

FDIC ISSUES ADVANCE NOTICE OF PROPOSED RULEMAKING FOR SAFE HARBOR PROTECTION FOR SECURITIZATIONS

HOWARD S. ALTARESCU AND SCOTT A. STENGEL

The authors review a recent proposal by the Federal Deposit Insurance Corporation relating to the transfer of financial assets by an insured depository institution in a securitization or participation transaction.

On December 15, the Board of Directors of the Federal Deposit Insurance Corporation (“FDIC”) approved an Advance Notice of Proposed Rulemaking (the “ANPR”) to solicit comments for amendments to regulations that govern the treatment by the FDIC, as conservator or receiver, of financial assets transferred by an insured depository institution (a “Bank”) in a securitization or participation transaction. The potential amendments would create a safe harbor to confirm legal isolation of assets transferred by a Bank in a securitization or participation 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.

Howard S. Altarescu is a partner in Orrick’s New York office and is a member of the Financial Markets Group. Scott A. Stengel is a partner resident in the firm’s office in Washington, D.C. The authors can be reached at haltarescu@orrick.com and [sstengel@orrick.com](mailto:ssengel@orrick.com), respectively.

BACKGROUND

Existing Safe Harbor Rule

The rule adopted by the FDIC in 2000¹ (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 166² and FAS 167.³ For most Banks, these GAAP modifications will be effective for reporting periods beginning January 1, 2010 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

The ANPR notes that 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 (the “Secured Lending Stay Period”). 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.

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 that complied with

the conditions for sale accounting treatment under GAAP as in effect prior to November 15, 2009. Among the questions raised in the ANPR is whether the transition period to March 31, 2010 is sufficient to implement any changes necessary for a final rule and how it affects existing shelf registrations.

THE SAMPLE REGULATIONS

The ANPR includes sample regulatory text (the “Sample Regulations”) to provide context for the responses to the questions posed in the ANPR. The ANPR notes that the inclusion of the Sample Regulations should not imply that the Board has proposed or adopted the Sample Regulations. Certain provisions of the Sample Regulations are discussed below.

Safe Harbors and Other Protections

The Sample Regulations provide a safe harbor for securitizations and participations meeting the conditions described below. If a securitization or participation has the benefit of the proposed safe harbor, 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 such securitization or participation.

Securitizations and Participations Occurring on or Before March 31, 2010

Securitizations and participations that do not satisfy the new GAAP conditions for sale accounting treatment but do satisfy the GAAP conditions for sale accounting treatment that existed prior to the effectiveness of the new GAAP conditions will have safe harbor protection.

Securitizations Occurring After March 31, 2010

Securitizations that do satisfy the new GAAP conditions for sale accounting treatment and do satisfy the requirements of the Sample Regulations will also have safe harbor protection.

Securitizations that do not satisfy the new GAAP conditions for sale ac-

counting treatment but do satisfy the requirements of the Sample Regulations will have the following protections in the event of the failure of a Bank sponsor of a securitization:

- if the FDIC is in monetary default, an investor may pursue contractual remedies ten business days after sending a request to the FDIC, as conservator or receiver of a Bank, as long as no involvement by the FDIC is required; or
- if the FDIC, as conservator or receiver of a Bank, gives written notice of repudiation of securitization agreements and does not pay the required damages within 10 business days, an investor may pursue contractual remedies.

Participations

Participations that do satisfy the new GAAP conditions for sale accounting treatment will have safe harbor protection, without reference to whether such participations satisfy the requirements of the Sample Regulations. The ANPR notes that most participations will continue to meet the conditions for sale accounting treatment under GAAP.

Continued Scheduled Payments

During the Secured Lending Stay Period, the FDIC as conservator or receiver of a Bank will consent to regularly scheduled payments to investors and to any servicing activity for securitizations that satisfy the requirements of the Sample Regulations.

Deferred and Performance Based Compensation

The Sample Regulations contain compensation requirements which apply only to securitizations of residential mortgage securities. These include a requirement that compensation to the lender, sponsor, rating agencies, and underwriters must be payable over five years based on the performance of the underlying residential mortgage loans, with a maximum of 80 percent of total

compensation payable at closing. Also, compensation to servicers must create incentives for servicing and loss mitigation actions that maximize the value of the financial assets as shown by a net present value analysis.

Origination and Risk Retention Requirements

The Sample Regulations require that the sponsor of any type of securitization retain at least 5% of the credit risk of the financial assets. This can be accomplished by the sponsor taking an interest in each tranche of the securitization or a representative sample of the underlying assets. This retained interest may not be sold or hedged during the life of the securitization.

Additional origination requirements apply to securitizations of residential mortgage loans. All mortgage loans must be seasoned at least twelve months and all loans must be originated in compliance with all statutory, regulatory, and originator underwriting standards then in effect. Also, each of the mortgages must be underwritten at the fully indexed rate and rely on documented income.

Capital Structure and Credit Support

The Sample Regulations provide that any type of securitization 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 risk, cannot be contingent on market or credit events that are independent of the assets. Unfunded and synthetic securitizations cannot get the benefit of the Sample Regulations.

The Sample Regulations contain additional requirements for securitizations of residential mortgage loans. These securitizations may have a maximum of six credit tranches, with no sub-tranches other than time-based sequential pay sub-tranches of the most senior tranche. Also, although there may be credit support at the loan level, external credit support or guarantees to enhance the credit quality of the securities issued by the securitization are prohibited. Temporary payment of principal and interest may be supported by liquidity facilities.

Documentation and Servicing Standards

Although the Sample Regulations impose specific documentation requirements for all types of securitizations, they impose additional requirements for securitizations of residential mortgage loans. For example, the Sample Regulations provide that residential mortgage servicers must 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, as defined by a net present value analysis.

The Sample Regulations provide that the primary servicer cannot be required 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.

Disclosure

Under the Sample Regulations, all types of securitizations must comply with the disclosure standards of Regulation AB⁴ in order to benefit from the protections of the Sample Regulations. Information that is unknown to the securitization issuer without unreasonable effort or expense may be omitted if the offering document makes clear that the specific information is unavailable.

Securitizations of residential mortgage loans face additional disclosure requirements under the Sample Regulations. For example, the sponsor must affirm compliance with all applicable statutory and regulatory standards for origination of mortgage loans and the disclosure must include loan level data to confirm that mortgages in the pool 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.

QUESTIONS

The ANPR includes a list of 35 questions with regard to the topics referred to above. Comments to the FDIC are requested within 45 days of

publication of the ANPR in the *Federal Register*. A copy of the ANPR can be found at <http://www.fdic.gov/news/board/DEC152009no5.pdf>.

NOTES

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.