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presents

FASB Statement 166 and Commercial Loan Participations

Meeting Complex Accounting and Disclosure Standards for Lead and Participating Lenders

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Bill McGaughey, Executive Vice President and Director of Capital Markets, **Excel National Bank**, Beverly Hills, Calif.

Brett Schwantes, Senior Manager and Technical Issues Committee Chair, **Wipfli LLP**, Wausau, WI

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Wednesday, March 24, 2010

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
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FASB Statement 166 And Commercial Loan Participations Webinar

March 24, 2010

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(*Brett Schwantes*)

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(*Bill McGaughey, Melissa Beck and Ken Kohler*)

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FAS 166 Changes Relevant To Loan Participations

Melissa Beck and Ken Kohler,
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FAS 166

- In June 2009, the FASB issued Statement No. 166, Accounting for Transfers of Financial Assets (FAS 166), effective as of the beginning of a filer's first annual reporting period that begins after Nov. 15, 2009.
- For calendar-year companies, FAS 166 became effective on Jan. 1, 2010. It will first be reflected on 3/31/10 quarterly financial statements and, for public companies first disclosed and filed in April or May 2010.
- FAS 166 amends FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, by:
  - Eliminating the concept of a "qualifying special-purpose entity;"
  - creating the concept of a "participating interest;"
  - Changing the requirements for derecognizing financial assets; and
  - Requiring additional disclosures.
- It is not a wholesale replacement of FAS 140; many FAS 140 principles and rules remain in effect.

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FAS 140: The Predecessor To FAS 166

- Under FAS 140, a transfer of financial assets in which the transferor surrendered control over those assets was accounted for as a sale, to the extent that consideration other than beneficial interests in the transferred assets was received in exchange.
- The basic question addressed by this presentation is:
  "What requirements must be met to treat the transfer of a participation as a sale of the participation for accounting purposes, rather than a secured borrowing?"
- This basic principle still applies under FAS 166.
- FAS 140 itself became effective for transfers of financial assets on or after April 1, 2001; and replaced FAS 125 (which, in turn, replaced FAS 77 in June 1996).

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FAS 140: The Predecessor To FAS 166 (Cont.)

- Under infamous paragraph 9 of FAS 140, the transferor surrendered control over transferred assets (and thus qualified for sale treatment) if and only if all of the following conditions are met:
  - The transferred assets are isolated from the transferor (put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership);
  - Each transferee (or, if the transferee is a qualifying special purpose entity [QSPE], each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it receives, and no condition both (1) constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and (2) provides more than a trivial benefit to the transferor; and
  - The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity, or (2) the ability to unilaterally cause the holder to return specific assets, other than through a clean-up call.

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FAS 140: The Predecessor To FAS 166 (Cont.)

- Under FAS 140, a transfer of assets to an entity that met the definition of “qualified special purpose entity” would not have to be consolidated on the books of the transferor.
- An entity was a “qualified special purpose entity” if it:
  - Was demonstrably distinct from the transferor;
  - Had limited permitted activities established by the majority of the beneficial interest holders; and
  - Was limited to certain specified financial assets.
- Most securitizations have relied on a transfer to a QSPE to achieve sale treatment under FAS 140.
- In contrast, most loan participations are transferred directly to a commercial participant and not to a QSPE. So, originators and lead lenders had to satisfy the conditions of paragraph 9 to achieve sale treatment of a transferred participation.

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FAS 140: Application To Loan Participations

- FAS 140 does not speak extensively about participations, but it is clear that they were covered by its principles.
- FAS 140 specifically states that a “loan syndication is not a transfer of financial assets,” and is thus not subject to FAS 140 (paragraph 103), because each lender in a syndicated loan has a direct debtor-creditor relationship with the borrower. If the lead lender in a syndicated loan is the only party who collects payments from the borrower and distributes them to other lenders, the lead lender “is simply acting as servicer.”
- In contrast, in a participation, in which a single lender makes a large loan to a borrower and subsequently transfers undivided interests in the loan to other parties, the transfer of the undivided interests constitutes a transfer of financial interests. (See paragraphs 104-106)

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FAS 140: Application to Loan Participations (Cont.)

- The FAS 140 provisions on loan participations focus on the right of the participant to pledge or exchange its participation under paragraph 9.b.
- Paragraph 106 of FAS 140 states that "[i]f the loan participation agreement gives the [participant] the right to pledge or exchange those participations and the other criteria in paragraph 9 are met, the transfers to the [participant] shall be accounted for by the transferor as sales of financial assets."
- Paragraph 106 also states that the following features of a participation sale presumptively do not constrain the ability of a participant to pledge or exchange its participation, and thus do not preclude sale treatment:
  - A lead lender's right of first refusal on a bona fide offer from a third party;
  - A requirement to obtain the lead lender's permission to sell the participations, which shall not be unreasonably withheld; or
  - A prohibition on a sale to the lead lender's competitor, if other potential willing buyers exist.

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FAS 166: What Changed?

- Under FAS 140, a seller of participations desiring sale accounting treatment had to concern itself principally with satisfying paragraph 9, especially 9.b. regarding restrictions on the participant's right to pledge or exchange its participation interest.
- This generally required avoiding placing undue restrictions on the participant's right to sell or pledge its participation.
- The requirements of FAS 140 were quickly adopted by the market and became standard provisions in loan participation agreements. So, for the most part, sellers of participations have not had to concern themselves with FAS 140 on a regular basis.
- Under FAS 166, there are now <u>two</u> basic requirements that must be met to achieve sale treatment:
  - Relinquishment of control under paragraph 9,

    <u>PLUS</u>

  - Ensuring that the sold participation is a qualifying "participating interest" under FAS 166

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FAS 166: Creation Of Participating Interest

- To meet the definition of a “participating interest” under FAS 166, the transfer of a loan participation must have all of the following characteristics:
  - Each participant’s interest, including the lead lender’s, must represent a proportionate (pro rata) ownership interest in the underlying loan
  - All cash flows received from the underlying loan, except cash flows allocated as servicing compensation (which may not be subordinated and may not significantly exceed standard market servicing fees), must be divided proportionately among the participants in an amount equal to their respective shares of ownership.
  - The rights of each participant (including the lead lender) must have the same priority, no interest may be subordinated to another interest, and no participant may have recourse to the lead lender or another participant other than remedies for breaches of standard representations and warranties and ongoing contractual servicing obligations.
  - No party may have the right to pledge or exchange the underlying loan unless all participants agree to do so.

FAS 166: Participating Interests

- Under FAS 166, if a transfer of a participation in an underlying loan meets the definition of a "participating interest," then the lead lender/seller must also evaluate whether the transfer meets all of the conditions to qualify for sale accounting.
- In the case of a loan participation, these conditions – virtually unchanged from paragraph 9 of FAS 140 – are:
  - The isolation of the transferred participation from the lead lender/seller, even in bankruptcy or receivership,
  - The participant's right to pledge or exchange its participation, and
  - The lead lender/seller's lack of effective control over the transferred participation.

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Impact On Participation Structures

- The combined effect of the pro rata ownership requirement and the prohibition on subordination means that participations qualifying for sale treatment are limited to “vertical slices” of the underlying loan, and that “horizontal” slices are no longer permitted.
  - By “vertical slice,” we mean that the participation must represent a pro rata percentage share of the entire credit spectrum of the underlying loan.
  - Previously, a participation could have been structured as a “horizontal slice,” representing a percentage share with credit priority over, or subordination to, other participants.
- Similarly, the requirement of pro rata cash flow distribution precludes “fast pay” or “slow pay” structures in which cash flows are allocated to some participants earlier or later than to other participants.

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FAS 166: Practical Impacts

- Certain provisions in loan participation agreements previously qualifying for sale treatment are not permissible for "participating interests" under FAS 166, and will preclude sale treatment going forward. Examples include:
  - LIFO (last in, first out) and FIFO (first in, first out) participations, in which one participant is entitled to receive payments before another, are no longer permitted because of the pro rata cash flow requirement of FAS 166.
  - Interest rate strips, including interest-only ("IO") participations and servicing strips that allow the servicer to retain interest in excess of market servicing compensation, will no longer be permitted in participation structures for which the lead lender/seller desires sale treatment.

FAS 166: Practical Impacts (Cont.)

- Subordinated participations in which a lead lender agrees to retain a percentage participation interest subordinated to the interest of investor participants, usually to demonstrate “skin in the game,” are no longer required.

- As Bill will address in greater detail, participations established in connection with government loan programs, such as SBA programs, often have subordination and/or interest rate strip features that will preclude sale treatment.

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FAS 166: Derecognizing Financial Assets

- Even if a participation qualifies as a sale, only the transferred interest is treated as having been sold and can be removed from the balance sheet. The lead lender's retained interest must remain on the balance sheet, subject to the following rules.
- Upon the completion of a transfer of a participation interest that qualifies as a "participating interest" and otherwise satisfies the conditions to be accounted for as a sale (including the paragraph 9 tests), the lead lender must:
  - Allocate the previous carrying amount of the underlying loan between the participations sold and any that are retained based on their relative fair values at the transfer date;

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FAS 166: Derecognizing Financial Assets (Cont.)

- Derecognize the participations sold;
- Recognize and initially measure at fair value servicing assets (or servicing liabilities) and any other assets obtained and liabilities incurred in the sale;
- Recognize in earnings any gain or loss on the sale; and
- Report any retained participations as the difference between the previous carrying amount of the underlying loan and the amount derecognized.

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FAS 166: Additional Disclosures

- Generally speaking, FAS 166 requires more information about:
  - Transfers of financial assets, including securitization transactions;
  - Transaction gains and losses resulting from transfers of financial assets during a reporting period; and
  - Continuing exposure of the seller to the risks related to transferred financial assets, such as through:
    - Recourse or guarantee arrangements,
    - Servicing arrangements, and/or
    - Certain derivative instruments.
    - Disclosure relating to exposure must be continuously updated until the exposure is no longer present.

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New Disclosures Required In Financial Statements

Brett Schwantes, Wipfli LLP

Disclosure Requirements

- Principal objectives are to provide users with an understanding of:
  - Any continuing involvement in transferred assets
  - Nature of any restrictions on assets
  - How servicing assets and liabilities are reported
  - For sales when a transferor has continuing involvement and for secured borrowings, how the transfer affects financial position, financial performance and cash flows

Disclosure Requirements (Cont.)

- Examples of continuing involvement
  - Servicing arrangements
  - Recourse or guarantee arrangements
  - Agreements to purchase or redeem transferred assets
  - Options written or held
  - Derivative instruments entered into with the transfer
  - Arrangements to provide financial support
  - Pledges of collateral
  - Beneficial interests in the transferred financial assets

Disclosure Requirements (Cont.)

- Disclosures may be aggregated if appropriate
  - Must disclose how similar transfers are aggregated
  - Must distinguish between sales and secured borrowings

- If aggregated, consider quantitative and qualitative information about the transferred assets
  - Nature of continuing involvement
  - Types of financial assets transferred
  - Risk related to the transferred assets
  - Concentrations of credit risk

Disclosure Requirements (Cont.)

- Clearly and fully explain risk exposure and restrictions

- Balance between complete disclosures and obscuring important information with excessive detail or too much aggregation

- Apply to all transfers that occurred both before and after the effective date

Sample Disclosures

- The following slides present sample disclosures

- This is only sample wording – the facts and circumstances of each situation falling under the standard of FAS No. 166 (ASC 860-10) should be examined carefully to determine the appropriate disclosures are made

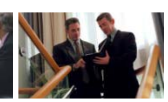
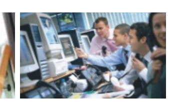
Sample Disclosures (Cont.)

- "As of December 31, 2010, the Company has transferred interests in several commercial loans ('participations sold') to other financial institutions ('participants') that are accounted for as secured borrowings. All of the principal payments received from the borrowers for these loans will be remitted to the participants until their interests are completely paid off, after which the remaining payments will be used by the Company to reduce the outstanding balance of its remaining interest in the loans. The entire balance of these loans continues to be reported as assets of the Company and the transferred interests totaling $x,xxx are reported as 'Secured borrowings' on the Company's balance sheet."



Sample Disclosures (Cont.)

- “The Company sells the guaranteed portion of Small Business Administration (SBA) loans to outside investors with a provision whereby the Company must rebate the premium received on sale if a loan prepays or defaults within 90 days of the loan origination (the ‘recourse provision’). These transfers are recognized as secured borrowing transactions while the recourse provision is in effect. After the recourse provision expires, the Company recognizes the outstanding transactions as sales by decreasing the Company’s loan balance and removing the secured borrowing and also recognizes the gain associated with the sale. At December 31, 2010, the guaranteed portion of SBA loans sold with recourse provisions in effect continue to be reported as assets of the Company and the transferred interests totaling $x,xxx are reported as ‘Secured borrowings’ in the balance sheet. Unrecognized gain on these sales totaling $xxx is expected to be recognized as income after the recourse provisions on these loans expire.”

Sample Disclosures (Cont.)

- "During 2010, the Company sold an interest in a pool of residential real estate mortgage loans to another institution. The terms of the sale allow the Company to repurchase these loans at their then-outstanding principal balance after four years. The Company has accounted for this transfer of loans as a secured borrowing. Consequently, the entire balance of these loans continues to be reported as an asset of the Company and the transferred balance totaling $x,xxx is reported as a secured borrowing on the Company's balance sheet."

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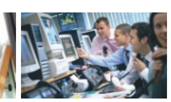

Some Issues To Watch Out For

- New draws on lines of credit participated to other institutions
  - Standard applies to transfers that occur on or after the effective date.
  - New draws on lines of credit or other open-ended facilities that occur after the effective date of the standard must follow the standard, even if the participation agreement was in effect prior to the effective date.

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Some Issues To Watch Out For (Cont.)

- Recourse provisions
  - When selling entire financial assets, certain recourse provisions may be included that would not preclude the entity from using sale accounting treatment.
  - When selling a portion of a financial asset, virtually any recourse provision will preclude the use of sale accounting treatment.

Some Issues To Watch Out For (Cont.)

- Call option on a pool of loans
  - Scenario facts: Institution sells a pool of loans with the right to call them after five years or after the principal is reduced to 20% of the original principal.
  - Old accounting: Principal balance of the amount that could be called (e.g., 20%) is treated as a secured borrowing, and the remainder is a sale.
  - New accounting: All is treated as a secured borrowing.

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Practical Accounting, Compliance Considerations

Bill McGaughey, Excel National Bank

Melissa Beck and Ken Kohler, Morrison & Foerster

Proportionate Interest (¶ 8B a.)

- The SBA guarantees typically 75% to 90% of a qualifying loan to small businesses.
- The originating lender can sell the guaranteed portion of the loan using SBA Form 1086 (secondary Participation Guaranty Agreement), which is a tri-party agreement among the lender, SBA and investor.

Cash Flows Divided Proportionately (¶ 8B b.)

- The guaranteed portion of SBA loans can be sold for a premium, or at par with the originating lender retaining a portion of the interest payments on the guaranteed portion sold.
  - The SBA requires that a minimum of 1% of the interest payments on the guaranteed portion be retained by the lender.
  - 40 basis points has been generally considered adequate servicing compensation, based on a study performed by the industry's trade association.
  - After discussions with banking regulators and other industry participates, 1% has been determined not to be excessive compensation.
- If more than 1% is retained, the excess is considered an IO strip receivable, which would eliminate sales treatment.

Rights Of Each Participant Have Same Priority (8B c.)

- The SBA guarantee created a problem with priority; however, FASB provided an exclusion for third-party guarantees.

- The SBA participation agreement provides for a rebate of a premium received in the event of a pre-payment within 90 days of settlement or up to 275 days after settlement if the borrower misses one of the first three payments after settlement.
  - Recognition of a SBA loan sale must be deferred for at least 90 days.

No Party Can Pledge Or Exchange Entire Asset (¶ 8B d.)

- The SBA participation agreement does not create a problem with this requirement.

Meets The Definition Of A Participating Interest?

- If more than 1% of the interest received on the guaranteed portion of the loan is retained by the lender, the transaction does not qualify for sales treatment and must be recorded as a secured borrowing. (¶ 26 F.)

- If the guaranteed portion is sold for a premium and 1% is retained, the transaction will be treated as a secured borrowing until at least the 90 day premium rebate period expires. (¶ 26 G.)

Do SBA Transactions Meet Requirements of ¶ 9?

- Industry trade association and certain lenders received "true sale" opinions, which stated that the assets have been isolated from the lender. (¶ 9 a)

- The buyers are generally broker-dealers who resell or pool the loans and sell the pools to investors. (¶ 9 b)

- The SBA participation agreement prohibits the lender from taking any actions independent of approval by the SBA and investor. (¶ 9 c)

FAS 166 Impact On SBA Loan Participations

- Income statement
  - If more than 1% retained in servicing, there is no gain on sale.
  - Gain on sale will be deferred for at least 90 days. Thus, lenders will lose a quarter of the gain on sale income in the first year of adoption.

FAS 166 Impact On SBA Loan Participations (Cont.)

- Statement of financial position
  - Increases loan balances
  - Increases other borrowings

- Impact on ratios
  - Decreases leverage and total risk-based capital ratios
  - Increases non-core fund dependence ratio
  - Increases loans to total assets
  - Increases loans to total deposits

Other Discussion Items Regarding SBA Participations

- A number of SBA lenders have requested that the SBA remove the warranty period from the participation agreement.
- Several SBA lenders are adopting FAS 159 fair value accounting for SBA loans held for sale.
  - Offsets the income statement impact
  - Unguaranteed portion will have to continued to be carried at fair value and reviewed at each reporting date (including estimated losses).
  - The allowance for loan losses would exclude the unguaranteed portions valued at fair value, further complicating the analysis.
- Lenders will classify the participations waiting for the warranty period to expire as "loans held for sale."
- Lenders will disclose the carrying amounts and classifications of both assets and associated liabilities, including qualitative information about the relationships between those assets and associated liabilities.

Example

We made the loan for $1 million for 25 years with an interest rate of prime + 2.75% (6%). Assume that we sold the 90% guaranteed portion on the same day for 108% or $972,000 with a pass through rate of prime + 1.75% (5%). The implied rate for the sold portion of the note is 3.85% ($972,000 with payments of $5,049 a month over 300 periods; the 5,049 steady payment was used for convenience of the speaker). The actual payments vary each month, declining due to the amortization of the principal at the note rate not the implied rate of 3.85%.

Example (Cont.)

Make Loan:

Loans	1,000,000	
Cash		1,000,000

Settle the loan sale:

Cash	972,000	
Secured Borrowing		972,000

Example (Cont.)

1st Payment Received:

Cash	6,443	
Interest Receivable		$5,000
Loans		$1,443

1st Payment sent to guaranteed holder:

Secured Borrowing	1,930	
Interest Payable	3,119	
Cash		5,049

Example (Cont.)

2nd Payment Received:

Cash	6,443	
Interest Receivable		4,993
Loans		1,450

2nd Payment sent to guaranteed holder:

Secured Borrowing	1,937	
Interest Payable	3,112	
Cash		5,049

Example (Cont.)

3rd Payment Received:

Cash	6,443	
Interest Receivable		4,986
Loans		1,457

3rd Payment sent to guaranteed holder:

Secured Borrowing	1,944	
Interest Payable	3,106	
Cash		5,050

Example (Cont.)

After the first 3 payments and 90 days, recognize the loan sale:

Servicing Asset	14,785	
Secured Borrowing	966,189	
Loans		896,085
Discount on Unguaranteed		7,866
Gain on Sale		77,023

Example (Cont.)

Information on some of the numbers

Value of servicing asset (995,650 x (1% - .4%) x 2.75)
Cost allocation:

Guaranteed	980,974	90.79%
Unguaranteed	99,565	9.21%

Guaranteed fair value = Secured Borrowing Balance 966,189 + 14,785 Servicing Asset
Unguaranteed = Gross Note Balance 995,650 x 10%
Discount on unguaranteed = (995,650 x 10%) – (996,650 x 9.21%)
Gain = (Servicing Asset 14,785 + Secured Borrowing 966,189) – (Note balance 995,650 x 90.79)

LIFO And FIFO Participations

- Call report date: Dec. 31, 2009, supplemental instructions
  - "…neither LIFO nor FIFO participations transferred after the effective date of FAS 166 will qualify for sale accounting and instead must be reported as secured borrowings."

- LIFO and FIFO participations do not meet the requirement in ¶ 8B. b., which requires that all cash flows received from the entire financial asset be divided proportionately.

FDIC Securitization Rule – Overview

- The FDIC's rule regarding its treatment of securitizations sponsored by, and participations sold by, banks, thrifts and other FDIC-insured depository institutions ("IDIs") in the IDI's receivership or conservatorship, is set forth at 12 C.F.R. § 360.6, and is popularly known as the "Securitization Rule."
- Despite the popular name, the Securitization Rule applies to sales of participations by banks and other IDIs to the same extent it applies to securitizations.
- Banks and other IDIs selling participations must comply with the Securitization Rule as well as FAS 166 to achieve sale accounting treatment, because compliance with the rule constitutes satisfaction of the paragraph 9.a. condition requiring isolation of the sold participation from the selling bank, even in the bankruptcy or receivership of the seller (often referred to as the "legal isolation" condition) and there is no other recognized way for a bank or IDI to satisfy the legal isolation condition.
- Banks and other IDIs constitute a large percentage of lead lenders of participated loans, so the Securitization Rule is quite important to the loan participation marketplace.

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FDIC Securitization Rule – Origins

- The Securitization Rule was originally adopted by the FDIC in July 2000, two months before, and clearly in anticipation of, FASB's adoption of FAS 140, in September 2000.
- Under FAS 140's predecessor, FAS 125, banks were expressly exempt from the paragraph 9.a. requirement of demonstrating legal isolation.
  - The exemption for banks included in FAS 125 was based on an erroneous belief by FASB that, in the event of a conservatorship or receivership of a bank in which the FDIC repudiated an obligation or attempted to reclaim the assets collateralizing the obligation, the FDIC was required to repay the obligation with interest to the date of payment to creditors.
  - Several years after the adoption of FAS 125, FASB discovered that, while it had been the general practice of the FDIC to make investors whole when it repudiated an obligation, it was not obligated to do so.
  - It therefore became clear that, when the FASB next amended FAS 125, it would almost certainly remove the bank exemption from the paragraph 9.a. legal isolation condition.

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FDIC Securitization Rule – Origins (Cont.)

- Without an exemption from paragraph 9.a. or some other clear way to demonstrate legal isolation, banks would have no ability to achieve sale treatment under GAAP.
  - For non-bank sellers of financial assets, which are subject to bankruptcy under the U.S. Bankruptcy Code, the legal isolation condition is generally satisfied by delivery of a legal opinion that the transfer of assets constitutes a “true sale at law,” the standard used by bankruptcy courts.
  - Because banks and other IDIs are subject to FDIC conservatorship and receivership proceedings rather than bankruptcy proceedings, and because the FDIC has broad discretionary powers as conservator or receiver, lawyers were unable to deliver legal opinions that would assure that sold assets were truly outside the reach of bank creditors in the event of a bank’s receivership or conservatorship.
- In order to assure that banks and other IDIs could compete in the financial markets on a level playing field, the FDIC adopted the Securitization Rule to establish a “safe harbor” of transactions that the FDIC would agree in advance it would not challenge or repudiate, thereby providing a basis for lawyers to deliver legal opinions that a bank’s sold or securitized assets were legal isolated from the bank.

FDIC Securitization Rule – Prior To FAS 166

- The Securitization Rule provides that the FDIC as conservator or receiver will not use its statutory authority to disaffirm or repudiate contracts to reclaim, recover or recharacterize as property of the institution or the receivership any financial assets transferred by an IDI in connection with a securitization or participation or in the form of a participation, provided that such transfer is made in compliance with the conditions of the rule and otherwise meets all conditions for sale accounting treatment under GAAP, except for the legal isolation condition (which is satisfied by compliance with the Securitization Rule itself).
- The Securitization Rule provides a “safe harbor” to permit transfers of financial assets by IDIs to an issuing entity in connection with a securitization or in the form of a participation to satisfy the "legal isolation" condition of GAAP as it applies to institutions for which the FDIC may be appointed as conservator or receiver. To satisfy the legal isolation condition, the transferred financial asset must have been presumptively placed beyond the reach of the transferor, its creditors and, in the case of an insured depository institution, the FDIC as conservator or receiver.

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FDIC Securitization Rule – Prior To FAS 166 (Cont.)

- While the original Securitization Rule imposes a number of conditions on securitizations, the conditions it imposes on participations to obtain the benefit of the safe harbor are quite straightforward:
  - A participation subject to the rule is defined as the transfer or assignment of an undivided interest in all or a part of a loan or lease, without recourse to the lead lender, pursuant to an agreement between the lead lender and the participant.
  - "Without recourse," in turn, 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.
  - The selling IDI must receive adequate consideration for the transfer of the participation at the time of the transfer.
  - The documentation effecting the transfer of the participation must reflect the interest of the parties to treat the transaction as a sale, and not as a secured borrowing, for accounting purposes.

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FDIC Securitization Rule – Prior To FAS 166 (Cont.)

- Since its adoption, the Securitization Rule has been relied on by securitization participants, including rating agencies, and purchasers of participations as assurance that investors could look to underlying financial assets for payment without concern that the financial assets would be interfered with by the FDIC as conservator or receiver.

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The Interim Rule

- The adoption, as of Jan. 1, 2010, of FAS 166 has resulted in many securitizations and some loan participations being recharacterized from sales to secured borrowings.

- As early as last summer, before FAS 166 became effective, market observers became concerned with the prospect that, when existing transactions lost their sale characterization as a result of FAS 166, they would no longer meet the Securitization Rule's safe harbor requirement that the transaction constitute a sale under GAAP, and therefore would no longer have the benefit of the FDIC's undertaking not to reclaim, recover or recharacterize as property of the IDI or the receivership the underlying financial assets.

- While failure to meet the Securitization Rule safe harbor requirements was not a concern from an accounting standpoint, since the transactions at issue were already expected independently to lose their sale treatment under FAS 166, other constituencies, including investors and rating agencies, derive comfort from the substantive undertaking of the FDIC that it will not challenge the transaction.

- The uncertainty as to whether the FDIC would continue to grant safe harbor treatment to securitizations of an IDI in its conservatorship or receivership created considerable marketplace concern that caused many then-pending securitizations to come to a halt.

- This concern culminated when Moody's issued a report on Sept. 1, 2008 warning that it would review outstanding bank-sponsored credit card securitizations that were sponsored by banks not rated at least Aa3 for possible rating downgrades unless the safe harbor issue was addressed.

The Interim Rule (Cont.)

- In response to the marketplace concern, and presumably to the Moody's threat, the FTIC on Nov. 15, 2010 adopted an interim rule to "grandfather," in all securitizations and loan participations for which beneficial interests have been issued on or before March 31, 2010, if satisfied GAAP requirements for sale treatment as in effect prior to the adoption of FAS 166 and if they otherwise met the safe harbor requirements under the Securitization Rule.
- The adoption of the interim rule was intended to buy the FDIC time to consider long-term changes to the Securitization Rule to reflect the new accounting regime represented by FAS 166 and FAS 167.
- On Dec. 15, 2009, the FDIC released an advanced notice of proposed rulemaking ("ANPR") seeking comment on proposed revisions to the Securitization Rule to address the longer-term impact of FAS 166 and FAS 167. Many provisions of the ANPR are controversial, and industry concerns and comments have resulted in the FDIC postponing the timeframe for amending the Securitization Rule such that it will not be adopted before summer 2010, if even then.
- Recognizing that it will need more time than the March 31, 2010 extension included in the interim rule, on March 11, 2010 the FDIC revised the interim rule to extend the "grandfather" provision until Sept. 30, 2010 and announced that an expected final rule will be completed this summer.
- The FDIC adopted a final rule to extend the "grandfather" provision of the interim rule until Sept. 30, 2010, thus granting itself an additional six months' reprieve during which to finalize the longer-term amendments to the securitization rule.

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Securitization Rule And Loan Participations

- The ANPR provisions regarding participations are very straightforward. By continuing to require that participations meet all requirements for sale treatment under GAAP except for the legal isolation requirement, the ANPR essentially incorporates by reference the definition of "participating interest" from FAS 166.
- The ANPR bolsters this conclusion by largely carrying forward the definition of "participation" from the original Securitization Rule, but adds in the additional requirement that the interest be a "participating interest," which it does not define but which is almost certainly a conscious incorporation of the FAS 166 definition.
- In the supplementary materials accompanying the ANPR, the FDIC offers the following encouraging comment: "While the GAAP modifications will have some effect on participations, most participations are likely to continue to meet the conditions for sale accounting under GAAP."
- Finally, the ANPR addresses 35 specific questions to comments, almost all of them about securitizations. The very first question, however, is about participations.
- Specifically, the "participation question," which is innocuous and even suggests a favorable attitude towards participations, is : "Do the changes to the accounting rules affect the application of the pre-existing Securitization Rule to participations? If so, are there changes to the Securitization Rule that are needed to protect different types of participations issued by IDIs?"
- Although the ANPR gives some guidance regarding the FDIC's likely approach, the degree of financial industry opposition in response to its ANPR, and the fact that the FDIC has recognized that it will need substantially more time than initially contemplated to bring this rulemaking to closure, suggests that major revisions may be made prior to the final adoption of a new rule.

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