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News Bulletin

December 18, 2009

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

As a follow-up to its announcement at its November 15, 2009 meeting that it would propose additional changes to 12 C.F.R. §360.6 (the "Securitization Rule") concerning the treatment by the Federal Deposit Insurance Corporation (the "FDIC"), as conservator or receiver, of financial assets transferred in connection with a securitization or participation, the Board of Directors of the FDIC issued, at its December 15, 2009 meeting, an advance notice of proposed rulemaking (the "Notice") regarding possible amendments to the Securitization Rule.[1] The Notice includes a draft of "sample" regulatory text (the "Sample Rule") that contains a provocative array of possible standards that must be satisfied in order for securitizations issued after March 31, 2010 to qualify for safe harbor treatment under the Securitization Rule. The Notice seeks public comment on such possible securitization standards and poses a number of questions intended to stimulate submission of comments. Further, the Notice underscores that the FDIC is not adopting or recommending the Sample Rule, but only offering it to "provide context" for responses to the questions posed.

The Notice was issued on the heels of the House of Representatives' December, 11, 2009 passage of the Wall Street Reform and Consumer Protection Act (the "Wall Street Reform Bill"), which includes a number of reforms targeted at asset-backed securitizations, including requirements that loan originators or securitizers retain an economic interest in the credit risk of the underlying loans and increased disclosure obligations for issuers of asset-backed securities.[2]

Background

The FDIC originally adopted the Securitization Rule in 2000 to provide comfort that loans or other financial assets transferred by an insured depository institution ("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 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 Notice is posted at http://www.fdic.gov/news/board/DEC152009no5.pdf.
[2] For a discussion of the Wall Street Reform Bill, please see our client alert, "Update: House Passes Securitization Reform" at http://www.mofo.com/news/updates/files/091211House_Passes_Securitization_Reform.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 will become effective on January 1, 2010.) These changes will cause many securitization transfers that would previously would have been treated as sales to be treated as secured borrowings for accounting purposes, and 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 IDIs in 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 was addressed.

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 at the December 15, 2009 meeting 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.

The Sample Rule

The Sample Rule 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 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 March 31, 2010*. The Sample 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 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 Sample Rule provides that, with respect to securitizations issued after March 31, 2010 that are treated as secured borrowings for accounting purposes and that otherwise satisfy all qualitative standards under the Sample Rule, the FDIC, as conservator or receiver, will be deemed to consent to continued regularly scheduled payments under the securitization agreements and continued servicing of the assets, as well as the ability of the investors to exercise self-help remedies ten days after a payment default by the FDIC or the repudiation of a securitization transfer agreement during the stay period under Section 11(e)(13)(C) of the Federal Deposit Insurance Act.

- *Securitizations that are Treated as Sales and Issued After March 31, 2010*. Under the Sample Rule, securitizations issued after March 31, 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 March 31, 2010*. The Sample Rule assumes that participations will continue to be treated as sales under the new accounting pronouncements. Accordingly, it provides that participations issued after March 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 March 31, 2010*. The Sample Rule provides that all securitizations and participations issued on or before March 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.

Qualitative Securitization Standards

The Sample Rule includes a number of qualitative standards that securitizations must comply with in order to be afforded safe harbor treatment.[3] Noting that certain "defects and misalignment of incentives" in the securitization process for residential mortgages in particular contributed significantly to an "erosion" of underwriting standards throughout the mortgage finance system, the FDIC structured the Sample Rule to include specific standards for securitizations supported by residential mortgage loans ("RMBS"). Set forth below are some of the more noteworthy standards contained in the Sample 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. In its current form, this requirement is not entirely consistent with the similar "skin in the game", or risk retention, provisions found in the Wall Street Reform Bill which would require that a minimum of 5% of the credit risk be retained by creditors or securitizers subject to upward or downward adjustment depending on whether certain underwriting or due diligence standards set by the relevant regulators are met.

  Critics of the Sample Rule's retention requirement will likely point out that its failure to allow for adjustment may create regulatory gaps between the FDIC's retention requirement and the retention requirements of the relevant federal banking agencies. For example, if bank regulators determine that a particular class of loans qualifies for a risk retention percentage of less than 5%, or should be exempted from the risk retention requirement altogether, the Sample Rule would nonetheless require a 5% risk retention by the IDI to qualify for the rule's safe harbor.

  Critics are also likely to point out that the prohibition on hedging the retained interest flies in the face of 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 these retained positions accumulate on a bank's

[3] Such qualitative standards do not apply to participation under the Sample Rule.

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 adopted by the Securities and Exchange Commission (the "SEC") 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 such privately placed securitizations to voluntarily prepare offering documents that comply with Regulation AB due to investor demands. Nevertheless, objections may surface to the effect that the FDIC is overstepping its bounds by including disclosure requirements that fall squarely within the SEC's jurisdiction.

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. While the FDIC appears to have set the tranche limit at 6 simply to engender comment regarding the impact of limiting the number of tranches in general, the arbitrary nature of any limit will likely be objected. Additionally, 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.
- *12 Month "Seasoning" Prior to Transfer*. All residential mortgage loans transferred into a securitization must have been originated no less than 12 months prior to such transfer. This requirement appears to be aimed at eliminating, at least for banks, the "originate to sell" business model which has been blamed for many of the adverse effects of the prior securitization cycle. However, this requirement may also have the ironic effect of assuring that loans with problems that manifest within 12 months remain on bank balance sheets and increase the risk to the banking system, while other higher quality loans may be sold to other investors.
- *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*. 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.
- *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 lenders, sponsors, credit rating agencies and underwriters are to be payable in part over 5 years after the first issuance of obligations with no more than 80% of the total estimated compensation due to any party at closing. The compensation to all parties involved in the securitization process must 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.
- To the extent that payment of future compensation is tied to the future performance of a securitization and its underlying assets, detailed arrangements would need to be worked out in future bank securitizations that would prescribe methodologies for measuring performance, dividing the risk of non-performance among various parties with different levels of responsibility for factors affecting future performance, and tracking and distributing future payments to individuals (in the case of loan brokers and loan underwriters) and companies over a 5-year period. Although this is similar in some respects to royalty payment arrangements already commonplace in the entertainment business, there is currently no infrastructure for such arrangements in the banking industry, and their implementation is likely to materially increase the cost of bank securitizations.

The Bigger Picture Has Yet to Unfold

While FDIC Chairperson, Sheila Bair, has stated that the Sample Rule is very consistent with the direction of legislation in Congress, some of its proposed standards, especially those relating to limitations on tranching, external credit enhancement and loan seasoning restrictions on RMBS, go beyond Congressional proposals that have been made to date. Mindful of its duty to address the defects in the securitization process that caused many IDIs to fail, resulting in significant losses to the Federal Deposit Insurance Fund, the FDIC Board has repeatedly expressed a desire to take action to address such defects. However, the Board's desire to take action has also been tempered by the FDIC's realization that any action taken without coordination with other regulators and Congress risks creation of an uneven playing field, further harming the insured banks and thrifts the FDIC ultimately seeks to support.

As a result, FDIC Board members have repeatedly emphasized the need to coordinate efforts with other banking, lending and securities regulators and Congress prior to taking any action of its own. With the issuance of the Notice, the FDIC is ultimately doing no more than continuing its wait-and-see approach with the hope that consensus will build regarding the actual direction that securitization reform will take. Until such consensus reaches critical mass, the proposals contained in the Sample Rule should provide ample food for thought and commentary.

Commentary: The Long-Term Impact of the Notice and Other Recent Actions on Securitization and U.S. Mortgage and Consumer Finance Markets

The Notice, including the Sample Rule, should also be considered in the broader context of the Obama Administration and Congressional financial reform initiatives, recent and proposed actions by other federal banking regulators, and the FASB's adoption of FAS 166 and 167. Taken together, these actions, to the extent adopted in their current forms, will increase the cost of securitization to financial institutions and, perhaps more significantly in the long run, will require banks to retain on their balance sheets a substantially greater portion of financial assets that they originate, including residential and commercial mortgage loans and consumer financial assets, than has been the case in recent periods.

In the recent past, the ability of financial institutions and other originators to utilize off-balance sheet securitization to efficiently recycle newly originated assets into new funds for lending has been a significant engine of the U.S. mortgage and consumer credit markets. To be sure, this activity may have significantly contributed to he asset bubble that led to the financial crisis of 2007-2009. However, an overreaction to the "originate to sell" model and off-balance sheet financing techniques may pose a serious impediment to the reinstitution of rational mortgage and consumer credit markets. While one or more of the proposed and recently implemented changes to the regulatory and accounting rules governing the securitization market might make sense, an observer might reasonably wonder whether the cumulation of these restrictions will be counterproductive for both the banking system and the economy.

The most significant change to date to the rules of securitization has not come from Congress or banking regulators, but from the accountants. The recharacterization of previous off-balance sheet, sale securitization structures as on-balance sheet, secured debt obligations resulting from the implementation of FAS 166 and 167 alone may be expected to have a substantial chilling effect on securitizations, and impose a real financial and structural limit on the ability of bank and non-bank issuers alike to provide the credit that many observers view as the key to a sustained economic recovery. This limit results from the simple fact that assets retained on-balance sheet must be supported by capital. Banks and other lenders are already capital-challenged in the current environment, and many of the pending financial reform proposals would impose even higher capital requirements on banks. Under current regulatory risk-based capital and leverage requirements, banks will be unable to significantly increase their retained financial assets without substantial increases in their capital, which are often difficult and costly to achieve.

As a result of the new accounting pronouncements and likely adoption of some version of risk retention requirements, banks are likely to move increasingly toward financing their financial assets through on-balance sheet investment vehicles such as covered bonds, which have been utilized widely by European banks in recent years with considerable success, and which have been promoted by U.S. regulators as a partial solution to the current lending slowdown.[4] However, covered bonds are currently subject to the same capital constraints as other on-balance financing devices, so their usefulness in generating replenishing sources of funding for new lending is limited.

Moreover, the cumulative effect of the various "skin in the game," or risk retention, proposals currently embodied in proposed federal financial reform legislation and in regulatory proposals such as the Notice, including the unhedged risk retention requirement and the Sample Rule's seasoning requirement and prohibition on external credit support, may have the perverse effect of trapping credit risk within the banking system that could otherwise be spread to investors outside the banking system and indeed outside the U.S. While these "skin in the game" measures are proposed as a means of ensuring that banks have an incentive to originate higher quality assets, many policymakers appear unaware of the fact that many originators and securitizers in the prior cycle already had substantial "skin in the game," with little apparent effect on asset quality.

While many observers have pointed out that originators and securitizers had some degree of "skin in the game" by reason of their representation and warranty liability, a far more significant source of "skin in the game" by originators and securitizers in the prior cycle has rarely been mentioned. Specifically, many of the large bank and non-bank securitizers, including Countrywide, IndyMac, Washington Mutual and New Century, often retained the

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[4] For a discussion of covered bonds generally, see our Client Alert, "An Update on Covered Bonds" at http://www.mofo.com/news/updates/files/090401CoveredBonds.pdf.
For a report on a December 15, 2009 Congressional hearing on proposed legislation to establish a U.S. statutory scheme for covered bonds, see our Client Alert, "Hearing on Covered Bond Legislation" at http://www.mofo.com/news/updates/files/091215Hearing_on_Covered_Bond_Legislation.pdf.

most subordinated tranches and residual interests of their securitizations, which could not be readily sold at a profit. As a result, many securitizers already held first loss positions in the assets they originated—which is even more "skin in the game" than the *pari passu* interests contemplated by Congressional proposals and the Sample Rule. Indeed, these retained interests have been a significant source of losses and write-downs, which have contributed to multiple failures both within and outside the banking system. It is a fair question whether the cumulative effect of the various measures proposed to push credit risk back on the banking system will have the intended effect of increasing asset quality to such an extent that the benefits outweigh the risks created by concentrating credit risk on bank balance sheets rather than distributing it to other capital markets participants.

Governments worldwide are facing these questions. In the U.S., while Congress and federal banking regulators move forward on proposals that substantially restrict the ability of banks and others to securitize financial assets, other elements of the government have recognized the importance of securitization in restoring the financial markets. Indeed, the Treasury and the Federal Reserve Board are in effect subsidizing new and existing securitizations through the Term Asset-Backed Securities Loan Facility, or TALF, and the Public-Private Investment Program, or PPIP, programs which, to date, have produced lackluster results.

In Europe, regulators face a similar dilemma. On December 12, 2009, a senior representative of the European Central Bank, or ECB, stated in a speech in Berlin that the ECB is planning initiatives to help re-launch securitization "on a sound basis" "so as to facilitate the provision of credit to the economy and the better distribution of risk among market participants."[5]

It remains to be seen where the balance will be struck between restricting securitization and other off-balance sheet financing techniques to prevent future financial crises, and encouraging such techniques to tap the credit reservoir available in the larger global capital markets and to distribute risk among various capital markets constituencies. This game of tug-of-war is likely to play out over several years, and the Notice will perhaps, in retrospect, be seen as an extreme example of overreaction to the traumatic financial events of the past several years.

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[5] *See* "ECB to help relaunch securitisation," Reuters UK, *available at* http://uk.reuters.com/article/idUKTRE5BB0VX20091212.