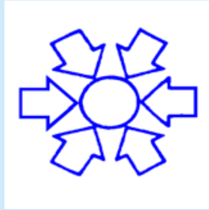

Financial Services Management

Insured-Depository Asset Securitization Safe Harbor

CFO	Asset/Liability Management Action Item

Cite

FDIC

Final Rule

Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010

Recommended Distribution

CFO, Asset/Liability Management, Treasury, Capital Markets, Retail Banking, Corporate Planning, Mortgage Finance, Corporate Secretary, Legal, Government Relations

Website

http://www.fdic.gov/news/board/10Sept27no4.pdf

Overview

Despite strong objections from the banking industry and others seeking securitizations by them, the FDIC has finalized tough new rules limiting the "safe harbor" for assets backing issuances by insured depositories (IDs). Although IDs may still issue asset-backed securities (ABS) that do not comply with the FDIC's safe-harbor standards, markets are likely to be reluctant to accept them or, at the least, price them considerably higher to reflect the greater risk for ABS investors without a safe harbor. Residential mortgages sold through government channels are not covered, meaning that non-private residential mortgage-backed securities (RMBS) should continue uninterrupted. Other ABS will, however, be dramatically affected in the near term, possibly sharply curtailing ABS comprised of commercial mortgages, auto loans, credit-card receivables and similar obligations.

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Once ABS rules mandated by the Dodd-Frank Act are promulgated,[1] some of the FDIC's standards will "auto-conform" to them, ending legal uncertainty and, perhaps, liberalizing the risk-retention rules in ways that restart private-label securitization. However, even then, significant new disclosures, operational duties, and corporate-governance requirements applicable only to IDs will apply to ABS from IDs, requiring an overhaul of procedures and contracts at all affected institutions. RMBS from insured depositories will also be subject to new compensation requirements that could conflict with current contracts and tough reserve requirements that will not be eliminated after the FDIC conforms its risk-retention rules to the exemption mandated by the new law for "qualified residential mortgages."

Impact

The FDIC rule follows two proposals earlier this year[2] to limit a "safe harbor" from FDIC claim related to assets in ABS. The issue is critical to cost-effective ID securitization because, without a safe harbor, ABS investors cannot clearly claim collateral that the FDIC might seize if a bank fails and is placed in receivership or conservatorship. Importantly, the FDIC's rule applies only to ABS for which an insured depository seeks a "safe harbor" from potential claim. Should markets discount this – deemed unlikely by the FDIC and many in the industry – then securitization from insured depositories could continue without compliance with all of the terms and conditions discussed below either in general or for any asset class not adversely affected by lack of the safe harbor.

Although the FDIC's current rule is limited to insured depositories, it has broader application to large issuers because, following passage of the Dodd-Frank Act, a new "orderly" liquidation process is mandated.[3] Were the FDIC's final rule applied to all systemic firms after failure – likely given the FDIC's role setting this standard – many ABS would be subject to post-failure asset seizure. This undermines the "true-sale" premise of asset securitization, but reflects recent decisions by U.S. accounting-standards regulators and, following that, bank regulators,[4] that ABS pose significant risk to issuers despite nominal off-balance sheet treatment and to the financial system more generally due to misaligned incentives.

As noted, the FDIC has largely stood by its proposed, tough treatment of ID- issued ABS. The agency notes that the safe harbor is consistent with its conservative approach to covered bonds.[5] It also reflects the view of Chairman Bair and others that the "originate-to-distribute" securitization model

[1] See Client Report **ABS17**, *Financial Services Management*, August 6, 2010.

[2] See Client Report **ABS13**, May 11, 2010, and Client Report ABS14, *Financial Services Management*, May 19, 2010.

[3] See Client Report **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

[4] See Client Report **CAPITAL154**, *Financial Services Management*, September 8, 2009.

[5] See Client Report **COVEREDBOND2**, *Financial Services Management*, July 22, 2008.

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must be reformed to prevent a repeat of the financial-market crisis. However, critics of the proposal argue that it would impose such strict securitization requirements on IDs that securitization would cease other than through exempt channels (e.g., government entities) or "shadow" (non-ID) originators. This could put IDs at a significant competitive disadvantage, as well as fail to cure the "originate-to-distribute" problem.

To prevent exempt channels, the Dodd-Frank Act imposes strict ABS restrictions for all securitizers that build not only on the initial FDIC proposal, but also on a Securities and Exchange Commission proposal to revise both risk-retention and issuer-disclosure requirements.[6] However, the law gives the inter-agency groups of regulators charged with its implementation considerable flexibility to provide modification or even exemptions from its tough rules, also stipulating that "qualified residential mortgages" – those found to have low risk of default – be exempted from risk retention. As noted, the FDIC plans to conform its final rules to those mandated by the Dodd-Frank Act related to risk retention once these are finalized, but the rest of the FDIC rule could stay as is. Indeed, even the risk-retention requirements could still differ, as mandatory five-percent "reserve" requirements associated with RMBS do not appear set for conformity to the Dodd-Frank Act, thus posing a significant challenge for IDs in this sector.

Further, it is unclear if the FDIC disclosure requirements will conform to final SEC disclosures mandated in the Dodd-Frank Act. While the FDIC's proposals are modelled after the SEC, they are very extensive and in some cases different. The final rule states that SEC requirements are a minimum threshold. As a result, IDs may well need not only to provide extensive disclosures and develop costly systems now, but still will be subject to broader disclosures after the SEC's rules are finalized. It remains to be seen if this added burden enhances investor demand for ID-issued ABS.

Although the Dodd-Frank rules could be tough and the FDIC standards then not significantly different, "shadow" securitization concerns will remain. Non-ID securitizers are exempt from the capital charges associated with securitization under the Basel III rules,[7] resulting in ongoing competitive advantage. Further, international accounting and ABS rules so far will not parallel either the FDIC standards or the Dodd-Frank ones.

As noted, the FDIC also imposes extensive new procedural, contractual and corporate-governance obligations for ABS eligible for the safe harbor. The most significant of these requires board approval of each securitization agreement related to an ABS seeking the safe harbor. This could create significant burden, especially at large banks with active securitization functions, possibly undermining the FDIC's goal related to board scrutiny.

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[6] See Client Report **ABS16**, July 1, 2010.

[7] See Client Report **CAPITAL169**, September 13, 2010.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

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Considerable operational work will also be required at all issuing IDs, with a new ban on commingling funds likely to require considerable system restructuring at issuers, servicers, custodians and paying agents.

What's Next

The FDIC approved this rule at its meeting on September 27 by a vote of 4-1 (Acting Comptroller Walsh dissenting).[8] It was declared effective the same day, although securitizations from IDs are unaffected until December 31, 2010. However, master or revolving trusts as well as any open commitments established after the rule's effective date must comply with the rule to enjoy a safe harbor.

The Dodd-Frank rules noted above are to be issued 270 days after enactment, although FDIC Chairman Bair has indicated this date might be missed due to all of the other rules requiring action under the new law. The Dodd-Frank rules affect RMBS one year after issuance and all other ABS two years after issuance.

Analysis

I. General Framework

A. Covered ABS

1. General Criteria

Eligible ABS must be arms-length, bona fide securitization transactions undertaken in the "ordinary course" of business without regard to potential insolvency. This could endanger ABS that would otherwise qualify for the safe harbor if an ID securitizes assets in hope of restoring capital adequacy to prevent failure.

Documents related to eligible ABS must limit sales to affiliates (other than wholly-owned subsidiaries which are consolidated for accounting and capital purposes) and to insiders. The Rule applies only to transfers made for adequate consideration and those properly perfected under the UCC or applicable state law. The FDIC anticipates that it will be difficult to determine whether a transfer complying with the Rule is a sale or a security interest, and therefore expects that a security interest will be properly perfected under the UCC either directly or as a back-up.

The rule also includes additional requirements such as new databases that show which assets went into ABS. As noted, ABS funds may generally

[8] See Client Report **ABS18**, September 27, 2010.

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not be commingled. Additional legal documents to clarify duties and provide other information of concern to the FDIC are also mandated.

2. Eligible ABS

In general, all ABS for which performance is based on that of underlying assets (not market or similar risks) that meet the criteria described above are eligible for the safe harbor. However, the rule excludes those issued by “specified GSEs.” These are defined to include Fannie Mae, Freddie Mac, Ginnie Mae and federal- or state-sponsored mortgage finance agencies. Although confusingly drafted, this exclusion appears intended to ensure that all “GSE-specified RMBS transactions proceed without any of the interruptions or restrictions associated with the rules detailed below, not that the GSE-specified purchasers of ID-originated mortgages are at greater risk. Investors in government/GSE RMBS would not be at greater risk regardless of FDIC action due to the guarantee provided by these issuers.

Unfunded and synthetic securitizations are excluded from the safe harbor, but existing credit lines that are not fully drawn in a securitization are not barred. Resecuritizations and collateralized debt obligations are also excluded unless documentation provides all asset-level information that would be required to qualify an ABS for the safe harbor.

3. Participations

Participations treated as true sales are eligible for the safe harbor. Last-in first-out participations are specifically included, provided that they satisfy requirements for sale accounting treatment other than the pari-passu, proportionate interest requirement.

B. Board Review

Securitization agreements must be in writing, approved by the board of directors or its loan committee (as reflected in the minutes of a meeting), and be in continuous effect in the ID’s official records from date of execution.

C. FDIC Claim

The final rule is revised to provide greater certainty as to when the FDIC will intervene, making clear that interest on ABS will be paid until a repudiation determination. The rule also clarifies the treatment of assets like mortgages that are true sales except for the potential “control” an ID affiliate (e.g., a mortgage servicer) may have. Legally-perfected and enforceable sales may not be voided by the FDIC except if these are undertaken in anticipation of a failure to avoid otherwise-applicable FDIC or ID/creditor obligations.

The final rule also clarifies that, prior to repudiation or, in the case of a monetary default, to the date on which the FDIC’s consent to the exercise of

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remedies becomes effective, required payments of principal and interest and other amounts due on the securitized obligations will continue to be made. If the FDIC decides to repudiate the securitization, it will pay damages equal to the par value of the outstanding obligations, less prior payments of principal received, plus unpaid, accrued interest through the date of repudiation. The payment of damages will discharge the lien on the securitization assets.

The rule also provides that, in the event the FDIC is in monetary default under the securitization documents due to its failure to pay or apply collections from the financial assets received by it in accordance with the securitization documents and the default continues for a period of ten business days after written notice to the FDIC, the FDIC will be deemed to consent to the exercise of contractual rights on account of such monetary default, and this consent satisfies obligations of the ID and FDIC.

D. Dodd-Frank Act

The final rule states that the FDIC will conform its regulations to those promulgated under Section 941(b) of the Dodd-Frank Act. Thus the final rules related to risk retention will define securitizations eligible for the FDIC safe harbor upon their effective date. However, as noted, other provisions of the Dodd-Frank Act may not affect the FDIC's final rule and, thus, ID securitizations eligible for the safe harbor.

II. All ABS

A. Disclosures

All ABS must "at a minimum" meet SEC Rule- AB requirements, even if they are private placements or otherwise exempt. These standards relate both to current Rule AB and successors to it (such as the SEC proposal noted above). As noted the final rule details a wide array of data for ABS (with still more required of RMBS) not yet covered by SEC regulation.

B. Record-Keeping

Operative agreements must use available standardized documentation for each asset class. The FDIC states that it is not possible to define in advance when standardized documentation will be appropriate, but stipulates that this is true when there is general market use of documentation for a particular asset class or where a trade group has formulated standardized, generally accepted documentation. The rule also requires that the securitization documents define contractual rights and responsibilities, including but not limited to representations and warranties, ongoing disclosure requirements and any measures to avoid conflicts of interest.

C. Risk Retention

For all securitizations, the sponsor must retain an economic interest in a material portion of not less than five percent of the credit risk of the financial

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assets. The retained interest may be either in the form of an interest of not less than five percent in each credit tranche or in a representative sample of the securitized financial assets equal to not less than five percent of the principal amount of the financial assets at transfer. This retained interest cannot be sold, pledged or hedged during the life of the transaction, except for interest-rate or currency risk.

III. RMBS

In addition to the restrictions described above, additional ones apply for RMBS eligible for the safe harbor.

A. Structure

1. Tranching

RMBS may have no more than six tranches, although the most senior tranche may include time-based sequential pay or planned-amortization and companion sub- tranches. Issuer may create the economic equivalent of multiple tranches by resecuritizing one or more tranches, so long as they meet the conditions set forth in the rule, including adequate disclosure in connection with the re-securitization. In addition, RMBS cannot include leveraged tranches that introduce market risks (such as leveraged super senior tranches).

2. Credit Enhancement

Assets transferred into an RMBS may benefit from asset level credit support, such as guarantees, co-signers, or insurance. However, the RMBS cannot benefit from external credit support at the issuing entity or pool level (although pool coverage from specified GSEs is allowed). Guarantees permitted at the asset level include guarantees of payment or collection, but not credit default swaps or similar items. The temporary payment of principal and interest, however, can be supported by liquidity facilities.

B. Disclosures

In addition to the SEC Rule AB disclosures noted above, the FDIC requires additional disclosures which may or may not be mandated by the SEC. The rule also requires the disclosure by servicers of any ownership interest of the servicer or any affiliate in other whole loans secured by the same real property that secures a loan included in the financial asset pool. This provision does not require disclosure of interests held by servicers or their affiliates in the securitization securities.

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C. Loan Modification

Additional conditions require that servicers have the authority to mitigate losses on mortgage loans consistent with maximizing net present value. Therefore, for RMBS, contractual provisions in the servicing agreement must provide servicers with the authority to modify loans to address reasonably-foreseeable defaults and to take other action to maximize the value and minimize losses on the securitized financial assets. The documents must require servicers to apply industry best practices related to asset management and servicing.

The RMBS documents may not give control of servicing discretion to a particular class of investors. Loan modifications must begin within ninety days after initial delinquency unless all delinquencies are cured. Servicers must also maintain records to permit review of their actions.

D. Advances

The servicing agreement for RMBS must not require the primary servicer to advance delinquent payments of principal and interest by borrowers for more than three payment periods unless financing or reimbursement facilities to fund or reimburse the primary servicers are available. However, such facilities may not be dependent for repayment on foreclosure proceeds.

E. Compensation

1. Rating Agencies

Securitization documents are required to provide that any fees payable to credit rating agencies or similar third-party evaluation companies must be payable in part over the five-year period after initial issuance based on the performance of surveillance services and the performance of the financial assets, with no more than sixty percent of the total estimated compensation due at closing. Thus payments to rating agencies must be based on the actual performance of the financial assets, not the ratings.

2. Servicers

Compensation to servicers must include incentives for servicing, including payment for loan restructuring or other loss mitigation activities, which maximizes the net present value of the financial assets in the RMBS.

F. Reserve Requirement

In addition to the general risk-retention requirements noted above, RMBS securitization documents must require that a reserve fund be established equal to at least five percent of the cash proceeds due to the sponsor. This reserve must be held for twelve months to cover any repurchases required for breaches of representations and warranties. The requirement apparently applies to all IDs issuing RMBS regardless of their actual risk under these representations or warrantees or, indeed, if any exist in the securitization

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documents other than those mandated by the FDIC (which may pose legal, but not necessarily financial risk to the issuer). It would also appear that this section will continue to apply regardless of changes the FDIC makes to the risk-retention rules for all ABS following the Dodd-Frank regulations.

G. Compliance

Securitization documents must include a representation that residential mortgages in an RMBS have been originated in compliance with statutory, regulatory and originator underwriting standards in effect at the time of origination and were underwritten at the fully indexed rate and rely on documented income. The loans must also comply with all existing supervisory guidance, including non-traditional mortgage rules[9] and the Interagency Statement on Subprime Mortgage Lending.[10] Any supervisory standards in effect at origination must also be met and sponsors must disclose third-party due diligence reports on their compliance with all relevant regulation as well as compliance with representations and warrantees.

[9] See Client Report **MORTGAGE14**, *Financial Services Management*, October 10, 2006.
[10] See Client Report **MORTGAGE35**, *Financial Services Management*, August 29, 2007.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

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