Cleary Gottlieb
Alert Memo
NEW YORK & WASHINGTON OCTOBER 28, 2010
www.clearygottlieb.com

FDIC's Final Safe Harbor Rule Imposes New Securitization Standards

On September 27, 2010, the Board of Directors of the Federal Deposit Insurance Corporation (the "FDIC") approved a final rule, codified as 12 C.F.R. § 360.6, entitled "Treatment of financial assets in connection with a securitization or participation" (the "Safe Harbor Rule"). The Safe Harbor Rule establishes new conditions for the FDIC's assurance that it will not, in its capacity as conservator or receiver for a failed insured depository institution ("IDI"), assert its repudiation power with respect to contracts of the IDI so as to avoid transfers of financial assets in connection with qualifying securitizations or participations originated by that IDI. Adoption of the rule follows an Advance Notice of Proposed Rulemaking by the FDIC of December 15, 2009,[1] and a Notice of Proposed Rulemaking of May 11, 2010.[2] The FDIC's memorandum describing the final Safe Harbor Rule (the "FDIC Rule Memorandum"), including the text of the final rule, is available at http://edocket.access.gpo.gov/2010/pdf/2010-24595.pdf.

The Safe Harbor Rule takes effect on December 31, 2010.

The Safe Harbor Rule has important implications for disclosure and risk retention requirements for asset backed securities ("ABS") and other securitizations involving IDIs. This memorandum briefly described the background to the FDIC's repudiation power as it relates to the Safe Harbor Rule, summarizes the principal provisions of the Rule, and assesses the impact of the Safe Harbor Rule in light of related regulatory developments.

I. Background to the FDIC's Repudiation Power and the 2000 Safe Harbor

The Federal Deposit Insurance Act (the "FDIA") grants the FDIC the power in its capacity as conservator or receiver for a failed IDI to repudiate unperformed contracts of the IDI where the FDIC determines such contracts to be burdensome.[3] This power has been construed by the FDIC to allow the FDIC to "repudiate" a secured financing of an IDI by repaying the financing amount and recovering the relevant collateral. The economic characteristics of a securitization – in which an IDI transfers loans or other financial assets to a special purpose entity ("SPE") and the SPE issues securities backed by these financial

[1] See 75 Fed. Reg. 934 (Jan. 7, 2010)

[2] See 75 Fed. Reg. 27471 (May 17, 2010) ("Proposing Release").

[3] 12 U.S.C. § 1821(e)(1).

assets, with the IDI typically retaining some portion of the residual or equity securities of the SPE – are economically similar to a limited recourse secured financing by the IDI. A securitization transaction therefore raises the prospect of being recharacterized as secured debt.

Outside the FDIC context, such recharacterization concerns are addressed by structuring the relevant transaction such that under applicable state law, the securitization SPE will be considered separate from the originator in a bankruptcy and the sale of assets to the SPE will be considered a "true sale". Securitization structures involving IDIs must address the possible recharacterization of the transaction by the FDIC as secured debt, with the result that the FDIC might apply the repudiation power to reclaim assets transferred to the securitization SPE. Since 2000, a prior FDIC safe harbor rule has specified that securitizations meeting certain basic conditions would not be avoided by means of the repudiation power.[4]

One factor relevant to whether a securitization might be recharacterized is the accounting treatment of the transaction. A securitization may result in the securitized assets being accounted for as off balance sheet, having been sold by the originator to the SPE; or the assets may remain on the balance sheet of the originator, with the originator accounting for the securitization as a secured financing. The FDIC's discussion of the rationale for the Safe Harbor Rule highlights that the FDIC places considerable importance on this feature in the context of the repudiation power. The FDIC referred to its "longstanding evaluation of the assets potentially subject to receivership powers" as having been "based on the treatment of those assets as on or off balance sheet."[5] The FDIC further emphasized that "it is appropriate for the FDIC to rely on the books and records of a failed IDI in administering a conservatorship or receivership and consider how to apply a safe harbor for assets that are deemed part of the IDI's balance sheet under GAAP."[6]

The FDIC's focus on the importance of the accounting treatment of a securitization is prompted by recent changes to accounting standards. Prior to the changes effected by Statement of Financial Accounting Standards 166 and 167,[7] the prevailing model for securitization was that of off-balance sheet financing. SPEs were established to qualify as "qualified special purpose entities" which were not subject to accounting consolidation by their parent originator. Previous FAS 140 standards required "legal isolation" assurances to

---

4 See current 12 C.F.R. § 360.6 (the "2000 Safe Harbor Rule").

5 75 Fed. Reg. 60287, 60291 (Sept. 30, 2010).

6 Id. at 19-20.

7 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"). As noted in its title, FAS 166 amends in important respects a prior sale accounting standard, Statement of Financial Accounting Standards No. 140 ("FAS 140").

the effect that the relevant transfer of assets would be treated as a "true sale" and not clawed back in the insolvency of the originator or its affiliates, in order to treat a transfer to the SPE as a sale for accounting purposes. The 2000 Safe Harbor Rule facilitated such off-balance sheet treatment by confirming that the FDIC would not use the repudiation power to challenge a sale of financial assets to an SPE which otherwise met the requirement for isolation of the relevant assets under FAS 140.

With the changes to FAS 140 wrought by FAS 166 and FAS 167, it has become much less likely for securitizations to be treated as off-balance sheet. Through a combination of new standards for sale accounting under FAS 166, and new standards for consolidation of SPEs and similar entities ("variable interest entities" or "VIEs") under FAS 167, securitizations that have the same legal and economic characteristics as transactions previously treated as off balance sheet by an IDI will now be treated as secured financings. Responding to this change, the FDIC has refused to maintain the 2000 Safe Harbor Rule. Separately, in reaction to the perceived role of past securitization practices in contributing to the credit crisis, the FDIC has also sought to add a substantive regulatory element to the safe harbor rule. The new conditions to the safe harbor, summarized below, go well beyond the factors that would be relevant to the FDIC's assessment of whether respecting a securitization as a true sale would disadvantage an IDI in receivership. Instead, by imposing substantial conditions on safe harbor treatment, the FDIC seeks to impose new standards on the securitization market.

II. The Operation of the Safe Harbor

A. Key Definitions; GSE Exclusion

A "securitization" for purposes of the Safe Harbor Rule is defined as the "issuance by an issuing entity of obligations for which the investors are relying on the cash flow or market value characteristics and the credit quality of transferred financial assets" to service the relevant obligations.[8] An "issuing entity" is broadly defined as an "entity that owns a financial asset or financial assets transferred by the sponsor and issues obligations supported by such asset or assets."[9] A "sponsor" is "a person or entity that organizes and initiates a securitization by transferring financial assets, either directly or indirectly, including through an affiliate, to an issuing entity."[10] The notion of a securitization is thus not limited to transfers of assets that occur in connection with primary credit origination: repackagings or transfers by banks of assets acquired in the secondary market could also be included as "securitizations." Even a transfer of a single asset, without tranching a credit risk, to an "issuing entity" may be a "securitization" under the Safe Harbor Rule.

[8] 12 C.F.R. § 360.6(a)(7); 75 Fed. Reg. 60287, 60297 (Sept. 30, 2010).

[9] 12 C.F.R. § 360.6(a)(3); 75 Fed. Reg. 60287, 60297 (Sept. 30, 2010).

[10] 12 C.F.R. § 360.6(a)(10); 75 Fed. Reg. 60287, 60298 (Sept. 30, 2010).

The definition of "issuing entity" embeds within it an exclusion for transactions involving the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association or similar government sponsored enterprises (each a "GSE") from the ambit of the Safe Harbor Rule. Under the definition of "issuing entity," a "Specified GSE or an entity established or guaranteed by a Specified GSE shall not constitute an issuing entity."[11] Due to the nature of the rule as a safe harbor, the effect of this exclusion is unclear. The intent of this exclusion may have been to relieve GSE transactions from the conditions of the Safe Harbor Rule, but the operation of the exclusion would instead appear to deny safe harbor treatment, whether or not the GSE transaction complies with the conditions of the rule. Since under FAS 167 standard GSE-guaranteed transactions do not leave the underlying mortgage loans on the balance sheet of the originating IDI, however, the Safe Harbor Rule may have been thought unnecessary.

A significant portion of the conditions of the Safe Harbor Rule are described below as being applicable only to residential mortgage backed securities ("RMBS") transactions. However, it should be noted that the Safe Harbor Rule defines this class of transactions by reference to "securitizations in which the financial assets include *any* residential mortgage loans."[12] Even a very low concentration of residential mortgage assets would thus appear to trigger the more stringent conditions of the Safe Harbor Rule that apply to RMBS.

B. Conditions to the Safe Harbor

1. Risk Retention and RMBS Reserve

The Safe Harbor Rule provides that the securitization documents for a safe harbored transaction must require a 5 percent retention of credit risk on the transferred assets.[13] The credit risk retained "may be either in the form of an interest of not less than five (5) percent in each of the credit tranches sold" or "in a representative sample of the securitized financial assets equal to not less than five (5) percent of the principal amount of the financial assets at transfer." In allowing risk retention with respect to the assets, rather than the securitization tranches themselves, the FDIC was responding to concerns that the risk retention requirement "could cause securitizations that might otherwise qualify for sale accounting treatment" under FAS 166 and 167 "to not qualify for that treatment."[14] The retained

11 12 C.F.R. § 360.6(a)(7); 75 Fed. Reg. 60287, 60297 (Sept. 30, 2010).

12 See, e.g., 12 C.F.R. § 360.6(b)(1)(ii); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010) (emphasis added).

13 The formulation in various provisions of the Safe Harbor Rule that the "documents shall require" compliance with a specified condition, rather than a direct requirement that the IDI comply, was a change from the originally proposed form of the rule, aimed at addressing the need for rating agencies and other parties to be able to assess compliance with the rule at the outset. In addition, the change mitigated an unfavorable aspect of the rule as originally structured, which is that the consequences of noncompliance with the rule – uncertainty and the possible repudiation of securitization investments – fell not on the IDI charged with complying with the rule but on investors who were intended to benefit from it.

14 Proposing Release, 75 Fed. Reg. at 27471, 27479 (May 17, 2010).

interest may not be "sold or pledged, or hedged . . . except for the hedging of interest rate or currency risk" while the securitization is outstanding.[15]

The foregoing risk retention provisions will take effect prior to the more detailed interagency risk retention rules implementing Section 941(b) of the Dodd-Frank Act. However, the Safe Harbor Rule provides that when the Dodd-Frank rules become effective, "such final regulations shall exclusively govern" the risk retention requirement under the safe harbor.[16]

For RMBS transactions, the Safe Harbor Rule further provides that the documents must require "the establishment of a reserve fund equal to at least five (5) percent of the cash proceeds of the securitization" to cover repurchases of financial assets "for breach of representations and warranties."[17] The unused balance of the fund shall be released to the sponsor after 1 year from issuance. This reserve fund requirement is a separate requirement from the risk retention provisions and will not be superseded by the Dodd-Frank risk retention rules.

2. Disclosure

The Safe Harbor Rule provides generally that the documents for a securitization must require that "information about the obligations and the securitized financial assets shall be disclosed to all potential investors at the financial asset or pool level, as appropriate for the financial assets, and security level to enable evaluation and analysis of the credit risk and performance of the obligations and financial assets."[18] The disclosure requirement applies both for the initial sale "on or prior to issuance of obligations" and on an ongoing basis "at the time of delivery of any periodic distribution report and, in any event at least once per quarter."[19] The required information must "at a minimum" comply with the requirements of Regulation AB under the Securities Act "even if the obligations are issued in a private placement or are not otherwise required to be registered."[20] This reference to Regulation AB is particularly important in light of the extensive asset-level reporting and disclosure requirements currently proposed as amendments to Regulation AB and related rules under the Securities Act (so-called "Reg AB II").[21]

---

15 12 C.F.R. § 360.6(b)(5)(i)(A); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010).

16 12 C.F.R. § 360.6(b)(5)(i)(B); 75 Fed. Reg. 60287, 60291 (Sept. 30, 2010).

17 12 C.F.R. § 360.6(b)(5)(ii)(A); 75 Fed. Reg. 60287, 60290 (Sept. 30, 2010).

18 12 C.F.R. § 360.6(b)(2)(i)(A); 75 Fed. Reg. 60287, 60298 (Sept. 30, 2010).

19 Id.

20 Id.

21 See Securities Act Release No. 33-9117 (April 7, 2010); 75 Fed. Reg. 23328 (May 3, 2010).

In addition to several general references to the type of initial disclosure and reporting information that is required, the Safe Harbor Rule expressly provides that the securitization documents require that "the nature and amount of compensation paid to the originator, sponsor, rating agency or third-party advisor, any mortgage or other broker, and the servicer(s)" be disclosed, as well as "the extent to which any risk of loss on the underlying assets is retained by any of them for such securitization."[22] The securitization documents must also require disclosure of changes to this information on an ongoing basis.

For RMBS transactions, the Safe Harbor Rule additionally requires (i) disclosure of specified loan level information, (ii) that a representation and warranty address, and that the sponsor confirm, compliance with applicable regulatory standards and guidances for mortgage loans, (iii) disclosure of a third party diligence report on compliance with such standards and representations and warranties on the relevant financial assets and (iv) disclosure of any "ownership interest by the servicer or an affiliate of the servicer" in other whole loans secured by the same real property.[23]

An important general qualification to the disclosure requirements is that "[i]nformation that is unknown or not available to the sponsor or the issuer after reasonable investigation may be omitted,"[24] if the issuer expressly discloses that such information is unavailable.

3. <u>Transaction Structure</u>

Similarly to the condition applicable to securitizations under Regulation AB, a securitization qualifying under the Safe Harbor Rule "must be primarily based on the performance of financial assets that are transferred to the issuing entity and, except for interest rate or currency mismatches between the financial assets and the obligations, shall not be contingent on market or credit events that are independent of such financial assets."[25] Products such as synthetic securitizations, credit-linked notes or similar structured products are thus outside the scope of the Safe Harbor Rule.

In the case of RMBS, additional structural restrictions apply:

a. *RMBS capital structure*. The capital structure of the securitization is limited to six tranches. However, the rule provides an exception for prepayment allocations within the most senior class, and contemplates that a tranche may be further repackaged or securitized into additional tranches.

---

22 12 C.F.R. § 360.6(b)(2)(i)(D); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010).

23 12 C.F.R. § 360.6(b)(2)(ii)(A)-(C); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010).

24 12 C.F.R. § 360.6(b)(2)(i)(A); 75 Fed. Reg. 60287, 60298 (Sept. 30, 2010).

25 75 Fed. Reg. 60287, 60298 (Sept. 30, 2010).

b. *No RMBS external credit enhancement*. The obligations "cannot be enhanced at the issuing entity or pool level through external credit support or guarantees."[26] There are exceptions for loan-level mortgage insurance and GSE guarantees, as well as for support for the "temporary payment of principal and/or interest" by liquidity facilities. However, ABS financial guaranty policies such as those previously issued by monoline insurance companies would be disqualified.

c. *RMBS servicer standards*. Servicers must have specified authorities and responsibilities to take actions, including modifying assets "to address reasonably foreseeable default," and to maximize the value and minimize losses on the securitized assets. The securitization documents must require "industry best practices" for servicers and that servicers must "act for the benefit of all investors, and not for the benefit of any particular class of investors."[27] Requirements that a servicer make advances for delinquent payments of principal and interest must be limited to three payment periods unless qualifying reimbursement facilities are available.

d. *RMBS compensation provisions*. Compensation to rating agencies or "similar third-party evaluation companies" is required to be payable under the securitization documents in part over the five-year period after issuance of the obligations "based on the performance of surveillance services and the performance of the financial assets," with no more than 60 percent of such compensation being payable at closing.[28] Documents must also provide for compensation incentives for servicers for loss mitigation and other specified activities.

4. <u>Resecuritizations</u>

A resecuritization which includes underlying ABS does not qualify under the Safe Harbor Rule unless the disclosures that would be required by the Safe Harbor Rule for the assets underlying those Resecuritized ABS are made available to the investors in the resecuritization. A complete "drill down" of information on the underlying ABS asset pool would appear to be required, irrespective of the relevant asset concentration.

5. <u>Affiliate/Insider Sale Restriction</u>

The securitization documents must require that obligations issued in the securitization "shall not be predominantly sold to an affiliate (other than a wholly-owned subsidiary consolidated for accounting and capital purposes with the sponsor)" or to an "insider" of the sponsor.[29]

---

[26] 12 C.F.R. § 360.6(b)(1)(ii)(B); 75 Fed. Reg. 60287, 60298 (Sept. 30, 2010).

[27] 12 C.F.R. § 360.6(b)(3)(ii)(A); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010).

[28] 12 C.F.R. § 360.6(b)(4)(i); 75 Fed. Reg. 60287, 60299 (Sept. 30, 2010).

[29] 12 C.F.R. § 360.6(c)(1); 75 Fed. Reg. 60287, 60300 (Sept. 30, 2010).

CLEARY
GOTTLIEB

6. Other Requirements

Certain other basic documentation and structuring requirements apply, such as the requirement for the transaction to be an "arms length, bona fide securitization," for the securitization agreements to be in writing and reflected in the IDI's official records, for the securitization to be in the ordinary course of business and not in contemplation of insolvency, for adequate consideration, for transfers to be properly perfected, for the roles of servicer and sponsor to be documented separately, for securitized assets to be properly identified and cash proceeds not to be commingled, and certain other requirements. These are largely requirements retained from the 2000 Safe Harbor Rule.

C. Effect of the Safe Harbor Rule on Securitizations Treated as Sales

Where a securitization satisfies the conditions for sale accounting under GAAP (except for the "legal isolation" requirement itself), the Safe Harbor Rule confirms that the FDIC "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" the relevant transferred financial assets.[30]

D. Effect of the Safe Harbor Rule on Securitizations Treated as Financings

For a securitization accounted for as a secured financing, the Safe Harbor Rule does not actually prevent the repudiation power from being applied. Instead, the rule constrains the manner in which the repudiation power would be exercised. For a qualifying securitization, the Safe Harbor Rule provides for two alternatives in this respect.

First, if the FDIC as conservator or receiver "is in monetary default under a securitization due to its failure to pay or apply collections from the financial assets received by it in accordance with the securitization documents," and such default continues for 10 business days following a notice to the FDIC, the FDIC is deemed to consent "to the exercise of contractual rights" in accordance with the documents governing the securitization, including secured creditor remedies.[31] The exact circumstances that give rise to a "monetary default" are not clear. The Safe Harbor Rule could be read to state that monetary default and the resulting consent would arise independently from *either* a "failure to pay" – i.e. a default in the sense of a shortfall in scheduled distributions of principal or interest – *or* in the alternative due to a default arising from the FDIC's "failure to apply collections" per the securitization documents. The better reading, however, appears to be that monetary default requires both circumstances: i.e. that a default must have arisen "due to" a failure to pay the amounts actually collected. To the extent that creditors' remedies arise under contractual securitization documents following a shortfall in payment, even

30 12 C.F.R. § 360.6(d)(3); 75 Fed. Reg. 60287, 60300 (Sept. 30, 2010).

31 12 C.F.R. § 360.6(d)(4)(i); 75 Fed. Reg. 60287, 60288 (Sept. 30, 2010). Such consent is given under 12 U.S.C. § 1821(e)(13)(C) and 12 U.S.C. § 1825(b)—sections of the FDIA that would otherwise stay liquidation of collateral.

where available funds have been appropriately paid or applied, it is unclear whether such remedies would be covered by the Safe Harbor Rule.

Second, if the FDIC provides a written notice of repudiation of the securitization agreement, and the FDIC fails to pay specified damages in connection with such repudiation, the FDIC is similarly deemed to consent to the exercise of contractual remedies by the creditors in respect of the securitization. The required damages are specified as an amount equal to (i) the "par value of the obligations outstanding on the date of the appointment of the conservator or receiver" (less any interim payments of principal) plus (ii) "accrued interest through the date of repudiation in accordance with the contract documents to the extent actually received" from proceeds of the financial assets.[32] The "to the extent actually received" language – effectively making the required payment limited recourse to proceeds of the securitized assets -- appears to modify only the required payment of interest. The required payment of "par value" does not appear to be subject to a similar limitation of recourse. Thus, it is unclear what "par value" would be in the case of obligations that have experienced a writedown following realized losses in respect of principal in the asset pool. Similarly, the "par value" of securities that are in the form of residual or equity instruments is uncertain. Finally, the requirement for payment of "par value" plus "accrued interest" does not appear to include any makewhole payments or redemption premiums.

In either of the alternatives above, the deemed consent of the FDIC is subject to the proviso that "no involvement of the receiver or conservator is required" other than consents, waivers or transfers "in the ordinary course of business."[33] Also, the Safe Harbor Rule further provides that prior to a repudiation described above, or prior to the effectiveness of a consent following a monetary default, the FDIC (i) consents to the servicer making (or as servicer shall make) payments to the extent actually received on the financial assets in accordance with the securitization documents and (ii) consents to the servicer conducting its servicing activity (or as servicer shall perform such activity) in accordance with the transaction documents.

E. Loan Participations

The Safe Harbor Rule distinguishes "securitizations" from "participations" for purposes of the provisions of the rule. Thus, with respect to "transfers of financial assets made in connection with participations," the disclosure, risk retention, servicing standards, and other of the principal conditions to the Safe Harbor Rule are not applicable. The only condition imposed by Section 360.6(d)(1) of the Safe Harbor Rule on participations is that "such transfer satisfies the conditions for sale accounting treatment" under GAAP. This favorable treatment for participations is expressly extended to "last-in, first-out"

[32] 12 C.F.R. § 360.6(d)(4)(ii); 75 Fed. Reg. 60287, 60301 (Sept. 30, 2010).

[33] 12 C.F.R. § 360.6(d)(4)(i) and (ii); 75 Fed. Reg. 60287, 60301 (Sept. 30, 2010).

participations, provided that "the transfer of *a portion of* the financial asset" – as opposed to the entire participation interest – satisfies the conditions for sale accounting treatment.[34]

III. The Implications of the New Safe Harbor

The Safe Harbor Rule has important implications for securitization transactions effected after December 31, 2010. While the primary requirements of the rule – additional disclosure and risk retention requirements – overlap with parallel new requirements under Reg AB II and under the Dodd-Frank Act, respectively, the Safe Harbor Rule has significant incremental effects in these two areas. In the area of risk retention, the effect is primarily one of timing. The Safe Harbor Rule conditions become effective on December 31, 2010, whereas the Dodd-Frank implementing regulations will become effective one year after publication (for residential mortgage backed securities) and two years after publication (for other ABS), respectively, of the relevant implementing rules. As a result of the Safe Harbor Rule, therefore, the economic consequences of the 5 percent risk retention requirement will be felt before the implementation period envisioned by the Dodd-Frank Act.

In the case of the additional disclosure conditions, the Safe Harbor Rule requirements extend to circumstances beyond those contemplated by Reg AB II. While proposed amendments to Rule 144A, Rule 144 and Regulation D under the Securities Act in connection with Reg AB II may also compel privately placed ABS transactions to meet the disclosure and reporting requirements similar to those applicable to registered transactions, these amendments as proposed would only require such disclosure and reporting upon the request of investors. No such "upon request" condition is present in the Safe Harbor Rule. Moreover, the Safe Harbor Rule's conditions would apply even in circumstances not reached by Reg AB II, such as in transactions that are exempt under Section 3 of the Securities Act, Section 4(2) private placements and related "Section 4(1 ½)" secondary transfers, and transactions exempt under Regulation S.

The Safe Harbor Rule may also create investor uncertainty and impair investor expectations for securitizations that are accounted for as secured financings (generally by consolidation of the issuing entity under FAS 167), due to the absence of complete relief from the repudiation power. First, while as noted it is unclear what the "par value" would be of a securitization interest not in the form of debt, the provisions of the Safe Harbor Rule seem to leave open the ability of the FDIC to reclaim the equity or residual value of securitized assets – i.e. the value of the securitized assets over and above the "par value" of the obligations issued in the securitization -- in the event of an IDI insolvency. Equity interests that are not held by the IDI itself may thus lose the benefit of any gain in a receivership of the IDI. Similarly, no adjustment is made in the Safe Harbor Rule for obligations that may be trading at a premium or a discount – due to interest rate characteristics, currency features, maturity characteristics and so on. As noted above, payment at "par value" does not appear to include makewholes or other adjustments that might ordinarily be payable to address such characteristics. The allocation of prepayment

[34] 12 C.F.R. § 360.6(d)(1); 75 Fed. Reg. 60287, 60300 (Sept. 30, 2010).

risks associated with a mortgage pool among different classes of RMBS – a core feature of RMBS structures -- would appear to be subject to being upset in the event of a repudiation of an RMBS transaction accounted for as a financing. The adverse effects on investor expectations would be particularly substantial in the case of "interest-only" or "principal-only" interests.

The Safe Harbor Rule also creates uncertainty as to the effect of changes in accounting consolidation treatment that may take place after the initial securitization. FAS 167 provides for the possibility of reconsideration events resulting from changes in the ownership of interests in a VIE and a reassessment of what entity is the primary beneficiary that should consolidate a VIE. It is thus quite possible that a securitization initially accounted for as a sale could subsequently be brought on balance sheet by an IDI. The Safe Harbor Rule does not address what would happen in such a circumstance. Indeed, because the Safe Harbor Rule distinguishes securitizations not based on how they are actually accounted for, but on whether the *conditions* for sale accounting are met, the rule raises the prospect that a securitization erroneously accounted for as a sale might lose the protections of the Safe Harbor Rule after the fact.

Finally, the Safe Harbor Rule poses problems for "re-REMICs" and other re-securitizations of outstanding ABS. As noted above, existing ABS may be resecuritized only where the IDI complies with the new disclosure requirements as to such ABS on a "drill down" basis. However, agreements for existing assets would not give holders the right to obtain all of the information required under the Safe Harbor Rule, and no "grandfathering" or similar provision applies. This may prove a significant impediment to an IDI wishing to use resecuritization techniques to address existing inventories of ABS assets. This concern may, however, be mitigated by the carveout mentioned above for disclosure for information that is "unknown or not available to the sponsor or the issuer after reasonable investigation."

IV. Transactions Outside the Scope of the Safe Harbor Rule

It should be remembered that the conditions of the Safe Harbor Rule are not regulatory prescriptions. If an IDI does not need to avail itself of the safe harbor, it need not comply with the rule. In this respect, the primary motivation for compliance with the 2000 Safe Harbor Rule – accounting treatment – will no longer apply in most cases to the new Safe Harbor Rule. Because many securitizations can no longer be accounted for as off balance sheet, even with the benefit of the Safe Harbor Rule, IDIs that formerly complied with the safe harbor in order to assure themselves of off balance sheet treatment for a securitization have no reason to do so. The practical importance of the Safe Harbor Rule largely rests with the requirements of rated transactions. Rating agencies have not indicated definitively what comfort they might require regarding compliance with the Safe Harbor Rule in order to rate securitization interests of an IDI separately from the credit risk of the IDI.

Even in unrated transactions, securitization investors seeking a higher degree of certainty as to the results of a possible future FDIC receivership may of course also be concerned that an IDI comply with the Safe Harbor Rule. Nevertheless, outside the rating agency context, the importance of the Safe Harbor Rule is more uncertain. The FDIC has noted that the Safe Harbor Rule "is not exclusive, and it does not address any transactions that fall outside the scope of the safe harbor or that fail to comply with one or more safe harbor conditions."[35] And in the Safe Harbor Rule and accompanying memorandum, the FDIC has not asserted that its repudiation power will necessarily be applied to a securitization if the safe harbor conditions are not satisfied. The FDIC further notes that the repudiation power is not a power to avoid asset transfers or recover assets that are sold.[36] Accordingly, many purchases of assets from IDIs in connection with a securitization – for example, where the relevant IDI sells assets but is not a primary sponsor of the securitization -- can and should occur without the need for compliance with the safe harbor conditions.

The FDIC has also not asserted that the repudiation power is any more likely to apply to asset pledges or transfers that do *not* involve securitizations and do not comply with the conditions of Safe Harbor Rule. Thus, ordinary secured lending, covered bond transactions or other transactions not falling within the scope of a defined "securitization"—though they may be subject to repudiation—should not suffer any additional consequences for failure to comply with the rule. Moreover, while the Safe Harbor Rule seems necessarily to raise the prospect of "repudiation" of transactions entered into by certain subsidiaries of an IDI – <u>i.e</u>. issuing entities for securitizations -- as opposed to the IDI itself, the FDIC has not questioned basic legal standards of corporate separateness. The FDIC has long had criteria for recognizing the legal separation of a corporate subsidiary from an IDI, [37] and nothing in the materials accompanying the Safe Harbor Rule purports to revoke or overturn this guidance.

Even so, while the Safe Harbor Rule is cast as a non-exclusive safe harbor, the FDIC plainly intends the rule to have a prescriptive effect. Whether driven by rating agency concerns, a desire for greater investor certainty or otherwise, market participants face significant new burdens in complying with the conditions of the rule.

If you have any questions, please feel free to contact any of your regular contacts at the firm or Seth Grosshandler at (212) 225-2542 or Michael A. Mazzuchi at (202) 974-1572.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

[35] 75 Fed. Reg. 60287, 60289 (Sept. 30, 2010).

[36] <u>Id.</u>

[37] See Letter to Neil D. Baron, Esquire from John C. Murphy, Jr., FDIC General Counsel (April 9, 1986). In 2008, in its Covered Bond Policy Statement, the FDIC confirmed that "[t]he FDIC applies well-defined standards to determine whether to treat such entities as ''separate'' from the IDI. If a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a ''separate'' entity under applicable law, the FDIC as conservator or receiver has not applied its statutory powers to the subsidiary's or SPV's contracts with third parties." 73 Fed Reg. 43754, 43755 (July 28, 2008).

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax