Methodology

Rating U.S. Structured Settlements
Asset-Backed Securitizations

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Scope and Limitations

This methodology represents the current DBRS approach for rating structured settlement securitizations issued in the United States. It describes the DBRS approach to analysis, which includes: (i) a focus on the quality of the sponsor/servicer; (ii) evaluation of the collateral pool and (iii) utilization of historically employed credit evaluation techniques. This report also outlines the asset class and discusses the methods DBRS typically employs when assessing a transaction and assigning a rating. It is important to note that the methods described herein may not be applicable in all cases. Further, this methodology is meant to provide guidance regarding the DBRS rating methods used in the sector and should not be interpreted as prescribing a rigid template applicable in all circumstances, but understood in the context of the dynamic environment in which it is intended to be applied.

Executive Summary

This report updates the DBRS methodology for rating structured settlement transactions, which may differ based on proposed transaction structure and issuer, but generally are subject to a review and analysis of the following key analytical considerations:

- Quality of originations, underwriting practices and portfolio management;
- Quality of servicing capabilities;
- Collateral quality analysis, including creditworthiness of the insurance carriers backing collateral pool;
- Capital structure, target ratings and credit enhancement;
- Cash flow scenario analysis; and
- Legal structure and opinions.

Overview

A structured settlement is usually created when a claimant in a legal action receives a judgment or settlement, often for a personal injury claim, which is then divided into a long-term stream of fixed payments. In a typical structured settlement, which is evidenced by an agreement between the claimant, the defendant and the defendant’s insurer, the claimant agrees to accept a series of fixed payments instead of a one-time fixed payment. Occasionally, personal circumstances may compel the claimant to sell/assign the whole or portions of the payment stream to a specialty finance company in order to receive a lump sum payment.

Issuers, most often specialty finance companies, have packaged such structured settlements into asset-backed security (ABS) transactions since 1998. Since then, federal, state and tax regulations have facilitated the financing of these assets in the securitization market. The current aggregate market volume of structured settlements is approximately $[140] billion with approximately $5 to $6 billion in new structured settlements being originated per year. Purchasers of structured settlements estimate that less than 10% of the total outstanding structured settlements has been sold in the secondary market. More than $[5.0] billion of structured settlements has been securitized into the public and Rule 144A markets, totaling more than [40] transactions.
The entities that have issued structured settlement securitizations include:
• JGWPT Holdings, Inc./JG Wentworth Company/Peachtree Settlement Funding;
• Novation Ventures/Novation Capital;
• SuttonPark Capital;
• SenecaOne Finance, Inc.; and
• Structured Asset Funding.

HISTORY
Until the early 1970s, successful plaintiffs, either in private settlements or pursuant to court order in personal injury suits, typically received a lump sum payment for their injuries. Beginning in the 1970s, favorable tax rulings allowed claimants to receive periodic payments, including implicit investment earnings on the settlement amount, tax free as an alternative to lump sum payments, whose investment earnings are taxable. In addition, Congress codified these rulings in the 1982 Periodic Payment Settlement Act and extended tax benefits to the insurance entities involved in funding settlement payments. The increasing size of jury awards in personal injury litigation provided another impetus to the growth of structured settlements. As a result of these factors, the structuring of litigation settlements has evolved into an established industry.

STRUCTURED SETTLEMENT DESCRIPTION
One of the more popular options for settling a claim is the structured settlement, an agreed-upon arrangement whereby an insurer (or defendant) makes payments to the injured party (claimant) over a number of periods as a substitute for a lump sum. Structured settlements can vary in their financial terms regarding the amounts paid, structure and timing as payments may be made monthly, annually or less frequently. Once settled, the timing and size of the periodic payments under the structured settlement cannot typically be modified.

Under the terms of the agreement between the claimant, the defendant and the defendant’s insurer, either the defendant or its insurer is obligated to pay a number of future payments to the claimant. This stream of future payments is intended to satisfy the injuries and damages encountered by the claimant. While the insurer may choose to make the stream of payments directly, in many situations, it elects to remove the obligations from its balance sheet. In this case, the payment liability is assigned to an assignee which is often another insurance company or an affiliate of the insurer that focuses on this type of specialized transaction. The assignee takes on the payment obligations after receiving an upfront payment from the original insurer. This arrangement lets the insurer and the claimant gain access to certain tax benefits associated with structured settlements (Section 130 of the Internal Revenue Code (IRC) of 1986). In order to facilitate and better document the making of the future payments, the assignee, insurer or, as the case may be, the defendant typically purchases an annuity contract from a life insurance company; under the annuity, the paying party (assignee, insurer or defendant) is often referred to as the owner, with the claimant as the beneficiary of the payment stream. In this analysis, the term “settlement provider” is used to describe the payor, irrespective of whether an annuity is purchased.

STRUCTURED SETTLEMENT ORIGINATION
A description of the manner in which a typical structured settlement is established by the purchase of an annuity is as follows:
• Claimant suffers a personal injury as a result of a defendant’s negligence;
• Claimant sues defendant;
• Settlement is reached among claimant, defendant and defendant’s insurer which calls for the claimant to receive periodic payments over time;
• If not being paid directly, the defendant/insurer obtains an annuity from a related or unrelated annuity issuer. The claimant is named as beneficiary of payments due under the annuity; and
• The settlement provider (or, as the case may be, the defendant/insurer), makes payments to the claimant over the defined period.
STRUCTURED SETTLEMENT SALES
Claimants who are already receiving periodic payments under a structured settlement have several options available to them over time. Claimants can:
• Continue to receive the defined, periodic payments until the end of the contract (often with the estate continuing to collect in the event of death);
• Sell a portion of the periodic payment stream to gain access to some amount of immediate cash while retaining the rights to the remainder of the payment stream (e.g., sale of the first three years’ worth of payments but retention of the final 17 years of a structured settlement with a 20-year term);
• Sell a percentage portion of each of the future payments to gain access to some level of immediate cash while retaining the periodic nature of the remaining payment stream (e.g., sale of 25% of each payment, but retention of 75% of each payment over a 20-year term); or
• Sell the entire payment stream, gaining the largest amount of immediate funds while forgoing any future cash flow.

Recipients of the payment streams may have one or more reasons to sell a portion of the future receipts. In most instances, the sale provides access to immediate cash that may be needed for a particular expense (e.g., repayment of debt, housing, medical bills, education, transportation, change in marital status, etc.).

There has been a growing market for transacting in structured settlements, with the seller opting among the second, third and fourth bullet points above. In these cases, the relevant payments (or portions thereof) are assigned (or reassigned) to the buyer; in return, the buyer makes a lump sum payment, taking into account a variety of factors including current interest rates, fees, creditworthiness of the settlement provider. Typically, specialty finance companies are the buyers of structured settlements (Settlement Buyers). Some of the more active Settlement Buyers are listed above.

STRUCTURED SETTLEMENT PURCHASE PROCESS
Generally, the process for a Settlement Buyer to purchase a structured settlement is as follows:
• The claimant makes the decision to sell his/her structured settlement, or a portion thereof;
• The Settlement Buyer inquiries into the current financial and life circumstances of the claimant to formulate a transaction (mechanics and funding amount) that meets the seller’s specific need and to evaluate whether such a transaction may be acceptable in a court proceeding;
• An offer to purchase a designated portion of the future payments from the claimant is made by the Settlement Buyer;
• The offer is accepted by the claimant;
• Purchase agreement is executed and due diligence is conducted by the Settlement Buyer;
• A petition is filed in court, pursuant to applicable state law, seeking court approval of the transfer. In
determining whether or not to grant such approval, among other things, the judge decides whether the sale is in the best interest of the claimant, that the terms of the sale (particularly price) are reasonable and that the transfer does not contravene any other order or statute; and

• Once court approval is granted, the sale is consummated with the lump sum being paid to the claimant.

Typical Settlement Buyer Timeline

<table>
<thead>
<tr>
<th>Underwriting and documentation</th>
<th>Court approval</th>
<th>Funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1: Claimant contacts Company seeking lump sum payment in exchange for payment stream.</td>
<td>Day 10-30: Company analyzes the structured settlement contract; makes offer to purchase all or portion of remaining payments. Documentation to consumer, attorney recommended.</td>
<td>Day 70-80: Court approves or denies motion to assign rights to structured settlement.</td>
</tr>
</tbody>
</table>

Structural and Legal Matters

As discussed above, one of the key legal risks with structured settlements, historically, has been the state’s degree of willingness to recognize the sale of the annuity; however, recent legislation has mitigated the issue in most states. Those states that do not have such legislation are less likely to be included in a transaction. Other legal issues that pertain to the claimants’ rights which are typically reviewed by Settlement Buyers at time of purchase include: bankruptcy of claimant, ability of claimant to assign rights (e.g., for minors), spousal approval, double assignment, existing liens, etc; however, origination policies and procedures usually address these specific situations. DBRS typically reviews the transaction structure as well as the standard legal opinions provided in a securitization for consistency with the DBRS Legal Criteria for U.S. Structured Finance.

LEGAL, REGULATORY AND TAX DEVELOPMENTS

Over the past ten years, further clarity has evolved with respect to the handling of structured settlements, particularly as it relates to the ability to sell/assign them as well as certain tax benefits. Initially, a key issue related to anti-assignment provisions within annuity contracts existed which caused some discomfort with the assignment process and made such assignments less certain. Challenges against the sale/assignment were a possibility and presented a risk which was more difficult to quantify. In addition, with respect to taxation, any assignments could have resulted in a 40% excise tax to the buyer.
Since 2000, several governmental actions have been instituted in order to ease these challenges. Firstly, in 2000 industry participants and regulators agreed upon language designed to protect consumers when selling structured settlements. The language is known as the Model State Structured Settlement Protection Act (Model Language) and has been used, to varying degrees, by states in creating statutes related to structured settlements transactions. It covers disclosure rules, the need for court order prior to effective assignment, procedural aspects, etc. With respect to the court order, there is a view that the court approval supersedes any anti-assignment language within an annuity contract. Though this concept has been challenged in some cases (e.g., a JG Wentworth Henderson case in California), ultimately, the transactions have generally been upheld and the assignments confirmed via appeal and otherwise.1

Secondly, in 2002, IRC Section 5819 – Treatment of Certain Structured Settlement Payments – was signed into federal law. With the passing of this legislation, an exception was created whereby any excise tax is not due if a qualified court order from a state court authorizes the sale as noted above.

Forty-eight states have adopted laws that are based on the Model Language (in some cases, using it verbatim), thereby making it possible for a sale or assignment to be executed with greater certainty. In two states, the handling remains unclear as New Hampshire and Wisconsin have not adopted any statues. Within these two states, citizens may be transfer their settlement payment rights under the law of the state where the insurance company is based. Structured settlements originated from these states, however, are typically not included in securitizations or are minimized to account for less than 1% of the transaction with such exposures considered when evaluating proposed credit enhancement.

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Operational Risk Review

ORIGINATOR REVIEW

The originator review process evaluates the quality of the parties that originate the structured settlements that are about to be securitized in a transaction rated by DBRS. While DBRS does not assign formal ratings to these processes, it typically conducts operational risk reviews to assess if an originator is acceptable and incorporates the results of the review into the rating process.

DBRS typically begins the initial originator review process by sending a questionnaire to the company that outlines the topics to be covered during the discussion with management and includes a list of documents to be provided such as organizational charts, financial statements and underwriting guidelines. In instances where DBRS determines that the originator is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support or a third-party firm to provide the requisite representations and warranties so that DBRS can rate the transaction. In the event that DBRS determines that an originator is unacceptable, it may refuse to rate the deal.

The originator review process typically involves a review and analysis of the following:
(1) Company and management
(2) Financial condition
(3) Controls and compliance
(4) Origination and sourcing
(5) Underwriting guidelines
(6) Technology

For details on the originator review process, please refer to the DBRS methodology Operational Risk Assessment for U.S. ABS Originators.

1. On August 26, 2013, the Appellate Court of Illinois, Fourth District invalidated a structured settlement transfer because of anti-assignment language in the settlement documentation in Settlement Funding, LLC v. Cathy Brenston.
SERVICER REVIEW
The servicer review process evaluates the quality of the parties that service or may conduct backup servicing on the structured settlements that are about to be securitized in a transaction rated by DBRS. While DBRS does not assign formal ratings to these processes, it typically conducts operational risk reviews to assess if a servicer is acceptable and incorporates the results of the review into the rating process.

DBRS typically begins the initial servicer review process by sending a questionnaire to the company that outlines the topics to be covered during the discussion with management and includes a list of documents to be provided such as organizational charts, financial statements and performance statistics. In instances where DBRS determines that the servicer is below average, issuers may incorporate certain structural enhancements into a proposed transaction such as additional credit support, dynamic triggers or the presence of a warm or hot backup servicer so that DBRS can rate the transaction.

The servicer review process typically involves an analysis of the following:
(1) Company and management
(2) Financial condition
(3) Controls and compliance
(4) Portfolio administration
(5) Customer service
(6) Account maintenance
(7) Default management
  • Collections
  • Loss mitigation
  • Bankruptcy
  • Fraud
(8) Investor reporting
(9) Technology

For details on the servicing review process, please refer to the DBRS methodology Operational Risk Assessment for U.S. ABS Servicers.

Evaluating Credit Enhancement

TYPES OF CREDIT ENHANCEMENT
Credit enhancement can typically be classified as hard, which are enhancements directly available to support the securitization obligations, or soft, which are enhancements that support the securitization obligations, if and when they are available. Typical forms of credit enhancement in structured settlement securitizations include a cash reserve account, overcollateralization (OC) and subordination. While a transaction could be structured by an issuer to create excess spread, that is not typical for this sector. In the event that a transaction was structured by an issuer to include excess spread, DBRS would typically assess the potential benefit provided as credit enhancement.

Cash Reserve Accounts
Cash reserve account is a form of hard credit enhancement that is typically available to pay interest and sometimes principal on the securitization obligations. Reserve accounts usually are included in most structured settlement securitizations as set dollar amounts and are generally funded at the outset of a transaction. Reserved amounts provide additional liquidity to a transaction and may be used to allow it to successfully perform under stressful scenarios or under periods of non-level cash flows from the structured settlement portfolio. Typically three to six months of interest and fees or at least 1% of the aggregate portfolio balance are made available within a dedicated cash account for liquidity purposes.
Overcollateralization
OC is a form of hard credit enhancement which normally acts as an unrated first loss piece, absorbing obligor default shocks before any payment shortfalls to securitization investors are realized. OC is typically achieved by issuing ABS obligations in an amount less than the value of the balance of the collateral securing those obligations.

Subordination
Subordination is a form of hard credit enhancement that usually creates an additional cushion for losses in the collateral portfolio for more senior ABS tranches. Subordination is typically created by issuing a junior class of notes that is subordinate in right to a senior class with respect to amounts available for payment of ABS. The junior classes are generally available to absorb losses and, therefore, act as additional OC for more senior classes. DBRS typically analyzes any mechanisms within a transaction that modify the availability of these junior classes to act as credit enhancement for senior classes. In particular, the impact of the priority of payments (i.e., (A) interest/principal/interest/principal versus (B) interest/interest/principal/principal versus (C) the structures which allow for pro rata principal distributions between the senior and subordinated tranches until the occurrence of a trigger event) is analyzed to assess the effectiveness of subordination in providing additional protection.

Evaluating Structured Settlement Securitizations

Collateral Credit Quality and Historical Performance
Once a structured settlement company has a well-developed, diversified portfolio (Pool), it often considers a structured settlement securitization transaction. While characteristics may differ somewhat by transaction, the pools generally include certain definable characteristics which aid in the performance of risk analysis.

Structured Settlement Pool
For any new transaction, DBRS normally reviews characteristics of the proposed Pool. Typically, except as described below, transactions are reviewed assuming a static Pool, so the composition of the Pool’s obligors does not change except because of repayments. This inventory represents an important item typically reviewed as part of the DBRS ratings analysis. Transactions backed by a revolving Pool are discussed below in the Revolving Versus Static Pools section.

Among other things, DBRS typically expects the following information to be provided:
• Origination date and sales date;
• Legal jurisdiction for origination and sales;
• Original and current notional balance;
• Whether or not a court order was obtained;
• Payment frequency (including any irregularities);
• Payment amounts;
• Lump sum paid for settlement stream;
• Whether settlement is a partial or full assignment;
• Settlement provider; and
• Claims paying ability rating of settlement providers.

Revolving versus Static Pools
While most transactions are structured on a static basis with some providing a defined prefunding period typically not exceeding three or four months, there may be situations where the composition of a Pool changes over time, as is the case with asset-backed warehouse facilities. In these revolving structures, eligibility criteria, concentration limits and the dynamic nature of credit enhancement become more impor-
tant. Pool migration within the proposed concentration limits is typically evaluated during the revolving period. In general, revolving periods are limited to periods permitted by the warehouse provider, but may also be limited based on the availability of data with additional credit enhancement potentially necessary to address negative trends in the Pool’s credit characteristics. DBRS also usually reviews any concentration limit that permits assets with contingencies (e.g., life contingent).

**Collateral Performance**

DBRS typically reviews data received showing loss, delinquency, error, collection, court order success and other performance metrics. The purpose of this analysis is to assess the quality of the origination process and to help evaluate a Pool’s expected default and loss severity. DBRS usually reviews at least three years of data, taking into account the number of years in business and expertise of management with structured settlements, among other things. DBRS also typically focuses on a number of important areas including the following:

Loss management: Past performance with respect to frequency and magnitude of loss is an important component for defining quality and future potential for credit losses within a Pool. Also, it is indicative of the origination and servicing quality of the Settlement Buyer. Typically, historical losses are non-existent to very low (under 0.25%) because of the quality of the asset class, the payers and related legal processes and structures. While it is important to note the levels of loss incurred in the past, this record is not usually the primary driver in assessing proposed credit enhancement levels. Normally, proposed credit enhancement levels are primarily based on the Pool's exposure to the insurance industry which is discussed below in the Quantitative Credit Analysis section.

Non-Payment Issues: It is important to review the originator’s record with respect to non-payment or delay issues. Again, this type of information is indicative of origination and servicing quality. These types of issues are generally limited and, to the extent that issues arise, the Settlement Buyer can typically explain how such issues were discovered and resolved. Such issues may include administrative errors, cash diversion, disputes, etc.

Collection timing: Using the settlement companies’ history (in the case of a term issuance), expected collection curves are usually analyzed by DBRS to assist in evaluating expected transaction performance which may be particularly important in assessing tail risks. In addition, cash flow timing is typically evaluated to determine the expected payment timing of the structure’s liabilities and to assess the sufficiency of cash reserves in the structure.

Court Order Record: DBRS also typically reviews an originator’s record with respect to gaining court approval on its purchases. While this performance may differ among originators because of business focus, it is generally consistent with additional information provided regarding denials and how they may have been resolved.

Volumes: The Settlement Buyer generally provide statistics related to deal flow, originations and assets under management. DBRS typically reviews these statistics to assess the viability and efficiency of the origination process as well as the adequacy and capacity of the servicing organization.

**Eligibility**

DBRS typically reviews the representations and warranties from the originator (Settlement Buyer) which usually states that each structured settlement is an eligible receivable as defined in the transaction and trust legal documents. Typically, eligibility also requires that a court order approving the sale of the structured settlement will be obtained and that payment by the insurance company/annuity provider will be made to an account accessible by the transaction.

**Geographic Concentrations**

The Pool is usually reviewed to assess the level of concentration risk in any given state. As legislation
and political climate can change in the future, significant exposure within a particular state is generally reviewed and additional credit enhancement may be needed to address excess concentrations. For Pools with state concentrations in excess of 15%, DBRS may use a higher industry correlation coefficient as discussed in the CLO Asset Model analysis section.

**Settlement Provider Concentrations**
The Pool is typically reviewed to evaluate the concentrations among the Settlement Providers. The concentrations and how the related credit ratings compare with the rated debt are taken into account as part of the Quantitative Credit Analysis section below.

**CREDITWORTHINESS OF INSURANCE CARRIERS BACKING THE COLLATERAL POOL**
A risk inherent to structured settlement transactions is default and/or insolvency by the insurance carriers backing the Pool. Structured settlement transactions have significant exposure to the insurance industry and often have concentrated exposure amongst specific obligors in the insurance industry. In addition, two other factors typically increase a structured settlement transaction’s exposure to the insurance industry: (1) as a result of the long nature of structured settlements cash flows that may exceed 40 years, structured settlement transactions have long maturities; and (2) structured settlement transactions have little excess spread, so they do not de-leverage quickly like some ABS structures. As a result of these factors, structured settlement transactions normally have significant exposure to event risk in the insurance industry. In general, there are a number of factors that provide comfort regarding the ability of a structured settlement provider to make payments.

Structured Settlement Providers: Settlement providers are usually large, highly rated insurance companies with large insurance portfolios. Generally speaking, the rate of default on these organizations is low (under 0.25%). A list of the key players in the market is included in Appendix II.

Insurance Claims Paying Ability: For insurance subsidiaries, the payments made on structured settlements are at the claims paying ability level. The claims paying ability normally measures the capacity of an insurance company to pay its policyholder claims as they fall due. The claims paying ability is generally higher than the long-term senior unsecured credit rating for an insurance company since claims are paid ahead of all debt. Accordingly, amounts due are usually more likely to be paid than unsecured obligations of the same entity.

Other Factors: Upon default of an insurance carrier, other mitigating factors may come into play such as state insurance funds and the likelihood that a failing carrier be succeeded by another. While these qualitative factors exist, they are not typically considered as credit enhancement in quantitative analysis for defaults but may be considered when determining potential recoveries following a default.

**Quantitative Credit Analysis**
DBRS typically performs a quantitative credit analysis on the carriers backing the Pool using three methods: the Carrier Rating Analysis, the Largest Obligor Analysis and the CLO Asset Model analysis. The first analysis generates the weighted-average (WA) rating of the carriers backing the Pool, while the other two analyses estimate Pool losses at certain statistical confidence intervals. Before starting these three analyses, DBRS usually calculates the implied principal balance for each carrier by discounting the scheduled payments from that carrier at the transaction discount rate. DBRS also usually discounts the scheduled Pool payments for the entire transaction at the transaction discount rate, generating a discounted Pool balance (Discounted Pool).

Carrier Rating Analysis: DBRS typically calculates the WA credit rating of the overall Pool using two different methods. The first method is based on the credit ratings of each carrier exposure in the Pool while the second method is based on the default probabilities (implied by the credit rating) of each carrier exposure in the Pool.
The first method is normally generated by (1) assigning numerical values (Credit Score) for each ratings level (i.e., 1 for AAA, 2 for AA (high), 3 for AA and so on) and applying these values to each carrier backing the Pool and then (2) calculating the WA rating value of the Pool based on the exposure of the Pool to each carrier. It is not expected that such WA credit rating will be equal to or in excess of the rating on the transaction, but it serves as a guideline for assessing Pool-wide creditworthiness.

In cases where DBRS does not maintain a public rating of a specific third-party institution, DBRS may rely on public ratings assigned and monitored by other credit rating agencies. For individual settlement providers that are affiliates, DBRS may aggregate the exposures when completing the analysis described in this section.

The second method is typically generated by assigning default probabilities for each credit rating level which are derived from DBRS Idealized Default Table which is included in Appendix III. The default probabilities are then used as DBRS Risk Scores (Risk Scores) for each credit rating. Table 1 provides a typical example below. Credit ratings are in the first column while their corresponding Credit Scores, which are used in the first method detailed above, are in the second column. The third column contains Risk Scores for a given credit rating over a ten-year period. For example, the AAA carrier has a 0.34% probability of defaulting over a ten-year horizon.

<table>
<thead>
<tr>
<th>Credit Rating</th>
<th>Credit Score</th>
<th>DBRS Risk Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>1.00</td>
<td>0.34%</td>
</tr>
<tr>
<td>AA</td>
<td>3.00</td>
<td>0.77%</td>
</tr>
<tr>
<td>A</td>
<td>6.00</td>
<td>1.92%</td>
</tr>
<tr>
<td>BBB</td>
<td>9.00</td>
<td>5.49%</td>
</tr>
<tr>
<td>BB</td>
<td>12.00</td>
<td>16.18%</td>
</tr>
<tr>
<td>B</td>
<td>15.00</td>
<td>34.20%</td>
</tr>
<tr>
<td>CCC</td>
<td>18.00</td>
<td>63.89%</td>
</tr>
</tbody>
</table>

DBRS then typically calculates the WA Risk Score of the Pool based on the exposure of the Pool to each carrier. Table 2 provides a typical example for both methods in the WA Carrier Rating Example below. In the example, there are three equally sized carrier exposures that are rated AA, “A” and BBB. In the first method, the corresponding Credit Scores are 3, 6 and 9, respectively, while in the second method the corresponding Default Scores are 0.77%, 1.92% and 5.49%, respectively. The WA Credit Score is 6.00 while the WA Risk Score is 2.73. In the example, on average, 2.73% of the carriers backing the Pool are expected to default.

<table>
<thead>
<tr>
<th>Annuity Provider</th>
<th>Discounted Balance</th>
<th>% Discounted Balance</th>
<th>Internal Rating</th>
<th>Method 1 Credit Score</th>
<th>Method 2 DBRS Risk Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Co. A</td>
<td>10,000,000</td>
<td>33.3%</td>
<td>AA</td>
<td>3</td>
<td>0.77%</td>
</tr>
<tr>
<td>Insurance Co. B</td>
<td>10,000,000</td>
<td>33.3%</td>
<td>A</td>
<td>6</td>
<td>1.92%</td>
</tr>
<tr>
<td>Insurance Co. C</td>
<td>10,000,000</td>
<td>33.3%</td>
<td>BBB</td>
<td>9</td>
<td>5.49%</td>
</tr>
<tr>
<td>Total/Wtd Average</td>
<td>30,000,000</td>
<td>100.0%</td>
<td></td>
<td>6.00</td>
<td>2.73%</td>
</tr>
</tbody>
</table>
Note that Credit Scores increase at a constant rate as credit ratings decrease: the Credit Score increases by 3.0 for each credit level below AAA. This property differs from Risk Scores in that default probabilities rise at an increasing rate for each lower credit rating. Both the Risk Score and the Credit Score are graphed below by credit rating from the Credit and Risk Score Table to illustrate this point (Table 3). In the example, rescaling has been performed on the Risk Scores to put them on a similar scale with the Credit Scores by dividing each Risk Score by the AAA default probability, 0.34%. The graph highlights a key observation: Risk Scores grow at an increasing rate as credit ratings decrease. As noted in the WA Carrier Rating Example, the WA Credit Score of two equally sized AA (3) and BBB (9) carrier is A (6) while the WA Risk Score of these two carriers, 2.73%, exceeds the Risk Score of an “A” carrier. Consequently, carriers with lower credit ratings typically have a disproportionate impact on the overall Pool Risk Score.

Default Probability by Credit Rating

Largest Obligor Analysis: This analysis focuses on potential losses to the Pool from exposures to large carriers backing the Pool and overall event risk in the insurance industry. The Largest Obligor Analysis typically defaults three to five carriers, depending on the requested rating level, and then applies recoveries in the 50% to 70% range. This calculation provides a Pool loss estimate. DBRS usually selects the largest three to five carriers’ exposures based on discounted future payments, with ratings lower than the anticipated rating. This analysis is normally performed for each rated tranche of the transaction.

The carrier exposures are also usually recalculated at several points in the future to analyze the potential impact of changes in carrier exposures over time (e.g., typically at the beginning of years five, ten and 20 of the transaction). The analysis is performed using the same mechanics as applied in the initial calculation above, resulting in estimated Pool losses at different points in time. The estimated Pool loss results (through time) are then typically applied to the transaction structure as described in the Cash Flow Analysis section.

Table 4 provides a hypothetical pool of Settlement Providers in a Pool to illustrate the typical Largest Obligor Analysis for evaluating proposed credit enhancement for a transaction. Anticipating a AAA rating for a tranche, DBRS usually analyzes the five largest carrier concentrations in the Pool with ratings below the AAA level. As discussed above, a AAA rating corresponds to a numerical rating of one, so the largest five carriers with ratings higher than one are selected. The ratings for the largest five obligors in Table 4 range from 4 to 6, corresponding to AA (low) to “A,” respectively. In the example, the simulated default of this group generates an expected default of 41.72%; assuming a 65.00% default recovery, the expected loss on the Pool is 14.60%. Typically, in application, if proposed credit enhancement equals or exceeds this value, the AAA stress for the Largest Obligor Test is met.
Obligor Table

<table>
<thead>
<tr>
<th>Annuity Provider</th>
<th>Discounted Balance</th>
<th>% Discounted Balance</th>
<th>Rating Agency #1</th>
<th>Rating Agency #2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance Co. A</td>
<td>12,505,005</td>
<td>10.52</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>Insurance Co. B</td>
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<td>8.34</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Insurance Co. C</td>
<td>9,662,706</td>
<td>8.13</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Insurance Co. D</td>
<td>8,778,008</td>
<td>7.39</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Insurance Co. E</td>
<td>8,728,446</td>
<td>7.34</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>49,590,734</strong></td>
<td><strong>41.72</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

CLO Asset Model Analysis: The third analysis focuses on the default and loss risk from the overall carrier exposures backing the Pool and estimates losses to the Pool at different statistical confidence intervals that correspond to a given rating level. In this analysis, DBRS normally utilizes its proprietary model, the DBRS CLO Asset Model, to estimate Pool losses. The DBRS CLO Asset Model uses several key inputs including notional exposure, default probability which is derived from the carrier rating, expected recoveries for each carrier and correlation assumptions among the carriers. Notional exposures are calculated from discounted future payments for each carrier, default probabilities are derived from the ratings assessments for each carrier and expected recoveries are usually assumed to be in the 50% to 70% range. A single correlation factor is typically used across all the carriers as they are generally in the same industry. The DBRS CLO Asset Model then provides estimates of losses at statistical confidence intervals that correspond to potential ratings.

**TRANSACTION CAPITAL STRUCTURE AND ESTIMATED LOSSES**

The estimated losses from both the Largest Obligor Analysis and the CLO Asset Model Analysis are normally used by DBRS to assess the sufficiency of the proposed credit enhancement of each tranche to be rated in the transaction capital structure. Typically, the higher of the two results from the analytical approaches is used to evaluate proposed credit enhancement for each tranche.

**Events of Default**

DBRS typically reviews the transaction’s Events of Default and servicing termination events. These may include a variety of events such as payment defaults, covenant defaults, false representations and warranties as well as lack of valid assignment. Typical Events of Default include:

- Non-payments to security holders that are not cured within a contractual grace period;
- Security interests granted to the indenture trustee are impaired and not cured within a contractual grace period;
- Events of voluntary bankruptcy of the issuer; and
- Involuntary bankruptcy of the issuer that is not cured within a contractual grace period.

With respect to servicing termination events, DBRS details its views in its *Legal Criteria for U.S. Structured Finance*.

**CASH FLOW ANALYSIS**

**Modeling Methodology**

DBRS typically utilizes its proprietary cash flow modeling tool (Model) to analyze the transaction structure’s ability to absorb losses to the Pool and still make timely payments of expenses, interest and principal to the various stakeholders of the structure. For structured settlement transactions that have two or more rated bond tranches, each tranche is usually analyzed separately. The Model uses a number of key inputs, including priority of payment assumptions, liability structure assumptions and asset payment assumptions. The priority of payment and liability structure assumptions are modeled according to the transaction documents. The key asset payment assumptions include contractual cash flow for the Pool, default and loss levels, default and loss timing and recoveries (discussed below).
The originator or its agents typically provide contractual cash flows for the Pool used in the Model. The Monte Carlo Analysis usually generates default and loss assumptions which are expressed as percentages of total collateral as detailed in the Quantitative Credit Modeling section above. The Model typically provides the sum of contractual cash flows as the total collateral (Collateral). For example, if contractual cash flows total $100 million and the Monte Carlo Analysis generates 15% default and 5% losses, then the Model generally defaults $15 million and imposes $5 million of losses on the contractual cash flows; however, to the extent that the Largest Obligor Analysis indicates higher expected losses for a given tranche, DBRS usually incorporates these results into the assessment of the proposed credit enhancement.

Defaults and losses are normally applied to the Pool in a manner that is consistent with contractual features of the structured settlement cash flows. Historically, when one or more Settlement Providers experiences financial distress, the other Settlement Providers continue to pay their obligations to claims holders. The anticipated reduction in cash flows from Settlement Providers in financial distress is generally represented by haircuts applied to the payments as dictated by the severity of the financial distress. The Model also usually applies different default timing ramps to analyze the structure’s ability to absorb a given level of defaults and losses over different time horizons. Typically DBRS applies a single recovery rate to the default ramp that generates the loss level at each rating level. The projected cash flows are distributed according to the priority of payments, making sure to incorporate the impact of any transaction features that may modify the priority of payments, such as performance triggers.

Delayed Payment of Timely Interest/Servicing Fees
Defaults and losses are not the only events that can potentially affect the transaction structure. If contractual payments are not made on a timely basis or scheduled receipts are not closely matched to the transaction liabilities, there may be delays in the payment of interest and transaction fees. While it is expected that payments are timely, DBRS typically evaluates whether the structure and each tranche can withstand temporary payment shortfalls.

In determining the amount of financing available under a securitization transaction, scheduled cash flows are typically discounted using the WA bond interest rate and senior transaction fees. Assuming no delinquencies, the scheduled cash flows are used to make timely interest and fee payments. Aggregate scheduled cash flows may present some unevenness, which is then reviewed in light of timely interest and transaction expenses set forth in the transaction documents.

In order to provide for coverage of uneven/non-level cash flows and delinquent payments because of timing differences and administrative errors, DBRS usually assesses the amount of cash held within the transaction structure, such as reserve accounts, to assess whether debt interest payments and transaction fees are appropriately covered.

Interest Rate and Basis Risk
DBRS typically assesses the transaction to determine if there is an interest rate mismatch between the collateral and bonds. If so, DBRS normally applies a stress to the forward interest rates consistent with the target rating. DBRS also applies interest rate stresses via its Unified Interest Rate Model (UIRM). For a complete description of the DBRS UIRM, see Unified Interest Rate Model for Rating U.S. Structured Finance Transactions.
Surveillance

DBRS discusses its surveillance methodology in the DBRS Master U.S. ABS Surveillance Methodology.

Appendix I: Annuity/Settlement Providers

The National Structured Settlement Trade Association (www.nssta.com) lists the following members, among others, which are some of the key annuity/settlement providers:

- American General Life Insurance Company
- Amica Mutual Insurance Company Life Insurance
- Berkshire Hathaway Group Structured Settlements
- John Hancock Financial
- Liberty Mutual Group Insurance
- MetLife Inc.
- Midland States Bank
- Mutual of Ohama
- New York Life Insurance Company
- Pacific Life Insurance
- Prudential Financial, Inc.
- United Services Automobile Association
# Appendix II: DBRS Idealized Default Table

## DBRS Idealized Default Table

<table>
<thead>
<tr>
<th>Rating</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.0110%</td>
<td>0.0264%</td>
<td>0.0460%</td>
<td>0.0699%</td>
<td>0.0987%</td>
<td>0.1330%</td>
<td>0.1736%</td>
<td>0.2212%</td>
<td>0.2765%</td>
<td>0.3405%</td>
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<tr>
<td>AA (high)</td>
<td>0.0161%</td>
<td>0.0390%</td>
<td>0.0691%</td>
<td>0.1071%</td>
<td>0.1539%</td>
<td>0.2107%</td>
<td>0.2784%</td>
<td>0.3580%</td>
<td>0.4501%</td>
<td>0.5554%</td>
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<tr>
<td>AA</td>
<td>0.0212%</td>
<td>0.0517%</td>
<td>0.0922%</td>
<td>0.1442%</td>
<td>0.2091%</td>
<td>0.2883%</td>
<td>0.3832%</td>
<td>0.4948%</td>
<td>0.6237%</td>
<td>0.7703%</td>
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<tr>
<td>AA (low)</td>
<td>0.0281%</td>
<td>0.0709%</td>
<td>0.1297%</td>
<td>0.2055%</td>
<td>0.2994%</td>
<td>0.4123%</td>
<td>0.5445%</td>
<td>0.6962%</td>
<td>0.8672%</td>
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<td>A (high)</td>
<td>0.0419%</td>
<td>0.1095%</td>
<td>0.2045%</td>
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<td>0.4801%</td>
<td>0.6602%</td>
<td>0.8671%</td>
<td>1.0991%</td>
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<td>0.0487%</td>
<td>0.1287%</td>
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<td>0.7841%</td>
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<td>1.3005%</td>
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<td>A (low)</td>
<td>0.0945%</td>
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<td>0.9643%</td>
<td>1.2825%</td>
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<td>2.3990%</td>
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<td>BBB (high)</td>
<td>0.1860%</td>
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<td>1.2659%</td>
<td>1.7521%</td>
<td>2.2792%</td>
<td>2.8359%</td>
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<td>4.0013%</td>
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<td>1.0305%</td>
<td>1.5581%</td>
<td>2.1460%</td>
<td>2.7776%</td>
<td>3.4384%</td>
<td>4.1166%</td>
<td>4.8024%</td>
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<tr>
<td>BBB (low)</td>
<td>0.3732%</td>
<td>0.8912%</td>
<td>1.5142%</td>
<td>2.2099%</td>
<td>2.9528%</td>
<td>3.7230%</td>
<td>4.5053%</td>
<td>5.2884%</td>
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<td>6.8252%</td>
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<tr>
<td>BB (high)</td>
<td>1.0800%</td>
<td>2.4384%</td>
<td>3.9327%</td>
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<td>BB</td>
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<td>3.0573%</td>
<td>4.9001%</td>
<td>6.7721%</td>
<td>8.5997%</td>
<td>10.3408%</td>
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<td>BB (low)</td>
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<td>11.9572%</td>
<td>14.0507%</td>
<td>15.9604%</td>
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<td>19.9866%</td>
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<td>25.1805%</td>
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<td>B (low)</td>
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<td>34.9314%</td>
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<tr>
<td>CCC (high)</td>
<td>18.7898%</td>
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<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
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<td>100.0000%</td>
</tr>
</tbody>
</table>