News Bulletin

May 14, 2010

FDIC Issues Notice of Proposed Rulemaking on Securitization Safe Harbor; Seeks Comments on Securitization Reforms

On May 11, 2010, the board of directors of the Federal Deposit Insurance Corporation ("FDIC") resolved by a three-to-two vote to issue a notice of proposed rulemaking concerning proposed amendments to 12 C.F.R. §360.6 (the "Securitization Rule") relating to the FDIC's treatment, as conservator or receiver, of financial assets transferred by an insured depository institution ("IDI") in connection with a securitization or participation.[1] While the proposed amendments (the "Proposed Rule") were initially prompted by changes to accounting standards on which the original Securitization Rule was premised, the FDIC was also prompted by a desire to address perceived structural failures inherent in the "originate to sell" model on which securitizations that contributed to the recent financial meltdown were based. Accordingly, the FDIC has included in the Proposed Rule a number of market reform oriented qualitative conditions which securitizations would need to satisfy in order to be afforded safe harbor protections under the rule. The FDIC is seeking comment on the Proposed Rule on or before July 1, 2010.

The Proposed Rule was issued just days before the United States Senate and House of Representatives each passed financial reform bills which contained securitization reforms similar to those contained in the Proposed Rule. In addition, the Securities and Exchange Commission (the "SEC") recently announced proposed regulations (the "Proposed Reg AB Reforms") that would significantly modify Regulation AB and other laws governing asset-backed securitizations to impose qualitative standards as well as additional disclosure requirements on such securitizations.

Background

The FDIC originally adopted the Securitization Rule in 2000 to provide comfort that loans or other financial assets transferred by an IDI into a securitization trust or participation would be "legally isolated" from an FDIC conservatorship or receivership if, among other requirements, the transfer met all conditions for sale accounting treatment under generally accepted accounting principles ("GAAP"). Securitization participants have long relied on the Securitization Rule as a safe harbor for assurance that investors could satisfy payment obligations from securitized assets without fear that the FDIC might interfere as conservator or receiver.

Such assurances were dashed on June 12, 2009 when the Financial Accounting Standards Board (the "FASB") adopted Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* ("FAS 166"), and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* ("FAS 167"). These new accounting pronouncements substantially narrow the circumstances under which a transfer of financial assets in connection with a securitization may be accounted for as a sale and expand the circumstances under which IDIs are required to

[1] The NPR is posted at http://www.fdic.gov/news/news/press/2010/pr10112a.pdf.

consolidate issuer entities to which financial assets have been transferred for securitizations in their financial statements for fiscal years beginning after November 15, 2009. (For most institutions, the new GAAP rules became effective on January 1, 2010.) These changes will cause many securitization transfers that previously would have been treated as sales to be treated as secured borrowings for accounting purposes, and the Securitization Rule would not have applied unless it were amended.

The uncertainty over whether the FDIC would continue to grant safe harbor treatment to securitizations of an IDI in its conservatorship or receivership created considerable marketplace concern that caused many then-pending securitizations to come to a halt. This concern culminated when Moody's Investors Service issued a report in September 2009 warning that it would review outstanding bank-sponsored credit card securitizations that were sponsored by banks not rated at least Aa3 for possible rating downgrades unless the safe harbor issue were addressed.

Temporary Relief — FDIC Adopts Transitional Safe Harbor

In response to the marketplace concerns and, presumably, the Moody's threat, the FDIC Board met on November 15, 2009 to adopt interim amendments to the Securitization Rule that "grandfathered" all securitizations and participations for which financial assets were transferred, or for revolving securitization trusts for which securities are issued, prior to March 31, 2010. Specifically, the interim amendments provided that such transactions would not be subject to the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover or recharacterize as property of the institution or the receivership any such transferred assets so long as the transfers would have been accounted for as sales under GAAP as in effect before November 15, 2009 and satisfied all other conditions of the Securitization Rule. At the November 15 meeting, the FDIC Board stated that it would consider additional changes to the Securitization Rule that would address the impact of FAS 166 and 167 after the March 31, 2010 transition period and introduce qualitative standards for securitizations designed to encourage "sustainable lending" and avoid the "massive losses" and "landmines" that had recently plagued IDIs.

Food for Thought — FDIC Introduces Provocative Changes to Securitization Rule

On December 15, 2009, the FDIC Board issued an Advance Notice of Rule Making (the "ANPR") regarding possible amendments to the Securitization Rule.[2] The ANPR included a draft of "sample" regulatory text (the "Sample Rule") containing a provocative array of possible standards that must satisfied in order for securitizations to qualify for safe harbor treatment under the Securitization Rule. The ANPR sought public comment on the possible securitization standards and posed a number of questions intended to stimulate submission of comments. Further, the ANPR underscored that the FDIC was not adopting or recommending the Sample Rule, but only offering it to "provide context" for response to the questions posed.

Buying More Time — FDIC Extends Transitional Safe Harbor

On March 11, 2010, the FDIC Board adopted a final rule amending the Securitization Rule to extend the date (the "Sunset Date") on or prior to which all securitizations and participations for which financial assets are transferred, or revolving securitization trusts for which securities are issued, would remain "legally isolated" so long as those securitizations and participations would have been accounted for as sales under GAAP as in effect before November 15, 2009 and satisfy all other conditions of the Securitization Rule from March 31, 2010 to September 30, 2010. The FDIC Board's adoption of the Final Rule to extend the Sunset Date to September 30, 2010 was a recognition that more time would be needed to consider the more extensive securitization reforms it proposed under the ANPR.

[2] The ANPR is posted at http://www.fdic.gov/news/board/DEC152009no5.pdf

The Proposed Rule

The Proposed Rule retained most of the features of the Sample Rule and modifies the Securitization Rule in two significant ways. First, it takes the position that the safe harbor under the Securitization Rule should be applied differently for participations and securitizations depending on whether they are treated as secured borrowings or sales under the new accounting pronouncements. Second, it requires that securitizations satisfy market reform oriented qualitative standards before they can qualify for safe harbor treatment.

Qualification for Safe Harbor Treatment

- *Securitizations that are Treated as Secured Borrowings and Issued After September 30, 2010*. The Proposed Rule assumes that most securitizations will be treated as secured borrowings under the new accounting pronouncements. Under Section 11(e)(13)(C) of the Federal Deposit Insurance Act, the consent of the FDIC as conservator or receiver is required for 45 or 90 days, respectively, after its initial appointment as conservator or receiver before a secured creditor may take any action against collateral pledged by the IDI. This requirement could prevent the holders of securitization interests from recovering monies due to them by up to 90 days in a receivership, during which time interest on the investors' securitization interests could remain unpaid. If not addressed, this potential delay could cause significant downgrades on ratings on existing and future securitizations.

  To address these concerns, the Proposed Rule provides that, with respect to securitizations issued after September 30, 2010 that are treated as secured borrowings for accounting purposes and that otherwise satisfy all qualitative standards under the Proposed Rule, the FDIC, as conservator or receiver, will be deemed to consent to the making of required payments in accordance with the securitization documents and continued servicing of the assets. Furthermore, the FDIC will be deemed to consent to the exercise of contractual rights and self-help remedies by an investor (1) commencing from ten business days after such investor delivers to the FDIC a request to exercise such contractual rights or remedies with respect to a payment default by the FDIC, as conservator or receiver, or (2) if the FDIC delivers a notice of repudiating a securitization transfer agreement during the stay period under Section 11(e)(13)(C) of the Federal Deposit Insurance Act and does not pay damages within ten business days after the effective date of such notice.

- *Securitizations that are Treated as Sales and Issued After September 30, 2010*. Under the Proposed Rule, securitizations issued after September 30, 2010 that are treated as sales under the new accounting pronouncements will not be subject to the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover or recharacterize as property of the institution or the receivership any assets transferred pursuant to the securitizations so long such securitizations satisfy all qualitative standards under the rule and satisfy all conditions for sale accounting treatment other than the "legal isolation" condition.

- *Participations Issued After September 30, 2010*. The Proposed Rule assumes that participations will continue to be treated as sales under the new accounting pronouncements. Accordingly, it provides that participations issued after September 30, 2010 will not be subject to the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover or recharacterize as property of the institution or the receivership any assets transferred pursuant to the participations so long as such participations satisfy all conditions for sale accounting treatment other than the "legal isolation" condition.

- *Securitizations and Participations Issued Prior to September 30, 2010*. The Proposed Rule provides that all securitizations and participations issued on or before September 30, 2010 will not be subject to the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover or recharacterize as property of the institution or the receivership any such transferred assets provided that such transfers satisfy the conditions for sale accounting treatment set forth by GAAP as in effect for reporting

periods before November 15, 2009 other than the "legal isolation" condition and the transaction otherwise satisfies the provisions of the Securitization Rule.

Qualitative Securitization Standards

The Proposed Rule includes a number of qualitative standards that securitizations must satisfy comply in order to be afforded safe harbor treatment.[3] Citing an attempt to respond to investor demands for greater transparency and alignment of interests of the various securitization parties, the FDIC structured the Proposed Rule to include specific standards for securitizations supported by residential mortgage loans ("RMBS"). Significantly, the Proposed Rule retains most of the qualitative standards first featured under the Sample Rule. Set forth below are some of the more noteworthy standards contained in the Proposed Rule.

Standards Applying to All Securitizations

- *Risk Retention*. Sponsors must retain an unhedged economic interest of no less than 5% of the credit risk of the financial assets underlying a securitization. Critics are concerned this requirement may not ultimately be consistent with similar "skin in the game" securitization reform proposals contained in the House Bill, Senate Bill, or the Proposed Reg AB Reforms.

  Critics may also point out that the prohibition on hedging the retained interest violates the principles of prudent asset-liability management, which banks are required to use in conducting their businesses in virtually all other respects. To the extent unhedged retained positions accumulate on a bank's balance sheet, the prohibition on hedging could pose material risks to banks on an individual basis and the banking system on an aggregate basis.

- *Increased Disclosures*. Sponsors, issuing entities and servicers, as appropriate, must provide information regarding the securitized financial assets in compliance with Regulation AB for securitizations issued through public offerings or private placements. While this in theory increases disclosure obligations for privately placed securitizations, it is already common practice for issuers of privately placed securitizations to voluntarily prepare offering documents that comply with Regulation AB due to investor demands. Further, the SEC's Proposed Reg AB Reforms, in their current state, also require issuers conducting securitizations through private placements to comply with Regulation AB disclosure requirements.

Standards Applying Only to RMBS

- *Tranche Restrictions*. RMBS must be limited to no more than 6 credit tranches and cannot include sub-tranches designed to further increase leverage in the capital structures. Notwithstanding the foregoing, the most senior credit tranche may include time-based sequential pay sub-tranches. Commentators will object to the arbitrary nature of the limit. Since credit tranching is utilized by securitization issuers to increase the total proceeds of a securitization offering by targeting particular tranches to investor groups with different risk appetites, an arbitrary limit will at the margin reduce the profitability of securitizations for banks.

- *Reserve Fund*. A reserve fund equal to at least 5% of the cash proceeds payable to a sponsor must be established for each RMBS securitization to cover the repurchase of financial assets due to a breach of representations. The balance of the fund would be released after one year. This requirement is apparently being proposed in lieu of the controversial "12 month seasoning" requirement under the Sample Rule that would have required that all residential mortgage loans transferred into a securitization must have been originated no less than 12 months prior to such transfer. The "12 month seasoning" requirement would ironically have caused IDIs to keep loans which manifested problems within 12 months on their balance sheets, thereby increasing the risk to the banking system, while higher quality loans were sold to investors.

[3] Such qualitative standards do not apply to participations under the Proposed Rule.

- *Prohibition on External Credit Supports*. The credit quality of securitization obligations cannot be enhanced through external credit supports or guarantees at the pool or issuer level, but temporary payment of principal and interest may be supported by liquidity facilities. Additionally, loan-level credit enhancement, such as mortgage insurance or guarantees, would continue to be permitted. FDIC Director and Comptroller of the Currency, John Dugan, noted with concern during the December FDIC Board meeting that such prohibitions would likely increase risk to investors thereby causing them to demand higher rewards, the increased costs of which would likely be borne by consumers.

  The prohibition of external credit support, which the FDIC suggests would "better realign incentives between underwriting and securitization performance," may particularly impact home equity loan and HELOC securitizations, which historically have relied to a great extent on financial guaranties or bond insurance. To the extent obtaining third-party credit enhancement has reduced the all-in cost to issuers of these securitizations, similar transactions in the future will likely be less profitable for banks if this prohibition is adopted.

- *SOX-like Affirmations/Additional Disclosures*. Sponsors must affirm compliance with all applicable statutory and regulatory standards for origination of mortgage loans and include loan level data to confirm compliance with existing supervisory guidelines. Such affirmations would effectively create Sarbanes-Oxley-like certifications for RMBS sponsors that would increase their potential liability.

  The Proposed Rule requires that sponsors disclose a third party due diligence report on compliance with applicable regulatory standards and the representations and warranties made with respect to the financial assets. Servicers would also be required to disclose any ownership interest by the servicer or its affiliate in other whole loans secured by the same real property that secures the loan included in the financial asset pool for an RMBS.

- *Servicer Loan Modification Authority*. Servicing and other agreements must provide servicers with authority to mitigate losses on financial assets consistent with maximizing the net present value of the financial asset, including authority to modify assets to address reasonably foreseeable defaults. Servicers must act for the benefit of all investors and commence action to mitigate losses no later than 90 days after the asset first becomes delinquent.

- *Compensation*. Fees and other compensation payable to credit rating agencies are to be payable in part over 5 years after the first issuance of obligations with no more than 60% of the total estimated compensation due at closing. This requirement is less burdensome than its counterpart requirement under the Sample Rule, which would have required that the compensation restrictions noted above apply to lenders, sponsors and underwriters.

  The compensation to all parties involved in the securitization process must generally be structured "to provide incentives for sustainable credit and the long-term performance of the financial assets and securitization." Servicing compensation must provide incentives for servicing and loss mitigation actions that maximize the value of financial assets on a net present value basis.

Waiting for the Bigger Picture to Unfold

Other than shedding certain extreme requirements such as the "12 month seasoning" rule and the requirement that lenders, sponsors and underwriters receive compensation from securitizations over time, the Proposed Rule by and large mirrors the Sample Rule. While securitization participants and other interested parties will have much to comment on with respect to the Sample Rule, it appears that one central concern among participants is the extent to which the securitization reforms contained in the Proposed Rule will deviate from the securitization reforms which may ultimately be adopted by the U.S. Congress, the SEC and other regulatory agencies. Another

central concern is that any requirement that is adopted by the FDIC, but not by authorities regulating the securitization activities of non-IDIs, will create an uneven playing field that puts IDIs at a disadvantage with respect to their non-IDI counterparts in the securitization industry. Therefore, based on the simple proposition that the tail should not wag the dog, many participants agree that Congressional action on securitization reform should take place prior any action on the matter that the FDIC might take. Given that Congressional action on securitization reform may very well be taken prior to the Congressional recess which begins on July 4, 2010, there is an impetus among certain industry participants to request that the FDIC extend the comment period on the Proposed Rule beyond July 1, 2010 in order to afford commentators the opportunity to analyze the Proposed Rule in light of any congressional securitization reform which may be taken first. And so these participants hope that the FDIC defers its determination yet again in order to wait for the bigger picture to unfold.

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