June 4, 2009

DRAFT

To: Kevin Corser

From: Carole Valentine

Subject: Kaplan Higher Education Corporation Reserve Estimate for Kaplan Choice Loans

Executive Summary

Student Finance recommends the use of a two-tiered reserve for the Kaplan Choice Loan Program: 60% for in-school loans (interim status), and 80% for loans in repayment. Over 95% of the Kaplan Choice Loans are in interim status as of the date of this memorandum. Our reserve estimates for the Kaplan Choice Loan Program stem from our student drop rate experience, the student profile and repayment experience for the Universal Loan Program, and the poor state of the economy in the U.S.

Despite these estimates, there are some mitigating factors that may provide a better outcome than our projections. Kaplan is taking steps to promote financial responsibility among these students, and these actions may cause a better outcome than our projections. Unlike students in the Universal Program, Kaplan is having students make cash payments under separate payment plans, and we are considering a financial literacy course requirement for students in the Kaplan Choice Loan Program. We may also put in a cosigner requirement for these students in the future, depending on the student profile and the performance of the loan portfolio. Kaplan will make every effort to educate students on their financial responsibilities in the hope that our repayment experience will improve.

Universal Loan Program/Kaplan Choice Loan Program

The majority of Kaplan's students must finance their education with multiple sources of financial aid. Many students utilize federal loans, and a small percentage use private loans to cover educational expenses not covered by federal aid. Approximately 90% of our student's financing needs are covered with federal loans, and the remaining 10% is normally covered by private loans provided by the banking sector.

For the past 3 years, Kaplan Higher Education utilized Citibank's Universal Loan Program to meet the needs of its credit-challenged students. In November, 2008, Kaplan's access to the Universal Loan Program ceased when Citibank began to experience high default rates on the Universal Loan portfolio. With the credit crisis, Kaplan had anticipated disruptions in the private student loan market, and the company was piloting an institutional loan program (with Genesis Financial Services) when Universal Loan access was lost. KHEC on-ground campuses and Kaplan University began using the program in November, 2008, as the Universal Loan Program ceased operations.

The Kaplan Choice Loan Program allows students to borrow up to $15,000, depending on their program of study and financial need, and they can take up to 10 years to repay. The program carries a fixed rate of 15%, and the loans are deferred while students are in-school. Students must apply for private loans with outside lenders before pursuing the Kaplan Choice Loan, so the program is positioned as a last resort for the students. For 2009, Kaplan Higher Education is estimating the Kaplan Choice Loan Program to reach approximately $29 million (KHEC-$15.5; KU-$13.2). The Kaplan Choice Loan portfolio (disbursed loans) is approximately $5 million as of June 1, 2009.

<u>Kaplan Choice Loan Reserve</u>

<u>Interim Reserve</u>

Our students drop at a rate of 5% per month, and this rate equates to an annual drop rate of 60%. More than 80% of drop students fail to pay back their educational loan debt; therefore, we are recommending an in-school default reserve of 60%. Over 95% of our Kaplan Choice Loans are in interim status as of June 1, 2009.

<u>Repayment Reserve</u>

[redacted] The lending industry reports a high correlation between the original FICO and actual losses in their private loan portfolios (Sallie Mae Private Credit ABS Investor Presentation in September, 2008). In general, consumer loans in similar FICO tiers are exhibiting default rates of approximately 80%. Consequently, we view the original FICO as a key benchmark for our repayment reserve estimate.

As of 3/31/09, the 2006 cohort default experience for Kaplan Higher Education's on-ground campuses and Kaplan University was 69.5%. KHEC on-ground campuses are exhibiting a default rate of 81.5%, and KU students are defaulting at a 62.6% rate. [redacted] In general, student loan defaults tend to peak in the first five years of repayment, and decline after this timeframe. Another benchmark to consider is Kaplan's seasoned loan portfolio of K-Loans, which is defaulting at a rate of 68%.

The poor economic conditions add another dimension to portfolio performance. Students are having a harder time finding jobs, and they may find themselves in the position of taking lower paying positions than anticipated. Given the low FICO profile of the students, Universal Loan default trends, and the poor economy, Kaplan is recommending a repayment default reserve of 80%.