THE OPPORTUNITY

Senior securitized FFELP bonds, which are backed by government-guaranteed student loans, carry little risk of principal loss.

STUDENT LOAN REPAYMENTS HAVE SLOWED since the financial crisis due to the generally challenging economic environment and number of options that allow borrowers to defer principal payments.

THERE IS NOW A RISK that some FFELP bonds will breach their stated maturity date, which has prompted Moody’s and Fitch to consider taking a negative rating action.

THE POTENTIAL FOR A DOWNGRADE HAS LED TO a widening of spreads and proactive selling of the bonds, as the typical investor in FFELP senior bonds is a ratings-sensitive buyer.

NOW, WE SEE A COMPELLING OPPORTUNITY to acquire these securities at very attractive levels given their underlying government guarantee and the fact that major deal sponsors are pursuing multiple solutions to resolve the legal/structural issues. This is particularly true when compared to other securitized asset classes.

A COMPELLING OPPORTUNITY IN SECURITIZED STUDENT LOANS

The Global Securitized Products Group is actively pursuing a program for purchasing securitized debt backed by government-guaranteed student loans (also known as FFELP loans). We believe these bonds currently offer significant value in the context of other securitized products, and we invest in them as part of our broader investment-grade strategies.

Slowdown In Student Loan Repayment

Student loans are a common part of many students’ higher-education experience. The federal government is a primary source of student loans, accounting for more than 90% of the market, while private lenders – banks, schools and other lending institutions – make up a much smaller portion. Of the approximately $1.2 trillion in outstanding student loans, more than $380 billion were issued by the federal government under the now-defunct Federal Family Education Loan Program (FFELP), a needs-based program under which government loans were often supplemented with loans from the private sector. Many of the loans made through FFELP were securitized by companies like Navient, the loan servicer that was formerly part of Sallie Mae. The bonds backed by these loans were assigned AAA ratings and sold primarily to investors who favored a highly rated instrument.

FFELP

The Federal Family Education Loan Program (FFELP) is a needs-based government program that until July 1, 2010 provided federal backing for privately issued student loans. Under the program, private lenders – local banks, a borrower’s school or other institutions – provided loans to students that were ultimately insured by the federal government. Many of the loans made through FFELP were securitized by companies like Navient (formerly a part of Sallie Mae) and sold to investors. Currently, there are $173.8 billion in FFELP securitized bonds outstanding, compared to $34.7 billion of private securitized bonds. The Direct Loan Program completely replaced FFELP in July 2010, though the types of loans made under the program are identical to those issued under FFELP.

The slowdown in FFELP loan repayment since the financial crisis is largely a result of the challenging post-crisis economic environment. As graduates struggle to find work, they often delay or postpone the payments on their loans through deferment and forbearance programs. Deferment is available for up to 3 years, and can be applied when the borrower goes back to school or experiences economic hardship. For certain types of subsidized loans, interest will not accrue during this period. Forbearance is similar, but can be applied for 3 years or longer at the discretion of the lender. Interest accrues for all types of loans during forbearance.

Since the government’s introduction of income-based repayment (IBR) in 2009, borrowers have also had the option to reduce the interest and principal payments on their loans through deferment and forbearance programs. Deferment and forbearance allow the borrower to take a break from making payment on their loans. Deferment is available for up to 3 years, and can be applied when the borrower goes back to school or experiences economic hardship. For certain types of subsidized loans, interest will not accrue during this period. Forbearance is similar, but can be applied for 3 years or longer at the discretion of the lender. Interest accrues for all types of loans during forbearance.

As more and more borrowers utilize these options, loan repayments are being pushed further into the future, well beyond the timeframes expected by market participants at the time the loans were originated.

\(^1\)MeasureOne. As of March 31, 2015.
FIGURE 1: FFELP TRANCHE MATURITY DATES UNDER THREE DIFFERENT SCENARIOS

CASH FLOWS WERE ESTIMATED USING A REPRESENTATIVE DEAL FROM 2007.

Although we would consider a default under this scenario technical rather than credit-driven, the rating agencies are nonetheless required to assess the situation in accordance with their standards, which dictate that a bond must ultimately be rated according to the timely payment of principal and interest by its stated maturity date. Because some bonds will likely breach their stated maturity dates given the slowdown in loan repayments, they are facing a potential downgrade by the ratings agencies despite there being no change in the credit profile of the underlying asset.

FIGURE 2: THE LOOMING POSSIBILITY OF A LARGE-SCALE RATING ACTION HAS CAUSED FFELP BONDS TO TRADE AT RECORD LEVELS

Potential Rating Action
In the last few months, Moody’s, and to a lesser degree Fitch, have put roughly 20% of FFELP bonds on downgrade watch. This has notably impacted the bonds' investors, many of whom were attracted to the asset for its AAA rating. Given these investors’ low tolerance for ratings volatility, the looming possibility of a large-scale negative rating action has caused FFELP bonds to trade at record-wide spreads relative to LIBOR — moving anywhere from 50 to 100 basis points (bps) wider (FIGURE 2).

Should Moody’s or Fitch decide to take a severe rating action, there are concerns that many investors would be forced to sell their bonds. To date, we haven’t seen any forced selling, but rather the selling of blocks of bonds meant to pare risk.

CAUSE FOR CONCERN?
The stated maturity date, or legal final date, is the date when all investors in a bond, by the terms of the indenture, must be paid in full. It is normally set well into the future. Investors in asset-backed security (ABS) bonds backed by FFELP are typically more concerned with a bond’s weighted average life (WAL), which represents an estimate of maturity based on prepayment assumptions.

Historically, the stated maturity date was viewed as a check-the-box criteria and set well beyond the estimated WAL to a point in time when a bond was expected to be repaid in full. More recently, however, some deals – mostly those issued in 2007 and 2008 – were given maturity dates that, in hindsight, were too short. As such, some of these bonds are on track to default (FIGURE 1).

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WATCH-LIST METHODOLOGY DRAWS CRITICISM

While the rating agencies may be forced by legal standards to reassess the FFELP bonds’ ratings, a number of research organizations and market participants have questioned Moody’s and Fitch’s methodology for watch-listing bonds. Moody’s methodology essentially assumes that the current levels of interim repayment status (i.e. deferment, forbearance and IBR), prepayments and defaults continue indefinitely for the life of the transaction. Normally, borrowers transition from interim status into repayment over time.

Fitch’s approach, on the other hand, is more focused on recent trends and takes into account sponsor actions such as loan repurchases. The agency has not announced any overall changes to their methodology to date.

In particular, many critics have argued that the assumption that current levels of payment modification will remain unchanged is unrealistic, for several reasons. First, a borrower cannot remain in deferment or forbearance indefinitely. In addition, a borrower that has opted for income-based repayments must reapply for the program each year and prove they meet the criteria. Critics have also pointed to the fact that borrowers are rarely reaching the default stage, meaning they remain in an interim payment status indefinitely. Further, even if a borrower does default, lenders may be repaid almost in full as FFELP loans are at least 97% government guaranteed.

A Near-Term Opportunity

Given the credit worthiness of these bonds, we believe the potential downgrade has created a window of opportunity during which investors may be able acquire the securities at attractive levels relative to other risk assets in the securitized space. Due to several factors, we believe the issue will likely be resolved by early 2016:

- **Deal Sponsors are Pursuing Multiple Solutions to Resolve the Legal/Structural Issues.** Navient, the largest sponsor of the FFELP loans under review, is taking extensive measures to ensure the potentially impacted bonds are paid off by their legal final date. The company has taken a number of remedial steps, including repurchasing loans from trusts and changing their legal final maturities. While we see these actions as positive, we also note that it’s possible the agencies will give little credit to these solutions, and that, even if the issue does not materialize, there could still be downgrades.

- **Should the Situation Worsen Significantly, Resulting in a Large Number of Downgrades, We Anticipate the Emergence of a Strong Buyer Base to Capitalize on Forced Sales.** However, the preventative steps being taken by key deal sponsors mitigate this risk.

- **There Has Been Significant Pushback from the Investment Community for Moody’s to Reconsider Its Methodology.** The rating agency recently released its cash flow assumptions for these deals and extended the period for market participant feedback. We believe the investor pushback could cause Moody’s to either delay a potential action or affirm many of the watch-list bonds at their current ratings. Under either scenario we would expect spreads to contract. Another outcome we see potentially playing out is for Moody’s to affirm the majority – but not all – of the FFELP bonds at their current ratings. In this case, spreads on bonds with unchanged ratings would likely retrace 75% - 80% of initial spread widening, while the others may continue to trade wider.
# FFELP Bond Spreads: Past, Present and Potential Future Moves

## PAST

<table>
<thead>
<tr>
<th>AAA SPREADS PRIOR TO RATINGS WATCH</th>
<th>1-3 YR</th>
<th>3-5 YR</th>
<th>5-7 YR</th>
<th>7 YR</th>
</tr>
</thead>
<tbody>
<tr>
<td>as of 3/31/2015</td>
<td>30-45bps</td>
<td>45-65bps</td>
<td>65-85bps</td>
<td>85-100bps</td>
</tr>
</tbody>
</table>

## PRESENT

<table>
<thead>
<tr>
<th>AAA SPREADS AT PRESENT LEVELS</th>
<th>1-3 YR</th>
<th>3-5 YR</th>
<th>5-7 YR</th>
<th>7 YR</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOT ON DOWNGRADE WATCH</td>
<td>55-75bps</td>
<td>85-105bps</td>
<td>105-130bps</td>
<td>150bps</td>
</tr>
<tr>
<td>change &gt;</td>
<td>25-30bps</td>
<td>40bps</td>
<td>45bps</td>
<td>50bps</td>
</tr>
<tr>
<td>DOWNGRADE WATCH - DISCOUNT</td>
<td>75-110bps</td>
<td>110-125bps</td>
<td>125-150bps</td>
<td>175bps</td>
</tr>
<tr>
<td>change &gt;</td>
<td>45-65bps</td>
<td>65bps</td>
<td>65bps</td>
<td>75bps</td>
</tr>
<tr>
<td>DOWNGRADE WATCH - PREMIUM</td>
<td>100-135bps</td>
<td>135-150bps</td>
<td>150-170bps</td>
<td>200bps</td>
</tr>
<tr>
<td>change &gt;</td>
<td>70-90bps</td>
<td>90bps</td>
<td>85bps</td>
<td>100bps</td>
</tr>
</tbody>
</table>

## POTENTIAL FUTURE MOVES

If these AAA-rated bonds are downgraded to A, BBB and BB, we would expect the bonds to trade with the following spreads*:

- **A**: 75-100bps, 100-135bps, 135-175bps, 200bps
- **BBB**: 75-125bps, 125-150bps, 125-200bps, 225bps
- **BB**: 125-175bps, 125-200bps, 175-225bps, 250bps

*Based on Barings market forecasts. The forecasted spreads represent Barings’ views as of September 15, 2015 and are subject to change without notice.

---

**Current spreads trading at attractive levels relative to other securitized markets**

<table>
<thead>
<tr>
<th>AAA</th>
<th>CRT</th>
<th>CMBS</th>
<th>SFR</th>
<th>CLO</th>
<th>CORPORATES</th>
<th>SUB PRIME AUTO</th>
<th>PRIME AUTO</th>
<th>CONTAINERS</th>
<th>TIMESHARE</th>
<th>FRANCHISE</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>125</td>
<td>300</td>
<td>250</td>
<td>150</td>
<td>110</td>
<td>130</td>
<td>225</td>
<td>110</td>
<td>200</td>
<td>125</td>
</tr>
<tr>
<td>BBB</td>
<td>180</td>
<td>450</td>
<td>285</td>
<td>425</td>
<td>215</td>
<td>325</td>
<td>325</td>
<td>170</td>
<td>250</td>
<td>175</td>
</tr>
<tr>
<td>BB</td>
<td>460</td>
<td>MH600</td>
<td>390</td>
<td>700</td>
<td>375</td>
<td>475</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. Credit Risk Transfer (agency risk-sharing deals)
2. Commercial Mortgage-Backed Security
3. Single Family Rental
4. Collateralized Loan Obligation

Based on Barings market observations.

All spread data as of September 15, 2015.
BARINGS’ ADVANTAGE
Since 2009, Barings’ Global Securitized Products Group has been heavily involved in the student loan market and has built a substantial book of securitized FFELP student loans. This includes not only relatively liquid securities from companies like Navient, but also less liquid securities – particularly auction-rate securities – from state agencies or other private companies.

By virtue of our broad expertise in asset-backed securities, we have built strong relationships with market participants, including some of the most active investment banks in the market, as well as sponsors of these trusts.

Seizing The Opportunity
Given the limited window for this investment opportunity, we have pinpointed specific areas where we see potential opportunities.

ATTRACTION OPPORTUNITIES

1. 2008 vintage bonds with stated maturities greater than five years: Because these bonds were issued while market conditions were stressed, they were issued with high coupons. The bonds would normally trade at a high premium, but current spreads allow investors to buy bonds closer to par, thus making them less susceptible to prepayment risk.

2. 2006/2007 vintage bonds with a longer average life and low coupon: Given these bonds’ longer spread duration, we believe they offer the most room for price appreciation.

   *These bonds are less likely to suffer severe downgrades.*

OPPORTUNITIES WITHIN CERTAIN POCKETS OF THE ASSET CLASS

1. Early vintage auction rate securities that have a low likelihood of dropping below investment grade and have excellent carry and a high call incentive.

2. LIBOR subordinated notes, which are already suffering from lower liquidity as all bonds are currently trading wider. Many of these notes have no downgrade issues, and their longer spread duration provides price upside potential, in our opinion.

3. Bonds with no maturity issues also offer a potential opportunity, particularly those that are trading cheaply in sympathy with the overall FFELP market.

Conclusion
As a traditionally AAA-rated asset class, senior securitized FFELP bonds have not historically been subject to the level of volatility they have experienced in recent months. The widening of spreads and concerns about potential rating agency downgrades are reflective of a technical issue relating to maturity dates being pushed further into the future but, in our view, the creditworthiness of these securities remains intact. As a result, we believe there are currently compelling value opportunities for experienced investors in the securitized student loan space.
Barings is a $275 billion* global asset management firm dedicated to meeting the evolving investment and capital needs of our clients. We build lasting partnerships that leverage our distinctive expertise across traditional and alternative asset classes to deliver innovative solutions and uncompromising service. A member of the MassMutual Financial Group, Barings maintains a strong global presence with over 600 investment professionals and offices in 17 countries.

**Learn More, At [www.barings.com](http://www.barings.com).**