HUNTON & WILLIAMS

CLIENT ALERT

FINANCIAL INDUSTRY RECOVERY CENTER

December 2009

FDIC Asset Sale Safe Harbor Proposal and Regulatory Capital Rule

On December 15, 2009 FDIC undertook a couple of rulemaking matters of importance to securitizations by regulated institutions.

1. *FDIC Safe Harbor for Sales of Assets in Securitizations*. In 2000, the FDIC adopted a legal isolation safe harbor providing that the FDIC would not use its contract repudiation powers to "unwind" or otherwise challenge the integrity of securitizations satisfying the criteria for treatment as sales under generally accepted accounting principles in the event of the insolvency or receivership of the sponsoring bank. Earlier this year, the Financial Standards Accounting Board adopted revised criteria for sales under GAAP (FAS 166 and 167), under which most securitizations would not qualify as sales for GAAP accounting purposes. If the FDIC were not to respect the integrity of such securitizations, the rating agencies would not be able to provide the requisite ratings that make securitizations by banks viable.

As a remedy for this, the FDIC issued an interim rule (effective through March 31, 2010) protecting existing securitizations that comply with the existing safe harbor until a new safe harbor is put in place. On December 15, 2009, the FDIC issued an advance notice of proposed rulemaking ("ANPR") regarding a new safe harbor available to insured institutions selling assets in connection with securitizations. An ANPR is used to elicit comments with in 45 days on the broad outlines of, or issues to be addressed in, a proposed rule and to provide a regulator with background information on the area of the proposed rule.

View the FDIC's ANPR.

In connection with the FDIC's ANPR, the Comptroller of the Currency, John C. Dugan, issued a press release on December 15, 2009 describing his views and expressing some concerns with some of the proposals described in the FDIC's ANPR.

View Comptroller Dugan's press release.

The FDIC's ANPR contemplates that future securitizations by insured institutions would have to satisfy certain conditions in order for those securitizations to be respected by the FDIC in an insolvency or receivership of the insured institution. Furthermore, the FDIC's ANPR proposes that securitizations backed by residential mortgages meet certain additional requirements. In order to be respected, the FDIC's ANPR inquires whether securitizations should include the following features, among others:

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- The bank must maintain 5 percent credit exposure on the assets in the transaction (on vertical strip basis or by retaining a representative sample of the assets).
- If the transaction is not registered under the Securities Act of 1933, the transaction must nevertheless satisfy all Reg AB requirements.
- The transaction may not be a synthetic securitization.
- If the assets are residential mortgages, the FDIC's ANPR inquires whether the following additional requirements should apply:
  - the loans must be seasoned at least 12 months;
  - the sponsoring bank must affirm compliance with all origination legal requirements and agency requirements, and the loans must be underwritten at a fully indexed rate based upon documented income;
  - no more than 80 percent of the fees to the lender, the sponsor, the rating agencies and the underwriters can be paid at closing and the remaining fees must be paid over a five-year period, based upon asset performance;
  - no external credit enhancement may be used at the pool level; however temporary liquidity may be provided and individual assets may be guaranteed or insured;
  - the servicer must have a duty to mitigate losses on a net present value basis, for the benefit of all investors and not any particular class; the servicer must have the ability to modify loans to mitigate losses; and servicing fees must provide an incentive for the servicer to mitigate losses;
  - in the absence of reimbursement or financing facilities, advancing on delinquent loans may be required for only three months; and
  - the transaction may have no more than six credit tranches and cannot include any sub-tranches; however, the most senior tranche may include sequential pay sub-tranches.

2. *Regulatory Capital.* The FDIC also issued a final rule on regulatory capital matters relating to the implementation of FAS 166 and FAS 167. The other federal banking regulators, however, have not joined the FDIC on this final rule, so further changes may yet be made.

View the FDIC's final rule.

FAS 166 and FAS 167 have the effect of causing many previously off-balance sheet assets and any future asset that does not satisfy the requirements for off-balance sheet treatment under FAS 166 or that is consolidated under FAS 167 to be either brought back or remain on balance sheet, with a resulting effect on a bank's risk-based capital requirements. To address this, the FDIC's final rule provides for (a) a two-quarter delay, at the option of the bank, for the implementation by a bank in recognizing prior existing assets brought or remaining on balance sheet by FAS 166 and FAS 167 and (b) a two-quarter phase-in (following the optional two-quarter delay in implementation) of capital resulting from the assets being on balance sheet. There will be no capital relief where the bank provided implied or voluntary support and no relief from leverage ratio requirements.

The FDIC's final rule also provides that asset-backed commercial paper conduits will be on balance sheet, with no exemptions or other relief available. It also rejects the industry's interpretation of Basel II's internal assessment approach that this approach could be applied to conduit exposures by saying that such approach is available only to off-balance sheet ABCP conduits and exposures.

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