Accounting Changes: Easing the Transition

On Nov. 12, 2009, the Board of the Federal Deposit Insurance Corp. (FDIC) approved an Interim Rule that provides some crucial transitional relief relating to recent changes in U.S. accounting standards for securitizations. One of the key impacts of the accounting changes is that banks (among other entities) will no longer be able to achieve sale accounting treatment in securitizations of credit card and other receivables using many traditional structures. Among other issues, this change creates uncertainty about the continuing availability of the FDIC's Securitization Rule relating to the treatment of securitizations in receivership or conservatorship.

The Securitization Rule was originally adopted in 2000 to clarify the scope of the FDIC's statutory authority as conservator or receiver to disaffirm or repudiate contracts of a bank with respect to transfers of financial assets in connection with a securitization. In order for a securitization to achieve sale accounting treatment, the transfer of financial assets must satisfy, among other conditions, the "legal isolation" condition under generally accepted accounting principles. To satisfy the legal isolation condition, the transferred financial asset must have been presumptively placed beyond the reach of the transferor, its creditors, a bankruptcy trustee, or in the case of a bank, the FDIC, as conservator or receiver.

However, due to the FDIC's broad powers to repudiate contracts and thus disrupt cash flows to investors in a securitization, it became extremely difficult to satisfy the legal isolation condition as it applied to banks for which the FDIC may be appointed as conservator or receiver. As a result, the securitization industry requested relief from the FDIC, and the FDIC adopted the Securitization Rule to provided a "safe harbor" to permit transfers of financial assets by banks in connection with a securitization to satisfy the legal isolation condition. Since its adoption, the Securitization Rule has been relied on by rating agencies and other securitization participants as assurance that investors could look to securitized financial assets for payment without concern that the financial assets would be treated as property of the failed bank or receivership by the FDIC, as conservator or receiver.

The Securitization Rule provides that for transactions that satisfies its requirements, the FDIC as conservator or receiver will not use its repudiation power to reclaim financial assets transferred by the bank to an issuing entity in connection with a securitization, 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 requirements that a securitization has to satisfy in order to obtain the benefit of the Securitization Rule are consistent with mainstream securitization practice. Generally, the transaction must be a "securitization," which is defined as an "issuance by a special purpose entity of beneficial interests," and the transfer of the securitized assets by the bank must meet all the conditions for sale accounting treatment under generally accepted accounting principles, other than the legal isolation condition as it applies to banks for which the FDIC may be appointed as conservator or receiver (which is addressed by the Securitization Rule). Furthermore, the bank must receive adequate consideration for the transfer at the time of the transfer, and the transfer documents must reflect the intent of the parties to treat the transaction as a sale, and not as a secured borrowing, for accounting purposes. The rule also does not prevent the FDIC from recovering assets if a fraudulent conveyance has occurred or from repudiating ongoing performance obligations in connection with a securitization.

With the recent implementation of new accounting rules, this uncertainty has resurfaced for securitization participants. On June 12, 2009, the Financial Accounting Standards Board finalized modifications to generally accepted accounting principles that affect whether a special purpose entity must be consolidated for financial reporting purposes, thereby subjecting many special purpose entities to generally accepted accounting principles consolidation requirements. Recall that the FDIC's agreement not to use its repudiation power is conditioned upon satisfaction by the subject securitization of the conditions for sale accounting (other than the legal isolation condition, because the Securitization Rule was meant to help satisfy that condition). Because these recent accounting changes make it difficult for securitizations to achieve sale accounting, this requirement threatens to make the repudiation portion of the Securitization Rule unavailable, at least for transfers completed after the accounting changes take effect (Jan. 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 Securitization Rule. 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, 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 Securitization Rule 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 Securitization Rule would also not be subject to the automatic stay. The impending loss of sale accounting treatment and possible unavailability of the repudiation portion of the Securitization Rule posed the additional threat that the automatic stay might apply to some securitized assets.

These threats have created significant issues for some credit card banks because any securitization of credit card receivables completed in 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 (and avoid both the repudiation power and the automatic stay) without the Securitization Rule through a common law true sale, and a number of our clients have continued to issue transactions rated on that basis. 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 addresses the possible loss of protection from the repudiation power by adding a new paragraph to the Securitization Rule that eliminates the requirement for transactions closed on or prior to March 31, 2010 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 March 31, 2010, 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 Securitization Rule through March 31, 2010. Each of the major credit rating agencies has issued statements indicating that they view the FDIC's actions as sufficiently addressing the legal isolation issues for transactions closed through that date. Even for transactions that are structured to achieve common law true sale, the Interim Rule provides welcome additional certainty.

On Dec. 15, the FDIC's board approved publication of an advanced notice of proposed rulemaking relating to further amendments to the Securitization Rule. These further amendments will address securitizations completed after March 31, 2010 and are likely to condition the availability of the Securitization Rule (for at least some asset classes) on compliance with some of the new standards for bank securitizations that are currently under debate. The purpose of the advanced notice is primarily to obtain public comment on what those conditions should be.

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