

subordination or other means. If subordination is used, however, the subordinated class will have no greater credit risks or fewer legal protections in comparison with other credit-supported classes that possesses the same rating.

There is much benefit to plan investors in having subordinated securities eligible for exemptive relief. First, credit support provided through third-party credit providers is more expensive than an equal amount of credit support provided through subordination. As a result, the ability to use subordinated tranches to provide credit support for the more senior classes (which may or may not themselves be subordinated) creates economic savings for all the parties to the transaction which, in turn, can allow greater returns to investors. In addition, if the credit rating of a third-party credit support provider is downgraded, the rating of the securities is also downgraded. Second, the yields available on subordinated securities are often higher than those paid on comparably rated non-subordinated securities because investors expect to receive higher returns for subordinated securities. Third, subordinated securities are usually paid after other more senior securities, which results in their having longer terms to maturity. This is appealing to many investors who are looking for medium-term fixed income investments to diversify their portfolios. The combination of these factors benefits investors by making available securities which can provide higher yields for longer periods. It should be noted that as the rating of a security generally addresses the probability of all interest being timely paid and all principal being paid by maturity under various stress scenarios, the rating agencies are particularly concerned with the ability of the pool to generate sufficient cash flow to pay all amounts due on subordinated tranches, and several features of the credit support mechanisms discussed below are designed to protect subordinated classes of securities.

Types of Credit Support

29. Credit support consists of two general varieties: external credit support and internal credit support. The Applicant notes that the choice of the type of credit support depends on many factors. Internal credit support which is generated by the operation of the Issuer is preferred because it is less expensive than external credit support which must be purchased from outside third parties. In addition, there is a limited number of appropriately rated third-party credit support providers available. Further,

certain types of credit support are not relevant to certain asset types. For example, there is generally little or no excess spread available in residential or CMBS transactions because the interest rates on the obligations being securitized are relatively low. Third, the ratings agencies may require certain types of credit support in a particular transaction. In this regard, the selection of the types and amounts of the various kinds of credit support for any given transaction are usually a product of negotiations between the underwriter of the securities and the ratings agencies. For example, the underwriter might propose using excess spread and subordination as the types of credit support for a particular transaction and the rating agency might require cash reserve accounts funded up front by the sponsor, excess spread and a smaller sized subordinated tranche than that proposed by the underwriter. In addition, market forces can affect the types of credit support. For example, there may not be a market for subordinated tranches because the transaction cannot generate sufficient cash flow to pay a high enough interest rate to compensate investors for the subordination feature, or the market may demand an insurance wrap on a class of securities before it will purchase certain classes of securities. All of these considerations interact to dictate which particular combination of credit support will be used in a particular transaction.

External Credit Support

30. In the case of external credit support, credit enhancement for principal and interest repayments is provided by a third party so that if required collections on the pooled receivables fall short due to greater than anticipated delinquencies or losses, the credit enhancement provider will pay the securityholders the shortfall. Examples of such external credit support features include: insurance policies from "AAA" rated monoline²¹ insurance companies (referred to as "wrapped" transactions), corporate guarantees, letters of credit and cash collateral accounts. In the case of wrapped or other credit supported transactions, the Insurer or other credit provider will usually take a lead role in negotiating with the sponsor concerning levels of overcollateralization and selection of receivables for inclusion into the pool as it is the Insurer or credit

provider that will bear the ultimate risk of loss.

Internal Credit Support

31. Internal credit support relies upon some combination of utilization of excess interest generated by the receivables, specified levels of overcollateralization and/or subordination of junior classes of certificates. Transactions that look almost exclusively to the underlying pooled assets for cash payments (or "senior/subordinated" transactions) will contain multiple classes of certificates, some of which bear losses prior to others and, therefore, support more senior certificates. A subordinate certificate will absorb realized losses from the asset pool, and have its principal amount "written down" to zero, before any losses will be allocated to the more senior classes. In this way, the more senior classes will receive higher rating classifications than the more subordinate classes. However, the rating agencies require cash flow modeling of all senior/subordinated structures. These cash flows must be sufficient so that all rated classes, including the subordinated classes, will receive timely payment of interest and ultimate repayment of principal by the maturity date. The cash flow models are tested assuming a variety of stressed prepayment speeds, declining weighted average interest payments and loss assumptions. Other structural mechanisms to assure payment to subordinated classes are to allow collections held in the reserve account for the next payment date to be used if necessary to pay current interest to the subordinated class or to create a separate interest liquidity reserve. The collections held in the reserve account are from principal and interest paid on the underlying mortgages or other receivables held in the trust and are not from the securities issued by the issuer.²² Also, some structures allow

²¹ The term "monoline" is used to describe such insurance companies because writing these types of insurance policies is their sole business activity.

²² A collections reserve account is established for almost all transactions to hold interest and principal payments on the mortgages or receivables as they are collected until the necessary amounts are paid to securityholders on the next periodic distribution date. In some transactions, the rating agencies or other interested parties may require, in order to protect the interests of the securityholders, that excess interest in amount(s) equal to a specified number of future period anticipated collections be retained in the collection account. This protects both senior and subordinated securityholders in situations where there are shortfalls in collections on the underlying obligations because it provides an additional source of funds from which these securityholders can be paid their current distributions before the holders of the residual or more subordinated securities receive their periodic distributions, if any. Accordingly, any reference to "collections" from principal and interest paid on the mortgages is intended to describe such excess