

Student Loan ABS 101

An Introduction to Student Loan ABS

26 January 2005

Table of Contents

Introduction	1
Investment Characteristics of Student Loan ABS.....	2
Spreads.....	2
Relative Value.....	3
Cash Flows	5
Credit Quality	5
Risks of SLABS.....	7
Structural Developments	7
Issuers/Issuance of SLABS	8
Sallie Mae	8
Other Issuers of SLABS	9
Issuance Volume.....	10
Student Loans	12
Federal Programs	12
Private Student Loans	19
Student Loan Performance	21
Timing of Principal Payments on Student Loans.....	23
History of the Education Loan Market	24
Conclusion	25

I. Introduction

Student Loan ABS (SLABS) can be appealing to fixed income investors because they offer high credit quality, credit stability, and low spread volatility. SLABS backed by federally reinsured loans command tight spreads, in roughly the same range as deals backed by credit card receivables or auto loans. SLABS backed by other loans (so-called "private" student loans) command somewhat wider spreads, reflecting incrementally greater perceived credit risk.

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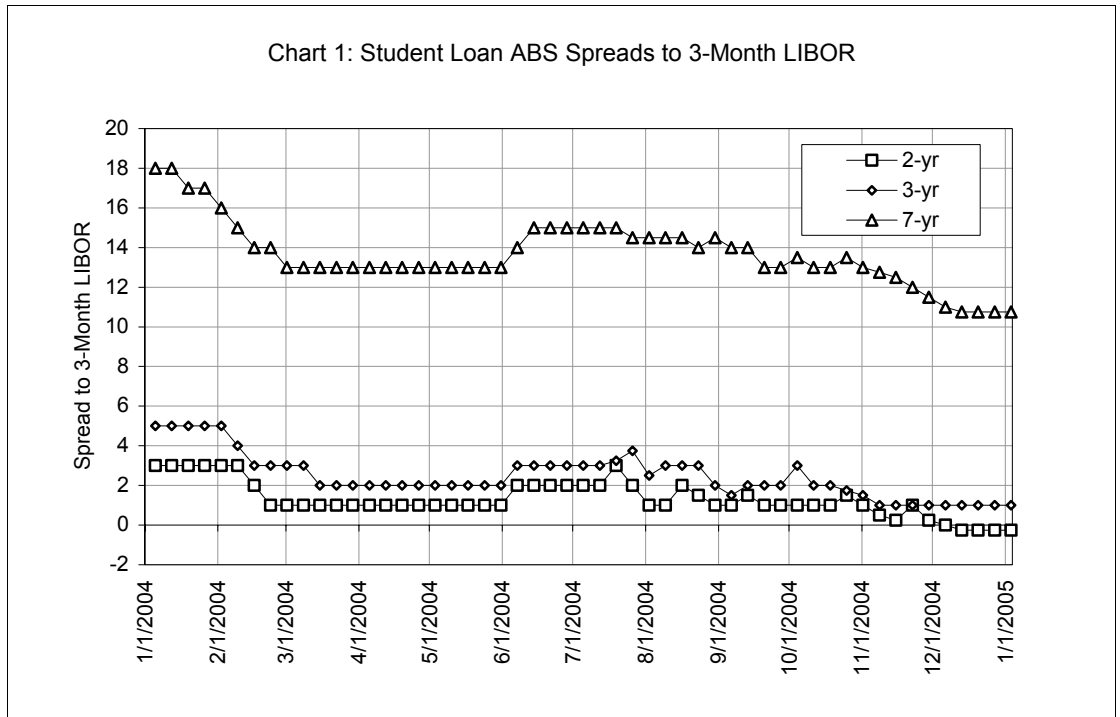
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II. Investment Characteristics of Student Loan ABS

A. Spreads

Generic secondary trading spreads for triple-A rated SLABS tranches with short (2-3 year) weighted-average lives tend to fluctuate a few basis points above three-month LIBOR. Generic trading spreads for longer WAL tranches are somewhat wider, usually between 10 and 20 basis points above three-month LIBOR. SLABS spread volatility is generally modest. The following graph shows representative spread levels for top-tier 2-, 3-, and 7-year SLABS over the past year:



Source: Asset Securitization Report

SLABS backed by federally reinsured student loans tend to have tighter spreads than SLABS backed by private student loans. For example, SLMA series 2004-5 is backed by federally reinsured loans and its 7-year tranche priced at 3ML +15. In contrast, National Collegiate Student Loan Trust 2004-1 (NCSLT 2004-1) is backed by private student loans and its 7-year tranche priced at 3ML + 26. The two deals priced just one day apart. The federal reinsurance on the loans backing SLMA 2004-5 covers at least 98% of principal and accrued interest on the underlying loans.

Spread levels for the subordinate B pieces range between 30 and 50 basis points over three-month LIBOR for both private and federally reinsured SLABS.

The following table shows pricing for a sample of new issues available to investors in 2004:

Table 1: Spreads on Selected 2004 Student Loan ABS										
Date	Deal	Series	Loan Types	Spread to 3ML at Various Wtd.-Avg. Lives (years)					Class B Ratings (M/S/F)	Deal Size (\$ mil.)
				2	3	5	7	Cl. B		
15-Jan-04	Nelnet Student Loan Trust	2004-1	C		11	15		AR	A2/AA-/AA-	1,010
21-Jan-04	Sallie Mae Student Loan Trust	2004-1	C		4		14	50	Aa1/AA+/AA+	2,025
27-Jan-04	AZ Educational Loan Marketing	2004-A	F		10		22	AR	A2/A/A	1,000
25-Feb-04	Sallie Mae Student Loan Trust	2004-2	C		2	8	13	47	Aa1/AA+/AA+	2,806
10-Mar-04	Sallie Mae Student Loan Trust	2004-3	C		1	9	13	47	Aa1/AA+/AA+	2,344
15-Mar-04	NorthStar Education Finance	2004-1	F 64% C 36%		5	12	17	AR	A2/A/A	1,000
16-Mar-04	Sallie Mae Student Loan Trust	2004-A	P		6		20	58	A1/A/A+	1,336
15-Apr-04	Collegiate Funding Services	2004-A	C		5		17	AR	A2/A/A	1,113
22-Apr-04	Access Group, Inc.	2004-A	P			11		AR	A2/A/A	771
22-Apr-04	Nelnet Student Loan Trust	2004-2	C		3	10		AR	A2/AA-/AA	1,000
27-Apr-04	Sallie Mae Student Loan Trust	2004-4	F		2	9	13	38	Aa1/AA/AA+	2,526
5-May-04	Education Funding Capital Trust	2004-1	C	4			16	AR	A2/A/A	1,000
11-May-04	College Loan Corporation Trust	2004-1	C 90% F 10%		5	11	16	AR	A2/A/A	1,300
18-May-04	Sallie Mae Student Loan Trust	2004-B	P		5		20	47	A1/A/A+	1,508
2-Jun-04	National Collegiate SL Trust	2004-1	P	12			26	AR	A2/A/A	790
3-Jun-04	EduCap SL Asset Backed Notes	2004-1	P				20	AR	NR/A/A	267
3-Jun-04	Sallie Mae Student Loan Trust	2004-5	C		3	9	15	48	Aa1/AA+/AA+	1,739
23-Jun-04	Sallie Mae Student Loan Trust	2004-6	F		4	10	15	38	Aa1/AA/AA+	3,030
8-Jul-04	Penn. Higher Edu. Assist. Agency	2004-1	F			12		AR	A2/A/A	400
20-Jul-04	Nelnet Student Loan Trust	2004-3	F 58% C 42%		3	9	15	35	Aa1/AA/AA+	1,355
20-Jul-04	Sallie Mae Student Loan Trust	2004-7	F		3	8	15	36	Aa1/AA/AA+	1,510
17-Aug-04	Sallie Mae Student Loan Trust	2004-8	C		2	9	14	46	Aa1/AA+/AA+	1,239
14-Sep-04	Sallie Mae Student Loan Trust	2004-9	F		2	9	13	33	Aa1/AA/AA+	3,025
21-Sep-04	Nelnet Student Loan Trust	2004-4	F 61% C 39%		2	9	13	30	Aa1/AA/AA+	2,020
7-Oct-04	Sallie Mae Student Loan Trust	2004-10	C		2	9		37	Aa1/AA+/AA+	2,854
18-Oct-04	Access Group, Inc.	2004-2	F 56% C 44%				15	70	A2/A/A	767
26-Oct-04	National Collegiate SL Trust	2004-2	P	11		15	21	54	Aa1/AA/AA+	1,123
17-Nov-04	SLC Student Loan Trust	2004-1	C		1	6	11	29	Aa1/AA/AA+	1,486
7-Dec-04	NorthStar Education Finance	2004-2	F 71% C 29%				12	AR	A2/NR/A	1,000

Note: F= FFELP, P=Private, C=Consolidation, AR= auction rate
Senior Tranches are all rated triple-A by Moody's, S&P, and Fitch

Source: Asset Securitization Report, MCM, Bloomberg, Nomura Securities International

B. Relative Value

We believe that, at current spread levels, SLABS are fairly valued compared to other floating-rate ABS.

SLABS with short (2-3 year) weighted-average lives (WALs) offer incremental yield compared to floating rate ABS backed by auto loans. Both SLABS and auto loan ABS are amortizing securities. Short-WAL SLABS backed by federally reinsured loans offer *nominal* spreads that appear roughly the same as auto loan ABS. However, SLABS spreads are measured against three-month LIBOR, while spreads on floating-rate auto loan ABS are measured against one-month LIBOR. Three-month LIBOR is higher than one-month LIBOR; as of January 25th the difference is 15 basis points. Short-WAL SLABS backed by private loans offer an even greater yield advantage, but lack the strength of federal reinsurance on their underlying collateral.

SLABS with WALs of five years or longer can be compared to ABS backed by credit card receivables or to ABS backed by home equity loans. However, both such comparisons have limitations.

Compared to credit card ABS, 7-year WAL SLABS offer the advantages of higher yield and (in most cases) federally reinsured collateral. If the underlying student loans lack federal reinsurance, the yield advantage increases. The yield advantage is entirely attributable to the difference between three-month LIBOR and one-month LIBOR.¹ On the other hand, the amortizing structures of SLABS are a disadvantage compared to credit card bullet maturities.

Comparing long-WAL SLABS to home equity loan ABS is also difficult. HEL ABS offer both wider nominal spreads and higher yields, even after adjusting for the difference between three-month LIBOR and one-month LIBOR. However, most long-WAL tranches of HEL ABS have wide payment windows and are subject to significant average life volatility because of prepayments. In contrast, long-WAL SLABS have narrower payment windows and are subject to less volatility in their average lives. Non-amortizing senior (NAS) tranches of HEL ABS deals arguably are the most similar to long-WAL SLABS. NAS tranches have somewhat less average life volatility than other HEL ABS tranches, but they have tighter spreads as well.

The following table illustrates the variability of principal windows for selected student loan ABS in comparison to home equity ABS.

Table 2: Variability of Principal Windows of Selected Student Loan and Home Equity ABS								
Ticker + Asset	Pricing Speed	Original WAL	Payment Window at Multiple of Pricing Speed (mm/yy)					
			50%	75%	100%	150%	200%	300%
SLMA 2004-7 A4 (SLABS)	9 CPR	7	7/11-1/14	1/11-4/13	7/10-1/13	10/09-4/12	10/08-4/11	1/08-1/10
COLLE 2004-1 A3 (SLABS)	4 CPR	6.96	10/10-1/12	10/10-1/12	10/10-10/11	10/10-10/11		10/10-10/11
SLMA 2004-7 A5 (SLABS)	9 CPR	8.68	1/14-7/16	4/13-1/16	1/13-10/15	4/12-1/15	4/11-1/14	1/10-10/12
SLMA 2004-6 A4 (SLABS)	9 CPR	7	7/11-1/14	10/10-4/13	4/10-10/12	4/09-1/12	7/08-1/11	10/07-10/09
SLMA 2004-6 A5 (SLABS)	9 CPR	8.95	1/14-7/16	4/13-1/16	10/12-10/15	1/12-1/15	1/11-1/14	10/09-10/12
NEF 2004-2 A1 (SLABS)	7 CPR	6.98	10/08-4/14	10/08-4/14	10/08-4/14	10/08-1/14	10/08-10/12	n.a.
NSLT 2004-4 A4 (SLABS)	7 CPR	7	10/11-4/14		7/10-1/13	10/09-1/12	10/08-10/10	1/08-7/09
BSABS 2004-2 A5 (HEL)	25 CPR	7.7	1/13-8/30	8/10-5/25	3/09-12/20	2/07-5/15	6/06-8/07	10/05-4/06
BSABS 2004-SD3 A3 (HEL)	24 CPR	7.7	12/12-10/30	7/10-2/26	2/09-9/21	3/07-12/15	7/06-9/12	10/05-7/06
LBMLT 2004-A M1 (HEL)	30 CPR	6.9	10/08-11/21	1/07-10/19	7/06-11/16	12/05-8/12	8/05-1/10	3/05-1/07
HEMT 2004-5 A2 (HEL)	30 CPR	9.39	9/18-3/22	5/14-8/19	11/11-11/18	1/07-4/07	4/06-6/06	7/05-8/05

Source: Bloomberg

Investors in SLABS include banks and insurance companies. European investors, with their strong appetite for floating rate paper, have been notable as buyers of longer-term tranches.

¹ On a nominal basis, spreads on 7-year SLABS backed by federally reinsured loans appear three basis points tighter than spreads on 7-year credit card ABS.

C. Cash Flows

SLABS provide for quarterly payments of interest and principal. Principal distributions fluctuate from quarter to quarter based on the payment status of the underlying loans and because of deferments, forbearance, defaults, and prepayments (see below). Principal distributions can decrease if the proportion of a deal's underlying loans in deferment or forbearance increases. Conversely, principal payments can increase if borrowers consolidate (i.e., refinance) their loans, resulting in higher prepayments.

SLABS generally employ pay-through structures with time-tranching layered over a senior-subordinated framework. The senior-subordinated structure provides credit enhancement for senior tranches. Even deals backed by federally reinsured loans use senior-subordinated structures because the federal reinsurance may not cover 100% of defaults. A typical deal backed by federally reinsured loans might have 97% senior securities that carry triple-A ratings and 3% subordinate securities that carry double-A ratings. A typical deal backed by private student loans (i.e., non-federally reinsured) might have 90%-92% senior securities rated triple-A and 8%-10% subordinate securities with a variety of lower ratings.

Time tranching in a typical SLABS involves sub-dividing the senior class into several serially maturing tranches. In a typical structure, the senior class is sub-divided into tranches with weighted-average lives of 1, 3, 5, and 8+ years. Senior principal distributions go entirely to the "shortest" tranche until it is retired, before being applied to the next tranche in the sequence.

Dealers generally price SLABS using a prepayment assumption of 7% CPR. However, actual prepayments can vary from as low as 2% CPR to higher than 20% CPR. Deals backed by private student loans tend to display the lowest prepayment rates. Private student loan borrowers often carry substantial debt burdens and may lack the resources to prepay their educational loans. Those borrowers usually have exhausted their borrowing capacity under federally reinsured programs before turning to private loans. Deals backed by federally reinsured consolidation loans also display low prepayment rates. Under present law, borrowers cannot readily refinance consolidation loans (see page 18). Accordingly, prepayments of consolidation loans occur, only slowly. In contrast, deals backed by ordinary federally reinsured loans frequently have displayed prepayment rates much faster than 7% CPR. Borrowers on such loans have aggressively taken advantage of the low interest rate environment to consolidate their loans.

Prepayment variability gives long-WAL SLABS the *potential* for significant average life volatility. So far, average life volatility has been modest. It remains to be seen whether a rising rate environment causes the average lives of longer-WAL tranches to extend materially from slowing prepayments.

D. Credit Quality

SLABS have displayed exceptionally strong credit quality. Senior classes carry triple-A ratings and subordinate classes usually carry ratings of double-A or single-A. A few deals have included tranches with triple-B ratings.

According to S&P, there have been no downgrades to SLABS due to negative collateral performance since the inception of the student loan market.²

In a weakening economy, student borrowers may have more options for avoiding defaults than regular consumer borrowers. For example, a student borrower who is temporarily unable to pay his loans can seek forbearance. The borrower can obtain a deferment by entering military service or the Peace Corps. The borrower may be able to delay his payment obligation by remaining in school.

² Conroy, C., *Hot Topics in Student Loan Securitization*, S&P presentation, at 17 (19 Oct 2004). S&P downgraded University Support Services 1991-1 Class A on 11-16-94 from AA- to A-. However, the negative rating action was due to the corresponding downgrade of the bond's support provider, Fireman's Insurance Company of New York.

Lastly, the borrower may be able to lower his monthly payments through consolidation. As a result, student loan credit performance should be less sensitive than regular consumer loans to changes in the overall economic environment.

Bond insurance has been a factor in supporting the strong credit quality of SLABS. By using bond insurance, an issuer avoids the need to achieve triple-A credit quality on a stand-alone basis. Instead, an issuer need only attain single-A or triple-B credit quality in order for a bond insurer to be willing to supply insurance to bring a deal's rating to triple-A.

Despite their pristine credit performance to date, SLABS have experienced challenges that suggest the potential for deals to face downgrades or defaults in the future. In particular, the SLABS sector has encountered two instances involving allegedly improper conduct by servicers.

SFC: The first incident occurred in June 2002. Student Loan Finance Corp (SFC) was an originator of private student loans, primarily to students with poor credit histories who attended *vocational* schools. A particularly high concentration of SFC's borrowers attended truck-driving schools.

SFC executed a series of eight student loan securitizations.³ Royal Indemnity Company, a multi-line insurance company, issued insurance policies guaranteeing the underlying student loans. MBIA insured the ABS backed by the student loans, and partly relied on the policies from Royal Indemnity in doing so.

In June, Royal Indemnity disavowed its obligations under its insurance policies, asserting that SFC had fraudulently induced it to write the policies.⁴ MBIA reacted quickly and, along with deal trustee Wells Fargo, filed a suit against Royal Indemnity's rescission. MBIA also declared that it would honor its policies on the bonds even if Royal Indemnity refused to honor its obligations.

The incident was resolved on 2 October 2003, when the U.S. District Court for the District of Delaware granted MBIA's motion for summary judgment to enforce the policies issued by Royal Indemnity on the loans included in the SFC deals.⁵

The Royal Indemnity incident has several implications for the SLABS market. This case highlights the fact that fraud or allegations of fraud can occur – and potentially affect securitizations – even in the student loan market. The incident also demonstrates that insurance companies will often resist payment on credit insurance policies. Third, it emphasizes the importance of bond insurance in ABS transactions. In its lawsuit, MBIA claimed that if Royal Indemnity did not honor its insurance policies, approximately 70% of the portfolio would be in default.⁶ If the SFC deals had lacked bond insurance, SFC's actions could have produced a lengthy interruption of cash flow to investors.

AMS: The most recent incident of alleged fraud in the SLABS market occurred in July 2003 and involved Academic Management Services (AMS), then a unit of insurance company UICI. The scandal broke when UICI announced problems in three special purpose entities (SPEs) created by AMS.⁷ UICI disclosed that the SPEs had three problems: (i) insufficient collateral, (ii) impermissibly high levels of private loans, and (iii) reporting deficiencies.⁸ UICI partially corrected the problems by

³ SFC Grantor Trusts 2000-1, 2000-2, 2000-3, 2000-4, 2001-1, 2001-2, 2001-3, and SFC Owner Trust 2001-1.

⁴ Gregory, M., *MBIA Looks to Prevent Royal Indemnity Guaranty Rescission*, Asset Securitization Report, 22 Jul 2002.

⁵ MBIA Inc., *Delaware District Court Grants MBIA Motion for Summary Judgment in Royal Case*, press release, 2 Oct 2003 (MBIA Inc., Current Report on Form 8-K, Exhibit 99.1 (2 Oct 2003)).

⁶ Gregory, M., *MBIA Looks to Prevent Royal Indemnity Guaranty Rescission*, Asset Securitization Report, 22 Jul 2002.

⁷ The three SPEs were (1) EFG Funding, (2) EFG-III, and (3) AMS-1 2002. EFG Funding was a commercial paper program. Its underlying asset was a variable funding certificate issued by EFG-III. AMS-1 2002 issued auction rate notes.

⁸ UICI, *UICI Announces Collateral Issues at Subsidiary's Student Loan Financing Facilities*, press release (21 Jul 2003) (available at http://www.uici.net/ireye/ir_site.zhtml?ticker=UCI&script=410&layout=-

contributing capital and replacing ineligible collateral. Further resolution came in November 2003 when Sallie Mae acquired AMS from UICI. Sallie Mae paid down the outstanding transactions in the trust and transferred the loans in the pool to its own future securitizations.⁹

The AMS incident was significant to the SLABS market because it arguably was a second example of fraud affecting SLABS. The incident cast doubt on the accuracy of all AMS reports. Furthermore, it demonstrated that there could be problems with the collateral supporting SLABS in spite of the high credit quality of the student loans themselves.

E. Risks of SLABS

The main risk associated with SLABS backed by federally reinsured loans is non-compliance with servicing standards. If a servicer fails to comply with the required standards, it may void the guaranty and reinsurance on the affected loans. If that happens, the guarantor on a loan and the Department of Education (DOE) as reinsurer, may reject claims for any losses on the loan. In that case, losses would flow through to the deal in which the loan was included. Subordination helps mitigate the risk of improper servicing.

Another potential risk for an SLABS investor is basis risk. Basis risk refers to the risk of a detrimental change in the spread between the interest index for a deal's assets and the interest index for its liabilities. The interest rates on student loans generally are indexed to the yield on the 91-day Treasury Bill. Other sources of cash flow in SLABS, such as "special allowance payments," may be indexed to the yield on 91-day commercial paper. However, today's SLABS generally are indexed to three-month LIBOR. Basis risk can erode a transaction's credit enhancement that is intended to cover credit risk caused by servicer rejections and risk sharing on defaulted loans. Historically, there has been fairly strong correlation between the relevant different indices, which tends to mitigate basis risk in actual deals.

III. Structural Developments

LIBOR Floaters vs. Auction Rate Notes: During 2003 and 2004, SLABS issuers switched to three-month LIBOR as the predominant interest index. The rise in issuance of LIBOR-based SLABS came mostly at the expense of auction rate notes, which have all but disappeared.

In 2002, the spread between the auction rate and LIBOR widened significantly due to increased supply of auction rate notes from Sallie Mae and other loan consolidators who financed consolidation loans in the auction rate market. As a result, some issuers found it uneconomical to issue in the auction rate market and instead turned to the LIBOR market.¹⁰

Another reason for the increased use of LIBOR floaters involves the SEC investigation into auction rate deals.¹¹ That has called the integrity of auction processes into question. Accordingly some SLABS issuers have sought to diversify their funding sources beyond the relatively small market for auction rate notes. For example, some state agencies and not-for-profit lenders are starting to use LIBOR floaters instead of auction rate paper.

[6&item_id=433109](#)); Donovan, K., *AMS Sends Ripples Through the Student Loan Market*, Asset Securitization Report, 28 July 2003.

⁹ Donovan, K., *Sallie Mae Bails Out Student Lender AMS*, Asset Securitization Report, 24 Nov 2003.

¹⁰ Asch, S., *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's special report, (20 Jan 2004).

¹¹ See, e.g., *SEC Probes Deception in Bond Auctions*, Associated Press, (24 Jun 2004) (available at <http://www.forbes.com/feeds/ap/2004/06/24/ap1432727.html>); *SEC Probes Brokers' Ties to Bond Auction Investors, People Say*, Bloomberg (19 Jul 2004) (available at <http://www.xak.com/main/newsshow.asp?id=34608>).

Reset Rate Notes: Another relatively new structural development in the SLABS market is the use of "reset rate notes." A reset rate note essentially has an extendible maturity. A typical reset rate note bears interest at specified fixed or floating rate until it reaches its "reset date." The reset date might be as soon as three years after closing or it might be more than ten years in the future. The reset date is essentially the "soft bullet" maturity date for the notes. On the reset date, the issuer attempts to retire the reset rate notes by "remarketing" new notes. If the issuer succeeds in selling enough new notes, it retires the original reset rate notes. If not, the original reset rate notes remain outstanding and earn interest at a higher rate – essentially a penalty for the failed remarketing.

The soft bullet maturity of reset rate notes makes them useful for financing long-term assets like 30-year consolidation loans. Sallie Mae first used reset rate notes in 2003 and continued to incorporate them into its transactions in 2004. Six of Sallie Mae's 12 SLABS transactions in 2004 featured at least two tranches of reset rate notes. Each of these transactions was backed by consolidation student loans.

IV. Issuers/Issuance of SLABS

A. Sallie Mae

The Student Loan Marketing Association (Sallie Mae) is both the largest issuer of SLABS and serves as the largest private source of funding, delivery and servicing for student loans in the U.S.¹²

On 29 December 2004 Sallie Mae officially completed its separation from the federal government, four years ahead of schedule, through the termination of its federal charter. The company set aside enough cash and U.S. Treasury securities in a special purpose trust to pay the remaining \$1.85 billion in outstanding debt obligations from its government sponsored entity (GSE) subsidiary. The Treasury then signed documents that officially retired Sallie Mae's federal charter. Sallie Mae is now a completely private company with no ties to the federal government.

Congress created Sallie Mae in 1972 as a GSE in order to provide a national secondary market for federally reinsured student loans and to act as a source of credit to postsecondary education lenders.

When Sallie Mae became a public company in 1983, the GSE retained its federal benefits, including exemption from state and local taxes and a lucrative funding advantage that allowed Sallie Mae to borrow money at near-government rates in order to purchase federally reinsured loans.

In the 1990s, Congress levied a 3% fee against Sallie Mae's borrowing, a move that caused shareholders to consider privatization.

In 1996, Congress passed the Student Loan Marketing Association Reorganization Act, which called for the complete dissolution and privatization of Sallie Mae by September 30, 2008. The Privatization Act authorized the creation of a state-chartered holding company that could engage in activities outside of Sallie Mae's restrictive federal charter. "Sallie Mae's shareholders approved a reorganization that created SLM Corporation, a Delaware-chartered holding company, and Sallie Mae's GSE became its wholly-owned subsidiary."¹³

Privatization has allowed Sallie Mae to enter other areas of consumer finance (such as auto loans), debt collection, and guarantor servicing.

¹² Conroy, C., *U.S. Student Loan ABS Market Closes 2003 With Record Volume*, Standard & Poor's special report (15 Apr 2004).

¹³ U.S. Treasury Office of Public Affairs, *Treasury Announces Successful Privatization of Sallie Mae*, press release (29 Dec 2004), (available at <http://www.ustreas.gov/press/releases/js2173.htm>).

Sallie Mae currently manages more than \$98 billion in student loans from over seven million student borrowers. Currently, Sallie Mae's portfolio of federally reinsured student loans generates 60% of its revenues.¹⁴ Private consumer lending and fee-for-service business generate the remainder of Sallie Mae's revenues.

Sallie Mae issues SLABS backed by both federally reinsured and private student loans. In 2004, SLMA issued 12 deals totaling approximately \$26 billion. The only private student loans that Sallie Mae includes in its SLABS are loans to students in four-year colleges and professional schools.¹⁵

As part of its privatization plan, Sallie Mae used securitization to refinance the assets of its GSE. In this way, Sallie Mae was a huge contributor to the rising volume in SLABS over the last few years. Now that Sallie Mae has completed the wind-down of its GSE, we expect the company to continue funding new originations but at a somewhat reduced pace.

B. Other Issuers of SLABS

Although Sallie Mae remains the dominant issuer of SLABS, other companies also are active issuers. These include College Loan Corp, Collegiate Funding Services, U.S. Education Loan Trust, the Education Lending Group, and Student Loan Consolidation Center.

The following table summarizes the top SLABS issuers in 2004:

Issuer	Number of Deals	volume (\$ millions)
Sallie Mae (SLM Student Loan Trust)	12	25,940
Nelnet Education Loan Funding, Inc	4	5,404
NorthStar Education Finance, Inc.	3	2,320
Access Group Inc.	3	2,288
SLC Student Loan Trust	1	1,486
College Loan Corporation Trust	1	1,300
KeyCorp Student Loan Trust	1	1,200
Collegiate Funding Services	1	1,113

Source: Asset Securitization Report, MCM, Bloomberg, Nomura Securities International

The main players in the area of SLABS backed by private student loans include First Marblehead, Access, and KeyCorp.

First Marblehead: First Marblehead is an originator and servicer of private student loans as well as an issuer of private SLABS. In FY2004, First Marblehead originated over \$1.8 billion in private student loans and issued two SLABS transactions totaling approximately \$1.84 billion.¹⁶

In June 2001, First Marblehead Corporation (FMC) and The Education Resources Institute (TERI) formed a strategic alliance. TERI is a non-profit entity that supplies guarantees for many private student loans.¹⁷ The alliance provided for FMC to take-over certain TERI assets including TERI's historical database and its loan processing operations. FMC did not acquire TERI's investment assets or its guarantee liabilities. In October 2004, FMC announced plans to extend its Master Guaranty with TERI through 2011.

¹⁴ Kopecki, D., *Sallie Mae Concludes Privatization Plan Early*, The Wall Street Journal, 29 Dec 2004.

¹⁵ *ABS Gold Coast Report 2004*, Nomura Fixed Income Research at 19 (21 October 2004).

¹⁶ First Marblehead, *The First Marblehead Approach and ABS Investors* (available at <http://www.firstmarblehead.com/loan-origination-software/index.asp> and <http://phx.corporate-ir.net/phoenix.zhtml?c=147457&p=irol-absHome>).

¹⁷ Private guarantors are private or non-profit companies that write guarantees on alternative student loans. Another private guarantor is HEMAR Insurance Corporation of America (HICA). HICA is a subsidiary of SLM Corp.

Access: Access Group is a non-profit originator of private student loans through the Access Group Loan Program and an issuer of SLABS backed by private student loans. In 2004, Access Group originated \$1.44 billion in private and federally reinsured student loans and issued approximately \$2.3 billion of SLABS. At its inception in 1983, Access Group (known then as Law Access, Inc.) originated only federally reinsured loans to law school students. Since then, Access has expanded its program to include private loans for medical, dental, business and other graduate and professional school students.

KeyCorp: KeyCorp is a bank-based financial services company that originates private and federally reinsured student loans through its lender Key Education Resources. Since 1993, KeyCorp has issued 15 SLABS transactions totaling over \$10 billion.¹⁸ In 2003, KeyCorp sold \$1.2 billion of education loans (\$998 million through securitizations).¹⁹ KeyCorp originates private student loans to law, medical, dental, MBA, and general graduate school students in addition to undergraduate, information technology and aviation school students. KeyCorp also makes private student loans to parents of students attending K-12 private schools.

The pace of activity in the private student loan sector is increasing. FMC's experience is illustrative: For the second quarter of its 2005 fiscal year,²⁰ FMC reported that it had facilitated \$560 million of private student loans. That level of activity represents a 55% increase over the same period in the prior year. FMC also reported that the second quarter volume of loans available for securitization increased by 66% to \$450 million from the same period a year earlier.²¹

Private student loan originators offer wide variety of student loan products spanning the entire range of borrower credit quality.

C. Issuance Volume

Review: SLABS issuance had a record year in 2004, with approximately 34 transactions totaling \$43 billion.²² The majority (~85%) was backed by FFELP student loans (~\$38B) while private student loan ABS accounted for the rest (~\$5B).²³ Several factors contributed to the significant growth experienced last year in student loan ABS issuance.

The plan to wind-down the Sallie Mae GSE contributed substantially to the rising volume of SLABS issuance in recent years.²⁴ The majority of Sallie Mae's student loan ABS securitizations were associated with refinancing loans that had been in the GSE. Sallie Mae's issuance accounted for about 60% of the SLABS market in 2004.

The recent increase in consolidation loan volume also has contributed to growth of SLABS issuance. Issuers have included a significantly higher proportion of consolidation loans in their pools. In 2004, Sallie Mae issued seven student loan transactions backed entirely by consolidation loans. Other issuers brought deals in 2004 where the proportion of consolidation loans ranged from 80% to 100%.

¹⁸ Keycorp, Education Student Loan Securitizations, available at (<http://www.key.com/templates/le3.jhtml?nodeID=A-4.3>), Bloomberg.

¹⁹ KeyCorp, 2003 Annual Report at 27, (available at <http://www.snl.com/cache/1432015.PDF>)

²⁰ FMC's fiscal year runs from July 1 to June 30.

²¹ First Marblehead Corporation, *First Marblehead Reports Second Quarter 2005 Facilitation Volume*, press release, 7 Jan 2005.

²² The total issuance figure includes deals that we consider SLABS but generally excludes tax-exempt financings by state agencies. Including these deals produces a higher total issuance number. According to Inside MBS & ABS, total SLABS issuance for 2004 was \$63B (Inside MBS & ABS, Non-Mortgage ABS Issuers & Underwriters by Deal Type: 2004, 21 Jan 2005, at 5.) According to S&P, the rating agency rated \$58 billion in SLABS issuance in 2004 (Conroy, Christopher, *Growth Expected as U.S. Student Loan ABS Issuance Shifts in 2005*, 18 Jan 2005, Standard & Poor's).

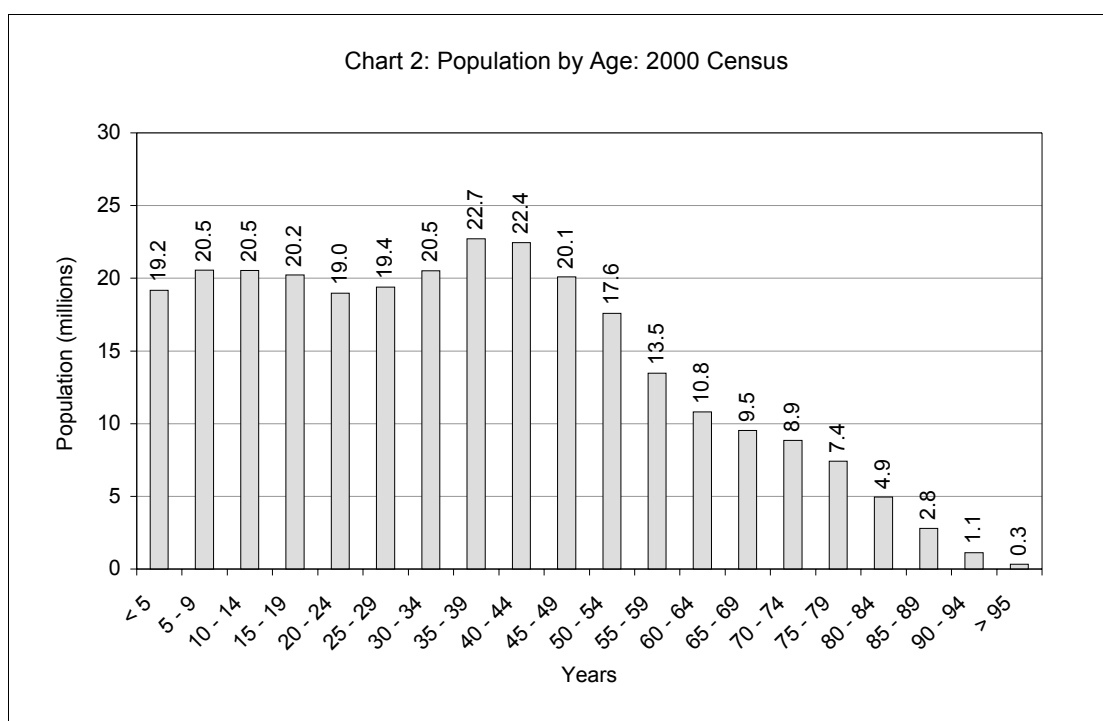
²³ Asset Securitization Report, 10 Jan 2005, at 33.

²⁴ SLM Corporation, Quarterly Report on Form 10-Q for the Quarterly Period Ended 30 Jun 2004, at 12.

Those issuers included Student Loan Corporation, Nelnet, Collegiate Funding Services, and College Loan Corporation Trust.

The increase in SLABS backed by private student loans also has contributed to the overall increase in SLABS issuance. As college tuition costs and enrollment rates increase, students are increasingly turning to private student loans as an additional source of funding to supplement federally reinsured student loans.

Outlook: Market participants have expressed mixed views concerning expected SLABS issuance volumes in 2005 and beyond. We expect SLABS issuance to experience continued growth in 2005, but at a slower rate. College tuition costs continue to rise and enrollment levels increase in undergraduate and graduate programs. The U.S. population that is college bound continues to grow. Specifically, in 2000, the population between ages 5 and 9 was greater than the population between the ages of 10 and 14. And, the population between the ages of 10 and 14 was greater than the population between ages 15 and 19.²⁵ The following chart shows the age distribution of the U.S. population in 2000:



Source: U.S. Census Bureau

We expect the demand for federally reinsured and private student loans to remain robust. We expect these conditions to fuel continued growth in the SLABS sector. As a private corporation, Sallie Mae will likely continue to use the securitization market as a source of funding. On the other hand, we note that Sallie Mae's financing needs will likely be slightly lower now that it has completed the wind-down of its GSE.

Prospects for growth in the long run depend on continuing developments in the FFELP program and the reauthorization of the Higher Education Act in 2005 (see below).

²⁵ Meyer, Julie, *Age: 2000 - Census 2000 Brief*, U.S. Census Bureau, October 2001, (available at <http://www.census.gov/prod/2001pubs/c2kbr01-12.pdf>)

V. Student Loans

A. Federal Programs

FFEL Program: The Federal Family Education Loan Program (FFELP) offers student loans that are financed by private lenders. State guarantee agencies guarantee the loans and the federal government reinsures the guarantees. The state guarantees generally cover (i) 100% percent of loans disbursed before 10/1/93 and (ii) not more than 98% of loans first disbursed on or after 10/1/93.²⁶

In addition to reinsuring the state guarantees, the federal government also *reimburses* the state guarantee agencies for losses incurred on the guarantees. However, the reimbursement may not fully cover all losses. In general, the reimbursement is as follows:

- 95% for loans disbursed on or after 10/1/98
- 98% for loans disbursed between 10/1/93 and 9/30/98
- 100% for loans disbursed before 10/1/93 and for certain special loans.²⁷

Eligible lenders include commercial banks, credit unions, thrift institutions, insurance companies, state agencies, and non-profit student loan companies.

There are several types of loans offered under the FFEL program.

Subsidized Stafford: A student who meets certain financial need tests can get a subsidized Stafford loan. The federal government pays the interest on a subsidized Stafford loan while the student is in school and during grace and deferment periods. Such payments are called "interest subsidy payments." A student has up to 10 years to repay a subsidized Stafford loan and he may obtain extensions for special circumstances.²⁸

Unsubsidized Stafford: Students who cannot qualify for a subsidized Stafford loan can get an unsubsidized Stafford loan. In addition, in some cases, a student may be able to borrow additional funds with an unsubsidized Stafford loan after he has exhausted his borrowing capacity in the subsidized program. A student who gets an unsubsidized Stafford loan is responsible for the interest on his loan while enrolled in school and during any grace period or deferment. The borrower generally has two choices for handling interest before principal repayment of the loan begins. First, he can pay interest on a current basis. Second, he can not pay, in which case the interest accrues and is added to the principal of his loan (i.e., capitalized).

Principal repayment of a Stafford loan usually starts six months after the student leaves school or if enrollment drops below half-time. The interest rates for both subsidized and unsubsidized Stafford loans are currently capped at 8.25%.

SLS: Supplemental Loans to Students (SLS) were made mostly to graduate and professional students but were replaced in July 1994 by unsubsidized Stafford Loans. Like unsubsidized Stafford loans, students were required to pay interest while in school.

PLUS: Parental Loans for Undergraduate Students (PLUS) are offered to *parents* of dependent undergraduate students. PLUS loans are not based on financial need and the parent borrower is responsible for all interest payments. Unlike Stafford loans, there is no six-month grace period for principal repayment after a student leaves school; the first payment of principal is due within 60 days

²⁶ 34 C.F.R. § 682.401.

²⁷ 34 C.F.R. § 682.404(a).

²⁸ The College Board, *Student Federal Stafford Loans*, (available at <http://www.collegeboard.com/article/0,,6-33-0-25524.00.html>).

after the loan is fully disbursed. Many market participants view PLUS loans as less risky than loans to student borrowers because lenders evaluate the credit quality of parent borrowers on PLUS loans. In contrast, loans to a student under the federal programs do not entail a review of the student's credit quality.

Perkins Loans: Federal Perkins loans are offered to undergraduate and graduate students based on financial need. A Federal Perkins loan has a fixed interest rate of 5% for the life of the loan. A qualifying undergraduate student can borrow up to \$4,000 per year with a maximum limit of \$20,000. A qualifying graduate/professional student can borrow up to \$6,000 per year, with a maximum limit of \$40,000 (including any Perkins loans as an undergraduate).

College financial aid offices determine eligibility for Perkins loans. Each college that participates in the Perkins loan program receives a limited allotment of funding through the program, which it can allocate among its qualifying students. Accordingly, colleges tend to be very selective in awarding Perkins loans.

In the Perkins loan program, a participating school acts as the lender and the student borrower repays the loan to his school. The federal government provides a school with most of the funds for the loan and the participating school also contributes to a portion of the loan. The school generally disburses the loan to the student in at least two payments per academic year.²⁹

Like subsidized Stafford loans, the interest on Perkins loans are subsidized by the federal government. The student begins repayment nine months after leaving school, with minimum payments of \$40 per month per loan, and has up to ten years to repay. A borrower of Perkins loans can apply for deferment or receive forbearance under certain conditions, as long as he is not in default on his loan.

²⁹ U.S. Dept. of Education, *The Student Guide: Financial Aid from the U.S. Department of Education 2003-2004, Types of Federal Student Aid, Federal Perkins Loans*, (available at http://studentaid.ed.gov/students/publications/student_guide/2003_2004/english/types-fedperkinsloan.htm).

The following table summarizes the basic characteristics of the FFEL programs:

Table 4: Summary of Federal Family Education Loan Programs (FFELP)				
	Subsidized Stafford	Unsubsidized Stafford	PLUS	Perkins
Borrower	Dependent or independent student	Dependent or independent student	Parent of dependent undergraduate student	Dependent or independent student
Interest Rates	Max. Rate 8.25% (variable rate adjusts every July 1)	Max. Rate 8.25% (variable rate adjusts every July 1)	Max. Rate 9% (variable rate adjusts every July 1)	Fixed rate of 5% for the life of the loan
Eligibility	Based on Financial Need	No income restrictions	No income restrictions	Based on financial need
Annual Loan Limits	Yr. 1 - \$2,625 Yr. 2 - \$3,500 Yrs. 3 & 4 - \$5,500 per year Graduate or professional student- \$8,500 per year	Dependent Student: Same as subsidized Stafford less any amount of subsidized federal loans received. Independent Student: Same as subsidized Stafford plus additional amounts: Yr. 1 - \$2,625 (dep.), \$6,625 (independent) Yr. 2 - \$3,500 (dep.), \$7,500 (independent), Yrs. 3 & 4 - \$5,500 per year (dep), \$10,500 per year (independent) Graduate - \$18,500 per year (less amount of subsidized Stafford loan awarded)	Cost of education less any financial aid awarded	Undergraduate: \$4,000 per year of study with a maximum total of \$20,000 Graduate/Professional: \$6,000 per year of study with a maximum total of \$40,000 (including any Federal Perkins loans borrowed as an undergraduate)
In-School Interest	Paid by federal government	Borrower responsibility	Borrower responsibility	Paid by federal government
Grace Period	Interest paid by federal government during 6-month grace period	6 months interest paid by borrower	No grace period	Interest paid by federal government during nine month grace period
Repayment Terms	Repayment begins after grace period, \$50 minimum payment per FFEL loan per month, repayment term is up to 10 years (up to 25 under an extended repayment plan)	Repayment begins after grace period, \$50 minimum payment per FFEL loan per month, repayment term is up to 10 years (up to 25 under an extended repayment plan)	1st payment due within 60 days after loan is fully disbursed, \$50 min. monthly payment, repayment term is up to 10 years (up to 25 under an extended repayment plan)	Repayment after nine-month grace period, \$40 minimum per loan per month, repayment term is up to 10 years

Sources: Sallie Mae, EdFinancial, 34 C.F.R. § 682.209, The Student Guide – Financial Aid from the U.S. Department of Education 2003-2004

Loan Interest Rates: FFEL loans provide for floating interest rates with caps. During in-school, grace or deferment periods, the interest rate for federal student loans disbursed after 7/1/98 is the 91-day T-bill yield + 1.7%. During repayment periods, the interest rate is the 91-day T-bill yield +2.3%.³⁰ These interest rates adjust annually on July 1 of each year. Interest rates on federal student loans adjust annually every July 1 and are subject to rate caps between 8.25% and 11%. For subsidized and unsubsidized Stafford loans and for consolidation loans the maximum interest rate is currently capped at 8.25%. The interest rate for PLUS loans is currently capped at a slightly higher rate of 9%.

³⁰ College Board, *Student Federal Stafford Loans*, (available at <http://www.collegeboard.com/article/0,,6-33-0-25524.00.html>).

The table below summarizes how the lender and borrower interest rates are calculated for FFEL and Direct student loans:

Table 5: Summary - Variable and Fixed Rate Rules for Borrower Rates and Lender Yield	
Conditions	Formula
Student Loans: Variable Rate Rules in Effect until June 30, 2006	
Borrower Rate on FFEL and Direct Loans effective July 1 of each year	
In repayment	91-day T-Bill + 2.3 %, capped at 8.25%
In school, grace or deferment	91-day T-Bill + 1.7 %, capped at 8.25%
Lender Yield (determined quarterly)	
In repayment	CP + 2.34%, but no less than the borrower rate
In school, grace, or deferment	CP + 1.74%, but no less than the borrower rate
Student Loans: Fixed Rate Rules in Effect after June 30, 2006	
Borrower Rate on FFEL and Direct Loans at all times	6.8%
Lender Yield (determined quarterly)	Same as under variable rate rules
Parental Loans (PLUS): Variable Rate Rules in Effect until June 30, 2006	
Borrower Rate on FFEL and Direct Loans effective July 1 of each year at all times	CP + 3.1%, but no more than 9 %
Lender Yield (determined quarterly)	
Borrower Rate is less than 9%	Same as borrower rate
Borrower rate is at 9%	CP + 2.64%, but no less than the borrower rate (9%)
Parental Loans (PLUS): Fixed Rate Rules in Effect after June 30, 2006	
Borrower rate on both FFEL and Direct Loans at all times	7.90%
Lender Yield (Determined Quarterly)	
CP-June + 2.64% is less than 9%	Same as borrower rate (7.9%)
CP-June + 2.64% is greater than or equal to 9%	CP+2.64%, but no less than borrower rate (7.9%)

Source: Congressional Budget Office

Special Allowance Payments: To encourage lenders to make loans under the FFEL program, the federal government guarantees lenders a "statutorily specified rate of return" or "lender yield" on the loans that they hold.³¹ The guaranteed lender yield currently is based on the quarterly average bond equivalent yield on three-month commercial paper of financial institutions plus an additional margin. When the borrower rate on a loan is less than the guaranteed lender yield, the government makes a subsidy payment, called a "special allowance payment" (SAP) to the lender.

Several factors affect the calculation of the lender yield such as loan type, loan repayment status, and when the loan was disbursed. Congress periodically changes the formula for lender yields in order to reflect market interest rates, constraints on the federal budget, or costs incurred by lenders to finance loans. For example, in response to the high interest rate environment of 1980, Congress enacted the Education Amendment of 1980, which changed the calculation of special allowance payments for loans financed with tax-exempt bonds. Specifically, the act stated that loans made after 10/1/80 would receive half the SAP of loans financed with taxable bonds, but would also be guaranteed a minimum yield of 9.5%.

This provision was partly repealed in 1993, when Congress enacted the Omnibus Budget Reconciliation Act, which eliminated the minimum 9.5% lender yield for loans financed with tax-exempt bonds issued on or after 10/1/93. However, Congress failed to remove the guaranteed

³¹ 34 C.F.R. § 682.302.

minimum yield of 9.5% to lenders for loans financed before 10/1/93. The existence of this provision had serious consequences for the student loan market.

The 9.5% Loan Scandal: In September 2004, the Government Accountability Office³² published a study that investigated special allowance payments for 9.5% loans.³³ The GAO found that SAPs for 9.5% loans have increased significantly in recent years. According to the GAO, the main reason is the decline in borrower interest rates relative to the 9.5% yield combined with the rising dollar volume of 9.5% loans. Because interest rates are currently very low, lenders have a strong incentive to maintain or increase their 9.5% loan volume. The GAO recommends that Congress change the yield on loans "made or purchased in the future with the proceeds of 10/1/93 tax-exempt bonds, and any associated refunding bonds, to better reflect market interest rates."

Lender practices to maintain or increase their 9.5% loan volume represented a major loophole in the Education law. According to the GAO, one of these lenders, National Education Loan Network (Nelnet), increased its holdings of 9.5% loans from \$375 million in 2002 to \$3.5 billion by June 2004. "In calling for an SEC investigation, Senator Kennedy charged that Nelnet had used the subsidies to mislead investors, manipulate the market, and profit from insider trading."³⁴ In the summary of its findings, the GAO stated that in FY 2003, 37 lenders received SAP for 9.5% loans and that SAP payments increased from \$209 million in FY 2001 to over \$600 million through the third quarter of FY 2004.³⁵

Reacting to outcry over the situation, Congress passed the Taxpayer-Teacher Protection Act of 2004³⁶ to close the loophole for 9.5% loans. However, critics argued that that law was insufficient because it would close the loophole for only one year. In January 2005, Congressman Kildee introduced a bill to provide further remedial measures.³⁷

Federal Loan Origination Volume: Overall student loan originations have grown significantly since the creation of the FFELP. The following charts show historical FFELP annual commitments in terms of dollar volume and number of loans for subsidized Stafford, unsubsidized Stafford and PLUS loans.

³² The Government Accountability Office (GAO) was formerly known as the General Accounting Office. The name was changed by section 8 of the GAO Human Capital Reform Act of 2004, Pub. L. 108-271, 118 Stat. 811 (2004).

³³ U.S. Government Accountability Office, *Federal Family Education Loan Program, Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO Rep. No. 04-1070 (Sep 2004) (available at <http://www.gao.gov/new.items/d041070.pdf>).

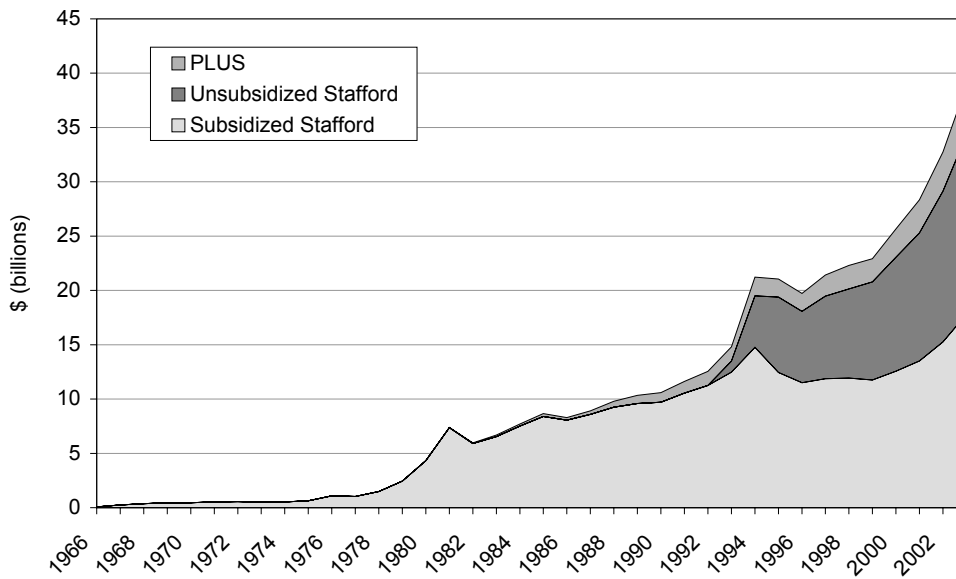
³⁴ AFT Connecticut, *Loophole Lets Lenders Make Killing on Student Loans*, (10 Oct 2004) (available at http://www.aftct.org/News/story_101004.htm).

³⁵ U.S. Government Accountability Office, *Federal Family Education Loan Program, Statutory and Regulatory Changes Could Avert Billions in Unnecessary Federal Subsidy Payments*, GAO Rep. No. 04-1070 (Sep 2004) (available at <http://www.gao.gov/new.items/d041070.pdf>).

³⁶ Pub. L. No. 108-409.

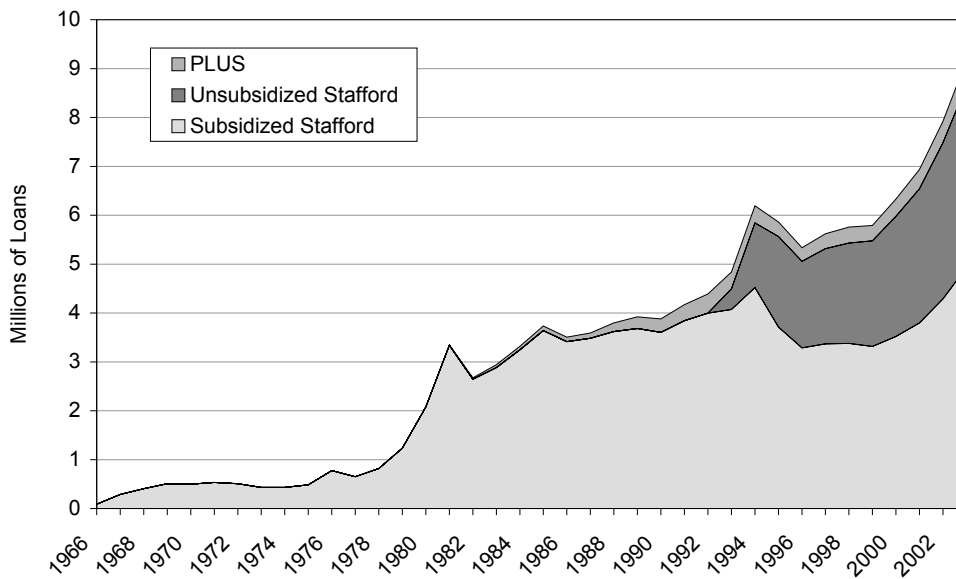
³⁷ Emergency Loan Abuse Prevention Act of 2005, H.R. 134, 109th Cong., 1st Sess. (4 Jan 2005).

Chart 3: Historical FFEL Annual Commitments by Program
(dollar volume)



Source: U.S. Department of Education

Chart 4: Historical FFEL Annual Commitments by Program
(by number of loans)



Source: U.S. Department of Education

The William D. Ford Federal Direct Student Loan Program (FDSLP) was established in 1992. The FDSLP provides Stafford and PLUS student loans that are funded directly by the federal government.

Servicing: As noted above, servicing of federal student loans is "process-oriented." A servicer must adhere to a process that preserves the guaranty from the guaranty agency. The servicer is less concerned with whether or not its servicing activities actually result in payment from the borrower. Federal regulations specify the collection actions that a servicer must take in order not to void a loan's

guarantee and its reinsurance.³⁸ At various stages of delinquency, the regulations require specific actions. The following chart highlights certain required servicer collection activities:

Table 6: Servicing Requirements for Federal Programs	
Number of Days Delinquent	Required Activity
1-15 Days Delinquent	During this period, the lender must send the borrower at least one written collection notice or letter that informs the borrower of the delinquency and urges the borrower to make payments sufficient to eliminating the delinquency. The notice or collection letter must include, at minimum, a lender or servicer contact, a telephone number, and a prominent statement that informs the borrower that assistance is available if he or she is having difficulty in making a scheduled payment
16-180 Days Delinquent (16-240 for a loan repayable in installments less frequent than monthly)	During this period, the lender must engage in at least four diligent efforts to contact the borrower by phone and send at least four collection letters urging the borrower to make required payments on the loan. At least one of the collection efforts by phone must occur on or before, and another must occur after, the 90th day of delinquency. Collection letters must include, at a minimum, information for the borrower regarding deferment, forbearance, income-sensitive repayment and loan consolidation, and other available options to avoid default.
180-270 Days Delinquent (241-330 days delinquent for a loan repayable in installments less frequently than monthly)	During this period, the lender must urge the borrower to make the required payments on the loan. The lender must, at a minimum, provide information to the borrower regarding options to avoid default and the consequences of defaulting on the loan.
Final Demand	On or after the 241st day of delinquency (the 301st day for loans payable in less frequent installments than monthly) the lender must send a final demand letter to the borrower requiring repayment of the loan in full and notifying the borrower that a default will be reported to a national credit bureau. The lender must allow the borrower at least 30 days after the date the letter is mailed to respond to the demand letter and to bring the loan out of default before filing a default claim on the loan.

Source: 34 C.F.R. § 682.411.

Consolidation Loans: The Higher Education Act (HEA)³⁹ allows borrowers under both the FFELP and Direct Loan programs to combine multiple federal student loans (e.g., one for each year of college) into a single new loan with one monthly payment at a fixed rate of interest for up to 30 years.

Current law permits a borrower to consolidate his loans only one time.⁴⁰ While there is no cost to consolidate, the borrower must be out of school or attending school less than half the time and have at least one eligible government loan to qualify for consolidation.

Consolidation loans have several advantages for borrowers. A student loan borrower can lock in a lower interest rate by replacing his adjustable-rate loans with one fixed-rate consolidation loan. A borrower can reduce his monthly payments by extending the maturity of his loan from the standard 10 years to a maximum of 30 years.⁴¹ If a borrower has loans from more than one FFELP lender, that borrower can approach any lender to consolidate. By consolidating his loans, a borrower who was paying multiple lenders can instead pay one monthly bill to a single lender, thus making it easier for him to manage his debt.⁴²

Single Holder Rule: The so-called "single holder rule" states that if all of a borrower's FFELP loans are from a single lender, the borrower must consolidate through that lender (providing that the lender

³⁸ 34 C.F.R. § 682.411.

³⁹ 20 U.S.C. § 1001 et seq., Pub. L. No. 89-329, 79 Stat. 1219, as amended

⁴⁰ 20 U.S.C. § 1078-3(a)(3)(B). A student borrower who has already consolidated his federal student loans can only receive a new federal consolidation loan if the borrower receives an eligible student loan(s) after the date of the receipt of the first consolidation loan or if the borrower had other eligible student loans prior to the date of the first consolidation loan that were never consolidated.

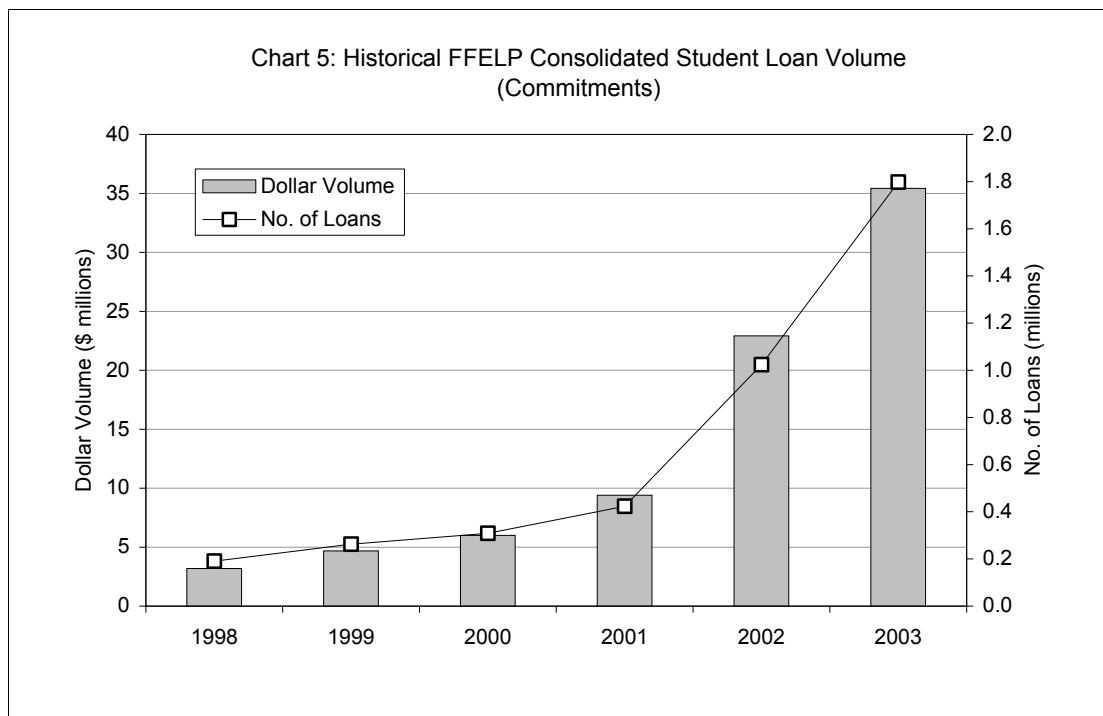
⁴¹ Sallie Mae, *Loan consolidation, Reasons to consolidate*, (available at http://www.salliemae.com/school/faqs/consolidation_faq.html?Q=Q13).

⁴² U.S. Dept. of Education, *Direct Consolidation Loan—Frequently Asked Questions*, Federal Direct Consolidation Loans Information Center, <http://www.loanconsolidation.ed.gov/index.shtml>

offers consolidation loans and an income sensitive repayment schedule). The single lender rule has been the point of much contention in the student loan marketplace. For example, in July 2003 a House sub-committee held a hearing on a proposal to eliminate the single holder rule.

Specifically, on July 22, 2003, the House Education and Workforce Subcommittee on 21st Century Competitiveness held a hearing to address a proposal (H.R. 942) by Rep. Ralph Regula (R-Ohio) to eliminate the "single lender" rule. Regula argued that this would allow borrowers to apply to any lender for a consolidation loan.⁴³ However, so far, the rule has not been repealed.

Consolidation loan volume has grown substantially in recent years. The current low interest rate environment has produced a higher demand for consolidation loans.⁴⁴ Additionally, many new consolidation loan companies have entered the market and contributed to an increase in consolidation loan volume. Companies that entered the sector in recent years and whose presence continued to be felt in 2004 included Collegiate Funding Services, College Loan Corp, Student Loan Consolidation Center, Education Lending Group, and U.S. Education Loan Trust. The graphs below illustrate the tremendous growth in consolidated loan origination in number of loans and by millions of dollars.



Source: U.S. Department of Education

B. Private Student Loans

Private student loans are unsecured consumer loans that are not reinsured by the federal government. Because private loans do not benefit from federal reinsurance, private lenders consider the credit risk of potential borrowers when underwriting loans. As a result, private student loans have

⁴³ Association of American Medical Colleges, *House Panel Addresses Student Loan Consolidation* (25 Jul 2003) (available at <http://www.aamc.org/advocacy/library/washhigh/2003/072503/4.htm>).

⁴⁴ Asch, S., *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's special report, (20 Jan 2004)

much stricter underwriting criteria and are offered based on credit worthiness. Most student loans have co-signers.⁴⁵

Leading originators of private student loans include Access Group Inc., KeyCorp, First Marblehead, and Sallie Mae.

Private student loans sometimes have guarantees. However, unlike state guarantee agencies that support FFELP loans, third-party guarantors of private student loans do not receive reinsurance from the Department of Education. As a result, the guarantee fee charged by third-party guarantors is generally higher than the fee for federally guaranteed loans.

TERI (see page 9 above) is an example of a third-party guarantee agency. All of the programs for which TERI acts as a third-party guarantor are private and each loan that TERI guarantees is funded by a participating institute. TERI's current participating lenders include Citizens Bank, Educaid, National City Bank, Bank of America, HSBC, Charter One Bank, and Allfirst Bank. TERI administers the loans to undergraduate, graduate and professional school students, and it covers 100% of principal and interest on each defaulted loan that it guarantees.⁴⁶

Private student loans are appealing to borrowers because they offer larger maximum loan balances than federal student loans. For many private student loan lenders, the maximum annual amount available is equal to a borrower's cost of education minus all other financial aid awarded. Although there is usually an annual cap set for private student loans, it is substantially higher than that for federal student loans. For example, Educaid's Select Loan offers a minimum balance of \$500 and maximum of \$45,000.⁴⁷

The private student loan area is the fastest growing portion of the student loan sector. According to the College Board, originations of private student loans in constant dollars grew from \$1.3 billion in the 1995-96 academic year to \$10.6 billion in the 2003-04 academic year.⁴⁸ The rising costs of tuition and increasing enrollment levels have contributed to the growth trend. Additionally, many students spend more than four, and sometimes up to six, years in college. For the ten-year period ending 2004-05, in constant dollars, average tuition and fees increased by 51% (\$1,725) at public four-year colleges and 36% (5,321) at private four-year colleges.⁴⁹ This trend of rising tuition has continued in recent years. For the 2004-05 academic year, the average cost for a four-year private college tuition and fees increased to \$20,082, up \$1,132 or 6.0% from \$18,950 in 2003-04. At the same time, average tuition and fees for students at public four-year colleges and universities increased to \$5,132, up \$487 or 10.5% from \$4,645 in 2003-04.⁵⁰ Despite the rising cost of education, the government has not increased FFELP loan limits since 1992.⁵¹ Thus the FFELP program has become increasingly inadequate at meeting students' needs, driving them to seek private loans.

Servicing: In contrast to being "process oriented," servicing of private student loans is "results oriented." Servicers of private student loans must actually care about the results they achieve through their servicing efforts.

⁴⁵ Conroy, C., *U.S. Student Loan ABS Market Closes 2003 With Record Volume*, Standard & Poor's special report (15 Apr 2004).

⁴⁶ The Education Resources Institute, *Company Background* (available at <http://www.teri.org/bg.html>).

⁴⁷ Educaid Loan Center, *Select Loan Information, Borrowing Limits*, (available at <http://www.educaid.com/selectloan.htm>).

⁴⁸ College Board, *Trends in Student Aid 2004* at 6 (available at http://www.collegeboard.com/prod_downloads/press/cost04/TrendsinStudentAid2004.pdf).

⁴⁹ College Board, *Trends in College Pricing 2004* at 3 (available at http://www.collegeboard.com/prod_downloads/press/cost04/041264TrendsPricing2004_FINAL.pdf)

⁵⁰ *Id.*

⁵¹ Asch, S., *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's special report (20 Jan 2004).

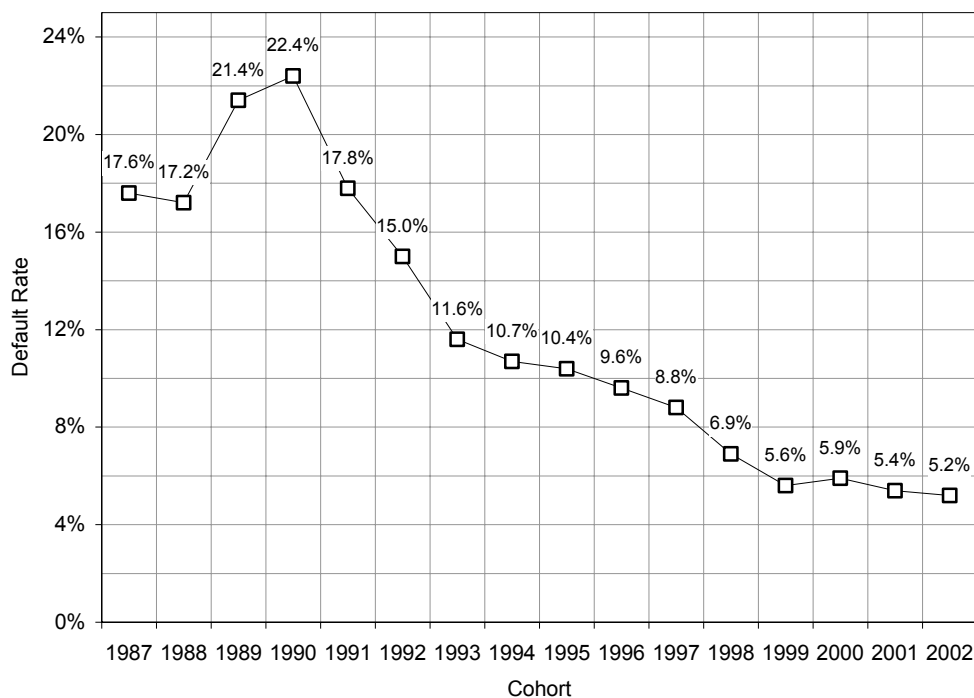
C. Student Loan Performance

1. Federal Student Loan Performance

The national cohort default rate, which is a common measure for the credit performance of student loans, has declined substantially in recent years. The cohort default rate is defined as "the percentage of borrowers who enter repayment in a *fiscal* year and default or meet other specified conditions by the end of the next *fiscal* year."⁵²

The chart below shows the dramatic decline in the national cohort default rate between 1990 and 2002. While the national cohort default rate is currently low, we suspect that it would appear even lower if the calculation excluded loans to students at vocational schools. According to the Department of Education, for FY2000, FY2001 and FY2002, the default rate for loans to students attending proprietary schools (e.g. truck driving, welding, beauty) was higher than for loans made to four-year undergraduate or professional graduate school students.⁵³ For students attending proprietary schools for 2-3 years, the borrower default rate was 9.2% in comparison to the 6.1% borrower default rate for students who attended private institutions for the same period of time. As a result, we think that if the national cohort default rate were based only on loans made to four-year undergraduate or professional graduate school students, it would actually be somewhat lower than 5.2%.

Chart 6: National Cohort Default Rates



Source: U.S. Department of Education

⁵² U.S. Department of Education, *National Student Loan Cohort Default Rates*, (available at <http://www.ed.gov/offices/OSFAP/defaultmanagement/defaultrates.html>).

⁵³ U.S. Department of Education, *Institutional Default Rate Comparison of FY 2000, 2001, and 2002 Cohort Default Rates* (14 Sep 2004), (available at <http://www.ed.gov/offices/OSFAP/defaultmanagement/2002instrates.html>).

The national cohort default rate calculation includes subsidized and unsubsidized Stafford loans and Federal Supplement Loans for Students (which have not been made since July 1, 1994). The calculation does not include Federal Direct Subsidized/Ford loans and Federal Direct Unsubsidized/Ford Loans (Direct Stafford/Ford Loans), Federal PLUS Loans, Federal Direct PLUS Loans, Federal Insured Student Loans or Federal Perkins Loans. Federal consolidation loans and federal direct consolidation loans also are excluded from the cohort default rate calculation.⁵⁴

The national cohort default rate captures defaults that occur during a two-year period, but for any particular loan, the period during which a default can count might be as short as a year and a day. For example, if a loan enters repayment on 10/1/00, it would be part of the 2001 cohort (10/1/00 to 9/30/01). If the loan defaults between 10/1/00 and 9/30/02 (a full, two-year window), it would count as a default for the cohort's default rate. Now suppose that a second loan enters repayment on the 9/30/01 – the last day of the 2001 fiscal year. The second loan also would be part of the 2001 cohort. However, a default of the second loan would count toward the cohort's default rate only if it occurs before 9/30/02. Thus, for the second loan, the "default window" is just a year and a day. For many loans, the "default window" is roughly 20 to 22 months – because most students graduate in the spring and a typical FFELP loan provides a grace period of six months.

Factors that have contributed to the decline in national cohort default rates include improvements to the DOE's screening process for institutions, increased efforts to prevent defaults (such as more aggressive collection practices and borrower incentive programs), increased financing options for borrowers, the use of deferments or forbearances to prevent defaults, the use of consolidation loans to lower monthly payments, and new graduate repayment plans that offer flexibility and reduce debt burden.⁵⁵

Cohort default rates for individual schools are important because they may affect a school's eligibility to participate in federal financial aid programs. If a school has a default rate of 25% or higher for three consecutive years or a default rate of 40% for one year, it could lose its eligibility in federal student aid programs.⁵⁶

2. Private Student Loan Performance

The expected credit performance of private student loans varies markedly among different lenders. Projected default rates reflect each lender's underwriting criteria, business model, program guidelines, and targeted geographic market. In early 2004, Standard and Poor's performed an extensive static pool analysis of all of the private student loan pools backing deals that it rates.⁵⁷ The table below shows the expected cumulative default rates from that study and illustrates the magnitude of variation among issuers:

⁵⁴ U.S. Department of Education, Cohort Default Rate Guide, ch. 2.1 at 2-3 (Aug 2001) (available at <http://www.ifap.ed.gov/drmaterials/attachments/Chapter21.pdf>)

⁵⁵ Asch, S., *2003 Review and 2004 Outlook: Student Loan-Backed Securities Growth to Continue*, Moody's Special Report (20 Jan 2004).

⁵⁶ U.S. Department of Education, Cohort Default Rate Guide, ch. 2.2 at 3 (Aug 2001) (available at <http://www.ifap.ed.gov/drmaterials/attachments/Chapter22.pdf>)

⁵⁷ Conroy, C., *U.S. Student Loan ABS Market Closes 2003 With Record Volume*, Standard & Poor's Special Report (15 Apr 2004).

Table 7: S&P Expected Cumulative Default Rates for Private Student Loans

Originator	Primary Program	Expected Cumulative Default Rate (%)
Access Group Inc.	Law	12.0
Alaska Student Loan Corp.	Undergraduate	20.0
KeyBank USA	Graduate	8.0
Massachusetts Educational Financing Authority	Undergraduate	2.0
Michigan Higher Education Student Loan Authority	Undergraduate	4.0
N.J. Higher Education Student Assistance Authority	Undergraduate	3.0
The Education Resources Institute Inc.	Undergraduate	6.0
The Education Resources Institute Inc.	Graduate	18.0
University Support Services	Undergraduate	10.0
Sallie Mae	MBA	3.0
Sallie Mae	Law	5.5

Source: Standard and Poor's

For example, according to the S&P study, undergraduate loans originated by Alaska Student Loan Corp have a relatively high cumulative default rate in comparison to the MBA and law school loans originated by Sallie Mae. Alaska Student Loan Corp (ASLC) originates student loans under the Alaska Advantage Program, which offers low-interest rate private and federally reinsured loans to Alaskans pursuing postsecondary education or attending postsecondary schools within the state of Alaska. ASLC is a government instrumentality and makes student loans with the interests of the state in mind. In order to encourage Alaskans to attend school in the state, the ASLC employs looser underwriting criteria. ASLC's relaxed underwriting guidelines may attract students of weaker credit quality and contribute to a higher cumulative default rate for that lender. In contrast, Sallie Mae is a for-profit corporation that operates by making loans to borrowers in a variety of programs. Sallie Mae uses stricter underwriting criteria and attracts borrowers with better credit quality. The low cumulative loan default rates on pools consisting of MBA and law student loans reflect both the competitive program types and SLMA's underwriting guidelines.

Lifecycle: The in-school period for student loans ranges from one to five years, depending on the type of school (undergraduate, graduate/professional, or trade) that the borrower is attending. After graduation, subsidized and unsubsidized Stafford loans enter a six-month grace period during which interest is either paid by the government or by the borrower. There is no six-month grace period for PLUS loans and the first payment is due within 60 days after the loan is fully disbursed. Active repayment of principal begins after the grace period and for all federal loans there is a \$50 minimum payment per loan per month. The borrower generally has ten years to repay the loan depending on the loan specifications.

D. Timing of Principal Payments on Student Loans

Factors that contribute to variability in the timing of principal payments on student loans include deferments, forbearance, defaults, and consolidation. Deferments and forbearances cause principal payments to come more slowly. Consolidations are essentially prepayments and cause principal payments to accelerate. Defaults initially cause principal cash flow to slow down, but guarantee payments ultimately amount to early prepayments.

Deferment: A deferment allows a student borrower to postpone making principal payments on his loans for a limited period. The government pays interest on subsidized Stafford loans during periods of deferment. For unsubsidized Stafford loans, the borrower ultimately is responsible for paying the interest that accrues and is capitalized during deferment. In order to be eligible for deferment on a federal student loan, a borrower must request the deferment and provide the lender with all information and documents required to establish the eligibility for a specific type of deferment.⁵⁸

⁵⁸ 34 C.F.R. § 682.210(a)(4).

Deferments are usually granted to students for enrollment in school, study in a graduate fellowship program, or entry into the armed forces, and are issued in specified increments.

Forbearance: If a borrower does not qualify for deferment, he can request forbearance. Forbearance allows for a temporary postponement or reduction in the repayment of a loan. Forbearance is usually granted if the borrower is experiencing economic hardship and is generally offered in 12-month intervals for up to three years.⁵⁹ Interest continues to accrue during forbearance and the borrower is responsible for paying it. The DOE encourages lenders to grant forbearance for the benefit of the borrower in order to prevent the borrower from defaulting on his loans.⁶⁰

For federally insured student loans, there is a policy that provides for deferment or forbearance. In contrast, for private student loans, it is up to the discretion of the lender whether or not to grant a student borrower deferment or forbearance. In most cases, the borrower must apply, meet certain qualifications and make arrangements with the servicer of the loans.

Consolidation: Finally, consolidation has contributed significantly to prepayments on federally reinsured student loans. With short-term interest rates at record lows, student borrowers have increasingly exercised their option to consolidate. Consolidation offers a borrower the advantage of combining all of his floating rate student loans into one fixed rate loan. This has resulted in the rapid prepayment of many Stafford loans. Since students can consolidate only once, we expect this trend to slow down eventually, especially if interest rates rise.

Default: Default is another factor that contributes to prepayments of student loans. A loan generally is classified as a default when it becomes 270 days past due.

When a loan originated under the FFELP program enters default status, the state guarantor reimburses the lender for not more than 98% of the unpaid principal balance on the loan. This results in the rapid prepayment of the loan and the investor receives his principal at a much faster rate.

In 1998, Congress amended the Bankruptcy Code to prevent student borrowers from discharging their student loan debts through personal bankruptcies.⁶¹ The enactment of that legislation has helped deter students from defaulting on their student loans.

VI. History of the Education Loan Market

Higher Education Act: The enactment of the Higher Education Act of 1965 (HEA) was a defining moment in the history of the education loan market. The purpose of the Higher Education Act was to "strengthen the educational resources of our colleges and universities and to provide assistance for students in postsecondary and higher education."⁶² The HEA represented a federal commitment to alleviating the cost of higher education and equalizing college opportunities for low- and middle-income students. The FFEL Program was created under Title IV of the HEA.

Since its inception, the Higher Education Act has been subject to a series of amendments. Highlights of these amendments include the 1972 approval of federal aid for students attending vocational or trade schools as well as community colleges and the establishment of Sallie Mae as a GSE, and the 1976 provision for federal incentives to states to organize guarantee agencies that would guarantee federal student loans.⁶³

⁵⁹ FinAid, Defaulting on Student Loans, (available at <http://www.finaid.org/loans/default.phtml>).

⁶⁰ 34 C.F.R. § 682.211.

⁶¹ 11 U.S.C. § 523(a)(8).

⁶² 20 U.S.C. § 1001 et seq., Pub. L. No. 89-329, 79 Stat. 1219, as amended.

⁶³ Gladieux, L., *Federal Student Aid Policy: A History and an Assessment* (Oct 1995), (available at <http://www.ed.gov/offices/OPE/PPI/FinPostSecEd/gladieux.html>).

In October 2004, Congress extended the HEA through September 2005.⁶⁴ Although Congress had spent the previous two years working to renew the HEA through reauthorization, final legislation was not passed and a temporary extension was necessary. The Extension Act will extend all programs and services under the HEA for one year.⁶⁵

Congress reportedly plans to reauthorize the Higher Education Act in the 109th Congress in 2005. In addition, several other education-related bills have been introduced. They include the College Affordability and Accountability Act (H.R. 3519), the College Opportunity for All Act (H.R. 3180) and the Emergency Loan Abuse Prevention Act of 2004 (H.R. 5113). The purposes of these bills are to boost college opportunities for low- and middle-income students and to permanently and completely close the loophole for SAPs on 9.5% loans (see page 15 above).⁶⁶

Dept. of Education: The U.S. Department of Education (DOE) was established by Congress on May 4, 1980 under the Department of Education Organization Act.⁶⁷ The objectives of the DOE were to strengthen the commitment to equal educational opportunity for every individual, to supplement the efforts of the states in order to improve the quality of education, to encourage public, parental, and student participation in federal education programs, and to improve coordination and management of federal education programs/activities.⁶⁸

VII. Conclusion

SLABS are potentially attractive to investors because they provide excellent credit quality, credit stability, and modest spread volatility. We think that SLABS are fairly valued and can offer higher yield and lower average life volatility in comparison to credit card and HEL ABS, respectively. We expect SLABS issuance to continue to grow in 2005, particularly in the private SLABS sector.

— E N D —

⁶⁴ Higher Education Extension Act, Pub. L. No. 108-366.

⁶⁵ House Committee on Education and the Workforce, *Bill Summary—Higher Education Extension Act (H.R. 5185)*, (7 Oct 2004), (available at <http://edworkforce.house.gov/issues/108th/education/highereducation/5185billsummary.htm>).

⁶⁶ Democratic Staff of House Committee on Education and the Workforce, *Update on Reauthorization of the Higher Education Act*, (available at http://edworkforce.house.gov/democrats/higheredinfo.html#information_pertaining_to_higher_education).

⁶⁷ Pub. L. No. 96-88.

⁶⁸ U.S. Dept. of Education, *Overview of the Department of Education—Mission*, (available at <http://www.ed.gov/about/overview/mission/mission.html>).

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