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News Bulletin

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FDIC Extends Securitization Safe Harbor Yet Again; Gains More Time to Further Consider Securitization Reforms

On March 11, 2010, the board of directors of the Federal Deposit Insurance Corporation ("FDIC") adopted a final rule (the "Final Rule") amending 12 C.F.R. §360.6 (the "Securitization Rule") regarding the FDIC's treatment, as conservator or receiver, of financial assets transferred by an insured depository institution ("IDI") in connection with a securitization or participation.[1] The Final Rule extends the date (the "Sunset Date") on or prior to which all securitizations and participations for which financial assets are transferred, or revolving securitization trusts for which securities are issued, will remain "legally isolated" so long as those securitizations and participations would have been accounted for as sales under GAAP as in effect before November 15, 2009, and satisfy all other conditions of the Securitization Rule from March 31, 2010, to September 30, 2010. The FDIC Board's adoption of the Final Rule to extend the Sunset Date to September 30, 2010, was recognition that more time would be needed to consider the more extensive and provocative securitization reforms it proposed under an Advance Notice of Rule Making (the "ANPR") it issued on December 15, 2009.

Background

The FDIC originally adopted the Securitization Rule in 2000 to provide comfort that loans or other financial assets transferred by an IDI into a securitization trust or participation would be "legally isolated" from an FDIC conservatorship or receivership if, among other requirements, the transfer met all conditions for sale accounting treatment under generally accepted accounting principles ("GAAP"). Securitization participants have long relied on the Securitization Rule for assurance that investors could satisfy payment obligations from securitized assets without fear that the FDIC might interfere as conservator or receiver.

Such assurances were dashed on June 12, 2009, when the Financial Accounting Standards Board (the "FASB") adopted Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* ("FAS 166"), and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* ("FAS 167"). These new accounting pronouncements substantially narrow the circumstances under which a transfer of financial assets in connection with a securitization may be accounted for as a sale, and expand the circumstances under which IDIs are required to consolidate issuer entities to which financial assets have been transferred for securitizations in their financial statements for fiscal years beginning after November 15, 2009. (For most institutions, the new GAAP rules became effective on January 1, 2010.) These changes will cause many securitization transfers that previously would have been treated as sales to be treated as secured borrowings for accounting purposes, and the Securitization Rule would not have applied unless it were amended.

The uncertainty over whether the FDIC would continue to grant safe harbor treatment to securitizations of an IDI in its conservatorship or receivership created considerable marketplace concern that caused many then-pending

[1] The Final Rule is posted at http://www.fdic.gov/news/news/press/2010/pr10048a.pdf.

securitizations to come to a halt. This concern culminated when Moody's Investors Service issued a report in September 2009 warning that it would review outstanding bank-sponsored credit card securitizations that were sponsored by banks not rated at least Aa3 for possible rating downgrades unless the safe harbor issue was addressed.

Temporary Relief — FDIC Adopts Transitional Safe Harbor

In response to the marketplace concerns and, presumably, the Moody's threat, the FDIC Board met on November 15, 2009, to adopt interim amendments to the Securitization Rule that "grandfathered" all securitizations and participations for which financial assets were transferred, or for revolving securitization trusts for which securities are issued, prior to March 31, 2010. Specifically, the interim amendments provided that such transactions would not be subject to the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover, or recharacterize as property of the institution or the receivership any such transferred assets so long as the transfers would have been accounted for as sales under GAAP as in effect before November 15, 2009, and satisfied all other conditions of the Securitization Rule. At the November 15 meeting, the FDIC Board stated that it would consider additional changes to the Securitization Rule at the December 15, 2009 meeting that would address the impact of FAS 166 and 167 after the March 31, 2010 transition period and introduce qualitative standards for securitizations designed to encourage "sustainable lending" and avoid the "massive losses" and "landmines" that had recently plagued IDIs.

Food for Thought — FDIC Introduces Provocative Changes to Securitization Rule

On December 15, 2009, the FDIC Board issued the ANPR regarding possible amendments to the Securitization Rule.[2] The ANPR includes a draft of "sample" regulatory text (the "Sample Rule") containing a provocative array of possible standards that must be satisfied in order for securitizations to qualify for safe harbor treatment under the Securitization Rule. The ANPR sought public comment on such possible securitization standards and posed a number of questions intended to stimulate submission of comments. Further, the ANPR underscored that the FDIC was not adopting or recommending the Sample Rule, but only offering it to "provide context" for response to the questions posed.

The ANPR was issued on the heels of the U.S. House of Representatives' December 11, 2009 passage of the Wall Street Reform and Consumer Protection Act (the "Wall Street Reform Bill"), which includes a number of reforms targeted at asset-backed securitizations, including requirements that loan originators or securitizers retain an economic interest in the credit risk of the underlying loans and increased disclosure obligations for issuers of asset-backed securities.[3]

The legislative landscape for securitization reform became even more crowded on March 15, 2010, when Senator Christopher Dodd introduced a financial reform bill to the U.S. Senate (the "Dodd Bill") that is intended to be the U.S. Senate's companion bill to the House's Wall Street Reform Bill. The Dodd Bill also contains extensive restrictions on the securitization markets.

The Sample Rule

The Sample Rule includes a number of qualitative standards that securitizations must satisfy in order to be afforded safe harbor treatment.[4] Noting that certain "defects and misalignment of incentives" in the securitization process for residential mortgages in particular contributed significantly to an "erosion" of underwriting standards throughout the mortgage finance system, the FDIC structured the Sample Rule to include specific standards for securitizations supported by residential mortgage loans ("RMBS").
Set forth below are some of the more noteworthy standards contained in the Sample Rule.

[2] The Notice is posted at http://www.fdic.gov/news/board/DEC152009no5.pdf.
[3] For a discussion of the Wall Street Reform Bill, please see our client alert, "Update: House Passes Securitization Reform."
[4] Such qualitative standards do not apply to participations under the Sample Rule.

- *Risk Retention*. Sponsors must retain an unhedged economic interest of no less than 5% of the credit risk of the financial assets underlying a securitization.[5]
- *Tranche Restrictions*. RMBS must be limited to no more than six credit tranches and cannot include sub-tranches designed to further increase leverage in the capital structures. Notwithstanding the foregoing, the most senior credit tranche may include time-based sequential pay sub-tranches.
- *12-Month "Seasoning" Prior to Transfer*. All residential mortgage loans transferred into a securitization must have been originated no less than 12 months prior to such transfer. This requirement appears to be aimed at eliminating, at least for banks, the "originate to sell" business model that has been blamed for many of the adverse effects of the prior securitization cycle.
- *Prohibition on External Credit Supports*. The credit quality of securitization obligations cannot be enhanced through external credit supports or guarantees at the pool or issuer level, but temporary payment of principal and interest may be supported by liquidity facilities.
- *Servicer Loan Modification Authority*. Servicing and other agreements must provide servicers with authority to mitigate losses on financial assets consistent with maximizing the net present value of the financial asset, including authority to modify assets to address reasonably foreseeable defaults. Servicers must act for the benefit of all investors and commence action to mitigate losses no later than 90 days after the asset first becomes delinquent.
- *Compensation*. Fees and other compensation payable to lenders, sponsors, credit rating agencies, and underwriters are to be payable in part over five years after the first issuance of obligations with no more than 80% of the total estimated compensation due to any party at closing. The compensation to all parties involved in the securitization process must be structured "to provide incentives for sustainable credit and the long-term performance of the financial assets and securitization." Servicing compensation must provide incentives for servicing and loss mitigation actions that maximize the value of financial assets on a net present value basis.

More Time Needed — The Bigger Picture Deferred Yet Again

In hindsight, it appears that the FDIC had been overly optimistic in hoping to adopt substantive securitization reforms by March 31, 2010, the original Sunset Date under the Interim Rule, as the substantive standards under the Sample Rule were extremely controversial from the outset. Even at the December 15, 2009 FDIC Board meeting, two of the FDIC's board members, Comptroller of the Currency John Dugan and Acting Director of the Office of Thrift Supervision John Bowman, expressed concern over the Sample Rule as drafted.

The FDIC received 35 letters commenting on the Sample Rule, including letters from the American Securitization Forum, American Bankers Association, Securities Industry and Financial Markets Association, and the American Bar Association.[6] Many of the commentators cautioned the FDIC against taking piecemeal action prior to full Congressional consideration of the pending legislation impacting securitization reform, including the Wall Street Reform Bill, or coordination with other relevant regulatory agencies such as the Federal Reserve Board and Securities and Exchange Commission. Others questioned the efficacy of using the Sample Rule, which is primarily intended to govern the treatment of assets in insolvency, to impose upfront substantive requirements on securitizations. Doing so, they argue, effectively obliterates the "safe harbor" purpose of the rule by making it impossible to determine whether an IDI has complied with the rule at the time assets are transferred in a

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[5] The Wall Street Reform Bill also contains "skin in the game" provisions requiring that a minimum of 5% of the credit risk be retained by creditors or securitizers subject to upward or downward adjustment, depending on whether certain underwriting or due diligence standards set by the relevant regulators are met.

[6] The comment letters can be accessed at http://www.fdic.gov/regulations/laws/federal/2010/10comAD55.html. Most of the letters were submitted on the February 22, 2010 deadline to the commenting period.

securitization, since many of the qualitative securitization standards described above can only be assessed during the course of the securitization. Several observers also noted that since the Sample Rule applied only to IDIs, it would create an uneven playing field, imposing burdensome restrictions on IDIs to the advantage of non-bank securitizers. Overall, many of the commentators expressed concern that many components of the Sample Rule would create uncertainty and impose heavy burdens on securitizations and discourage market participants, who are already wary from the impact of the recent economic crisis, from reengaging in the securitization market.

By extending the Sunset Date under the Final Rule to September 30, 2010, the FDIC wisely gave itself more time to assess the controversial reforms it proposed in the Sample Rule. With Congress, the FDIC, and the handful of other government agencies considering a number of proposals for substantive securitization reform and the myriad of industry participants reacting vigorously to the various proposals, only time will tell how the FDIC ultimately determines to fashion the Securitization Rule. For now, IDIs will need to be satisfied with the continued temporary relief that the Final Rule affords to them.

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