



FDIC Issues Final Safe Harbor Rule

Recent weeks have seen a number of legal, regulatory and political developments in the realm of asset securitization, culminating for the moment on September 27 with the issuance by the FDIC of a long-awaited “safe harbor” rule specifying the conditions under which U.S. banks and thrifts may issue mortgage-backed and other asset-backed securities without the threat that the FDIC will attempt to unwind the transaction in the event of the issuer’s seizure by the FDIC.

Below we offer a summary of the FDIC’s final safe harbor rule. We leave it to the reader to reach her or his own assessment of where the securitization market is, where it is headed, and at what speed.

What Now? FDIC’s Final Safe Harbor Restrains Bank Securitization

They said they were going to do it—and now, some critics say, “they’ve really done it.”

On September 27, 2010, the Board of Directors of the Federal Deposit Insurance Corporation (“FDIC”) resolved by a four-to-one vote to issue a final rule amending 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 Although initially prompted by the need to address changes to accounting standards on which the original Securitization Rule, adopted in 2000, was premised, the FDIC capitalized on the opportunity to address at the same time perceived structural failures inherent in the “originate to sell” securitization model widely believed to have contributed to the recent financial meltdown. As adopted, the Final Rule contains a number of reform-oriented qualitative conditions that securitizations must satisfy in order to be afforded safe harbor protections under the rule.

The Final Rule was issued a little more than two months after the enactment of the landmark Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). The Dodd-Frank Act mandates a host of securitization “reforms,” including requirements relating to risk retention, asset class differentiation, disclosure, conflicts of interest and due diligence, which are to be “fleshed out” and implemented through an interagency rulemaking process.² Truly ahead of the game with the issuance of the Final Rule, the FDIC adopted securitization reforms before the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission (the “SEC”), the other regulatory agencies charged with adopting regulations to implement the securitization reforms prescribed by the Dodd-Frank Act. Notably, the Final Rule was issued prior to the SEC’s issuance of final rules (“Regulation AB II”) that would significantly modify Regulation AB, the SEC’s rule governing registration of and disclosures regarding asset-backed securities, by imposing qualitative standards and additional disclosure requirements on asset-backed securitizations.

¹ The Final Rule is posted at <http://www.fdic.gov/regulations/laws/federal/2010/10FinalAD55.pdf>.

² For a discussion of the securitization provisions of the Dodd-Frank Act, please see our client alert, “[Dodd-Frank Act Securitization Reform: New SEC ABS Office.](#)”

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”).

The Securitization Rule fulfilled two important functions. First, it satisfied a technical requirement of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (“FAS 140”), not uncoincidentally adopted by the Financial Accounting Standards Board (the “FASB”) at the same time the original Securitization Rule was adopted by the FDIC, that accountants have a reasonable basis for concluding that securitized assets have been legally isolated from the sponsor. Second, quite apart from the technical accounting purpose, the Securitization Rule has provided investors and credit rating agencies with substantive comfort that securitized assets will not be reclaimed by the FDIC in conservatorship or receivership of an IDI sponsor. Securitization participants have thus relied for a decade 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 upended on June 12, 2009 when 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 narrowed the circumstances under which a transfer of financial assets in connection with a securitization may be accounted for as a sale and expanded the circumstances under which IDIs are required to consolidate issuer entities to which financial assets have been transferred for securitizations in their financial statements for fiscal years beginning after November 15, 2009.³ As a result, many securitization transfers that previously would have been treated as sales would be instead treated as secured borrowings to which the Securitization Rule would not apply unless it were amended. The uncertainty over whether the FDIC would continue to grant safe harbor treatment to securitizations of an IDI in a conservatorship or receivership created considerable marketplace concern that caused many then-pending securitizations to come to a halt.

Temporary Relief; Extended Relief and the Road to Reform

In response to the market uproar over FAS 166 and FAS 167, on November 15, 2009, the FDIC Board adopted 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, on or prior to March 31, 2010 (the “Sunset Date”). The Sunset Date was subsequently extended on March 11, 2010, to September 30, 2010, and ultimately by the Final Rule to December 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. Portending things to come, the FDIC Board stated at the November 15 meeting that it would consider additional changes to the Securitization Rule that would not only address the impact of FAS 166 and FAS 167 after the Sunset Date, but also introduce qualitative standards for securitizations designed to encourage “sustainable lending” and avoid “massive losses” and “landmines” that had recently plagued IDIs.

On December 15, 2009, the FDIC Board issued an Advance Notice of Proposed Rulemaking (the “ANPR”) regarding possible amendments to the Securitization Rule. The ANPR included a draft of “sample” regulatory text (the “Sample Rule”) containing a then-provocative array of possible standards that would need to be satisfied in order for securitizations to qualify for safe harbor treatment under the Securitization Rule. After receiving a large number of comments on the ANPR, on May 11, 2010, the FDIC Board resolved by a three-to-two vote to issue a

³ For most institutions, the new GAAP rules became effective on January 1, 2010.

Notice of Proposed Rulemaking concerning proposed amendments to 12 C.F.R. § 360.6 (the “NPR”)⁴ that would become the Final Rule by retaining most of the features of the Sample Rule.

And Now They’ve Done it (The Final Rule)

The Final Rule extends the Sunset Date to December 31, 2010 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 reform-oriented qualitative standards before they can qualify for safe harbor treatment.

Qualification for Safe Harbor Treatment

The original 2000 Securitization Rule applied only to a single class of transactions—securitizations and participations that were treated as sales under GAAP but for the “legal isolation” requirement intended to be established by operation of the rule. The Final Rule is much more complex; it prescribes different outcomes for securitizations and participations, and for securitizations otherwise treated as sales under GAAP as opposed to securitizations that are treated as secured borrowing. As a result, the Final Rule set forth four different possible outcomes depending on the particular classification of the asset transfer under consideration.

- *Securitizations that are Treated as Secured Borrowings and Issued After December 31, 2010.* The Final Rule assumes that most securitizations will be treated as secured borrowings under FAS 166 and FAS 167. Under Section 11(e)(13)(C) of the Federal Deposit Insurance Act (the “FDI 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 for 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 Final Rule provides that, with respect to securitizations issued after December 31, 2010 that are treated as secured borrowings for accounting purposes and that otherwise satisfy all qualitative standards under the Final 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 FDI Act and does not pay damages within ten business days after the effective date of such notice.

The Final Rule clarifies that the FDIC will not attempt to reclaim any interest payments made to investors in accordance with the securitization documents prior to repudiation and that, as conservator or receiver, the FDIC’s failure to perform its obligations as a servicer triggers an investor’s right to exercise its remedies under the securitization documents.

- *Securitizations that are Treated as Sales and Issued After December 31, 2010.* Under the Final Rule, securitizations issued after December 10, 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.

⁴ <http://edocket.access.gpo.gov/2010/pdf/2010-11680.pdf>.

- *Participations Issued After December 31, 2010.* The Final Rule assumes that participations will continue to be treated as sales under the new accounting pronouncements. Accordingly, it provides that participations, including last-in, first-out participations, issued after December 31, 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 December 31, 2010.* The Final Rule provides that all securitizations and participations issued on or before December 31, 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 in effect prior to the date of the Final Rule.

Qualitative Securitization Standards

The Final Rule includes a number of qualitative standards that securitizations must satisfy in order to be afforded safe harbor treatment.⁵ Citing an attempt to respond to investor demands for greater transparency and alignment of interests of the various securitization parties, the FDIC structured the Final Rule to include specific standards for securitizations supported by residential mortgage loans ("RMBS"). The Final Rule retains most of the qualitative standards first featured under the Sample Rule included in the ANPR and retained in the NPR, with the one major modification being that it provides for certain requirements to "auto-conform" to regulations adopted through the interagency process mandated under the Dodd-Frank Act. Set forth below are some of the more noteworthy standards contained in the Final Rule.

Qualitative Standards Applying to All Securitizations

- *Unhedged Risk Retention.* Sponsors must retain an economic interest of no less than 5% of the credit risk of the financial assets underlying a securitization until the joint interagency regulations required to be adopted, with respect to risk retention under the Dodd-Frank Act, become effective. The sponsor is not permitted to hedge the credit risk of the retained interest, but it may hedge the interest rate and currency exchange risk of the retained interest. After their effective date, the interagency regulations will govern the risk retention requirements for sponsors.
- *Increased Disclosures.* Sponsors, issuing entities and servicers, as appropriate, must provide information regarding securitized financial assets in compliance with Regulation AB for securitizations issued through public offerings or private placements. Such disclosures are expected to increase significantly once the Regulation AB II reforms are adopted by the SEC.

Qualitative Standards Applying Only to RMBS Securitizations

- *Tranche Restrictions.* RMBS securitizations 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 or planned amortization and companion sub-tranches.
- *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 may be released to the sponsor after one year.

⁵ 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.
- *SOX-like Affirmations/Additional Disclosures*. Sponsors must affirm compliance in all material respects 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 effectively create Sarbanes-Oxley-like certifications for RMBS sponsors that could increase their potential liability.

The Final Rule requires that sponsors disclose any third party due diligence reports on compliance with applicable regulatory standards and representations and warranties made with respect to financial assets. Servicers are also required to disclose any ownership interest of servicers or affiliates in other whole loans secured by the same real properties that secure the loans 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 assets, 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 an 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.

What Now?

The FDIC’s issuance of the Final Rule comes ahead of interagency action with regard to risk retention as contemplated by the Dodd-Frank Act. Some industry participants fear that by being ahead of the game, the FDIC’s action may exacerbate confusion in the securitization market in a number of ways, including effectively creating an uneven playing field between IDI and non-IDI securitizers and making the safe harbor under the Securitization Rule less “safe” because of the subjectivity inherent in determining conformity to the qualitative conditions under the Final Rule.⁶

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⁶ See press releases, each dated September 27, 2010, issued by the CRE Finance Council, “[FDIC Finalizes ‘Safe-Harbor’ Rule](#)” and the American Securitization Forum, “[ASF Says FDIC’s Safe Harbor Action Hurts Liquidity and Seriously Threatens Government’s Ability to Exit Housing Market](#).”

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