



Structured Products Research Consumer ABS

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Bill to Amend Higher Education Act Proposed Interest Rate Cuts for Subsidized Stafford Loans

Executive Summary

How might the Democrats' bill affect student loan ABS? This is the question circling investors as the House passed H.R. 5 (the College Student Relief Act of 2007) with a 356-71 vote on Jan 17. The bill now moves to the Senate for debate and, if passed, the Higher Education Act (HEA) could face the following amendments:

- A cut in interest rates for subsidized Stafford loans;
- A decrease in the special allowance payments to lenders;
- A rise in the rebate fee that consolidation loan holders pay;
- The elimination of the "exceptional performer" designation;
- A reduction in the insured loan percentage;
- An increase in lenders' loan fees; and
- A decrease in the guarantee agencies' collection fees.

Some of these changes could have an effect on student loan ABS, and some most likely would not. **We do not expect interest rate cuts for subsidized loans to affect current or future transactions.** If a FFELP lender's rate of return falls below a certain percentage, special allowance payments are made to lenders by the Department of Education (DOE) to ensure a floating rate of return equal to a margin plus three-month commercial paper.

A 10-bp decrease in special allowance payments and an increase in lenders' loan fees (for certain lenders of consolidation loans) would likely cause excess spread to decrease, therefore, other forms of credit enhancement might need to step up. Higher requirements for reserve accounts or possibly added subordination could be used to compensate for the decreasing excess spread.

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Overview¹

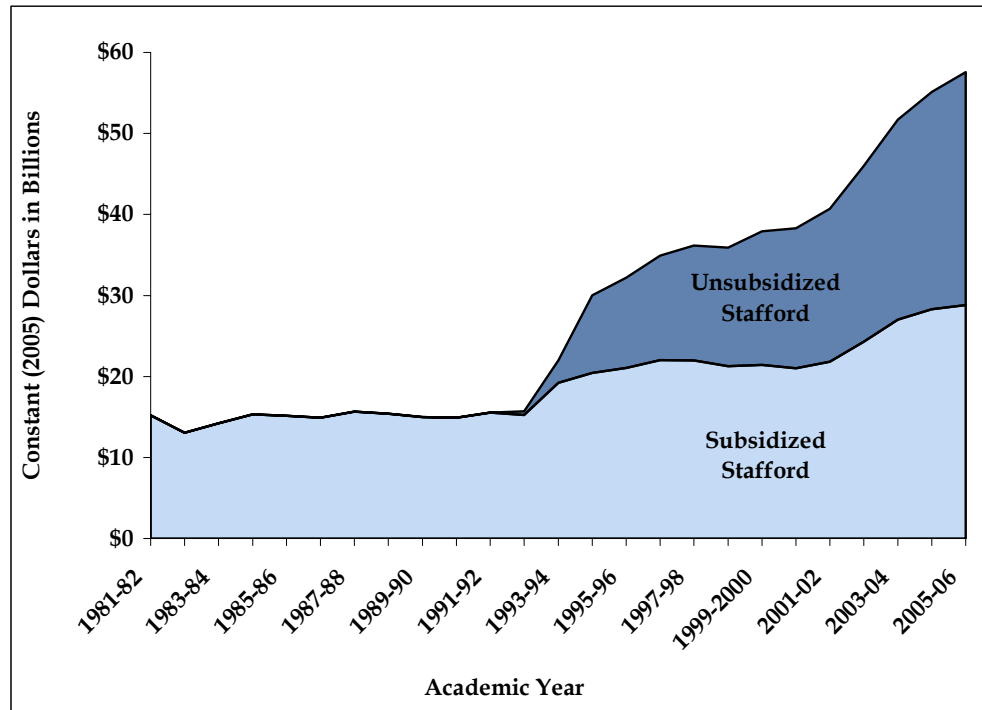
The HEA of 1965 opened the gates for federal financing of post-secondary education. Under this act, the Federal Family Education Loan Program (FFELP) was created. FFELP is a public-private partnership that provides a federal guarantee to lenders for loans to students and their parents.

According to the College Board's *Trends in Student Aid*, Stafford loans made up 38% of aid used to finance post-secondary education for the 2005-2006 academic year. Students borrow either directly from the U.S. Department of Education (Direct Stafford loans) or a bank or private lender where the funds are guaranteed by the federal government (FFELP Stafford loans). Only loans under the FFELP program can be securitized for student loan transactions.

Financial need is not a requirement for Stafford loans. However, for students who demonstrate need, the U.S. Department of Education (DOE) pays the interest that accrues while in school. These subsidized loans cannot exceed the amount of a student's financial need.

Stafford loan growth is shown in Exhibit 1 below. In 1992, unsubsidized Stafford loans were introduced and saw immediate rapid growth. We interpret this growth as an indication of the strong demand for financial aid.

Exhibit 1: Stafford Loan Growth



Source: Trends in Student Aid 2005, The College Board.

¹ For additional information, see *ABCs of Student Loan ABS*, Dec. 19, 2006, Erin K. Walsh, Wachovia Capital Markets, LLC.

Interest Rate Reductions for Subsidized Loans

H.R. 5 would cut **subsidized** Stafford loan interest rates in half, from 6.8% to 3.4%, over a five-year period. Exhibit 2 below summarizes the proposed cuts. Interest rates reset on July 1 every year, so the cuts would not affect any loans originated before the 2007 reset.

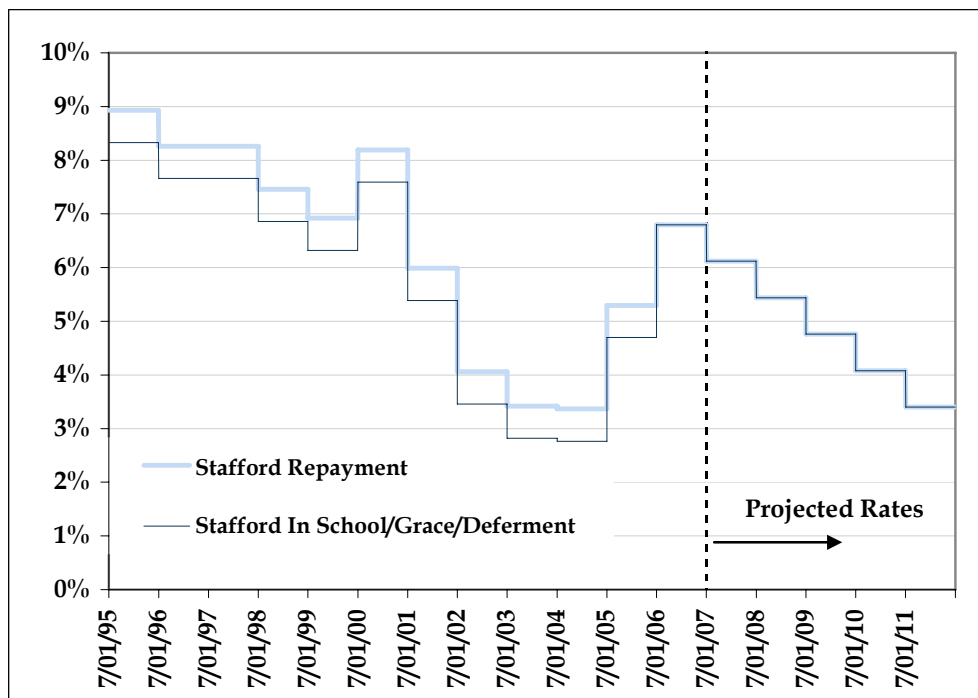
Exhibit 2: Proposed Interest Rate Cuts

Loans Disbursement Date	Subsidized Stafford Loans
7/1/2007 - 6/30/2008	6.12%
7/1/2008 - 6/30/2009	5.44%
7/1/2009 - 6/30/2010	4.76%
7/1/2010 - 6/30/2011	4.08%
7/1/2011 - 6/30/2012	3.40%

Source: The Library of Congress, H.R. 5

Historical interest rates for Stafford loans are shown below in Exhibit 3. The proposed rates for subsidized Stafford loans are projected with equal cuts of 68 bps over a five-year period starting on July 1, 2007. Unsubsidized Stafford loans would remain at the fixed rate of 6.8% going forward as the legislation pertains only to subsidized loans.

Exhibit 3: Historical and Projected Subsidized Stafford Loan Interest Rates



Source: FinAid.org, TreasuryDirect.gov, Wachovia Capital Markets, LLC

How would interest rate cuts affect ABS? They wouldn't really. If a FFELP lender's rate of return falls below a certain percentage, special allowance payments (discussed below) are made to lenders by the Department of Education to ensure a floating rate of return equal to a margin plus three-month commercial paper.

In addition, interest rate swaps are included in most securitizations. These swaps hedge basis risk as the majority of transactions' coupons are indexed to three-month LIBOR and the underlying collateral is either three-month commercial paper or fixed rate.

Would loan origination volume increase due to lower interest rates? While we expect Stafford loan volume to increase, it is not likely that the increase will be due to a drop in interest rates. A previous amendment to the HEA has limits for Stafford loans set to increase on July 1, 2007, for the first time in more than a decade. Most students max out their Stafford loan limits before turning to alternative funding such as private loans. An increase in dollar volume is likely for Stafford loan origination because of this increase in loan limits.

Does the cut in interest rates make education more affordable? As we stated before, for subsidized loans, the government pays the interest for borrowers while they are in school, so the view that cutting interest rates will make education more affordable is somewhat confusing because a student would not see the effect of the interest rate cut until after graduation, when the loans enter into repayment.

Reduction of Lender Special Allowance Payments (SAP)

Special allowance payments are made by the Department of Education to FFELP lenders to ensure a rate of return equal to a margin plus three-month commercial paper. The bill would decrease margins 10 bps for Stafford and PLUS² loans. Exhibit 4 below shows the proposed margin cuts for most lenders (small lenders would receive an exemption).

Exhibit 4: Special Allowance Payment Margins

Loan	From	To
Stafford (in school, grace, deferment)	1.74	1.64
Stafford (repayment)	2.34	2.24
PLUS	2.64	2.54

Source: The Library of Congress, H.R. 5

How would these SAP margin cuts affect student loan ABS? Excess spread would likely decrease, therefore, other forms of credit enhancement might need to step up. Higher requirements for reserve accounts or possibly added subordination could be used to compensate for the decreasing excess spread.

² Parent Loan for Undergraduate Students.

Interest Payment Rebate Fees

Rebate fees are required to be paid by consolidation loan holders to the DOE. The collected fees are placed in a student loan insurance fund to cover defaulted loans. Currently, these fees are equal to 1.05% of the principal plus accrued unpaid interest.

For institutions with holdings of consolidation loans (including principal and accrued unpaid interest) greater than 90% of total holdings, rebate fees would increase to 1.30% from 1.05%.

Holders affected by this increase are expected to have lower amounts of excess spread as the rebate requires them to pay an additional 25 basis points. This increase in the rebate fees coupled with the reduction in SAP payments could cause some holders to see considerable deterioration in excess spread.

Elimination of Exceptional Performer Status for Lenders

The bill also calls for the elimination of the “exceptional performer” designation. This designation is given to lenders and servicers that meet and maintain an overall compliance performance rating of 97% or higher for servicing requirements set by the DOE. Most of the largest and best-known lenders and servicers have the exceptional performer designation.

Before July 1, 2006, exceptional performers received a 100% federal guarantee on FFELP loans. That guarantee was reduced to 99% for exceptional performers and went to 97% from 98% for all others. If this designation is eliminated, then there would no longer be a 200-bp incentive to have exceptional servicing operations, which could possibly lead to a weakening of servicing standards.

Reduction of Lender Insurance Percentage

In addition to the removal of the exceptional performer designation, a proposed decrease in the lender insurance percentage would drop the guarantee to 95% – a 400-bp drop for exceptional performers and a 200 bp decrease for everyone else.

Currently, the rating agencies do not give credit for servicers with the exceptional performer designation. The reinsurance rates are assumed to be 97%. The rating agencies would likely decrease this to 95% if the bill is enacted.

Lower reinsurance rates mean higher loss severities for defaulted loans. However, because the actual loss percentage is so low, we do not expect a need for additional credit enhancement due to this change. Excess transaction spread would likely provide enough credit support to mitigate this added risk.

However, as we discussed before, declining excess spread due to SAP payment cuts and increased rebate fees could call for additional credit enhancement for future transactions.

Increased Loan Fees from Lenders

H.R. 5 would increase the origination fees FFELP lenders pay to the DOE to 100 bps from 50 bps. This increase in origination fees is not expected to have any effect on student loan ABS.

Guarantee Agency Collection Retention

Collections that are retained by guarantee agencies would also decrease under this bill. Currently at 24%, the bill would decrease this to 23% and further to 20% starting on Oct. 1, 2007, and further still to 18% on Oct. 1, 2008. Student loan ABS transactions are not expected to be affected by a decrease in guarantee agency retention.

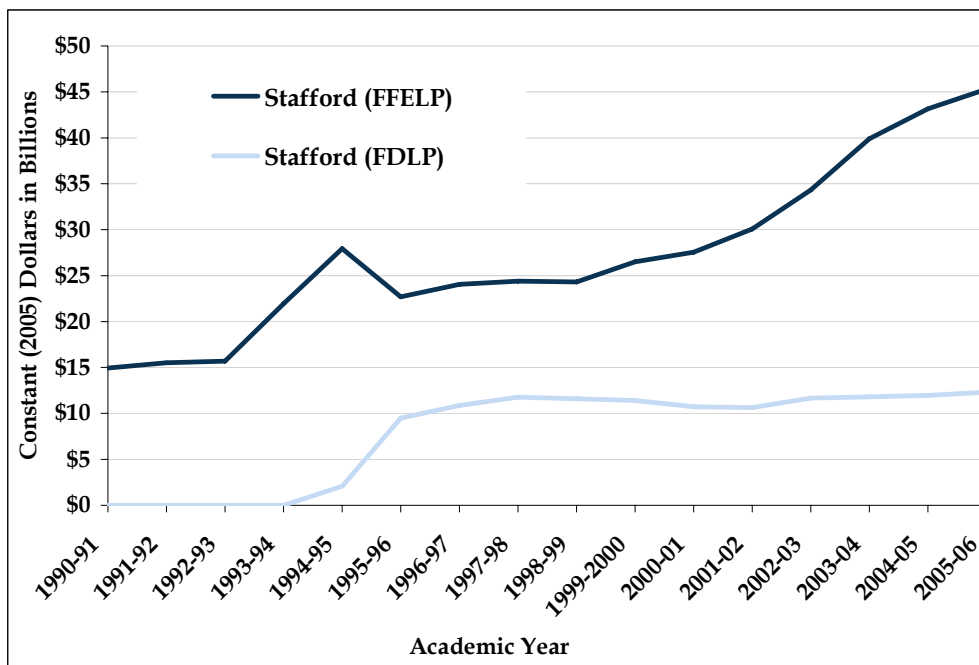
Conclusions

If this bill is enacted as is, additional credit enhancement could be required for future transactions as excess spread will likely decrease.

Is securitization volume at risk? Growth of the Federal Direct Program (FDLP) has remained stagnant over the past several years where growth in FFELP has increased significantly and has been gobbling up market share (Exhibit 5). Cutting interest rates in half would be costly. To help alleviate the cost, channeling loans through the less-costly FDL program would be considered.

This raises concerns regarding securitization volume because only FFELP loans are securitized. However, we expect this option to be difficult to implement and therefore would not lead to any negative effect on the volume of student loan securitization. In fact, we expect volume to increase as the Stafford loan limits have been increased.

Exhibit 5: Growth of Stafford Loans for FFELP versus FDLP



Source: Trends in Student Aid 2005, The College Board.

DISCLOSURE APPENDIX

Additional information is available on request.

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