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Clients&Friends Alert

S&P Likely to Refuse De-Linked Ratings for Bank-Sponsored Securitizations That Fail to Meet FDIC's Final Safe Harbor Rule

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Standard & Poor's announced recently[1] that it will likely treat as secured loans Bank-sponsored securitizations that constitute sales under GAAP, but fail to comply with the FDIC's final securitization safe harbor rule (the "**Rule**").[2] As secured loans, these transactions may not receive credit ratings linked solely to the credit of the underlying assets, but instead will receive credit ratings linked to those of the insured depository institution (each, a "**Bank**") that sponsored the securitization.[3] S&P's announcement follows a conversation it reports to have had with the Federal Deposit Insurance Corporation ("**FDIC**"). According to S&P, the FDIC suggested it could repudiate any Bank securitization that failed to comply with the Rule. Since the adoption of the Rule last month, rating agencies and other industry players have been grappling with the Rule's ramifications. S&P's announcement suggests that to avoid any legal risk associated with structuring a transaction outside of the Rule, rating agencies likely will favor transactions that comply with the Rule's safe harbor.

S&P's position would have the effect of causing Bank-sponsored securitizations to fall within three categories – (i) safe harbored off-balance sheet transactions, (ii) safe harbored secured loan transactions entitled to expedited stay relief and par recoveries (and de-linked credit ratings)[4], and

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1 *See* "Ratings Implications of FDIC's Final Rule Regarding Safe Harbor Protection for Securitizations", Oct. 14, 2010 ("S&P 10-14-10 Release"), www.standardandpoors.com/ratingsdirect.

2 *See* Cadwalader's Client & Friends Memo dated October 11, 2010, titled "FDIC Adopts Final Securitization Safe Harbor Rule"; http://www.cadwalader.com/assets/client_friend/101110FDICAdoptsSafeHarborRule.pdf. The final rule was adopted on September 27, 2010. *See* 12 C.F.R. § 360.6; Final Rule 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. http://www.fdic.gov/news/board/10Sept27no4.pdf.

3 Under the original safe harbor, 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 other conditions (focusing on the enforceability of the transaction) of the safe harbor were met, the FDIC 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 in November 2009, sale treatment potentially became more difficult to achieve and the FDIC therefore sought to clarify the requirements of its securitization safe harbor.

4 *See* S&P 10-14-10 Release at 4.

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(iii) the catch-all "secured loan" transactions without the benefit of the safe harbor. The non-safe harbored "secured loan" category would be subject to the statutory stay period and reduced recoveries associated with a Bank insolvency. S&P indicated as follows:

> [W]e likely would analyze these transactions as secured loans to the institution, and our ratings on these transactions would likely directly reflect our view of the creditworthiness of the institution, unless, in our opinion, the transactions' structures protect investors against these risks . . . . [T]he final rule summary states that the safe harbor is not exclusive. Therefore, some transaction participants might opt to forgo the safe harbor and its conditions, instead focusing on qualifying the asset transfer as a legal sale under state law. This would generally be achievable because treatment of an asset transfer as a sale for accounting purposes is generally not a requirement for a sale at law. *Based on a conversation with the FDIC, however, we believe it is likely the FDIC, acting as receiver for the insolvent [Bank] would, in this set of circumstances, attempt to repudiate the agreement governing the transfer and pursue the assets*. It's likely, in our opinion, that this would result in a dispute that could potentially delay payments on the assets while it's being resolved in the court system. *Therefore, even in the case where transaction participants deliver a true sale opinion, if the transfer doesn't meet the final rule's conditions, we would likely analyze the transaction as a secured loan to the [Bank]*.[5]

The FDIC's statements to S&P therefore telegraph to the industry that Bank-sponsored securitizations that attempt to bypass compliance with the Rule risk falling into the non-safe harbored "secured loan" category above, with potential adverse consequences to Banks and investors in their securitizations.

The FDIC's communication to S&P appears to contradict earlier FDIC pronouncements about the scope of the Rule. In adopting the Rule , the FDIC stated that the Rule did not establish the exclusive means by which Bank securitizations can avoid being subject to the FDIC's repudiation power in the event of a Bank failure.[6] This statement is consistent with the FDIC's repudiation power under the Federal Deposit Insurance Act[7], which does not enable it, when acting as conservator or receiver, to recover financial assets that previously were sold and treated as off-balance sheet under GAAP. The repudiation power, as the FDIC has acknowledged, "is not an avoiding power enabling the conservator or receiver to recover assets that were previously sold and no longer reflected on the books and records of a Bank".[8] Instead, the repudiation power

5 *See* S&P 10-14-10 Release at 5.

6 *See supra* n.2.

7 12 U.S.C. §§ 1811-1835a.

8 *See* 75 Fed. Reg. 60,287 (Sept. 30, 2010).

authorizes the FDIC as conservator or receiver to breach a contract or lease entered into by the Bank and to suspend performance under such contract.[9]

S&P recognizes that the ultimate determination of the scope of the FDIC's repudiation power lies with the courts but, in light of the litigation risk and potential delay associated with the FDIC's position, S&P announced it will likely assign credit ratings linked to the Bank's credit if the Bank-sponsored securitization does not comply with the Rule:

> [B]ased on a conversation with the FDIC, we believe it is likely that the FDIC would claim that these transfers, since they don't meet the safe harbor conditions, are subject to the FDIC's repudiation rights. The FDIC established the safe harbor with the goal of regulating bank-originated securitizations and to foster compliance with the safe harbor conditions. Whether the FDIC's claim on the transferred assets would prevail in court is uncertain, but the court case would likely delay payments on the securitization. *Therefore, we would likely analyze securitizations backed by these transfers as secured loans to the financial institution, and rate them with a link to our rating on the [Bank].*[10]

The FDIC's statements to S&P should not come as too much of a surprise, given that the newly promulgated Rule imposes extensive new substantive requirements as a condition for Bank-sponsored[11] securitizations to qualify for the safe harbor, regardless of whether the transaction qualifies for sale accounting treatment under FAS 166 and 167. The Rule's new provisions for expedited stay relief and par recoveries for non-sale transactions clearly were intended to encourage Bank issuers to comply with its requirements. Indeed, S&P confirms that its ratings of such transactions would reflect their reduced risk: "[B]y addressing repudiation and stay risk, [the final rule] should enable transactions that the FDIC views as secured loans and that comply with the new rule's conditions to nevertheless receive ratings based on the underlying assets' credit characteristics in accordance with our criteria."[12]

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9 *Id.* Therefore, for example, the FDIC as 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 in an off-balance sheet transaction.

10 *See* S&P 10-14-10 Release at 3.

11 "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* 12 C.F.R. § 360.6(a)(10).

12 *See* S&P 10-14-10 Release at 5.

S&P does acknowledge, however, that non-Bank sponsored securitizations should fall outside the scope of the FDIC's power:

> Transactions that are sponsored by non-banks would not be subject to FDIC supervision and would not have to comply with the safe harbor rules, though they would likely be subject to similar conditions under other regulations, making alternative structures by [Banks] who have that option dependent on capital requirements and other cost considerations.[13]

As a result, Banks may, under certain circumstances, be able to structure securitization transactions that do not comply with the Rule, but qualify for de-linked ratings.

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[13] *See* S&P 10-14-10 Release at 5.