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JULY 29TH, 2003 CREDIT COMMENTARY

Peeling Back the Onion: Uncovering the True Risks of Student Loan Backed Auction Rate Securities

A Commentary on Rating Agencies' action on AAA-rated AMS ARS Notes

Moody's Review for Downgrade and Fitch Rating Watch Negative:

AMS-3, 2003, LP, Class A-1 auction rate note (Aaa/AAA)
AMS-3, 2003, LP, Class A-2 auction rate note (Aaa/AAA)
AMS-3, 2003, LP, Class A-3 auction rate note (Aaa/AAA)
AMS-3, 2003, LP, Class A-4 auction rate note (Aaa/AAA)
AMS-3, 2003, LP, Class B auction rate note (A3/A)

OPINION SUMMARY:

In light of the current credit events and ratings actions surrounding auction rate securities (ARS) issued by Academic Management Services Corp (AMS), investors need to reassess the unique risk characteristics of this obscure security class. It is our opinion that current holders should strongly consider redeeming existing holdings issued by the same entity.

It is easy to dismiss the discrepancies discovered at AMS as isolated events unique to this servicer; however, we hold the view that scant disclosure, limited external oversight, as well as unfamiliarity of the investing public with this relatively new asset class, will likely contribute to more credit surprises in the industry.

Limited by the length of this commentary, we attempt to focus on just one of the risks associated with ARS investments, the structural risk. We seek to articulate why such a pristine triple-A credit rating on an ARS may not be as indicative of the true risk as one on corporate debt.

For a highlight of the other common risks associated with ARS investments, please refer to our publication "Seven Facts and Fiction About Auction Rate Securities".

BACKGROUND:

Swansea, Massachusetts-based AMS is a unit of Texas issuer UICI that markets, originates, funds and services guaranteed student loans. It held $1.3 billion of student loans at year-end 2002, according to UICI's SEC filings.

On July 21, 2003, AMS discovered a shortfall in the type and amount of collateral supporting two of the "securitized student loan financing facilities" by three of its "special financing subsidiaries." In addition, all seven of its financing subsidiaries may have failed to comply with their reporting obligations. The former president of AMS was placed on leave and was relieved of all responsibilities.

Special financing subsidiaries are special trusts that allow a student loan originator to hold the assets legally separate from the parent organization for securitization purposes.

Financing facilities are legal arrangements between an asset-backed issuer and a financial firm that allow the issuer to receive emergency funding support under certainty difficult circumstances. Common facilities may include a letter of credit, a line of credit, or a liquidity loan from a bank.

Three problems were highlighted in AMS press release: insufficient student loan collateral, a higher percentage of non-federally-guaranteed loans in the collateral than allowed, and deficiencies in reporting.

On this news, both Moody's and Fitch placed several series of AMS's notes, including the above-mentioned ARS notes, under review for downgrade. A.M. Best, an insurance rating agency also placed the A- ratings of several insurance companies that share the same parent with AMS under review for downgrade, thanks to the need for UICI to provide fresh capital to AMS.

On July 24th, UICI took emergency measures to prevent an immediate "technical default" by reaching "waiver and release" agreements with AMS lenders and transferring cash and assets into the deficient accounts. While the investigations are on-going, investors who just witnessed the precipitous downgrades of NPF and Hollywood Funding trusts in 2002 are faced with heightened anxiety awaiting the outcome.

LESSONS FROM THE AMS DEBACLE AND MORE:

AAA ratings of a structured bond are far more vulnerable than that of a corporate bond.

Unlike corporations, whose ratings are intrinsic to their credit metrics, the ratings of structured bonds, including ARS, are often based on a set of rules. While credit deterioration of a corporation is usually a gradual process and somewhat detectable by the investing public, ratings on structured bonds

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could fall precipitously when some parts of the rules are broken.

When an issuer sets up a new securitization program, it usually promises to keep certain performance statistics of the student loan pool within certain levels in order to receive liquidity funding from the banks and triple-A ratings from the rating agencies.

In some cases, the bank conditions and the rating agency conditions could be correlated with each other or with the market, so that when one condition is violated, the issuer could also violate other conditions and cause a domino effect on the ratings. These conditions are commonly referred to as the "*rating triggers*".

For example, an unusually high level of claims (i.e. loan loss) rate may result in a ratings downgrade, which in turn may result in reduced funding support. Less funding support could lead to further downgrades, which may lead to investors dumping the bonds that causes further liquidity problems that leads to further bank pressure and ratings downgrade.

A real life example just occurred last year at the medical-receivables backed NPF trusts and their servicer National Century Financial Enterprise. Shortly after the company discovered insufficient collateral and unauthorized transfers of the reserve fund, *the triple-A bonds fell 24 notches to Caa in three separate rating actions within a month.* Both the servicer and the trusts are currently under bankruptcy protection.

An experienced servicer should stress test the rating triggers on an on-going basis. Rating agencies also need to monitor these statistics for ratings purposes. Investors should request periodic portfolio reports that contain the testing information to avoid falling over the "credit cliff" when something bad does happen. Yet, as we will discuss later, this task is rather difficult in the student loan market.

Many moving parts challenge rating agencies' capabilities.
A machine with more moving parts is more likely to break down. The same is true with rating a structured bond. Since there are many parties to a transaction, all of which could have credit implications on a structured bond, the chance that a rating agency misunderstood the risk characteristics of some of them increases. Furthermore, since business trusts add new loans and replenish paid-off loans on an on-going basis, close on-going monitoring of compliance also becomes more demanding.

In addition, the agencies often try to indemnify themselves by stating in public that they are not "forensic accountants" or "fraud investigators", meaning they make assumptions that information submitted to them is credible and accurate. Given the complexity of ARS transactions, investors may run the risk of paying the ultimate price for a rating agency's investigative deficiency.

We do not know the extent of Moody's and Fitch's knowledge of the collateral deficiency at AMS, and would be alarmed if the agencies did not engage in prior conversations with the servicer with regard to its internal control and compliance mechanism.

Low new loan generation affects all student loan issuers.
Most people know that the current low rates result in reduced interest income, due to a narrowing margin between interest revenue and interest expense for the issuers. In addition, as more people seek to refinance their student loans, student loan originators face the problem of not having enough loans in the collateral portfolio to back up the ARS notes. Failure to have sufficient collateral may result in 'tripping" of the bond covenant and initiate the domino effect discussed earlier.

Sufficient collateral is important because less than 100% collateral would mean some of the notes were no longer backed by a pool of assets. We witnessed that, in the current market, most student loan servicers have had to resort to purchasing loans in the secondary market to keep up with the growth of the notes they issue. This is not only a profitability issue - secondary market loans are more expensive - but also an asset quality concern, since the servicers have no control of the underwriting and servicing standards of the prior servicer.

What exactly contributed to the under-collateralization in the AMS trusts was not disclosed; but based on our review of several SEC filings, it would not be surprising that lack of new loans for collateral has hurt AMS and other issuers of ARS notes.

Finding a strong servicer is key to a good ARS credit, but is extremely difficult in this space.

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Selection of a good servicer is among the most important aspects of the credit quality of a given ARS note. The servicers, and sometimes sub-servicers, are companies responsible for processing and collecting loan payments and submitting non-payment claims to Department of Education for reimbursement.

Risk appetite and credit culture of a servicer directly affect the performance of the underlying loans, and in turn, the credit quality of the ARS notes. In addition, a claim that does not properly follow government guidelines may be rejected and becomes a loss to investors.

With the exception of very few large servicers such as Sallie Mae and Citigroup, most student loan servicers do not have the financial resources and technological expertise to perform at the same level of servicers for credit card or automobile ABS transactions. At this moment, rating agencies do not rate student loan servicers as they do on the established ABS classes.

What struck us as alarming was that issuers generally do not verify, nor do they endorse the accuracy of information supplied by the servicers in their "official statements" (prospectus). In the case of multiple servicers, the issuer is not even required to disclose all of its servicers, nor do they disclose the makeup of servicers.

Surveillance, Surveillance, Surveillance.

This is the only way to know what you bought into. Unfortunately in ARS land, this task is often a trying game. Unlike other ABS notes, monthly collateral performance information is not publicly available. There is no industry standard as to the frequency and details of student loan portfolios. Moody's admits that the lack of resources and expertise on the part of the servicers were the main reasons performance reports were not made available to the public.

Information disclosed in issuers' annual reports often does not contain detailed credit performance, and is usually outdated. The issuers have up to 150 days to file an annual report, compared to just 90 days for corporations.

Investors likely would have caught all three of the problems encountered by AMS, under-collateralization, ineligible collateral, and incompliant reporting, had public information been available. The fact that the company acknowledged potentially all of its seven trusts might be out of compliance tells a story far beyond a simple issue of under-collateralization. It may be an indication of lax internal risk management and control at AMS. Since there are no clearly defined disclosure requirements, this problem is likely an industry phenomenon.

CONCLUDING REMARKS:

Since the SEC prohibits money market mutual funds from investing in auction rate notes, this market has not been under the watchful eye of institutional investors. As a result, the industry is laden with lack of disclosure, minimal collateral surveillance, lax bond indenture enforcement, and inadequate regulatory oversight.

Unless and until heightened investor awareness and structural overhaul of this industry is in place, only professional money managers with dedicated resources to sift through many intricate details should contemplate investing in ARS.

While the initial market anxiety over the AMS incident may die down, we fear the student loan auction rate securities market may be headed into a danger zone that has not been fully appreciated by many participants.

We want to remind investors that this commentary only seeks to uncover one relevant class of risk, the structural risk. It is our opinion that concerns raised in this commentary are just the tip of an iceberg. For other relevant risk considerations, please refer to our publication "Seven Facts and Fiction About Auction Rate Securities".

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