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Clients&Friends Alert

FDIC Approves Final Securitization Safe Harbor

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On Monday, September 27, 2010, the Federal Deposit Insurance Corporation (the "**FDIC**") approved its final rule[1] (the "**Rule**") regarding amendments to its securitization "safe harbor rule."[2] The Rule ostensibly was approved 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.[3] Through adoption of the 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 *December 31, 2010*.

Notably, in approving the Rule, the FDIC has imposed new substantive securitization requirements as a condition to utilizing the safe harbor 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*.

1 12 C.F.R. § 360.6. See 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 These amendments follow 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. at 27471 – 27487 (5/17/10); http://edocket.access.gpo.gov/2010/pdf/2010-11680.pdf.

3 Under its 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.

The 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 Rule.[5]

In order to get the benefit of the safe harbor under the Rule, securitizations must satisfy, among other things:

- new risk retention requirements; and
- increased disclosure and reporting requirements that generally satisfy the requirements of Regulation AB and apply to both registered securitizations and private placements (whether they are traditional private placements or sales pursuant to Rule 144A or Regulation D under the Securities Act of 1933)[6].

In addition, the Rule also imposes significant additional conditions that must be satisfied with respect to residential mortgage-backed securitizations by Banks. Included among these are:

- 5% reserve for representations and warranties breach repurchase obligations;
- limitation of up to 6 credit tranches;
- no external credit support at pool level;

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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, 12 U.S.C. § 1821(e)(13)(C).

5 The 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 Rule. The Rule clarifies 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, less any payments of principal received by investors through the date of repudiation, plus unpaid, accrued interest through the date of repudiation in accordance with the contract documents to the extent actually received through payments on the financial assets received through the date of repudiation, will discharge the lien on the securitization assets. See 12 C.F.R. §§ 360.6(d)(4) and (e).

6 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 entitled "SEC Proposes Significant Enhancements to Regulation of Asset-Backed Securities"; http://www.cadwalader.com/assets/client_friend/042010SEC_Enhancements.pdf.

- compensation hold-back for rating agencies;
- third party due diligence report on compliance with applicable legal standards for origination of loans, including that loans were underwritten at the fully indexed rate relying on documented income.

The substance of the Rule is in large part unchanged from the proposal set forth in the NPR. Certain of the changes include:

- shifting the transition safe harbor period end date from September 30, 2010 to December 31, 2010[7];
- the adoption of an "auto-conform" provision[8], which will automatically conform the requirements of the safe harbor to the risk retention rules that are finalized on an interagency basis under the Dodd-Frank Act, upon the effective date of such rules;
- the apparent grandfathering of (i) revolving trusts or master trusts (e.g., credit card master trusts) issued on or before 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; and
- certain clarifying changes based, in part, upon comments to the NPR.

As was the case under the NPR, the Rule will only affect securitizations involving transfers of financial assets by Banks, *but not by Bank affiliates,* to the extent that such affiliate transfers constitute sales under GAAP or if the assets of such affiliate are not consolidated into the balance sheet of the Bank.

In addition, with respect to transactions that qualify as legal and accounting true sales, the FDIC's repudiation power does not enable the conservator or receiver to recover financial assets previously sold for fair value. The repudiation power, as the FDIC acknowledges[9], 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

7 With respect to a securitization or participation transaction that occurred on or before December 31, 2010, as long as such transaction complied with sale accounting treatment in effect prior to November 15, 2009 and the FDIC's safe harbor rule adopted in 2000, such transaction would be grandfathered under the Rule.

8 In order 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.

9 Rule at 3.

conservator or receiver to breach a contract or lease entered into by the Bank and to suspend performance under such contract.[10]

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

For a discussion of the NPR, see our Clients and Friends Memo dated May 21, 2010 entitled "FDIC Seeks "Stronger, Sustainable Securitizations" by Imposing Additional Conditions to Eligibility for Securitization Safe Harbor". In the next few days we will circulate an updated Clients and Friends Memo that provides the details and analysis of the Rule.

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[10] 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 for fair value in a legal and accounting true sale.