELP: Student Loan ABS Cash Flow Considerations

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Related Research

- “Rating U.S. Federal Family Education Loan Program Student Loan ABS,” dated Oct. 31, 2006

The purpose of the report is to provide the marketplace with an overview of borrower benefit programs that appear in Fitch-rated Federal Family Education Loan Program (FFELP) student loan ABS, and the potential effects of borrower benefits on the ABS cash flows. The report also discusses the effects of recent changes to borrower benefit programs resulting from legislative changes to the FFELP effective July 1, 2006. For Stafford and PLUS loans originated (applications received) on or after July 1, 2006, the loans will change from variable to fixed rate at 6.8% and 8.5%, respectively.

■ Summary

The proliferation in the quantity and types of borrower benefit programs offered by issuers who finance student loans in the asset-backed securities (ABS) market has prompted Fitch Ratings to more closely examine potential cash flow implications. A borrower benefit is formed by an agreement with a lender and a borrower, for the lender to provide cost savings in the form of principal or interest rate reductions for on-time payments, in addition to discounting certain fees associated with origination. The right of borrowers to continue to receive benefits lies exclusively with the lender, who may terminate them at any time. Certain lenders have granted permanent borrower benefits, and others have allowed borrowers to regain their lost benefits after a cure period.

Borrower benefits can be funded within or outside a securitization trust. In cases where the issuer funds borrower benefits within the trust, Fitch applies assumptions in the cash flow stress scenario analysis. These assumptions are based on Fitch’s research regarding borrower benefit product utilization, specifically whether the benefit is available to all borrowers or if the borrower needs to meet lender qualification requirements before receiving the benefit, i.e. making a certain number of on-time payments, in addition to lender disqualification requirements, i.e. losing the benefit after a certain number of days of borrower delinquency. In cases where borrower benefits are funded outside of the trust, Fitch reviews the transaction’s legal documents to ensure that if the provider becomes unable to fund the benefits, the benefits are terminated with no risk assumed by the trust.

Based on Fitch research, the most common type of borrower benefit program offered is the Automated Clearing House (ACH), with approximately 80% of Fitch-rated issuers offering interest rate reductions of at least 0.25%. The next most common type of program offered is the on-time interest rate reduction after 48 on-time payments, which is offered by approximately 55% of Fitch-rated issuers, and 36 on-time payments, offered by approximately 45% of Fitch-rated issuers. Principal rebate programs also have become more widespread, with approximately 30% of Fitch-rated issuers offering this type of product.

Fitch expects to see further product offerings due to the recent repeal of the single holder rule on June 15, 2006 by the Emergency Appropriations Act of 2006, which affected where loans can be consolidated. With this repeal, borrowers can now choose to consolidate with the lender that offers the most attractive loan options in the form of borrower benefit products.

October 31, 2006

■ Findings and Observations

Based on research conducted by Fitch, the types of borrower benefit programs offered by lenders or issuers that are currently present in FFELP ABS include the following:

- Reduction to borrowers' interest rates.
- Reduction to borrowers' principal through either a rebate or loan forgiveness.
- Discount or elimination of loan origination fees.

With these programs, the following are the primary conclusions from Fitch's research:

- On-time interest rate reduction programs are being offered earlier in the borrower's repayment term. Currently, some program qualification period requirements include only one on-time payment to be eligible. These types of borrower benefit programs yield a higher reduction to a student loan ABS transaction's overall cash flow. In this case, more borrowers would qualify as a result of the less stringent qualifying requirements.
- With these shorter qualification period requirements, lenders have implemented stricter disqualification parameters from the commonly used 15-day grace period to only one day of delinquency. As this is a relatively new trend, Fitch anticipates that more borrowers would qualify for a given program; however, it is more difficult to project the level of disqualification as borrowers are more likely, if delinquent, to be delinquent one day versus 15 days. Nonetheless, the effects on a student loan ABS cash flow consist of reduced payments from the borrowers.
- Certain lenders are offering reduced or no origination fees to borrowers. Lenders who offer these borrower benefits pay the 2% origination fee and/or the 1% default fee. These benefits have little to no affect on a securitization as the origination fee is paid prior to the loan being securitized.
- Borrower benefit programs, such as 100% loan forgiveness, interest only periods, and interest free programs, are mostly offered by not-for-profit issuers of student loan ABS. These programs are intended to promote a particular type of school program or type of degree for residents of a specific state. As a result, these benefits are not frequently offered and possess strict qualification requirements.
- Interest rate reduction programs are more stressful to a cash flow than principal rebate programs with a comparable percentage reduction. The principal rebate program has the same effect as a prepayment on a trust, while the effect of the

interest rate reduction is different depending on how the benefit is applied.

- Fitch has discovered that even though borrower benefit reductions do not directly affect interest subsidy or special allowance payment (SAP) calculations, they do affect overall borrower payments due to the reduction of principal.
- No industry standards exist with regard to how student loan servicers handle borrower benefit reductions. Depending on the servicer, the loans can be managed very differently. Certain servicers reamortize the monthly loan payment once borrowers qualify for their benefits, whereas others do not reamortize the loan. Loans that are not reamortized result in a principal prepayment of the loan and in turn, to the trust. Depending on the percentage of the interest rate reduction and the original term of the loan, the amount of cash received from a borrower could be dramatically reduced.
- In general, borrower benefits have a direct effect on a transaction's excess spread. Excess spread, the primary source of credit enhancement for student loan ABS, is the positive difference between borrower and ED interest collections and debt interest costs, net servicing and trust fees.

■ Types of Borrower Benefit Programs

There are three general types of borrower benefit programs that affect the economics of a securitization. These include reductions to borrower interest rates, principal forgiveness, and fee forgiveness.

Automated Clearing House or Direct Debit

The most common type of borrower benefit program is the ACH program. ACH is an automatic electronic funds transfer process whereby a borrower's monthly loan payments are withdrawn directly from a designated financial account. Borrowers in repayment that use ACH to make monthly payments are offered an interest rate reduction. The majority of ACH programs currently offer a 25 basis points (bps) interest rate reduction; however, Fitch has observed interest rate reductions as high as 200 bps. The 200 bps interest rate reduction would result in a 4.8% fixed interest rate for newly originated 6.8% fixed-rate Stafford loans disbursed after July 1, 2006. Lenders offer the ACH benefit to ensure timely payments from their borrowers.

Interest Rate Reduction for On-Time Payments

Another type of borrower benefit program consists of an interest rate reduction after a certain number of on-time

Types of Borrower Benefit Programs

Borrower Benefit Programs	Reduction Range (%)	% of Issuers Offering These Programs*
Automated Clearing House (ACH)	0.25–2.00	79
24 or Less Months of On-Time Interest Rate Reduction	0.25–2.00	18
36 Months of On-Time Interest Rate Reduction	1.00–3.00	44
48 or Greater Months of On-Time Interest Rate Reduction	0.25–2.50	54
Interest Only Period	1–4 Years	4
Origination Fee Reduction	2.00	11
Default Fee Reduction	1.00	11
Loan Forgiveness	50–100	3
Principal Rebate	0.75–6.00	32

*The same issuers may offer different types of programs based on loan types, such as Federal Family Education Loan Program (FFELP) Stafford Loans, PLUS loans, and consolidation loans.

payments. As measured by the number of Fitch-rated ABS issuers who offer these types of programs (54%), the most common is the 2% interest rate reduction after 48 on-time monthly payments are made. At month 49, the borrower’s current interest rate would be reduced by 2%. For example, the interest rate for a 6.8% fixed-rated Stafford loan would be reduced to 4.8%. Despite the total interest rate reduction, the total return on the cash flow using the same borrower benefit program would be less stressful when the benefit reduction begins at a later point of the repayment term.

The 48-month on-time interest rate reduction program is one of the first established borrower benefit programs. Over time, Fitch has observed that lenders changed their programs to either shorten or lengthen the qualification periods, which, respectively, decrease or increase the number of on-time payments needed to qualify for interest rate reductions. The length of qualifying periods range from 1–60 months of on-time monthly payments.

In addition to different on-time qualifying periods, the amount of interest rate reduction also differs. For the 24, 36, and 48 on-time payment programs, the range of the interest rate reductions are 0.25%–2.00%, 1.00%–3.00%, and 0.25%–2.50%, respectively.

For loans that were originated on or after July 1, 2006, some lenders have reduced the number of monthly on-time qualification requirements to only one on-time monthly payment. The interest rate reductions are lowered, but since the reductions occur in the beginning of repayment, the effects on the overall cash flow may be greater depending on the interest rate percentage reduction and how early the reduction occurs in the loan’s cash flow.

Discount or Elimination of Borrower Fees

Discount or elimination of loan origination fees for borrowers reduces the borrower’s cost of obtaining a

loan. Currently, FFELP loans have a 2% origination fee and/or the 1% default fee, both of which are typically paid at disbursement through a reduction of loan proceeds received by the borrower. The default fee was previously referred to as the guarantor fee. This borrower benefit is a reduction or elimination of origination fees paid by the borrower. Some lenders credit the origination fee to the borrowers at repayment by reducing the outstanding loan principal balance by the fee percentage. The origination fee for FFELP Stafford loans are decreasing and will be eliminated by 2010.

Other Borrower Benefit Programs

Other types of borrower benefits programs are 100% loan forgiveness, interest only periods, and interest free programs. These borrower benefits programs are typically offered by not-for-profit issuers to promote a particular type of school program or type of degree, such as a teacher’s program. These benefits are not frequently offered, and the qualification requirements can be quite strict. For example, the benefit may require that the borrower work in the state where the loans were issued or practice a certain type of discipline, such as medical professionals in rural areas.

The table above summarizes the breakdown of the available borrower benefit programs present in Fitch-rated student loan ABS, the percentage reduction ranges, and the percentage of issuers offering these programs. As noted, same issuers may offer different programs based on loan types.

■ Qualification and Utilization Rates for Borrower Benefit Programs and Disqualification

When rating student loan ABS, Fitch has always considered the utilization rates and qualification periods for various borrower benefit programs. In addition, Fitch has evaluated the disqualification parameters

associated with each borrower benefit program. Fitch incorporates assumptions for borrower benefit programs in the cash flow scenarios, in particular when they are paid within the trust. Select issuers pay for borrower benefits outside of a student loan ABS transaction by repurchasing loans with a reduced interest rate due to borrower benefits. As such, the stress scenario would not include a borrower benefit assumption, but the repurchase money would be incorporated in the constant prepayment rate (CPR).

Qualification and Utilization Rates

Even though lenders extend the ACH program to most borrowers, utilization rates for programs offering a 25 bps reduction are relatively low, ranging from 10%–30%. However, when issuers offer an increased interest rate reduction of 50 bps instead of 25 bps, utilization rates increased significantly to almost double the utilization rates for the 25 bps reduction.

Qualification rates have varied for interest rate reduction programs based on a number of on-time payments. Historical performance has shown that the lower the number of on-time monthly payments required by a lender to qualify for an interest rate reduction borrower benefit, the higher the qualification rate. On average, programs requiring 24, 36, or 48 months of on-time payments have qualification rates ranging from 10%–25%, 10%–20%, and 5%–10%, respectively.

Disqualification Rates

Lenders have implemented processes to control and monitor which borrowers qualify and subsequently which borrowers become disqualified from receiving their borrower benefits. For most products, borrowers are disqualified after being delinquent in their monthly payment for 15 days. For those products that have shorter qualification periods, the disqualification delinquency period can start as early as the first day a loan becomes delinquent. Also, there are some FFELP Stafford borrower benefit programs that discourage borrowers from consolidating their loans by disqualifying their current borrower benefits when the loan is consolidated.

■ Effects on Student Loan Cash Flows

Student loan ABS cash flows are used to size the credit enhancement for each class of debt in the capital structure at the issuer's desired rating levels. As borrower benefit programs directly affect the amount and timing of collateral cash flows, an

analysis of their potential effects is required to gain a full understanding of transaction economics.

If a lender or issuer offers discounts or eliminates loan origination fees for borrowers, Fitch assumes a utilization rate of 100%. In cases where the lender offers origination fee credits to borrowers, the utilization rate is also assumed to be 100% and is reflected in the cash flows by reducing the outstanding loan principal balance by the fee percentage. This type of borrower benefit is not frequently offered, and the qualifications are often very specific and strict.

Fitch's FFELP cash flows assume both a high and low utilization/qualification rate environment for borrower benefit programs determined by the interest rate environment. In a high utilization/qualification rate environment, the total loan receipt amounts will be substantially less than expected, which will ultimately increase the liquidity risk to the trust, with a small affect on a deal's liquidity in a low utilization/qualification rate environment. To better delineate the effects of borrower benefit programs on student loan cash flows, Fitch focused its analysis on Stafford loans originated on or after July 1, 2006, which have a fixed 6.8% interest rate.

To analyze the level of potential credit and liquidity risk in a student loan ABS transaction resulting from borrower benefit programs and recently enacted legislative changes described earlier, Fitch performed the following analysis:

- ACH utilization rate effects on a cash flow.
- Interest rate reductions constant; on-time monthly payment qualification period varies.
- Interest rate reductions vary; on-time monthly payment qualification period varies.
- Interest rate reduction vs. principal reduction.
- Overall total cash flow effects.

ACH Utilization Rate Effects on a Cash Flow

Fitch compared the overall effects to the total cash flow on a \$100 million portfolio of loans that were originated on or after July 1, 2006 in the ACH Program Utilization Rate Comparison table on page 5. By using one type of borrower benefit product, the ACH interest rate reduction, Fitch compared the overall effects on total cash flows at each of the various interest rate reduction percentages — 0.25%, 0.50%, and 2.00% based on 25% and 50% utilization rates. In keeping the utilization rates equal, the results show there is a minimal effect on the cash flows

ACH Program Utilization Rate Comparison*

FFELP Stafford Student Loan

Loan Amount (\$):	100,000,000
Loan Term:	10 years (120 months of repayment)
Loan Interest Rate (%):	6.8 (fixed rate)
Loan Origination Date:	July 1, 2006
Scenario A — Utilization Rate (%):	25% of total assets
Scenario B — Utilization Rate (%):	50% of total assets

Interest Reduction	Total Payment Without Borrower Benefits (\$)	Reduced Total Payment (\$)	Total Payment Reduction (\$)	% Of Total Payment Reduction
Scenario A — Based on 25% Utilization Rate				
ACH — 0.25%	138,096,396	137,713,061	383,336	0.28
ACH — 0.50%	138,096,396	137,332,200	764,196	0.55
ACH — 2.00%	138,096,396	135,099,484	2,996,912	2.17
Scenario B — Based on 50% Utilization Rate				
ACH — 0.25%	138,096,396	137,329,725	766,671	0.56
ACH — 0.50%	138,096,396	136,568,005	1,528,392	1.11
ACH — 2.00%	138,096,396	132,102,572	5,993,824	4.34

*This example excluded servicing fees; consolidation rebates; delinquencies, defaults, deferment, and forbearance assumptions; and other associated fees. For the purpose of analyzing only the effects of borrower benefit programs to the cash flow, everything else was excluded from the analysis. ACH – Automated Clearing House. FFELP – Federal Family Education Loan Program.

between 25 and 50 bps in interest rate reductions; however, the effect is substantially higher for the 200 bps reduction. Overall the cash flow effects for ACH could be significant if a large percentage of a securitized pool is in repayment and the interest rate reduction is close to 2%.

the higher the qualification rate. The results show that the highest cost to the trust or the highest reduction in total loan payments results from the shortest qualification period of 12 months. The total cost to the trust is a 3.61% reduction of the total expected cash flow, compared with a 1.68% reduction for the program that starts after 48 months. As shown in the Interest Rate Reduction Program Comparison Over A 10-Year Level Term table on page 6, it is more advantageous for a borrower to select or be eligible for a borrower benefit program that has a shorter qualifying repayment period.

Interest Rate Reduction — Interest Rate Reduction Constant; On-Time Monthly Payment Qualification Period Varies

For the initial part of the analysis, all interest rate reduction percentages were 1%, 100% of borrowers qualified, and the number of on-time monthly payments was varied. As noted earlier, Fitch has found that the lower the number of on-time monthly payments required by a lender to qualify for a borrower benefit,

The total payment comparison is more striking when using different interest rate reduction percentages. For example, when Fitch compared the more traditionally offered borrower benefits program of 2% after

Borrower Assumptions*

FFELP Stafford Student Loan

Loan Amount (\$):	10,000
Loan Term:	10 years (120 months of repayment)
Loan Interest Rate (%):	6.8 (fixed rate)
Loan Origination Date:	July 1, 2006
Initial Monthly Payment without Borrower Benefits (\$):	115.08
Total Cash Flow Payments without Borrower Benefits (\$):	13,810
Total Cash Flow Payment with 1.0% Interest Rate Reduction at Month 12 (\$):	13,311
Total Cash Flow Payment with 1.0% Interest Rate Reduction at Month 24 (\$):	13,410
Total Cash Flow Payment with 1.0% Interest Rate Reduction at Month 36 (\$):	13,499
Total Cash Flow Payment with 1.0% Interest Rate Reduction at Month 48 (\$):	13,578

*This example excluded servicing fees; consolidation rebates; delinquencies, defaults, deferment, and forbearance assumptions; and other associated fees. For the purpose of analyzing only the effects of borrower benefit programs to the cash flow, everything else was excluded from the analysis. FFELP – Federal Family Education Loan Program.

Interest Rate Reduction Program Comparison Over A 10-Year Level Term

Borrower Benefits Program	Initial Interest Rate (%)	Initial Monthly Payment (\$)	Rate Reduction (%)	Reduced Interest Rate (%)	Reduced Monthly Payment (\$)*	Monthly Payment Reduction Amount (\$)	Monthly Payment Reduction (%)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
Interest Rate Reduction at 12 Months	6.80	115.08	1.00	5.80	110.46	4.62	4.02	499.07	3.61
Interest Rate Reduction at 24 Months	6.80	115.08	1.00	5.80	110.91	4.17	3.62	400.09	2.90
Interest Rate Reduction at 36 Months	6.80	115.08	1.00	5.80	111.38	3.70	3.22	310.88	2.25
Interest Rate Reduction at 48 Months	6.80	115.08	1.00	5.80	111.86	3.22	2.80	231.90	1.68

*This example assumes the loan's monthly payment is reamortized when the borrower benefit program is in effect.

48 monthly on-time payments program with a program that would reduce the borrower's rate by 1% after 12 months, the program with the 1% reduction reduced the total cash flow by 3.61%. Whereas, the 2% interest rate reduction program would reduce the total cash flow by 3.33%. Although the 48-month on-time program offers a higher interest rate reduction, the 12-month on-time program still had a greater effect to the overall cash flow. Fitch believes it is not only important to look at the reduction percentage in evaluating the effects of borrower benefits programs, but also to evaluate the timing of the interest rate reductions in the different programs.

Interest Rate Reduction — Interest Rate Reduction Vary; On-Time Monthly Payment Qualification Period Varies

To fully understand and evaluate the liquidity risk of borrower benefits programs to the overall cash flow, expected utilization rates are an integral part of the analysis. Based on the assumptions indicated in the Cash Flow Assumptions table on page 7, Fitch analyzed the total cash flow results and effect of the various borrower benefit programs based on utilization percentages of 25% and 50%. The total payment reductions for each different type of borrower benefit program are illustrated in the table on page 7 for each utilization rate. At 50% utilization, the total payment reduction doubles.

Looking at the individual borrower benefit programs, the total reduction percentage does not appear to have a significant effect to the overall cash flow. However, if borrowers qualify for multiple borrower benefits

programs, then the total reduction could be significant and have an adverse effect on the overall cash flow, as illustrated on pages 7 and 8.

For example, based on the 25% utilization rate assumption, assuming that 25% of the student loans in the asset pool signed up for the ACH program reduction of 0.25% and then later qualified for the 48 on-time monthly payment interest reductions of 2%, the total cash flow payments would be reduced by approximately 1.10%. If the borrower further qualifies for a 3% principal reduction, the total cash flow could be reduced by almost 1.82%.

If the utilization rate increased to 50%, with the same 25% of the student loans using the ACH program reduction of 0.25% and later qualifying for the 48 on-time monthly payment interest reductions of 2%, the total cash flow would be reduced by approximately 2.21%. If a 3% principal reduction also is applied, the total cash flow could be reduced by almost 3.64%.

Given the results of multiple borrower benefit programs coupled with conservative benefits, there was a significant reduction to the overall cash flow. If borrowers qualify and take advantage of more generous borrower benefits programs, the reduction in cash flow will be greater.

Interest Rate Reduction vs. Principal Reduction

Fitch compared the total payment results using a 1% reduction for both the interest rate and principal reduction. The results showed that a 1% reduction in the

Interest Rate Reduction Program Comparison — 12-Month vs. 48-Month Qualification Periods

Borrower Benefits Program	Initial Interest Rate (%)	Initial Monthly Payment (\$)	Rate Reduction (%)	Reduced Interest Rate (%)	Reduced Monthly Payment (\$)*	Monthly Payment Reduction Amount (\$)	Monthly Payment Reduction (%)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
Interest Rate Reduction at 12 Months	6.80	115.08	1.00	5.80	110.46	4.62	4.02	499.07	3.61
Interest Rate Reduction at 48 Months	6.80	115.08	2.00	4.80	108.69	6.39	5.55	459.81	3.33

*This example assumes the loan's monthly payment is reamortized when the borrower benefit program is in effect.

Cash Flow Assumptions*

FFELP Stafford Student Loan

Loan Amount (\$):	100,000,000
Loan Term:	10 years (120 months of repayment)
Loan Interest Rate (%):	6.8 (fixed rate)
Loan Origination Date:	July 1, 2006
Scenario A — Utilization Rate (%):	25% of the total assets
Scenario B — Utilization Rate (%):	50% of the total assets

Borrower Benefits Programs	Total Payment Without Borrower Benefits (\$)	Reduced Total Payment (\$)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
Scenario A — Based on 25% Utilization Rate				
ACH — 0.25%	138,096,396	137,713,061	383,336	0.28
ACH — 0.50%	138,096,396	137,332,200	764,196	0.55
Interest Reduction — 1% after 24 Payments	138,096,396	137,096,183	1,000,214	0.72
Interest Reduction — 2% after 48 Payments	138,096,396	136,946,856	1,149,540	0.83
Principal Rebate — 3%	138,096,396	137,060,673	1,035,723	0.75
Principal Rebate — 6%	138,096,396	136,024,950	2,071,446	1.50
Scenario B — Based on 50% Utilization Rate				
ACH — 0.25%	138,096,396	137,329,725	766,671	0.56
ACH — 0.50%	138,096,396	136,568,005	1,528,392	1.11
Interest Reduction — 1% after 24 Payments	138,096,396	136,095,969	2,000,427	1.45
Interest Reduction — 2% after 48 Payments	138,096,396	135,797,316	2,299,080	1.66
Principal Rebate — 3%	138,096,396	136,024,950	2,071,446	1.50
Principal Rebate — 6%	138,096,396	133,953,504	4,142,892	3.00

*This example excluded servicing fees; consolidation rebates; delinquencies, defaults, deferment, and forbearance assumptions; and other associated fees. For the purpose of analyzing only the effects of borrower benefit programs to the cash flow, everything else was excluded from the analysis. FFELP – Federal Family Education Loan Program. ACH – Automated Clearing House.

interest rate yielded a greater reduction in total payments of 4.4% versus 1.0% for the principal reduction. When the principal reduction was increased to 3%, the 1% interest rate reduction still reduced the total payment by a higher amount. Therefore, interest rate reduction programs are more stressful to overall total cash flows than that of principal rebate programs.

■ **The Mechanics of Calculating Borrower Benefit Programs, Special Allowance Payments, and Rebate Arbitrage for Not-for-Profit Issuers**

SAP is paid to holders of FFELP loans by the U.S. Department of Education (ED), to provide a market rate of return on the loan. In addition, the ED pays interest subsidies on behalf of subsidized Stafford borrowers in in-school, grace, and certain periods of deferment. The

ED makes the payments on a quarterly basis, each March 31, June 30, Sept. 30, and Dec. 31.

SAP equals the SAP rate multiplied by the average outstanding principal loan balance plus any capitalized interest during the quarterly period. The SAP rate is calculated based on the bond equivalent yield of the three-month commercial paper rate plus the applicable margin, based on the loan type and status, minus the borrower's interest rate divided by four. The margin for Stafford loans in-school, grace, or deferment periods is 1.74%, and for Stafford loans in repayment is 2.34%. For PLUS and consolidation loans, the margin is 2.64%.

The recent legislation changes passed in February 2006 made significant changes to the Higher Education Act of 1965, but left the SAP payment calculations

Based on 25% Utilization Rate

Borrower Benefits Programs	Initial Total Payment (\$)	Reduced Total Payment (\$)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
ACH — 0.25% and Interest Reduction of 2.0% at 48th Payment	138,096,396	136,573,198	1,523,199	1.10
ACH — 0.25%, Interest Reduction of 2.0% at 48th Payment, and Principal Reduction of 3.0%	138,096,396	135,583,171	2,513,226	1.82

ACH – Automated Clearing House.

Based on 50% Utilization Rate

Borrower Benefits Programs	Initial Total Payment (\$)	Reduced Total Payment (\$)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
ACH — 0.25% and Interest Reduction of 2.0% at 48th Payment	138,096,396	135,049,999	3,046,397	2.21
ACH — 0.25%, Interest Reduction of 2.0% at 48th Payment, and Principal Reduction of 3.0%	138,096,396	133,069,945	5,026,451	3.64

ACH – Automated Clearing House.

unchanged. However, it introduced SAP rebate payments to be made by the holder of the loans to the ED when the SAP rate is below the borrower's interest rate. The SAP rebate requirement only affects student loans originated on or after April 1, 2006. These loans will not benefit from floor income from negative SAP and will rebate this amount back to the ED. Student loans originated prior to April 1, 2006 still continue to benefit the trust of any SAP floor income.

The SAP calculations, for both payments and rebates, are based on the stated regulatory borrower interest rate regardless of any borrower benefit reductions. Issuers receive borrower interest payments net of borrower benefit reductions. In a rising interest rate environment, the trust benefits from SAP payments; however, in a declining rate scenario, with the new fixed-rate Stafford (6.8%) and PLUS (8.5%) loans, the issuer is responsible to rebate the difference between the borrower's interest rate and SAP rate, while earning a lower borrower interest rate resulting from the applicable borrower benefit programs.

Fitch has evaluated that even though the SAP and the interest subsidy calculations are not affected by borrower benefit programs, the SAP and interest payments for the overall cash flow would be affected by the interest rate reductions. Since the interest portion of the monthly payment is decreased and the

principal portion is increased, the principal balance of the loan will pay down at a faster speed. If the SAP and interest subsidy payments are based on the current principal loan balance, the total loan balance would also decrease. Fitch has quantified the cash flow implication that borrower benefits have on the total SAP payments, depending on the reduction percentage, and the timing can be minimal. For example, a 1% interest rate reduction after 12 on-time payments would reduce the total SAP payment by approximately 1%. While keeping everything the same, but increasing the interest rate reduction by 2%, the total SAP payment loss would be about 2%. If applying the SAP payment reduction and borrower benefit interest rate reduction together before applying any other defaults in a cash flow, it would be very stressful to the overall liquidity of a cash flow. Arbitrage rules for not-for-profit issuers govern the amount of spread, essentially the positive difference between the portfolio's student loan interest and the cost of funds associated with financing the student loans in a securitization, net of servicing, and trust fees.

■ Servicers and Borrower Benefit Programs

As student loan servicers are responsible for monitoring a borrower's repayment of the loan, servicers are also responsible for ensuring that the borrower made the right number of on-time payments

Interest Rate Reduction vs. Principal Reduction Comparison*

FFELP Stafford Student Loan

Loan Amount (\$):	10,000 (one loan)
Loan Term:	10 years (120 months of repayment)
Loan Interest Rate (%):	6.8 (fixed rate)
Loan Origination Date:	July 1, 2006
Total Cash Flow Payments without Borrower Benefits (\$):	13,809.64

Borrower Benefit Programs	Total Payment Amount (\$)	Total Payment Reduction Amount (\$)	Total Payment Reduction (%)
1.0% Interest Reduction at First Month of Repayment	13,202	607	4.4
1.0% Principal Reduction at First Month of Repayment	13,672	138	1.0
3.0% Principal Reduction at First Month of Repayment	13,395	414	3.0

*This example excluded servicing fees; consolidation rebates; delinquencies, defaults, deferment, and forbearance assumptions; and other associated fees. For the purpose of analyzing only the effects of borrower benefit programs to the cash flow, everything else was excluded from the analysis. FFELP – Federal Family Education Loan Program.

Nonamortized Loans vs. Reamortized Loans with Borrower Benefits

10-Year Term Loan

Loan Amount (\$):	10,000
Loan Interest Rate (%):	6.8
Loan Repayment Term:	10 years (120 months)
Total Monthly Payment without Borrower Benefits (\$):	13,809.64

Borrower Benefit Programs	Total Monthly Payment (\$)	Total Interest Payment (\$)	Difference Amount (\$)	% Difference	Final Amortization Term (Months)	Loss Months
1.0% at 24 Months, 120-Month Term (Reamortization)	13,409.55	3,409.55	400.09	2.90	120	0
1.0% at 24 Months, 120-Month Term (No Reamortization)	13,349.32	3,306.26	460.32	3.33	116	4

30-Year Term Loan

Loan Amount (\$):	10,000
Loan Interest Rate (%):	6.8
Loan Repayment Term:	10 years (360 months)
Total Monthly Payment without Borrower Benefits (\$):	23,469.31

Borrower Benefit Programs	Total Monthly Payment (\$)	Total Interest Payment (\$)	Difference Amount (\$)	% Difference	Final Amortization Term (Months)	Loss Months
1.0% at 24 Months, 360-Month Term (Reamortization)	21,368.56	11,368.58	2,100.75	8.95	360	0
1.0% at 24 Months, 360-Month Term (No Reamortization)	19,036.22	9,029.08	4,433.09	18.89	292	68

before providing an interest rate reduction. In addition, if the borrower disqualifies, it is the servicer’s responsibility to ensure that the borrower benefit is discontinued, and in cases where borrowers are able to requalify, it is the servicer’s responsibility to ensure they have made the requisite cured on-time payments.

Servicers play another important role in monitoring the student loans. Depending on the servicer or issuer, FFELP student loans qualifying and receiving any benefits may require that their loan payment is reamortized based on the new reduced rate.

Unfortunately, there is not clear guidance as to how the loan payments are to be readjusted based on the new reduced rate. Most student loan monthly payments are generally reamortized when the reduction occurs and the loan would maintain its original loan term. As some servicers reamortize their loans only once a year, the newly reduced rate loan would benefit from paying less interest and more principal for almost a year if the benefit is applied right after the loan is reamortized. This would cause the loan to prepay, which would not have a detrimental implication to the trust.

There are some issuers and servicers that do not reamortize the loans based on the current interest rate, resulting in the loans prepaying earlier. As illustrated in the table above, Fitch tested this scenario with a 1%

interest rate reduction program and discovered that loans that do not reamortize could shorten their amortization schedule by more than five years (68 months). This effect happened when using 30-year consolidation loans, as compared with 10-year Stafford loans. The amortization term was shortened more drastically when a longer repayment term loan was applied. The amortization effect for a 10-year Stafford loan is only four months, as the reduction in the repayment term also affected the total loan payments. Since the repayment term was shortened, the interest that would have been paid during the final months was lost.

The cash flow reduction percentage of the Stafford loans that were reamortized was 2.90%, compared with the same loan not reamortized was 3.33%. The difference is more obvious when compared with consolidation loans as the terms are longer and more stressful on the overall cash flow. The total payment reduction for reamortized consolidation loans with the 1% borrower benefit was 8.95%, compared with a consolidation loan that does not reamortize resulting in an 18.89% total payment reduction. With this difference, it is important to stress the amortization implication on consolidation loans and to determine the methodology of how the servicers apply borrower benefit programs to a loan portfolio.

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