January 23, 2020

TO: Board of Directors

FROM: Maureen E. Sweeney
Director
Division of Resolutions and Receiverships

SUBJECT: Final Rule to Revise Securitization Safe Harbor Rule

RECOMMENDATION

Staff recommends that the Board adopt and approve for publication in the *Federal Register* the attached final rule (the "Final Rule") to revise 12 C.F.R. Section 360.6, "Treatment of financial assets transferred in connection with a securitization or participation" (the "Securitization Safe Harbor Rule"), in order to remove a requirement for safe harbor treatment that the documents governing a securitization issuance require compliance with Regulation AB of the Securities and Exchange Commission ("SEC"), 17 CFR 229, subpart 229.1100 ("Regulation AB"), in circumstances where Regulation AB is not, by its terms, applicable to that transaction. Under current law, Regulation AB imposes significant disclosure obligations in connection with an issuance of obligations in a securitization but does not impose such obligations on private placement transactions.

DISCUSSION

I. Background

In 2010, the Securitization Safe Harbor Rule amended and restated a rule adopted in 2000 which provided that the FDIC as conservator or receiver would not use its authority to repudiate contracts to reclaim, recover or recharacterize as property of the IDI or the receivership any financial assets transferred by an insured depository institution ("IDI") in connection with a securitization or in the form of a participation, provided that such transfer met the conditions for sale accounting treatment under generally accepted accounting principles ("GAAP") and two other conditions relating to the securitization were satisfied. In June 2009, the Financial Accounting Standards Board modified GAAP as it applied to securitization transactions. These changes caused market participants to be concerned that some IDIs would be required to consolidate securitized assets on their balance sheets for financial accounting purposes. In view of these changes, the FDIC amended and restated the safe harbor in its entirety by adopting the Securitization Safe Harbor Rule in September 2010.

The Securitization Safe Harbor Rule in general provides, with respect to transfers of financial assets in connection with a securitization transaction that satisfy the GAAP requirements for sale accounting treatment, that the FDIC, in its capacity as receiver or conservator of an insured depository institution, will not - in the exercise of its authority to repudiate contracts - recover or reclaim such financial assets if the other conditions of the Securitization Safe Harbor Rule are satisfied. For transactions that do not qualify for sale accounting treatment but that comply with the other conditions of the Securitization Safe Harbor Rule, the Rule authorizes investors to exercise certain remedies on an expedited basis in certain circumstances, including in the event that the FDIC recovers transferred financial assets and does not pay damages as required by the Securitization Safe Harbor Rule. For securitization transactions that are not grandfathered by the Securitization Safe Harbor Rule, numerous conditions must be satisfied in order for a transaction to qualify for the benefits of the Rule.

In adopting the Securitization Safe Harbor Rule, the FDIC explained that "The FDIC, as deposit insurer and receiver for failed IDIs, has a unique responsibility and interest in ensuring that residential mortgage loans and other financial assets originated by IDIs are originated for long-term sustainability. . . . To ensure that IDIs are sponsoring securitizations in a responsible and sustainable manner, the Rule imposes certain conditions on securitizations that are not grandfathered. . ."[1] One of the conditions included in 2010 in the Securitization Safe Harbor Rule was paragraph (b)(2)(i)(A), which requires that the securitization documents require that information about the securitization obligations and the securitized financial assets be disclosed to potential investors at the financial asset or pool level and security-level to enable evaluation and analysis of the credit risk and performance of the obligations and financial assets that, at a minimum, complies with Regulation AB, even if the obligations are issued in a private placement or are not otherwise required to be registered.

The SEC first adopted Regulation AB in 2004 as a new, principles–based set of disclosure items specifically tailored to asset–backed securities. The regulation was intended to form the basis of disclosure for both Securities Act registration statements and Exchange Act reports relating to asset-backed securities. In 2014, the SEC significantly revised Regulation AB to require specified asset-level disclosures for particular asset classes but did not require the same disclosure for exempt offerings as is required for registered offerings. The disclosure requirements of Regulation AB vary, depending on the type of securitization issuance. The most extensive disclosure requirements relate to residential mortgage securitizations ("RMBS"). These requirements became effective in November, 2016.

[1] 75 *Fed. Reg.* 60287 (September 30, 2010) at 60289-60290.

Before issuance of the NPR (as defined below), FDIC staff had been told that potential IDI sponsors of registered RMBS had decided to not issue registered RMBS because the sponsors found it difficult to provide certain information required by Regulation AB, either because the information was not readily available to them or because there is uncertainty as to the information requested to be disclosed and, thus, uncertainty as to whether the disclosure would be deemed accurate. Staff was further advised that due to the Securitization Safe Harbor Rule requirement for Regulation AB disclosure in private transactions, private offerings by IDI sponsors of RMBS that are compliant with the Securitization Safe Harbor Rule were similarly challenging, and that the net effect was to discourage IDIs from sponsoring RMBS.

Since the Securitization Safe Harbor Rule was adopted in 2010, there have been numerous regulatory developments, some relating to residential mortgages, others relating to all securitizations, that imposed rules that staff believes should prevent any significant build-up in poorly underwritten mortgages and other securitized loans

These regulatory developments include the following:

(i) liquidity regulations adopted in 2014 by the FDIC, the Board of Governors of the Federal Reserve System (FRB) and the Office of Comptroller of the Currency (OCC) (12 CFR Part 329, 12 CFR Part 249, 12 CFR Part 50);

(ii) capital rules adopted by the FDIC, the FRB and the OCC that became effective in 2014 (12 CFR Part 324, 12 CFR Part 271, 12 CFR Part 3);

(iii) the ability to repay rule adopted by the Bureau of Consumer Financial Protection (CFPB) pursuant to section 129C of the Truth in Lending Act (TILA) (15 U.S.C. § 1639c);

(iv) the Integrated Mortgage Disclosures Rules adopted by the CFPB in 2013 pursuant to the Truth in Lending Act, the Real Estate Settlement Procedures Act (RESPA), and sections 1032(f), 1098, and 1100A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act);

(v) the loan originator compensation regulation adopted in 2013 by the CFPB pursuant to sections 129B and 129C of TILA (15 U.S.C. § 1639B & 1639C);

(vi) the appraisal rule adopted by the FDIC and other regulators in 2013 pursuant to Section 129H of TILA (15 U.S.C. § 1639h);

(vii) the requirements for residential mortgage loan servicers adopted by the CFPB in 2013 pursuant to title XIV of the Dodd-Frank Act, which amended Regulation X (implementing RESPA) and Regulation Z (implementing TILA); and

(viii) the interim final rule establishing new requirements for appraisal independence adopted by the FRB in 2010 pursuant to section 129E of TILA (15 U.S.C. § 1639e).[2]

[2] Other aspects of the Securitization Safe Harbor Rule and regulatory developments also reduce the risks of risky mortgage securitizations and complex opaque structures. For example, securitization credit risk retention requirements, compliance with which is a condition set forth in a different section of the Rule, have been adopted and become effective. The Securitization Safe Harbor Rule also includes a specific disclosure requirement relating to re-securitizations.

In addition, the other numerous disclosure requirements of paragraph (b)(2) of the Securitization Safe Harbor Rule are unaffected by the Final Rule and continue to strongly promote the Securitization Safe Harbor Rule's goal of preventing opaque and poorly underwritten securitizations. Among these are:

(i) Section 360.6(b)(2)(ii)(A), which requires that prior to issuance of the RMBS obligations, the sponsor must disclose loan level information about the underlying mortgages including, but not limited to, loan type, loan structure, interest rate, maturity and location of property;

(ii) Section 360.6(b)(2)(i)(B), which requires that the securitization documents mandate that on or prior to issuance of obligations there is disclosure of numerous matters, including the credit and payment performance of the obligations and the structure of the securitization, including the capital or tranche structure of the securitization, priority of payments and subordination features, and representations and warranties made with respect to the financial assets, the remedies and time permitted for breach of the representations and warranties, liquidity facilities and any credit enhancements permitted by the Securitization Safe Harbor Rule, any waterfall triggers or priority of payment reversal features, and policies governing delinquencies, servicer advances loss mitigation and write-offs of financial assets;

(iii) Section 360.6(b)(2)(i)(D), which requires, in connection with the issuance of the securitization obligations, that the documents require disclosure of the nature and amount of compensation paid to originators, the sponsor, rating agencies, and certain other parties, and the extent to which any risk of loss on the underlying assets is retained by any of them;

(iv) Section 360.6(b)(ii)(B), which requires that prior to issuance of the securitization obligations in an RMBS transaction, the sponsors affirm compliance with applicable statutory and regulatory standards for origination of mortgage loans, including that the mortgages are underwritten at the fully indexed rate relying on documented income, and that sponsors disclose a third party due diligence report on compliance with the representations and warranties made with respect to the financial assets;

(v) Section 360.6(b)(ii)(C), which requires that the documents governing RMBS transactions require that prior to the issuance of obligations (and while the obligations are outstanding), servicers disclose any ownership interest by the servicer or an affiliate of the servicer in other whole loans secured by the same real property that secures a loan included in the financial asset pool; and

(vi) Section 360.6(b)(i)(C), which requires ongoing provision of information relating to the credit performance of the financial assets.

Other provisions of the Securitization Safe Harbor Rule also serve to restrict a resurgence of securitizations of risky residential mortgages. They include provisions that:

(i) limit the capital structure of RMBS to six credit tranches; prohibit most forms of external credit enhancement of obligations issued in an RMBS;

(ii) in the case of RMBS, require that servicing and other agreements provide servicers with authority, subject to oversight, to mitigate losses on the financial assets and to modify assets, and take other action to maximize the value and minimize losses on the securitized mortgage loans, and in general require that servicers take action to mitigate losses not later than 90 days after an asset first becomes delinquent;

(iii) require that RMBS documents include incentives for servicing, including loan restructuring and loss mitigation activities, that maximize the net present value of the financial assets;

(iv) require that RMBS documents mandate that fees and other compensation to rating agencies are payable over the five-year period after first issuance of the securitization obligations based on the performance of surveillance services, with no more than 60 percent of the total estimated compensation due at closing; and

(v) require that RMBS documents require the sponsor to establish a reserve fund, for one year, equal to 5% of cash proceeds of the securitization payable to the sponsor, to cover repurchases of financial assets required due to the breach of representations and warranties.

On August 22, 2019, the FDIC published in the *Federal Register* a notice of proposed rulemaking (the "NPR"), that proposed to limit the requirements of paragraph (b)(2)(i)(A) of the Securitization Safe Harbor Rule to securitizations to which Regulation AB is applicable, while retaining all of the other requirements of the Securitization Safe Harbor Rule, including the loan-level and other disclosure requirements. The effect of this change, as applied to Regulation AB as currently in effect, is to no longer impose a requirement for Regulation AB disclosure on private placements of securitization obligations.[3]

The comment period under the NPR ended on October 21, 2019. The FDIC received ten comment letters in total: five from trade organizations; one from an IDI; two from individuals; one from a financial reform advocacy group; and one from a financial market public interest group. These comment letters are available on the FDIC's website. The FDIC considered all of the comments it received when developing the Final Rule, which is unchanged from the rule proposed in the NPR. A detailed discussion of the comments is included in the Final Rule. A summary of the comments is set forth below.

II. **Analysis of Comments on the Proposed Amendment included in the NPR**

A majority of the comment letters support the FDIC's analysis. Each of the five trade group letters and the IDI letter support removing the requirement to impose Regulation AB compliance on transactions where Regulation AB is not otherwise applicable. This requirement was characterized by the letters as an "insurmountable obstacle", a "barrier", a "regulatory impediment" and a "disincentive" to IDI sponsorship of RMBS, and a "roadblock" to increased RMBS issuance by IDIs. Three of the letters observed that aligning the Regulation AB disclosure requirement contained in the Securitization Safe Harbor Rule with the SEC rule as to the scope of transactions to which Regulation AB disclosure applies would level the playing field

[3] The amendment to paragraph (b)(2)(i)(A) in the Final Rule also includes certain technical revisions required by the *Federal Register* in connection with the NPR, including a revised form of citation to Regulation AB and deletion of the specification that the requirement for Regulation AB compliance refers to Regulation AB as in effect at the relevant time and that the requirement applies to successor public issuance requirements to Regulation AB.

for securitization between IDIs, which prior to the Final Rule are required by the Securitization Safe Harbor Rule to comply with Regulation AB in private transactions, and other securitization sponsors, which are not required to comply with Regulation AB in connection with private transactions. Several of the letters expressed the view that removal of this Regulation AB requirement would help promote an increase in credit available to the mortgage market. Some of the letters also maintained that this amendment to the Securitization Safe Harbor Rule would increase liquidity for mortgage and other asset classes and lower costs and improve choices for consumers. One letter stated that the proposal would provide benefits to the economy by weaning the mortgage market off of its significant dependency on government backed securitization programs and thus reduce the risk to taxpayers.

None of the comment letters responded to the question included in the NPR as to whether the results intended to be achieved by the proposed rule included in the NPR would and should be achieved as set forth in the proposed rule or by way of different modifications to the Securitization Safe Harbor Rule.

The letters from the individuals, the financial reform advocacy group and the public interest group were critical of the rule change. One letter asserted that an expected result of the change, an increase in RMBS, was not an appropriate goal since, according to the letter, RMBS was a primary cause of the 2008 financial crisis. The letter stated that because the amendment to the Securitization Safe Harbor Rule might result in an increase in privately sponsored RMBS, it was inconsistent with findings by the FDIC and others relating to the financial crisis that excessive RMBS issuance was a primary cause of the financial crisis. The letter also stated that the FDIC should include a finding that adequate safeguards protecting investors and the financial system remain in place. On the other hand, one of the letters asserted that any expected increase in IDI sponsored securitization activity was speculative. One of the letters criticized the NPR for not identifying the regulatory changes that the NPR stated had made the resurgence of a substantial amount of problematic RMBS unlikely. One of these letters also stated that the proposal did not address the danger that the amendment could increase activity in other potentially risky asset classes.

Staff does not believe that the objections raised by the letters are justified. Staff has evaluated the numerous significant disclosure requirements of the Securitization Safe Harbor Rule that are unchanged by the Final Rule and has concluded that the Securitization Safe Harbor Rule will continue to require robust and adequate disclosure to investors. As noted in the NPR, a significant portion of the problems experienced with RMBS during the financial crisis arose from subprime and alternative mortgages, and the numerous regulatory changes since the Securitization Safe Harbor Rule was adopted in 2010, including those identified in *II. Background* above, have made it unlikely that a substantial growth in the securitization of similar types of risky mortgages will re-occur.

The comment letters reinforced the staff's understanding as to the difficulty that potential IDI RMBS sponsors would have in complying with all of the data requirements of Regulation AB and that, as a result, the Securitization Safe Harbor Rule requirement for compliance with Regulation AB in private transactions has posed an obstacle to IDI sponsorship of RMBS. The Regulation AB disclosure requirements identified as difficult or impossible in the comment letters include the back-end debt-to-equity income ratio disclosure requirement, the requirements for disclosure of appraisals, automated valuation model results and credit scores obtained by any credit party or credit party affiliate, and the inconsistency of data elements with the standards set forth in the Mortgage Industry Standards Maintenance Organization. In addition, according to one of the trade association letters, some of the required Regulation AB disclosure fields cannot be included in publicly accessible securities filings without creating "unacceptable and reputational risks for RMBS sponsors and privacy risks to borrowers."

The FDIC agrees with the comment that the NPR did not offer an analysis of whether amendment to the Securitization Safe Harbor Rule could increase activity in other "potentially risky asset classes." This is because staff is not aware that the requirement for compliance with Regulation AB in private transactions had prevented IDIs from sponsoring the securitization of asset classes other than residential mortgages.

The comment letters that criticized the amendment also assert that if the FDIC adopts the amendment to the Securitization Safe Harbor Rule, the FDIC will be acting contrary to its mandate to protect the Deposit Insurance Fund (DIF) and that, in not applying Regulation AB to transactions to which Regulation AB does not otherwise apply, the FDIC lost sight of the fact that it has a different mandate than the SEC. Staff has carefully considered risks to IDIs and to the DIF related to the amendment to the Securitization Safe Harbor Rule and does not agree with these assertions. Staff expects the Final Rule to enable IDIs to diversify their sources of funding. Comment letters support this analysis. One letter states that the amendment would benefit "IDIs, who would see additional risk management paths that would allow them to maintain lending through a variety of economic circumstances." A different letter evaluated the amendment to the Regulation AB provision as "an appropriate balance of protection of the Deposit Insurance Fund and facilitation of insured institutions' prudent participation in the private securitization markets."

III. Discussion

When it adopted the Securitization Safe Harbor Rule in 2010, the FDIC stated that it was designed to provide greater clarity and transparency to allow for better ongoing evaluation of the quality of lending by banks and to reduce the risks to the DIF from opaque securitization structures and poorly underwritten loans that led to onset of the financial crisis. One of the provisions of the Securitization Safe Harbor Rule that was included to help achieve that goal was paragraph (b)(2)(i)(A), one of many provisions included in the Securitization Safe Harbor Rule that requires disclosure. As discussed in *I. Background* above, in the years since the Securitization Safe Harbor Rule was adopted there have been numerous regulatory changes which have the effect of reducing the risks of poorly underwritten loans being securitized by IDIs. In the three years since the requirements of Regulation AB became applicable to RMBS, potential IDI sponsors of RMBS have found the requirements of Regulation AB to be major obstacles to securitizing mortgages.

When staff recommended adoption of the NPR, an obvious inquiry was whether deleting the Securitization Safe Harbor Rule requirement for loan level compliance that at a minimum would satisfy Regulation AB would increase any risk of resurgence of the type of poorly underwritten loan pools that contributed to the financial crisis. After reviewing the regulatory measures adopted since 2010, as well as the numerous unchanged conditions to eligibility for safe harbor treatment included in the Securitization Safe Harbor Rule that promote sustainable securitizations, staff believed that the risk of a resurgence of the securitization of such loan pools as a result of the proposed amendment was not significant. Review of the comment letters did not change that analysis but reinforced staff's understanding of why amending the Securitization Safe Harbor Rule as set forth in the NPR is necessary.

IV. The Final Rule

The text of the amendment to paragraph (b)(2)(i)(A) of the Securitization Safe Harbor Rule is unchanged from the text of the amendment included in the NPR. The Final Rule amends paragraph (b)(2)(i)(A) of the Securitization Safe Harbor Rule by removing the requirement that the documents governing securitization transactions require disclosure sufficient to evaluate the credit risk and performance of securitization obligations and financial assets that at a minimum complies with Regulation AB in circumstances where, under the terms of Regulation AB itself, Regulation AB is not applicable to the transaction. As amended, such disclosure is required under paragraph (b)(2)(i)(A) only in the case of an issuance of obligations that is subject to Regulation AB.

CONCLUSION

Staff recommends that the Board of Directors approve the Final Rule and authorize publication of the attached Federal Register notice.

CONCUR:

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ATTACHMENTS

A – Resolution

B – Federal Register Notice