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Federal Student Loan Legislation: The Upshot So Far

In passing the Deficit Reduction Omnibus Reconciliation Act (DRA) (S. 1932) last December, the Senate also reauthorized and amended sections of the Higher Education Act (HEA). Although the DRA has yet to be vetted by the House and signed by the President, Capitol Hill observers generally agree that its substantive HEA proposed amendments are likely to become law. Accordingly, we have outlined the salient amendments and their corresponding probable implications for FFELP ABS below:

A. Loan Interest Rates

Effective 7/1/06, coupons on both student (Stafford) and parent (PLUS) loans would be fixed at 6.8% and 8.5%, respectively. Currently, coupons on these loans (disbursed on or after 7/01/98) adjust annually and accrue interest at a 91-day T-bill bond-equivalent rate plus a spread.¹ Although the legislation would increase both student and parent borrowing costs, loan demand should be unaffected.

B. Special Allowance Payments and Rebates

The current Special Allowance Payment (SAP) formula would continue. Hence, the lender or loan holder would be paid the greater of i) the coupon paid by the borrower or ii) the borrower coupon + the SAP margin (calculated at 90-day CP plus a spread). However, a kind of "windfall" profit adjustment has been added to the formula in the form of an interest rebate. Without the rebate, a drop in market rates below the proposed fixed coupons would generate an "excessive" SAP for loan holders. The net result should still be a floating-rate return for loan holders. Additionally, lender "recycling" of the notoriously profitable 9.5% Special Allowance loans would be dropped for for-profit lenders and for all lenders holding more than \$100 million of these loans. All "9.5% loan" recycling would be eliminated by 2010.

C. Loan Guaranty Coverage

The government guaranties for FFELP loans underwritten by Exceptional Performer (EP) lenders would decrease from covering 100% of losses to 99%. Non-EP lender coverage would drop from 98% to 97%.

D. Student Loan Limits

Annual Stafford Loan limits would increase to \$3,500, \$4,500, and \$12,000 for freshmen, sophomore, and graduate/professional students, respectively. Additionally, a new borrower class would be created by making parents of graduate/professional students eligible for PLUS loans. These changes should contribute to a rise in new FFELP loan volume.

E. In-School Loan Consolidation Restrictions

In-school consolidation of FFELP loans would no longer be permitted. Loan refinancing on the massive scale experienced in 2005 may not occur again. Nevertheless, passage of the DRA should produce some upward prepayment pressure through June 2006.

F. Conclusion

It is unlikely that the FFELP sections of the current DRA draft would significantly augment or disturb the SLABS market. Nevertheless, the proposed law would redress some perceived imbalances, hopefully precipitating a period of relative political stability for the government student loan industry.

For questions or comments, contact Frederic Vigneron at fvigneron@dbrs.com.

To access a toll-free replay of DBRS's 1/11/06 Year in Review and Outlook 2006 conference call, dial 1-800-645-1799, pass code 1702#.

¹ For Stafford borrowers who are (1) in school, (2) in the post-school grace period, or (3) in authorized deferment, the spread charged is 170 bps. For Stafford borrowers in repayment, the spread is 230 bps. The rate limit for both is 8.25%. For PLUS loans, the spread is 310 bps, not to exceed 9%.