

FDIC Notice of Proposed Rulemaking for Safe Harbor Protection for Securitizations

On May 11, the Board of Directors of the FDIC approved a Notice of Proposed Rulemaking (the “NPR”) proposing a rule which would govern the treatment by the FDIC, as conservator or receiver of a failed insured depository institution (a “Bank”), of financial assets previously transferred by such Bank in a securitization or participation transaction. The proposed rule would create a safe harbor to confirm legal isolation of these financial assets if certain conditions are satisfied. Accounting rule changes announced on June 12, 2009 will result in GAAP consolidation for many transactions and, as a result, cause the FDIC’s current safe harbor to no longer apply. In the absence of clarification of how the FDIC, as conservator or receiver, would treat such assets, investors would be left with uncertainty in the event of a failure of a Bank sponsor of a transaction.

Background

Existing Safe Harbor Rule

The rule adopted by the FDIC in 2000^[1] (the “Safe Harbor Rule”) provides that the FDIC, as conservator or receiver of a Bank, will not use its statutory authority to disaffirm or repudiate contracts in order to reclaim financial assets transferred by a Bank in a securitization or participation if the transfer met all conditions for sale accounting treatment under GAAP.

Accounting Developments

On June 12, 2009, FASB introduced FAS 166^[2] and FAS 167.^[3] These modifications are effective for annual financial statement reporting periods that begin after November 15, 2009 and will make it more difficult for securitization vehicles to meet the conditions for sale accounting treatment under GAAP. As a result, the existing Safe Harbor Rule would no longer provide a safe harbor for many securitizations.

Treatment of Secured Loans

A securitization that is not treated as a sale for accounting purposes may instead be treated as a form of secured lending. Current rules prohibit a secured creditor from taking action against collateral pledged by a Bank subject to conservatorship or receivership without the consent of the conservator or receiver for 45 days from the date of appointment of the conservator or 90 days from the date of appointment of the receiver. As a result, investors in a securitization that is characterized as a secured lending may be prevented from taking actions against the collateral for up to 45 or 90 days.

Contacts

We encourage you to contact us if you have any questions regarding the Notice of Proposed Rulemaking.

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The Interim Final Rule

In November 2009, the FDIC issued an Interim Final Rule amending the Safe Harbor Rule to provide for safe harbor treatment for participations and securitizations created on or before March 31, 2010 (and subsequently extended to September 30, 2010) that complied with the conditions for sale accounting treatment under GAAP as in effect prior to November 15, 2009 (in other words, prior to FAS 166 and 167).

The Advance Notice of Proposed Rulemaking

On December 15, 2009, the FDIC approved an Advance Notice of Proposed Rulemaking (the “ANPR”) to solicit comments to a sample regulation to address the matters which are now the subject of the NPR. The FDIC received 37 comment letters on the ANPR. Click [here](#) to view the comment letters.

Differences Between ANPR and NPR

As discussed in greater detail below, the NPR differs from the ANPR in a number of respects, including:

- 12 Months Seasoning Requirement – The ANPR requirement that mortgage loans included in a securitization be seasoned for at least 12 months was not included in the NPR;
- Deferred Compensation for Services – The ANPR required that compensation for services to lenders, sponsors and rating agencies be payable over 5 years with a maximum of 80% of total estimated compensation payable at closing. This requirement was narrowed in the NPR to apply only to rating agencies and reduced the maximum amount payable at closing to 60% of estimated compensation;
- Disclosure of Servicer Interest in Second Liens – The NPR adds a provision requiring a servicer to disclose any ownership interest it or an affiliate has in a whole loan that is secured by the same real property that secures a loan in the securitization; and
- Reserve Fund for Loan Repurchases – The NPR has a requirement, which was not included in the ANPR, that a one-year reserve fund of at least 5% of the cash proceeds payable to the sponsor be established to cover repurchases of loans resulting from breaches of representations and warranties.

The Proposed Rule

Certain provisions of the Proposed Rule are discussed below. A copy of the NPR can be found [here](#). Orrick’s “**Guide to the NPR**”, which includes a more detailed breakdown of the Proposed Rule, can be found [here](#).

Safe Harbors and Other Protections

The Proposed Rule provides a safe harbor for securitizations and participations meeting the conditions described below.

Securitizations and Participations occurring on or before September 30, 2010:

For securitizations and participations occurring **on or before September 30, 2010**, the FDIC will not use its repudiation power to reclaim, recover, or recharacterize as property of the Bank or the receivership financial assets that were transferred by the Bank if:

- the transfer **does not satisfy** the new GAAP conditions for sale accounting treatment, but
- the transfer **does satisfy** the GAAP conditions for sale accounting treatment that existed prior to the effectiveness of the new GAAP conditions and the other requirements of the existing Safe Harbor Rule.

Securitizations occurring after September 30, 2010:

For securitizations occurring **after September 30, 2010**, the FDIC will not use its repudiation power to reclaim, recover, or recharacterize as property of the Bank or the receivership financial assets that were transferred by the Bank if:

- the transfer **does satisfy** the new GAAP conditions for sale accounting treatment, and
- the securitization **does satisfy** the requirements of the Proposed Rule.

For securitizations occurring **after September 30, 2010**, if:

- the transfer **does not satisfy** the new GAAP conditions for sale accounting treatment, but
- the securitization **does satisfy** the requirements of the Proposed Rule

the FDIC will provide the following protections:

- if the FDIC, as conservator or receiver for the Bank, remains in **monetary default** under the securitization for ten business days after a request is made to exercise contractual rights because of that default, investors may pursue their contractual rights as long as no involvement by the FDIC is required, and the FDIC's consent will fully satisfy its and the Bank's obligations for all amounts due; or
- if the FDIC, as conservator or receiver for the Bank, gives written notice of **repudiation** of the securitization agreement under which the transfer was made but within ten business days does not pay damages equaling the par value of the securities as of the date of the receivership, less any principal payments made to the date of repudiation, investors may pursue their contractual rights as long as no involvement by the FDIC is required.

Participations:

For participations that **do satisfy** the new GAAP conditions for sale accounting treatment, the FDIC will not use its repudiation power to reclaim, recover, or recharacterize as property of the Bank or the receivership financial assets that were transferred by the Bank without reference to whether such participations satisfy the other requirements of the Proposed Rule. The FDIC expects that most participations will continue to meet the new GAAP conditions for sale accounting treatment.

Continued Scheduled Payments:

For securitizations that satisfy the requirements of the Proposed Rule, during the secured lending stay period discussed under "Treatment of Secured Loans" above and prior to the payment of damages or the consent to any exercise of contractual rights, the FDIC as conservator or receiver for the Bank will consent to required payments being made to investors (other than payments that are triggered by the appointment of a conservator or receiver) and to any servicing activity.

Capital Structure and Credit Support

The Proposed Rule provides that any type of securitization must provide that payment of principal and interest on the securities issued by a securitization be primarily based on the performance of the underlying assets and, except for interest rate or currency mismatches between the financial assets and the obligations, cannot be contingent on market or credit events that are independent of the assets.

The Proposed Rule contains additional requirements for securitizations including any residential mortgage loans. These securitizations may have a maximum of six credit tranches, with no sub-tranches (other than time-based sequential pay or planned amortization sub-tranches of the most senior tranche), grantor trusts or other structures. Also, although there may be credit support at the individual loan level, external credit support or guarantees to enhance the credit quality of the loans at the pool level or the securities issued by the securitization are prohibited. Temporary payment of principal and/or interest may be supported by liquidity facilities including facilities designed to permit the temporary payment of interest following appointment of the FDIC as conservator or receiver.

Unfunded and synthetic securitizations cannot get the benefit of the safe harbor under the Proposed Rule.

Disclosure

Under the Proposed Rule, documents for all types of securitizations, including private placements, must require that the securitization comply, at a minimum, with the disclosure standards of Regulation AB[4] in order to be eligible for the protections of the Proposed Rule. Information that is unknown or unavailable to the sponsor or issuer after reasonable investigation may be omitted if the offering document makes clear that the specific information is unavailable.

The Proposed Rule also provides that the issuer must provide investors with information regarding the credit performance of the securities and the underlying financial assets, including periodic and cumulative financial asset performance data, delinquency and modification data for the financial assets, substitutions and removal of financial assets, servicer advances, as well as losses that were allocated to such tranche and remaining balance of financial assets supporting such tranche, if applicable, and the percentage of each tranche in relation to the securitization as a whole. The issuer must also provide investors with information regarding changes to compensation paid to the transaction parties and the amount and nature of any payments of deferred compensation.

Securitizations including any residential mortgage loans face additional disclosure requirements under the Proposed Rule:

- The documents must require that the sponsor affirm compliance with all applicable statutory and regulatory standards for origination of mortgage loans, including that the mortgages were underwritten at the fully indexed rate relying on documented income, and that they comply with existing supervisory guidance governing the underwriting of residential mortgages.
- Sponsors must disclose a third party due diligence report on compliance with these standards and the representations and warranties with respect to the loans.
- The securitization documents must require that a servicer disclose any ownership interest it or an affiliate has in other whole loans secured by the same real property that secures a loan included in the pool. (This requirement was not present in the ANPR.)

Documentation and Servicing Standards

Although the Proposed Rule imposes specific documentation requirements for all types of securitizations, they impose additional requirements for securitizations including any residential mortgage loans.

For example, the Proposed Rule provides that the securitization documents must require that residential mortgage servicers act for the benefit of all investors, not just a particular class. Also, servicing agreements must give residential mortgage servicers full authority, subject to oversight by a master servicer or oversight advisor, to mitigate losses to maximize the net present value of the financial asset, and must require that the servicer commence loss mitigation activities within 90 days of a loan becomes delinquent.

The Proposed Rule provides that the servicing agreement cannot require a primary servicer to advance delinquent payments of principal and interest for more than three payment periods unless financing or reimbursement facilities are available which do not depend on foreclosure proceeds.

Deferred and Performance Based Compensation

The Proposed Rule contains compensation requirements which apply only to securitizations including any residential mortgage loans. These include a requirement that compensation for services to rating agencies or similar third-party evaluation companies must be payable over five years based on the performance of surveillance services and of the underlying residential mortgage loans, with a maximum of 60% of total estimated compensation payable at closing. (Under the ANPR, similar compensation requirements would also have been imposed on lenders, sponsors and underwriters, with a maximum of 80% payable at closing.)

In addition, compensation to servicers must create incentives for servicing and loss mitigation actions that maximize the net present value of the financial assets.

Origination and Risk Retention Requirements

Under all forms of securitization, the Proposed Rule requires that the sponsor retain at least 5% of the credit risk of the financial assets. This can be accomplished by the sponsor taking an interest of at least 5% of each tranche transferred to investors or a representative sample of at least 5% of the underlying assets.

This retained interest may not be sold or hedged during the term of the securitization.

Additional origination requirements apply to securitizations including any residential mortgage loans. All mortgage loans must be originated in compliance with all statutory, regulatory, and originator underwriting standards then in effect. (The ANPR requirement that loans be seasoned at least twelve months has been eliminated.) Also, each of the mortgages must be underwritten at the fully indexed rate, rely on documented income, and comply with all existing supervisory guidance.

Also, the Proposed Rule includes a requirement, which was absent from the ANPR, that the securitization documents establish a reserve fund of at least 5% of the cash proceeds payable to the sponsor to cover repurchases of loans resulting from breaches of representations and warranties. Amounts remaining in this fund one year after the issuance of the securities would be released to the sponsor.

Comments

The NPR includes a list of 18 questions with regard to the topics referred to above. Comments to the FDIC are requested within 45 days of publication of the NPR in the Federal Register.

[1] 12 C.F.R. §360.6

[2] Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140

[3] Amendments to FASB Interpretation No. 46(R)

[4] Securities and Exchange Commission Regulation AB, 17 C.F.R. §§ 229.1100-1123