



Methodology

*Rating U.S. Private Student Loan  
Securitizations*

MAY 2006

*Operational Risk Review section updated in methodology entitled  
“Operational Risk Assessment for U.S. ABS Servicers” in June 2011*



*Insight beyond the rating.*

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### Related Research:

Legal Criteria for U.S. Structured Finance Transactions  
Operational Risk Assessment for U.S. ABS Servicers

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This methodology replaces and supersedes all related prior methodologies. This methodology may be replaced or amended from time to time and, therefore, DBRS recommends that readers consult [www.dbrs.com](http://www.dbrs.com) for the latest version of its methodologies.



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# Rating U.S. Private Student Loan Transactions

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## Executive Summary

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Private student loans (PSLs) are used to fund education at various institutions, including primary, secondary, post-secondary, graduate, and professional/career training schools. Unlike federal loans, which are offered under the Federal Family Education Loan Program (FFELP) and are effectively guaranteed,<sup>1</sup> PSLs are credit risk instruments that are subjected to credit underwriting guidelines and priced using lenders' risk-based pricing matrices. PSLs are often guaranteed by either a co-signer or a third-party insurer (or both).

Similar to student loans originated under the FFELP, PSLs are funded primarily by commercial banks. These banks will either: (1) originate PSLs under their own loan platform, or (2) provide warehouse financing or conduit facilities to specialty finance companies that originate the loans. Often the PSL product is a natural complement to the lender's FFELP business and enables them to appeal to financial aid administrators as a "preferred lender" by offering a suite of loan products.

Consistent with the DBRS rating methodology applied to other ABS transactions, DBRS reviews the (1) sponsor's origination guidelines as well as (2) the loan servicer's operational capabilities (as outlined in Operational Risk Assessment for ABS servicers dated June 2011). In terms of collateral evaluation, the DBRS methodology considers many factors including the issuer's historical portfolio performance, the underlying credit risk associated with the borrower(s), the impact of loan guaranties (if applicable) on expected transaction performance, the unique characteristics of the loans, and the timing of losses and collateral prepayments.

DBRS outlines its rating approach for PSL ABS securitizations in the following sections and provides a summary of key assumptions utilized in its methodology in Appendix A.

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## Structure

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PSL securitizations typically have several generic structural features which are summarized below:

- Owner Trust Structure
- Senior/Subordinate Capital Structure
- Sequential Payment with Step-Down Date
- Step-Down Date
- Excess Spread
- Reserve, Capitalized Interest, and Cash Capitalization Accounts
- Note Triggers

### OWNER TRUST STRUCTURE

Most PSL securitizations utilize an owner trust structure where the collateral pools are discrete and amortizing. PSL securitization trusts, similar to trusts in other ABS transactions, must be bankruptcy remote special purpose entities. In connection with PSL ABS transactions, legal opinions are rendered to provide assurance that the trust collateral has been transferred from the originator/seller to the trust via a true sale mechanism. With a true sale transfer mechanism, collateral can not be consolidated into a seller's estate should they go bankrupt.

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<sup>1</sup> Currently up to 98% of principal and accrued interest is guaranteed for loans that are sponsored under the Federal Family Education Loan Program ("FFELP"). This program is an entitlement program where loans are guaranteed by eligible guarantors under the program and reinsured by the U.S. Department of Education. For loans originated after July 1, 2006, the guarantee percentage will drop to 97%.



## SENIOR/SUBORDINATE CAPITAL STRUCTURE

PSL ABS transactions typically have capital structures that include multiple senior, highly rated classes of floating-rate notes along with one or two classes of subordinate notes. The subordinate notes, which usually represent seven to ten percent of the capital structure, are the primary source of credit enhancement for the senior notes. The credit ratings on subordinate tranches are typically investment grade, ranging from AA to BBB.

Senior notes are “time” tranced [e.g., tranced out by weighted-average life (WAL)] in order to meet the bond maturity/duration targets for various investors. The WAL of senior PSL tranches tends to range from one to 15 years or more, while the WAL of subordinate tranches tends to range from seven to ten years. The WAL for subordinate notes can be shorter than the WAL for some of longer dated senior notes due to the inclusion of certain structural mechanisms. One mechanism requires principal payments to be made on a pro rata basis between senior and subordinate notes, but paid sequentially within each class, after a specified date (see Step-Down Date section). Another mechanism requires the excess loan collections (both principal and interest) to be used to pay principal, in reverse priority order, after regular principal payments are made, but ahead of distributions to the residual holder. The inclusion of either or both of these mechanisms may cause some subordinate classes of notes to pay down faster than some senior note classes.

## SEQUENTIAL PAYMENT WITH STEP-DOWN DATE

For most PSL ABS transactions, student loan principal and interest collections are commingled and distributed as available funds through one cash flow payment waterfall. Payments to transaction constituents are typically allocated in the following order of priority:

- (1) Servicing and administrative fees.
- (2) Swap payments.
- (3) Interest to senior noteholders.
- (4) Interest to subordinate noteholders if the parity ratio (asset-to-liability ratio) is met. If parity falls below 100%, many transactions require subordinate note interest to be redirected to pay down senior note principal until parity is restored (see Note Triggers section for further details).
- (5) To replenish the reserve account to meet the minimum required balance.
- (6) Note principal sequentially to senior and subordinate notes until the step-down date. Once the step-down date is passed and certain deal triggers are not breached, note principal is paid on a pro rata basis between senior and subordinate notes.
- (7) Release of remaining available funds to the residual holder if certain parity ratios are met.

Principal payments to the noteholders at a distribution date are generally a function of: (1) the amount of principal amortization, both voluntary and involuntary (e.g., prepayments), that occurs on the underlying collateral during the collection period, and (2) any additional amounts from excess available funds (see Excess Spread section) that must be used to pay down notes due to non-compliance with parity tests. When calculating principal distribution amounts, some PSL structures require the transaction to achieve parity ratio levels as high as 103% in order to build overcollateralization as additional credit enhancement.

Although most PSL ABS transactions have a parity ratio of 100% at closing, some transactions may have less. This situation can occur when securitization proceeds are used to cover transaction costs or when the loan collateral is acquired at a premium. A transaction parity ratio of less than 100% at closing is permitted as parity ratios or overcollateralization can be built up through: (1) excess spread, which typically is high for PSL collateral (see Excess Spread section), and (2) the inclusion of a “lock out” period for subordinate note principal payments (see Step-Down Date section for further details).

Note that all transactions must pass cash flow stress scenarios that reflect the actual collateral pool to be securitized, as well as the transaction’s legal and capital structure.



## STEP-DOWN DATE

In order to provide PSL senior investors with additional protection from collateral defaults, most PSL ABS structures pay note principal sequentially prior to the step-down date. Step-down dates are usually set to occur at distribution dates approximately five to seven years after closing. Additionally, after the step-down date occurs, most PSL ABS structures switch to pro rata pay. However, if certain triggers are breached, subordinate note principal payments are redirected to pay additional senior note principal to de-lever the transaction and build parity until 100% parity is restored. Frequently, triggers that “lock out” subordinate note principal after a step-down date are tied to either maintaining specified parity levels or reaching specified levels of cumulative loan defaults or net losses.

## EXCESS SPREAD

Similar to other ABS transactions, PSL ABS transactions rely on the transaction’s excess cash flow or “excess spread” for additional credit enhancement. Excess spread is the difference between the coupon income generated by the collateral less amounts paid out in servicing fees, hedging, and noteholder interest payments. Excess spread can be used to pay interest and principal payments due to the noteholders in the event of any shortfalls.

Structurally, excess spread is utilized first to absorb collateral losses and is the primary source of credit enhancement for subordinate tranches. Excess spread, in the form of “excess available funds”, is only released to the residual noteholder or certificate holder if the transaction is in compliance with a specified parity level. If the parity ratio is not met, both before and after any potential distribution to the residual holder, excess spread remains in the transaction and will be used to pay down senior noteholders until the parity ratio is restored.

The level of excess spread in PSL transactions can vary based on the credit quality of the underlying collateral pool. It is also impacted by the servicing and administrative costs of the transaction, which vary with each servicer and issuer.

## RESERVE, CAPITALIZED INTEREST AND CASH CAPITALIZATION ACCOUNTS

In most PSL transactions, liquidity is a concern. Some loans included within a PSL pool may not be generating interest and principal cash flow due to the student’s in-school status or his use of permitted grace, deferment or forbearance periods. Consequently, PSL transactions are often structured with reserve accounts to provide liquidity that can compensate when loans are not cash flowing. Also, reserve accounts can be used to cover interest and principal shortfalls caused by loan delinquencies and defaults.

Reserve accounts are sized to cover interest shortfalls and principal at maturity and are factored into the transaction’s overall credit enhancement levels. Reserve accounts are:

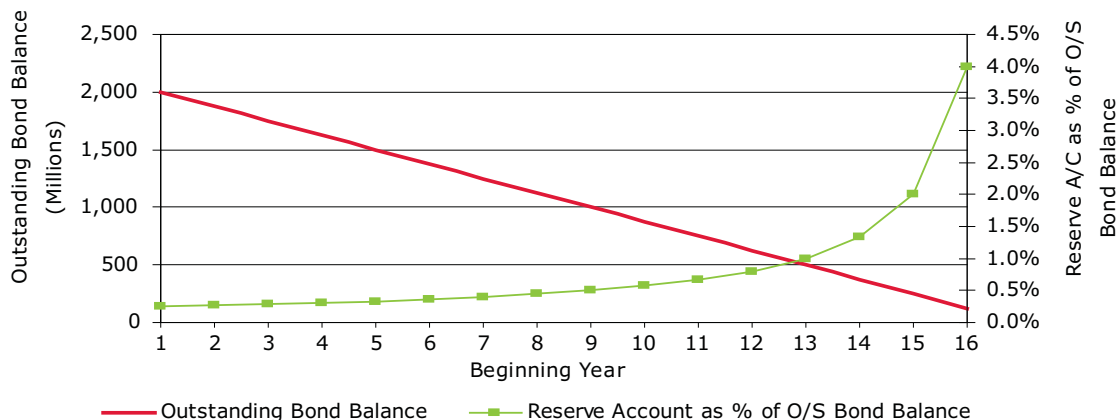
- (1) fully funded at the time the transaction is closed,
- (2) often static, or subject to static calculations, and
- (3) replenished on future distribution dates from available funds.

In PSL ABS transactions where the reserve account is non-declining (e.g., sized based on the initial bond or pool balance), the reserve account can provide longer dated PSL ABS bonds with increased credit enhancement as the transaction amortizes (see Chart 1 on the following page).

However, some transactions provide for declining reserve account balances as the underlying bond or collateral balance amortizes. In these transactions, as the specified dollar amount of the reserve account steps down over time, excess funds are released and distributed according to the priorities set forth in the cash flow waterfall. Most transactions with declining reserve account balances require a nominal floor or minimum reserve account balance through the duration of the transaction.



**Chart 1: Sample Private Loan Trust Reserve Account Analysis**



Capitalized interest or cash capitalization accounts also serve as liquidity reserve accounts. These accounts are sized depending primarily on the characteristics of the loan collateral to be securitized and are intended to be used solely to cover interest shortfalls stemming from non-cash flowing student loans. Capitalized interest or cash capitalization accounts are always fully funded at closing at a specified dollar amount and usually step down in size over the first few years of the transaction. Withdrawals from capitalized interest or cash capitalization accounts are not replenished from available funds.

**NOTE TRIGGERS**

Most PSL ABS transactions include note triggers, or deal covenants, to further protect senior noteholders against deteriorating collateral pools. Note triggers are generally tied to a transaction’s parity levels, cumulative loan defaults or net losses, or targeted enhancement or overcollateralization levels. When in effect, note triggers most often redirect either subordinate note interest or principal to the payment of additional senior note principal in order to de-lever transactions and build parity.

Both note interest triggers and note principal triggers usually redirect subordinate note interest when 100% parity is not maintained. However, note principal triggers also usually redirect subordinate note principal when either 100% parity is not maintained, cumulative loan defaults or cumulative net losses on the transaction’s collateral pool reach a specified level, or a targeted level of overcollateralization is not reached. Note triggers, in general, turn off when requisite parity levels are restored, losses or defaults fall below triggering thresholds, or specified credit enhancement levels are reached.

**Loan Sourcing and Origination**

**LOAN SOURCING**

PSLs are sourced through two main channels: (1) school financial aid offices, and (2) direct-to-consumer or retail marketing. The majority of PSLs are sourced through the school channel, although lenders utilize retail marketing efforts to supplement their school origination channels.

For many students and schools, the financial aid office is the primary source of information for student loans and serves as the intermediary for obtaining loans. Financial aid administrators (FAAs) often maintain “preferred lender” lists and typically refer students to lenders that have established relationships with the schools’ financial aid offices. In order to maintain their status as a “preferred lender”, many FFELP origina-



tors have added private loans to their product suites. Consistent with this dynamic, some PSL lenders have also initiated partnerships with FFELP-only lenders to gain access to the desirable school channel.

Although the direct-to-consumer or retail marketing channel accounts for a smaller portion of origination volume, many lenders utilize this channel to maximize their borrower universe. To develop retail channels, PSL lenders have either leveraged established FFELP direct-to-consumer marketing platforms, such as consolidation loan marketing platforms, or have established specialized private loan marketing programs. Loans sourced through retail channels tend to have a wider dispersion of credit quality, as direct-to-consumer marketing reaches more students at a wider spectrum of schools and lenders may not have relationships with the schools' FAAs. Additionally, if loans are not sourced through a school's financial aid office, borrowers may not receive financial aid and debt management counseling.

Loan facilitators are unique to the PSL market. Similar to traditional secondary market entities in the FFELP market, loan facilitators provide exit or loan disposition strategies for PSL originators that do not desire to hold PSLs on their balance sheets. Additionally, however, PSL loan facilitators provide lenders with full origination platforms that include: (1) marketing information such as loan description, terms, and parameters; (2) underwriting guidelines and criteria; (3) decision matrices such as risk-based pricing; and (4) origination processing. Facilitators provide exit or loan disposition strategies by agreeing to purchase PSLs originated by lenders after the loans are disbursed. Facilitators generally fund their strategies through warehouse financing and loan securitization. The lender's role is typically limited to sourcing borrowers and funding the loans. Lenders that originate loans using the facilitator's platform usually have the ability to market the PSL loan products under their own brand names.

## ORIGINATION

The underwriting process for PSLs is similar across originators. In general, lenders begin with a set of borrower eligibility criteria that mirrors the basic criteria of the FFELP, including requirements for citizenship, minimum age and school enrollment, school eligibility, and the absence of a previous student loan default. Most lenders combine these basic criteria with output from their credit scoring models and other borrower financial information (e.g., debt-to-income ratios) to arrive at an underwriting decision. Some lenders also use proprietary models to determine risk-based pricing, loan terms and limits, and to also manage the overall credit risk inherent in their portfolios. Many PSL lenders require students to borrow the maximum amount permitted under FFELP before taking private loans.

PSL lenders typically require a credit review of the applicant, as well as that of any required co-signer. Lenders obtain Fair Isaac Corp. (FICO) scores on potential borrowers and co-signers. Many lenders with proprietary scoring models utilize inputs in addition to borrower FICO scores to arrive at a loan approval decision. These inputs can include factors such as loan type (i.e., academic discipline), school type (i.e., cohort default tier), loan balance, and student status (i.e., in-school, deferment, repayment, etc.). Loan types may be differentiated by K-12, general undergraduate, law, medical, business, general graduate, and vocational or career training. Default performance can be impacted by loan type.

Originators typically segregate borrower creditworthiness into multiple scoring bands. These bands usually have ranges of ten to 20 points each, with the lowest band applying to borrowers who score below the range of 600 to 630, while the highest band applies to borrowers who score above 800 to 830. Weaker credits may have lower borrowing limits and shorter repayment terms. Loan type and school type may also affect borrower limits and terms.

Borrowers with limited credit history or who fail to achieve minimum credit scores are generally allowed to reapply with a co-borrower or co-signer (usually a parent or legal guardian). Minimum credit score cut-offs that require co-borrowers on the PSL application tend to run in the range of 630 to 650. Some lenders also review debt-to-income ratios of the co-borrower to fine tune their underwriting and loan pricing process.



DBRS reviews the complete underwriting process for a prospective PSL ABS issuer before undertaking the loan pool analysis. This review may include an on-site visit to the loan origination facility, with specific focus on industry experience, staffing, scoring model development, the use of technology, reporting, and efficiency and sufficiency of processes.

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## Servicer Risk

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Private student loans are essentially unsecured consumer loans. Similar to other ABS asset classes, the servicing of PSLs can be critical to the overall performance of the PSL ABS collateral pool. Consequently, DBRS conducts a review of the PSL servicer's operations and servicing capabilities in connection with the transaction rating process (as outlined in Operational Risk Assessment for ABS servicers dated June 2011).

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## Analysis of Expected Loss for PSL ABS

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The DBRS rating methodology uses several assumptions including expected collateral defaults, the timing of expected defaults, and defaulted loan recovery levels to arrive at expected pool losses. The DBRS approach to developing these assumptions is described below.

### LOAN DEFAULTS

Up to this point in time, PSLs have had lower default frequencies than FFELP loans primarily due to two main factors: (1) PSLs are credit underwritten, and (2) PSLs often have co-signers, giving the lender a second payment source as well as a contact during delinquency periods. Other key factors that impact the determination of defaults and expected losses for PSL pools are: (1) loan type, (2) loan seasoning, and (3) dispersion of borrower credit scores within the pool.

Default frequency can vary widely among lenders due to differences in underwriting criteria, borrower base, product type, and other factors. Consequently, DBRS analyzes issuer-specific static pool or cohort data to arrive at an expected base case cumulative default assumption for a PSL pool. DBRS prefers a minimum of ten years of an issuer's portfolio data. Once the data is received, DBRS reviews it to identify and minimize the effect of statistical anomalies or inaccuracies that may occur due to: (1) extraordinarily small or large cohorts, (2) changes in the lender's underwriting criteria, and/or (3) any extraordinary circumstances that may skew the data. This exercise is performed to ensure that the historical data set from which the base case assumption is derived represents the most logical comparison to the portfolio being securitized.

For situations where the issuer's loan performance data set may not include a sufficient number of years, the base case default assumption may be grossed up to compensate for the lack of a full data set. Additionally, if an issuer is unable to produce a sufficient amount of useful historical data to accomplish a satisfactory default analysis, DBRS may benchmark the issuer's portfolio to that of another issuer based on underwriting criteria and loan characteristics. This analysis usually includes unfavorable adjustments to the analytical results to reflect the issuer's lack of historical data.

Once the base case default assumption for the pool is determined, the base case is then stressed depending on the desired tranche rating (e.g., the higher the tranche rating, the more onerous the stress) as shown in Table 1 below:



**Table 1**

Rating Category	Stress Multiples
AAA	3.0x - 4.0x
AA	2.5x - 3.0x
A	1.5x - 2.5x
BBB	1.0x - 1.5x
BB	0.0x - 1.0x

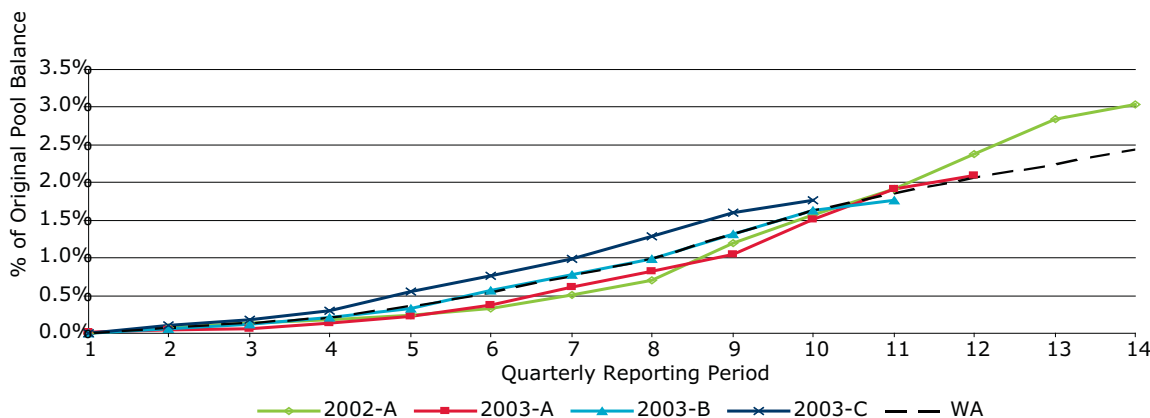
The multiples in Table 1 above are driven by DBRS’s requirement that a tranche be able to withstand expected pool base case losses plus zero to 4.00 standard deviations, depending on tranche rating, but under no circumstance less than the base case expectation. Notwithstanding the standard deviation ranges and corresponding multiples shown in Table 1, DBRS will adjust the default assumption in the event the resulting credit enhancement level is deemed insufficient.

Seasoning credit may be given to a loan portfolio and can reduce the base case default assumptions that would otherwise be applied to the pool. In order for DBRS to evaluate the level of seasoning credit that can be applied to a pool, the originator must provide DBRS with pool stratifications detailing the loans’: (1) original terms, (2) remaining terms, and (3) number of months in repayment. When DBRS applies seasoning credit, total expected defaults for a PSL portfolio may be adjusted depending on: (1) the level of actual pool losses incurred to date, (2) the timing of those losses as expected by the DBRS default curve, and (3) the remaining life of the pool loans. In student loan portfolios, default assumptions are very sensitive to seasoning credit as the default curve is relatively front-loaded. Therefore, loan seasoning data must be sufficiently reliable before DBRS can consider giving seasoning credit to a pool.

### DEFAULT LOSS TIMING CURVE

The actual default curve (e.g., timing of defaults) for PSLs tends to be flatter versus that of FFELP loans. Conservative underwriting and the use of co-signers are prevalent amongst all PSL issuers and slow the timing of defaults. DBRS uses a default curve of (20%/25%/35%/15%/5%). Once the defaults for a given period have been determined based on the aforementioned allocation, defaults are then evenly spread within each period. DBRS may, on a case-by- case basis, adjust the loss curve to reflect anomalies in a specific transaction. Chart 2 below shows the cumulative default performance for Sallie Mae Private Credit Student Loan Trusts. Note that the trusts contain loans in various statuses and stages of repayment and do not represent vintage year cohorts; therefore, default speeds depicted in Chart 2 on the following page may be slower than that of actual vintage cohorts.

**Chart 2: SLM Private Credit Student Loan Trust Cumulative Defaults\***



\*Purchases by Servicer (Delinquencies >180 Days)  
 Source: Sallie Mae



## LOSS SEVERITY AND RECOVERIES

As PSLs are generally not guaranteed, loss severities are higher for these loans than those incurred on FFELP loans. However, PSLs have two key features that have enabled these loans to have relatively higher rates of recoveries versus other unsecured consumer debt. These features are: (1) the general lack of dischargeability of student loan debt in the event of borrower bankruptcy, which has historically been based on case precedent but codified in the bankruptcy code as of October 17, 2005, and (2) the addition of a co-signer, which provides an alternate payment source and contact during default collection activities.

Table 2a and Table 2b show the percentage of co-signers in various PSL ABS trusts. In many cases, co-signers are parents or grandparents of student borrowers. Often in the underwriting process, if a student borrower cannot meet the minimum credit qualifications for the private loan, which most undergraduate students cannot and many graduate students struggle to, lenders will often require a credit-worthy borrower to co-sign the loan.

**Table 2a: SLM Private Credit Student Loan Trusts**

Trust	All Loans*	Co-Borrower Loans*		Loans w/o Co-Borrowers*	
2002-A	\$690,334,386	\$271,389,060	39.3%	\$418,945,326	60.7%
2003-A	\$1,005,180,179	\$443,122,917	44.1%	\$562,057,262	55.9%
2003-B	\$1,247,280,318	\$623,674,218	50.0%	\$623,606,100	50.0%
2003-C	\$1,249,966,061	\$621,922,042	49.8%	\$628,044,019	50.2%
2004-A	\$1,252,158,292	\$553,297,696	44.2%	\$698,860,596	55.8%
2004-B	\$1,282,574,440	\$649,201,091	50.6%	\$633,373,350	49.4%
2005-A	\$1,505,063,683	\$727,326,393	48.3%	\$777,737,289	51.7%
2005-B	\$1,500,154,963	\$768,109,881	51.2%	\$732,045,082	48.8%
		<b>Average:</b>	<b>47.2%</b>	<b>Average:</b>	<b>52.8%</b>

\* Aggregate outstanding principal balance as of the statistical cut-off date.

Source: Sallie Mae

**Table 2b: National Collegiate Student Loan Trusts**

Trust	All Loans*	Co-Signed Loans*		Non-Co-Signed Loans*	
2004-1	\$503,446,069	\$406,294,601	80.7%	\$97,151,468	19.3%
2004-2	\$808,890,478	\$661,343,448	81.8%	\$147,547,030	18.2%
2005-1	\$549,213,652	\$435,459,395	79.3%	\$113,754,257	20.7%
2005-2	\$305,911,953	\$237,456,376	77.6%	\$68,455,578	22.4%
2005-3	\$979,298,024	\$786,094,854	80.3%	\$193,203,169	19.7%
2006-1	\$513,068,490	\$408,713,792	79.7%	\$104,354,698	20.3%
		<b>Average:</b>	<b>79.9%</b>	<b>Average:</b>	<b>20.1%</b>

\* Outstanding principal balance as of the statistical cut-off date.

Source: First Marblehead

Similar to its analysis of an originator's default history, DBRS requires detailed information on the recovery experience of the ABS issuer's portfolio. DBRS derives a recovery assumption from the issuer's historical experience, which is then used in the DBRS stress and cash flow scenarios. Loss severity assumptions will vary based on the desired tranche rating. More onerous loss assumptions are used for higher-rated tranches. DBRS assumes recoveries will lag defaults by three to six months. Defaults are timed using the allocation described in the Default Loss Timing Curve section.



Some PSL programs have loan-level guarantees from third-party financial institutions. For the purpose of determining recoveries in a PSL ABS transaction backed by guaranteed loans, the financial strength of the guarantor and the rating level of each bond tranche are considered. If the issuer rating of the guarantor is equal to or above the tranche rating, the ABS transaction will receive full credit for the percentage of loan guarantee for the duration of the transaction. If the issuer rating is below the tranche rating, the transaction receives full credit for the guarantee for only a limited amount of time. In the latter circumstance, after the guarantee is deemed to be terminated, recoveries are determined in accordance with the standard DBRS recovery methodology.

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## Other Factors Impacting PSL ABS Cash Flows

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Factors other than defaults and recoveries can impact cash flows to PSL ABS transactions. Some of these factors are generic across ABS asset classes, such as prepayments and basis and interest rate risk. Other factors, such as the lender options for grace periods, deferment, forbearance, and borrower benefit programs are unique to student loans.

The DBRS methodology for evaluating the potential impact these factors may have on PSL ABS transactions is discussed below.

### PREPAYMENTS

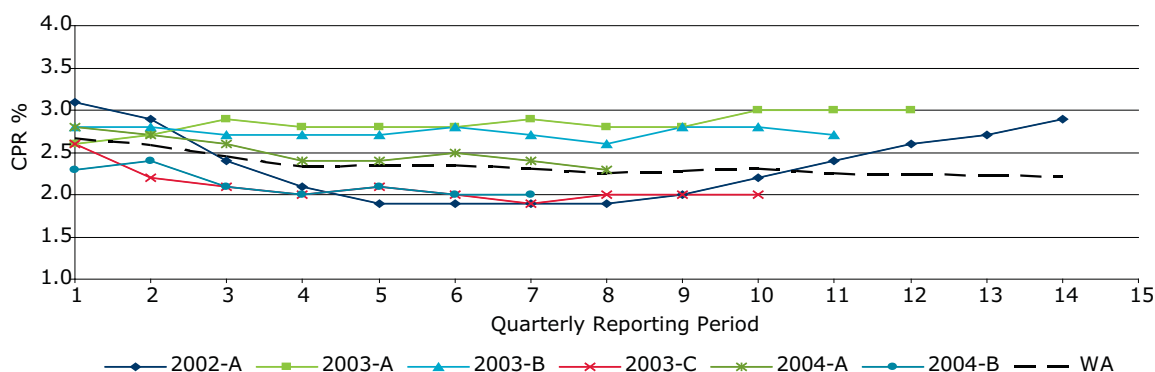
Private loan prepayments typically occur for the following reasons: (1) borrowers accumulate funds and pay off their loans, (2) borrowers refinance their loans at lower rates in falling interest rate environments, (3) third-party loan guarantors pay on claims for defaulted loans, (4) servicers purchase defaulted loans from the trust, (5) other amounts are recovered on defaulted loans, and (6) borrowers consolidate their serial loans. However, not all PSLs are guaranteed or will be repurchased by the servicer in the event of default and some PSL lenders do not offer loan consolidation. Lenders that do offer loan consolidation typically offer only variable-rate consolidation loans. Consequently, there is both limited opportunity and incentive to consolidate loans in the PSL sector.

Historically, prepayment speeds for the major PSL lenders have ranged from 1% to 6%. This range is approximately one-third to one-quarter of the historical Constant Prepayment Rate (CPR) for FFELP Stafford loan pools, but similar to that observed for FFELP Consolidation loan pools. For cash flow assumptions, DBRS uses an issuer-specific prepayment curve based on the pricing speed used to price a particular issuer's transactions. This assumption has typically been a CPR of at least 4.0% over a ten-year horizon. Higher speeds may be used for higher rating categories.

The graph below, Chart 3, illustrates the since-issued CPR for Sallie Mae PSL trusts, which measures the actual prepayment behavior of the Sallie Mae private loan ABS collateral pools.



**Chart 3: SLM Private Credit Trust Since-Issued CPRs\***



\*Constant Prepayment Rate.  
 Source: Sallie Mae

### BASIS RATE/INTEREST RISK

In general, the coupons on PSL ABS collateral are indexed to the Prime rate, LIBOR, or a fixed rate. Typically, the coupons on PSL ABS notes are indexed to LIBOR. To the extent that the underlying coupons on the collateral and ABS notes are indexed to different rates, and/or the timing of the periodic interest rate reset is mismatched, basis risk in the form of index and reset risk, can exist.

To address reset risk stemming from mismatches between the timing of asset/liability cash flows, DBRS uses a base rate forward curve, which is typically three-month LIBOR on the cash flow stress scenarios. If the index for the PSL ABS notes is not three-month LIBOR, DBRS will use the forward curve that best matches the transaction liabilities.

To address index risk (e.g., coupons for assets and liabilities are indexed to different interest rate indices), DBRS stresses the difference between the two indices over the duration of the transaction. The stress scenarios are derived from the historical relationship observed for the indices over a 15 year period. The average basis gap is either widened or compressed at each rating category by standard deviations of the historical average. The standard deviations will span 1.00 at the BBB level to 4.00 at the AAA level.

To the extent that PSL ABS transactions contain fixed-rate collateral with floating-rate liabilities, or vice versa, further interest rate stresses will be applied to address duration mismatches.

### GRACE, DEFERMENT AND FORBEARANCE

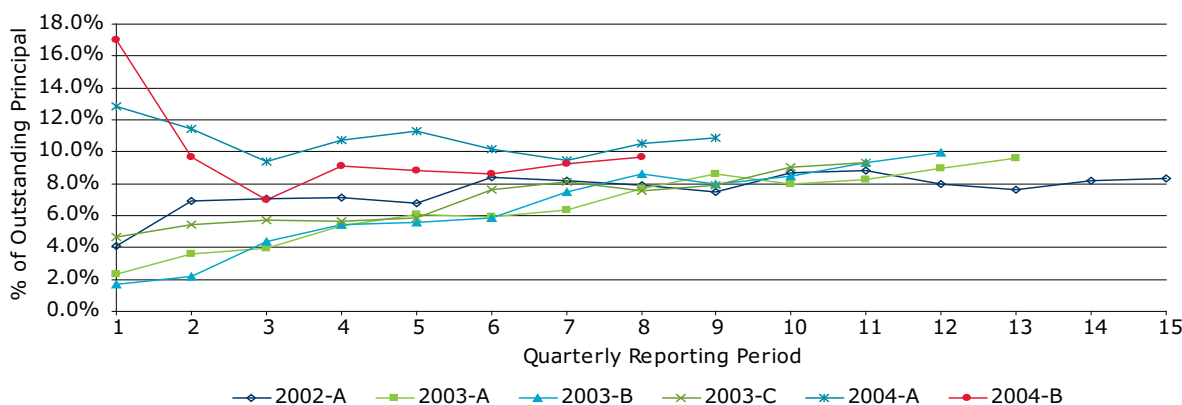
Many private loan lenders will provide PSL borrowers with an in-school grace period, and either deferment or forbearance options, or both. With in-school grace periods, lenders may only require borrowers to make minimum interest payments or lenders may require no payments at all while the student is in school. PSL lenders may also offer deferment and forbearance options or grace periods following graduation. During this time a borrower may be permitted to: (1) make no payment of interest or principal with unpaid interest capitalized, consistent with the in-school period, or (2) make partial payments of interest and/or principal, with unpaid interest capitalized.

Although DBRS views the use of grace periods, deferment, and forbearance periods as beneficial to securitizations because they serve as default aversion tools, their use poses liquidity risk to PSL ABS transactions. This liquidity risk has typically been addressed by requiring adequate amounts for reserve accounts in order to cover interest shortfalls that may occur when borrowers are in grace, deferment, or forbearance (see Reserve Account section).



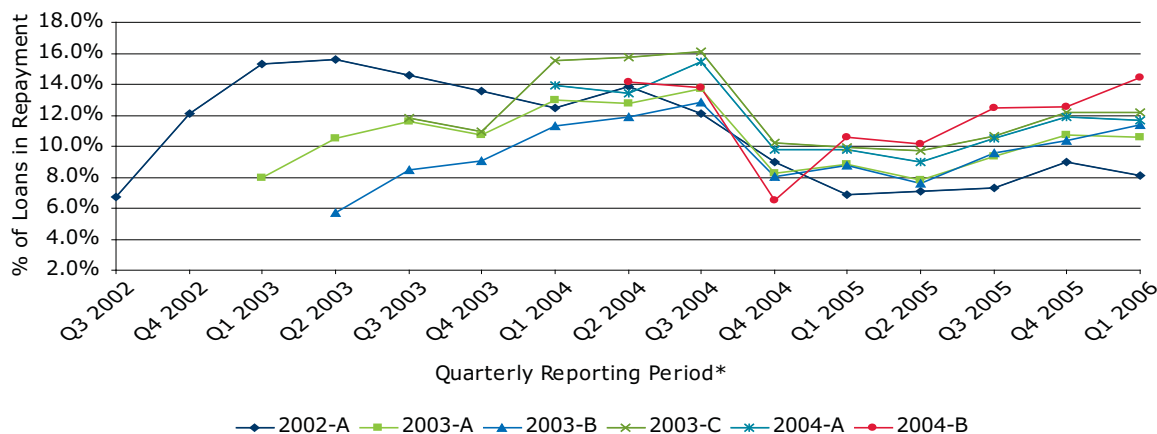
DBRS requires originators to furnish comprehensive data with respect to the terms under which grace periods, deferments, and forbearances can be exercised by the borrower, as well as historical utilization rates. DBRS uses assumptions as to the expected volume of loans that may exercise these options, as well as the length of time that loans will not be generating cash flows or will be generating only partial cash flows. DBRS's assumptions are issuer-specific and are derived principally from historic portfolio data provided by the issuer. These assumptions are stressed at each rating category based on standard deviations from the base case observations. Charts 4 and 5 present loan volume within Sallie Mae Private Credit Student Loan Trusts that have exercised deferment and forbearance options.

**Chart 4: SLM Private Student Loan Trust Deferment**



Source: Sallie Mae

**Chart 5: SLM Private Student Loan Trust Forbearance**



\* Sallie Mae Quarterly Reporting Periods through 2003-12 are February, May, August, and November.  
 Source: Sallie Mae

## BORROWER BENEFITS

Some PSL lenders offer borrower benefits. Common borrower benefits include interest rate reductions for scheduling automatic payments, interest rate reductions for consecutive on-time monthly payments, and principal rebates for program completion or other qualifications. Borrower benefits are not as widely used by PSL lenders as they are by FFELP lenders. Nonetheless, borrower benefits can impact the cash flow of a PSL ABS transaction. Consequently DBRS requests that originators furnish comprehensive information on any borrower benefit programs that they may sponsor, as well as historical utilization rates. Similar to its approach for deferments and forbearance, DBRS develops assumptions with respect to benefit utiliza-



tion rates based on the originator's historical portfolio experience and then will stress these assumptions based on the desired rating for a tranche.

## DELINQUENCIES

DBRS will look primarily to a lender's historical delinquency experience when developing delinquency assumptions. DBRS uses delinquency assumptions for three delinquency buckets – current, 30-days delinquent, and 60-days delinquent. For each rating category, delinquency rates are stressed using base case observations plus standard deviations from the base case observations.

Further, in order to qualify for borrower benefits, borrowers are often required to have histories of no payment delinquencies. When a PSL program includes borrower benefits that are granted based on a borrower's lack of delinquency status, DBRS delinquency assumptions, to be conservative, assume that more borrowers are current and less borrowers are delinquent. This results in more borrowers qualifying for the borrower benefit, which will reduce the PSL ABS transaction cash flows. The DBRS standard delinquency assumptions are presented in Table 3.

**Table 3: Standard Delinquency Assumptions**

***No Borrower Benefits (or paid outside of the trust)***

**Non-Co-signed Loans**

Rating Category	Current	30-days Delinquent	60-days Delinquent
AAA	20%	35%	45%
AA	30%	30%	40%
A	40%	25%	35%
BBB	55%	20%	25%
BB	60%	20%	20%

**Co-signed Loans**

Rating Category	Current	30-days Delinquent	60-days Delinquent
AAA	35%	35%	30%
AA	45%	30%	25%
A	55%	25%	20%
BBB	65%	20%	15%
BB	70%	20%	10%

***Borrower Benefits (paid inside of the trust)***

**Non-Co-signed Loans**

Rating Category	Current	30-days Delinquent	60-days Delinquent
AAA	60%	20%	20%
AA	55%	20%	25%
A	40%	25%	35%
BBB	30%	30%	40%
BB	20%	35%	45%

**Co-signed Loans**

Rating Category	Current	30-days Delinquent	60-days Delinquent
AAA	70%	20%	10%
AA	65%	20%	15%
A	55%	25%	20%
BBB	45%	30%	25%
BB	35%	35%	30%



Finally, delinquency statistics for student loan programs that offer deferment and forbearance may understate the amount of non-cash flowing loans in a pool. Lenders and servicers often steer delinquent borrowers into deferment or forbearance statuses to avoid traditional delinquency classification and therefore borrowers in those statuses are generally not included in the delinquency roll data. Therefore, when formulating liquidity stress assumptions, and specifically delinquency rates, DBRS considers the number of borrowers in deferment and forbearance statuses to properly analyze the loan pool. Standard assumptions may, therefore, be adjusted on a deal-by-deal basis depending on the type and quality of the data provided by the issuer.

Lastly, delinquent borrowers are often charged late fees. However, most often, DBRS provides credit for no more than 50 percent of late fees expected to be collected in its cash flow scenarios. The inclusion of late fees in the DBRS cash flow analysis is determined on an issuer-by-issuer basis and is impacted by whether any late fees are charged by the lender, as well as what discretion the servicer may have with respect to waiving late fees. Ideally, the data provided by the issuer will determine what amount of late fees, if any, may be included in the DBRS cash flow scenarios.

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## Conclusion

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The private student loan market is expanding rapidly. As the financing of PSL loan volume within the ABS market continues to grow, the funding or financing of these loans becomes more efficient and commoditized. DBRS has developed a comprehensive PSL ratings methodology to better serve both investors and issuers that participate in the PSL ABS sector. This methodology considers the most important characteristics of private loan products, the unique risks inherent in them, and the most common structural elements of ABS financing. The analytical approach is logical, accurate, and consistent while remaining flexible and transparent. DBRS will continue to study the private student loan sector and make adjustments and upgrades to the rating criteria as necessary.

For a summary of key DBRS rating criteria applied to PSL, see Appendix A.



## Appendix A

The table below summarizes key assumptions utilized in the DBRS ratings approach to Private Student Loan ABS transactions. Scenario 1 assumptions address the absolute level of transaction cash flows from a fundamental perspective. These factors influence the likelihood that principal and interest payments will be made on the PSL ABS notes. Scenario 2 assumptions address extension risk.

### Summary of Cash Flow Assumptions

#### Scenario 1

Transaction Characteristic	Rationale	Stress
Cumulative Gross Collateral Default Rates	Increase levels of defaults to reduce collateral cash flow; reduce parity; increase prepayments on insured loans	Apply standard deviations to base cases derived from historical loan data, range from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Default Timing	Front-load frequency to reduce collateral yield and increase prepayments on insured loans	Compress timing to 20/25/35/15/10, spread evenly within each year
Cumulative Net Recovery Rates	Reduce collateral balance	Apply standard deviations to base cases derived from historical data
Recovery Timing	Limit liquidity support and parity	Shorten timing curve (20/25/35/15/10)
Prepayment Rates	Reduce parity; increase extension risk	Run pricing CPR in unexceptional circumstances
Collateral Delinquency Rates	Reduce collateral yield	For loans with payment-dependent benefits, apply lower standard deviations to base cases derived from historical loan data; for loans without payment-dependant benefits, apply higher standard deviations to base cases
Deferment and Forbearance Utilization Rates	Reduce collateral yield	Apply standard deviations (lower than in Scenario 2) to base cases derived from historical loan data, range from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Borrower Benefits Utilization Rates	Reduce collateral yield/balances	Apply standard deviations (higher than in Scenario 2) to base cases derived from historical loan data, ranging from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Servicing Fees	Reduce portfolio yield	Increase at historical CPI
Interest Rates	Increase cost of funds; increase basis risk	Apply base rate ramp; increase basis gap by standard deviations from base cases of historical spread relationships

#### Scenario 2†

Transaction Characteristic	Rationale	Stress
Prepayment Rates	Maintain parity; extend WAL	Run reduced CPR
Collateral Delinquency Rates	Match base case expected delinquency experience	Apply standard deviations (lower than in Scenario 1) to base cases



Deferment and Forbearance Utilization Rates	Extend loan terms; increase loan balances through interest capitalization	Apply standard deviations (higher than in Scenario 1) to base cases, ranging from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Borrower Benefits Utilization Rates	Match base case expected utilization	Apply standard deviations (lower than in Scenario 1) to base cases, ranging from 1.5-2.0 at BBB to 3.0-4.0 at AAA
Interest Rates	Increase cost of funds; increase basis risk	Apply base rate ramp; increase basis gaps by standard deviations from base cases of historical spread relationships

† No collateral defaults occur in Scenario 2; servicer fee increases and interest rate stresses are the same as in Scenario 1.

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