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CAPITAL MANAGEMENT

INVESTMENT MEMO

Merganser Today

Merganser has been buying and analyzing asset backed securities (ABS) since their creation in the mid 1980s. Issuance of student loans began roughly a decade later and has evolved greatly since then.

New asset backed securitizations are made possible due to rehabilitated FFELP loans.

Do Your Homework: Uncertainty in the FFELP Student Loan Market

Are government guaranteed student loans at risk of default? This question has been at the front of ABS investors' minds over the last several months as slowing payment trends have resulted in ratings agencies raising warnings of extension risk and potential downgrades. This memo addresses implications for cash flows, ratings volatility, liquidity and pricing.

Overview of FFELP Loan Program

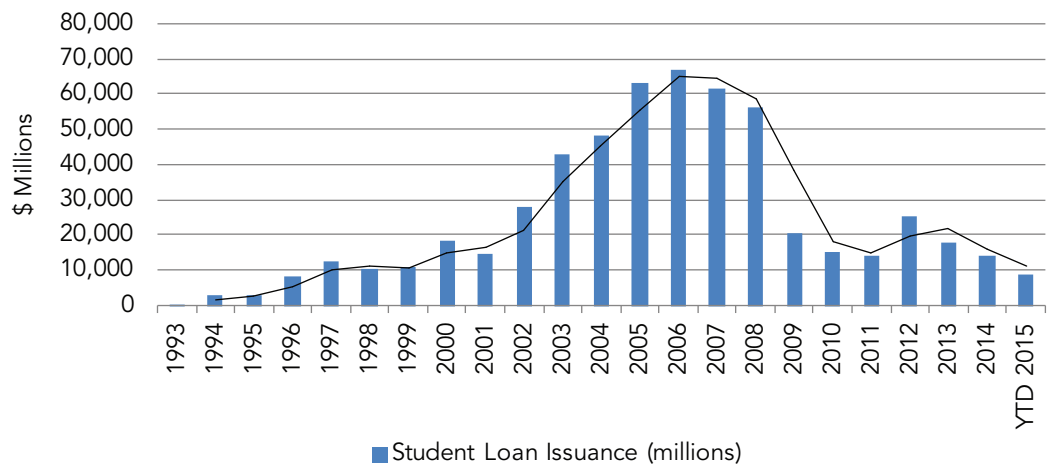
The Federal Family Education Loan Program (FFELP), established in 1965 through the creation of the Higher Education Act, was one of several vehicles utilized by the US government to facilitate lending at the state and local level to prospective students. Under FFELP, private lenders, such as Sallie Mae, used their own capital to finance loans to students and parents of dependants and in return the government provided subsidies and guarantees to protect lenders against default. It is estimated that approximately \$878 billion in lending occurred through this program between 1965 and 2009. Today, no new loans are being issued under the Federal Family Education Loan Program due to the enactment of the Health Care and Education Reconciliation Act of 2010. The US government felt that substantial savings could be realized by lending directly to borrowers using funds provided from the US Treasury with administration services rendered through the Department of Education (DOE), a process known as "direct loans," thus eliminating the need for intermediaries.

Securitization

According to the Securities Industry and Financial Markets Association (SIFMA), student loan asset backed securitizations first appeared in the early 1990s and annual issuance peaked in 2006 at an annual run rate of approximately \$67 billion. As of Q1 2015, the total market value of outstanding student loan ABS stood at \$212.5 billion, but issuance has dropped off precipitously in recent years. According to JPMorgan, only \$12 billion in loans is expected to price in 2015. Although the FFELP program officially expired in July 2010 and issuance has steadily declined, new asset backed securitizations are made possible due to rehabilitated FFELP loans, restructured auction rate securities and private institutions selling loans held on their balance sheet. Private lenders have attempted to fill the gap in FFELP issuance, but following the credit crisis many institutions exited the business due to increased regulatory oversight and margin pressures. As of 2015, Sallie Mae Bank/Navient Corporation is the dominant issuer of private label student loans. However, a new form of private lending involving refinancing loans for super-prime quality borrowers is emerging. One company, SoFi, is currently the market leader in this space and has issued two deals thus far in 2015 totaling \$725 million.

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Figure 1: Annual Student Loan Issuance



Source: SIFMA As of July 31, 2015

Extension Risk and Technical Default

Extension risk can arise if a security fails to amortize fast enough to factor down by the legal final maturity date.

Following the financial crisis, asset backed securitizations collateralized by FFELP student loans started to exhibit slower payment rates compared with historical periods and certain trusts are now at risk of extending beyond their legal final maturity dates, a situation known as a "technical default."¹ Extension risk can arise if a security fails to amortize fast enough to factor down by the legal final maturity date recorded in the prospectus.

The slowing payment rate is due to a confluence of factors, including the following:

- High post graduate unemployment
- Weaker labor market coming out of the crisis
- Increased utilization of payment alternatives, such as

Deferment: Borrowers are granted flexibility to postpone making payments on their loans. Under this scenario, interest accrues for the duration of the deferment period. Eligibility for deferment can be related to economic hardship or pursuing higher education opportunities.

Forbearance: Eligible borrowers stop making payments or make reduced monthly payments for a period of up to 12 months, extendable for additional 12-month intervals. Total time in forbearance is at each lender's discretion. Interest accrues for the duration of the forbearance period.

Income Based Repayment Plans (IBR Plans): A type of repayment plan for federal student loans that can help make monthly payments more affordable by basing them on the borrower's income and family size.

Typically, a borrower under a standard repayment scenario takes out a 10-year loan with monthly payments set at a minimum of \$50, although some consolidated loan terms can be as long as 30 years. Conversely, when a borrower enters deferment or forbearance, the borrower makes no monthly payments and in the case of forbearance, the interest gets capitalized into the outstanding principal balance. Perhaps the most worrisome and important development to take shape over the past several years is the increased use of IBR Plans. Under this scenario, borrower payments are modified and re-calculated according to a sliding scale which can range from 15% of discretionary income to zero. In some cases the borrower

¹ A technical default is not limited to ABS securitizations. Technical default encompasses a wide variety of non-payment related failures of a borrower including failure to comply with financial covenants as well as non-financial covenants.

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will be required to pay only the interest on the loan. The IBR Plan term can last up to 25 years, which is twice as long as the standard loan period, and any unpaid balance beyond this point is simply forgiven.

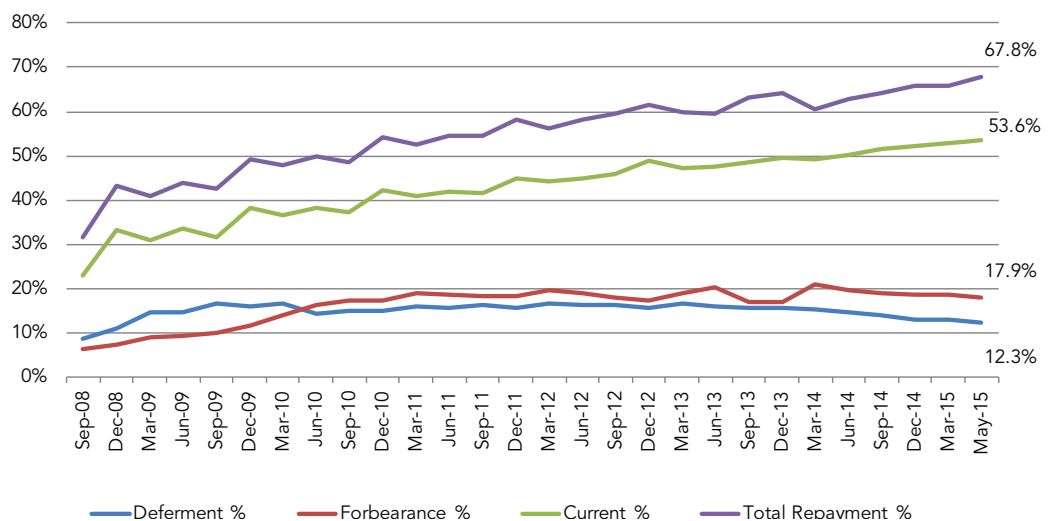
Interestingly, the use of these payment plans has been increasing steadily since their introduction in 2009 and the government has been broadly marketing these alternatives as a way to mitigate the occurrence of delinquencies and subsequent defaults. This increase has significant implications for the timing of cash flows in asset backed securitizations and the timely repayment of principal. It is important to note that ultimate repayment in FFELP securitizations is not in question, as 97% of the principal balance is guaranteed by the government; the issue is more one of timing.

Extension Risk Example

As an illustration of the challenging collateral trends in the student loan market, we examined one of the FFELP Sallie Mae deals Moody's watch-listed in April 2015. This deal was securitized under the FFELP program during June 2008, approximately one-third of the way through the recession that began in December 2007. As many will recall, the financial crisis was beginning to intensify and graduating college seniors were faced with few employment prospects. As Figure 2 illustrates, the percentage of the pool balance in "repayment" has grown to the current level of 68%, reflecting a steady migration of borrowers coming out of the six month grace period immediately following graduation. More recently, the rate of increase has been slowing, suggesting that borrowers are likely pursuing alternative payment avenues (e.g. IBR Plans). A quick comparison of the loan balance classified as "in repayment" versus the loan balance classified as "current" suggests that a little more than 14% of the deal is in delinquency. It is also important to note that 18% of the deal is in forbearance while 12% is in deferment. Combining these totals with the percentage of the pool that's in delinquency, one can infer that approximately 44% of the deal is not making any payments. This number is actually greater when one factors in the percentage of borrowers utilizing IBR Plans who are making reduced payments or no payment at all.

Perhaps the most worrisome and important development to take shape over the past several years is the increased use of IBR plans.

Figure 2: Collateral by Loan Status



Source: Navient

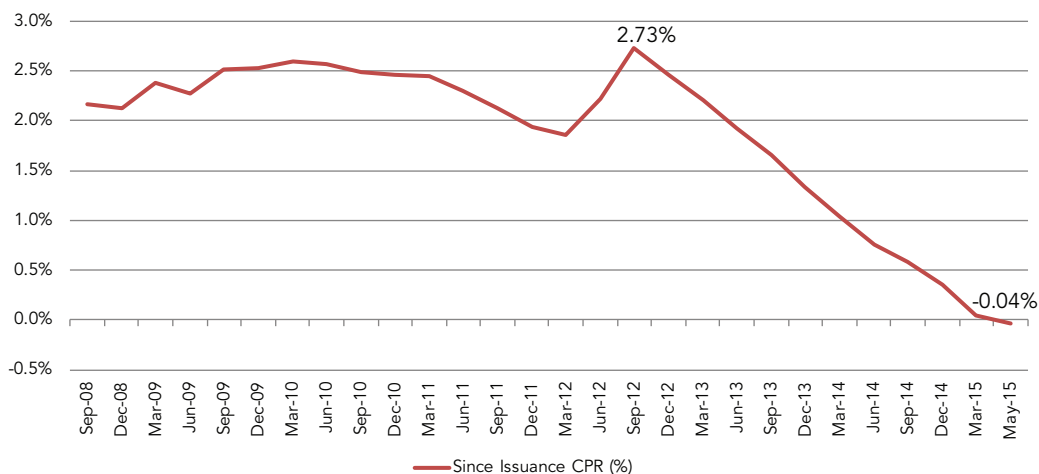
While these statistics certainly have negative implications for bond holders and the timely repayment of principal, the issue is exacerbated when one considers that voluntary prepayments, as measured by lifetime Conditional Prepayment Rate (CPR), have essentially fallen to zero,

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whereas they were above 2% at the time of issuance. In fact, this deal was issued at an initial pricing speed of 12% CPR, suggesting an expected maturity date of January 2017, which equates to an average life of 7.43 years. Figure 3 shows that lifetime CPR peaked at 2.73% in September 2012 following the debt consolidation plan orchestrated by the DOE and has since fallen precipitously to the current level of -0.04%.

The IBR terms can last up to 25 years, which is twice as long as the standard loan period.

Figure 3: Since Issuance CPR (%)

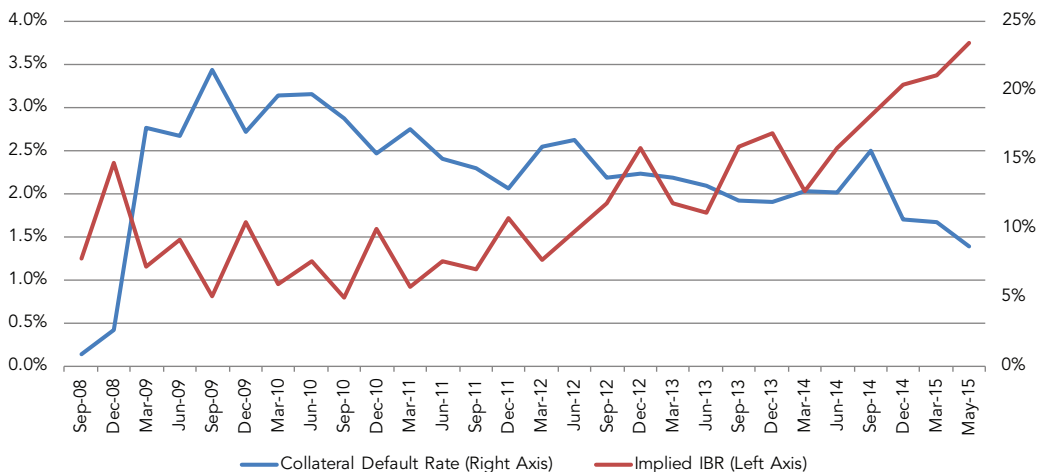


Source: Navient

As stated previously, one of the primary objectives of the income based repayment initiative set forth by the DOE is to stem the number of borrowers defaulting on their loan obligations. Figure 4 provides some evidence that the borrowing program seems to be finding some traction. Stated as a percentage of the outstanding collateral balance, the default rate has been declining steadily from 2.62% in June 2012 to the current level of 1.38%. Meanwhile, the deal-implied IBR Plan has been on a clear upward trend, increasing by 15.7% between March 2012 and May 2015.

As a way to showcase extension risk firsthand, we examine the last cash flow tranche of the SLMA student loan deal referenced above. For purposes of this analysis, we assume that

Figure 4: Implied IBR versus Collateral Default Rate



Source: Navient

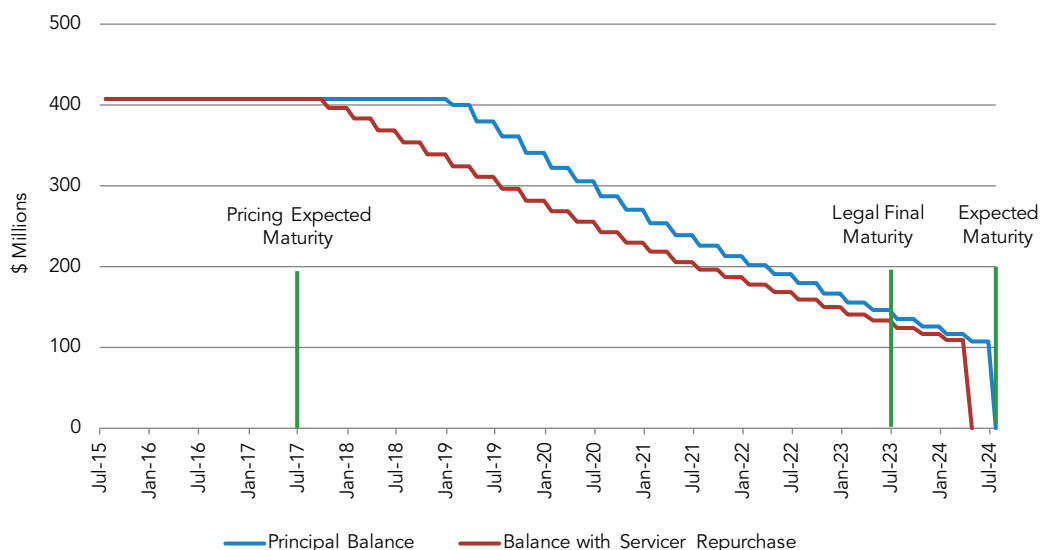
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" The preliminary analysis indicates that even under cash flow assumptions in the expected case scenario, many tranches do not pay off by their final maturity dates."

- Moody's

the servicer, Navient, exercises its voluntary repurchase option of up to 10% of the initial collateral balance. Navient actually amended the existing servicer agreement to include a repurchase clause after realizing that certain tranches may fail to pay by the legal final date. We also assume a 0% CPR since this is the reported lifetime payment speed realized over the past 81 months. Due to the increased use of alternative payment methods and low voluntary prepayments, this tranche will not start receiving principal until January 2018, a full year after the expected maturity date identified at pricing. As Figure 5 illustrates, this bond will ultimately miss both its expected maturity date and legal final maturity date, resulting in a technical default and a downgrade.

Figure 5: Collateral Balance (0% CPR Scenario)



Source: Navient; Wells Fargo Securities

Ratings Agency Response and Implications

On April 8, 2015 Moody's announced their decision to place 14 FFELP transactions on review for downgrade due to the increased risk that the bonds will fail to pay in-full by their legal final maturity date. Following this initial announcement, the universe of securities was expanded on June 22, 2015 to include a total of 120 tranches, representing over \$37 billion in outstanding principal balance and approximately 21% of the outstanding FFELP ABS issuance, according to SIFMA. Fitch followed suit and placed several tranches on watch list, although the universe of impacted securities is much smaller.

Moody's has issued a "request for comment" from investors regarding revised assumptions used in rating FFELP student loan transactions. Moody's has stated that "the preliminary analysis indicates that even under the cash flow assumptions in the expected case scenario, many tranches do not pay off by their final maturity dates." Moody's also states that they expect to downgrade the ratings of outstanding FFELP securitizations that will not pay off by their final maturity dates, though they will consider the ability and willingness of transaction sponsors to repurchase slower paying loans from the underlying collateral pools. These downgrades may range from low investment grade to non-investment grade.

Several issuers have taken steps to prevent downgrades, including amending trust documents to extend legal final maturities, buying back slow-paying loans and depositing cash sufficient to redeem tranches out of the trust by their legal final maturity date. Importantly, while issuers

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have expressed a willingness to take whatever actions are necessary to prevent downgrades, it is no small task, as Moody's has identified over \$37 billion across 50 separate trusts that are at risk of downgrade. We are concerned that balance sheet constraints could limit the issuers' ability to buy back tranches and alleviate the extension scenario.

Conclusion

The unfavorable headlines and uncertainty in FFELP ABS ratings are clear negatives for the sector that was severely tarnished during the 2007-2008 financial crises. Investors remain apprehensive and we may see a wave of selling if tranches get downgraded, particularly below investment grade. Ratings volatility is an important consideration for separate account managers, like Merganser, who must adhere to client-specific guidelines. According to Moody's, if a tranche were to be at risk of extension and technical default, the agency would look to move proactively and downgrade the tranche to "B," assuming they expect no losses. They would simultaneously assign a likely recovery estimate of close to 100% given the government guarantee and could ultimately upgrade it later, but the price impact from forced selling would be damaging and would diminish liquidity.

We have been hesitant to invest in the FFELP student loan sector because of inadequate servicer disclosure, lack of transparency, poor cash flow analytics and continued political risk associated with debt forgiveness. While we have opportunistically added some pre-crisis deals that are not at risk of technical default, we feel that opportunities in the sector are limited and that spreads in most FFELP ABS do not adequately compensate investors. Furthermore, until there is increased disclosure with respect to alternative payment methods (IBR Plans), deal level cash flows and clarity with respect to ultimate rating agency actions, the market will likely remain dislocated and vulnerable to sell-offs. As "gatekeepers of risk," we deem it prudent to lend our clients' capital to areas of the ABS market that offer predictable cash flows, stable ratings and superior liquidity.

Rating volatility is an important consideration for separate account managers like Merganser.

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