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- Operational Risk Assessment for U.S. ABS Servicers
- Operational Risk Assessment for U.S. ABS Originators
- Unified Interest Rate Model for U.S. Private Student Loan and U.S. Federal Family Education Loan Program Securitizations
- DBRS Master U.S. ABS Surveillance Methodology

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Rating U.S. Private Student Loan Securitizations

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Scope and Limitations

DBRS evaluates both qualitative and quantitative factors when assigning ratings to a U.S. structured finance transaction. This methodology represents the current DBRS approach for rating auto lease securitizations issued in the United States with auto lease collateral originated in the United States. It describes the DBRS approach to analysis, which includes: (1) a focus on the quality of the sponsor/servicer, (2) evaluation of the collateral pool and (3) 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 methods used in the sector and should not be interpreted as prescribing a rigid template, but understood in the context of the dynamic environment in which it is intended to be applied.

Executive Summary

This DBRS methodology, Rating Private Student Loan Securitizations, outlines the DBRS rating approach for private student loan (PSL) U.S. asset-backed securities (ABS). DBRS evaluates both quantitative and qualitative factors when assigning and monitoring ratings for PSL ABS transactions, including the following:

- Operational risk review;
- Quality of the proposed collateral pool and historical performance of an issuer’s PSL portfolio;
- Transaction capital structure, priority of payments, and credit enhancement; and
- Legal structure and opinions.

DBRS performs an operational risk review and assessment of the key parties involved in origination and servicing. The operational risk review provides insight into the processes that impact pool performance.1

For each target rating, DBRS analyzes the proposed transaction structure under various cash flow stress scenarios to determine the ability of the transaction to repay timely interest and ultimate principal in accordance with the terms of the transaction.

DBRS reviews the transaction’s legal structure and opinions to assess that all necessary steps have been taken and no subsequent actions are needed to protect the issuer’s ownership interest in the assets.

Introduction and Industry Overview

PSLs are unsecured consumer loans used to help bridge the funding gap between the cost of education and funds available through federal, state and institutional aid. Unlike federally funded student loans, PSLs are credit underwritten. However, since student loan borrowers typically have limited credit experience, and have little or no income, PSL lenders often require a credit experienced co-signer.

PSLs are not guaranteed against losses whereas student loans originated through the Federal Family Education Loan Program are guaranteed by the U.S. Department of Education. Further, unlike federal student loans, there are no set interest rates for PSLs. Interest rates differ based on a borrower’s (or co-

1. Refer to DBRS Operational Risk Assessment for U.S. ABS Servicers.
signer’s) creditworthiness and other factors decided upon by the specific PSL lender. Interest rates are fixed or variable and typically indexed to one-month LIBOR, three-month LIBOR, the 91-day T-Bill rate or the Prime rate.

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**Operational Risk Review**

**ORIGINATOR REVIEW**
The originator review process evaluates the quality of the parties that originate the loans (leases or receivables) 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*.

**SERVICER REVIEW**
The servicer review process evaluates the quality of the parties that service or may conduct backup servicing on the loans (leases or receivables) 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. Loan administration
Collateral Quality

As part of the analysis of the transaction, DBRS analyzes the characteristics of the underlying collateral pool to assess the probability of default and loss severity expectation. In addition, as warranted, DBRS assesses the collateral pool statistics against the eligibility criteria set forth in the transaction legal documents. This step serves to ensure that prescribed limits of certain collateral types are reflected in the analysis.

When rating a transaction backed by a pool of student loans, DBRS typically receives pool stratifications that provide a summary of the pool’s characteristics (as described in the following sections). In general, the characteristics of the underlying loans that comprise the proposed collateral pool should mirror the issuer’s historical static pool default performance as closely as possible. It is important that issuers have the reporting capability to provide historical static pool default data that can be stratified by attributes, such as school type, degree type, loan term or other relevant attributes, necessary to assess a proposed pool’s risk of loss. In cases where sufficient performance detail has been provided, DBRS can refine its analysis by using the data to determine a default estimate for each distinct component of the pool and then use this information to develop a weighted-average default expectation for the securitized pool based upon the relative contribution of each segment.

Data Request and Developing a Base Case Default Expectation

As part of the rating process, DBRS develops an expected cumulative net default expectation for each PSL pool. As mentioned, DBRS analyzes an issuer’s performance history and pool-specific characteristics and utilizes this historical information to help assess future performance. DBRS expects issuers to provide default information, as described herein, that covers asset performance during various economic cycles (or a period of at least five years). This assists DBRS in evaluating the impact that macroeconomic factors, such as unemployment levels, may have on collateral performance.

STATIC POOL ANALYSIS

DBRS uses a static pool approach to develop an expected cumulative net default assumption for a transaction. Static pool analysis relies on historical default data from discrete groups of loans originated over a period of time; ideally, these time periods should be monthly or quarterly, as annual vintage data may lack the precision to assess performance volatility during periods of economic stress. In this analysis, a ratio of...
defaults-to-original loan balance is tracked for a static pool of assets as they amortize. If the transaction’s collateral composition is similar, static pool analysis is deemed an effective tool for establishing default expectations because, all else being equal, two pools of assets that have similar collateral composition during similar economic environments can be expected to have similar defaults over their lives.

If an issuer provides a limited amount of relevant historical data, DBRS may implement a supplemental approach that may include the use of worst case assumptions relative to the data available or the use of proxy data that is determined to be sufficiently relevant to the proposed transaction. In the absence of adequate performance history from the issuer, or if a reliable set of historical proxy data cannot be obtained or derived, DBRS may decline to rate the transaction.

As mentioned above, issuers typically provide default data on a monthly or quarterly basis segregated by origination vintage and based on a percentage of original loan balance. The average of the periodic change in defaults for each vintage determines the issuer’s overall average cumulative default at each period from origination. The year-over-year changes are also used to determine the issuer’s historical default timing curve, which serves as a useful tool in anticipating the timing for defaults on the proposed pool. The historical default timing curve is also used to project cumulative defaults for more recent vintages that are still active. The realized and projected cumulative default rates for all vintages weighted by principal balance represent the basis for the cumulative default rate assumption for the proposed pool.

LOAN CONCENTRATIONS AND ATTRIBUTES AFFECTING EXPECTED DEFAULT
The collateral supporting a PSL securitization often includes several thousand student loans with differing characteristics and terms. While characteristics may differ by transaction, pools generally share certain collateral characteristics that aid in the determination of expected defaults. DBRS asks each issuer to segregate historical static pool performance data and the proposed securitization portfolio into sub-pools of these common collateral characteristics. Default estimates for each sub-pool determine a weighted-average default expectation for the entire securitization pool.

Characteristics that are isolated for analysis may vary based on the overall composition of the pool but usually include school type, school degree, presence of a co-signer, repayment option, origination channel and seasoning. Certain concentrations of any of these loan attributes may have an impact on projected defaults. DBRS may also consider parameters such as credit bureau score (i.e., FICO score), geographic concentration and loan term. The following section provides a description of each loan characteristic assessed when establishing a base case net default assumption.

SCHOOL TYPE
DBRS analyzes the concentration of school types and incorporates this analysis in its determination of expected defaults. School types include four-year, two-year and proprietary institutions (also referred to as for-profit or vocational schools). Historical PSL performance demonstrates that loans to borrowers attending proprietary institutions have the highest default rates. Four-year schools historically have had the lowest default rates.

DEGREE
Type of degree can have a significant impact on expected defaults. Degree programs encompass undergraduate (i.e., bachelor’s and associate’s degrees), graduate (i.e., master’s degree), doctoral/professional (i.e., medical and MBA degrees) and certificate programs. Historical PSL performance demonstrates that loans for graduate and professional programs have lower historical default rates than loans for undergraduate and certification programs.

CO-SIGNER
Often in the underwriting process, if a student borrower cannot meet the minimum credit qualifications for a loan, which a very large percentage of students struggle to, lenders will often require a creditworthy
borrower to co-sign the loan. The co-signer is required to sign the loan document, although the student is the primary borrower. By signing the promissory note, the co-signer agrees to be legally responsible for repaying the loan if the student does not fulfill his or her obligations. PSLs without co-signers have historically defaulted at higher rates than those with co-signers. Certain lending programs may also allow for a co-borrower (a joint signer of the promissory note also legally liable for the loan), which also supports the performance of a student loan portfolio.

**REPAYMENT OPTION**

Loans that allow a student to defer principal or interest tend to have a higher default rate for a number of reasons. For one, interest typically accrues during the period that the student is in school and is capitalized at the start of repayment. This capitalized amount is added to the outstanding principal balance of the loan. Further, with a deferred loan, the student will not be in constant communication with the lender during the deferral period, which increases the chance of default once repayment begins.

**ORIGINATION CHANNEL**

PSLs are originated either through the school or directly to the consumer (DTC). DTC loans became prevalent during the lending boom from 2005 to 2007 as PSL lenders sought to increase lending volumes. While circumventing a school’s financial aid office, lenders marketed mainly through mass media with funds being disbursed directly to the student rather than through the school. DTC loans are deemed riskier than loans made to borrowers with the involvement of the school in the process, as the school does not certify the borrower’s financial need, and students many times borrow more than they need to finance their education. Since the financial crisis, most lenders have eliminated or greatly reduced DTC originations.

**SEASONING**

DBRS may make certain adjustments to its default projections for a securitization pool based on loan seasoning. Loans in repayment may be given credit for seasoning by applying only the remaining portion of the default curve to the pool. For example, if an issuer’s historical static pool default data shows that 40% of defaults occur in the first two years of repayment, and assuming that a proposed loan pool has two years of in repayment seasoning, 60% of the default curve would be expected for the remaining life of the pool. Although default expectations for seasoning would typically reduce the default estimate on the securitization pool, the potential impact of loan seasoning on default estimates depends upon the total principal amortization of the underlying pool. For instance, in the example above, assuming a pool with a $100 million original balance, and assuming a 10% base case default projection ($10 million cumulative defaults assumed), the remaining $6.0 million of expected defaults would be applied as a percentage of the current balance of the seasoned pool. So, if the seasoned pool was $80 million, for example, the base case default rate assumption would be 7.5%.

In PSL portfolios, default assumptions are sensitive to seasoning credit as the default curve is usually front-loaded. Therefore, historical loan seasoning data must be sufficiently reliable before DBRS considers giving seasoning credit to a pool. DBRS requests historical performance data reflecting loans with similar pool characteristics and similar seasoning levels to those of the securitization pool being analyzed. DBRS considers an originator’s deferment and forbearance policies, historical utilization of such payment options and the historical performance of such loans after their deferred payment periods to determine whether to give seasoning credit. For a proposed securitization, DBRS looks for in-repayment seasoning sufficient enough that future expectations can be extrapolated, typically at least 24 months.
Transaction Capital Structure

Typical PSL ABS transactions utilize a financial structure whereby bondholders receive protection against pool losses from available credit enhancement and the transaction’s structural features.

SENIOR/SUBORDINATE STRUCTURE
PSL ABS transactions are typically senior/subordinate structures whereby there are one or more classes of senior securities along with one or more classes of lower-rated subordinate securities. The interest rate on the securities can be fixed or floating. In certain structures, principal is paid first to the senior notes and then to the subordinate notes once the senior notes are reduced to zero. Other structures also pay principal sequentially, but have a step-down date where principal switches to pro rata pay after a certain target date or once the structure reaches a certain parity threshold. However, if certain note triggers are breached, subordinate note payments may be redirected to pay additional senior note principal to de-lever the transaction and build back parity.

PAYMENT WATERFALL
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 first to servicing, trustee and other administrative parties. Bondholder interest and principal for all classes then follows pursuant to the “priority of payments” specified in the transaction’s legal documents. In accordance with the transaction’s legal documents, amounts that remain may be required to replenish a reserve account or to build a reserve account to a required minimum balance. Release of remaining available funds to the residual holder may then be allowed if certain parity ratios and conditions are met.

PERFORMANCE TRIGGERS
Performance triggers are generally tied to a transaction’s parity levels and cumulative defaults. Such triggers are designed to protect senior classes against deteriorating collateral pools. At the most basic level, when the risk of a securitization increases, larger amounts of cash are diverted and allocated to pay principal at higher points in the waterfall. This mechanism is intended to ensure that subordinate bonds remain outstanding for longer and continue to act as credit support to the more senior bonds, in addition to building credit enhancement levels to required levels. Performance triggers, in general, turn off when parity levels are restored or cumulative losses or defaults fall below triggering thresholds.

PREFUNDING STRUCTURES
Many PSL securitizations utilize prefunding structures that allow issuers to deposit bond issuance proceeds in an account (prefunding account) for future collateral acquisitions. Cash held in the prefunding account is an asset of the securitization trust and is used to purchase loans during the prefunding period. Prefunding periods typically last no longer than one year and any unused prefunding amount at the end of the prefunding period is applied as available funds toward the liability structure.

Prefunding creates liquidity risk as interest earned on the prefunding account balance is usually less than the amount paid on the securities, creating negative carry. To mitigate such shortfalls, amounts are required to be deposited in a capitalized interest account (described in the next section).

PSL ABS transactions may also utilize recycling, whereby after the transaction closes, principal collections on the loans can be used to purchase additional student loans into the trust for a specified period of time. Recycling also exposes a transaction to liquidity risk as loans funded may not be in active repayment.

2. Some recent transactions have been issued without subordinate bonds.
3. Parity is the ratio of a securitization trust’s assets to liabilities.
Eligibility criteria is incorporated into the transaction’s legal documents specifying the type of collateral that may be acquired during the prefunding or recycling period and spelling out any concentration limits.

Forms of Credit Enhancement

Credit enhancement is the method by which investors are protected from cash flow disruptions that can affect the timely and full payment of security interest and principal. Credit enhancement improves the credit quality of a security with structural features that mitigate credit and liquidity risk. The amount and type of credit enhancement reflects the credit rating of a particular security. Common forms of credit enhancement in PSL ABS transactions are excess spread, subordination, overcollateralization, capitalized interest accounts and reserve accounts.

EXCESS SPREAD
Similar to other ABS transactions, PSL ABS transactions rely on a transaction’s excess cash flow or excess spread for credit enhancement. Excess spread is the difference between the interest generated by the collateral less amounts paid out in servicing and other trust fees, hedging costs (if applicable) and bondholder interest payments. Excess spread may be used to cover interest and principal payments due to bondholders 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 is only released to the residual certificateholder if the transaction is in compliance with a specified parity (or overcollateralization) level. If this level 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 bondholders until the parity level is restored.

OVERCOLLATERALIZATION
Overcollateralization is the amount by which the collateral balance exceeds the amount of the outstanding bond balance. In some transactions, overcollateralization begins at a certain level and builds up to a specified target amount. This target amount is reached by using excess spread to accelerate the pay down of the liabilities. Once a target amount is reached, overcollateralization may be allowed to decline in order to maintain a certain parity ratio (asset-to-liability ratio) as the deal structure pays down. Such decline may be limited to a floor.

SUBORDINATION
Credit ratings on subordinate tranches of PSL ABS are typically investment grade, ranging from AA to BBB. Typically, bond subordination provides protection to the senior classes of bonds after other forms of credit enhancement, such as excess spread, are exhausted. Senior bondholders experience losses only after the subordinate bonds have been reduced to zero.

RESERVE ACCOUNTS AND CAPITALIZED INTEREST ACCOUNTS
In most PSL transactions, liquidity is a concern as a portion of the loans included within a pool may not be generating interest and principal cash flow due to the student’s in-school or grace status, or if the loan is in deferment or forbearance. To mitigate the risk that there are insufficient cash flows to cover obligations within a securitization, the transaction typically has certain cash or liquidity accounts.

A reserve account is generally available to pay servicing and administration fees, certain swap payments (if applicable), timely interest on the bonds and principal on the bond’s legal final maturity date. Reserve accounts are typically fully funded at the time the transaction is closed, often static, and replenished on

4. DBRS assumes the current one-month LIBOR minus 25 basis points for all cash investment accounts.
future distribution dates from available funds. Reserve account balances are typically 0.25% to 1.00% of the initial pool balance.

A capitalized interest account also serves to provide liquidity to a securitization. The proposed size of the account depends primarily on the characteristics of the loan collateral to be securitized and mainly covers shortfalls in bond interest and trust fees stemming from non-cash flowing student loans. Capitalized interest accounts are 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 accounts typically are not replenished from available funds.

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**Cash Flow Analysis**

In the following section, DBRS describes the manner in which it assesses credit enhancement levels to support each target rating. Cash flow scenarios are reviewed to assess whether investors are protected against losses and to determine if there is sufficient credit enhancement available to pay obligations at each target rating when due.

**STRESS CASE CUMULATIVE NET DEFAULTS**

To assess whether there is an appropriate level of proposed credit enhancement to support a target rating, the base case default figure is stressed by applying certain multiples to the base case net default figure. To achieve a given credit rating, a transaction would have to maintain credit enhancement in an amount sufficient to withstand the stressed multiple of defaults over the life of the transaction, as well as other cash flow stresses as described in this section.

The multiples serve to protect the rated securities from much harsher and more stressful conditions than assumed within the base case cash flow scenario. The multiples below are representative of those that DBRS uses to assign ratings to U.S. PSL ABS transactions and are designed to capture uncertainties and variables that may affect future transaction performance. Ranges are expected to encompass most outcomes of the asset correlation analysis performed by DBRS.

The following table represents the range of multiples utilized in the rating of U.S. PSL ABS transactions:

<table>
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<tr>
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<th>AAA</th>
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<th>A</th>
<th>BBB</th>
<th>BB</th>
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<tbody>
<tr>
<td>Multiple</td>
<td>3.00x-4.50x</td>
<td>2.25x-3.25x</td>
<td>1.75x-2.50x</td>
<td>1.50x-2.00x</td>
<td>1.25x-1.50x</td>
</tr>
</tbody>
</table>

In the determination of the multiples used in each transaction, DBRS generally starts at the midpoint of the prescribed multiple ranges for each rating class.

DBRS considers various quantitative and qualitative factors and may adjust, up or down, from the midpoint based on its assessment of the transaction’s perceived risks. The combination of the relevant factors ultimately results in the multiple used to determine the amount of loss coverage necessary to achieve each target rating. These factors include, but are not limited to:

- The absolute level of a proposed pool’s base case default figure,
- The results of an operational risk assessment of the originator and/or servicer,
- The sufficiency of the provided data,
- Macroeconomic conditions,
- Concentrations,
- The industry position of the sponsor, and
- The results of an asset correlation analysis.
For example, for a transaction with a relatively high default expectation (relative to others in the same asset class), DBRS, absent other factors, would generally adjust to a multiple that is at the lower end of the prescribed multiple range for a target rating. Conversely, for a transaction with relatively low default expectations (relative to others in this asset class), DBRS, absent other factors, would generally adjust to a multiple that is at the higher end of the prescribed multiple range for a target rating.

A description of some of the above factors and the directional impact on the determination of the multiples within the prescribed ranges, when considering each factor in isolation, are discussed in the following sections.

**SUFFICIENCY OF THE PROVIDED DATA**

A major factor contributing to the assessment of risk of a securitization pool is availability of data related to the characteristics of both the pool being securitized and the historical data pool. Limited information makes it more difficult to evaluate the relevance of historical data to the future performance of the pool being securitized thereby increasing the uncertainty around expected losses.

Typically DBRS receives sufficient performance history from an issuer to perform a rating analysis. Where the performance history for the originator’s assets is insufficient, DBRS may consider proxy data, such as performance of similarly originated assets from different originators or federal student loan data. However, in all cases where originator-specific static pool data are unavailable, DBRS is likely to adopt a significantly more conservative opinion regarding the assets’ expected performance than would otherwise be the case.

DBRS also considers the consistency of the performance across vintages in its assessment of the expected loss figure for the proposed collateral pool. In cases when an issuer’s performance exhibits inconsistent trends, which may be attributable to a variety of factors, such as a change in underwriting criteria, DBRS may apply multiples at the higher end of the prescribed ranges. For issuers that demonstrate consistency in originations and performance trends, multiples at the lower end of the prescribed ranges may be used.

**MACROECONOMIC CONDITIONS**

In determining the multiples, DBRS considers potential variability in future macroeconomic conditions. Macroeconomic conditions are considered with respect to the sponsor’s historical performance statistics timeframe and the degree of relevance of the historical performance data in the derivation of the expected loss figure. DBRS also considers macroeconomic conditions in terms of the presence of a benign or recessionary environment over the period of the sponsor’s historical performance data and derivation of the expected loss figure.

**CONCENTRATIONS**

The degree to which a pool has concentrations, geographic or otherwise, can also affect a transaction’s risk profile and may magnify the risk of loss. DBRS assesses any pool concentration and determines whether such concentration would contribute to an adjustment of the loss multiple.

**ADDITIONAL CASH FLOW ASSUMPTIONS**

*Loss Timing*

Loss timing is an important component of the cash flow analysis as it affects the availability of excess spread to cover losses and other potential liquidity stresses. DBRS analyzes an issuer’s historical performance data to develop a customized loss timing curve that reflects when losses are expected to be experienced during the life of the transaction.

After the shape of the curve is determined, DBRS develops and applies front-loaded and back-ended loss timing curves. The curves are developed to evaluate scenarios whereby losses materialize sooner or later than expected, as might be the case if the economy entered a recession shortly after a transaction closed or toward the tail end of a transaction’s life. The impact of default timing stresses typically affect transactions differently under different scenarios. Front-loaded default scenarios typically add stress to
the credit enhancement of the most senior securities in the structure. A front-loaded stress scenario will also compound liquidity risk, which is typically the highest in the beginning of a securitization, as many borrowers have not entered repayment or may be in grace, deferment or forbearance. Back-ended defaults add stress to subordinate bonds and test a transaction’s ability to withstand defaults in the latter years of the cash flows, especially if the transaction allows for credit enhancement to be released to the residual holder.

**Recoveries**
While PSLs are generally not dischargeable in the event of borrower bankruptcy⁵ and the presence of a cosigner provides an alternate payment source and contact during default collection activities, the PSLs have relatively low rates of recovery, averaging about 20%-25% historically. PSL recoveries typically occur over an extended period of time.

In determining a recovery rate assumption and a recovery timing curve, DBRS reviews an issuer’s historical recovery experience and underwriting and servicing policies. DBRS only gives credit to cash recoveries that are net of collection costs. For issuers who cannot provide adequate historical recovery data, DBRS may determine a recovery assumption based on historical data from originators with similar collection policies, or DBRS may assume no recoveries. For issuers who cannot provide an adequate recovery curve, DBRS assumes a ten-year recovery curve spread evenly over such period.⁶ DBRS may also consider front-loaded and back-ended recovery timing curves in certain cases.

**Interest Rates**
Interest rates on PSLs may be fixed or variable and are typically indexed to one-month LIBOR, three-month LIBOR, the 91-day T-Bill rate or the Prime rate. The coupon on PSL ABS is usually a floating rate based on one-month LIBOR, although interest rates may be based off another index such as three-month LIBOR or the Prime rate. Coupons may also be fixed rate. Interest rate mismatch risk, or basis risk, occurs when the interest rate on the underlying collateral adjusts differently from the interest rate on the bonds. For example, assuming that the underlying student loans are based on the 91-day T-bill rate and the PSL ABS are based on one-month LIBOR, if the two indices were to converge, excess spread would decrease.

DBRS quantifies the effect of an interest rate mismatch by performing stressed sensitivity analyses to determine if there is expected to be sufficient excess spread to cover losses. Based on the historical relationship between the indices pertaining to the assets and liabilities of a transaction, DBRS applies certain stressed spreads at each rating level. These spreads will consist of both constant stresses typically lasting for the life of the deal, as well as certain spikes to account for the impact of large basis shocks. Spikes are generally applied at periods in the cash flows exhibiting the highest defaults and liquidity risk and on a periodic basis (approximately every six years to eight years).

In addition to evaluating upward interest rate stresses in its cash flow analysis, DBRS assumes certain downward interest rate environments for each rating level. DBRS’s interest rate stresses (upward and downward) for each transaction are based on the DBRS methodology Unified Interest Rate Model for U.S. Private Student Loan and U.S. Federal Family Education Loan Program Securitizations.

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⁵. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was passed to prevent abusive or fraudulent bankruptcy filings.

⁶. Recovery rates are generally higher for state agencies with special administrative tools used to collect loans. Additionally, the recovery window for state agencies is generally shorter as compared to loans made by private lenders.
**Swaps**

To hedge basis risk, issuers may enter into a basis swap agreement. For example, if a securitization pool consists of loans that are indexed to the Prime rate but the bonds are indexed to one-month LIBOR, the issuer may enter into a basis swap to help protect the securitization trust from the risk that the spread between the two indices will narrow. If this occurs, interest collected under the Prime rate loans may not be sufficient to service the interest due under the one-month LIBOR-based term debt (in addition to paying ongoing deal expenses). Under the swap agreement, the trust will typically pay an amount equal to the Prime rate minus a margin to the swap counterparty in exchange for one-month LIBOR. The notional balance of the swap is generally equal to the balance of the loans indexed to the Prime rate, and in certain transactions may decline if the transaction’s overcollateralization exceeds a certain percentage. Alternatively, if the same pool included loans with a fixed coupon, the same issuer may enter into a fixed-for-floating rate swap to hedge against a decrease in excess spread.

A PSL ABS transaction may also offer a fixed-rate payment while the underlying student loans are floating rate. In this case, the trust would be exposed to the risk of diminishing revenue flows if interest rates fall. To mitigate this risk, the trust may enter into a swap arrangement whereby it pays a floating rate to a swap counterparty in return for fixed payments. The trust may then use such payments to pay interest on the securities.

A swap agreement introduces swap counterparty risk into the transaction. Where rated securities are dependent on the performance by the swap counterparty of its obligations pursuant to the swap, those securities are exposed to the risk that the counterparty may default on those obligations. To help address such risk, DBRS rating criteria for swap counterparties includes minimum short- and long-term ratings for all counterparties. If a counterparty fails to maintain such ratings, it would be expected to post certain collateral, find a guarantee from an acceptable guarantor or find an acceptable replacement. Where it is possible for issuers to meet the criteria, the reduction in exposure to the swap counterparty should result in reduced risk to the rated securities.

**Prepayments**

If prepayment speeds are faster than expected, the average life of the transaction will be shorter than originally estimated; if prepayment speeds are slower, the transaction’s average life will be extended. Faster prepayments add to cash flow uncertainty in a student loan transaction and can have a negative impact on excess spread that is used as a cushion to help offset losses. Slower prepayments in transactions with negative excess spread increases credit risk as credit enhancement may erode for a longer period of time. DBRS uses an issuer-specific prepayment curve based on the historical performance of collateral originated by the issuer to determine prepayment stresses.

**Forbearance and Deferments**

PSLs have a variety of repayment options, most of which allow a borrower to defer payments while in school. When a borrower leaves school, lenders generally offer grace periods of up to twelve months, with six months being the most common. Following such grace period, PSL lenders generally offer deferment and forbearance options that enable a qualifying borrower to postpone or reduce monthly payments.

Recent graduates are more likely to elect deferments and/or forbearances as there is a greater likelihood of a borrower returning to school or experiencing economic hardship. Although this increases liquidity risk earlier in the life a transaction, it may benefit a transaction as interest is usually capitalized on the loan balance. This has the effect of creating more credit enhancement due to an increasing principal balance (in the form of overcollateralization and excess spread). However, there is the risk that a deferment or forbearance is postponing the inevitable in terms of losses.

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7. See the DBRS methodology *Legal Criteria for U.S. Structured Finance*.
8. DBRS rating criteria for a swap counterparties currently includes a long-term rating of A (high) or short-term rating of R-1 (middle).
DBRS determines customized base case deferment and forbearance rates for each issuer based on several factors, including historical deferment and forbearance utilization rates, deferment and forbearance policies and the current and anticipated economic environment. Because most borrowers go into deferment and forbearance soon after their payment obligations begin, DBRS assumes that borrowers that are in school or in grace status will immediately enter forbearance and deferment for the maximum term allowable according to the originator’s policies. Loans that enter the securitization already in deferment or forbearance status remain through the maximum period. DBRS stresses deferments and forbearances concurrently to test a transaction’s ability to absorb liquidity risk. In the DBRS maturity stress scenario, deferments and forbearances are stressed upward and run consecutively.

Although the DBRS deferment and forbearance stresses increase liquidity risk earlier in the life of a transaction, it may benefit a transaction as interest is capitalized on the loan balance. This may have the effect of creating additional credit enhancement due to an increasing principal balance, as well as increased excess spread. To account for this, DBRS looks at low deferment and forbearance scenarios at each rating category where deferments and forbearances are assumed to be zero, although loans already in deferment or forbearance as of the cut-off date remain in such states.

**Borrower Benefits**
Some PSL lenders offer borrower benefits that may include interest rate reductions for scheduling automatic payments, interest rate reductions for consecutive on-time monthly payments or principal rebates for program completion or other qualifications. Borrower benefits can negatively affect the cash flow of a PSL ABS transaction since they reduce the interest rate on the underlying loan pool. DBRS requests that originators furnish comprehensive information on any borrower benefit programs that they sponsor, as well as historical utilization rates. Based on this historical information and the issuer’s most recent borrower benefit policies, DBRS cash flow analysis includes reducing the weighted-average coupon of the proposed loan pool. DBRS stresses its base case expected borrower benefit utilization rate at each rating category.

**Servicing Fees**
DBRS assumes a servicing fee based on the servicing agreement in each transaction. The servicing fee may be expressed as a percentage of the outstanding principal balance or may be a set amount per loan in the pool. If the terms of the servicing agreement call for the servicing fee to be increased, DBRS will assume the maximum possible fee in the transaction’s cash flow scenarios. Otherwise, to adjust for inflation and the possibility that the servicer is replaced, DBRS assumes that the servicing fee increases 3.00% annually starting in year one of the transaction.

**Legal Final Maturity**
DBRS stresses a securitization’s cash flows to determine if the bonds will be paid down by their legal final maturity date. In modeling such cash flows, DBRS assumes that a higher-than-expected number of loans enter deferment and forbearance and that deferments and forbearances occur consecutively. Additionally, prepayments and defaults are assumed to be zero.

**Substitutions and/or Repurchase of Defaulted Loans**
Another common transaction mechanic in student loan securitizations is the ability of the sponsor to substitute and/or repurchase defaulted loans. DBRS reviews the underlying transaction provisions to assess if there is a limit to the amount of substitutions and/or repurchases permitted under the transactions documents. DBRS typically does not reduce its loss expectation based on the sponsor’s right to substitute and/or repurchase defaulted loans.
Legal Structure

BANKRUPTCY REMOTENESS/TRUE SALE
Similar to other asset classes, a key feature of PSL ABS is that the underlying loans are legally isolated from the seller9 and its creditors, allowing investors to rely on the creditworthiness of the assets and to decrease the risk that principal and interest payments will be reduced or delayed by a bankruptcy proceeding. The most common legal structure used to achieve bankruptcy remoteness is a legal true sale where the seller transfers its right, title and interest in the assets to a bankruptcy-remote special-purpose vehicle (SPV).

DBRS expects that true sale and non-consolidation opinions supporting this legal structure are delivered by the securitization’s legal counsel. The true sale opinion concludes that the securitization constitutes a true sale that effectively transfers the seller’s right, title and interest in the assets to the SPV and that the assets will not be considered part of the estate of the seller if the seller declares bankruptcy. The opinion also concludes that the creditors of the seller could not look to the assets to satisfy a claim against the seller. The non-consolidation opinion states that, in the event of a bankruptcy of the seller, the SPV and the seller will not be treated as the same entity and consolidated for bankruptcy purposes. DBRS also expects to see a perfected security legal opinion that concludes that investors have a first-priority perfected security interest in the assets and the proceeds of the trust.

State agencies and non-profit corporations under Section 501 (c)(3) are subject to different risks related to bankruptcy. DBRS expects an opinion concluding that a sponsor that is a state agency or a non-profit corporation would not be subject to involuntary bankruptcy. DBRS also evaluates the likelihood that the issuer would file a voluntary bankruptcy. In securitizations where a state agency is acting as sponsor and there is no sale or transfer of the student loans to a bankruptcy-remote vehicle, but the trustee has a perfected security interest in the assets, DBRS relies on legal opinions provided by external transaction counsel that address the isolation of the assets assuming the originator becomes insolvent or declares bankruptcy, as well as the benefit to the noteholders of a grant of a first-priority perfected security interest in the collateral.

In addition to the matters described above, all student loan-secured transactions are expected to comply with the DBRS methodology Legal Criteria for U.S. Structured Finance.

9. For purposes of this section, the term “seller” refers to the party that securitizes the pool of the student loans and sells such loans to the SPV (or issuer).