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Clients&FriendsMemo

FDIC Adopts Final Securitization Safe Harbor Rule

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On September 27, 2010 the Federal Deposit Insurance Corporation ("**FDIC**") adopted its final safe harbor rule (the "**Rule**")[1] for securitizations sponsored by insured depository institutions (each, a "**Bank**"), which replaces the FDIC's original safe harbor adopted in 2000.[2]

The original safe harbor was created to provide securitization investors certainty that the FDIC, as receiver or conservator of a failed Bank, would not seek to reclaim assets transferred into a securitization sponsored by such Bank or avoid securitization contracts to which such Bank is a party. In changing the Rule, the FDIC's stated purpose was to align the original safe harbor with the Financial Accounting Standards Board's FAS 166 and 167 governing sale accounting treatment, which replaced FAS 140 for reporting periods beginning after November 15, 2009.[3]

As a technical matter, with respect to transactions that constitute legal true sales and qualify for off-balance sheet treatment under GAAP, the FDIC's repudiation power does not enable the conservator or receiver to recover financial assets that previously were sold and are off-balance sheet for accounting purposes. The repudiation power, as the FDIC acknowledges, "is not an avoiding power that enables the receiver or the conservator to recover assets previously sold and

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[1] 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.

[2] The adoption of the Rule follows the comment period applicable to the FDIC's Notice of Proposed Rulemaking ("**NPR**") issued in May 2010 and Advance Notice of Proposed Rulemaking issued in December 2009. 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. 27,471–27,487 (May 17, 2010), http://edocket.access.gpo.gov/2010/pdf/2010-11680.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.

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no longer reflected on the books and records of a Bank".[4] Instead, the repudiation power 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.[5]

Notably, however, the newly promulgated Rule imposes significant new substantive securitization requirements as a condition for Bank-sponsored[6] securitizations to qualify for the safe harbor, *without regard to whether the transaction qualifies for sale accounting treatment under FAS 166 and 167*. Thus, through the Rule, the FDIC effectively leverages its power to reclaim assets or avoid contracts when a Bank fails as the basis for comprehensively regulating Bank-sponsored securitizations occurring *after December 31, 2010*.[7]

To be safe harbored under the Rule, Bank-sponsored securitizations must comply with, among other things, new risk retention requirements and increased disclosure and reporting requirements. In addition, the Rule also imposes substantial additional conditions that must be satisfied with respect to Bank-sponsored residential mortgage-backed securitizations.

The substance of the Rule is, in large part, unchanged from the proposal set forth in the NPR.[8] Notable changes include:

- extending the transition safe harbor period from September 30, 2010 to December 31, 2010;[9]
- adopting an "auto-conform" provision[10] that automatically will cause the Rule's risk retention requirements to be replaced by the risk retention regulations finalized on an interagency basis under the Dodd-Frank Act;

[4] *See* 75 Fed. Reg. 60,287 (Sept. 30, 2010).

[5] *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.

[6] "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).

[7] The Rule grandfathers FAS 140 compliant transactions occurring before December 31, 2010 that meet the requirements of the original safe harbor, including qualifying for sale accounting treatment under FAS 140 standards in effect prior to November 15, 2009. *See* 12 C.F.R. § 360.6 (d)(2).

[8] *See* NPR, supra, n. 2.

[9] *See* 12 C.F.R. § 360.6(d)(2).

[10] To assure consistency between the Rule and these required interagency regulations, the Rule provides that upon the effective date of final regulations required by Section 941(b) of the Dodd-Frank Act, such final regulations shall exclusively govern the requirement to retain an economic interest in a portion of the credit risk of the financial assets under the Rule.

- grandfathering (i) revolving trusts or master trusts (*e.g.*, credit card master trusts) having issued obligations as of September 27, 2010 and (ii) obligations issued under open commitments (*e.g.*, conduits), up to the maximum amount of such commitments as of September 27, 2010, if one or more obligations were issued on or before December 31, 2010;
- excluding specified GSE's (*i.e.*, Fannie Mae, Freddie Mac and Ginnie Mae, their respective affiliates, and any federal or state sponsored mortgage finance agency)[11] from certain provisions of the Rule; and
- clarifying certain points based, in part, upon comments to the NPR.

The Safe Harbor

The Rule provides for different safe harbors depending on whether the transaction (i) occurs on or before December 31, 2010 or (ii) achieves off-balance or on-balance sheet accounting treatment under post-November 15, 2009 GAAP.

Transition Period/Grandfathered Transactions.

With respect to a securitization or participation transaction that occurred on or before December 31, 2010, as long as such transaction complied with the GAAP sale accounting treatment in effect prior to November 15, 2009 and the other conditions of the original safe harbor, such transaction will be grandfathered under the Rule.[12] In addition, the Rule grandfathers any securitization issued by (i) revolving trusts or master trusts (*e.g.*, credit card master trusts), for which one or more obligations were issued as of September 27, 2010 or (ii) obligations issued under open commitments (*e.g.*, conduits) up to the maximum amount of such commitments as of September 27, 2010 if one or more obligations were issued under such commitments on or before December 31, 2010.[13]

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[11] *See* definitions of "Issuing Entity" and "Specified GSE" at 12 C.F.R. §§ 360.6(a)(3), 360.6(a)(9).

[12] *See* 12 C.F.R. § 360.6 (d)(2).

[13] *See* 12 C.F.R. § 360.6 (d)(2).

Off-Balance Sheet Transactions.

Securitizations involving financial assets[14] transferred[15] after December 31, 2010 (including master trusts, revolving trusts or open commitments that are not grandfathered as discussed above) will benefit from safe harbor protection similar to the protection that would have been afforded under the original safe harbor, so long as such transactions achieve off-balance sheet treatment under GAAP and satisfy the Rule's new eligibility conditions. Specifically, if such eligibility conditions are satisfied "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 under generally accepted accounting principles in effect for reporting periods after November 15, 2009.[16]

The Rule also contains a parallel provision that applies to transfers of financial assets in connection with participations that achieve off-balance sheet treatment under GAAP.[17]

On-Balance Sheet Transactions.

With respect to transactions (including those involving master trusts, revolving trusts or open commitments that are not grandfathered as discussed above) that do not achieve off-balance sheet accounting treatment under GAAP (and therefore are treated as secured loans), but otherwise satisfy the new eligibility requirements of the Rule, the following new safe harbor protections are provided that were not covered by the original safe harbor:

1. FDIC Consent to Expedited Access to Transferred Assets.

   Monetary Default by FDIC Under Securitization Contracts. If the FDIC, as receiver or conservator, is in monetary default under a securitization due to its failure to pay or apply collections from financial assets received in accordance with the securitization documents, whether as servicer or otherwise, and remains in monetary default for ten business days following actual delivery of a written notice to the FDIC pursuant to the Rule, then the FDIC consents to the exercise of contractual rights in accordance with the securitization

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[14] A "financial asset" is defined as "cash or a contract or instrument that conveys to one entity a contractual right to receive cash or another financial instrument from another entity." 12 C.F.R. § 360.6(a)(1).

[15] "Transfer" refers to the conveyance of [a financial asset] or creation of a security interest in a financial asset to or for the benefit of the issuer. *See* 12 C.F.R. § 360.6(a)(11).

[16] *See* 12 C.F.R. § 360.6(d)(3).

[17] *See* 12 C.F.R. § 360.6(d)(1). The Rule confirms that, under certain circumstances, "LIFO" participations may be safe harbored.

documents. Such rights include taking possession of the financial assets and exercising self-help remedies as a secured creditor under the transfer agreements, provided that no material involvement of the FDIC is required.[18]

Repudiation by FDIC of Securitization Contracts. If the FDIC, as receiver or conservator, repudiates a securitization agreement and does not pay repudiation damages (as defined below) within ten business days, then the FDIC consents to the exercise of contractual rights in accordance with the securitization documents. Such rights mirror those set forth above with respect to a monetary default.[19] The Rule provides that "repudiation damages" due in connection with a repudiation by the FDIC shall equal the par value of the outstanding securitization obligations on the date of receivership, less payments of principal received through the date of repudiation, plus unpaid, accrued interest through such date, in accordance with the contract documents to the extent actually received through payments on the financial assets received through the repudiation date. Payment of such damages would discharge the lien on the securitization assets.[20]

2. No Claw Back of Interest Payments Made Prior to Repudiation

The Rule also clarifies that if the FDIC repudiates or disaffirms a securitization agreement, it shall not claw back interest payments made to investors prior to the date of repudiation or disaffirmance.[21]

3. FDIC Consent to Securitization Payments and Servicing Activity Prior to Repudiation or FDIC Consent to Exercise Rights Following Monetary Default

The Rule clarifies that during the period prior to its repudiation or its consent to the exercise of contractual rights following a monetary default, the FDIC consents to the making of payments to investors on the securitized obligations to the extent actually

[18] *See* 12 C.F.R. § 360.6(d)(4)(i). The Rule contemplates that the FDIC would issue such consents, waivers, or execution of transfer documents as may be reasonably requested in the ordinary course of business in order to facilitate the exercise of such contractual rights. In addition, the Rule clarifies that the FDIC's consent to the exercise of such rights "shall not waive or otherwise deprive the FDIC or its assignees of any seller's interest or other obligation or interest issued by the issuing entity and held by the FDIC or its assignees", but shall serve as full satisfaction of the obligations of the Bank (and of the FDIC, as receiver or conservator).

[19] *See* 12 C.F.R. § 360.6(d)(4)(ii).

[20] *See* 12 C.F.R. § 360.6(d)(4)(ii). This change clarifies the NPR in response to comments expressing concern that damages could have been based on the market value (as opposed to par value) of the assets (particularly when market value was less than the outstanding amount owed to investors) and might not include accrued interest through the date of repudiation.

[21] 12 C.F.R. § 360.6(d)(4)(ii)-(iii).

received through payments on the underlying financial assets,[22] and to certain servicing activity in accordance with the securitization documents.[23]

New Eligibility Requirements to Utilize Safe Harbor

To get the benefit of the safe harbor under the Rule, the transaction must comply with new substantive securitization requirements. The Rule imposes increased requirements on Bank-sponsored securitizations of all financial assets and adopts further requirements with respect to RMBS (*i.e.*, if a securitization includes any residential mortgage loans, the RMBS restrictions discussed below will apply).

All Securitizations (including RMBS)

Origination and Risk Retention. The safe harbor is available only if the governing documents require the sponsor to retain an economic interest of at least 5% in (a) each of the tranches sold to investors (*i.e.*, a "vertical strip") or (b) a representative sample of all securitized assets, as opposed to a single tranche of securities. The sponsor's retained interest may not be sold or pledged. It may be covered by interest rate or currency hedges but not by hedges related to credit risk. This risk retention provision automatically will be conformed to, and replaced by, the final risk retention regulations enacted under the Dodd-Frank Act, on the effective date of such regulations.

Synthetics Ineligible. Synthetic and unfunded securitizations are ineligible for the safe harbor under the Rule (with the understanding that the inclusion of a partially drawn credit line will not cause a securitization to be viewed as "unfunded").[24] Participations continue to be eligible for the safe harbor as long as they qualify for off-balance sheet treatment under GAAP.[25]

Capital Structure and Financial Assets. The securitization documents must require that payments of principal and interest on sold securities depend primarily on the performance of the securitized assets (routine interest rate or currency swaps are permitted) and cannot be conditioned upon

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[22] In connection with repudiation, such amounts are payable only to the extent supported by payments on the financial assets received through the date upon which notice of repudiation is given.

[23] *See* 12 C.F.R. § 360.6(e).

[24] *See* 75 Fed. Reg. 60,292.

[25] 12 C.F.R. § 360.6(d)(1). "Participation" is defined as the "transfer or assignment of an undivided interest in all or part of a financial asset, that has all of the characteristics of a 'participating interest' from a seller, known as the 'lead' to buyer, known as the 'participant', without recourse to the lead, pursuant to an agreement between the lead and the participant. "Without recourse" means that the participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying obligation." 12 C.F.R. § 360.6(a)(6).

independent market or credit events.[26] Documentation governing resecuritizations, whether static or managed CDOs, must include 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.[27]

Disclosure. The Rule contains increased disclosure requirements that apply to the securitization documents in both public securitizations and private placements (whether they are traditional private placements or sales pursuant to Rule 144A under the Securities Act of 1933, as amended).[28] The disclosure must, at a minimum, comply with the requirements of Regulation AB (to the extent then in effect), even if the obligations are issued in a private placement or are not otherwise required to be registered.[29]

Other disclosure requirements focus on the securitization's payment and capital structure; priority of payment; performance of underlying assets; credit enhancement; liquidity facilities; the scope of representations and warranties and remedies for their breach; and policies governing delinquencies, servicer advances, loss mitigation and write-offs.

In addition, there must be disclosure of the nature and amount of compensation of servicers, brokers, originators, rating agencies, advisors, and sponsors, as well as 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.[30]

Periodic Reporting. The Rule requires periodic reporting (at least once per calendar quarter) by the sponsor, issuing entity[31] and/or servicer of data regarding asset performance, including data related

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[26] 12 C.F.R. § 360.6(b)(1)(i)(B).

[27] 12 C.F.R. § 360.6(b)(1)(i)(A).

[28] "The conditions require that, at a minimum, the securitization documents require that disclosure comply with the provisions of Regulation AB promulgated by the SEC or any successor disclosure regulation, whether or not a securitization is sold in a public issuance. The disclosures required under the Rule parallel New Regulation AB requirements but apply to all securitizations, including traditional private placements." *See* FDIC Staff Memo at 18 and 12 C.F.R. § 360.6(b)(2)(i)(A). Under the SEC's current proposal to amend Regulation AB, the Regulation AB disclosure requirements would not apply to non-registered securitizations that do not rely upon Rule 144A or Regulation D. *See* our Clients & Friends Memo dated April 20, 2010 titled "SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities"; http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf.

[29] *See* C.F.R. § 360.6(b)(2)(i)(A).

[30] *See* 12 C.F.R. § 360.6(b)(2)(i)(D).

[31] An "issuing entity" is an entity (other than a Specified GSE) that owns a financial asset "transferred by the sponsor and issues obligations supported by such asset", and in a multi-step transaction, includes the ultimate issuer and intermediate transferees. 12 C.F.R. § 360.6(a)(3).

to the modification, substitution and removal of financial assets, servicer advances, and loss allocations.[32]

Documentation and Recordkeeping. The operative agreements are required to specify the respective 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, and provide authority for the parties to fulfill their duties and exercise their rights under the agreements.[33] In addition, the agreements must use, as appropriate, "any available standardized documentation for each different asset class."[34]

Note: There is likely to be uncertainty as to what would constitute standardized documents, which could result in uncertainty as to whether a securitization qualifies for the safe harbor.

Other Requirements. The transaction must be an arm's length, bona fide securitization transaction entered into in the ordinary course of business without contemplation of insolvency or intent to hinder, delay or defraud the Bank or its creditors.[35] The governing documentation must prohibit obligations from being predominantly sold to an affiliate (other than a wholly-owned subsidiary consolidated for accounting and capital purposes with the sponsor) or insider of the sponsor.[36] The securitization agreements must be in writing and approved by the Bank's board of directors or loan committee and maintained continuously as an official record of the Bank.[37] Assets must be transferred for adequate consideration and any transfer or security interest must be properly perfected under applicable law.[38] The transfer and duties of the sponsor, 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.[39] The governing documents must require sponsors to separately identify in their databases, the assets transferred into securitizations and maintain copies (electronic or paper) of the closing documents for each securitization and the

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[32] *See* 12 C.F.R. § 360.6(b)(2)(i)(C).

[33] *See* 12 C.F.R. § 360.6(b)(3)(i).

[34] *See* C.F.R. § 360.6(b)(3).

[35] *See* 12 C.F.R. § 360.6(c)(1) and (3).

[36] *See* 12 C.F.R. § 360.6(c)(1).

[37] *See* 12 C.F.R. § 360.6(c)(2).

[38] *See* 12 C.F.R. § 360.6(c)(4)-(5). "The FDIC anticipates that it will be difficult to determine whether a transfer complying with the Rule is a sale or a security interest, and therefore expects that a security interest will be properly perfected under the UCC, either directly or as a backup." *See* Rule at 60300.

[39] *See* 12 C.F.R. § 360.6(c)(7). The 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 ("**FDIA**"). *See* 12 C.F.R. § 360.6(g).

most recent Form 10-K or other period reports for each securitization. If the sponsor is also a servicer, the governing documents must prohibit commingling of securitization funds with its own funds.[40]

Additional Requirements Applicable Only to RMBS.

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 of the securitization due to the sponsor.[41]

RMBS Limited to 6 Tranches. The FDIC limits RMBS securitizations to a maximum of six credit tranches, although the senior tranche may include time-based sequential pay or planned amortization features and companion subtranches.[42] 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 "external credit support" at the issuing entity or pool level, but may be enhanced by guarantees from Specified GSEs. It is permissible for RMBS to have liquidity facilities at the issuing entity or pool level to cover temporary payments of principal and interest. Underlying financial assets, individually, may be guaranteed by governmental agencies, private entities, co-signers, or insurance.[43]

RMBS Loan Level Data and Underwriting. RMBS disclosure must include detailed loan level data. Sponsors must certify compliance "in all material respects" 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. Sponsors must disclose a third party due diligence report on compliance with such standards and the representations and warranties made with respect to the mortgages.[44]

RMBS Servicers are Obligated to Mitigate Losses; Limitations on Advances. To enable RMBS servicers to maximize the net present value of securitized mortgages, as defined by a standardized net present value analysis, the securitization documents must provide servicers with the authority to modify loans to address reasonably foreseeable defaults and to take action to maximize the value

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[40] *See* C.F.R. § 360.6(c)(7).

[41] *See* 12 C.F.R. § 360.6(b)(5)(ii)(A).

[42] *See* § 360.6(b)(ii)(A).

[43] *See* 12 C.F.R. § 360.6(b)(1)(ii)(B).

[44] *See* 12 C.F.R. § 360.6(b)(2)(ii)(B).

and minimize losses on the mortgages. The documents also must require the servicer to act in accordance with industry best practices and for the benefit of all investors and not for any specific class. Further, the securitization documents must require servicers to take action to mitigate losses (short of instituting foreclosure or other formal proceedings) no later than 90 days after an asset first becomes delinquent (unless all delinquencies on such asset have been cured) and maintain records of their actions to permit full review by the trustee or other investor representatives.[45] Servicers cannot be required to advance delinquent principal and interest payments for more than three payment periods, unless financing or reimbursement facilities (other than facilities dependent on foreclosure recoveries for repayment) are available to fund or reimburse the primary servicers.[46]

RMBS Compensation Hold Back. Seeking to incentivize the securitization's long-term performance, the 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 surveillance services and of the underlying assets. In addition, pursuant to the governing documents, servicers must be entitled to receive incentive compensation for servicing, including for loan restructuring/loss mitigation, which maximizes net present value.[47]

RMBS Representations and Warranties. The securitization documents must include representations that underlying mortgages have been originated in all material respects in compliance with statutory, regulatory, and originator underwriting standards in effect at origination, and that such mortgages were underwritten at the fully indexed rate, based upon borrowers' ability to repay the mortgages from documented income.

Conclusion

Because the Rule affords expedited relief from the statutory stay and par recoveries to investors in an on-balance sheet securitization while continuing to protect off-balance sheet transactions sponsored by Banks, the Rule offers strong incentives for the marketplace to comply with its risk retention and other directives. However, such compliance is not mandatory.[48] As discussed above, the FDIC's repudiation power is not an avoiding power that enables the receiver or the conservator to recover assets previously sold and treated as off-balance sheet under GAAP.[49] Instead, the

[45] *See* 12 C.F.R. § 360.6(b)(3)(ii)(A).

[46] *See* 12 C.F.R. § 360.6(b)(3)(ii)(B).

[47] *See* 12 C.F.R. § 360.6(b)(4).

[48] *See* 75 Fed. Reg. 60,289 ("The safe harbor is not exclusive, and it does not address any transactions that fall outside the scope of the safe harbor or that fail to comply with one or more safe harbor conditions.")

[49] *See* 75 Fed. Reg. 60,287.

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. As a result, securitizations involving assets that are not reflected in a Bank's books and records, including in a transaction conducted by a non-bank affiliate, presumably should continue to fall outside the FDIC's repudiation power.

Of course, because the Rule purports to apply to all securitizations involving transfers of financial assets sponsored (*i.e.*, sold directly or indirectly to an issuer) by a Bank, whether on or off balance sheet, it remains to be seen in what circumstances a Bank's reliance on the Rule's safe harbor will become a standard or required practice.

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