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Final Rule: Amendment to Securitization Safe Harbor Rule

January 30, 2020

The final rule before the FDIC Board today would amend the FDIC's Securitization Safe Harbor Rule¹. It would eliminate an important disclosure requirement of the Rule that applies to private placements of residential mortgage backed securities (RMBS) by insured depository institutions (IDIs). It would thereby weaken a key measure taken by the FDIC to address a central cause of the financial crisis – the transmission of risk from badly underwritten mortgage loans through RMBS. For that reason I will vote against this final rule.

The FDIC Board originally adopted the Securitization Safe Harbor Rule in 2000. Its purpose is to provide assurance that the FDIC would not use its authorities as conservator or receiver of a failed bank to repudiate bank contracts if certain conditions are met.

In 2010, in response to the financial crisis, the FDIC added several disclosure requirements to the Safe Harbor Rule, particularly related to residential mortgage backed securities. The preamble to the Rule made clear the purpose of the disclosure requirements:

The conditions are designed to provide greater clarity and transparency to allow a better ongoing evaluation of the quality of lending by banks and reduce the risks to the DIF [Deposit Insurance Fund] from opaque securitization structures and the poorly underwritten loans that led to the onset of the financial crisis.²

¹ 12 CFR 360.6.

² Preamble to Final Rule: Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation after September 30, 2010, 75 Fed. Reg. 60287, 60291 (Sept. 30, 2010).

A number of these requirements are FDIC-specific and apply to both publicly and privately placed securitizations.³ In addition, the 2010 Safe Harbor Rule requires that a securitization comply with the requirements of the SEC’s Regulation AB “even if the obligations are issued in a private placement or are not otherwise required to be registered.”⁴

The preamble to the final rule before the FDIC Board today frames the purpose of the rule as conforming the FDIC’s 2010 rule to the SEC’s Regulation AB:

The FDIC is amending its securitization safe harbor rule... in order to eliminate a requirement that the securitization documents require compliance with Regulation AB of the Securities and Exchange Commission in circumstances where Regulation AB by its terms would not apply to the issuance of obligations backed by such financial assets.⁵

The eliminated requirement referred to is the application of Regulation AB to private as well as public placements of securitizations. The FDIC Board, however, explicitly intended that the Securitization Safe Harbor Rule disclosure requirements apply to public and private placements, whether or not the SEC rule did, for safety and soundness reasons reflecting the differing missions of the agencies.

The preamble to the Notice of Proposed Rulemaking for the 2010 Safe Harbor Rule specifically addressed the policy concern behind this decision:

The FDIC believes that regardless of whether the securitization transaction is in the form of a private rather than public securities issuance, full disclosure to investors in such transaction is necessary.... In particular, the FDIC is concerned that ... ongoing monthly reports are provided to investors in a securitization, whether or not there is an ongoing obligation for filing

³ 12 CFR 360.6(b)(2).

⁴ 12 CFR 360.6(b)(2)(i)(A). The SEC’s Regulation AB governs the offering process, disclosure requirements and ongoing reporting requirements for securitizations. 17 CFR 229.1100 through 1123. After proposing significant changes to Regulation AB in April 2010, including disclosures for private placements, the SEC ultimately dropped the provision requiring disclosure for privately placed securitizations. See Preamble to the FDIC’s 2019 Notice of Proposed Rulemaking: Securitization Safe Harbor Rule, 84 Fed. Reg. 43732, 43734 (Aug. 22, 2019).

⁵ Preamble to Final Rule: Amendment to Securitization Safe Harbor Rule at 1.

with respect to such securitization under the Securities Exchange Act of 1934.⁶

The preamble to the final 2010 Safe Harbor Rule specifically addressed the issue of possible differences with the SEC:

An important consideration is that different regulatory agencies have different regulatory jurisdiction. The FDIC has regulatory jurisdiction over the rules applied in the resolution of failed IDIs, as the SEC has jurisdiction over disclosure requirements under the securities laws. In exercising their different responsibilities, the agencies may have to adopt rules addressing the same issues within their regulatory mandate. In those cases, those rules should be harmonized except where differences are appropriate to accomplish their different regulatory missions. For the FDIC's safe harbor rule, the FDIC is setting the conditions that define how it will apply its receivership powers and thereby, what types of transactions will be entitled to the safe harbor protecting them from application of certain of those powers.⁷

The decision by the FDIC to apply the disclosure requirements of the SEC's Regulation AB to private and public placements of securitizations was a considered judgment intended "to protect the Deposit Insurance Fund ("DIF") and the FDIC's interests as deposit insurer and receiver by aligning the conditions for the safe harbor with better and more sustainable securitization practices by insured depository institutions...."⁸ It is consistent with the mission of the FDIC, distinct from that of the SEC.

In support of today's final rule, the preamble makes two arguments. First, the preamble cites difficulties potential insured depository institution sponsors of residential mortgage backed securities have in providing certain information in connection with RMBS:

⁶ Notice of Proposed Rulemaking: Treatment by the FDIC as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection with a Securitization or Participation after September 30, 2010, 75 Fed. Reg. 27471, 27478 (Mar. 17, 2010).

⁷ Preamble to the 2010 Final Rule, 75 Fed. Reg. 60291.

⁸ Id. at 60287.

The Regulation AB disclosure requirements identified in the comment letters as difficult or impossible to comply with include the back-end debt-to-equity income ratio disclosure requirement, the requirements for disclosure of appraisals, automated valuation model results and credit scores obtained by any credit party or credit party affiliate, and the inconsistency of data elements with the standards set forth in the Mortgage Industry Standards Maintenance Organization.⁹

These potential RMBS sponsors may have difficulty disclosing the debt-to-equity income ratios, appraisals, and credit scores underlying the mortgages in the securitization. However, it was precisely the lack of transparency into these elementary risk factors for investors that contributed to the difficulties experienced in assessing the true performance of residential mortgage backed securities during the financial crisis.

Second, the preamble to today's final rule provides a list of regulatory developments adopted since the financial crisis to justify the conclusion that the Regulation AB disclosures that are applicable to public placement of asset-backed securities are unnecessary for privately-placed residential mortgage backed securities. These include securitization credit risk retention requirements, liquidity and capital regulations, and ability to repay and other mortgage-related rules. It is stated in the preamble, without further analysis, that these other regulations "have the effect of limiting or precluding poorly underwritten, risky securitizations, particularly securitizations of residential mortgages", as well as the risk of complex, opaque structures.¹⁰

I hope that proves to be true. However, we have yet to experience an economic downturn since the financial crisis. As a result, we have not yet even tested these reforms through an economic cycle. The disclosures required by the FDIC's Securitization Safe Harbor Rule are intended to enable investors to exercise effective due diligence and serve as a discipline on the marketplace for residential mortgage backed securities. They are a valuable complement to the reforms that have been cited. Prudence, and hard experience, would suggest that they be maintained.

⁹ Preamble to Final Rule: Amendment to Securitization Safe Harbor Rule at 17.

¹⁰ Id. at 7-8.

For these reasons, I will vote against the final rule before the FDIC Board today.