Client Alert

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CURRENT ISSUES RELATED TO OUR CLIENTS SEPTEMBER 30, 2010

FDIC Adopts Final Amended Securitization Safe Harbor Rule: Rule Imposes Significant New Requirements on Bank Securitization Issuers Seeking Legal Isolation

The Federal Deposit Insurance Corporation (FDIC) adopted its final rule (the Rule) amending the securitization safe harbor for U.S. depository institutions at its board meeting on September 27, 2010.[1] The Rule amends FDIC rule 360.6, adopted in 2000. That rule provided that the FDIC would not seek to reclaim, recover, or recharacterize as property of a failed depository institution financial assets transferred in connection with a securitization, so long as such transfer met the conditions for sale accounting under GAAP. The adoption by the Financial Accounting Standards Board of its statements 166 and 167, effective for reporting periods beginning on or after November 15, 2009, rendered securitization GAAP sale treatment unavailable for most depository institutions, thereby closing the original safe harbor for these institutions.

The new rule extends the safe harbor to banks who no longer meet the original rule's GAAP sale requirement. However, the Rule imposes many new restrictions and disclosure requirements (including for transfers that meet sale accounting under FAS 166/167) similar to some of those required under The Dodd-Frank Act (e.g. 5% risk retention) and by the SEC in its proposed revisions of Regulation AB. Additional structural, disclosure, documentation, and compensation requirements are imposed on issuers of residential mortgage-backed securities (RMBS). In the words of the FDIC, these new conditions are intended to promote "better and more sustainable securitization practices" and "ensure that residential mortgage loans and other financial assets . . . are originated for long-term sustainability." The new requirements are effective after the expiration of a grandfathering period (described below) for securitizations that met the conditions of the original rule that expires for most issuers on December 31, 2010.

Safe Harbor

The extent of the safe harbor differs depending upon whether the securitization is accounted for as a sale at the time assets are transferred or a secured financing by the depository institution. The requirements to meet the safe harbor, however, are identical in both cases.

For securitizations that remain eligible for sale accounting treatment and which are not covered under the transition safe harbor, the Rule provides for legal isolation, as did the original rule. The FDIC will not use its statutory authority to disaffirm or repudiate contracts to reclaim, recover, or recharacterize as property of the bank assets sold in a securitization meeting the requirements of the Rule.

1 The final text of the Rule is published in the Federal Register at 75 FR No. 189 (Sept. 30, 2010), pg. 60287. The FDIC published its Advanced Notice of Proposed Rulemaking on January 7, 2010 and a Notice of Proposed Rulemaking on May 17, 2010 regarding its proposed amendments to the securitization safe harbor, each soliciting public comment.

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For securitizations not accounted for as sales and which are not covered under the transition safe harbor, the FDIC consents to the exercise of secured creditor remedies (e.g. foreclosure and liquidation) following monetary default or failure to pay damages upon repudiation after a 10 business day stay period. The Rule thereby provides relief from the 45 or 90 day stay that may be imposed by the FDIC under Section 11(e)(13)(C) (12 U.S.C. 1823(e)(13)(C)) of the Federal Deposit Insurance Act, provided the new requirements are satisifed. Creditors that exercise such remedies have no right to a deficiency judgment from the FDIC. If the FDIC elects to repudiate a securitization, the Rule provides that it will pay damages to investors equal to the par amount of the obligations, less principal received, plus accrued interest through the date of repudiation to the extent of actual collections received. The rule proposed in the January 2010 Advanced Notice of Proposed Rulemaking provided for payment only of the market value of the assets, thus exposing investors to market value risk. The May 2010 Notice of Proposed Rulemaking changed this provision to eliminate market value risk and pay par. The final rule is unchanged in this respect.

Transition Period

The final rule provides a transition period for issuers that meet the requirements of the original safe harbor.[2] The FDIC will not seek to recharacterize, reclaim, or recover assets transferred in a securitization, and the requirements of the final rule (described in detail below) will not apply, so long as:

- the transferred assets would have satisfied all conditions for sale accounting under GAAP effective for reporting periods beginning prior to November 15, 2009 (i.e. would have met the requirements for accounting sale treatment under FAS 140); and
- either (a) the securitized assets are transferred on or before December 31, 2010, (b) for any obligations of master trusts or revolving securitizations, the vehicle issued one or more obligations on or before the passage of the Rule (i.e. September 27, 2010), or (c) for any obligations issued under "open commitments" (presumably variable funding notes or other unfunded commitments), one or more obligations are issued under such commitment on or before December 31, 2010, up to the maximum amount of such commitment as of the date of the Rule.

Comparison to Proposed Rule

The final Rule is identical in most respects to the rule proposed in the FDIC's Notice of Proposed Rulemaking. Most notably, the requirement (discussed below) that pure private placements (those not relying on the registration exemption safe harbors of Rule 144A and Reg. D) adhere to the highly detailed disclosure requirements of SEC Regulation AB is unchanged.

Several changes were made in response to comments received by industry participants. For example, the Rule will automatically harmonize with the risk retention regulations adopted by the SEC in response to Dodd-Frank at the time they go into effect. In addition, the FDIC clarified that if it repudiates a securitization transaction, damages would include interest accrued through the date of repudiation (as opposed to accrued interest through the earlier date of receivership) to the extent of proceeds received on the assets. This change was in response to commenters' concerns

2 The provisions of the original safe harbor were grandfathered through September 30, 2010 in a transition rule adopted in March 2010.

that the loss of accrued interest could far exceed the 10-day stay period, which would stress rating agency analysis and greatly reduce the practicality of securitization.

The FDIC also eliminated a number of requirements that were either subjective or dependent upon the conduct of the issuer after the securities are sold. These provisions, in the words of Moody's, would have made the "safe harbor elusive." Many of the requirements are now expressed as a requirement that the contractual terms of the documents governing the securitization contain the required provisions. The FDIC intends these changes to "permit a clearer assessment" by investors of whether their investments fall inside the safe harbor.

Requirements of the Safe Harbor

The Rule includes risk retention requirements, compensation limits (RMBS only), detailed disclosure requirements, and required deal terms, representations, and warranties, as summarized below:

Risk Retention

The sponsor of the securitization must retain (unhedged) at least 5% of the risk of the assets transferred. Such retention must consist of either 5% of each credit tranche issued or a representative sample (e.g. pari passu retained seller interest) of the assets transferred equal to at least 5% of the principal amount of the pool. Upon the effective date of final SEC risk-retention regulations required under Dodd-Frank, such regulations will exclusively govern the risk-retention provisions of the Rule.

In addition, for RMBS only, the sponsor must maintain a 5% reserve fund to cover asset repurchase requirements arising from breaches of representations and warranties under the agreements in the first 12 months.

Compensation Limits

There are no compensation limits for non-RMBS. For RMBS, compensation payable to agencies rating the relevant securities must be spread over a five-year period and be based on asset performance and performance of surveillance services. No more than 60% of rating agency fees may be paid at closing. Additionally, the documents must require that servicing compensation include incentives, including payment for loss mitigation activities, to maximize the net present value of the RMBS assets. The Rule provides no specificity as to the qualitative requirements of rating agency performance and servicer incentives.

Reg AB Disclosure Required, including for Private Placements and 144A

The Rule requires that the agreements provide for asset level[3] and pool level disclosure at the time of issuance, and at least quarterly thereafter. Such disclosure must at a minimum meet the requirements of SEC Regulation AB, the disclosure regime for asset-backed securities, even if the securities are "issued in a private placement or are not otherwise required to be registered."

3 The FDIC release notes that where asset level disclosure would not provide investors with useful information, such as in securitizations involving credit card receivables or other transactions with high numbers of obligors but relatively small balance accounts, only pool level disclosure is required.

The SEC has issued proposed modifications to Regulation AB, the comment period for which ended on August 2, 2010, wherein the SEC proposes to extend the disclosure requirements for publicly registered asset-backed securities to private placement transactions that take advantage of the safe harbor exemptions from registration under Rule 144A and Rule 506 of Regulation D. Private placement securitization transactions that don't take advantage of a registration safe harbor (often referred to as "pure privates") typically involve highly sophisticated investors that directly negotiate the terms of their investment with issuers. The SEC appears to have taken note of this and exempted pure privates from Regulation AB.

The FDIC Rule, however, makes no distinction between 144A/Regulation D private offerings and pure private placements. Rather, it appears to extend the new, extensive disclosure requirements of the Rule to pure private transactions. For example, the securitization investments of commercial paper conduits, which are owned by large financial institutions who individually negotiate deal terms and are in a strong position to demand their own disclosure, would be subject to the Rule's extensive disclosure requirements. It is difficult to see the purpose served in dictating disclosure rules in these types of transactions, but this provision in the Rule appears to be intended. The ASF and other industry participants addressed this issue in their comments to the proposed rule, which contained the identical language included in the final Rule, but the concerns went unheeded.

Other Disclosure Requirements

The Rule does not permit re-securitizations or collateralized debt obligations unless the agreements require that the disclosures described above and below are made for the assets underlying the securities being re-securitized.

The Rule further requires that the deal documents provide for at the time of issuance disclosure of the structure, priority of payments, and subordination features; representations and warranties and remedies for breach thereof; and other features of the securities that are traditionally disclosed in securitization transactions.

The agreements must also require that, while the obligations are outstanding, the issuer make available to investors information regarding the performance of the securitized assets, delinquency data, substitution and removal, servicer advances, losses, remaining balance of assets, and percentage of each tranche relative to the securitization as a whole.

The agreements must further require disclosure at the time of issuance (and updated as necessary) of the nature and amount of compensation paid to any mortgage or other broker, originator, sponsor, rating agency, third-party advisor, and servicer, and the extent to which any risk of loss is retained by any such party.

For RMBS only, the issuer must disclose prior to issuance loan level information, including loan type, loan structure (i.e. fixed or adjustable, resets, and balloon payments), maturity, APR, and property location. In addition, prior to issuance of an RMBS security, the sponsor shall affirm compliance with regulatory requirements for loan origination, and affirm that all loans are underwritten at the fully indexed rate relying on documented income.

Structural Requirements

Unfunded and synthetic securitizations are not eligible for safe-harbor protection. In addition, payments must be primarily dependent upon performance of the assets, and not be contingent upon market or credit events independent of the supporting assets. The Rule requires for RMBS only that the capital structure of the securitization be limited

to six credit tranches to "discourage complex and opaque structures." RMBS may not be supported by external credit enhancement, such as bond insurance, other then GSE guarantees.

Documentation Requirements and Required Representations and Warranties

The securitization agreements must define all rights and responsibilities of the parties, ongoing disclosure requirements, and measures to avoid conflicts of interest. The sponsor must maintain securitization records separate from other business operations and make records available for FDIC review.

For RMBS only, servicers must have the authority to modify assets and take such other actions consistent with maximizing asset value for the benefit of all investors, and not for the benefit of a single class of investors. Servicers must also be required to take loss mitigation actions within 90 days of the first delinquency. The Rule further requires for RMBS that no servicer advances of delinquent payments are permitted for more than three payment periods unless financing or a reimbursement facility is available.

The securitization agreements must include representations that the mortgages underlying RMBS were underwritten based on the fully indexed rate, relying on documented income, and complying with all applicable supervisory guidance.

Other Requirements

The rule further requires, consistent with the original rule, that transactions covered by the safe harbor should be arms-length; made for adequate consideration; entered into in the ordinary course, not in contemplation of insolvency and with no intent to hinder or defraud creditors of the bank; approved in writing by the board of directors or the bank's loan committee; and have been continuously maintained as records of the bank.

Asset transfers and security interests must also be properly perfected under the Uniform Commercial Code or other applicable state law.

The Rule also requires that the duties of the sponsor as transferor, and its duties as servicer or in other capacities, must be documented in separate agreements. For example, transfer and servicing agreements or pooling and servicing agreements, often used in bank securitizations, must be split into two agreements.

If you would like to discuss any of the issues addressed in this Client Alert, please contact Kenneth Marin at 212.655.2510 or kmarin@chapman.com or the Chapman attorney with whom you usually work, or visit us online at chapman.com.

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