MEMORANDUM TO: The Board of Directors

FROM: Mitchell L. Glassman *Mitchell L. Glassman*
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SUBJECT: Proposed Interim Final Rule Amending 12 C.F.R. § 360.6 Defining Safe Harbor Protection for Treatment By The FDIC As Conservator Or Receiver Of Financial Assets Transferred By An Insured Depository Institution In Connection With A Securitization Or Participation; and

RECOMMENDATION

Staff recommends that the Board of Directors ("Board") adopt a proposed Interim Rule, effective immediately, to amend 12 C.F.R. § 360.6 to provide a transitional safe harbor for existing securitization and participation transactions potentially affected by changes to Generally Accepted Accounting Principles (GAAP). This transitional safe harbor will ensure that transactions that complied with Section 360.6 as currently in effect and any additional transactions in process through the transition date of March 31, 2010 will not lose the "legal isolation" protections under Section 360.6 due to the changes in accounting treatment. This extension of the protection of the preexisting Section 360.6 also will provide a transition period to implement changes to Section 360.6 that staff will be proposing for consideration by the Board in a proposed Notice of Proposed Rulemaking at the Board of Directors' meeting in December. In the interim, the FDIC will consult with other appropriate regulators in order to provide feedback to the Board of Directors on the proposed conditions that will be recommended in changes to Section 360.6 applicable to securitizations by insured depository institutions after March 31, 2010.

At the December meeting of the Board of Directors, following consultation with appropriate regulators, staff will recommend that the Board approve the Notice of Proposed Rulemaking to clarify the circumstances when the FDIC, as conservator or receiver, will treat a transfer for a securitization or participation as a sale and, if no accounting sale is possible, when consent will be provided for access to the financial assets that are securitized. By adopting appropriate standards for clarified treatment under the FDIC's receivership powers, the Proposed Rule will serve to protect the Deposit Insurance Fund (DIF) and the FDIC's interests as deposit insurer and receiver by aligning securitization transactions toward better and more sustainable lending by insured depository institutions (IDIs). The losses incurred by the DIF, as well as the significant impact on IDIs and thrifts, caused in part by the misalignment of incentives in preexisting securitization transactions demonstrate the need for strengthened conditions beyond those imposed when Section 360.6 was initially adopted by the Board in 2000. The notice and comment process will provide an opportunity for the FDIC to receive broad input and ensure that the strengthened conditions are appropriate to promote sustainable securitizations.

The Interim Rule is needed in the near term to forestall substantial downgrades in the ratings provided on existing securitizations and to enable planned securitizations for multiple asset classes to be brought to market after November 15, 2009, the effective date of changes in GAAP. While participations likely will continue to comply with the conditions for application of Section 360.6, the safe harbor in the Interim Rule is being extended to participations to ensure there are not unanticipated consequences to these banking transactions during the period of the safe harbor.

EXECUTIVE SUMMARY

In 2000, the FDIC adopted a regulation on these issues, which was codified at 12 C.F.R. § 360.6 (the "Securitization Rule"). The Securitization Rule provided comfort that the FDIC, as conservator or receiver, would not try to reclaim loans or other financial assets that had been transferred into a securitization trust or into a participation by an IDI. The condition for this commitment was that the transfer had to meet all conditions for sale accounting treatment under GAAP. If the transfer satisfied this condition, the Securitization Rule confirmed that the transferred financial assets were "legally isolated" from the IDI even in a conservatorship or receivership.

In June 2009, the Financial Accounting Standards Board ("FASB") announced changes to GAAP that would prevent most securitizations from being treated as off-balance sheet sales for accounting purposes. As a result, most securitizations will not meet the conditions for sale accounting treatment under GAAP and will be consolidated onto IDIs' balance sheets. Those changes become effective for reporting periods after November 15, 2009, and will normally apply to new securitizations as well as those created before that date. Consequently, since the Securitization Rule depends on sale accounting treatment, the "safe harbor" it provided will no longer apply to the transfer into a securitization. While there may be some effects on participations, most participations likely will continue to meet the conditions for sale accounting treatment under the Securitization Rule.

As a result of the changes by FASB, most securitizations will not be treated as sales for accounting purposes. Given this likely accounting treatment, securitizations alternatively could be considered to be a form of secured borrowing. In 2005 Congress enacted 11(e)(13)(C) of the FDI Act. In relevant part, this provision requires the consent of the conservator or receiver for 45 or 90 days, respectively, before any action can be taken by a secured creditor against collateral pledged by the IDI. If a securitization is not given sale accounting treatment under the changes to GAAP, but is treated as a secured borrowing, Section 11(e)(13)(C) could prevent the security holders from recovering monies due to them by up to 90 days. We have been advised that this 90-day delay would cause substantial downgrades in the ratings provided on existing securitizations and could prevent planned securitizations for multiple asset classes, such as credit cards, automobile loans, and other credits, from being brought to market.

Because the modifications to GAAP will require that financial assets transferred in connection with previously issued securitizations be consolidated on the books of the sponsor IDI and will apply to determine all sale transactions for the annual reporting periods commencing November 15, 2009, staff recommends that the Board adopt a proposed Interim Rule to be effective immediately.

The proposed Interim Rule will clarify the treatment of financial assets in participations and securitizations for the limited period of time until March 31, 2010. The proposed Interim Rule continues the safe harbor treatment for transfers of financial assets made in connection with participations and securitizations issued prior to the effective date of the changes to GAAP and new participations and securitizations that issue during the transition period. The Interim Rule will continue the safe harbor provisions for securitizations and participations during the transition period, if such securitizations or participations would have complied with the Securitization Rule under GAAP in effect prior to November 15, 2009. In effect, the Interim Rule grandfathers securitizations and participations that met the FDIC's prior Securitization Rule and allows securitization and participation transactions currently in process to be completed. The transition period will also enable the FDIC to consult with appropriate regulators, issue the Notice of Proposed Rulemaking described above, solicit comments from the market and adopt changes to Section 360.6.

DISCUSSION

I. Background

In 2000, the FDIC clarified the scope of its statutory authority as conservator or receiver to disaffirm or repudiate contracts of an IDI with respect to transfers of financial assets by an IDI in connection with a securitization or participation when it adopted the Securitization Rule. This rule provided that the FDIC as conservator or receiver will not use its statutory authority to disaffirm or repudiate contracts to reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an IDI in connection with a securitization or participation or in the form of a participation, provided that such transfer meets all conditions for sale accounting treatment under GAAP. The rule was a clarification, rather than a limitation, of the repudiation power. Such power authorizes the conservator or receiver to breach a contract or lease entered into by an IDI and be legally excused from further performance but it is not an avoiding power enabling the conservator or receiver to recover assets that were previously transferred by the IDI in connection with the contract. The Securitization Rule provided a "safe harbor" to permit transfers of financial assets by an IDI to an issuing entity in connection with a securitization or in the form of a participation to satisfy the "legal isolation" condition of GAAP as it applies to an institution for which the FDIC may be appointed as conservator or receiver. 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 an IDI, the FDIC as conservator or receiver. Since its adoption, the Securitization Rule has been relied on by securitization participants, including rating agencies, as assurance that investors could look to securitized financial assets for payment without concern that the financial assets would be interfered with by the FDIC as conservator or receiver.

Recently, the implementation of new accounting rules has created uncertainty for securitization participants. On June 12, 2009, the Financial Accounting Standards Board ("FASB") finalized modifications to GAAP through Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140* ("FAS 166") and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R)* ("FAS 167")(the "2009 GAAP Modifications"). The 2009 GAAP Modifications are effective for annual financial statement reporting periods that begin after November 15, 2009. For most IDIs, the 2009 GAAP Modifications will be effective for reporting periods beginning after January 1, 2010. The 2009 GAAP Modifications made changes that affect whether a special purpose entity ("SPE") must be consolidated for financial reporting purposes, even if legally isolated, thereby subjecting many SPEs to GAAP consolidation requirements because of the IDI's control over the financial assets. These accounting changes will require some IDIs to consolidate an issuing entity to which financial assets have been transferred for securitization on to their balance sheets for financial reporting purposes. Similarly, GAAP modification affect the way participations are treated on the issuing entity's balance sheets, requiring that participations that do not meet the conditions for sale treatment be treated as secured borrowings of an IDI. As a result, in either case, the safe harbor provision of the Securitization Rule will not apply to the transfers.

To the extent a securitization or participation does not qualify for sale treatment under accounting principles, Section 11(e)(13)(C)[1] of the FDIA creates some uncertainty for securitization investors and participants. This Section provides that no person may exercise any right or power to terminate, accelerate, or declare a default under a contract to which the IDI is a party, or to obtain possession of or exercise control over any property of the IDI, or affect any contractual rights of the IDI, without the consent of the conservator or receiver, as appropriate, during the 45-day period beginning on the date of the appointment of the conservator or the 90-day period beginning on the date of the appointment of the receiver. Consequently, securitized or participated assets that remain property of the IDI (but subject to a security interest) would be subject to the stay, raising concerns that any attempt by participants or securitization noteholders to exercise remedies with respect to the IDI's assets would be delayed by up to 90 days. During that time, interest and principal on the securitized debt or participations could remain unpaid.

The 2009 GAAP Modifications also affect the way securitizations are viewed by the rating agencies and whether they can achieve ratings that are based solely on the credit quality of the assets, independent from the rating of the IDI. Rating agencies are concerned with several issues, including the ability of a securitization transaction to pay timely principal and interest in the event the FDIC is appointed receiver or conservator of

[1] 12 U.S.C. § 1821(e)(13)(C).

the IDI. Moody's, Standard & Poor's, and Fitch have expressed the view that because of the 2009 GAAP modifications and the extent of the FDIC's rights and powers as conservator or receiver, bank securitization transactions are unlikely to receive AAA ratings and would have to be linked to the rating of the IDI. Securitization practitioners have asked the FDIC to provide assurances regarding the position of the conservator or receiver as to the treatment of both existing and future securitization transactions to enable securitizations to be structured in a manner that enables them to achieve de-linked ratings.

The FDIC, as deposit insurer and receiver for failed IDIs, has a unique responsibility and interest in ensuring that loans and other financial assets, as defined in the Proposed Rule, made by IDIs are originated for long-term sustainability. The supervisory interest in origination of quality loans and other financial assets, of course, is shared with other bank and thrift supervisors. However, the FDIC's responsibilities to protect insured depositors and resolve failed insured banks and thrifts, and its fiduciary responsibility to the DIF, require it to ensure that, where it provides consent to special relief from the application of its receivership powers, it should do so in a manner that fulfills these responsibilities.

Securitization can be a valuable tool for liquidity for insured banks and thrifts and other financial institutions if it is supported by properly underwritten financial assets and structured to align incentives among all parties to the transactions for long-term sustainable lending. The FDIC supports sustainable securitization to provide balance sheet liquidity and, where appropriate, off balance sheet transactions that enhance prudent credit availability. Securitization, properly structured, can play an important role in recovery from the financial crisis.

However, the evident defects in many subprime and other mortgages originated and sold into securitizations requires attention by the FDIC to fulfill its responsibilities as deposit insurer and receiver in addition to its role as a supervisor. The defects and misalignment of incentives in the securitization process for residential mortgages were a significant contributor to the erosion of underwriting standards throughout the mortgage finance system. While many of the troubled mortgages were originated by non-bank lenders, there can be no question that insured banks and thrifts also made many troubled loans as underwriting standards declined under the competitive pressures created by the returns achieved by lenders and service providers through the "originate to distribute" model.

Securitizations of other asset classes have not suffered the dramatic declines in issuance experienced by securitizations of newly originated mortgages. While mortgage securitizations have been extremely limited during 2009, and exclusively focused on seasoned mortgages, securitizations of credit card and other consumer loans have continued. However, securitizations of all asset classes are affected by the accounting changes and the changes in the application of the Securitization Rule consequent upon them.

Nonetheless, defects in the incentives provided by securitization through immediate gains on sale for transfers into securitization vehicles and fee income directly led to material adverse consequences for insured banks and thrifts. Among these consequences were increased repurchase demands under representations and warranties contained in securitization agreements, losses on purchased mortgage and asset-backed securities, severe declines in financial asset values and in mortgage- and asset-backed security values due to spreading market uncertainty about the value of structured finance investments, and impairments in overall financial prospects due to the accelerated decline in housing values and overall economic activity. These consequences, and the overall economic conditions, directly led to the failures of many IDIs and to significant losses to the DIF. In this context, it would be imprudent for the FDIC to provide extended consent or other clarification of its application of its receivership powers beyond the March 31, 2010 safe harbor extension without proposing conditions designed to realign the incentives in the securitization process to avoid these devastating effects. Staff will be proposing for consideration by the Board changes to Section 360.6 that include such conditions at the Board of Directors' meeting in December.

II. The Interim Rule – Amendment to Section 360.6

The Interim Rule amends the current Section 360.6 by inserting a new clause (b)(2) that addresses any participations or securitization (i) for which transfers of financial assets were made or (ii), for revolving securitization trusts, for which securitization notes were issued on or before March 31, 2010. The Interim Rule will continue the safe harbor provision of Section 360.6(b) for financial assets transferred in connection with a securitization or participation issued on or before March 31, 2010, if such securitization or participation complied with the conditions for sale accounting treatment at the time of issuance. In addition the Interim Rule will continue the safe harbor provision of securitization or participations if such securitizations or participations would have complied with Section 360.6 under GAAP in effect prior to November 15, 2009, notwithstanding the fact that the participation or the transfer of financial assets may not satisfy all conditions for sale accounting treatment under GAAP as effective for reporting periods after November 15, 2009.

Staff recommends that this transition period is appropriate to permit the market to continue operations until it can transition to the conditions imposed by the new Section 360.6 which will be proposed by the staff in December and to grandfather transactions that had complied with the prior Section 360.6. Based upon feedback from market participants, the failure to provide a transition safe harbor will result in ratings downgrades of most, if not all, current securitizations and will preclude favorable ratings for currently in process securitizations, including those under the Federal Reserve's Term Asset-Backed Securities Loan Facility.

For these reasons, staff recommends that the Board of Directors approve the safe harbor until March 31, 2010 to provide clarity for outstanding securitizations and participations as well as those currently in process.

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