

**Asset-Backed  
Servicer Report****Kentucky Higher Education  
Student Loan Corporation****Ratings**

Kentucky Higher Education Student Loan Corporation	
Federal Family Education Loan Program	Proficient Plus
Private	Proficient Plus

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**Summary**

Fitch Ratings affirmed Kentucky Higher Education Student Loan Corporation's (KHESLC, or the company) 'Proficient Plus' servicer rating for Federal Family Education Loan Program (FFELP) and private student loan servicing. The FFELP rating is based on the company exceeding Department of Education (ED) guidelines for servicing FFELP loans. The private education loan rating is based on KHESLC's assertive collection efforts that resemble servicing strategies used for other consumer loan collections.

As of fiscal year-end 2008, KHESLC's servicing portfolio totaled about \$8.1 billion, of which approximately \$5.7 billion was FFELP loans and about \$2.4 billion were private student loans. More than 70% of the serviced portfolio (in dollars) or 35% (in borrower count) is on a third-party basis for Access Group Inc. (AGI), including both FFELP and private student loans. Having built its own servicing platform, AGI expects to transfer its portfolio in stages throughout 2009. At this time, KHESLC continues to demonstrate the practices and maintain the management staff of a 'Proficient Plus' student loan servicer for both FFELP and private student loans. Fitch will closely monitor the platform during the transition and watch for deterioration in servicing quality or loss of material staff.

**Strengths**

- Experienced management team.
- Solid operational procedures.
- Consumer loan collection experience for servicing private student loans.

**Concerns and Mitigants**

- KHESLC losing the AGI portfolio reduces servicing volume by more than 70% based on dollars (35% based on borrower count).
  - The company continues to service loans in the same manner and management has stated they will be pursuing additional assignments.
- The evolving regulatory environment for FFELP and private student loans, as well as President Obama's budget proposal could lead to a significant market shift that KHESLC may find challenging to compete in.
  - KHESLC is the clear lender of choice in Kentucky with 72% FFELP market share. Additionally, it is possible some support could be provided by the state of Kentucky should Kentucky Higher Education Assistance Authority (KHEAA)/KHESLC get into financial difficulty.

**Corporate Overview****Company Background**

KHESLC is a de jure municipal corporation (independent of the commonwealth of Kentucky but still a political subdivision) and sister company to KHEAA. KHEAA is the primary guarantor (more than 80%) of KHESLC's FFELP volume. In 1996, the boards of directors of the two agencies were merged to create a common corporate governance

and a single board. KHESLC is headquartered in Louisville, KY, and KHEAA is headquartered in Frankfort, KY.

KHESLC was established in 1978 and maintains a 72% share of its primary market, Kentucky student loans. The company services from its headquarters in Louisville, KY, with some shared services from KHEAA in Frankfort, KY. KHESLC has been servicing FFELP loans for more than 30 years and private student loans for more than seven years (third-party only).

KHESLC and KHEAA's focus has been Kentucky, but they are the guarantor and servicer of choice for the state of Alabama, having offered the state similar student loan programs as they offer in Kentucky. More than 70% of KHESLC's current servicing volume is on a third-party basis from AGI. To reduce the effect of the lost contract, KHESLC will look for opportunities to add additional third-party clients and maintain its market share in Kentucky. Maintaining Kentucky market share has become more challenging, with schools increasing the number of lenders on their preferred lender lists. In addition, the company will continue to look for other revenue sources.

### Financial Condition

Fitch does not publicly rate the credit and financial strength of KHESLC or KHEAA. However, Fitch's Financial Institutions Group reviewed KHESLC's and KHEAA's financial statements to provide an internal assessment, as a company's financial condition is an important component of Fitch's servicer rating analysis and was one determinant of the servicer rating.

### Staffing and Training

While the senior management team of KHESLC is relatively new to the company, the chief executive officer has about 30 years of direct industry experience, having been an executive at another large student loan servicer. He joined KHESLC in August 2006. The executive vice president in charge of operations joined as a consultant in March 2006 and permanently in October of the same year. He joined KHESLC from the Kentucky Housing Corporation (KHC), where he was deputy director and chief financial officer since 1986. The senior vice president of operations joined KHESLC in 1994, having spent the previous 15 years with a financial institution working on student loans. Overall, Fitch believes this to be a strong management team.

Many of the middle managers have been with KHESLC for six years and joined with significant experience in the student loan industry or banking and consumer loan servicing. Average industry experience is about 10 years.

### Servicer Ratings

Fitch rates student loan seller/servicers in three categories: FFELP servicers; private student loan servicers; and private student loan seller/servicers. FFELP servicers do not underwrite or make credit decisions but instead follow government guidelines for originating student loans. While FFELP servicers adhere to the Common Manual for servicing standards, they must determine their own approach. In the case of private student loan seller/servicers, certain entities make underwriting decisions and generally service for themselves or third parties. However, some private student loan servicers do not make any underwriting or credit decisions.

In assessing and analyzing the capabilities of student loan seller/servicers, Fitch reviews several key factors, including the management team, organizational structure and operating history, financial condition, information systems, origination, and servicing operations.

Fitch rates asset-backed securities (ABS) seller/servicers on a descriptive scale consisting of three levels:

- Proficient Plus.
- Proficient.
- Proficiency Unproven.

For a description of Fitch's rating criteria, see the criteria reports, "Criteria for Rating U.S. ABS Seller/Servicers," dated Aug. 1, 2007, and "Criteria for Rating U.S. Student Loan Seller/Servicers," dated Aug. 1, 2007, both available on Fitch's web site at [www.fitchratings.com](http://www.fitchratings.com).

KHEAA/KHESLC employed 435 employees at Dec. 31, 2008, down from 524 employees at May 31, 2007. The customer service staff was reduced to 43 from 62 and collections to 65 from 101. KHESLC expects to continue reducing staffing levels significantly during 2009 because of the loss of the AGI contract. The majority of departures to date were voluntary allowing staff reductions to occur through attrition. Fitch is concerned with employee morale, staff reductions, and its effect on the company's operations. Fitch will continue to monitor KHESLC's servicing performance for deterioration and comment if any is noted.

KHESLC has a full-time training position. New hires spend their first week in a classroom setting training on systems, the second week on the floor listening to an experienced phone representative, the third week sitting side by side managing part of the call and data entry, and during the fourth week, a written test is administered that they must pass before being put on the phone. During the early stages of employment, the quality assurance team monitors 85% of their work. Every Thursday, KHESLC has ongoing training sessions for experienced employees.

### Technology

KHESLC uses the Student Loan Servicing System (SLSS) for servicing. SLSS was developed by Idaho Financial Associates (IFA), which is owned by NelNet. Other student loan servicing entities, plus KHESLC, form a user group that meets periodically to discuss enhancements to the system. IFA releases three updates per year. New releases are loaded to a test system and tested thoroughly before going live. The system is table driven, allowing users to create servicing protocols for each loan program they service. KHESLC has FileNet imaging with some work flow software but not for all functions. Servicing representatives using SLSS work on monochrome, green screens with no graphical user interface (GUI). The debt recovery team works on a system hosted by a collection agency that provides a front-end GUI. Fitch believes a GUI makes systems easier to navigate.

KHESLC has two information technology teams. The first team, Software Engineering Project Management, develops wraparound systems and performs quality assurance of new releases. The second team is Infrastructure Services, which provides telecom support (such as dialer and voice response unit [VRU]) and technical support. Since the last review, the technology teams decreased their staff by 10 employees; however, it remains staffed by 55 people with a strong average tenure of more than five years.

The data center is in Frankfort, KY, and shared with KHEAA. Backups are created nightly. KHESLC has a contract with IBM for a hot site in Sterling Forest, NY, for data recovery. The contract calls for systems to be available within 36 hours. KHESLC's back-up building for business continuity is in Frankfort (KHEAA's location) where it can house employees. The company has only one auto-dialer, in Louisville, leaving the company susceptible to a dialer outage. The disaster recovery/business continuity plan is tested annually, with the last test in September 2008 considered a full success.

Fitch believes that KHESLC's technology is industry standard and appropriate for servicing its portfolio. Its primary servicing system, SLSS, is the same system used by AGI, which will help facilitate the loan transfer.

### Servicing

#### Account Maintenance

Account maintenance at KHESLC entails the following:

- Monitoring student status.

- Managing borrower benefit programs and interest rate changes.
- Reporting to ED, credit bureaus and other prescribed parties.

KHESLC submits a file two times per week to the National Student Loan Data System (NSLDS) clearinghouse to verify repayment conversion date, last date of attendance, and the borrower's status. This ensures that KHESLC has the correct information to service loans appropriately according to the stage of the loan and borrower (e.g. in-school or grace).

When loans are entered into SLSS, they are coded with applicable interest rates and borrower benefits. Interest rate changes are automated based on the appropriate rate entered into the specific loan type table. For Stafford and Plus loans that have variable rates of interest (loans disbursed prior to July 1, 2006), when a new interest rate is received, the corresponding table is changed. If the loan is serviced on a third-party basis, the lender provides the appropriate interest rate index, which is loaded into the loan tables. Borrower benefits are managed in a similar manner depending on the program. Electronic fund transfer (EFT) benefits are flagged when the EFT is set up. Benefits that are earned after the correct number of on-time payments are tracked via loan code, and benefits automatically start once the borrower has met all qualifications.

As stipulated in the Common Manual, which provides a unified FFELP student loan policy, KHESLC reports to various parties (ED, credit bureaus, and guarantors) as required. The reporting is automated, and all data are subject to systemic edit checks prior to disbursement.

All paper that comes in, including applications, legal documents, correspondence, etc., is imaged upon receipt, and much of it is processed through work flow software. For the operational areas where work flow software is used, such as customer correspondence requiring KHESLC to respond, the image is forwarded to the appropriate department for processing; otherwise, manual intervention is necessary.

### Customer Service

At the time of Fitch's review, KHESLC had 43 customer service representatives (CSR) down from 62 at the last review. On average CSR's have 4.5 years tenure. The company has the following three levels of CSRs:

- Entry level.
- Senior CSR for escalated calls.
- Team leads, who handle the most difficult escalated calls.

The department's hours of availability are 8:00 am to 8:00 pm, Monday-Friday, Eastern Standard Time. Borrowers use a toll-free number to contact Customer Service and are routed by an automatic call distribution system to the next available agent. CSRs are cross-

trained to handle both FFELP and private student loan borrowers, as there is not a significant difference in managing the customer service needs of either loan type. KHESLC's actual service levels are shown in the table below. Borrowers also have the option to obtain information automatically 24 hours a day through the VRU or on KHESLC's web site, [www.studentloanpeople.com](http://www.studentloanpeople.com).

### Customer Service Metrics

(Years Ended Dec. 31)

	2008	2007	2006
Average No. of Calls per Month	18,369	18,151	15,945
% of Calls Resolved by the IVR	35	34	29
Average Speed of Answer (Seconds)	13	7	27
Abandonment Rate (%)	0.64	0.4	2.12

IVR — Interactive voice response system.

KHESLC provided Fitch with results of recent customer service satisfaction surveys, which showed very favorable results on quality and performance questions posed to borrowers. The customer service department also has a quality assurance team to monitor CSR calls for quality and thoroughness using a voice and data capture system to record 5% of all calls randomly. Three phone calls per CSR are formally monitored and scored each month.

KHESLC's average speed of answer and abandonment rate are within industry standard even with the decline year-over-year. With the loss of staff since the last review and the expected further staff reductions due to the loss of the AGI contract, Fitch will continue to closely monitor KHESLC's call center metrics for further deterioration.

### Cash Management and Billing

KHESLC mails billing statements monthly that direct borrower payments to a nationally recognized lockbox in Kentucky that utilizes Image Cash Letter (ICL) to reduce the float time. This accounts for 36% of the payments received. Fitch prefers a servicer to have multiple lockboxes with geographic dispersion to reduce the time borrower payments are outstanding and enhance the overall cash management process. Four percent of payments are manually processed in-house, these represent consolidation payments, claim payments, or lockbox rejects. The remaining 60% of payments are received electronically, either as EFT, web payments or through the VRU.

The lockbox has less than a 1% rejection rate. These funds are posted to an unapplied account while research is performed by the cash management team to identify the payment. Generally, lockbox rejects are identified and properly posted within 24 hours.

### Collections and Loss Mitigation

FFELP and private student loan collections are performed by the same due diligence/collection team. The collections team is down to 68 from 101 staff at the time of our last review. The average tenure is strong at 3.9 years. KHESLC does not outsource or offshore any customer interaction functions, including collections. Collectors currently work in a call-blending environment. All loans, regardless of type (FFELP or private), enter the auto dialer for virtual-calling campaigns at 15 days past due. As the loan becomes more delinquent, calling efforts become more assertive.

KHESLC exceeds the servicing standards established by ED to maintain the guarantee on FFELP loans including virtual-calling campaigns during the earliest stage of delinquency and becomes more assertive during later stages. It continues to work FFELP accounts until a claim is filed and the default has occurred.

KHESLC's private student loan collection effort resembles collection programs seen at other consumer asset servicing organizations, rather than traditional FFELP due diligence efforts. The collections manager has 10 years of collection experience with a credit card call center prior to joining KHESLC about six years ago. He brought with him other talent from the credit card call center that closed nearby, giving KHESLC consumer credit collection experience and knowledge. Until private loans reach 60 days past due, they are managed in a pooled environment with FFELP loans. Once a private loan exceeds 60 days past due, the account is assigned to a specific collection agent until the delinquency is resolved.

For both loan types, when contact is made with borrowers, the collector will first attempt to collect the total amount due. If the borrower cannot make the entire payment, the collector will try to get a partial payment and set up a payment plan. The last resort is a discretionary forbearance. KHESLC's primary goal is obtaining cash from the borrower first. Borrowers qualify for forbearance or deferment based on FFELP or established lender guidelines. KHESLC also started a consolidation program of risky FFELP assets and contacts these borrowers to offer a consolidation loan through the Federal Direct Loan Program.

## Collections Metrics

(Fiscal Years Ended June 30)

	2008	2007	2006
No. of Delinquent Accounts per Collector	1,262	1,018	N.A.
Right Party Contact Rate (%)	31	21	N.A.
Entire Portfolio Called (Days)	2.64	1.69	N.A.
Inbound ASA (Seconds)	49.8	9.7	N.A.
Inbound Abandonment Rate (%)	1.33	2.6	N.A.

N.A. — Not available. ASA — Average speed of answer.

Chargeoff occurs based on FFELP or lender guidelines. For FFELP loans, collections continue until a claim is filed and for private student loans until the servicing agreement entered into with the owner of the loan specifies (90 days past due for AGI loans). KHESLC's primary guarantor is KHEAA, representing more than 80% of its claims volume. KHESLC works with a total of 14 guarantors.

KHESLC has an extensive Skip Trace unit that attempts to locate borrowers first with free tools at its disposal, such as Internet searches and Kentucky Net (a tax record search for Kentucky loans only, not third party). If these tools do not locate a borrower, KHESLC will send files to LexisNexis Accurint for a thorough search. This historically has provided the company with good results.

Collectors work on SLSS, which is supplemented with an Avaya auto dialer. Encompassed within the system are checks to ensure the appropriate due diligence is being performed per ED guidelines and collection efforts are meeting the established guidelines of each lender with which the company contracts. Exception reports detail accounts that are close to missing compliance thresholds, allowing KHESLC to ensure the appropriate level

## Claims Filed

(\$, Fiscal Years Ended June 30)

	2008	2007	2006
Total Claims Filed	101,195,331	88,393,404	49,626,613
Rejected	339,320	405,207	149,830
Cured	241,418	329,059	131,294
Net Reject	97,902	76,148	18,536

of servicing (calls and notices) is performed. Other quality controls include monitoring three calls per phone representative per month for quality through the NICE system.

In 2008, call volume increased significantly causing the increased average speed of answer, which Fitch finds higher than industry standard (generally less than 30 seconds). In addition more borrowers are in repayment, resulting in a spike in inbound call volumes and a longer answer rate. KHESLC also had an increase in overall hold times. KHESLC's claims reject and cure rate are within industry standard.

In Fitch's opinion, KHESLC's collections and loss mitigation efforts are strong and in compliance with ED guidelines. For private student loans, it takes an aggressive approach to collections that more closely resembles servicing of other consumer loan products rather than traditional FFELP due diligence efforts. Fitch feels it is appropriate to manage and perform collection efforts for private student loans similar to other unsecured consumer loans. Experience collecting consumer debt is a strength that was noted by Fitch.

## Risk Management and Compliance

Operational risk management involves the following:

- Internal audit.
- External audit.
- Compliance.
- Quality assurance.

Since the last review, KHESLC hired a director of internal audit. She has a background in audit (four years of public accounting and 10 years as an internal audit director), but does not have experience with student loans. The internal audit department primarily works with external parties that audit KHESLC's operations, including the SAS70 audit and guarantor audits. In addition, an audit plan was prepared and will be carried out throughout the year. The internal audit department reports to the executive director and CEO of KHESLC and the audit committee of the board of directors. The most recent audits have not revealed material findings. The minor items noted by the auditors were addressed in a timely fashion by KHESLC management.

KHESLC regulatory compliance is managed in Frankfort, KY, and reports to the general counsel. The general counsel is new since the last review, having been promoted from assistant general counsel. The previous general counsel retired. Compliance changes are tracked on a macro level and information is disseminated through the intranet and emails to managers. The managers are then charged with implementing changes in their teams.

The quality assurance team monitors phone representative calls, including due diligence/collection efforts performed on delinquent loans, the quality of those calls, the quantity of forbearance and deferment forms processed, and appropriate coding of calls. Three calls per phone representative are monitored monthly.

KHESLC maintains an in-depth policies and procedures manual online that is available to all employees in PDF format. It is updated throughout the year and properly reviewed prior to changes being implemented and disseminated to the staff.

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