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Is SLIM In?

Student loan net interest margin securities (SLIMS) could see renewed interest in 2006. Like their counterparts in the HEL and Auto sectors, SLIMS are essentially interest-only strips; their cash flow is derived from a transaction's net interest proceeds ("excess spread"). As residual claims, SLIMS payments are subordinate to operating expenses, all noteholder interest and principal payments, and any required replenishment of reserve accounts.

Student loan ABS (SLABS) backed by mostly, if not all, federally reinsured consolidation loans¹ have proven to provide relatively stable and healthy levels of excess spread. Therefore, net interest margin securities structured from these transactions may be particularly attractive to investors. The strength and stability of excess spread can be attributed to the following factors: (a) the strong credit profile of the underlying collateral (at least 98% guaranteed), (b) the relatively low level of collateral prepayment rates,² (c) the relatively high portion of the collateral that is in the repayment period, and (d) the insulation of transaction excess spread from interest rate movements. Although consolidation loans carry a fixed coupon, they are effectively floating-rate assets due to the special allowance payment (SAP) to which FFELP loanholders are entitled. As an FFELP loanholder, the trust is entitled to receive a payment from the Department of Education that reflects the difference between the fixed-loan coupon and the 90-day commercial paper rate plus a margin of 264 basis points.³

A SLIM can be created at deal inception, when issuers can benefit from the monetization of a transaction's excess spread, or from seasoned SLABS. For seasoned transactions, a SLIM may be issued as a residual note as permitted under existing trust documents. Alternatively, a SLIM may be issued by a second trust that purchases the original residual trust certificate. Regardless of the legal structure of the SLIM, like all other net interest margin securities, the release of residual cash is subject to a transaction's compliance with deal covenants (e.g. specified parity, or overcollateralization, ratios). In many cases, reserve accounts are established to provide some degree of support to SLIMS.

The sizing of a SLIM note is impacted by assumptions that affect cash flow variability, and which are common to other NIM structures, such as prepayments, basis risk, and collateral defaults. Additionally, there are factors unique to SLABS that impact cash flow, such as deferments, forbearances, and borrower benefit utilization. Typical of net interest margin securities, SLIMS are amortized from available excess funds that are paid out on each distribution date.

Due to the abundance of SLABS transactions backed by consolidation loans, the high dollar amount of excess spread that can be monetized in these transactions, and the stable profile of SLIM cash flows, the market may see more SLIMS transactions this year.

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¹ Borrowers can exercise a one-time option to consolidate their outstanding federal student loans into a single loan. The coupon on the consolidated loan is equal to the weighted average of the coupon rates on the individual loans. Consolidation loans may have repayment terms of up to 30 years depending on the aggregate principal amount of the loans at consolidation.

² Consolidation loans generally have lower prepayment rates as borrowers are only permitted to consolidate their loans once. Also, historically, student loans carry lower interest rates than other consumer debt.

³ For consolidation loans originated prior to January 1, 2000, the SAP payment is indexed to the 90-day T-bill plus a margin of 310 basis points.