FDIC Adopts New Securitization Safe Harbors

On September 27, 2010, the Board of the Federal Deposit Insurance Corporation (FDIC) adopted new safe harbors1 (the New Rules) relating to the treatment of securitizations (and participations2) in receivership or conservatorship of an insured depository institution (bank). The New Rules replace a prior safe harbor (the Original Rule) that had been rendered largely obsolete by changes in US generally accepted accounting principles (GAAP).3 Initially, we believe that the FDIC has provided workable new safe harbors for banks that want to use them. We particularly applaud the FDIC for the provisions of the New Rules relating to existing master trusts.

The adoption of the New Rules is a watershed event for the residential mortgage-backed securities (RMBS) and other asset-backed securities (ABS) markets. Among the most significant features of the New Rules are:

- Grandfathering of established master trusts that satisfy old GAAP standards for sale treatment;
- Imposition of a 5 percent credit risk retention requirement for bank-sponsored4 ABS, which will automatically be superseded by the related interagency rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Retention Rules),5 once those interagency rules come into effect;
- Imposition of Regulation AB-style disclosure and reporting requirements on bank-sponsored ABS transactions closed after December 31, 2010, except for issuances by grandfathered master trusts; and
- Substantial additional requirements for bank-sponsored RMBS transactions closed after December 31, 2010, including limitations on capital structure (no more than six credit tranches and no pool-level external credit enhancement), mandatory terms as to servicer powers and incentives, incentive-oriented deferred compensation for rating agencies, a 5 percent reserve account for repurchases of ineligible receivables (in addition to the required 5 percent retention of credit risk) and third-party assessments on legal compliance of the underlying loans.

The Original Rule

For transactions that satisfied its requirements, the Original Rule provided that the FDIC would not:

- Use its repudiation power to reclaim financial assets transferred by the institution in connection with a securitization (the Original 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 Original Repudiation Safe Harbor was originally only available for securitizations that were treated as sales for accounting purposes. Because the recent accounting changes made it difficult for securitizations to achieve sale...
accounting, this condition threatened to make the Original Repudiation Safe Harbor unavailable at least for securitizations completed after the accounting changes took effect (January 1, 2010, for most banks). The Avoidance Safe Harbor never required sale treatment, and its availability was not placed in doubt by the accounting changes.

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 Original 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 of 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 Original 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 Original Rule would also not be subject to the automatic stay. The loss of sale accounting treatment and possible unavailability of the Original 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 issuers, effectively freezing issuance in the term markets by a number of the largest issuers.

**Interim Steps by the FDIC**

The FDIC has taken a number of timely and crucial steps to keep the Original Repudiation Safe Harbor available for bank securitizations:

- In November 2009, the FDIC adopted an interim rule (the Interim Rule) that relaxed the accounting sale requirement for securitizations completed through March 31, 2010.6
- In December 2009, the FDIC released an advanced notice of proposed rulemaking that provided an initial indication of what permanent safe harbor(s) the FDIC might provide going forward.7
- In March 2010, the FDIC extended the Interim Rule to cover securitizations completed through September 30, 2010.8
- In May 2010, the FDIC released a notice of proposed rulemaking that built on the December release and set out proposed language for the New Rules that closely corresponds to the final language.9
- In the New Rules, the FDIC extended the Interim Rule further to cover securitizations completed through December 31, 2010, as well as (i) securitizations completed at any time using revolving trusts or master trusts that had issued at least one series of ABS as of September 27, 2010 (the date of adoption of the New Rules), or (ii) any ABS issued after December 31, 2010 under open commitments existing as of September 27, 2010 up to the maximum amount of such commitments as of that date if some ABS was issued under such commitments on or before December 31, 2010 (expanding and codifying the Variable Funding Letter). We refer to the period from November 12, 2009 (when the Interim Rule was adopted) through December 31, 2010 as the Transition Period.

**The New Rules**

While the Interim Rule temporarily loosened the conditions for the Original Repudiation Safe Harbor without imposing any additional compensating conditions, the New Rules impose significant new conditions in order for securitizations that are not grandfathered to
benefit from the new safe harbors. The FDIC recognizes the importance of securitization as a source of liquidity for banks, but it also believes that securitization played a significant role in bringing about the recent credit and market crises. Consequently, while the FDIC has continued to facilitate bank securitizations by providing safe harbors from its repudiation, avoidance and automatic stay powers, it is also using the New Rules to reshape the securitization market. That is the goal of most of the additional conditions imposed by the New Rules.

The Original Rule always included conditions that transactions had to satisfy in order to qualify for its protections. However, apart from the sale accounting condition discussed above, the original conditions were focused on very basic good conduct points (e.g., absence of fraud, written agreements, proper corporate authorizations) that virtually any bona fide transaction could satisfy. We refer to these types of conditions, which are carried forward and elaborated somewhat in the New Rules, as good housekeeping conditions. The New Rules also impose conditions that regulate the substantive terms of transactions in a much more meaningful way, which we refer to as market regulating conditions. We discuss both types of conditions further below, after summarizing the terms of the final safe harbors.

The Safe Harbors

The New Rules create three different safe harbors relating to the repudiation power (in addition to the Avoidance Safe Harbor, which is largely unchanged). The New Rules also contemplate relief from the automatic stay in the form of advance consent to continued payments and contractual servicing activities during the automatic stay period (the Payments and Servicing Consent) in the event of a receivership or conservatorship of the sponsor. The Payments and Servicing Consent would apply to any “securitization” (as defined in the New Rules) that complied with the market regulating conditions and good housekeeping conditions, regardless of which (if any) of the repudiation safe harbors apply to the transaction.

Safe Harbor for Transition Period and Other Grandfathered Securitizations. Securitizations that satisfy the conditions of the Interim Rule and are completed prior to or during the Transition Period would generally continue to receive the same benefits as under the Interim Rule and would not have to comply with the market regulating conditions or any new good housekeeping conditions. The same is true of (i) securitizations completed at any time using revolving trusts or master trusts that had issued at least one series of ABS as of September 27, 2010 (the date of adoption of the New Rules), and (ii) any ABS issued after December 31, 2010 under open commitments existing as of September 27, 2010 up to the maximum amount of such commitments as of September 27, 2010 if some ABS was issued under such commitments on or before December 31, 2010. Securitizations falling within this safe harbor could also benefit from the Payments and Servicing Consent, if they happen to satisfy all of the applicable conditions in the New Rules.

Safe Harbor for On-Balance Sheet Securitizations (Other Than Grandfathered). This safe harbor is subject to the new conditions discussed below, including the market regulating conditions. Transactions that met those new conditions would benefit from a substantively new safe harbor that does not parallel the Original Repudiation Safe Harbor, but instead provides special relief relating to the automatic stay and a special rule for calculating damages in case of repudiation. Because these transactions are accounted for as secured loans to the sponsor and may not involve legal true sales, the FDIC applies a traditional secured loan analysis to them, similar to the FDIC’s treatment of covered bonds.10

Although the FDIC cannot ordinarily repudiate a valid security interest, it can repudiate the secured obligations of a failed bank. Upon such repudiation, the secured parties are entitled to the benefits of their collateral, but only to cover their
actual, compensatory damages arising from the repudiation. In response to the December and May releases, rating agencies and other market participants had expressed concerns that the permitted damages could be based on the market value of the related ABS at the time of repudiation – which might mean that the investors would not recover the full outstanding principal amount of the ABS – and might not include interest accrued through the date of repudiation. The FDIC addressed these concerns by saying that the damages for transactions within this safe harbor would equal the par value of the ABS at the time of receivership, less any principal payments made in the interim, plus unpaid, accrued interest through the date of repudiation to the extent covered by collections on the securitized assets.

Transactions covered by this safe harbor would also benefit from the Payments and Servicing Consent, so interest and principal payments due during the conservatorship or receivership (and prior to any repudiation) should continue to be made so long as collections on the underlying assets are sufficient to cover those payments. In response to comments on the May release, the FDIC has affirmatively undertaken to apply collections to make those payments as long as it is acting as servicer. Finally, transactions within this safe harbor would benefit from special consent procedures relating to the automatic stay, enabling secured parties to exercise remedies on an expedited basis upon (i) a monetary default (as defined in the New Rules) resulting from the FDIC’s failure to apply collections or (ii) failure by the FDIC to pay damages (as described above) within 10 days after any repudiation of the securitization documents.

**Safe Harbor for Off-Balance Sheet Securitizations (Other Than Grandfathered).** Transactions in this category that meet the new conditions would benefit from substantially the same protection from the repudiation power as is provided by the Original Repudiation Safe Harbor and would also benefit from the Payments and Servicing Consent. This safe harbor does not include expedited consent for exercise of remedies because the FDIC views the automatic stay as generally not applying to assets that are not reflected on the sponsor’s balance sheet.

**Summary.** The following table summarizes how each of the proposed safe harbors deals with the FDIC’s repudiation, automatic stay and avoidance powers, as well as the applicability of the proposed market regulating conditions.

<table>
<thead>
<tr>
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<th>POST-TRANSITION PERIOD AND NOT GRANDFATHERED TRANSACTIONS</th>
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<tr>
<td><strong>Market Regulating Conditions</strong></td>
<td>Required</td>
<td>Required</td>
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<td><strong>Repudiation Power</strong></td>
<td>Damages covering par balance and accrued interest through the date of repudiation</td>
<td>Safe harbor within rule</td>
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<tr>
<td><strong>Automatic Stay</strong></td>
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<tr>
<td>• Payments and Servicing Consent</td>
<td>Applies</td>
<td>Applies</td>
</tr>
<tr>
<td>• Expedited consent for remedies</td>
<td>Available upon monetary default or repudition</td>
<td>Should not be necessary, as stay should not apply</td>
</tr>
<tr>
<td><strong>Avoidance Power</strong></td>
<td>Safe harbor within rule</td>
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The Conditions

Paragraphs (b) and (c) of the New Rules set out conditions that a securitization would have to satisfy in order to qualify for either of the safe harbors available for post-Transition Period transactions that are not otherwise grandfathered, as well as the Payments and Servicing Consent. Paragraph (b) sets out the market regulating conditions, including some that apply to all ABS and some that would apply only to RMBS. We have summarized the market regulating conditions in the following table. In response to comments on the December and May releases, many of the conditions summarized in the table are phrased in terms of what securitization agreements must require, rather than direct, substantive requirements. For the sake of brevity, we have not drawn that distinction in the table.

<table>
<thead>
<tr>
<th>CONDITIONS APPLICABLE TO ALL ABS</th>
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<tr>
<td><strong>CAPITAL STRUCTURE AND FINANCIAL ASSETS CONDITIONS</strong></td>
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<tr>
<td>• Resecuritizations and CDOs only qualify if investors have access to disclosure on the underlying assets consistent with the new disclosure requirements below.</td>
<td>• Capital structures limited to no more than six credit tranches (though the most senior may be further divided into time tranches, and resecuritizations can be completed to further tranche). (^\text{14})</td>
</tr>
<tr>
<td>• Payments of principal and interest must depend primarily on securitized assets and must not be contingent on extraneous market or credit events, except interest rate and currency mismatches.</td>
<td>• No pool-level credit enhancement (such as surety bonds), though guaranties by government-sponsored entities and Ginnie Mae are permitted, as are temporary liquidity facilities (such as servicer advances) within limits.</td>
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<td>• Synthetic and “unfunded” securitizations are not eligible (but this does not seem to preclude variable funding or prefunded securities). (^\text{13})</td>
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**DISCLOSURE**

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<td>• Regulation AB disclosure required in all transactions (both prior to sale and periodically thereafter), whether or not registered. This goes beyond the SEC’s recent proposal in that it covers even private placements that do not rely on the SEC’s Original Rule 144A (or 144) or Regulation D. As revised Regulation AB is likely to require loan level disclosure for all asset classes other than credit and charge cards and stranded costs, this requirement effectively requires loan level disclosure for many asset classes other than RMBS.</td>
<td>• Prior to issuance: make loan-level disclosure (including loan type, loan structure, maturity, interest rate and property location); affirm compliance with all applicable legal origination standards for the underlying mortgage loans; disclose a third-party due diligence report on compliance with such standards and the related representations and warranties.</td>
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<td>• The New Rules also set out detailed disclosure requirements of their own, which largely seem to overlap with existing Regulation AB requirements. Market participants will, however, have to compare the separate requirements carefully with Regulation AB to check for incremental disclosure requirements.</td>
<td>• Prior to issuance and periodically thereafter, servicers to disclose any ownership in whole loans secured by the same real property as any loan in the securitized pool.</td>
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<td><strong>DOCUMENTATION AND RECORDKEEPING</strong></td>
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<td>• Must “use as appropriate any available standardized documentation for each different asset class.”</td>
<td>• Servicers must be authorized to mitigate losses consistent with maximizing the net present value of the underlying mortgage loans, modify the loans to address reasonably foreseeable default and generally to maximize value and minimize losses on the loans.</td>
</tr>
<tr>
<td>• Must set out the rights and responsibilities of all parties and provide sufficient authority for the parties to fulfill their respective duties and exercise their rights.</td>
<td>• Servicers must act for the benefit of all investors, not any particular class, and must commence action to mitigate losses no later than 90 days delinquent.</td>
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<tr>
<td>• Servicers must be authorized to mitigate losses consistent with maximizing the net present value of the underlying mortgage loans, modify the loans to address reasonably foreseeable default and generally to maximize value and minimize losses on the loans.</td>
<td>• Servicers must not be required to advance delinquent principal and interest for more than three payment periods, unless financing or reimbursement facilities are available (which must not depend for repayment upon foreclosure proceeds).</td>
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<th><strong>COMPENSATION</strong></th>
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<tr>
<td>• NA</td>
<td>• Compensation to rating agencies and similar third-party evaluation companies to be payable in part (at least 40 percent) over five years after issuance of the related ABS, based on performance of surveillance services and performance of the underlying loans.</td>
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<td>• Compensation for servicers must provide incentives for servicing which maximizes the net present value of the underlying loans (which may include payments for specific services and actual expenses).</td>
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<th><strong>ORIGINATION AND RETENTION FIVE REQUIREMENTS</strong></th>
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<td>• Sponsors must retain at least a 5 percent economic interest in the transaction, either through a “vertical slice” of all tranches or retention of a 5 percent representative sample of the securitized assets. This goes beyond the SEC proposal, which applied only to ABS issued under shelf registration statements.</td>
<td>Reserve fund of 5 percent required to cover repurchases of ineligible assets; may be released after one year. Underlying loans must have been originated in compliance with all applicable legal origination standards, including underwriting at the fully indexed rate, based upon the borrowers' ability to repay the loan; must rely on documented income and comply with existing supervisory guidance.</td>
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<tr>
<td>• Required retentions cannot be hedged (although interest rate and currency hedging are permitted, as under the SEC’s proposals).</td>
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<tr>
<td>• These requirements will automatically be superseded by the Dodd-Frank Retention Rules once they come into effect.</td>
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Paragraph (c) sets out an expanded set of good housekeeping conditions (e.g., arms length, bona fide transactions; written agreements with proper corporate approval), which include some that may be burdensome:

- Paragraph (c)(1) adds a requirement that the obligations issued in the transaction must not be sold predominantly to affiliates or insiders.
- 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 standard documents of many repeat issuers going forward.
- Paragraph (c)(7) (relating to segregation of securitized assets and related records from the general assets and records of the bank) appears to require segregation of collections within two business days if the sponsor bank is acting as servicer, custodian or paying agent, regardless of the bank’s credit rating.

**Key Differences Between the New Rules and the May Proposal**

The New Rules track closely the proposed rules included in the May release. The main differences from the May language are:

- Grandfathering of master trusts;
- The provision stating that the Dodd-Frank Retention Rules will automatically supersede the initial retention requirements in the New Rules;
- Changes that make many of the market regulating conditions more objective and verifiable, often by requiring that particular provisions appear in securitization agreements rather than requiring that those provisions actually be complied with;\(^\text{15}\)
- Adding interest through the date of repudiation to the defined damages in case of repudiation of an on-balance sheet securitization;
- A provision scoping government-sponsored entities out of the New Rules;
- Changing the proposed prohibition on sales of ABS to affiliates to a requirement that the ABS not be sold predominantly to affiliates or insiders; and
- A new prohibition on pledging interests that are retained to satisfy the minimum credit risk retention requirement.

**Non-Safe Harbor Transactions**

The safe harbors provided by the Original Rule have never been the exclusive means for a bank-sponsored securitization to achieve legal isolation, and the New Rules confirm this is still the case.\(^\text{16}\) Traditionally, the legal isolation analysis for banks has focused on the repudiation power, and the adopting releases for the initial Original Rule\(^\text{17}\) and the Interim Rule\(^\text{18}\) both confirmed that legal true sales completed prior to the appointment of the FDIC as conservator or receiver cannot be repudiated. Although the New Rules Release declines to reaffirm this point, we believe the prior releases stated the law correctly.

Notwithstanding our view of the law, we have recently found rating agencies and other market participants to be reluctant to rely on a legal analysis that the FDIC might be inclined to challenge. As a result, we anticipate that most bank-sponsored securitizations going forward will rely on the New Rules (including the grandfather provisions) if at all possible. Difficult issues may arise for transactions that fall outside the scope of the New Rules, for instance because a significant portion of the securitized assets are not financial assets. The analysis should be somewhat easier to the extent that sponsor banks can achieve sale treatment in transactions not covered by the New Rules, since even the FDIC’s more narrow statements acknowledge that the repudiation power “is not an avoiding power enabling the conservator or receiver to recover assets that were previously sold and are no longer reflected on the book and records of an [insured depository institution].”\(^\text{19}\)
Endnotes


2 We will not discuss the participation portion of the New Rules in this update, though we note that the FDIC revised that portion to provide safe harbor protection for qualifying last-in, first-out participations.


4 The New Rules define “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 In addition, the FDIC stated in a press release relating to the Interim Rule that the automatic stay would not apply to assets transferred in a transaction that qualified under that rule.

12 See footnote 11 above.


15 Compliance will still be necessary to avoid breaching these contractual obligations, but importantly those breaches should not deny investors the protections of the safe harbors.

16 New Rules Release, p. 60289. A similar analysis with respect to the avoidance power generally has not been necessary, as the Avoidance Safe Harbor has never been subject to substantive conditions.


18 Federal Register, Vol. 74, p. 59066 at 59067 (November 17, 2009).

19 New Rules Release, p. 560287. We believe a legal true sale is also effective to avoid the property element of the stay, since assets sold in a true sale would not be property of the bank.

If you have any questions with regard to the New Rules, or any other topic addressed above, please contact one of the lawyers listed below, or any of the partners in the Securitization or Financial Services Regulatory & Enforcement practices.


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