

Grappling With The FDIC's New Rule Proposals

Law360, New York (June 17, 2010) -- The foundation of securitization as a financing technique is the concept of legal isolation. Specifically, the assets transferred by a company to a separate legal entity, which assets will act as collateral for securities issued by such separate legal entity, must be legally isolated from the insolvency risk of the transferor company.

In the event that such transferor company is a regulated depository institution (i.e., a bank), the insolvency of the bank would not be governed by a bankruptcy proceeding, but instead by the powers of the Federal Deposit Insurance Corporation through a conservatorship or receivership proceeding under the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811 et seq. (the "FDIA").

The FDIA, and the FDIC's rules and regulations thereunder, sets forth a comprehensive regime for receiverships and conservatorships of insured depository institutions for whom the FDIC acts as receiver or conservator. In that regard, the FDIA gives to the FDIC an extraordinary power — the power to repudiate burdensome contracts — which does not have an analogous provision in the Bankruptcy Code.

In the context of securitizations, the accounting profession and securitization industry had been concerned that the FDIC, at least theoretically, could repudiate transaction agreements for securitizations, reclaim as property of the receivership financial assets that had purportedly been conveyed, and thereby compromise the legal isolation of the assets upon which the securitization was predicated.[1]

Rule 360.6

In response to the industry's concern about the impact of the FDIC's repudiation power, the FDIC adopted, in September 2000, Rule 360.6, 12 C.F.R. § 360.6.

Rule 360.6 provided that the FDIC shall not disaffirm or repudiate contracts or reclaim financial assets transferred by an insured depository institution in connection with a securitization, provided that such transfer generally meets all conditions for sale accounting treatment under generally accepted accounting principles ("GAAP"). Such sale accounting conditions, at the time of the enactment of Rule 360.6, were set forth under Financial Accounting Standards ("FAS") No. 140.

In the spring of 2009, the accounting profession adopted more rigorous sale accounting conditions pursuant to FAS 166, which amended FAS 140 and is applicable to transactions generally occurring on or after Jan. 1, 2010.

These new accounting standards affect whether transfers qualify for sale treatment and legal isolation, whereas other newly adopted accounting standards, under FAS 167, affect whether securitization vehicles must be consolidated with transferors of assets for financial reporting purposes.

Taken together, these new GAAP modifications and the likely accounting treatment of securitization transfers called into question whether the “safe harbor” of Rule 360.6 would continue to be applicable to securitization transactions.

Interim Rule

In response to industry concerns, the FDIC published, in November 2009, an interim rule (the “Interim Rule”) which effectively extended the Rule 360.6 “safe harbor” for securitizations issued before March 31, 2010.

Specifically, the Interim Rule provided that the FDIC shall not disaffirm or repudiate contracts or reclaim financial assets transferred by an insured depository institution in connection with a securitization, so long as such transfer generally satisfied the conditions for sale accounting treatment set forth by GAAP in effect for reporting periods before Nov. 15, 2009.

The extension of the “safe harbor” for securitization transfers effected before March 31, 2010, created the somewhat unusual result of applying certain accounting rules (i.e., FAS 140) to an analysis even though, as of 2010, such rules were generally no longer applicable under GAAP.

Final Rule

As the March 31, 2010, Interim Rule deadline approached, and in light of comments received by the FDIC on aspects of the Interim Rule, the FDIC, in March 2010, extended the transitional “safe harbor” until Sept. 30, 2010 (the “Final Rule”), again so long as those securitizations issued would have complied with the preexisting Rule 360.6 under GAAP in effect prior to Nov. 15, 2009 (i.e., FAS 140).

Notice of Proposed Rulemaking

Subsequent to the adoption of the Final Rule, the FDIC adopted an Advance Notice of Proposed Rulemaking and, last month, a “Notice of Proposed Rulemaking Regarding Safe Harbor Protection for Treatment by the Federal Deposit Insurance Corporation as Conservator or Receiver of Financial Assets Transferred by an Insured Depository Institution in Connection With a Securitization or Participation After September 30, 2010” (the “NPR”).

The NPR, rather than linking the FDIC’s “safe harbor” to a determination of sale accounting under GAAP, instead conditions its “safe harbor” on various securitization qualifications, such as relating to disclosure, documentation, capital structure and compensation.

Such securitization requirements are comparable, but — importantly — not identical to the securitization reform requirements currently proposed by the U.S. Securities and Exchange Commission in amendments to Regulation AB, and by the financial reform legislation currently being considered in Congress.

While there figures to be vigorous comment by the industry to the NPR, it is nevertheless safe to predict that the new FDIC “safe harbor” for transactions entered into after Sept. 30, 2010, will focus more comprehensively on securitization mechanics than on accounting isolation.

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The opinions expressed are those of the author and do not necessarily reflect the views of the firm, its clients, or Portfolio Media, publisher of Law360.

[1] The FDIC would have to pay damages to the securitization vehicle for any repossessed assets; however, those damages might be less than the full amount of principal and interest due on outstanding securities backed by such assets.