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Clients&FriendsMemo

The Revised FDIC Securitization Safe Harbor Rule; The FDIC Responds to Changes in GAAP Accounting Rules with Proposed Sweeping Regulation of Bank Securitization Structures

December 22, 2009

On Tuesday, December 15, 2009, the Federal Deposit Insurance Corporation (the "**FDIC**") released an Advance Notice of Proposed Rulemaking (an "**ANPR**") regarding proposed amendments to its securitization "safe harbor rule".[1] The ANPR poses 35 questions that suggest the FDIC is considering comprehensive regulation of bank-related asset-backed securities ("**ABS**"), using its authority to repudiate contracts of failed banks in order to do so.

Background

When banks fail, the FDIC is generally appointed as receiver or conservator of the bank's assets and liabilities. Among its powers as receiver or conservator is the power to repudiate any "burdensome" contract, repudiation of which it believes would promote the orderly administration of the bank's affairs.[2] Banks that securitize assets typically transfer them by contract to a special purpose securitization vehicle, and that contract is among those that the FDIC could theoretically repudiate. The insolvency of a non-bank would generally be administered in a bankruptcy proceeding rather than an FDIC insolvency proceeding. While bankruptcy trustees also have the power to repudiate contracts, such repudiation powers generally only apply to executory contracts (*i.e.*, contracts under which the obligations of the parties have not yet been substantially performed). The FDIC has the power to repudiate all contracts of an insolvent bank, which is why asset transfer agreements may theoretically be repudiated in a bank insolvency even though such contracts would generally not be considered executory contracts.

In order to remove the uncertainty that its repudiation authority would otherwise cause concerning securitization contracts, in 2000 the FDIC adopted a so-called "safe harbor rule"[3] (the "**Old Safe**

[1] 12 C.F.R. 360.6

[2] 12 U.S.C. 1821(e)(1)

[3] 12 C.F.R. 360.6

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Harbor") pursuant to which the FDIC would not use its repudiation authority to recover assets transferred in a securitization if the transfer constituted a "sale" under generally accepted accounting principles ("GAAP"). The FDIC safe harbor made it easier to legally isolate bank-sponsored securitizations from the insolvency risk of the sponsoring bank, and thereby to achieve ratings of the securitization based on the quality of the underlying assets and the integrity of the securitization structure rather than on the rating of the sponsoring bank.

On June 12, 2009, the Financial Accounting Standards Board promulgated FAS 166 and 167, effective for reporting periods that begin after November 15, 2009. The effect of FAS 166 and 167 is that the assets of some bank-sponsored securitizations may have to be consolidated on the balance sheets of selling banks. On-balance-sheet accounting would call into question the applicability of the Old Safe Harbor. Without the Old Safe Harbor, bank-sponsored securitizations arguably could be treated as secured borrowings by the selling bank, which could make it difficult to achieve ratings for securitizations that are above the rating of the sponsoring bank and could limit banks' access to the capital markets to finance lending operations.[4]

In order to avoid disruption in the markets, on November 12, 2009, the FDIC issued a transitional interim rule continuing the safe harbor rule until March 31, 2010. The interim rule grandfathers all securitizations issued prior to March 31, 2010 that otherwise comply with the Old Safe Harbor, so long as those securitizations meet the requirements for sale treatment under GAAP in as effect prior to the effectiveness of FAS 166 and 167.

Questions Focusing on Securitization Structures, Disclosure, Compensation and Retention

General. The ANPR issued last Tuesday poses 35 questions in six areas. The text of the questions is reproduced in Annex A hereto. The nature of the questions makes it clear that the FDIC is considering issues related to the structure of securitization transactions that go far beyond the issues that would typically determine whether the conservator or receiver of an insolvent bank could recover assets previously sold to a securitization vehicle.

The public will have 45 days after the ANPR appears in the Federal Register to provide comments. The FDIC will then issue a formal notice of proposed rulemaking containing the specific language of

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[4] The repudiation power authorizes the conservator or receiver to breach a contract entered into by the insolvent bank and be excused from future performance. It is not an avoiding power that enables the conservator or receiver to recover assets previously sold under applicable law. It is not clear that, even without the application of the Old Safe Harbor, the FDIC can use its power to repudiate contracts to terminate a completed contract of sale. As noted in the ANPR, the Old Safe Harbor was primarily a clarification rather than a limitation on the repudiation power.

a revised rule that the FDIC would plan to adopt in final form by March 31, 2010, effective at that time.

Different Rules for Different Asset Classes? The FDIC asks whether it would be advisable to adopt different safe harbor rules for different asset classes. For example, a special rule for residential mortgage-backed securities (RMBS) might need to be more detailed in light of "demonstrated greater difficulties" RMBS have encountered.

Capital Structure. The FDIC asks whether leveraged tranches of ABS should be eligible for the safe harbor and whether there should be a limit on the number of tranches in a securitization. This question seems to reflect a view on the part of the FDIC that multi-tranche structures are *per se* more risky than simpler structures and that simplicity equates to lower risk.

Synthetic Securitizations. The FDIC asks whether synthetic securitizations should be eligible for expedited consent. The reference to "expedited consent" appears to refer to the FDIC's authority to grant relief from the automatic stay on secured creditors imposed in an FDIC insolvency proceeding. It appears from this question that the FDIC is considering granting some safe harbor or other comfort to investors in bank-sponsored synthetic securitizations.

Disclosure. The FDIC also asks whether disclosure requirements should be imposed, such as disclosures about the performance of the underlying debt and disclosures of representations and warranties and remedies for their breach. It also asks whether disclosures should be periodic and, if so, how frequent, and whether information should be at the asset level, the pool level, or the tranche level. The FDIC is also considering whether compensation of brokers, originators, rating agencies, advisors, and sponsors should all be disclosed and has also suggested that disclosure of underwriting standards might be appropriate, including whether the loans were underwritten at fully indexed rates or merely at teaser rates, and whether borrower income was documented. The FDIC also asks whether the disclosure requirement applicable to publicly offered ABS under the Securities and Exchange Commission's Regulation AB should be made applicable to private placements.

Servicing Obligations. Suggesting that it is considering mandating substantive changes in securitizations, the FDIC asks whether the safe harbor should only be available, in the case of RMBS, where the servicing agreement clarifies the right of the servicer to mitigate losses by modifying underlying mortgages. It even goes further, asking whether servicers should be required to mitigate losses after a specified period (*e.g.*, 90 days) after a delinquency. Observing that there are cases in which servicers act for the benefit of particular classes of investors, the FDIC asks whether the safe harbor should only be available where servicers agree to act for the benefit of all investors. Finally, the FDIC, noting that servicer interests can become misaligned from those of

investors where servicers advance funds, asks whether the safe harbor should be reserved for those cases in which servicer advances are limited, such as for three payment periods.

Deferred Compensation. The FDIC asks whether fees payable to lenders, sponsors, rating agencies, and underwriters should be payable over a period of time such as five years, based on performance of the underlying assets. It also asks whether the safe harbor should only be available where the compensation of a servicer incentivizes loss mitigation.

Origination and Retention. In the spirit of "skin in the game", the FDIC asks whether the safe harbor should only be available where a sponsor retains an economic interest (five or ten percent) in the sold asset and does not sell or hedge that interest. Logically, that might support a conclusion that a sale was not a true sale, and the Comptroller of the Currency, the regulator of national banks, who sits on the board of the FDIC, questioned the effect of such a requirement on bank safety and soundness. The FDIC also asked whether, in the case of RMBS, the safe harbor should be limited to securitizations of seasoned loans, e.g. loans that have been performing for at least 12 months in order to mitigate early payment default risk. In that same vein, the FDIC asked whether a requirement that compliance with such representations and warranties be reviewed within six months, coupled with an obligation of the bank to repurchase loans that are found to breach those representations and warranties, might be desirable, perhaps funded by a five percent holdback at closing of the securitization.

Analysis

It appears that the FDIC is using its authority to repudiate contracts when a bank fails as the basis to regulate comprehensively the issuance and servicing of ABS. The logic of the nexus is not immediately apparent, however it seems clear that the FDIC has an interest in further regulating the securitization activities of banks.

Many of the ideas suggested in the ANPR have been present in other regulatory proposals regarding securitization activity.[5] The potential for differences, even subtle differences, in the structural limitations imposed on banks and non-banks participating in the securitization markets is troubling, as it creates the potential for competitive advantages for one group or the other that are not justified by market considerations or compelling policy considerations.

In addition, certain of the regulatory initiatives suggested by the ANPR questions, especially the suggestion of required retention of risk in connection with securitized assets, seem at odds with

[5] See our Clients & Friends Memo dated December 17, 2009 entitled "Securitization Reform Proposals: The Credit Risk Retention Act of 2009 and the Restoring American Financial Stability Act of 2009."

one of the FDIC's primary functions: promoting the safety and soundness of insured depository institutions.

Participants in the securitization industry may submit comments on the ANPR within 45 days after the publication of the ANPR in the Federal Register, which has not yet occurred as of the date of this memorandum. Notices are generally published in the Federal Register within one week after the date of the related FDIC press release. Therefore, it is expected that the period for submitting comments on the ANPR will end on or about February 5, 2010.

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ANNEX A

Explanatory notes and references to defined terms in the Cadwalader Clients & Friends Memo entitled, "The FDIC's New Proposed Securitization Safe Harbor Rule; The FDIC Responds to Changes in GAAP Accounting Rules with Proposed Sweeping Regulations of Bank Securitization Structures" have been added.

General Questions

1. Do the changes to the accounting rules affect the application of the preexisting Securitization Rule *[Old Safe Harbor]* to participations? If so, are there changes to the Securitization Rule that are needed to protect different types of participations issued by IDIs *[insured depository institutions]*?

2. Is the transition period to March 31,2010 sufficient to implement the changes required by the conditions identified by Paragraph (b) and (c) *[of the sample regulatory text attached as Addendum A to the ANPR, specifying certain conditions to be met by securitizations relating to structure, disclosure and administration]*? How does this transition period impact existing shelf registrations?

Capital Structure

3. Should certain capital structures be ineligible for the future safe harbor? For example, should securitizations that include leveraged tranches that introduce market risks (such as leveraged super senior tranches) be ineligible?

4. For RMBS specifically, in order to limit both the complexity and the leverage of RMBS, and therefore the systemic risk introduced by them in the market, should the capital structure of the securitization be limited to a specified number of tranches? If so, how many, and why? If no more than six tranches were permitted, what would be the potential consequence?

5. Should there be similar limits to the number of tranches that can be used for other asset classes? What are the benefits and costs of taking this approach?

6. Should re-securitizations (securitizations supported by other securitization obligations) be required to include adequate disclosure of the obligations including the structure and asset quality supporting each of the underlying securitization obligations and not just the obligations that are transferred in the re-securitization?

7. Should securitizations that are unfunded or synthetic securitizations that are not based on assets transferred to the issuing entity or owned by the sponsor be eligible for expedited consent?

8. Should all securitizations be required to have payments of principal and interest on the obligations primarily dependent on the performance of the financial assets supporting the

securitization? Should external credit support be prohibited in order to better realign incentives between underwriting and securitization performance.? Are there types of external credit support that should be allowed? Which and why?

Disclosures

9. What are the principal benefits of greater transparency for securitizations? What data is most useful to improve transparency? What data is most valuable to enable investors to analyze the credit quality for the specific assets securitized? Does this differ for different asset classes that are being securitized? If so, how?

10. Should disclosures required for private placements or issuances that are not otherwise required to be registered include the types of information and level of specificity required under Securities and Exchange Commission Regulation AB, 17 C.F.R. §§ 229.1100-1123, or any successor disclosure requirements?

11. Should qualifying disclosures also include disclosure of the structure of the securitization and the credit and payment performance of the obligations, including the relevant capital or tranche structure? How much detail should be provided regarding the priority of payments, any specific subordination features, as well as any waterfall triggers or priority of payment reversal features?

12. Should the disclosure at issuance also include the representations and warranties made with respect to the financial assets and the remedies for such breach of representations and warranties, including any relevant timeline for cure or repurchase of financial assets.

13. What type of periodic reports should be provided to investors? Should the reports include detailed information at the asset level? At the pool level? At the tranche level? What asset level is most relevant to investors?

14. Should reports included detailed information on the ongoing performance of each tranche, including losses that were allocated to such tranche and remaining balance of financial assets supporting such tranche as well as the percentage coverage for each tranche in relation to the securitization as a whole? How frequently should such reports be provided?

15. Should disclosures include the nature and amount of broker, originator, rating agency or third-party advisory, and sponsor compensation? Should disclosures include any risk of loss on the underlying financial assets is retained by any of them?

16. Should additional detailed disclosures be required for RMBS? For example should property level data or data relevant to any real or personal property securing the mortgage loans (such as rents, occupancy, etc.) be disclosed?

17. For RMBS, should disclosure of detailed information regarding underwriting standards be required? For example, should securitizers be required to confirm that the mortgages in the securitization pool are underwritten at the fully indexed rate relying on documented income, and comply with existing supervisory guidance governing the underwriting of residential

mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination?

18. What are the primary benefits and costs of potential approaches to these issues?

Documentation and Recordkeeping

19. With respect to RMBS, a significant issue that has been demonstrated in the mortgage crisis is the authority of servicers to mitigate losses on mortgage loans consistent with maximizing the net present value of the mortgages, as defined by a standardized net present value analysis. For RMBS, should contractual provisions in the servicing agreement provide for the authority to modify loans to address reasonably foreseeable defaults and to take such other action as necessary or required to maximize the value and minimize losses on the securitized financial assets?

20. Loss mitigation has been a significant cause of friction between servicers, investors and other parties to securitizations. Should particular contractual provisions be required? Should the documents allow allocation of control of servicing discretion to a particular class of investors? Should the documents require that the servicer act for the benefit of all investors rather than maximizing the value of to any particular class of investors?

21. In mitigating losses, should a servicer specifically be required to commence action to mitigate losses no later than a specified period, e.g., ninety (90) days after an asset first becomes delinquent unless all delinquencies on such asset have been cured?

22. To what extent does a prolonged period of servicer advances in a market downturn misalign servicer incentives with those of the RMBS investors? To what extent to servicing advances also serve to aggravate liquidity concerns, exposing the market to greater systemic risk? Should the servicing agreement for RMBS restrict the primary servicer advances to cover delinquent payments by borrowers to a specified period, e.g., three (3) payment periods, unless financing facilities to fund or reimburse the primary servicers are available? Should limits be placed on the extent to which, foreclosure recoveries can serve as a 'financing facility' for repayment of advances?

23. What are the primary benefits and costs of potential approaches to these issues?

Compensation

24. Should requirements be imposed so that certain fees in RMBS may only be paid out over a period of years? For example, should any fees payable to the lender, sponsor, credit rating agencies and underwriters be payable in part over the five (5) year period after the initial issuance of the obligations based on the performance of those financial assets? Should a limit be set on the total estimated compensation due to any party at that may be paid at closing? What should that limit be?

25. Should requirements be imposed in RMBS to better align incentives for proper servicing of the mortgage loans? For example, should compensation to servicers be required to take into account the services provided and actual expenses incurred and include incentives for servicing and loss mitigation actions that maximize the value of the financial assets in the RMBS?

26. What are the primary benefits and costs of potential approaches to these issues?

27. Should similar or different provisions be applied to compensation for securitizations of other asset classes?

Origination and Retention Requirements

28. For all securitizations, should the sponsor retain at least an economic interest in a material portion of credit risk of the financial assets? If so, what is the appropriate risk retention percentage? Is five percent appropriate? Should the number be higher or lower? Should this vary by asset class or the size of securitization? If so how?

29. Should additional requirements to incentivize quality origination practices be applied to RMBS? Is the requirement that the mortgage loans included in the RMBS be originated more than 12 months prior to any transfer for the securitization 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? What are the implications of such a requirement on credit availability and institutions' liquidity?

30. Would the alternative outlined above, which would require a review of specific representations and warranties after 180 days and the repurchase of any mortgages that violate those representations and warranties, better fulfill the goal of aligning the sponsor's interests toward sound underwriting? What would be the costs and benefits of this alternative?

31. Should all residential mortgage loans in an RMBS be required to comply with all statutory and regulatory standards and guidance in effect at the time of origination? Where such standards and guidance involve subjective standards, how will compliance with the standards and guidance be determined? How should the FDIC treat a situation where a very small portion of the mortgages backing an RMBS do not meet the applicable standards and guidance?

32. What are appropriate alternatives? What are the primary benefits and costs of potential approaches to these issues?

Additional Questions

33. Do you have any other comments on the conditions imposed by paragraphs (b) and (c) of the sample regulatory text *[attached as Addendum A to the ANPR, specifying certain conditions to be met by securitizations relating to structure, disclosure and administration]*?

34. Is the scope of the safe harbor provisions in paragraph (d) of the sample regulatory text *[attached as Addendum A to the ANPR]* adequate? If not, what changes would you suggest?

35. Do the provisions of paragraph (e) of the sample regulatory text *[attached as Addendum A to the ANPR]* provide adequate clarification of the receiver's agreement to pay monies due under the securitization until monetary default or repudiation? If not, why not and what alternatives would you suggest?