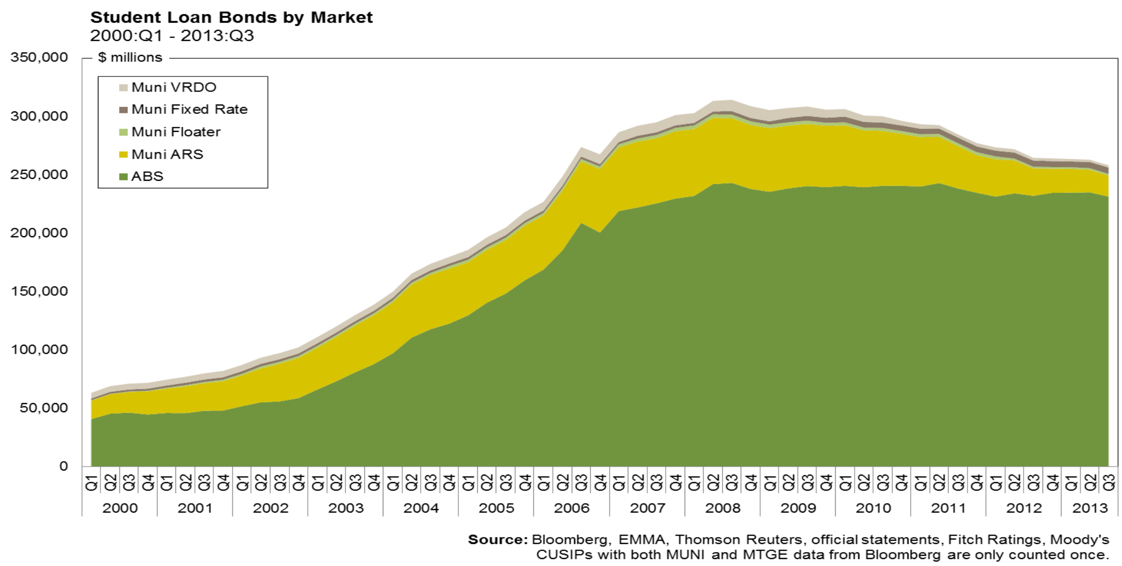
An Overview of Near-Term Catalyst in Student Loan-Backed Debt

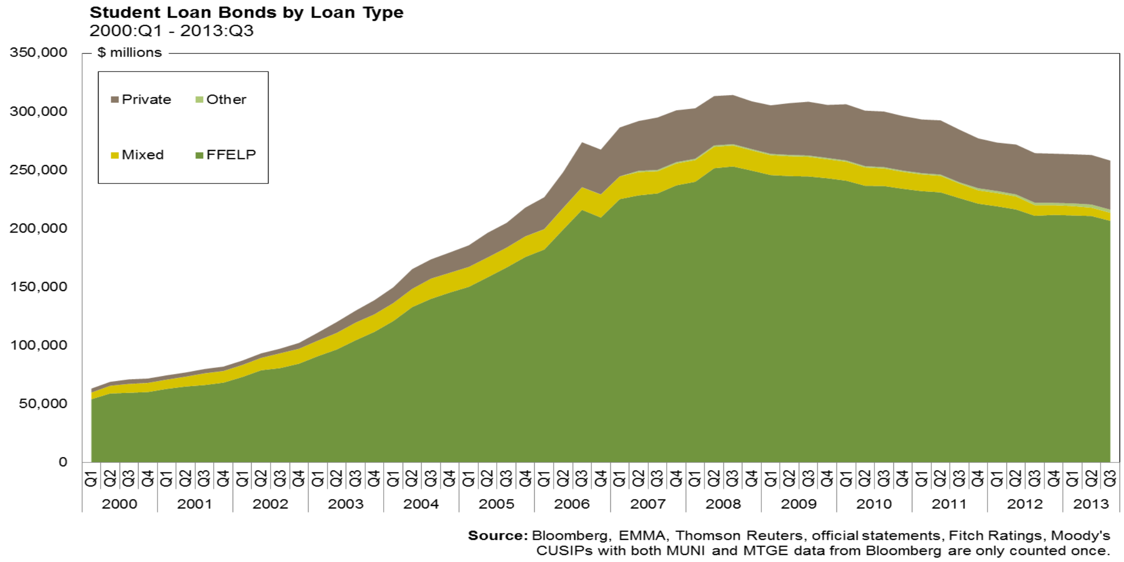
SLABS

Student Loan Asset-Backed Securities ("SLABS") represents a compelling opportunity in the near-term as the majority of FFELP tranches issued over the past decade are currently under review at the three largest credit rating agencies: Moody's, S&P, and Fitch. Holistically, the student loan market is rated AAA as 97% of FFELP loans are backed by the full faith and credit of the United States government. Despite that, due to macroeconomic factors, payment options, and several other factors it is highly likely that these bonds will not be paid by maturity. According to indenture on all bonds studied, and non-payment at maturity results in an event of default.



The chart above illustrates the exponential growth experienced by SLABS between the years 2003 and 2008; namely, in the asset-backed securities market. The deleterious credit underwriting standards during this time was not exclusive to the subprime mortgage market. In hindsight, we are seeing that credit scores did little to forecast repayment. During this time period, both for-profit and not-for-profit companies originated and issued these securities. In 2010, the Obama administration discontinued this operation as the conflicts of interest proved harmful for investors.

If we look closer at this timeframe, the growth in private education loans paralleled that of FFELP loan issuance. Private education loans require higher credit standards, as they are not backed by the federal government; in some cases, these notes are insured by guaranteed agencies and bond insurers (e.g., MBIA and Ambac). Private education loans are typically used to bridge the gap between federal loans and tuition, which can normally equate to tens of thousands of dollars.



The largest issuer during this growth period was Sallie Mae, a former Government Sponsored Entity ("GSE") that has since spun-off into a company called Navient Corporation. Private education loans became popular for several reasons: 1) tuition continued to rise at increasing rates; 2) For-profit colleges experienced rapid growth – some of which did not meet the standards for FFELP Loans and were also extremely expensive; and 3) Issuers could charge triple the interest rates to private borrowers.

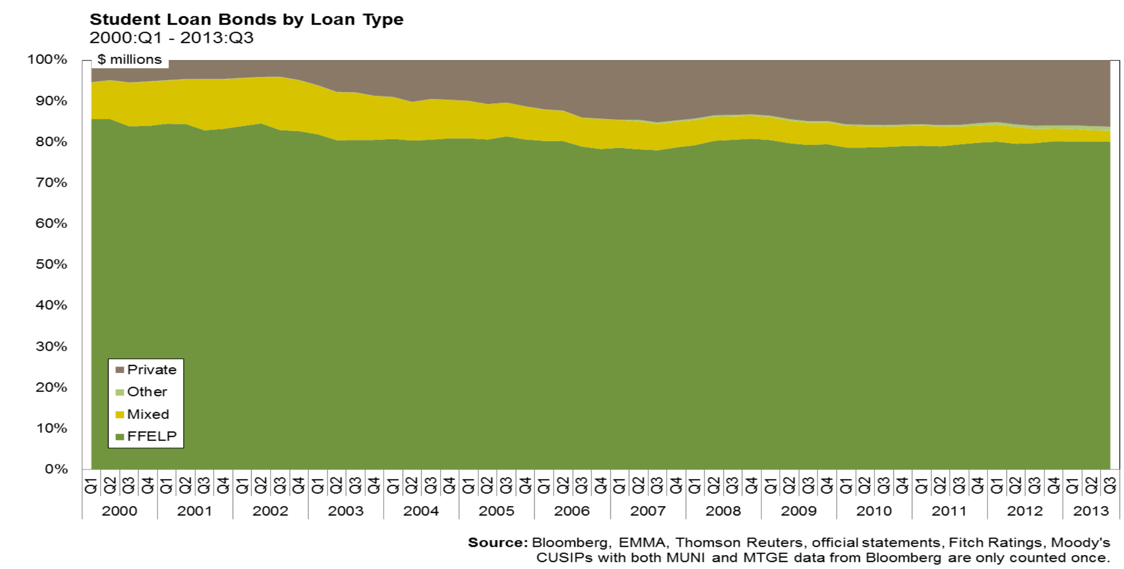


Exhibit 1: The majority of the FFELP loans currently under review are from Sallie Mae (Navient). Some of this is due to them issuing more than competitors; however, the rest of the potential downgrade is due to loose credit underwriting standards in the 2007/2008 vintages.

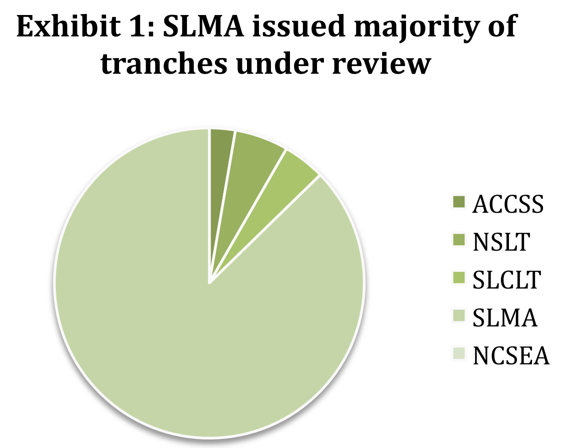


Exhibit 2: As discussed previously, about 60% of all tranches under review stem from the 2007/2008 vintages. This period underperforms for two reasons: 1) lenders trying to keep up with growth; and 2) Borrowers entering graduate school in the masses due to sub-optimal employment market.

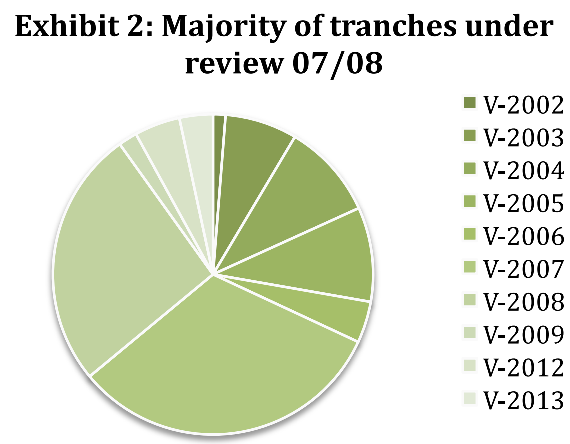
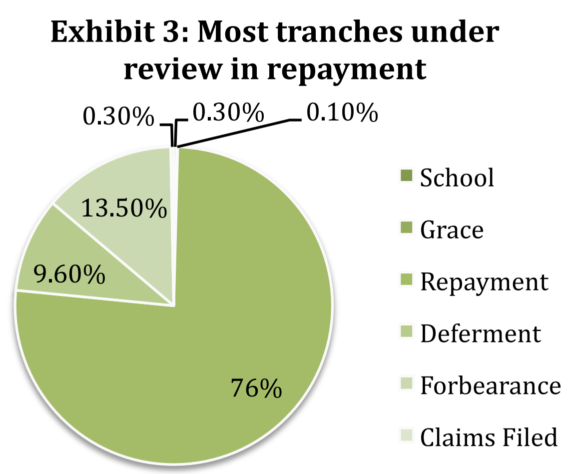


Exhibit 3: Paradoxically, most of the tranches under review have high repayment rates. A high repayment rate can be illusory – hiding the complexities behind repayment options. For example, if a borrower is an Income-Based Repayment plan, the borrower can pay $0 per month, and the payment will still count as a repayment. For FFELP loans, the investors would be better off if the borrower defaulted. With repayment options, it is likely that the debt will not be repaid until after maturity – the cause of a technical default.



Like all other consumer packed debt, student loans are bundled into securities and layered by risk level in what is known as tranches. In this case, it is the senior most tranches that are currently being reviewed for downgrade. On the left, you can see that it is actually those loans that have been consolidated that are at most risk to be downgraded. One of the biggest misconceptions in student loans is that they are assumed to be packed into one big loan. In actuality, borrowers have multiple loans, sometimes as many as ten; typically, loans very by interest rate.

Consolidated loans add a further complexity to this security valuation; the underlying loans have been bundled and can thus not be extrapolated for individual analysis. Furthermore, any type of refinancing via a third-party will discontinue the federal repayment options – a risk/reward that is often taken too lightly.

On the right, we can see that the overwhelming majority of tranches under review AAA. Nevertheless, as illustrated by MBIA in 2007 – a triple A rating can have adverse effects when downgraded. Currently, $40B of AAA-rated student loan debt is under review. If a downgrade were to occur, the funds owning the notes would likely be inclined to sell as their fund must hold AAA-rated debt. Additionally, the yield on these notes is atrocious. If downgraded, the notes would be competing directly with better, higher yielding alternatives.

Exhibit 4: Most tranches under review are consolidated loans

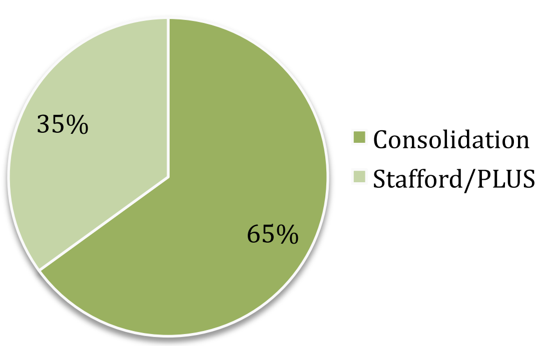
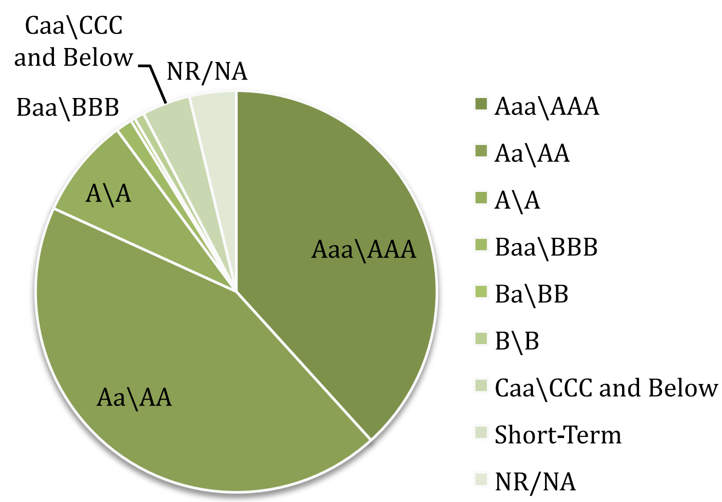


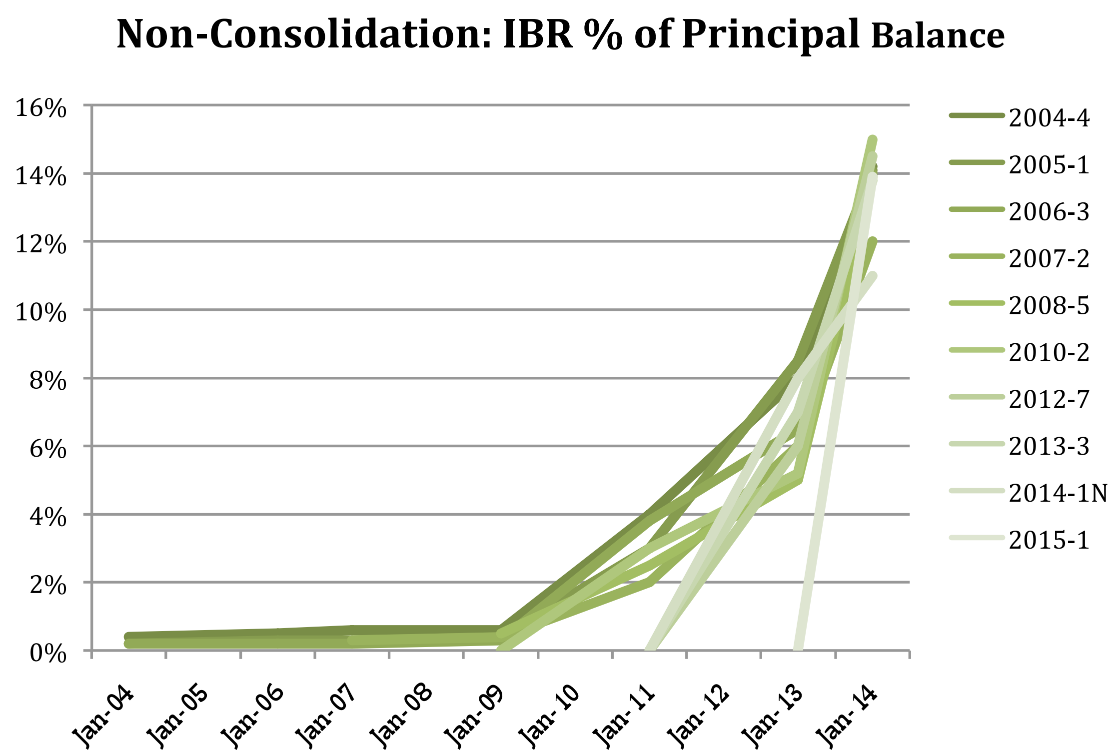
Exhibit 6: Loans by Rating



In closing, the probability of a massive downgrade within the senior tranches is becoming increasingly likely. Per agency metrics, the cash flow model no longer supports a AAA-rating, or even a AA rating for that much. As the options and variability increase within repayment plans, the likelihood of repaid at maturity is highly unlikely.

In addition to FFELP senior notes, subordinated private education tranches could likely be downgraded as well; namely, from those notes being securitized between 2006-08. Currently, there are several SLABS being triggered to cut-off class C notes as cumulative losses have surpassed the 20 percent threshold (SLM Private Credit Trust 2006-A).

The core catalyst against owning these securities can be summed up rather plainly in the chart below. Despite being slow initially, SLABS has seen an exponential uptick in those borrowers electing an income-based repayment option. Via income-based repayment – or Pay As You Earn ("PAYE") – it is highly unlikely that borrowers will ever default. Paradoxically, this will eventually be a net negative to both servicers and owners of this debt; it highly likely that these notes will not be repaid until well after the final maturity date. The chart below represents the percent of borrowers that have entered some type of income-based repayment options at Navient/Sallie Mae since 2004.



(Note: those loans that have been consolidated over the past decade reflect this exponential rise in repayment options. The data used in this analysis was derived from Elen Callahan and Kayvan Darouian of Deutsche Bank and Bloomberg).

With alterative repayment options gaining momentum and contract structures with servicers become less lucrative, we believe that margins within the debt servicing industry will continue to compress. The studies outlined in this overview represent the next step in the vicious cycle of student loan asset-backed securities: the industry-wide downgrade.

For questions or concerns, please contact taylor@pinecapitalpartners.com.