

Clients & Friends Memo

FDIC Seeks “Stronger, Sustainable Securitizations” by Imposing Additional Conditions to Eligibility for Securitization Safe Harbor

May 21, 2010

On Monday, May 17, 2010, the Federal Deposit Insurance Corporation (the “**FDIC**”) published a Notice of Proposed Rulemaking (“**NPR**”) regarding the proposed amendments to its securitization “safe harbor rule.”¹ These proposed amendments follow the comment period applicable to the transitional amendments set forth in the FDIC’s Advance Notice of Proposed Rulemaking (“**ANPR**”) issued in December 2009. The ANPR ostensibly was issued to bring the FDIC’s existing securitization safe harbor into line with the Financial Accounting Standards Board’s newly promulgated FAS 166 and 167 governing sale accounting treatment, which went into effect for reporting periods beginning after November 15, 2009.² Notably, the NPR indicates that the FDIC intends to impose substantive requirements for securitizations by insured depository institutions (each, a “**Bank**”), without regard to whether the transaction qualifies for sale accounting treatment under FAS 166 and 167.³

In proposing amended rule 360.6 (the “**Proposed Rule**”), the FDIC seeks to use its authority to repudiate contracts when a Bank fails as the basis for comprehensively regulating the issuance and servicing of Bank-related asset backed securities in connection with a securitization or a participation occurring after September 30, 2010. The Proposed Rule also imposes further conditions on residential mortgage-backed securitizations sponsored by Banks (“**RMBS**”). The

¹ 12 C.F.R. § 360.6. See Notice of Proposed Rulemaking regarding safe harbor protection for Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010. 75 Fed. Reg. at 27471 – 27487 (5/17/10); <http://fdsys.gpo.gov/fdsys/pkg/FR-2010-05-17/html/2010-11680.htm>.

² Under its existing safe harbor adopted in 2000, the FDIC established that notwithstanding a Bank’s becoming subject to FDIC conservatorship or receivership, if the sponsor’s asset transfer in a securitization constituted a “sale” under generally accepted accounting principles (“GAAP”) and the conditions of the safe harbor were met, it would not use its power to repudiate as burdensome the asset transfer agreement employed in the securitization. With the adoption of FAS 166 and 167, sale treatment potentially became more difficult to achieve and the FDIC therefore sought to clarify the requirements of its securitization safe harbor.

³ The Proposed Rule would grandfather FAS 140 compliant transactions occurring before September 30, 2010 that met the requirements of existing 12 C.F.R. § 360.6, including qualifying for sale accounting treatment under FAS 140 standards in effect prior to November 15, 2009. See proposed 12 C.F.R. § 360.6 (d)(2).

Proposed Rule clarifies that, when acting as conservator or receiver, the FDIC would consent to the making of required payments of principal and interest and other amounts due on securitized obligations, and to certain servicing activity, during the statutory stay period.⁴ It also sets forth conditions that would allow creditors expedited access to their collateral for securitizations that fail to meet the new accounting standards for off-balance sheet (sale) treatment but otherwise meet the requirements of the Proposed Rule.⁵ Through the Proposed Rule, the FDIC aims “to protect the Deposit Insurance Fund (“DIF”) and the FDIC’s interests as deposit insurer and receiver by aligning the conditions for the safe harbor with better and more sustainable securitization practices by [Banks]”.⁶

The proposed amendments are open to public comment within 45 days after the publication of the NPR in the Federal Register, or by July 1, 2010.⁷ Key aspects and a brief analysis of the Proposed Rule are set forth below. Specific issues that remain of concern to the FDIC are detailed in its 17 questions, which are reproduced in Annex A to this memorandum.

*Note: The Proposed Rule would only affect securitizations involving transfers of financial assets sponsored by Banks, but not by Bank affiliates.*⁸

New Requirements Related to Risk Retention, Asset Types, Disclosure and Compensation

Origination and Risk Retention. Under the Proposed Rule, the safe harbor is available only if the sponsor retains at least a 5% economic interest in a “vertical strip” or representative sample of all

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- ⁴ The “statutory stay period” refers to the period after which the FDIC is appointed as conservator (45 days) or receiver (90 days) during which the FDIC’s consent must be obtained for a secured creditor to exercise remedies with respect to its collateral. See Federal Deposit Insurance Act (“FDIA”), 12 U.S.C. § 1821(e)(13)(C).
- ⁵ The Proposed Rule clarifies that “the conservator or receiver cannot use its statutory power to repudiate or disaffirm contracts to avoid a legally enforceable and perfected security interest in transferred financial assets”. This provision applies if the securitization fails to meet the conditions for sale accounting treatment as long as the securitization otherwise meets the requirement of the Proposed Rule. The Proposed Rule would clarify that prior to any monetary default or repudiation, the FDIC as conservator or receiver would consent to the making of required payments of principal and interest and other amounts due on the securitized obligations, and to certain servicing activity, during the statutory stay period. In addition, if the FDIC decides to repudiate the securitization transaction, the payment of repudiation damages in an amount equal to the par value of the outstanding obligations on the date of receivership will discharge the lien on the securitization assets. See NPR at 7 and proposed 12 C.F.R. §§ 360.6 (d)(4), (e) and (f).
- ⁶ 75 Fed. Reg. at 27471 and NPR at 2.
- ⁷ The NPR was published in the Federal Register on May 17, 2010.
- ⁸ Under the proposed rule, “sponsor” includes any “person or entity that organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity, whether or not such person owns an interest in the issuing entity or owns any of the obligations issued by the issuing entity. See NPR proposed 12 C.F.R. § 360.6(a)(9).

securitized assets, as opposed to a single tranche of securities. In addition, the sponsor's interest may be covered by interest rate or currency hedges but not by hedges related to credit risk.

Increased Restrictions for All Asset Classes, Particularly for RMBS; Synthetics Ineligible.

The Proposed Rule imposes increased requirements on Bank-sponsored securitizations of all financial assets and adopts further restrictions with respect to RMBS (i.e., if a securitization includes any residential mortgage loans, the RMBS restrictions apply). Synthetic securitizations are ineligible for the safe harbor under the Proposed Rule (with the understanding that the inclusion of a partially drawn credit line will not cause a securitization to be viewed as "unfunded").⁹ Participations continue to be eligible for the safe harbor as long as they qualify for sale treatment under GAAP.¹⁰

Capital Structure and Financial Assets. For all securitizations subject to the Proposed Rule, payments of principal and interest on sold securities must be dependent primarily on the performance of the securitized assets (routine interest rate or currency swaps are permitted) and cannot be conditioned upon independent market or credit events. Resecuritizations, whether static or managed CDOs, must be accompanied by disclosure regarding the underlying financial obligations at initiation and while the obligations are outstanding, as opposed to disclosure of only the attributes of the securities being sold into the resecuritization.

Disclosure. The Proposed Rule contains increased disclosure requirements that apply to the securitization documents in both public securitizations and private placements (presumably whether they are traditional private placements or sales pursuant to Rule 144A under the Securities Act of 1933, as amended),¹¹ and contains additional disclosure requirements with respect to RMBS. Disclosure focuses on the securitization's payment and capital structure and priority of payment, performance of the underlying assets and any credit support and liquidity facilities, the scope of representations and warranties and remedies for their breach, and potential conflicts of interest. For example, RMBS securitization documents must disclose any ownership interest of the servicer

⁹ See NPR at 24-25 (further citations omitted): "Finally, although the Proposed Rule would exclude unfunded and synthetic securitizations from the safe harbor, the FDIC does not view the inclusion of existing credit lines that are not fully drawn in a securitization as causing such securitization to be an "unfunded securitization." In addition, to the extent an unfunded or synthetic transaction qualifies for treatment as a qualified financial contract under Section (11)(e) of the FDIA, it would not need the benefits of the safe harbor provided in the Proposed Rule in an FDIC receivership. Securitizations that are unfunded or synthetic transactions would not be eligible for expedited consent under the Proposed Rule."

¹⁰ See discussion, *infra* at 6 and n. 27.

¹¹ The FDIC "would expect disclosure for all issuances to include the types of information required under current Regulation AB (17 C.F.R. §§ 229.1100-1123) or any successor disclosure requirements with the level of specificity that would apply to public issuances, even if the obligations are issued in a private placement or are not otherwise required to be registered." See NPR at 25 and proposed 12 C.F.R. § 360.6(b)(2)(A)(i).

or its affiliates in “other whole loans secured by the same real property that secures a loan included in the financial asset pool.”¹²

*Note: According to the FDIC, most of the disclosure provisions would require that the securitization documents require proper disclosure rather than making disclosure itself a condition to eligibility for the safe harbor. This should help to assure investors and rating agencies that non-compliance with these contractual requirements will not cause the benefits of the safe harbor to be lost, as well as facilitate the delivery of legal opinions as to the availability of the safe harbor.*¹³

Periodic Reporting. The Proposed Rule requires periodic reporting by the sponsor, issuer and/or servicer, as frequently as monthly, regarding asset performance including data related to the substitution and removal of financial assets, servicer advances, and loss allocations.¹⁴

Documentation and Recordkeeping. For all securitizations, the operative agreements are required to set forth all necessary rights and responsibilities of the parties, including, but not limited to, representations and warranties, ongoing disclosure requirements and any measures to avoid conflicts of interest.¹⁵

Compensation. Disclosure of the nature and amount of compensation of servicers, brokers, originators, rating agencies, advisors, and sponsors is also required, as is disclosure of the extent to which they retain any risk of loss on the securitized assets. Any changes to this information also must be disclosed.¹⁶

Other Requirements. The transaction must be an arm’s length, bona fide securitization transaction and the obligations should not be sold to an affiliate or insider.¹⁷ The securitization agreements must be in writing and approved by the Bank’s board of directors or loan committee. The security interest must be properly perfected under applicable law.¹⁸ The transfer and duties of the sponsor,

¹² NPR at 27 and proposed 12 C.F.R. § 360.6(b)(2)(B)(iii).

¹³ See NPR at 28.

¹⁴ See proposed 12 C.F.R. § 360.6(b)(2).

¹⁵ See proposed 12 C.F.R. § 360.6(b)(3)(A).

¹⁶ See proposed 12 C.F.R. § 360.6(b)(2)(A)(iv).

¹⁷ See NPR at 38 and proposed 12 C.F.R. § 360.6(c)(1).

¹⁸ The Proposed Rule anticipates a protective security interest, even in transactions involving “true sales.”

as transferor, must be evidenced in a separate agreement from its duties, if any, as servicer, custodian, paying agent, credit support provider or any capacity other than transferor.¹⁹

The following additional requirements apply only to RMBS transactions:

RMBS Reserve for Repurchase Obligations. To cover repurchase obligations for breach of representations and warranties, RMBS securitization documents must provide for a reserve fund, to be held for 12 months, equal to at least 5% of the cash proceeds for the securitization due to the sponsor.²⁰

Note: This requirement is in lieu of a proposal that residential mortgage loans be seasoned for 12 months prior to becoming eligible for securitization.

RMBS Limited to 6 Tranches. The FDIC limits RMBS securitizations to a maximum of six tranches, although the senior subtranche may include time-based sequential pay or planned amortization features. RMBS tranches that otherwise comply with the safe harbor may be resecuritized.

RMBS External Credit Support Prohibited at Pool Level. RMBS are prohibited from including leveraged tranches that include market risk (such as leveraged super senior tranches) or benefiting from “external credit support” at the issuing entity or pool level, but may be supported at the loan level by guarantees (including from GSEs, governmental agencies or private entities), co-signers, or insurance. It is permissible for RMBS to have liquidity facilities to cover temporary payments of principal and interest.²¹

RMBS Underwriting. RMBS disclosure must include detailed loan level data, and sponsors must certify compliance with legal standards for origination of mortgage loans, including that the mortgages in the securitization pool are underwritten at the fully indexed rate relying on documented income.²²

RMBS Servicers are Obligated to Mitigate Losses. To enable RMBS servicers to maximize the net present value of securitized mortgages, as defined by a standardized net present value analysis,

¹⁹ The Proposed Rule also continues the safe harbor from the FDIC’s power to avoid a securitization agreement solely because the agreement fails to meet the “contemporaneous written agreement” component of the Federal Deposit Insurance Act. See proposed 12 C.F.R. § 360.6(g).

²⁰ See proposed 12 C.F.R. § 360.6(b)(5)(B).

²¹ See proposed 12 C.F.R. § 360.6(b)(1)(B).

²² See proposed 12 C.F.R. § 360.6(b)(2)(B)(ii).

the servicing agreement must provide servicers with the authority to modify loans to address defaults, subject to industry best practices. The servicer must act for the benefit of all investors and control over servicing cannot lie with a specific class. Action to mitigate losses (short of instituting foreclosure or other formal proceedings) must be taken no later than 90 days after an asset first becomes delinquent (unless all delinquencies on such asset have been cured).²³ Servicers cannot be required to advance delinquent payments for more than three payment periods unless financing or reimbursement facilities (other than foreclosure recoveries) are available to fund or reimburse the primary servicers.²⁴

RMBS Compensation Hold Back. Seeking to incentivize the securitization's long-term performance, the Proposed Rule contains a holdback with respect to the fees payable to rating agencies (and similar third party evaluators). No more than 60% of total estimated compensation can be paid at closing; instead, securitization documents must provide for a release of such fees of over a 5-year period based on performance of the underlying assets. In addition, servicers must receive incentive compensation for servicing, including for loan restructuring/loss mitigation.²⁵

The Proposed Safe Harbor

Safe Harbor for Post-September 30, 2010 Securitizations Meeting Sale Accounting Requirements. The Proposed Rule provides, with respect to securitizations after September 30, 2010 that comply with the Proposed Rule's eligibility conditions, that "the FDIC as conservator or receiver shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or recharacterize as property of the institution or the receivership such transferred financial assets, provided that such transfer satisfies the conditions for sale accounting treatment set forth by generally accepted accounting principles in effect for reporting periods after November 15, 2009, except for the 'legal isolation' condition that is addressed by this paragraph."²⁶

Safe Harbor for Participations. The Proposed Rule contains a parallel provision that applies to transfers of financial assets in connection with participations that comply with FAS 166/167.²⁷

²³ See proposed 12 C.F.R. § 360.6(b)(3)(B)(i).

²⁴ See proposed 12 C.F.R. § 360.6(b)(3)(B)(ii).

²⁵ See proposed 12 C.F.R. § 360.6(b)(4).

²⁶ See proposed 12 C.F.R. § 360.6(d)(1).

²⁷ See NPR at 43 and proposed 12 C.F.R. § 360.6(d)(1). "Non-recourse" means that the seller is not obligated to compensate the participant for a default on the underlying asset and the participation is not subject to a repurchase obligation. See proposed 12 C.F.R. § 360.6(a)(6). Under FAS 166, participating interests are defined as "pari-passu, pro rata interests in financial assets" (*i.e.*, not senior/subordinated interests) and are subject to the same conditions as sales of financial assets. See NPR at 5-6.

Note: In an effort to address participations that do not qualify as “participating interests” under post-2009 GAAP (e.g., LIFO participations), the FDIC seeks further input from the industry.

Transition Period Safe Harbor. With respect to a securitization or participation transaction that occurred on or before September 30, 2010, as long as such transaction complied with sale accounting treatment in effect prior to November 15, 2009 and existing 12 C.F.R. 360.06, such transaction would be grandfathered under the Proposed Rule.²⁸

Non-Sale Transactions. As discussed above, with respect to transactions that do not satisfy FAS 166/ FAS 167 but otherwise satisfy the requirements of the Proposed Rule, the FDIC will not use its repudiation power to invalidate a valid and perfected security interest in transferred financial assets. The Proposed Rule clarifies that the FDIC would consent, prior to any monetary default or repudiation, to payments of principal and interest and other amounts due on the securitized obligations, and to certain servicing activity, during the statutory stay period.²⁹ If the FDIC repudiates a securitization agreement and does not pay damages (as defined below) within ten business days, then the FDIC would consent to the exercise of contractual rights, including obtaining possession of financial assets through self-help remedies of a secured creditor, provided that no involvement of the receiver or conservator is required.

Note: The FDIC notes that this requirement does not preclude its providing documentation and consents, but it is unclear whether this requirement extends beyond simple ministerial acts. So, for example, FDIC non-involvement may hamper a secured creditor’s ability to transfer servicing.

The Proposed Rule provides that repudiation damages in an amount equal to the par value of the outstanding obligations on the date of receivership would discharge the lien on the securitization assets.³⁰ Similarly, if the FDIC as receiver or conservator is in monetary default under a securitization and remains in monetary default for ten business days following actual delivery of a written request to the FDIC pursuant to the Proposed Rule, then the FDIC would consent to the exercise of contractual rights of a secured creditor as described above in full satisfaction of the obligations of the Bank.

²⁸ See discussion, *supra* at 1 and n. 3.

²⁹ See NPR at 43-44.

³⁰ See discussion, *supra* at 2 and n. 5.

Analysis

The FDIC appears to be using its authority to repudiate contracts and to consent to the exercise of rights of a secured party within the 45- or 90-day statutory stay period following the commencement of a conservatorship or receivership, respectively,³¹ to regulate comprehensively the issuance and servicing of Bank-issued ABS without regard to whether the transaction qualifies for sale accounting treatment under FAS 166 and 167.³² In the FDIC's view, the Proposed Rule's requirements will increase the reliability of securitization structures and thereby fulfill its mandate to increase the soundness of the Depository Insurance Fund ("DIF") and insured depository institutions generally.

However, although the Proposed Rule contains ideas similar to SEC proposals to modify Regulation AB³³, the Proposed Rule does not correlate exactly with SEC initiatives and unintentionally could disadvantage Banks in the securitization market.

In addition, with respect to transactions that qualify as legal true sales, the FDIC's repudiation power does not enable the conservator or receiver to recover financial assets previously sold for fair value.³⁴ The repudiation power, as the FDIC acknowledges³⁵, is not an avoiding power that enables the receiver or the conservator to recover assets previously sold and no longer reflected on the books and records of the Bank. Instead, the repudiation power authorizes the conservator or receiver to breach a contract or lease entered into by the Bank and to suspend performance under such contract. Therefore, for example, a conservator or receiver could repudiate servicing obligations or representations and warranties in connection with a completed sale of financial assets, but it could not recover financial assets previously transferred for fair value in a legal true sale.

In purporting to apply the securitization safe harbor to transactions involving legal true sales, the FDIC offers comfort to the parties that may be unnecessary. It remains to be seen whether investors and rating agencies will accept legal true sale opinions with respect to securitizations that do not qualify for safe harbor treatment under the Proposed Rule.

³¹ See 12 U.S.C. §1821(e)(13)(C).

³² See our Clients & Friends Memo dated December 22, 2009 entitled "The Revised FDIC Securitization Safe Harbor Rule; The FDIC Responds to Changes in GAAP Accounting Rules with Proposed Sweeping Regulation of Bank Securitization Structures"; http://www.cadwalader.com/assets/client_friend/122209FDIC_SafeHarborRule.pdf.

³³ See our Clients & Friends Memo dated April 20, 2010 entitled "SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities"; http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf.

³⁴ See NPR at 20: "... the power to repudiate a contract is not a power to recover assets that were previously sold and are no longer reflected on the books and records of [a Bank]."

³⁵ See NPR at 4 and 20.

The FDIC seeks further comment with respect to the issues raised in *Annex A*. Although some of the more serious constraints under the Proposed Rule apply only to RMBS, the FDIC's questions indicate that it has not foreclosed the possibility of also applying them to other asset classes.

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ANNEX A

Cadwalader Note: *Although the FDIC is soliciting comments on all aspects of the Proposed Rule, it specifically raised the following questions:*³⁶

1. Does the Proposed Rule treatment of participations provide a sufficient safe harbor to address most needs of participants? Are there changes to the Proposed Rule that would expand protection different types of participations issued by [Banks]?
2. Is there a way to differentiate among participations that are treated as secured loans by the 2009 GAAP Modifications? Should the safe harbor consent apply to such participations? Is there a concern that such changes may deplete the assets of a [Bank] because they would apply to all participations?
3. Is the transition period to September 30, 2010 sufficient to implement the changes required by the conditions identified by Paragraph (b) and (c)? In light of New Regulation AB, how does this transition period impact existing shelf registrations?
4. Does the capital structure for RMBS identified by paragraph (b)(1)(B)(i) provide for a structure that will allow for effective securitization of well-underwritten mortgage loan assets? Does it create any specific issues for specific mortgage assets?
5. Do the disclosure obligations for all securitizations identified by paragraph (b)(2) meet the needs of investors? Are the disclosure obligations for RMBS identified by paragraph (b)(2) sufficient? Are there additional disclosure requirements that should be imposed to create needed transparency? How can more standardization in disclosures and in the format of presentation of disclosures be best achieved?
6. Do the documentation requirements in paragraph (b)(3) adequately describe that rights and responsibilities of the parties to the securitization that are required? Are there other or different rights and responsibilities that should be required?
7. Do the documentation requirements applicable only to RMBS in paragraph (b)(3) adequately describe the authorities necessary for servicers? Should similar requirements be applied to other asset classes?

³⁶ See NPR at 46-48.

8. Are the servicer advance provisions applicable only to RMBS in paragraphs (b)(3)(B)(i) effective to provide effective incentives for servicers to maximize the net present value of the serviced assets? Do these provisions create any difficulties in application? Are similar provisions appropriate for other asset classes?

9. Is the limitation on servicer interest applicable only to RMBS in paragraph (b)(3)(B)(iii) effective to minimize servicer conflicts of interest? Does this provision create any difficulties in application? Are similar provisions appropriate for other asset classes?

10. Are the compensation requirements applicable only to RMBS in paragraph (b)(4) effective to align incentives of all parties to the securitization for the long-term performance of the financial assets? Are these requirements specific enough for effective application? Are there alternatives that would be more effective? Should similar provisions be applied to other asset classes?

11. Are the origination or retention requirements of paragraph (b)(5) appropriate to support sustainable securitization practices? If not, what adjustments should be made?

12. Is the requirement that a reserve fund be established to provide for repurchases for breaches of representations and warranties an effective way to align incentives to promote sound lending? What are the costs and benefits of this approach? What alternatives might provide a more effective approach?

13. Is retention by the sponsor of a 5 percent "vertical strip" of the securitization adequate to protect investors? Should any hedging strategies or transfers be allowed?

14. Do you have any other comments on the conditions imposed by paragraphs (b) and (c)?

15. Is the scope of the safe harbor provisions in paragraph (d) adequate? If not, what changes would you suggest?

16. Do the provisions of paragraph (d)(4) adequately address concerns about the receiver's monetary default under the securitization document or repudiation of the transaction?

17. Could transactions be structured on a de-linked basis given the clarification provided in paragraph (d)(4)?

18. Do the provisions of paragraph (e) provide adequate clarification of the receiver's agreement to pay monies due under the securitization until monetary default or repudiation?