Authors:

Sean P. Mahoney
sean.mahoney@klgates.com
617.261.3202

Anthony R. G. Nolan
anthony.nolan@klgates.com
212.536.4843

K&L Gates is a global law firm with lawyers in 33 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit www.klgates.com.

FDIC Proposes Far-Reaching Changes to the Legal Isolation Safe Harbor: *New Requirements May Affect Securitization Sponsors, Servicers and Investors*

Introduction

A possible rule change being considered by the Federal Deposit Insurance Corporation ("FDIC") may make it difficult for banks and other securitization market participants to manage risks associated with FDIC conservatorship or receivership of sponsoring banks. This troubling development warrants attention not only from banks, but also from other participants in bank securitization transactions including servicers, rating agencies, law firms and auditors.

The Advance Notice of Proposed Rulemaking

The FDIC is soliciting public comment regarding proposed amendments to the legal isolation safe harbor for off-balance sheet securitizations and participations that is codified at 12 C.F.R. §360.6 (the "Securitization Rule"). The Board of Directors of the FDIC approved an Advance Notice of Proposed Rulemaking (the "ANPR") seeking such comments on December 17, 2009. Among other things, the ANPR requests comment on extending the range of the safe harbor for transactions consummated after March 31, 2010 and subjecting those transactions to several significant constraints.

While occasioned by a narrow accounting issue discussed below, the amendments for which the ANPR requests comment potentially would require that insured depository institutions comply with extensive disclosure and operational requirements for securitizations in order for the securitized assets to be considered to have been legally isolated from the credit risk of the sponsoring bank. Furthermore, the proposed waiver of FDIC rights with respect to securitizations that are treated as secured borrowings is limited and may expose investors to unacceptable market risk following the insolvency of a seller-sponsor depository institution. Thus, the concepts for which the ANPR seeks comment have significant potential consequences not only for depository institutions that seek to finance financial assets through securitization but also for investors in the securities issued in such securitizations.

The comment period for the ANPR is due to expire on February 22, 2010, which is forty-five days following the date of publication of the ANPR in the *Federal Register*, January 7, 2010.

Background

A central objective of securitization is to de-link the risks inherent in the securitized assets from the operating and credit risk of the transferor of those assets. In the case of depository institutions, this legal isolation analysis was grounded in a provision

of the Federal Deposit Insurance Act (the "FDI Act") requiring the FDIC to respect otherwise enforceable security interests and in several policy statements and general counsel opinions of the FDIC clarifying the FDIC's interpretation of the statutory mandate in the case of securitizations.

Basing legal isolation on a "hard" security interest created conceptual concerns for the United States financial accounting profession because one of the elements to be satisfied for a securitization transaction to be accounted for as a sale under Financial Accounting Standard 140 ("FAS 140") is that the transferred financial assets have been presumptively put beyond the reach of the powers of a receiver for the transferor or any consolidated affiliate of the transferor. The FDIC promulgated the Securitization Rule in 2000 in order to address these concerns by providing a safe harbor from certain aspects of the insolvency of the sponsoring institution by confirming that in the event of a bank failure, the FDIC would not try to reclaim loans transferred into a securitization so long as an accounting sale had occurred.

Recent changes in the accounting rules for securitizations have prompted a reconsideration of the role and purpose of the legal isolation safe harbor.[1] These amendments will require that many securitization transactions originally accounted for as sales come back on balance sheet, and will mandate that many such securitizations in the future be accounted as secured borrowings. In addition to raising questions about the treatment of existing transactions that are required to be brought on selling institutions' balance sheets, this development has also raised questions about whether, and under what circumstances, on-balance sheet securitizations should be covered by the legal isolation safe harbor, considering that many such transactions require legal isolation certainty in order to obtain external ratings or to satisfy investors' due diligence concerns.[2] Market participants and representative organizations requested that the FDIC revise the Securitization Rule to address these changes.

The ANPR seeks comment on a draft revised Securitization Rule (the "Proposed Draft Rule") that would make the interim grandfathering of securitizations closed before March 31, 2010 permanent, include within the safe harbor on-balance sheet securitizations that were not historically covered by the Securitization Rule, and provide limited relief from the "automatic stay" applicable to creditors of insolvent insured depository institutions for which the FDIC has been appointed as receiver and conservator.[3]

The ANPR also contemplates covering both on-balance sheet transactions as well as off-balance sheet transactions. When the FDIC promulgated the Securitization Rule, it indicated that a safe harbor was not required with respect to transfers of assets in on-balance sheet transactions if the transfer qualified as a common law sale. However, the ANPR acknowledges the issue created by 2005 legislation with respect to secured borrowings. That legislation provided the FDIC as conservator or receiver of an insolvent insured depository institution with a consent right to foreclosure by secured parties, which is essentially equivalent to an "automatic stay" in a bankruptcy case. For on-balance sheet securitizations, this created an issue as to whether the FDIC would treat a transfer of assets to a special purpose vehicle as a mere security interest, if such treatment was required by accounting rules. In that case, the special purpose vehicle (or its trustee) would be stayed for forty-five or ninety days from the appointment of the FDIC as conservator or receiver, as the case may be, before it could foreclose on the collateral. With the relative decline in importance of off-balance sheet

---

[1] The principal such change affecting securitizations is the amendment of Financial Accounting Statement 140 to eliminate qualified special purpose entities. These amendments are effectuated by Financial Accounting Statements 166 and 167, which took effect for most depository institutions on January 1, 2010.

[2] Although the FDIC interpretations of the statutory provision relating to security interests are still considered to be valid, many intervening changes, including the adoption in 2005 of an automatic stay in receiverships and conservatorships of insured depository institutions, have complicated the legal isolation analysis under those interpretations.

[3] In November 2009, the FDIC issued an Interim Final Rule amending the Securitization Rule to provide for safe harbor treatment for participations and securitizations until March 31, 2010, notwithstanding that such transactions may not qualify for sale treatment under FAS 140. The Proposed Draft Rule appended to the ANPR contemplates making this grandfather protection permanent.

securitizations as a result of the amendment to FAS 140, the provisions relating to the automatic stay will be of particular importance.

ANPR Substantive Regulatory Topics

Unlike the Securitization Rule, which was principally a mechanical rule designed to address accounting issues that arise in securitizations, the Proposed Draft Rule contemplates comprehensive substantive rules. The categories of substantive regulation can be divided into the following categories: (i) risk retention, (ii) disclosure requirements, (iii) documentation requirements, (iv) structural limitations, (v) rules applicable to residential mortgage backed securities and (vi) compensation restrictions.

Risk Retention

The Proposed Draft Rule would require a bank sponsoring a securitization to retain not less than five percent of the credit risk of the assets transferred to the securitization vehicle. The retained risk would be required to be either in the form of an interest in each of the tranches of the securitization or in a representative sample of the transferred assets equal to at least five percent of the principal amount of the assets at transfer. Any transfer of the retained interest or hedging of the associated risks would be prohibited.

Disclosure Requirements

The Proposed Draft Rule would require the sponsoring bank, special purpose vehicle, or servicer to make comprehensive *loan-level* disclosures to investors. The disclosures required by Regulation AB promulgated by the Securities and Exchange Commission (SEC) with respect to publicly offered securitizations would serve as a floor for securitizations intended to qualify for the safe harbor proposed by the Proposed Draft Rule. The disclosure requirement would not vary based upon whether the securitization is offered to the public or to institutional investors in a private placement. Disclosures would also be required with respect to compensation, the structure of the securitization, representations and warranties provided by the originator of the financial assets, and other related matters. Compensation disclosures would be subject to a duty to update the disclosure if the information were to change.

The Proposed Draft Rule would also provide comprehensive reporting requirements so long as any securities issued in a securitization remain outstanding. Such information would include: performance data; delinquency and modification data; substitutions and removal of financial assets, and servicer advances, as well as losses that were allocated to a tranche and the remaining balance of any assets supporting such tranche; and the percentage of each tranche in relation to the securitization as a whole.

Collateralized debt obligations and re-REMICs could qualify for the safe harbor in the Proposed Draft Rule only if similar disclosures are provided with respect to the underlying assets on a flow-through basis. In other words, no matter the structure, the safe harbor would only be available if the bank provided loan-level disclosures.

Documentation Requirements

The Proposed Draft Rule would require that all relationships in the securitization structure be governed by written agreements. Separate agreements would be required for each role of the bank or other parties in the securitization (*e.g.*, transferor, custodian, servicer, etc.). Such agreements would have to be approved by the board of directors of the bank or its loan committee and would have to have been in the official record of the bank continuously from the time of its execution. Representations and warranties in any such documents would have to be consistent with industry best practices. Reporting and conflicts of interest would also have to be addressed in the relevant documentation. The sponsor would be required to maintain records of its securitizations separate from records of its other business operations, which would be readily available for review by the FDIC promptly upon written request.

Structural Limitations

The Proposed Draft Rule would also require general separateness and fair dealing requirements and would not provide a safe harbor for securitizations that are contained within a single organization. Thus, the Proposed Draft Rule would provide that to qualify for the safe harbor, transactions would need to (i) be on arm's-length terms, (ii) be entered into in the ordinary course of business, and (iii) involve a transfer for adequate consideration. The transfer

of assets would be required to be properly perfected under the uniform commercial code or applicable state law. In addition, synthetic securitizations would not be eligible for the safe harbor.[4]

Rules Applicable to Residential Mortgage Backed Securities

In addition to the foregoing requirements, any securitization involving residential real estate loans would be subject to the following limitations and requirements:

- no more than six credit tranches and no "sub-tranches," grantor trusts, or other structures designed to further increase the leverage in the capital structure, other than time-based sequential pay sub-tranches with respect to the most senior tranche;
- no credit enhancements at the issuing entity or pool level although loan-level credit support would be permitted;
- disclosures of detailed loan-level information about the loans including, but not limited to, loan type, loan structure, maturity, interest rate and/or Annual Percentage Rate, and location of property;
- servicing and other agreements must provide servicers with full authority to "mitigate losses on financial assets consistent with maximizing the net present value of the financial asset," including authority to modify loans and take such other action as necessary or required to maximize the value and minimize losses on the loans by applying industry best practices for asset management and servicing;
- the servicing agreement cannot require a primary servicer to advance delinquent payments of principal and interest for more than three payment periods, unless financing or reimbursement facilities are available;
- all residential mortgage loans transferred into the securitization must be seasoned loans that were originated not less than twelve (12) months prior to such transfer; and
- all assets shall have been originated in compliance with all statutory, regulatory, and originator underwriting standards in effect at the time of origination.

Compensation Restrictions

Under the Proposed Draft Rule, no more than eighty percent of total estimated compensation could be paid to any lender, sponsor, credit rating agency or underwriter for services at closing. The remainder of fees would be payable over a period of five years or longer. Servicers would have to be paid incentive compensation based upon "loss mitigation," which seems to indicate participation in loan modification and foreclosure prevention programs.

Scope of Safe Harbor under the ANPR

For off-balance sheet securitizations that satisfy the requirements of the Proposed Draft Rule, the safe harbor will be similar to what it is currently under the Securitization Rule, as the Proposed Draft Rule provides that the FDIC as conservator or receiver shall not, in the exercise of its statutory authority to disaffirm or repudiate contracts, reclaim, recover, or recharacterize as property of the institution or the receivership such transferred financial assets, provided that such transfer otherwise satisfies the conditions for sale accounting treatment set forth by generally accepted accounting principles. However, this safe harbor will be unimportant to the extent that the amendment to FAS 140 described above eliminates most off-balance sheet accounting for securitizations.

[4] In a synthetic securitization, the sponsor enters into a credit derivative transaction with a special purpose entity that issues securities to investors or enters into offsetting derivatives. The credit derivative between the sponsor and the special purpose entity is designed to transfer credit risk with respect to assets the sponsor owns. In the case of synthetic securitizations by depository institutions, the derivatives are normally structured to meet the criteria for qualified financial contracts under the FDI Act. The exclusion of synthetic securitizations from the safe harbor is curious since there is no transfer of or grant of a security interest in the financial assets on which credit protection is obtained, all of which remain on the sponsor's balance sheet. The exclusion is also troubling because the FDI Act expressly protects the right of counterparties to qualified financial contracts to terminate or liquidate such contracts following appointment of the FDIC as receiver or conservator.

With respect to on-balance sheet securitizations, which are accounted for as secured borrowings, an issue of special concern for investors and sponsor institutions relates to the conditions under which the FDIC would treat these transactions as borrowings but would grant consent to obtain collateral for a securitization transaction before the expiration of the automatic stay period extending for forty-five days after appointment of a conservator or ninety days after appointment of a receiver. The Proposed Draft Rule provides that for on-balance sheet transactions that satisfy the substantive requirements of the Proposed Draft Rule, the FDIC will be deemed to consent to the exercise of contractual self-help rights if (i) at any time after appointment, the FDIC as conservator or receiver is in a "monetary default" under a securitization and remains in monetary default for ten business days after notice, or (ii) the FDIC as conservator or receiver has formally repudiated the securitization agreements and has not paid statutory damages within ten business days after the effective date of the notice. The self-help rights addressed by the consent include obtaining possession of the financial assets, exercising self-help remedies as a secured creditor under the transfer agreements, and liquidation of collateral.

Critique

It is curious that the ANPR is being released now while Congress is considering legislation that will affect many of the issues discussed in the ANPR. It would be premature to draft, let alone propose, any rule while Congress is still considering the same subject matter. In any event, the FDIC's approach in the ANPR, and in the Proposed Draft Rule in particular, raises more concerns than it solves. We suspect that if a regulation substantially in the form of the Proposed Draft Rule were adopted, the safe harbor provided would be seldom used.

Of particular concern is the conflict between the FDIC's role as deposit insurer and its role in policing securitization markets. As a deposit insurer, the FDIC is properly concerned with banks *acquiring* interests in securitizations where risks are not capable of being understood. However, the ANPR does not address securitizations that work their way onto bank balance sheets—it only addresses securitizations that are originated by banks. At best, the Proposed Draft Rule has the potential to regulate only a portion of securitizations into which banks may invest. To the extent that banks end up with more rigid requirements than other participants in the securitization marketplace, the Proposed Draft Rule could be detrimental to the safety and soundness of banks because it could threaten bank sources to liquidity. Moreover, a *risk retention* requirement is not what one would expect from an insurer. Given recent regulatory concern over *implicit* risks retained by banks in securitization transactions, it is surprising that a bank regulator would propose that banks keep more of the risk. Cases in which the FDIC and other bank regulators have challenged or disallowed securitization structures have tended to focus on the retention of inappropriate credit and liquidity risk.

It is questionable whether investor protection is an appropriate focus for a legal isolation safe harbor under the FDI Act, unless the rationale is that banks may invest in securitizations of other banks.[5] Even if investor protection is an appropriate objective of the safe harbor, the ANPR also takes a very odd approach to achieving it because it places the very investors sought to be protected in a Catch-22. If a securitization intended to comply with the safe harbor in the Proposed Draft Rule did not actually comply, what would be the remedy for investors harmed? In a worst-case scenario, the FDIC could seek to recharacterize the securitization transaction as a secured borrowing and not waive its consent right (analogous to an automatic stay) under the FDI Act. This remedy would only result in further losses to the investors and would do little to punish the offending institution.

The Proposed Draft Rule does not create the certainty that one would ordinarily expect from a safe harbor regulation. Before the Securitization Rule was promulgated, participants in securitization transactions typically addressed the isolation requirement of FAS 140 by analogy to a true sale analysis under the Bankruptcy Code and common law. If a transfer of assets by a bank to a securitization vehicle was a sale under common law, the assets transferred would be beyond the reach of the FDIC as conservator or receiver of that bank. However, given the dearth of case law pertaining to

[5] However, in that case regulation of securities issued in bank securitizations as permissible investments for banks would appear to be a more appropriate regulatory approach.

true sales in the context of FDIC receiverships, the Securitization Rule provided a more reliable basis on which to assure a complete separation of the credit risk of the assets transferred from the creditworthiness of the transferor. The Proposed Draft Rule would change this.

Compliance with the Proposed Draft Rule in many cases would be more uncertain than the legal isolation issues the safe harbor is intended to solve. The Proposed Draft Rule contains, and the ANPR seeks comment upon, many discrete requirements, including ones that relate to future performance and compliance with undefined "best practices."

Additionally, there would be uncertainty over the level of disclosures, given the reference to a minimum level of disclosure tied to Regulation AB issued by the SEC, but little detail on the additional specific disclosures required.[6] This would make reliance upon the safe harbor contained in the Proposed Draft Rule considerably less certain than reliance on a common law true sale analysis. It would be far easier to conclude at a closing that a true sale had taken place under common law than it would to conclude that the Proposed Draft Rule has been complied with.

Even assuming that a depository institution complies with the substantive requirements of the Proposed Draft Rule, investors in on-balance sheet transactions would be subject to risks arising from the limitation of the FDIC's waiver of its rights under the FDI Act to consent to the exercise of creditors' remedies. The safe harbor in the Proposed Draft Rule would still impose a ten day waiting period before self-help remedies could be taken against collateral, leaving investors subject to the risk that the value of their collateral may deteriorate during that period. Considering that the FDIC may repudiate a securitization agreement contract at any time during the forty-five day period or ninety day period after the date of the appointment of the conservator or receiver, as applicable, this could effectively expose investors to market value risk of up to fifty-five days or one hundred days depending on the circumstances. Many of the issues surrounding the scope of self-help remedies against collateral are similar to those that arose under the FDIC's final policy statement on covered bonds issued in July 2008. For a discussion of that policy statement, see our Alert "Cover from the Storm: Federal Regulators Promote Covered Bonds to Stabilize Capital Markets."

Conclusion

Given the recent accounting changes, it is understandable that the Securitization Rule would need to be revisited. And given the effect of securitizations on depository institutions in recent years, it is understandable that the FDIC would seek to effectuate reforms of the securitization practices of banks. However, the Proposed Draft Rule is deeply flawed. The manner of regulation creates additional confusion at a time when Congress is occupying the field. Moreover, restrictions that apply only to bank-originated securitizations will increase the difficulty for banks to finance their assets on efficient terms. A safe harbor in this context should be carefully designed to reduce the risk to investors of the uncertainty of FDIC action if the sponsor bank becomes insolvent. The Proposed Draft Rule does not accomplish this.

[6] Because the securities issued in bank securitizations are not "bank securities," they are subject to the SEC's regulatory jurisdiction. Separate FDIC jurisdiction may create confusion and may unlawfully impinge on the SEC's jurisdiction.

Anchorage Austin Beijing Berlin Boston Charlotte Chicago Dallas Dubai Fort Worth Frankfurt Harrisburg Hong Kong London
Los Angeles Miami Newark New York Orange County Palo Alto Paris Pittsburgh Portland Raleigh Research Triangle Park
San Diego San Francisco Seattle Shanghai Singapore Spokane/Coeur d'Alene Taipei Washington, D.C.

K&L Gates is a global law firm with lawyers in 33 offices located in North America, Europe, Asia and the Middle East, and represents numerous GLOBAL 500, FORTUNE 100, and FTSE 100 corporations, in addition to growth and middle market companies, entrepreneurs, capital market participants and public sector entities. For more information, visit www.klgates.com.

K&L Gates comprises multiple affiliated partnerships: a limited liability partnership with the full name K&L Gates LLP qualified in Delaware and maintaining offices throughout the United States, in Berlin and Frankfurt, Germany, in Beijing (K&L Gates LLP Beijing Representative Office), in Dubai, U.A.E., in Shanghai (K&L Gates LLP Shanghai Representative Office), and in Singapore; a limited liability partnership (also named K&L Gates LLP) incorporated in England and maintaining offices in London and Paris; a Taiwan general partnership (K&L Gates) maintaining an office in Taipei; and a Hong Kong general partnership (K&L Gates, Solicitors) maintaining an office in Hong Kong. K&L Gates maintains appropriate registrations in the jurisdictions in which its offices are located. A list of the partners in each entity is available for inspection at any K&L Gates office.

This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied upon in regard to any particular facts or circumstances without first consulting a lawyer.

©2010 K&L Gates LLP. All Rights Reserved.