

A Peek at the Future of the FDIC Securitization Safe Harbor

On December 15, 2009, the Board of the Federal Deposit Insurance Corporation (FDIC) approved publication of an advanced notice of proposed rulemaking¹ (ANPR) concerning the FDIC's rule (the Safe Harbor) relating to the treatment of securitizations (and participations²) in receivership or conservatorship (12 CF 360.6). The ANPR follows up on an interim rule that the FDIC adopted in November (the Interim Rule).³ Both the ANPR and the Interim Rule are responses to recent changes in US accounting standards for securitizations.⁴ While the Interim Rule assists with transactions completed through March 31, 2010,⁵ the ANPR provides an initial indication of what safe harbor(s) the FDIC may eventually provide for transactions completed after that. We refer to the period from November 12, 2009 (when the Interim Rule was adopted) through March 31, 2010 (or any later date to which the FDIC may eventually extend the transitional relief provided by the Interim Rule) as the Transition Period.

One of the key impacts of the accounting changes is that banks (among other entities) will no longer be able to achieve sale treatment in securitizations of credit card and other receivables using many traditional structures. Among other issues, this change created uncertainty about the continuing availability of the Safe Harbor for affected transactions.

The Original Safe Harbor

For transactions that satisfy its requirements, the Safe Harbor provides that the FDIC will not:

- Use its repudiation power to reclaim financial assets transferred by the institution in connection with a securitization (the Repudiation Safe Harbor), or
- Avoid an otherwise legally enforceable securitization agreement solely because the agreement does not meet the "contemporaneous" component of the "written agreement" requirements under the Federal Deposit Insurance Act (the Avoidance Safe Harbor).

The Repudiation Safe Harbor was originally conditioned upon satisfaction by the subject securitization of the conditions for sale accounting (other than the legal isolation condition, since the Safe Harbor was meant to help satisfy that condition).⁶ Because the accounting changes make it difficult for securitizations to achieve sale accounting, this requirement threatened to make the Repudiation Safe Harbor unavailable at least for transfers completed after the accounting changes take effect (January 1, 2010, for most banks).

Another issue that arose in connection with these developments relates to an automatic stay that was added to the FDIC's arsenal subsequent to the adoption of the Safe Harbor. In 2005, Congress added section 11(e)(13)(C) to the Federal Deposit Insurance Act. Under this new section, if the FDIC is appointed as conservator or receiver for a failed bank,⁷ then the FDIC's consent is required for a secured creditor to take any action against collateral pledged by the failed bank within a 45- or 90-day period, respectively, after the FDIC's appointment as conservator or receiver. Effectively, any such action would be automatically stayed for the specified period.

Although the Safe Harbor did not address this consent requirement, market participants were generally comfortable that assets transferred in an off-balance sheet securitization that qualified for the benefits of the Safe Harbor would also not be subject to the automatic stay. The impending loss of sale accounting treatment and possible unavailability of the Repudiation Safe Harbor posed the additional threat that the automatic stay might apply to some securitized assets.

These threats created significant issues for some credit card banks because any securitization of credit card receivables completed in the remaining portion of 2009 would contemplate revolving sales of new receivables arising after the year's end. This legal uncertainty effectively froze issuance in the term

markets by a number of the largest issuers. We believe that securitizations by bank originators can achieve legal isolation without the Safe Harbor through a common law true sale, and a number of our clients have continued to issue transactions rated on that basis.⁸ However, some large credit card trusts were apparently unable to obtain the necessary opinions to issue on that basis, due to structural, historical or other issues.

The Interim Rule

The Interim Rule addressed the possible loss of the Repudiation Safe Harbor by adding a new paragraph to the Safe Harbor that eliminates the requirement for transactions closed during the Transition Period to achieve sale accounting, so long as they meet the conditions for sale accounting that applied prior to the recent changes (again, other than the legal isolation condition). For revolving trusts, this relief applies to transfers made after the end of the Transition Period, so long as the related asset-backed securities were issued on or prior to that date. While the Interim Rule did not specifically address the automatic stay, an FDIC press release relating to the Interim Rule stated that any financial assets transferred into securitizations in compliance with the Interim Rule will not be treated as property of the bank or receivership, and consequently the automatic stay will not apply.

This relief enables banks to resume issuing in reliance on the Safe Harbor through the Transition Period. The major credit rating agencies have issued statements indicating that they view the FDIC's actions as sufficiently addressing the legal isolation issues for transactions closed during that period. Even for transactions that are structured to achieve common law true sale, the Interim Rule provides welcome additional certainty.

The ANPR

While the Interim Rule temporarily loosened the conditions for the Repudiation Safe Harbor without imposing any additional compensating conditions, the ANPR contemplates significant new conditions after the Transition Period. The FDIC recognizes the importance of securitization as a source of liquidity for banks but also believes that securitization played a significant role in bringing about the credit and

market crises of the last two years. Consequently, while the FDIC intends to continue to facilitate bank securitizations by providing a safe harbor from its repudiation, avoidance and automatic stay powers (as necessary), it also wants to use the amended Safe Harbor to reshape the securitization market in ways that will prevent a repeat of the practices that the FDIC views as contributing to the crises. That is the goal of the additional conditions contemplated by the ANPR.

The ANPR is unusual. It includes an addendum with "sample regulatory text" that shows how the amended Safe Harbor might look, but it repeatedly states that the sample regulatory text has not been considered or approved by the FDIC and is provided simply as "one example of regulatory text, and not a proposal."⁹ Furthermore, at least two members of the FDIC Board indicated at the December meeting that they did not support the "sample regulatory text." In these circumstances, any predictions about the final terms of the amended safe harbor are necessarily quite tentative, especially with respect to the conditions to qualify for the Safe Harbor.

From discussions at the November and December FDIC Board meetings, it appears that there are significant disagreements on the Board as to the terms of those conditions. Certain members of the Board were particularly concerned about two aspects. First, they believed that onerous conditions to qualify for the Safe Harbor would place banks at a competitive disadvantage to nonbank lenders when conducting securitizations. Second, there was a concern that certain conditions might conflict with some of the provisions contained in the financial reform legislation now being considered by Congress.

It seems likely that those disagreements are the main reason for the tentative manner in which the regulatory text is presented, and possibly for the fact that the FDIC Board only approved an ANPR, rather than proposing more definitive text. We cannot be certain, but it seems less likely that there are significant internal disagreements as to the other terms of the sample text. Supporting that hypothesis, the vast majority of the 35 specific questions raised for comment in the ANPR relate to the conditions.

The Safe Harbors. The sample text contemplates three different safe harbors for securitizations (in

addition to the Avoidance Safe Harbor, which is largely unchanged). Each of the three safe harbors relates to one of the following categories of transactions:

- **Securitizations completed during the Transition Period**, which would continue to receive the same benefits as under the Interim Rule and would not have to comply with any new conditions. Changes in defined terms in the sample text, as opposed to the existing Safe Harbor, could theoretically affect the scope of this safe harbor, but we have not identified any significant issues of this type in our initial review of the sample text.
- **Securitizations completed after the Transition Period that meet sale accounting requirements (under the revised accounting standards)**, which would have to meet the new conditions discussed below (to the extent applicable). Transactions that met those new conditions would benefit from substantially the same protection from the repudiation power as is provided by the existing Repudiation Safe Harbor. They would also benefit from an advance consent to continued payment of regularly scheduled payments and contractual servicing activities during the automatic stay period in the event of a receivership or conservatorship of the sponsor.¹⁰
- **Securitizations completed after the Transition Period that do not meet the revised sale accounting requirements**, which would also have to meet the new conditions discussed below (to the extent applicable). Transactions that met those new conditions would benefit from a substantively new safe harbor that does not parallel the existing Repudiation Safe Harbor and instead provides additional relief relating to the automatic stay. The

absence of the Repudiation Safe Harbor element is explained by the FDIC in the following manner: “The ability of the FDIC as conservator or receiver to reach financial assets transferred by an IDI¹¹ to an issuing entity in connection with a securitization is limited by the statutory provision prohibiting the conservator or receiver from avoiding a legally enforceable or perfected security interest, except where such an interest is taken in contemplation of insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution. Accordingly, in the case of a securitization that satisfies the standards set forth in the ANPR, the conservator or receiver will not, in the exercise of its statutory repudiation power, attempt to reclaim or recover financial assets transferred by an IDI in connection with a securitization if the financial assets are subject to a legally enforceable and perfected security interest under applicable law.”¹² Transactions qualifying for this safe harbor enjoy the same advance consents under the automatic stay as transactions that qualify for the accounting sale safe harbor described above (continued payment of regularly scheduled payments and contractual servicing activities during the automatic stay period). In addition, the sample text provides for expedited (10-day) consent to the exercise of remedies related to the collateral upon either a monetary default (defined as including expiration of any cure period) or notice that the FDIC is repudiating the securitization agreements.

The following table summarizes how each of the securitization safe harbors in the sample text deals with the FDIC’s repudiation, automatic stay and avoidance powers, as well as the applicability of the new market regulating conditions discussed in the ANPR.

	TRANSITION PERIOD TRANSACTIONS	POST-TRANSITION PERIOD TRANSACTIONS	
		Off Balance Sheet	On Balance Sheet
Market Regulating Conditions	Not applicable	Applicable	Applicable
Repudiation Power	Safe harbor in rule	Safe harbor in rule	Preamble statement that repudiation power is not available
Automatic Stay	Press release statement that stay does not apply to transferred assets	Safe harbor in rule for scheduled payments and contractual servicing activities	Safe harbor in rule for scheduled payments and contractual servicing activities 10-day notice for moving against collateral
Avoidance Power	Safe harbor in rule	Safe harbor in rule	Safe harbor in rule

We believe the FDIC intends that qualifying transactions in each of the three categories are in substantially the same position vis-à-vis the FDIC's repudiation, automatic stay and avoidance powers, and our initial view is that the sample text would (if adopted) have that effect. The differences between the safe harbors reflect differences in how the repudiation or automatic stay powers apply to each category in the absence of a safe harbor. Based on the FDIC's actions to date, we believe that a common law true sale structure would also continue to provide legal isolation for bank sponsored securitizations.

The Conditions. Paragraphs (b) and (c) of the sample text set out possible conditions that a particular securitization completed after the Transition Period might have to satisfy in order to qualify for either of the available safe harbors (for transactions that do or do not qualify as accounting sales). The conditions in paragraph (b) are oriented towards regulating the securitization market to avoid a repeat of past mistakes. In this regard, certain additional conditions are imposed on residential mortgage-backed securities (RMBS). All or most of those conditions are examples of types of regulation that are discussed in the body of the ANPR and are the subject of numerous questions on which the FDIC has requested comment. The topic areas addressed in paragraph (b) and some highlights of the sample conditions follow:

- **Capital structure and financial assets** (including, for RMBS, possible prohibitions on pool- or issuer-level third party credit enhancements, such as surety bonds, and limits on capital structure to no more than six credit tranches)
- **Disclosure** (including initial and ongoing loan level disclosure, imposing Regulation AB disclosure requirements on private placements, disclosure on compensation and risk retention for various parties involved in the securitization or in origination of the securitized assets and, for RMBS, regulation/disclosure relating to the origination of the securitized loans)
- **Documentation and recordkeeping** (including required use of any applicable standardized forms and compliance with applicable best practices and, for RMBS, authority for servicers to mitigate losses consistent with maximizing the net present value of distressed assets and new limits on servicer advances)

- **Compensation** (for RMBS only, required compensation incentives tied to “sustainable credit and the long-term performance of the financial assets and securitization,” including the requirement that compensation of several deal parties be payable in part over the first five years after issuance and based on performance of the securitized assets)
- **Origination and retention** (including a requirement that sponsors retain at least five percent of the credit risk of securitized assets and, for RMBS, a 12-month seasoning requirement prior to securitization)

The conditions in paragraph (c) are more generic and similar to conditions in the current Safe Harbor (*e.g.*, arms length, bona fide transactions; written agreements with proper corporate approval), except that:

- Paragraph (c)(1) adds a requirement that the obligations issued in the transaction must not be sold predominantly to an affiliate or insider; and
- Paragraph (c)(6) requires that transfers and the duties of a transferor as such must be evidenced in a separate agreement from duties of the same entity in other capacities (*e.g.*, as servicer), which will necessitate changes in the documents for many transactions.

Also paragraph (c)(7) may create issues, as it requires segregation of securitized assets and related records from the general assets and records of the bank.

Next Steps

Comments on the ANPR are due 45 days after it is published in the *Federal Register*. Given the extensive and detailed new market requirements included in the sample conditions, we encourage all interested parties to review those conditions and the related questions raised by the FDIC and submit comments.

Endnotes

¹ Available at <http://www.fdic.gov/news/board/DEC152009no5.pdf>.

² We will not discuss the participation portion of the Safe Harbor in the body of this update, but we note that the definition of “participation” was narrowed by reference to the characteristics of a “participating interest,” presumably as that term is defined in Statement of Financial Accounting Standards 166. The participation safe harbor was also pulled into a separate paragraph, largely because the FDIC did not have to address as many different situations for participations as it did in the three safe harbors relating to securitizations discussed in this update.

Otherwise, the ANPR does not contemplate significant changes to the treatment of participations under the Safe Harbor.

³ The interim rule is available at, <http://www.fdic.gov/news/board/2009nov12no6.pdf>. Our prior summary of the interim rule is available at <http://www.mayerbrown.com/publications/article.asp?id=7966&nid=6>, but we also summarize it in this update.

⁴ Summarized at <http://www.mayerbrown.com/publications/article.asp?id=7063&nid=6>.

⁵ Because the FDIC has issued an ANPR, rather than going straight to a more definitive proposal, it seems almost certain that the FDIC will eventually extend the interim rule to a later deadline, providing time to deliberate the final amendments to the Safe Harbor. The ANPR specifically requests comment as to whether such an extension is needed. The American Securitization Forum intends to request an extension in the near future.

⁶ The Avoidance Safe Harbor does not require sale treatment, and its availability has not been placed in doubt by the accounting changes.

⁷ We use the term “bank” in this update to refer to all depository institutions with deposits insured by the FDIC.

⁸ The preamble to the interim rule provides additional support for our views, noting that the repudiation portion of the Safe Harbor “was a clarification, rather than a limitation, of the repudiation power because such power authorizes the conservator or receiver to breach a contract or lease entered into by an [insured depository institution] and be legally excused from further performance but it is not an avoiding power enabling the conservator or receiver to recover assets that were previously transferred by the [insured depository institution] in connection with the contract.” The ANPR repeats this point.

⁹ ANPR, p. 2.

¹⁰ The sample text defines “sponsor” as a person or entity that organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity, whether or not such person owns an interest in the issuing entity or owns any of the obligations issued by the issuing entity.

¹¹ IDI stands for insured depository institution.

¹² ANPR, p. 7 (footnote omitted).

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