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FDIC Extends Securitization Safe Harbor and Portends Further Securitization Reforms

On November 12, 2009, the board of directors of the Federal Deposit Insurance Corporation ("FDIC") adopted an interim final rule (the "Interim Rule") amending 12 C.F.R. §360.6 (the "Securitization Rule") regarding the FDIC's treatment, as conservator or receiver, of financial assets transferred in connection with a securitization or participation.[1] The Interim Rule was adopted in response to recent changes to generally accepted accounting principles ("GAAP") that will require many securitizations and participations currently accounted for as "sales" under GAAP to be accounted for as secured on-balance sheet borrowings commencing with the sponsoring depository institution's first fiscal year that begins after November 15, 2009.

The Interim Rule provides that all securitizations and participations for which financial assets were transferred, or for revolving securitization trusts for which securities are issued, prior to March 31, 2010 will remain "legally isolated" so long as those securitizations and participations would been accounted for as sales under GAAP as in effect before November 15, 2009 and satisfy all other conditions of the Securitization Rule.

Marketplace Grumblings

The FDIC originally adopted the Securitization Rule in 2000 to provide comfort that loans or other financial assets transferred by an insured depository institution into a securitization trust or participation would be "legally isolated" from an FDIC conservatorship or receivership if, among other requirements, the transfer met all conditions for sale accounting treatment under GAAP. Since 2000, securitization participants have relied on this rule for assurance that investors could satisfy payment obligations from securitized assets without fear that the FDIC might interfere as conservator or receiver.

This uncertainty resurfaced on June 12, 2009 when the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment for FASB Statement No. 140* and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)*. The new accounting pronouncements substantially narrow the circumstances under which a transfer of financial assets in connection with a securitization may be accounted for as a sale and require insured depository institutions to consolidate issuer entities to which financial assets have been transferred for securitizations in their financial statements for fiscal years beginning after November 15, 2009. (For most institutions, the new GAAP rules will become effective on January 1, 2010.) These changes will cause such transfers to be treated as secured borrowings rather than sales for accounting purposes, and the Securitization Rule would not have applied unless it were amended.

The uncertainty over whether the FDIC would continue to grant "safe harbor" to securitizations of insured depository institutions in conservatorship or receivership created considerable concern in the marketplace. Additionally, anecdotes were relayed to the FDIC to the effect that credit card securitizations (one of the few areas

[1] The Interim Rule is posted at http://www.fdic.gov/news/board/2009nov12no6.pdf.

where securitization transactions have remained active) have been "held up" pending resolution of the safe harbor issue. The rating agencies also expressed their concern that bank securitization transactions would be unlikely to receive the highest ratings and would be linked to the rating of the sponsor bank unless the safe harbor was extended. Moody's Investors Service issued a report in September 2009 warning that it would review outstanding bank-sponsored credit card securitizations that were sponsored by banks not rated at least Aa3 for possible rating downgrade unless the safe harbor issue was addressed.

FDIC Adopts Transitional Safe Harbor

The interim amendments adopted by the FDIC "grandfather" all participations or securitizations (i) for which transfers of financial assets were made or (ii) for revolving securitization trusts, for which beneficial interests are issued, on or before March 31, 2010, by providing that those transactions would not be subject to the FDIC's exercise of its statutory authority as conservator or receiver to disaffirm or repudiate contracts or reclaim, recover or recharacterize as property of the institution or the receivership any such transferred assets provided that such transfers satisfy the conditions for sale accounting treatment set forth by GAAP in effect for reporting periods before November 15, 2009, except for the "legal isolation" condition, and otherwise satisfy the conditions of the Securitization Rule. Moody's and Fitch Ratings issued statements on the day of adoption that the Interim Rule had "effectively addressed" their key concerns.

December 15, 2009 – The Bigger Picture Unfolds

The FDIC staff members who recommended adoption of the Interim Rule at the November 12 board meeting also announced that they planned to propose additional changes to the Securitization Rule at the FDIC's next board meeting scheduled for December 15, 2009 to address the impact of the new accounting pronouncements after the transition period. Commenting that the "originate to distribute" model of structured finance transactions had led to an "erosion of underwriting standards," and "defects in incentives" caused by immediate gains on sales for transfers and fee income, the FDIC staff members stated that it would be "imprudent" for the FDIC to continue the safe harbor after the transition period without proposing "conditions designed to realign the incentives of the securitization process." FDIC Chairperson, Sheila Bair, underscored those views by stating that the conditions would be designed to encourage "sustainable lending" and avoid the "massive losses" and "landmines" that have recently plagued insured banks. While the FDIC staff did not provide further hints as to the content of those proposals, the changes sought may include increased disclosures to investors and required risk retention by issuers, according to past comments from FDIC officials.

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