



Federal Deposit Insurance Corporation
Washington, D.C. 20429

MEMORANDUM TO: Board of Directors

FROM: William F. Kroener III
General Counsel

James L. Sexton
Director
Division of Supervision

Mitchell Glassman
Director
Division of Resolutions and Receiverships

DATE: July 26, 2000

SUBJECT: Final Rule Regarding the Treatment of Securitizations
and Participations in Conservatorships and
Receiverships

This memorandum proposes that the Board of Directors adopt a final rule entitled "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" (the "final rule"). If adopted by the Board of Directors, the final rule would be codified at 12 C.F.R. § 360.6. The text of the final rule is contained in the proposed document for publication in the Federal Register, attached as Exhibit "A."

The final rule would resolve issues raised by Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 125"), as promulgated by the Financial Accounting Standards Board ("FASB"). More specifically, the issues relate to whether the FDIC's statutory authority to repudiate contracts pursuant to Section 11(e) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)) and the statutory requirements of Section 13(e) of the Act (12 U.S.C. 1823(e)) regarding the enforceability of agreements against the FDIC would prevent a transfer of

Memorandum to Board of Directors

Proposed Final Rule

financial assets by an insured depository institution in connection with a securitization or in the form of a participation from satisfying the "legal isolation" condition of SFAS 125. Failure to satisfy this condition would prevent such a transfer from being accounted for as a sale in financial statements and reports prepared in accordance with generally accepted accounting principles ("GAAP"). As a result, the transferred assets would continue to be carried as assets of the institution, and the transfer would be reported as a secured borrowing.

The final rule provides as follows:

- The FDIC will not, by exercise of its statutory power to repudiate contracts, recover, reclaim, or recharacterize as property of the institution or the receivership financial assets that were transferred by an insured depository institution in connection with a securitization or in the form of a participation, provided that the transfer meets all conditions for sale accounting treatment under GAAP.
- The rule defines both "securitization" and "participation," with "participation" specifically limited to those that are "without recourse" to the selling or "lead" institution.
- The rule does not apply unless the insured depository institution received adequate consideration for the transfer of financial assets at the time of the transfer, and the documentation effecting the transfer of financial assets reflects the intent of the parties to treat the transaction as a sale, and not as a secured borrowing, for accounting purposes.
- The rule will not be construed as waiving or limiting any other rights or powers of the FDIC as conservator or receiver of an insured depository institution to take any action or exercise any power not specifically addressed in the rule, including but not limited to any rights or powers of the FDIC regarding any transfer taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution.
- The FDIC will not seek to avoid an agreement executed by an insured depository

Memorandum to Board of Directors

Proposed Final Rule

institution in relation to a transfer of financial assets in connection with a securitization or with respect to a participation solely because such agreement was not executed contemporaneously with the acquisition of the financial assets by the insured depository institution.

- Any repeal or amendment of the rule by the FDIC will not apply to any transfers of financial assets made in connection with a securitization or participation that was in effect before such repeal or amendment.

Background

Over the last fifteen years, asset-backed securitization has expanded from residential mortgages to commercial mortgages to all types of business receivables, including the securitization of cash flows from sales of audio recordings.¹ During this period, asset-backed securitization has developed into one of the most significant funding sources for American and international corporations. The total volume of asset-backed securities issued in the United States reached \$1.5 trillion as of year end 1999, with newly issued securities approximating \$280 billion during both 1998 and 1999.

Securitization simply involves the pooling of loans or other financial assets and the sale of securities backed by the cash flows from those assets. In a simplified example, the originating bank sells the assets to a trust or other "special purpose corporation" in return for a lump sum cash payment and, in some cases, beneficial interests in the assets. The trust or "special purpose corporation" then sells securities to investors and holds the assets for their benefit. The investors, principally institutional rather than retail investors, receive payments based on the cash flow from the pooled assets.

For the originating banks or businesses, asset securitization can provide significant financial and regulatory benefits. First, it usually permits lower cost financing, because the

¹ Lois Lupica, "Asset Securitization: The Unsecured Creditor's Perspective," 76 Texas L. Rev. 595, 602 (Feb, 1998).

Memorandum to Board of Directors

Proposed Final Rule

resulting securities represent a better credit risk than the originator. Second, securitization opens new alternative sources of funding and increases the participation of the business in the financial markets. Many institutional investors could not directly purchase the assets, but can purchase the investment-grade securities created by the securitization. Third, securitization also may permit the removal of the securitized assets from the originator's balance sheet for financial and regulatory accounting purposes and may thereby free equity capital that otherwise would be used to support the assets on the institution's balance sheet. (In practice, however, this capital benefit may be limited from a regulatory perspective if the institution retains credit risk.) Fourth, securitization offers opportunities to more effectively manage assets produced by the originator's business and to improve its liquidity. The pooling and securitization of assets allows the originator to more precisely match the duration and market characteristics of its assets and liabilities. In addition, the originator can reinvest the cash received by a securitization for optimal returns. Fifth, these transactions may allow an originator to transfer the credit risks associated with a pool of assets to the investors. In practice, however, this benefit may be limited because the originator may retain an interest in subordinated tranches,² which are repaid only after prior tranches, or may provide other forms of credit enhancement to the investors. In addition, the originator will seek to maintain the credit quality of the pool and to avoid any defaults on the securities in order to preserve a high investment rating for this and future transactions. Finally, securitization transactions may provide additional fee income to the originator for management or other services in connection with the pooled assets.

The critical component of the securitization process is the isolation of the pooled assets, and their cash flows, from the originating business. If the assets are not sufficiently isolated from the originator, the transaction will be treated as a secured borrowing. If the transaction is treated as a secured borrowing, the originator must continue to carry the assets on its balance sheet and hold capital against the assets. In addition, unless the assets are truly isolated from the originator, the credit enhancements necessary to achieve an investment-grade rating for the

² Tranches are risk or maturity classes into which the pooled assets are divided in order to enhance the income and risk characteristics of the more senior classes of securities.

Memorandum to Board of Directors

Proposed Final Rule

securities will be ineffective.

While asset-backed securitization has expanded rapidly during recent years, loan participations remain an important method for insured banks and thrifts to diversify their credit risks, participate in transactions in which they might be unable to participate alone, and more effectively manage their assets. In a loan participation, an originating bank sells undivided interests in a loan or loans. Loan participations are particularly important for smaller institutions, which may be unable to accumulate a large enough pool of assets for securitization. Smaller banks also use loan participations in order to extend credit to customers whose borrowing needs exceed the bank's legal lending limit. As in securitizations, an actual sale or transfer without recourse of the undivided interest in the loan or loans is essential to achieve the credit risk reductions and concomitant regulatory capital reductions for a participation transaction.

In June 1996, the Financial Accounting Standards Board adopted SFAS 125.³ This standard sought to resolve whether a transfer of financial assets should be accounted for as a "sale" or as a "secured borrowing." This is an important distinction. If the transfer is treated as a "sale," the transferor can remove the assets from its balance sheet and, in the case of insured banks and thrifts, not hold leverage capital for any off-balance sheet exposure it may have in those assets. Depending on the nature and extent of credit risks retained in the assets that have been sold, the amount of risk-based capital that must be held to support the retained risk may be lower than the amount of risk-based capital held against the assets prior to their sale. If, however, the transfer creates only a "secured borrowing," then the transferring bank or thrift must retain the assets on its balance sheet and retain capital against them. Under SFAS 125, the principal dividing line between a sale and a secured borrowing is whether the transferor has surrendered control over the transferred asset.

³ SFAS 125 applies to all public and private companies, including insured depository institutions, to all public and private offerings, and to all financial assets. While it must be followed by insured banks and thrifts for regulatory reporting purposes, it does not govern the risk-based capital rules for insured banks and thrifts.

Memorandum to Board of Directors

Proposed Final Rule

While simple in concept, the distinctions between a sale and a secured borrowing are difficult to draw -- particularly with transactions that break up financial assets and liabilities into components with different credit and other risk characteristics, which may then be treated as separate assets and liabilities. Prior to SFAS 125, the accounting standards generally required that the transferor account for all components of the transfer as an inseparable unit. In an era in which financial assets are subdivided into different cash flow classes and risk components, these “all or nothing” standards were difficult to apply and created inconsistencies. In contrast, SFAS 125 permits separate accounting treatment for separate financial components and focuses on the effectiveness of the surrender of control by the transferor.

Under SFAS 125 (as originally issued in 1996), a transfer may be accounted as a “sale” if the transferor has surrendered control over the assets. This is demonstrated if, and only if, the transaction meets three conditions:

1. The transferred assets are “isolated from the transferor” -- even in bankruptcy or receivership;
2. The transferred assets can be freely pledged or exchanged by the transferee or, if the transferee is a “qualifying special purpose entity,”⁴ by the holders of beneficial interests; and
3. The transferor does not maintain effective control over the transferred assets by retaining either a) the duty and right to repurchase or redeem the assets before their maturity or b) the right to repurchase or redeem transferred assets that are not readily obtainable.

After the transfer, the transferor must continue to carry on its balance sheet any retained interest in the assets, but it may remove from its balance sheet the assets sold in the transaction.

⁴ A “qualifying special purpose entity,” in general, is a trust, corporation or other legal entity with standing at law separate from the transferor. The special purpose entity is effectively limited to holding and managing the transferred assets. SFAS 125 states explicitly that the requirement that the special purpose entity have standing at law separate from the transferor precludes the transferor from holding all of the beneficial interests in the special purpose entity.

Memorandum to Board of Directors

Proposed Final Rule

The critical issue for insured depository institutions that would be subject to FDIC receivership or conservatorship is the “legal isolation” element identified in the first condition, noted above. According to SFAS 125, “legal isolation” requires that the assets be “put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.”

The importance of this element to the securitization or loan participation is easily illustrated. An essential component of an asset-backed securitization or a loan participation is the isolation of the transferred assets and their cash flow from any insolvency of the originator. In a securitization, this is accomplished through creation of a bankruptcy-remote structure. In a participation this is accomplished through the sale of an interest in the loan. Not only does this logically support the conclusion that the assets were truly “sold,” but the transaction structure also permits potential investors in the asset-backed securities or purchasers of the participation interests to separate the credit quality of those interests from the financial characteristics of the originator. As a consequence, “legal isolation” is critical to the expanded liquidity and more efficient utilization of assets that many insured banks and thrifts have been able to obtain through securitizations and participations. In turn, this expanded liquidity for previously illiquid assets has provided additional funds for credit to businesses and consumers.

In its Implementation Guidance to SFAS 125 (as originally issued in 1996), the FASB comments that whether transferred assets have been “isolated from the transferor” depends on the circumstances, including whether it “would likely be deemed a true sale at law” and “other factors pertinent under applicable law.” In paragraph 58 of its Implementation Guidance, FASB states that securitization by an entity that is *not* subject to the Bankruptcy Code, such as an insured bank or thrift subject to FDIC receivership, may isolate transferred assets by transferring the assets directly to a special purpose entity.⁵

⁵ FASB noted that it was unlikely that assets transferred directly to a special purpose entity by a company subject to the Bankruptcy Code would be “legally isolated.” This conclusion was based on FASB’s view that a successful challenge by the bankruptcy trustee to the transaction would mean that the holders of the securities or participation interests would become general creditors of the estate and not

Memorandum to Board of Directors Proposed Final Rule

Unfortunately, this conclusion was based on a misunderstanding of the FDI Act. As FASB then understood the FDIC's powers as conservator or receiver, assets transferred by a U.S. bank,

could only be obtained by the receiver if it makes the investors completely whole, that is, the investors must be paid compensation equivalent to all the economic benefits contained in the transferred assets, including the bargained-for yield, before the FDIC could obtain those assets.

SFAS 125, ¶ 58. As interpreted by FASB, if the FDIC were to repudiate a transfer of assets in connection with a securitization, then “mak[ing] the investors completely whole” would require that the FDIC pay the “investors compensation equivalent to all principal and interest earned to date, in effect making the investors whole” through the date of the payment. SFAS 125, ¶ 121. However, the “actual direct compensatory damages” that a party to a repudiated contract is entitled to are to be determined as of “the date of the appointment of the conservator or receiver.” 12 U.S.C. § 1821(e)(3)(A). As a result, under the FDI Act, the counterparty will not receive all principal and interest earned to the date of the payment, as contemplated by the FASB.

On December 22, 1997, the FASB staff issued a statement noting that it had recently become aware that FDIC powers were broader than stated in SFAS 125. The FASB staff indicated that FASB would investigate the issue and then issue guidance as appropriate. In the interim, the FASB staff stated that it believes that it is reasonable for parties to conclude that the FDIC's powers do not preclude sale accounting for transfers subject to the FDIC's power to repudiate contracts. In fact, the FASB staff went further and emphasized the point by stating that it would not be reasonable for parties to change their “sale” conclusions until FASB completes its investigation and issues additional guidance.

receive full compensation for their interests.

**Memorandum to Board of Directors
Proposed Final Rule**

FDIC's Response and Notice of Proposed Rulemaking

Since December 1997, FDIC staff has discussed these issues with the FASB staff, representatives of the American Institute of Certified Public Accountants, accounting firms, banks, and law firms involved in securitization programs. The FASB staff has advised the FDIC staff that sale accounting treatment will not be possible under FASB 125 for securitizations and loan participations by depository institutions unless issues raised by the FDIC's powers as receiver with respect to the legal isolation condition are resolved. On June 28, 1999, the FASB issued proposed amendments to SFAS 125 which, if and when they are adopted, will override the FASB staff's December 1997 statement on sale accounting for transfers by depository institutions.

Based on discussions with the aforementioned parties, FDIC staff drafted a proposed policy statement regarding the FDIC's repudiation power that provided that the FDIC would not seek to recover or reclaim assets that were transferred by a depository institution in connection with a securitization or in the form of a loan participation.

The majority of comments received regarding the proposed policy statement after its publication in the Federal Register in December 1998 stated that only a regulation, as opposed to a nonbinding Statement of Policy, would be sufficient to resolve the issue. These comments also raised the issue of the effect of a Statement of Policy or regulation on securitizations and participations entered into by depository institutions in reliance thereon if the FDIC revoked the policy or regulation in the future. Commenters also raised the issue that the legal isolation test of SFAS 125 could not be met because a security agreement or participation agreement generally would not meet the requirement of 12 U.S.C. § 1823(e) that to be enforceable against the FDIC, an agreement must, *inter alia*, be executed by the depository institution contemporaneously with the acquisition by the institution of the asset that is the subject of the agreement.

In September 1999, the FDIC withdrew the proposed policy statement and published a notice of proposed rulemaking in the Federal Register. For the most part, the proposed rule was

Memorandum to Board of Directors Proposed Final Rule

substantively identical to the proposed policy statement, but provided further that (i) the FDIC shall not seek to avoid an agreement executed by an insured depository institution in relation to a transfer of financial assets in connection with a securitization or with respect to a participation solely because such agreement was not executed contemporaneously with the acquisition of the financial assets by the insured depository institution; and (ii) any repeal of the rule by the FDIC is to operate prospectively only.

Discussion of Comments Regarding the Proposed Rule

The FDIC received 14 comment letters concerning the proposed rule. The vast majority of the commenters expressed support for the rule.

One commenter, the American Institute of Certified Public Accountants (“AICPA”), raised the issue of the effect of any future repeal or amendment of the rule. The final rule addresses this concern by providing that any repeal or amendment of the rule by the FDIC shall not apply to any transfers of financial assets made in connection with a securitization or participation that was in effect before such repeal or amendment. The AICPA also specifically requested that FDIC counsel issue, concurrently with the adoption of the rule, a legal opinion confirming that the rule will bind receivers or conservators appointed after the repeal or amendment of the rule. In the AICPA’s view, such an opinion would be necessary for legal specialists “...to render opinions that provide reasonable assurance that the legal isolation condition of SFAS 125 is met.” Four commenters endorsed the issuance of an FDIC legal opinion if this would resolve the issue. Two other commenters expressed the view that such an opinion was unnecessary.

Staff recommends that the FDIC Legal Division not issue an opinion concurrently with the adoption of the rule, as requested by the AICPA. Paragraph (g) of the final rule, the safe harbor provision for transfers made in connection with a securitization or in the form of a participation that was in effect before any repeal or amendment of the rule, is clear and unambiguous. A legal opinion issued by FDIC counsel would not add anything that is not

Memorandum to Board of Directors

Proposed Final Rule

already contained in the rule itself. Furthermore, it can hardly be said that such an opinion is necessary in order for the final rule to become binding or effective, because an opinion by agency counsel does not create law or bind the agency, see, Sabella v. U.S., 863 F. Supp. 1, 5-6 (D.C. 1994).

Other commenters sought clarification regarding the term “without recourse” used in the definition of participation. While the presence of recourse does not necessarily require that a transaction be characterized as a secured borrowing instead of as a sale, see Major’s Furniture Mart, Inc. v. Castle Credit Corporation, Inc., 602 F.2d 538 (3rd Cir. 1979), courts generally do not view a transaction as a participation unless the buyer does not have recourse against the seller if a default occurs on the underlying obligation. See, e.g., In re Sackman Mortgage Corp., 158 B.R. 926, 931-34 (Bankr. S.D.N.Y. 1993). The final rule maintains this distinction.

One commenter expressed concern regarding the effect of the proposed rule on (a) a transaction that purports to be a participation, but includes recourse against the lead, and (b) a transaction that purports to be a sale (not a participation) of all of a financial asset, but includes recourse against the seller. A transaction that purports to be a participation, but includes recourse against the lead, is not encompassed by the rule; the FDIC, under certain circumstances, may recover previously transferred assets as a result of repudiation. As discussed, under the general legal view, a transaction that purports to be a participation but includes recourse against the lead would be characterized as a secured borrowing rather than as a participation. If the FDIC repudiated such a transaction, it would be entitled to recover any collateral to the extent that the value of the collateral exceeds the claim for repudiation damages, which is determined as of the date of the appointment of the conservator or receiver.

On the other hand, a transaction that purports to be a sale (not a participation) of all of a financial asset, even if it includes recourse against the seller, which would be characterized as a sale under the general legal view, should not need to be encompassed by the rule; the FDIC would not be able to recover transferred assets as a result of repudiation. In the case of a

Memorandum to Board of Directors
Proposed Final Rule

completed sale, the FDIC would have nothing to repudiate if no further performance is required. Even in the case of a sale transaction that imposes some continuing obligation, a repudiation by the FDIC would relieve the FDIC from future performance, but should not result in a recovery of any property that was transferred by the institution before the appointment of the conservator or receiver.

Recommendation

If adopted, the final rule should preserve sale accounting treatment for transactions used by increasing numbers of insured depository institutions as valuable tools to achieve more efficient use of assets, increase liquidity, and achieve greater credit availability for the economy. At the same time, the final rule does not deviate from existing law or the FDIC's past practices with respect to the scope and effect of the FDIC's power as conservator or receiver to repudiate contracts entered into by an insured depository institution. Therefore, staff recommends that the final rule be adopted.

A proposed resolution is attached as Exhibit "B."

Staff Contacts:

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Robert Storch, Division of Supervision, 898-8906.

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DRAFT

[6714-01-P]

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 360

RINN 3064-AC28

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

AGENCY: Federal Deposit Insurance Corporation.

ACTION: Final rule.

SUMMARY: The Federal Deposit Insurance Corporation (the FDIC) has adopted a rule regarding the treatment by the FDIC, as receiver or conservator of an insured depository institution, of financial assets transferred by the institution in connection with a securitization or in the form of a participation. The rule resolves issues raised by Financial Accounting Standards Board (FASB) Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 125). The rule provides that with respect to financial assets transferred by an institution in connection with a securitization or in the form of a participation, and subject to certain conditions described in the rule, the FDIC will not seek to recover or reclaim such financial assets in exercising its statutory authority to repudiate contracts pursuant to section 11(e) of the Federal Deposit Insurance Act (12 U.S.C. 1821(e)). The rule also provides that the FDIC will not seek to enforce the "contemporaneous" requirement of sections 11(d)(9), 11(n)(4)(I), and 13(e). The final rule applies to

securitizations and participations that are engaged in while the rule is in effect, even if the rule is later repealed or amended.

EFFECTIVE DATE:

FOR FURTHER INFORMATION CONTACT: Michael Krimminger, Division of Resolutions and Receiverships, (202) 898-8950; Robert Storch, Division of Supervision, (202) 898-8906; or Thomas Bolt, Legal Division, (202) 736-0168, Federal Deposit Insurance Corporation, 550 17th Street, N. W., Washington, D.C. 20429.

SUPPLEMENTARY INFORMATION:

I. Background

Pursuant to 12 U.S.C. 1821(e)(1), the FDIC, when acting as conservator or receiver of any insured depository institution, has the power to disaffirm or repudiate any contract or lease (i) to which the institution is a party; (ii) the performance of which the conservator or receiver, in the conservator's or receiver's discretion, determines to be burdensome; and (iii) the disaffirmance or repudiation of which the conservator or receiver determines, in the conservator's or receiver's discretion, will promote the orderly administration of the institution's affairs. Repudiation of a contract relieves the FDIC from performing any unperformed obligations remaining under the contract. Repudiation also entitles the other party to the contract to a claim for damages, which are limited by statute to actual direct compensatory damages determined as of the date of the appointment of the receiver or conservator. See 12 U.S.C. 1821 (e)(3).

In addition, pursuant to 12 U.S. C. 1821(d)(9), 1821(n)(4)(I), and 1823(e), no agreement that tends to diminish or defeat the FDIC's interest in an asset acquired from an insured depository institution is enforceable against the FDIC unless such agreement meets certain requirements. One of those requirements is that the agreement be executed by the depository institution and by any person claiming an adverse interest thereunder contemporaneously with the acquisition of the asset by the institution. This is referred to as the "contemporaneous" requirement.

Under generally accepted accounting principles, a transfer of financial assets is accounted for as a sale if the transferor surrenders control over the assets. One of the conditions for determining whether the transferor has surrendered control is that the assets have been isolated from the transferor, i.e., put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. This is know as the "legal isolation" condition.

Whether the legal isolation condition has been met is determined primarily from a legal perspective. This determination involves considerations of the kind of receivership into which the transferor may be placed and the powers of the receiver to reach assets that were transferred prior to its appointment. If the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or receiver for the transferor, then a determination that the transferred assets have been legally isolated is appropriate.

Where the transferor is an insured depository institution for which the FDIC may be appointed as conservator or receiver, the issue arises whether financial assets transferred by the institution in connection with a securitization or in the form of a participation would be put beyond the reach of the FDIC as conservator or receiver for the institution in light of (i) the statutory authority of the FDIC to repudiate contracts to which such institution is a party and (ii) the provisions of sections 11(d)(9), 11(n)(4)(I), and 13(e) of the Federal Deposit Insurance Act regarding the enforceability of agreements against the FDIC. The specific issues are whether the FDIC might, in the exercise of its authority to repudiate contracts, avoid a transfer of financial assets in connection with a securitization or in the form of a participation, and recover such assets; and whether the FDIC might challenge the enforceability of an agreement executed in relation to a transfer of financial assets in connection with a securitization or a participation by asserting the "contemporaneous" requirement with respect to such an agreement.

The final rule resolves these issues by clarifying the powers of the FDIC as conservator or receiver with respect to financial assets transferred by an insured depository institution in connection with a securitization or in the form of a participation. The FDIC believes that this clarification should provide sufficient assurance to determine that the legal isolation condition is met.

II. Proposed Rule

In September 1999, the FDIC requested comments on a proposed rule that provided that the FDIC shall not, by exercise of its authority to disaffirm or

repudiate contracts under 12 U.S.C. 1821(e), reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or in the form of a participation. The proposed rule would apply only to those securitizations or participations in which the transfer of financial assets meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the "legal isolation" condition as it applies to institutions for which the FDIC may be appointed as conservator or receiver, which would be addressed by the proposed rule. The proposed rule defined both "securitization" and "participation", with "participation" specifically limited to participations that are "without recourse" to the selling or "lead" institution. "Without recourse" would mean that the participation must not be subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant upon the borrower's default on the underlying obligation.

The proposed rule would not apply unless the insured depository institution received adequate consideration for the transfer of financial assets at the time of the transfer, and the documentation effecting the transfer of financial assets reflects the intent of the parties to treat the transaction as a sale, and not as a secured borrowing, for accounting purposes.

The proposed rule further provided that it shall not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically limited by this section, including, but not limited to, any rights, powers or remedies of the FDIC

regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

The proposed rule clarified that although the repudiation of a securitization or participation will not affect transferred financial assets, repudiation will excuse the FDIC from performing any continuing obligations imposed by the securitization or participation. If the FDIC, in order to terminate such continuing obligations or duties, seeks to disaffirm or repudiate an agreement or contract under which an insured depository institution has transferred financial assets in connection with a securitization or in the form of a participation, the FDIC will not seek to reclaim, recover, or recharacterize as property of the institution or the receivership such financial assets.

The proposed rule further provided that the FDIC shall not seek to avoid an otherwise legally enforceable securitization agreement or participation agreement executed by an insured depository institution solely because such agreement does not meet the "contemporaneous" requirement of sections 11(d)(9), 11(n)(4)(I), and 13(e) of the Federal Deposit Insurance Act.

The proposed rule was intended to apply to securitizations and participations that are engaged in by insured depository institutions while the rule is in effect, even if the rule is later repealed. Consequently, the last paragraph of the proposed rule provided that the rule would be effective unless repealed by the FDIC upon 30 days notice and opportunity for comment provided in the Federal

Register, but in the event of such repeal, the rule would continue to be effective with respect to any transfers made before the date of the repeal.

III. Summary of Comments

The FDIC received 14 comment letters concerning the proposed rule. The vast majority of the commenters expressed support for the rule.

One commenter specifically requested that FDIC counsel issue, concurrently with the adoption of the rule, a legal opinion confirming that paragraph (g) of the rule will bind receivers or conservators appointed after the repeal or amendment of the rule. In this commenter's view, such an opinion would be necessary for legal specialists "...to render opinions that provide reasonable assurance that the legal isolation condition of SFAS 125 is met."

Other commenters disagreed with this view, but endorsed the issuance of an FDIC legal opinion if this would resolve the issue. Two commenters expressed the view that such an opinion was unnecessary.

The FDIC believes that the final rule more than adequately provides reasonable assurance as to how the FDIC as conservator or receiver of a depository institution would treat financial assets transferred by the institution in connection with a securitization or in the form of a participation. Paragraph (g) of the rule, the safe harbor provision for transfers made in connection with a securitization or in the form of a participation that was in effect before any repeal or amendment of the rule, is clear and unambiguous. The FDIC believes that an opinion by FDIC counsel that paragraph (g) will bind receivers or conservators

appointed after any repeal or amendment of the rule would not add anything that is not already contained in the rule itself or in this preamble.

Other commenters sought clarification regarding the term "without recourse" used in the definition of participation. While the presence of recourse does not necessarily require that a transaction be characterized as a security interest instead of as a sale, see Major's Furniture Mart, Inc. v. Castle Credit Corporation, Inc., 602 F.2d 538 (3rd Cir. 1979), courts generally view a transaction as a participation only if the buyer does not have recourse against the seller when a default occurs on the underlying obligation. See, e.g., In re Sackman Mortgage Corp., 158 B.R. 926, 931-34 (Bankr. S.D.N.Y. 1993). The final rule maintains this distinction.

The final rule's definition of a participation as a transfer of an interest in a loan or a lease without recourse by the buyer against the lead should not exclude participations in which (a) the lead retains a subordinated interest in the obligation, against which losses are initially allocated; (b) the lead participated a loan in order to avoid a statutory lending limit violation, with the option of reacquiring some or all of the transferred interest when reacquisition would not result in a lending limit violation; or (c) the participation agreement provided for repurchase or compensation in connection with customary representations and warranties regarding the underlying asset. Thus, the meaning of the term "recourse", as used in the final rule, differs from its meaning for purposes of the FDIC's risk-based capital standards, 12 CFR Part 325, Appendix A.

One commenter expressed concern regarding the effect of the proposed rule on (a) a transaction that purports to be a participation, but includes recourse against the lead, and (b) a transaction that purports to be a sale (not a participation) of all of a financial asset, but includes recourse against the seller. A transaction that purports to be a participation, but includes recourse against the lead, is not encompassed by the rule; the FDIC, under certain circumstances, may recover previously transferred assets as a result of repudiation. As discussed, under the general legal view, a transaction that purports to be a participation but includes recourse against the lead would be characterized as a secured borrowing rather than as a participation. If the FDIC repudiated such a transaction, it would be entitled to recover any collateral to the extent that the value of the collateral exceeds the claim for repudiation damages, which is determined as of the date of the appointment of the conservator or receiver.

On the other hand, a transaction that purports to be a sale (not a participation) of all of a financial asset, even if it includes recourse against the seller, which would be characterized as a sale under the general legal view, should not need to be encompassed by the rule; the FDIC would not be able to recover transferred assets as a result of repudiation. In the case of a completed sale, the FDIC would have nothing to repudiate if no further performance is required. Even in the case of a sale transaction that imposes some continuing obligation, a repudiation by the FDIC would relieve the FDIC from future performance, but generally should not result in a recovery of any property that was transferred by the institution before the appointment of the conservator or receiver.

IV. Final Rule

The final rule is identical to the proposed rule except for the following. First, the proposed rule's definition of the term "participation" included language that referred to "the borrower's default" in describing the meaning of the term "without recourse". Since a participation may involve a lease as well as a loan, the final rule refers to "a default on the underlying obligation" instead of "the borrower's default".

Second, paragraph (g) of the final rule refers to any amendment of the rule, in addition to any repeal. Paragraph (g) of the final rule provides that any repeal or amendment of the rule by the FDIC shall not apply to any transfers of financial assets made in connection with a securitization or participation that was in effect before such repeal or amendment. The revision is intended to make paragraph (g) more effective as a safe harbor provision if the rule is ever repealed or amended in such a way as to preclude subsequent transfers of financial assets by depository institutions from satisfying the legal isolation requirement of SFAS 125. As a result of paragraph (g), if the FDIC is appointed as conservator or receiver of a depository institution after any repeal or amendment of the rule, the rule will continue to be effective with respect to a transfer that was made in connection with a securitization or participation in effect before the repeal or amendment. Thus, where a transfer of financial assets in connection with a securitization or in the form of a participation is made by a depository institution and the securitization or participation was in effect before any repeal or

amendment of the rule by the FDIC, such transfer will continue to satisfy the legal isolation requirement notwithstanding the repeal or amendment.

The rule is not intended to describe the exclusive circumstances in which legal isolation may occur. For purposes of the rule, the term "special purpose entity" encompasses a trust (including a grantor or owner trust), a corporation, and a limited liability company or partnership organized in compliance with applicable state law.

V. Matters of Regulatory Procedure

Paperwork Reduction Act

No collection of information pursuant to section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501 et seq.) is contained in the final rule. Consequently, no information was submitted to the Office of Management and Budget for review.

Regulatory Flexibility Act

The final rule is consistent with the FDIC's current practice and does not represent a change in the law with respect to securitizations and participations. Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), it is certified that the final rule will not have a significant economic impact on a substantial number of small business entities.

Small Business Regulatory Enforcement Fairness Act

The Office of Management and Budget has determined that the rule is not a "major rule" within the meaning of the relevant sections of the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA)(5 U.S.C. 801 et seq.). As required by SBREFA, the FDIC will file the appropriate reports with Congress and the General Accounting Office so that the final rule may be reviewed.

The Treasury and General Government Appropriations Act, 1999 -
Assessment of Federal Regulations and Policies on Families

The FDIC has determined that this final rule will not affect family well-Being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub.L. 105-277, 112 Stat. 2681(1998)

List of Subjects in 12 CFR Part 360

Banks, banking, Savings associations.

For the reasons set out in the preamble, the FDIC Board of Directors amends 12 CFR Part 360 as follows:

PART 360-RESOLUTION AND RECEIVERSHIP RULES

1. The authority citation for part 360 is revised to read as follows:

AUTHORITY: 12 U.S.C. 1821(d)(1), 1821(d)(11), 1821(e)(1), 1821(e)(8)(D)(i), 1823(c)(4), 1823(e)(2); Sec. 401(h), Pub.L. 101-73,103 Stat. 357.

2. Section 360.6 is added to part 360 to read as follows:

§ 360.6 Treatment by the Federal Deposit Insurance Corporation as conservator or receiver of financial assets transferred in connection with a securitization or participation.

- (a) Definitions. (1) Beneficial interest means debt or equity (or mixed) interests or obligations of any type issued by a special purpose entity that entitle their holders to receive payments that depend primarily on the cash flow from financial assets owned by the special purpose entity.
- (2) Financial asset means cash or a contract or instrument that conveys to one entity a contractual right to receive cash or another financial instrument from another entity.
- (3) Participation means the transfer or assignment of an undivided interest in all or part of a loan or a lease from a seller, known as the "lead", to a buyer, known as the "participant", without recourse to the lead, pursuant to an agreement between the lead and the participant. Without recourse means that the participation is not subject to any agreement that requires the lead to repurchase the participant's interest or to otherwise compensate the participant due to a default on the underlying obligation.
- (4) Securitization means the issuance by a special purpose entity of beneficial interests:
- (i) The most senior class of which at time of issuance is rated in one of the four highest categories assigned to long-term debt or in an equivalent short-term category (within either of which there may be sub-categories or gradations indicating relative standing) by one or more nationally recognized statistical rating organizations, or

- (ii) Which are sold in transactions by an issuer not involving any public offering for purposes of section 4 of the Securities Act of 1933, as amended, or in transactions exempt from registration under such Act pursuant to Regulation S thereunder (or any successor regulation).

(5) Special purpose entity means a trust, corporation, or other entity demonstrably distinct from the insured depository institution that is primarily engaged in acquiring and holding (or transferring to another special purpose entity) financial assets, and in activities related or incidental thereto, in connection with the issuance by such special purpose entity (or by another special purpose entity that acquires financial assets directly or indirectly from such special purpose entity) of beneficial interests.

(b) The FDIC shall not, by exercise of its authority to disaffirm or repudiate contracts under 12 U.S.C. 1821(e), reclaim, recover, or recharacterize as property of the institution or the receivership any financial assets transferred by an insured depository institution in connection with a securitization or participation, provided that such transfer meets all conditions for sale accounting treatment under generally accepted accounting principles, other than the "legal isolation" condition as it applies to institutions for which the FDIC may be appointed as conservator or receiver, which is addressed by this section.

- (c) Paragraph (b) of this section shall not apply unless the insured depository institution received adequate consideration for the transfer of financial assets at the time of the transfer, and the documentation effecting the transfer of financial assets reflects the intent of the parties to treat the transaction as a sale, and not as a secured borrowing, for accounting purposes.
- (d) Paragraph (b) of this section shall not be construed as waiving, limiting, or otherwise affecting the power of the FDIC, as conservator or receiver, to disaffirm or repudiate any agreement imposing continuing obligations or duties upon the insured depository institution in conservatorship or receivership.
- (e) Paragraph (b) of this section shall not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically limited by this section, including, but not limited to, any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.
- (f) The FDIC shall not seek to avoid an otherwise legally enforceable securitization agreement or participation agreement executed by an insured depository institution solely because such agreement does not meet the

"contemporaneous" requirement of sections 11(d)(9), 11(n)(4)(I), and 13(e) of the Federal Deposit Insurance Act.

- (g) This section may be repealed or amended by the FDIC upon 30 days notice and opportunity for comment provided in the Federal Register, but any such repeal or amendment shall not apply to any transfers of financial assets made in connection with a securitization or participation that was in effect before such repeal or modification.

By order of the Board of Directors.

Dated at Washington, D.C. this ____ day of _____, 2000.

FEDERAL DEPOSIT INSURANCE CORPORATION

Robert E. Feldman
Executive Secretary

(SEAL)