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METHODOLOGY

Rating Canadian Structured Finance Transactions

Appendix for Franchise Loans last updated April 2016
Appendix for Consumer Loans last updated April 2016
Appendix for Insurance Premium Loans last updated April 2016

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DBRS is a full-service credit rating agency established in 1976. Spanning North America, Europe and Asia, DBRS is respected for its independent, third-party evaluations of corporate and government issues. DBRS's extensive coverage of securitizations and structured finance transactions solidifies our standing as a leading provider of comprehensive, in-depth credit analysis.

All DBRS ratings and research are available in hard-copy format and electronically on Bloomberg and at DBRS.com, our lead delivery tool for organized, web-based, up-to-the-minute information. We remain committed to continuously refining our expertise in the analysis of credit quality and are dedicated to maintaining objective and credible opinions within the global financial marketplace.

Scope and Limitations

DBRS Limited (DBRS) evaluates qualitative and quantitative factors when assigning ratings to a Canadian structured finance transaction. This methodology represents the current DBRS general approach for rating securitization transactions with collateral originated in Canada. This report also discusses the methods DBRS typically employs when assessing a transaction and assigning a rating. It describes the DBRS approach to analysis, which includes a qualitative and quantitative review that considers (1) the quality of the originator/servicer, (2) the proposed transaction structure and legal risks, (3) an evaluation of the collateral pool and (4) an assessment of credit enhancement proposals using historically employed credit evaluation techniques. It is important to note that the methods described herein (including the accompanying appendices) 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 with formulaic inflexibility, but understood in the context of the dynamic environment in which it is intended to be applied.

Executive Summary

This methodology summarizes DBRS's approach typically used for rating structured finance transactions. This methodology provides a general guideline for the analysis of Canadian structured finance transactions and is complementary to, and may be used in conjunction with, the DBRS asset-specific rating approaches. In cases where DBRS primarily relies on this methodology for the basis of an initial rating in a new asset class, an asset-specific appendix, commentary or a press release is published concurrently with the issuance of the transaction rating(s). The appendix, commentary or press release provides readers with a description of the key analytical considerations made in the rating of the transaction. DBRS generally issues an asset-class specific methodology when market issuance and rating activity are sufficient to define the asset class. The methodology describes the general qualitative and quantitative factors that DBRS considers when assigning ratings for structured finance transactions. These include the following:

- The operational capabilities and financial strength of the transaction parties;
- Legal risks;
- Transaction structure;
- Asset quality and performance of the proposed collateral pool;
- Evaluation of credit enhancement proposals; and
- Cash flow stress scenarios.

In its analysis, DBRS reviews the characteristics of the proposed asset pool to be securitized and analyzes the historical performance of assets of a similar nature (if available) to determine a base-case performance for the proposed pool. In accordance with the criteria, DBRS subsequently applies stresses to the base case commensurate with each rating level. DBRS then reviews the level of stress that a security is able to withstand in light of the transaction's structural features.

This methodology provides a general guideline for the analysis of structured finance securities and is complementary to DBRS's asset-specific rating approaches. An asset-specific appendix will be added to this methodology to provide more detailed analysis when a transaction backed by an esoteric or infrequently securitized asset class occurs.

Qualitative Review

Operational Risk of Originator and Servicer

DBRS's review and analysis of securitized transactions starts with an operational risk review of the originator and servicer, including its commercial and operating procedures and policies. The operational review and assessment provides insight into the manner in which these processes may have affected asset performance and assists DBRS in establishing expectations for future performance of proposed asset pools to be securitized.

While DBRS recognizes that structured finance transactions are constructed to isolate the performance of the assets from the originator, an originator's financial strength is nonetheless an important component of DBRS's company assessment. Companies in a strong financial position with various sources of liquidity are better poised to maintain servicing quality in the event of unexpected losses and are more likely to be able to withstand market disruptions. Financially stronger companies are also more likely to be in a position to remedy any breaches of representations made to the securitization.

In addition to the originator's financial strength review, DBRS typically meets with senior management to discuss the origination operations, tour the facilities and review system demonstrations, as appropriate. DBRS reviews the origination process and its controls and consistency to compare the credit profile of the assets to be securitized with the assets for which information on historical performance is available.

DBRS also reviews the capabilities of the servicer, including its operational capabilities and financial strength, as required. DBRS then assesses the information gathered through its review process, to determine if a servicer is acceptable. In instances where DBRS determines that the servicer is below average, the transaction may incorporate certain structural enhancements in order for DBRS to rate the transaction.

DBRS assesses all of the information gathered through the review process to assess an originator. The transaction may incorporate certain structural enhancements to address identified deficiencies. If DBRS considers the mitigants insufficient, it may decline to rate the transaction.

For further details on the origination and servicing review process, please refer to the DBRS methodology *Operational Risk Assessments for Canadian Structured Finance* at www.dbrs.com.

Legal Risk

DBRS analyzes the legal structure of the proposed transaction by reviewing the primary and ancillary transaction documents as well as all relevant legal opinions.

Bankruptcy Remoteness, True Sale, Security Interest

Asset-backed transactions involve the legal separation of a pool of assets and their associated cash flows and contractual rights from the entity that originates the assets. This separation, referred to as securitization, is achieved by transferring assets from the originator/seller to a special-purpose vehicle (SPV). This transfer must be conducted properly to ensure that the assets are bankruptcy remote from the originator/seller and that the securities issued by the SPV can be rated independently of the credit risk of the originator/seller. Failure to obtain bankruptcy remoteness upon the transfer of the assets nullifies the benefits of securitization.

DBRS reviews legal opinions to (1) determine whether the transfer of the assets to the SPV constitutes a true sale such that the assets of the SPV would not be consolidated with those of the seller in the event of the seller's bankruptcy and also to (2) ensure that the indenture trustee has a first-lien, perfected security interest in the purchased assets, which secures the SPV's obligations to the noteholders.

For further details on the legal review process, please refer to the DBRS methodology *Legal Criteria for Canadian Structured Finance* at www.dbrs.com.

Transaction Structure

Priority of Payments

On a regular basis, collections on the assets are aggregated and then distributed to noteholders based on the priority of payments established in the transaction documents. Collections on the assets may be aggregated such that principal and interest collections are combined to create a pool of total available funds that is then subjected to the payment waterfall. Alternatively, principal and interest collections may be accounted for separately and then subjected to the payment waterfall. The transaction waterfall allocates collections in descending order of priority. Recurring transaction expense items such as servicing, trustee or transaction management fees are commonly senior in the waterfall, after which noteholders receive interest and principal. The allocation of interest and principal payments among noteholders is typically either sequential or pro rata as established in the transaction documents.

An example of a typical (simplified) payment priority under a sequential structure is as follows:

1. Servicing, trustee or certain other fees and expenses related to the trust;
2. Interest in order of seniority;
3. Principal in order of seniority;
4. Amount, if any, to be deposited into the reserve fund;
5. Any remaining amounts to the seller.

The other common payment priority is pro rata principal allocation, where principal collections are allocated to maintain constant credit enhancement levels. Under such a payment mechanism, subordinated tranches can receive principal payments while senior notes are still outstanding. However, pro rata pay structures typically contain performance triggers such that, should the transaction performance deteriorate to a certain pre-defined level, subordinated tranches can be locked out and payments are then redirected entirely to senior tranches before any payments are allocated to subordinated tranches.

Some transactions also include hedges such as interest rate swaps where net swap cash flows (other than termination payments) rank pari passu with interest payments. In the event that the swap terminates, the ranking of any termination payments typically depends on which counterparty defaults on the swap.

Counterparty Minimum Rating Criteria

All securitization transactions rely to some extent on the performance of third parties such as originators, servicers, hedge counterparties, liquidity providers and account banks. DBRS requires that all transaction parties maintain certain minimum rating thresholds or otherwise satisfy the Rating Agency Condition.¹

For further details on DBRS's counterparty criteria, please refer to the DBRS methodologies *Operational Risk Assessments for Canadian Structured Finance*, *Derivatives Criteria for Canadian Structured Finance*, *Legal Criteria for Canadian Structured Finance* and *Rating Canadian ABCP and Related Enhancement Features* with respect to originators, service providers and other counterparties to the transactions at www.dbrs.com.

Transaction Performance Thresholds and Triggers

Depending on the structure of a transaction, performance thresholds or triggers can mitigate the risk of deteriorating collateral performance. Some performance triggers are designed to increase credit enhancement levels beyond what is initially included in the transaction, enabling the transaction to absorb more losses. The degree to which triggers are beneficial in building additional credit enhancement depends on the level at which the triggers are set and the ability of the transaction to generate additional credit support. DBRS assesses the extent to which any additional credit enhancement may be built up in the overall assessment of the transaction structure and cash flow scenarios.

Transaction performance triggers may include levels of current delinquencies, defaults and/or losses and can also be based on cumulative defaults or losses. Other kinds of triggers can be based on the maintenance of overcollateralization above pre-defined levels. Once these levels are breached, amortization of the notes begins.

Asset Eligibility Criteria

The eligibility criteria incorporated in the transaction documents establish a standard for asset quality and are an important part of maintaining consistency of asset quality. Common eligibility criteria that DBRS would expect to see in a structured finance transaction include the following:

- Minimum and maximum terms of loans.
- Limitations on the severity of delinquency, typically not exceeding 30 days.
- No loans in charge-off or in bankruptcy.
- Minimum and maximum loan amount.
- Minimum interest rate or excess spread levels.
- Geographical limits and concentrations.
- Obligor concentrations.
- Limits on newly originated loans.
- Loans have been originated in accordance with existing credit policies and all applicable laws.
- The originator has legal title to the loans, and there are no liens or encumbrances on the loans (other than certain permitted liens).
- Loans or assets, including receivables from provincial and federal government entities, should be freely assignable to the third-party SPV.

1. DBRS indicates in writing that taking a proposed action will not, in and of itself, result in the rating(s) of the relevant Rated Securities being downgraded or withdrawn. If reference to satisfying the Rating Agency Condition relates to a proposed action that will be completed in connection with the initial assignment of a rating or transaction assessment, the Rating Agency Condition is considered to have been satisfied upon the assignment of the initial rating or transaction assessment, as the case may be.

Forms of Credit Enhancement

DBRS evaluates both the amount and form of credit enhancement when assigning ratings. This analysis is performed concurrently with the cash flow analysis discussed in the following section. The appropriate form and amount of credit enhancement depends on a number of factors, including the overall amount and timing of losses and any excess spread. Credit enhancement can be provided through a combination of overcollateralization, subordination, a reserve fund, excess spread or a letter of credit.

DBRS does not determine the required levels of credit enhancement but rather evaluates the sufficiency of credit protection from the proposed credit enhancement and transaction structure, taking into account the payment waterfall and transaction thresholds and triggers.

Overcollateralization

Overcollateralization (OC) is a common form of credit enhancement and consists of the amount by which the collateral amount exceeds the amount of securities issued. There may be an initial OC level that increases to a pre-specified target level based on amortization of the notes. One benefit of OC is that the extra collateral generates cash flows in the form of interest collections that can be used to cover losses through excess spread. However, OC is also prone to erosion as the quality of the underlying collateral deteriorates.

Subordination

Subordination is created by tranching the debts within the transaction's capital structure such that any subordinated classes of notes have a lower assigned priority of payment (as outlined in the transaction waterfall), providing an added level of protection from losses to the senior notes.

Cash Account or Reserve Fund

Reserve funds are accounts that supplement collections on the assets. Such accounts may be funded at issuance or designed to trap excess spread to a pre-specified target amount. Reserve funds are typically held in a deposit account with an eligible institution and invested in high-quality, short-term securities with little default risk. Reserve accounts have the benefit of providing liquidity to address compressed excess spread and unexpected spikes in losses.

Excess Spread

Excess spread is the interest generated by the assets in excess of the cost of funding on the securities and transaction expenses such as servicing, trustee and management fees. Generally, excess spread is available to absorb losses. To the extent that all of the obligations prescribed by the transaction legal documents are satisfied, excess spread can be released to the seller or residual holder. Consequently, excess spread is only available to cover losses incurred during the period when it is positive. Excess spread may also be trapped by transaction triggers related to collateral performance.

Letter of Credit

A letter of credit is an agreement between a provider, usually a bank, and the SPV, the beneficiary. Under the terms of the contract, in defined circumstances, the provider will forward funds directly to the SPV in satisfaction of its third-party obligations. Letters of credit can be a type of credit enhancement because they form contractual obligations between the SPV and the provider, independent of the conduct or status of the third party. DBRS's criterion for the letter of credit provider is a rating of A (high) or R-1 (middle) by DBRS or otherwise satisfy the Rating Agency Condition.

Quantitative and Cash Flow Analysis

DBRS typically receives pool stratifications that provide a summary of loan characteristics such as loan rate, term, seasoning and any other characteristics necessary to evaluate the credit quality of asset pools. Ideally, the characteristics of the underlying assets that generate the static pool loss experience should mirror the characteristics of the proposed pool as closely as possible. However, DBRS recognizes that pools with similar summary characteristics can demonstrate different performance. It is highly preferable that originators/sellers have the reporting capability to provide static pool performance data that can be stratified by various attributes such as loan term, seasoning, etc. In cases where sufficient loss performance detail has been provided, DBRS can refine its analysis by using the data to determine a more precise loss estimate for each distinct component of the pool and then use this result to develop a weighted-average loss expectation for the securitized pool based on the relative contribution of each segment.

Historical Performance

As part of the rating process, DBRS analyzes historical asset performance data provided by the originator/seller and looks to compare the originator's experience with the performance of the overall market. DBRS also uses this historical information to help assess future collateral performance. Preferably, DBRS expects sellers to provide separate default and recovery information that covers asset performance during various economic cycles to enable DBRS to evaluate the impact that macroeconomic factors may have on collateral performance. By evaluating defaults and recoveries separately, DBRS can not only gain additional insight into the unique factors that affect default and recovery rates but can also better understand the volatility drivers behind each set of information and develop more accurate and appropriate stresses. To the extent that only net loss data is available, DBRS applies adjustments to the data presented that take into account historical recoveries.

Loan-Level Data

DBRS may determine expected credit losses using proprietary loan-level models, as applicable. Default frequency and loss severity are estimated separately for each individual loan and then combined to determine an aggregate expected credit loss for the pool.

Base-Case Determination

As part of the quantitative review, DBRS estimates a base case default frequency and/or loss severity based on historical performance and/or loan-level data provided by the originator, if available. Alternatively, a base case expected loss may be estimated. In lieu of base-case analysis, alternative loss assumptions may be used, as detailed in the asset-specific appendices.

Typically, DBRS requires three to five years of performance history from an issuer to perform a rating analysis. In the absence of static pool data, DBRS requests supplemental data to help determine its loss projection. Where the performance history for the originator's assets is insufficient, DBRS may consider proxy data such as the performance of similarly originated assets within the same jurisdiction. In cases where originator-specific data is unavailable, DBRS is likely to use a higher base-case loss projection than would otherwise be suggested by the proxy data. In the absence of adequate performance information, DBRS may decline to rate the transaction.

To assess static pool losses, DBRS will determine if the attributes of the proposed pool to be securitized are similar to the pools for which performance data is available. Provided that this is the case, DBRS can use the historical static pools as a foundation to construct a base case and an estimate of future defaults and losses for the proposed pool.

To determine the base case, DBRS considers the economic environment that existed as the asset pools seasoned and any changes in origination or servicing practices that might be anticipated to result in markedly different performance metrics across different vintages. DBRS also contrasts the performance metrics with those of other originators operating in the same markets and examines the inherent volatility of the performance of the assets. DBRS then determines estimates that reflect this historical credit behaviour, and where appropriate (e.g., in the presence of negative trends, regime changes, inexplicable volatility or use of proxy data), conservatively adjusts the base case further to appropriately address any such limitations or concerns.

Cash Flow Analysis

After establishing a base case, DBRS performs cash flow analysis to determine whether the proposed or existing credit enhancement levels, as well as the transaction structure, warrant the requested rating level. The stress multiples vary by rating level based on pool characteristics, historical pool performance and its volatility. The ranges of stress levels DBRS typically applies are asset-specific and may be determined case by case. DBRS also ensures that its cash flow analysis replicates the transaction's priority of payments waterfall and trigger mechanisms.

Cash flow analysis involves combinations of stresses on key assumptions, including the following:

Probability of Default and Timing of Defaults

In its cash flow scenario analysis, DBRS may use one or more default timing curves, based on historical performance of the assets, for the distribution of defaults over time. These curves are combined with various prepayment and interest rate assumptions to produce several scenarios for use in cash flow modelling.

Loss Given Default and Recovery

DBRS lags recovery timing to reflect the likely delay in realizing proceeds from any asset upon default. Modelling scenarios incorporate delays in receiving recoveries that could occur because of the length of the liquidation process, ineffective servicing or a servicing transition. DBRS may assign different recovery lags by asset type.

Prepayments

Prepayment speed measures the rate at which borrowers make their principal payments in excess of required amounts. Prepayments reduce the outstanding principal balance of the collateral pool, thus reducing the amount of excess spread. The faster the prepayment speed, the larger the amount of excess spread that is depleted. DBRS needs monthly principal payment rate data to make an appropriate base-case prepayment rate assumption. This base-case assumption is then adjusted based on asset class performance factors or external macroeconomic factors and is subjected to stress ranges commensurate with the desired rating of each class in the cash flow analysis.

Interest Rate Risk

There are two types of interest rate risks:

- **Interest Rate Mismatch:** Interest rate mismatch (fixed/float) risk occurs when the interest rate terms on the underlying collateral (i.e., asset yield) are different from the coupon on the notes issued (i.e., cost of funds).
- **Basis Risk:** Basis risk arises when the basis for calculating interest charged on the securitized assets or swap contract is different from the basis for interest on the notes issued (e.g., prime versus Canadian Dealer Offered Rate (CDOR)).

To quantify the effect of these interest rate mismatch scenarios, DBRS applies stress multiples to the base-forward curve in its cash flow analysis. DBRS runs a series of interest curves to test the sensitivity of the structure to interest rate volatility. These curves generally include the applicable forward curve, as well as upward and downward stresses. Curves are generated for all rating ranges and are applied according to the desired rating of each tranche to test the ability of the deal to withstand movements in interest rates.

Foreign Currency Risk

This risk arises when the proceeds received from the collateral are in a different currency than the principal and interest payments required for the notes issued. Any mismatches in currencies that are not mitigated would be subject to additional stresses in DBRS's cash flow analysis.

Swaps / Hedging

When no derivative agreements are in place to hedge interest rate or foreign currency risk, DBRS attempts to quantify these risks by applying various stresses to the cash flows. If hedges or swaps are in place, DBRS will incorporate the hedging arrangement in its analysis in accordance with the underlying transaction documents.

Reinvestment Rate on Investments

A low rate of return on balances in the reserve fund can exert a drag on the transaction's cash flow, and this is incorporated in DBRS's cash flow analysis.

Surveillance / Monitoring

DBRS generally discusses its surveillance methodology in the *Master Canadian Structured Finance Surveillance* methodology.

Appendix: Franchise Loans

Credit Factors to Consider

Performance Metrics

- Franchisee concentration
- Third-party recovery rates
- Recovery timing
- Loss rates
- Loss/delinquency/dilution history
- Franchisor history and experience

Credit Quality of Pool

- Borrower: Franchisee characteristics
- Sponsor: Franchisor characteristics
- Third-party asset values
- Asset concentrations

Transaction Structure

- Advance rate/borrowing base
- Revolving period
- Amortization period
- Eligibility criteria
- Concentration limits

Transaction Triggers

- Franchisor credit rating
- Servicer termination events
- Commingling conditions
- Counterparty rating triggers
- Amortization events
- Performance triggers

Credit Enhancement

- Overcollateralization
- Cash reserve account
- Letters of credit
- Excess spread
- Subordination

This appendix focuses on securities backed by portfolios of loans to franchisees to finance the acquisition of inventory and some fixed assets. Rating considerations include a review of qualitative and quantitative considerations for the proposed structure with respect to the following:

- Operational risk review
- Legal structure review
- Securitized asset analysis

Background

Franchise loans generally provide financing to franchisees to purchase inventory and some fixed assets. They can be provided by third-party financiers, although DBRS to date has only seen transactions where the franchisor provides the financing. Compared with other types of asset securitization transactions, the securitization of loans to franchisees introduces additional risk caused by the lack of industry diversification and the higher level of operational reliance that the obligor (the franchisee) has on the franchisor. Franchise receivables lack the obligor and industry diversification characteristics that benefit trade and other corporate receivable transactions.

Correlation Risk

This lack of diversification presents much higher correlation risk in franchise receivables transactions, as a franchisee is largely dependent on the success of the seller, with varying degrees of reliance on inventory supply, retail space (land and building), advertising and branding support, and logistical and systems support. Similarly, severity of default may be high in the case of franchisee receivables, depending on the permitted advance rate against the value of assets, since a franchisor default is likely to have a significantly negative impact on the continued success of the franchisee. The lack of diversification and the significant dependence of the obligors on the seller may also lead to higher loss severity. Consequently, enhancement levels are expected to reflect this loss potential, with a primary focus on the strength of the seller, conditions or triggers that mitigate a decline in the strength of the seller and on the realization value of the financed assets.

Operational Risk Review

Similar to other asset classes, DBRS's evaluation of the transaction includes an operational review. DBRS conducts the review of the franchisor as part of the rating analysis as described in the Operational Risk section of the methodology (page 3). Of particular importance are the credit rating of the transaction sponsor (the franchisor), its management and operational track record and the depth and breadth of its presence in the market. As indicated in the Operational Risk section, historical results are also reviewed to establish the performance metrics necessary for evaluating the proposed enhancement structure.

Sponsor Review – Franchisor Analysis

The viability and financial health of the franchisor is integral to the likelihood of success of a transaction that contemplates funding of franchisee loans backed by a first-priority claim on franchisee assets. As such, a review of the transaction sponsor is conducted with an emphasis on the financial strength of the franchisor and any conditions or triggers that mitigate a decline in the financial

strength of the seller (such as the triggering of an early unwind scenario if the sponsor falls below a certain minimum rating). Transactions sponsored by an entity with a rating below investment grade will be reviewed on a case-by-case basis and should include an enhancement proposal and structure reflecting the creditworthiness of the franchisor.

Franchisee Review – Concentration Analysis

Similarly, the financial health of the franchisee network is also reviewed based on information provided by the franchisor. DBRS reviews portfolio concentrations, franchisee eligibility policies and ongoing franchisee monitoring, among other things. The degree of reliance the franchisee has on the franchisor for inventory supply, retail space (land and building), advertising support and systems is also considered.

Credit Analysis and Enhancement Evaluation

The degree of concentration risk and reliance on the health of the franchisor warrants the evaluation and analysis of the underlying collateral values. It is expected that third-party realization values be provided to DBRS on a timely basis. Credit enhancement for franchise loan securitizations is generally evaluated by taking into account several key factors that include, but are not limited to, the following:

- Eligibility criteria
- Delinquency and default history
- Historical payment characteristics (e.g., seasonality)
- Franchisee concentrations and credit quality
- Asset concentration limits
- Fixed-asset depreciation rates
- Securitization structure
- Franchisor and franchisee risk profile
- Quality of the servicer
- Third-party asset realizations
- Underwriting procedures and policies
- Quality of the data

Credit enhancement needs to address the various risks inherent in the specific transaction, which may include the following:

- Credit loss reserve
- Stress on third-party realization values
- Dilution reserve
- Yield or cost of funds reserve
- Replacement servicer reserve

Each element is assessed in isolation and as a whole to determine the adequacy of available credit enhancement to support the rating assigned.

Credit Loss Reserve

Franchisee Defaults

The credit loss reserve is intended to provide protection to the noteholders from credit losses that may arise over the life of the transaction. Notwithstanding the true sale structure of a securitization program, a transaction may experience losses during early amortization/unwind if the credit enhancement is insufficient to sustain high levels of franchisee defaults.

As the repayment of the franchise loans relies on the successful operations of the underlying franchisees, any franchisee bankruptcies may result in significant losses to the securitization program. The franchisee may experience financial difficulties because of increased competition, operational deficiencies or an economic downturn in its local region, which may lead to a franchisee default.

Franchisee default analysis is conducted based on historical information to establish a loss reserve. Typically, DBRS examines at least three to five years of monthly or quarterly loss and performance data as part of the analytical process in evaluating the proposed enhancement structure, including proposed eligibility criteria. This data is analyzed to determine a base-case loss assumption in the event of a prolonged amortization period.

When historical losses are non-existent or extremely small, an estimation of losses is calculated using a loss proxy. The loss proxy compares historical owned and managed loss rates associated with franchisee defaults to the rolling 12-month loss rates. Based on historical data, DBRS applies the loss rate to calculate the potential amount of losses expected in an amortization and liquidation of the securitized assets. A stress factor is then applied to the loss proxy in accordance with Table 1. The highest three-month rolling average in the last 12 months is applied in the credit loss calculation to reflect seasonality.

Table 1

	AAA/R-1 (high)	AA/R-1 (middle)	A/R-1 (low)	BBB/R-2 (high)
Loss Proxy Stress Factor	5-6x	4-5x	3-4x	2-3x

Franchisee Concentrations

Typically, concentration limits are included in the transaction to address franchisee concentration risk. In this scenario, funding available to the franchisee is a function of the credit enhancement in the transaction and the credit rating of the franchisee. It is expected that most franchisees are not rated and thus qualify for the lowest available funding indicated in Table 2.

Table 2

Franchisee Concentration Limits

Long-Term Obligor Rating (at least) (or its equivalent)²	As a Percentage of Total Enhancement	
	AAA/R-1 (high) Rating	AA/R-1 (middle) Rating
AAA	100%	100%
AA (low)	50.0%	100%
A (low)	33.3%	50.0%
BBB (low)	25.0%	33.3%
BB (high) or lower, or unrated	16.6%	25.0%

Franchisor Default

Depending on the franchise system, the franchisor, in addition to providing services such as branding, advertising, inventory management and purchasing, may also provide financing services. The concept of a replacement servicer is much more complex in such a scenario, given the dependence of the franchisee on the continued performance of the franchisor. In such a scenario, the bankruptcy of the franchisor has more profound implications than a bankruptcy of the sponsor of a typical consumer asset securitization transaction. A variety of corporate business risks becomes relevant to DBRS, such as the business and financial strategies of the franchise system, including the extent to which alternative financing is accessible.

To date, transactions rated by DBRS have only been sponsored by large, well-established franchisors with investment-grade ratings, whose probability of bankruptcy is relatively low. In assessing the effects of a possible franchisor bankruptcy on the securitized franchise loan pool, DBRS considers the credit risk of the franchisor (including its credit rating), any conditions or triggers that control for changes in the credit risk of the franchisor, as well as the sufficiency of asset value in an assumed franchisor bankruptcy scenario.

2. The phrase "or its equivalent" refers to the equivalent DBRS rating. All rating references used in this publication refer to the relevant rating by DBRS or its equivalent rating by DBRS.

Other considerations may also be important such as the reliance of the franchise system overall on the franchisor-sponsored financing program. For example, to the extent third-party financing is in place for at least some franchisees and is readily available as an alternative source of financing, the effect of an early amortization of the franchise loan securitization program may have less of an impact on the continued viability of the franchise than it would otherwise.

Asset Appraisal and Borrowing Base Deficiency

The underlying assets are expected to be appraised on a timely basis by an independent third party with experience in the appraisal of similar assets included in the securitization structure. DBRS recognizes that changes in economic and market conditions can cause asset values to fluctuate, and as such, an appropriate stress is expected to be applied to the appraised value. The stress on the third-party review is based on the frequency of the estimate provided and on the asset mix within the structure, and may also vary by the rating of the securitized assets. In addition, the stressed realization value of the underlying assets should incorporate additional costs such as marketing or brokerage fees, replacement servicer fees and debt servicing costs during the liquidation period.

If the stressed realization value is less than the loan amount, then a borrowing base deficiency exists. Exposure to any borrowing base deficiencies is expected to be covered by the available credit enhancement in the transaction. As franchise loan receivable transactions are typically revolving, the borrowing base deficiency should be calculated on a monthly basis to ensure that any exposure can be properly mitigated.

Enhancement Floor

Franchise receivables transactions are expected to be further supported through the application of a reserve floor, which acts as a minimum level of enhancement, regardless of credit performance. The reserve floor is a percentage of the total outstanding loan amount and is established to recognize that default risk from franchisees is unpredictable, and, given the relatively short turnover, the frequency of inventory and fixed-asset valuations and the potential buildup in seasonality, the amount at risk in any one month can be high. In transactions where the level of franchisee concentrations is high, the enhancement floor is also expected to be adjusted upward to mitigate the risk of default from any of the top obligors.

Portfolio Yield and Hedging Analysis

Whether franchise loans are interest or non-interest bearing, the structure needs to be robust enough to cover cost of funds throughout the duration of the amortization period. This risk includes the scenario of a rise in interest costs or a delay in cash flow receipts from franchisees or liquidation of the assets in an amortization scenario. As a result, enhancement is expected to mitigate the stress on interest rate coverage from this potential risk. To the extent that a hedge is required, it is expected to comply with DBRS standards outlined in the Derivatives Criteria for Canadian Structured Finance.

Summary

Total enhancement recommendations need to consider all of the following and perhaps other factors, depending on the transaction:

- The loss reserve multiplied by the ratings-based stress factor;
- The aggregate franchisee borrowing base deficiency as measured against the stressed third-party estimates;
- A stress on the largest franchisee borrowing base deficiency;
- Reserve in consideration for potential dilution risk, replacement servicer costs and portfolio yield; and
- The enhancement floor.

Application of Stress Multiple and Third-Party Realization Value Stress

The stress multiple and realization value stress serve to protect the rated securities from much harsher and more stressful conditions than assumed within the steady state scenario. The stress multiple is compared with the historical volatility of losses within the asset class such that an issuer with more consistent historical data than the industry average may warrant the use of a lower multiple within the range for a given rating. Similarly, stress levels on realization values of assets are established based on historical volatility of the underlying asset values and with the frequency of the third-party valuation.

The stress levels noted above are applied to transactions on a case-by-case basis determined by the following, among other things:

1. The quality and availability of historical data;
2. The originator/franchisor and franchisee considerations;
3. The transaction structure.

Historical Data

Consistent and lengthy historical data that covers at least one full economic cycle and includes all significant stratifications (e.g., new, used, perishable and non-perishable inventory, fixed assets, etc.) of the proposed portfolio may warrant a lower stress multiple. However, volatile and incomplete data sets may warrant a higher stress multiple to account for the lack of historical data.

Structural Mitigants

The transaction structure is also important in assessing the required credit enhancement for a given transaction. If the structure includes appropriately structured early warning triggers on metrics such as losses and delinquencies, it may warrant a lower stress multiple, resulting in lower required credit enhancement. However, if such triggers do not exist or are deemed to have been set at levels that are too high to be meaningful, a higher stress multiple may be applied. If credit enhancement has very high floor levels, or if an investment-grade originator is required to repurchase defaulted assets, a lower stress multiple may also be warranted; however, in the absence of these structural mechanics, a higher stress multiple may be more appropriate. Structural considerations may include the following:

- An early amortization trigger tied to the rating or shadow rating of the franchisor.
- The level of credit enhancement (including step-ups in required enhancement based on performance) and floor levels.
- Trigger levels (quality of receivables, credit rating, servicer, insurance, etc.).
- Amount of cash enhancement available.
- Value/recoverability of franchise operations and/or assets (i.e., inventory, fixtures, real estate, etc.).
- Depreciation rates on fixed assets.
- Likelihood/ability of franchisees to survive following default of the seller.
- Timely third-party asset valuations.
- Non-standard landlord restrictions on liquidation process.

The proposed credit enhancement structure is reviewed and may include subordination, overcollateralization, excess spread, letters of credit and/or a cash reserve account. The enhancement proposal is expected to include dynamic features to mitigate risks related to market and/or portfolio deterioration. To the extent that letters of credit are included, it is expected that the providers of the letter of credit meet the counterparty criteria as outlined in DBRS's *Legal Criteria for Canadian Structured Finance*.

The proposal is also expected to include performance triggers, which may include the following:

- Delinquency tests
- Loss tests
- Payment rate tests
- Inventory and fixed-asset valuation tests
- Inventory turnover tests
- Portfolio yield tests
- Franchisor credit rating tests

Typically, breached triggers result in an early amortization, the end of the revolving period, termination of the notes, or require that excess spread be trapped within the structure rather than released to the seller. Other triggers such as failure to pay within a certain time period or breach of certain representations or warranties may cause an event of termination. Additionally certain actions by the servicer may result in a servicer termination event, while rating actions negatively affecting the credit rating of the seller, servicer or performance guarantor may also trigger an acceleration of the notes.

Legal Structure

Legal considerations include, among other things, a review of the true sale/bankruptcy remoteness opinions and the process followed to ensure a perfected security interest in the securitized assets is consistent with DBRS's *Legal Criteria for Canadian Structured Finance* (www.dbrs.com).

Appendix: Consumer Loans

Credit Factors to Consider

Collateral Performance Metrics

- Delinquencies
- Defaults
- Recoveries
- Loss given default and recovery timing lag
- Cumulative net losses
- Prepayments
- Principal amortization
- Asset yield

Transaction Triggers

- Servicer termination events
- Commingling conditions
- Counterparty rating
- Lock-out events (e.g., amortization events)
- Termination events
- Asset yield maintenance

Credit Quality of Pool

- Pool characteristics (e.g., geographic concentration, obligor concentration, distribution channel, original term, remaining term, seasoning, credit balance, borrower quality, purpose of loan, installment/balloon)
- Eligibility criteria
- Volume and stability of historical originations and collateral characteristics

Typical Forms of Credit Enhancement

- Subordination
- Overcollateralization
- Cash reserves
- Excess spread levels and thresholds
- Letter of credit

Transaction Structure

- Discrete (amortizing) or revolving collateral pool
- Note structure/payment priorities (sequential pay, pro rata, turbo)
- Lock-out period
- Servicing and back-up servicing

Cash Flow Assumptions

- Expected losses
- Multiples of expected loss for each rating
- Loss timing
- Recovery amount and timing lag
- Prepayments
- Interest rate risk and basis risk

Consumer loans are typically unsecured, amortizing loans with scheduled equal payments. Borrowers are required to make equal payments at a frequency stipulated in the contract loan terms. Loan terms typically have a fixed rate of interest and generally are short term in duration. Consumer loans are commonly used for personal purposes such as to consolidate debt or for purchases.

Securitization transactions backed by consumer loans may include collateral pools that are discrete or revolving and have principal payments made by a large number of diversified individual obligors, which are passed through to reduce bond principal outstanding or reinvest in new loans. Any available excess cash flow is typically released to the seller. Release of excess cash flow may continue until a transaction mechanism such as a lock-out or a termination event (if applicable) occurs, typically based on pool or portfolio performance exceeding threshold levels. If a lock-out event occurs, excess cash flow is no longer released to the seller but instead may be used to build credit enhancement. Credit enhancement may be released if the threshold breach is cured. If a termination event occurs, excess cash flow is typically used to pay down the notes. Transactions may also be structured with a revolving period preceding the scheduled paydown of the notes.

Key Performance Metrics

Expected Losses

Consumer loans are considered in default once they are delinquent for a defined period of time or are written off according to the originator's credit and collection policy or the guidelines set by the regulators. Net losses are the result of defaulted loans less any recoveries received. Because of the unsecured nature of consumer loans, recovered amounts are typically limited, and the amounts depend on the means used to pursue defaulted balances. For cash flow modelling purposes, DBRS typically assumes a recovery rate of zero in the absence of recovery data to the contrary. In the event that the originator can provide historical data quantifying and supporting consistent recoveries, DBRS may consider incorporate partial credit for recoveries.

Prepayments

Prepayments occur when obligors make principal payments in an amount greater than the required instalment payment amount. Prepayments reduce the outstanding principal balance of a loan, thereby reducing the amount of excess spread but also possible future defaults and losses. Loans that prepay in full reduce the number of loans that may default going forward. Prepayments may arise as a result of a consumer's desire to refinance to take advantage of a more favourable interest rate. As it is often the better-quality obligors that have a higher likelihood of prepaying, higher prepayment rates may affect the amount and timing of pool cash flows. Accordingly, DBRS may stress a transaction's prepayment rate to assess the impact on excess spread, as well as to evaluate the collateral pool for potential negative obligor quality migration resulting from prepayments.

Asset Yield

Portfolio yield is generated from finance charges, which include interest charges and other miscellaneous fees. The portfolio yield is calculated as the annualized average of the monthly income earned on the portfolio divided by the receivables balance. The interest rate charged to borrowers can be a fixed rate or a floating rate based on a benchmark plus a spread.

Cash Flow Analysis

DBRS typically reviews at least three years of performance data of the seller to determine (1) defaults, (2) loss timing, (3) recovery rate and timing lag and (4) prepayment rates. When the performance history for an originator's assets is insufficient, DBRS may consider using proxy data, such as the performance of similarly originated assets, to determine the cash flow assumptions. The impact of a pool's seasoning is considered when determining the expected loss and loss timing. In the assessment of the historical performance data, and in cases where recoveries are an element of the analysis, DBRS typically estimates a recovery rate, as well as a timing lag between the default and the expected recoveries, based on the length of the liquidation and recovery process.

Once the expected case assumptions are established, DBRS applies stresses that correspond to the target rating levels. The cash flow scenarios incorporate a pool's assumptions and the structural elements of the transaction, including transaction triggers, lock-out events and termination events or covenants that may affect the cash flows. The impact of a derivative product, when included in the transaction structure, is also taken into consideration.

To evaluate proposed credit enhancement levels that support a target rating, the expected loss figure, as previously described, is stressed. The stress is applied as a multiple of the expected loss figure, which in turn results in losses for each target rating's cash flow scenario. DBRS typically evaluates the results of the stress analysis under a variety of scenarios. To achieve a requested rating, the cash flow results are expected to withstand DBRS stresses that are appropriate for the rating.

The multiples serve to protect the rated securities from much harsher and more stressful conditions than assumed within the expected case cash flow scenario. The table below indicates the typical range of multiples for consumer loan securitizations. Multiples are designed to capture uncertainties and variables that may affect future transaction performance. The multiples provided are guidelines and may not be applicable in all transactions.

Summary of Typical Consumer Loan Loss Multiples by Rating Category

Rating	Prime	Subprime
AAA (sf)	3.75x – 5.00x	3.00x – 5.25x
AA (sf)	3.25x – 4.25x	2.50x – 4.25x
A (sf)	2.75x – 3.75x	2.00x – 3.25x
BBB (sf)	2.25x – 3.00x	1.75x – 2.50x
BB (sf)	1.75x – 2.25x	1.40x – 1.75x

Appendix: Insurance Premium Loans

Credit Factors to Consider

Collateral Performance Metrics

- Delinquencies
- Defaults
- Recoveries
- Loss given default and recovery timing lag
- Cumulative net losses
- Payment rate
- Loan rate

Credit Quality of Pool

- Pool characteristics (e.g., geographic concentration, obligor concentration, carrier quality)
- Eligibility criteria
- Volume and stability of historical originations and collateral characteristics
- History and method of unearned premium recovery

Transaction Structure

- Typically revolving collateral pool
- Note structure/payment priorities (sequential pay, pro rata, turbo)
- Lock-out period
- Servicing and back-up servicing

Transaction Triggers

- Servicer termination events
- Commingling conditions
- Counterparty rating
- Lock-out events (e.g., amortization events)
- Termination events
- Financial Covenants
- Asset yield maintenance

Typical Forms of Credit Enhancement

- Subordination
- Overcollateralization
- Cash reserves
- Excess spread levels and thresholds

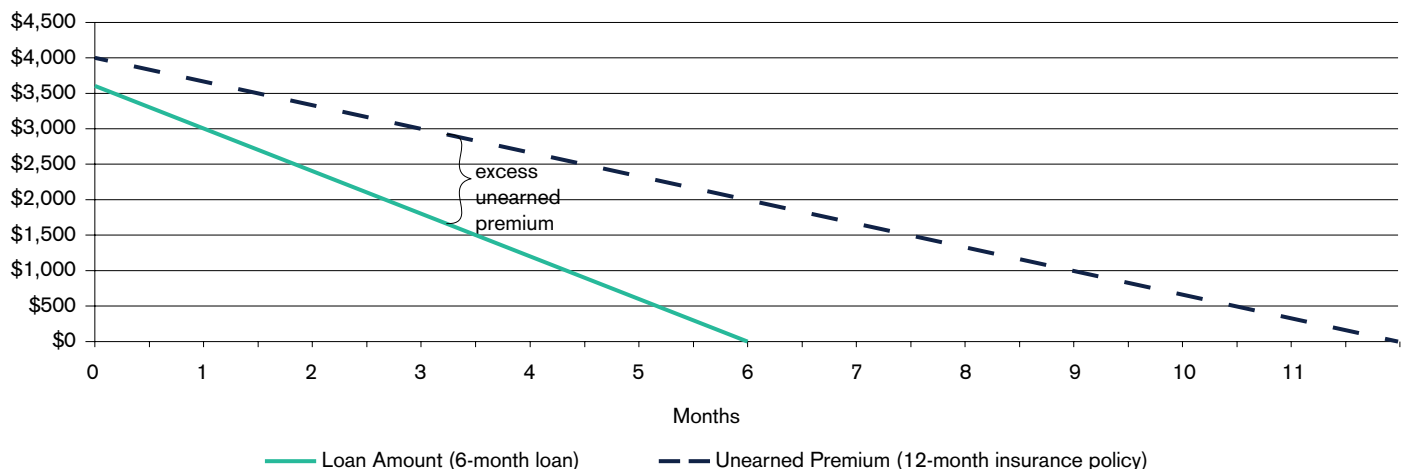
Cash Flow Assumptions

- Expected defaults
- Loss timing
- Recovery amount and timing lag
- Prepayments
- Yield
- Interest rate risk and basis risk

An insurance premium loan is extended to an obligor to pay for the premiums due on property and casualty insurance. The financing arrangement with the obligor requires monthly or periodic payments to the lender to repay the lump sum premium payment made by the lender to secure the insurance policy with an insurance carrier. Often, the premium is required to be paid in a lump sum by a lender (typically a finance company) to an insurance carrier. The amount of the premium is normally the cost to the obligor for a specific insurance contract. The financing arrangement also normally provides that the lender is entitled to any unearned premium due from the insurance carrier in the event of policy cancellation. The arrangement may also include a limited power of attorney to permit the lender to cancel coverage under the policy. To be an eligible loan for securitization, the lender must have power of attorney to effect cancellation and receive unearned premium under the policy.

In the financing arrangement, it is customary for the obligor to make a down payment (typically 5%–25%) at the time of financing, which creates excess collateral for the lender, being the difference between the unearned insurance premium and the insurance premium loan principal amount. The specifics of the insurance coverage, including the terms and cost, are typically negotiated and agreed upon between the obligor and the insurance carrier without the involvement of the finance company. The term of the premium loan is typically less than (or at most, equal to) the term of the insurance policy, which provides additional protection to the finance company. As the premium loan amortizes faster than the unearned insurance premium that has been paid (e.g., a six-month premium loan versus one year of insurance coverage), the excess unearned premium amount increases over time (see graph below).

Illustration of Unearned Premium



The primary risk occurs when an obligor fails to pay on the premium loan, and the corresponding policy must be cancelled. An obligor (or the lender acting through the power of attorney) is generally entitled to cancel the policy at any time. In such an event, the insurance carrier is obligated to reimburse the unearned premium paid under the insurance contract to the lender, as the insurance carrier ceases earning the premium that had been paid by the finance company. Therefore, quantitatively, the risk to the finance company (aside from insurance carrier insolvency risk) equals the excess, if any, of the aggregate amount of the outstanding loan over the amount of unearned premium the finance company is owed at cancellation.

The worst-case scenario occurs when a policy is cancelled on day one, when the finance company has its full premium lump sum payment paid to the insurance carrier, but the premium loan has not begun to amortize. However, the risk of loss to an investor is mitigated by the amount of down payment received by the finance company from the obligor, as well as the subordination, overcollateralization and reserve fund usually available in the transaction structure.

Insurance Carrier Risk

The main source of recovery in a premium finance arrangement is the insurance carrier that provides the insurance policy; therefore, the claims paying ability of the insurance carrier is an important analytical consideration.

DBRS reviews the claims paying ability ratings of the insurers and the diversity of such insurers in a transaction. Transactions typically include large pools of loans relating to policies issued by diverse insurance carriers with concentration limits that can protect against exposures to insurers representing high concentrations of receivables, low ratings or other concentrations that introduce additional risk in the transaction. Generally, a lack of diversity among insurers and/or high concentrations of lower-rated insurers could limit the rating of the transaction, as the primary source of payment is the rebate of unearned premium from the insurers.

Since the obligor has granted a security interest over the unearned premium to the finance company, should a carrier become insolvent, the finance company would normally file a claim as a secured creditor, allowing it to be reimbursed for the unearned premium. Insurance company policy obligations in Canada are supported with funds by an insurance industry association in the case of a carrier's insolvency. While the likelihood of recovery is increased because of the presence of such support funds, the timing of payment is uncertain, which can expose a transaction to timing delays, and the amount paid by the support fund may be capped.

Cash Flow Analysis

DBRS typically reviews at least three years of performance data of the finance company (the seller) to determine (1) delinquencies, defaults, losses or such other indicators of credit performance; (2) default/loss timing; (3) recovery rate and timing lag; and (4) prepayment rates. The starting point for the determination of a base case loss is this historical loss data. DBRS also typically performs an analysis on the probability of default of the insurance carriers in the pool, which is incorporated in the determination of the base case loss to which stress multiples are applied as described below. In the assessment of the historical performance data, and in cases where recoveries are an element of the analysis, DBRS typically estimates a recovery rate, as well as a timing lag between the default and the expected recoveries, based on the estimated length of the claims recovery process or recovery following a carrier insolvency. The amount of credit enhancement may vary depending upon the composition of the collateral pool, but a minimum threshold amount is typically established, which is derived from historical loss rates for insurance premium loan companies. The risks to recovery are generally the timing of the cancellation notice being delivered to the insurer, reliance on insurance agent intermediaries to collect unearned premiums and remit those funds to the finance company, and to a lesser extent, the insurer's becoming insolvent during that period of time. Ultimate losses result from a failure of an insurer to rebate the entire unearned premium following an obligor default on payment of the financing loan.

Summary of Typical Canadian Insurance Premium Loan Loss Multiples by Rating Category

Rating Category	Loss Coverage Multiple
AAA (sf)	5-6x
AA (sf)	4-5x
A (sf)	3-4x
BBB (sf)	2-3x
BB (sf)	1-2x
B (sf)	1x

To evaluate proposed credit enhancement levels that support a target rating, the expected loss figure, as previously described, is stressed. The stress is applied as a multiple of the expected loss figure, which, in turn, results in losses for each target rating's cash flow scenario. DBRS typically evaluates the results of the stress analysis under a variety of scenarios. To achieve a requested rating, the cash flow results are expected to withstand DBRS stresses appropriate for the rating.

The multiples serve to protect the rated securities from much harsher and more stressful conditions than assumed within the expected case cash flow scenario. The table to the left indicates the typical range of multiples of base case losses for insurance premium loan securitizations in Canada. Multiples are designed to capture uncertainties and variables

that may affect future transaction performance. The multiples provided are guidelines and may not be applicable in all transactions.



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