

Structured Finance Newsletter

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STUDENT LOAN ABS

The future of the student loan ABS market is highly dependent on the fate of the Federal Family Education Loan Program (FFELP). The Student Aid and Fiscal Responsibility Act of 2009 (SAFRA), which passed in the U.S. House of Representatives in September 2009 is awaiting action in the U.S. Senate, includes a provision to end the FFELP on June 30, 2010. This measure is critical to the ABS market because not only would the elimination of the FFELP trigger a wind down of the federally-guaranteed student loan asset class, but also many FFELP secondary market participants, namely not-for-profit state agencies, are also lenders of private student loans who could be severely impacted by the elimination of the FFELP business. At this time, under the specter of the FFELP going away, several smaller student loan companies are hoping to win a piece of the William D. Ford Direct Loan program servicing business to facilitate continuing their operations and their ability to offer private student loan programs. This issue will be the most watched in the student loan asset class in 2010.

Throughout 2009, lenders who were able to remain in business following the market collapse in 2007 and 2008 utilized the participation and put facilities provided by the U.S. Department of Education¹ as an outlet for new FFELP originations for the 2009-2010 academic year. At this time, those facilities have not been extended for the 2010-2011 academic year pending the outcome of SAFRA debate. Many lenders also avoided issuing debt in the capital markets in 2009 by securitizing older Stafford and PLUS loans (those still being held that were originated for the 2007-2008 academic year) through the Department of Education-sponsored Straight-A Funding asset-backed commercial paper conduit². Since Consolidation loans are not eligible for Straight-A Funding, some ABS transactions were executed that financed older Consolidation loans. And some lenders were able to issue tax-exempt funding to finance private loan programs.

As a result, in 2009, only 26 public student loan-backed³ transactions were executed for a total issuance of \$21.8 billion.

Collateral Type	No. of Transactions	Amount (in Billions)
FFELP Consolidation Loans	6	\$7.3
FFELP Stafford/PLUS Loans	6	\$4.4
FFELP Loans w/ 3 rd Party Credit Enhancement	3	\$0.6
Private Loans (For-Profit Issuer)	5	\$8.3
Private Loans (Not-for Profit Issuer)	6	\$1.2
<i>Total</i>	<i>26</i>	<i>\$21.8</i>

Going forward, with the margin on new FFELP lending already at an economically prohibitive level⁴, the conditions in the capital markets offer a very limited opportunity for FFELP lenders to finance current business through direct public securitization. Further, in 2010, should the SAFRA pass, market conditions for issuance will eventually become meaningless as no new FFELP collateral will be originated. Market conditions are and will continue to be important, however, to lenders seeking to refinance auction-rate securities.

Currently, there are billions of dollars of illiquid student loan auction-rate securities in the market for which there appears to be only two viable alternatives for holders of this paper: 1) utilize the limited, and at times volatile, secondary market to trade out of these positions or 2) rely on issuers to repurchase the securities. Much talk has taken place regarding the refinancing of auction-rate securities. However, there is a myriad of issues surrounding the product that make refinancing extremely challenging. These include, amongst other things: the type of collateral backing the bonds, the nature of the maximum interest rate on the bonds, the condition of the trust (in terms of parity level) and the concentration of holders of the securities.

Thus far the opportunities to refinance auction rate securities have been few in number. As holders of these securities become more interested in selling (most likely at a discount) and as issuers continue to chip away at

¹ The put and participation programs sponsored by the U.S. Department of Education are part of the *Ensuring Continued Access to Student Loans Act of 2008 (ECASLA)*, which provide for continued funding of FFELP loans for the 2008-2009 and 2009-2010 academic years.

² The Straight-A Funding asset-backed commercial paper program also falls under the Department of Education's loan funding authority under ECASLA and came online in February 2009.

³ DBRS includes in the student loan ABS category not-for-profit, state agency issuers whose issuances are not technically true ABS securitizations and which may include tax-exempt funding. Transactions from these issuers are included because the collateral being financed, being either FFELP loans or private student loans, has similar consumer lending characteristics to the collateral backing the true ABS transactions and may attract similar investors.

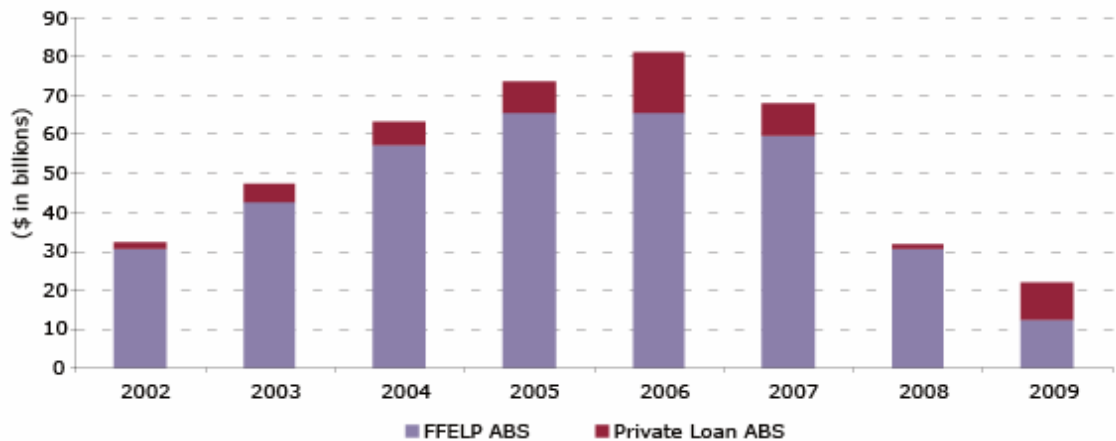
⁴ The *College Cost Reduction and Access Act of 2007* reduced the "special allowance payment" (SAP) margin on FFELP loans by 40-55 basis points depending on the loan type, the repayment status of the loan and for-profit/not-for-profit status of the lender.

the volume of outstanding securities through tenders and secondary market repurchases, parity levels in trusts may rise to levels that afford issuers sufficient equity to execute refinancing transactions. The direction of interest rates will also play a role in determining the level of activity in the auction rate refinancing arena as rising interest rates could push lenders to relent on the discounts they are willing to offer as their cost of funds increases.

For issuers of private student loans, the issue is similarly challenging to the fate belying FFELP issuers. Throughout 2010 and beyond, the demand for private student loans will remain robust as college tuition continues to escalate and federal loan limits remain comparatively low. However, the number of lenders of private student loans and their capacity to lend will remain limited. At the most basic level, few lenders have access to capital to operate private student lending businesses. Those that can lend have already tightened underwriting standards and will continue to refine their risk tolerance levels. So long as the condition of U.S. consumers remains pressured, unemployment remains elevated and performance on existing private student loan portfolios remains weak, investors will be cautious about participating in the ABS market for private student loans.

The upshot of this situation is that the market can expect a limited supply of student loan ABS issuance in 2010. This issuance will likely be backed by a mix of newer private loan collateral and seasoned FFELP loans. The FFELP-backed transactions will be executed as a means for larger lenders to flush through older Consolidation loans and possibly refinance auction-rate securities in a piecemeal manner. Total volume should be expected to equal an amount in the range of the 2009 issuance total, with perhaps a 10-20% increase.

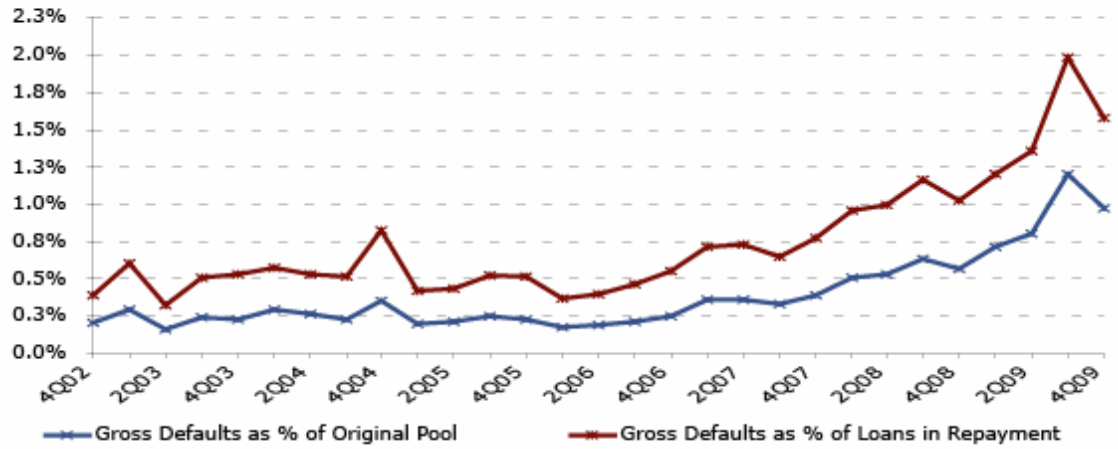
Student Loan ABS Issuance by Loan Type



Despite showing signs of improvement in the fourth quarter of 2009, performance on existing private student loan ABS throughout 2010 may well continue a long term trend of deterioration as a new slug of graduates enter repayment in a very challenging economic environment characterized most notably by a weak job market. Newly issued private loan ABS from 2009 is expected to show markedly better performance reflecting a clear initiative of lenders to tighten credit underwriting and utilize school certification programs versus riskier direct-to-consumer platforms.

One legislative landmine for private student loan ABS in 2010 could be the Private Student Loan Debt Swap Act of 2009 (S. 1541), a recently proposed bill in which private student loan borrowers would be offered an opportunity to refinance private student loan debt for federally-backed student loans under the Direct Loan program. This bill has not yet reached the Senate floor for debate, but has already generated widespread criticism amongst capital markets participants. The controversial element of the refinance offer is that it targets the best private loan credits. In the case of private student loan ABS pools, refinancing by the better borrowers in their portfolios would leave behind the worst performing borrowers and thus subject bondholders to higher-than-expected prepayments and worse-than-expected collateral performance in the long run.

DBRS Private Student Loan Quarterly Gross Default Index



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