



# U.S. STRUCTURED FINANCE NEWSLETTER

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## The Impact of the Deficit Reduction Act of 2005

The Deficit Reduction Act of 2005 (Pub.L. 109-171) was signed into law by President Bush on February 8, 2006. The Act is intended to reduce government spending in many areas and includes the framework for changes to existing laws governing the Federal Family Education Loan Program (FFELP). These changes are specified in Title VIII-A of the Act, otherwise referred to as the Higher Education Reconciliation Act of 2005 (HERA). The key provisions of HERA are summarized below:

- **Extension of the FFELP through fiscal year 2012** – The extension of the program ensures the supply of government reinsured student loan collateral for another six years which benefits the SLABS sector overall.
- **Increase in loan limits (effective July 1, 2007) for first-year Stafford undergraduates from \$2,625 to \$3,500, second-year undergraduates from \$3,500 to \$4,500, unsubsidized Stafford graduate and professional students from \$10,000 to \$12,000.** Federal loan limits should cause a corresponding increase in the supply of FFELP collateral available for securitization. However, demand for private loans should not be adversely impacted by FFELP limit increases; demand for private loans will continue to be fueled by sustained, high tuition growth rates and the overall rise in college enrollment.
- **Authorization for PLUS loans to graduate and professional students** – Expansion of PLUS loans to graduate and professional students will increase FFELP market volume, while potentially causing a decline in borrower demand for private loans. Borrowers will now be able to choose between PLUS loans (at a fixed rate of 8.5%) or private student loans with risk based pricing. Although private loan volume may be adversely impacted by this change, in today's interest rate environment, only risky borrowers are priced at rates in excess of 8.5%. Consequently, although volume may shift to the FFELP market, the performance of future private loans pools should become less volatile as the most risky borrowers opt out of the market.
- **Change in borrower interest rates and elimination of floor income** - Interest rates on new Stafford loans will be fixed at 6.8% and PLUS rates will increase from 7.9% to 8.5%. Furthermore, by requiring loan holders to remit the difference between the SAP rate<sup>1</sup> and the borrower rate when the SAP rate is lower, HERA eliminates windfall profits to loan holders when short term rates are low. This change takes place for loans originated beginning April 1, 2006. Both changes are expected to have a neutral impact on the performance of future FFELP SLABS. Historically, floor income was not relied upon to cover collateral losses and loan holders continue to be hedged through the SAP rate in a rising interest rate environment.
- **Prohibition of in-school consolidation** – The prohibition of originating in-school consolidation loans (beginning July 1, 2006) should reduce future pool risk. Currently deferments are utilized during the in-school consolidation process and thus students may be required to make payments immediately upon graduation. Limiting the use of grace periods to the post graduation period should reduce default risk; many students need time to find employment after graduation and cannot service their loans unless employed.
- **Reduction of 1% in the guarantee rate**- The 1% reduction in government reimbursement for defaulted loans is expected to have negligible impact on the performance of future FFELP SLABS. The potential increase in net losses is minimal and would be factored into transaction credit enhancement levels.

Overall, HERA should have a negligible impact on future FFELP SLABS in terms of collateral credit quality and transaction performance. HERA can potentially shift volume from the private loan market to guaranteed programs. However, the long term outlook for the private loan market continues to be positive.

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<sup>1</sup> Depending on the origination date, the SAP rate is the difference between either (i) the bond equivalent 91-day Treasury bill and a margin or (ii) 90-day commercial paper rate specified by the U.S. Treasury, plus a margin less the borrower rate. To the extent this amount is negative (applies only to loans originated after April 1, 2006.) loan holders will be required to remit payments to the government.