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Mapping the Harbor: FDIC Clarifies Securitization Safe Harbor Rules

On September 27, 2010, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") adopted new rules (the "Securitization Rules")[1] to apply to securitizations issued after the expiration on December 31, 2010 of the transitional safe harbor rule then in effect. Like the earlier safe harbor provisions, the Securitization Rules address the treatment of securitization transactions in the context of the receivership or conservatorship of an insured depository institution ("IDI"). These new rules were meant to clarify the criteria a securitization must satisfy in order for the FDIC to forebear exercising its statutory repudiation powers with respect to assets transferred into such securitization by an IDI. However, the broadly framed nature of certain of these criteria raised questions with respect to their practical application, especially with regard to RMBS structures. In August 2011, representatives of the American Securitization Forum ("ASF") met with the FDIC to clarify several provisions of the Securitization Rules. On February 7, 2012, the FDIC responded to ASF's interpretive requests with guidance on six aspects of the Securitization Rule: Disclosure, Servicer Best Practices, Reserve Fund for Repurchases, Underwriting of Obligations, Six-Credit Tranche Limitation, and Limitation on Advancing.[2] The following is a discussion of these clarifications.

1 75 Fed. Reg. 60287 (Sept. 30, 2010).

2 Letter from Federal Deposit Insurance Corporation to American Securitization Forum (Feb. 7, 2012).

Disclosure

The Securitization Rule amended 12 C.F.R. Part 360 to include various disclosure requirements applicable to all securitization transactions, including the requirement that the sponsor, issuing entity and/or servicer, as applicable, provide disclosure regarding "the policies governing delinquencies, servicer advances, loss mitigation, and write-offs of financial assets…."[3] The language, as amended, offered little guidance regarding what level of detail was needed to satisfy these disclosure requirements (*e.g.*, would servicing manuals need to be reproduced as part of the disclosure materials). In its response to ASF, the FDIC indicated that this requirement would be satisfied by descriptions of the material aspects of the material provisions of such policies. For these purposes, "materiality" could be interpreted based on federal securities law standards of materiality.

Servicer Best Practices

Another feature added by the Securitization Rule, albeit solely with respect to RMBS transactions, was the requirement "that servicers apply industry best practices for asset management and servicing."[4] How "industry best practices" should be determined was not specified; nor were the implications for an existing securitization of any evolution of

3 12 CFR §360.6(b)(2)(i)(B).

4 12 CFR §360.6(b)(3)(ii)(A).

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industry best practices following the issuance of the related securities. ASF had recommended that the servicing agreement for a securitization be permitted to identify a benchmark standard for measuring industry best practices. Under this recommendation, so long as the benchmark selected is reasonably consistent with industry best practices at the time of issuance of the related securities and is disclosed to investors in the related offering document, there would be no requirement to update the standard if industry best practices were to change after the issuance of the related securities. In its response to this request for clarification, the FDIC confirmed that the interpretation given to these provisions was acceptable.

Reserve Fund for Repurchases

Another safe harbor provision applicable only to RMBS transactions was the requirement for the "establishment of a reserve fund equal to at least five (5) percent of the cash proceeds payable to the sponsor to cover the repurchase of any financial assets required for breach of representations or warranties."[5] The unused balance, if any, of such fund would be released to the sponsor one year after the date of issuance. ASF advocated an interpretation of this requirement that would permit the establishment of such an account outside the securitization's deal documents, subject to the requirements that (a) permitted withdrawals from the fund are limited to (i) repurchases of any financial assets required as a result of breaches of representations and warranties, (ii) releases of amounts in excess of the required 5% balance and (iii) releases of amounts to the sponsor following the one-year anniversary of closing and (b) the account is pledged to the RMBS trustee under a security agreement effective to perfect a security interest in the assets of the reserve fund in favor of the RMBS trustee for the benefit of the securityholders. The FDIC endorsed this interpretation subject to the additional requirement that the reserve fund be established at a bank located in the United States and be funded prior to the date on which the securities are issued in the related securitization.

Underwriting of Obligations

The Securitization Rule imposes a restriction on all securitization transactions that the obligations issued in such 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 insider of the sponsor."[6] ASF expressed concerns that this restriction would interfere with aggregated shelf structures where a broker-dealer affiliated with the sponsor acts as the principal underwriter. ASF suggested a carve-out that would permit the sale of securities in a securitization to an affiliated broker-dealer that purchases such securities with a view to reselling them to non-affiliates, so long as (i) the securitization was "entered into in the ordinary course of business, not in contemplation of insolvency and with no intent to hinder, delay or defraud the bank or its creditors" and (ii) the transfer was made for adequate consideration. Although the FDIC was amenable to this interpretation, it did impose the additional condition that such affiliated broker-dealer acquires the securities with a view to distributing them and, at the time it purchases the securities, the affiliated broker-dealer must sell at least 51% of the securities it acquires to entities that are not affiliates (other than wholly-owned subsidiaries of the sponsor consolidated for accounting and capital purposes) or insiders of the sponsor.[7] It remains a condition to such transaction that the other requirements of the Securitization Rule (e.g., Section 360.6(c)(3) and (4)) be satisfied. It remains to be seen how these requirements would be addressed in unfavorable markets where the affiliated broker-dealer tries, but is unable to sell the required level of securities.

Six-Credit Tranche Limitation

Addressing what it perceived to be confusingly complicated transaction structures in RMBS securitizations, the FDIC imposed a limit of no more than six credit tranches in the capital structure of any RMBS securitization and prohibited the use of sub-tranches, grantor trusts and other structures that would impair the goal of easy-to-understand capital structuring. Despite this general prohibition, the Securitization Rule does permit the most senior tranche to include time-based, sequential pay or planned amortization and companion sub-tranches.[8] ASF sought two points of clarification regarding common structures in RMBS transactions: non-economic residual classes in real estate mortgage investment conduit

5 12 CFR §360.6(b)(5)(ii)(A).

6 12 CFR §360.6(c)(1).

7 Letter from Federal Deposit Insurance Corporation to American Securitization Forum, *supra*.

8 12 CFR §360.6(b)(1)(ii)(A).

("REMIC") transactions and interest-only/principal-only ("IO/PO") classes in ratio-stripped transactions.

Regarding non-economic REMIC residual classes, ASF argued that these classes are used solely to satisfy a tax structuring requirement – REMICs cannot be structured without a single class of residual interests. Residual interest classes are generally structured to receive no interest distributions and only a nominal principal distribution. The presence of a REMIC residual class in a transaction does not provide credit support to any other class of securities in such transaction. Given the tax law requirement for REMIC residual classes and the limited function they play in a securitization's capital structure, ASF urged the FDIC not to count these classes against the six-tranche limit. The FDIC confirmed that including REMIC residual classes in this limit was not its intent, so long as the original principal balance of any such class did not exceed $100 and that, at issuance, it is not contemplated that there will be more than *de minimis* distributions on such class.

Regarding IO/PO classes in ratio-stripped transaction structures, ASF argued that these classes should fall into the exception for "companion" sub-tranches under the Securitization Rule. The Securitization Rule does not provide a definition for "companion" sub-tranches. ASF argued for an interpretation of this concept that would not count IO/PO classes in ratio-stripped transactions against the six-tranche limit. According to ASF, IO/PO classes are correctly understood as a necessary support for the structuring of AAA-rated, single coupon senior RMBS tranches. In this role, ASF argued, ratio-stripped structures (which are dependent on IO/PO classes) make possible more certain returns to investors by minimizing the impact of fluctuating prepayment activity – a result analogous to the motivation behind the FDIC exception for "planned amortization" sub-tranches. According to ASF, counting IO/PO classes against the six-tranche limitation would actually result in less clear transaction structures by leading to smaller numbers of large subordinated tranches which would tend to render risks and decision-making process for such classes harder to model. Additionally, a reduction in the number of subordinated tranches could, according to ASF, make non-conforming loans more expensive for borrowers and could hinder the return of private RMBS markets. The FDIC was willing to accept ASF's interpretation, subject to the qualification that IO/PO classes would not count against the six-tranche limitation only so long as (i) the transaction structure provides only for a single IO class and/or a single PO class, each sized based on the difference between net mortgage rates and market rates of interest at the time of issuance, (ii) such classes do not provide credit enhancement to the transaction, (iii) each of the credit tranches (other than the most subordinated tranche) bears interest at a fixed rate, and (iv) the net mortgage interest rates of at least 90% of the underlying loans do not vary by more than 100 bps from the weighted average coupon of all of the underlying loans as of the cut-off date.

Limitation on Advancing

The Securitization Rule mandates that the servicing agreement may not "require a primary servicer to advance delinquent payments of principal and interest for more than three payment periods, unless financing or reimbursement facilities are available."[9] Repayment under such financing or reimbursement facilities is not to be dependent on foreclosure proceeds. ASF argued that the concerns addressed by this provision were best understood as targeted at affiliated servicers, which might be motivated to keep deals running and/or to maintain value in residual tranches due to their relationship with the transaction's sponsor. ASF advocated that unaffiliated servicers be exempted from these restrictions, with or without additional limitations placed on their activities. The FDIC rejected this suggestion, stating that its firm policy was that the Securitization Rule restrictions would apply to all servicing agreements, whether the servicer involved was independent or not.

Conclusion

The efforts of the FDIC to clarify a range of issues under the Securitization Rule will doubtless be appreciated by market participants.

This update was authored by

Patrick D. Dolan
(+1 212 698 3555; patrick.dolan@dechert.com),

Malcolm S. Dorris
(+1 212 698 3519; malcolm.dorris@dechert.com),

Robert H. Ledig
(+1 202 261 3454; robert.ledig@dechert.com),

Ralph R. Mazzeo
(+1 215 994 2417; ralph.mazzeo@dechert.com) and

Joshua A.O. Strathman
(+1 949 442 6016; joshua.strathaman@dechert.com).

9 12 CFR §360.6(b)(3)(ii)(B).

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Contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the authors listed.

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