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Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
Norwalk, Connecticut 06856

Re: Loan Participations – FASB Staff Request for Information Relating to the Isolation of Transferred Assets in Connection with Its Qualifying Special-Purpose Entity Project to Amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

Dear Bob,

The American Bankers Association appreciates the opportunity to comment on the staff paper issued by the Financial Accounting Standards Board (FASB) regarding the right of setoff. The ABA brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes the ABA the largest banking trade association in the country.

As you know, the ABA wrote to the FASB in April and asked for the comment deadline of the staff paper be extended to allow constituents more time to comment. Although the FASB decided to retain a 30-day comment period, we appreciate the FASB's decision to host roundtable discussions to fully consider bankruptcy and consumer protection law on May 25 and to address Federal Deposit Insurance Corporation (FDIC) receivership law and loan participations on June 17. We are aware that participation in the roundtables is by invitation only and that the Board plans to invite attorneys. This issue is critical to the banking industry and we appreciate the opportunity to participate in the June 17 roundtable.

We are extremely concerned about the impact that this rule will have on credit risk management, legal lending limits (including the impact on leverage ratios), customer relationships, and the lending market in general. At issue is whether rights of setoff prevent loan participations from qualifying as sales for financial accounting and reporting purposes. The right of setoff is defined as the right to

cancel mutual debts or cross demands between two parties with a mutual debtor/creditor relationship and, in regard to loan participations, the right of setoff is a borrower's right to offset deposit amounts against a loan obligation it holds in the same bank. On February 11, the FASB decided that rights of setoff prevent loan participations from being recognized as sales for accounting purposes, and instead, should be recorded as financings between banks. We strongly disagree. Sale accounting treatment for loan participations is consistent with the rules required by generally accepted accounting principles (GAAP) and we believe that a change in the accounting or structuring of loan participations is not warranted. We urge the FASB to reconsider its decision and conclude that loan participations are true sales.

We are aware that the FASB has faced strong pressure to issue rules on the accounting for off-balance sheet activities since the collapse of the Enron Corporation. In January 2003, the FASB issued Financial Interpretation No. 46 (FIN 46), Variable Interest Entities, an interpretation of rules existing in FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. In December 2003, the FASB issued more rules on off-balance sheet entities as a revision to FIN 46, referred to as FIN 46r. We are aware that the FASB is planning to issue even more accounting rules for off-balance sheet activities, specifically on qualified-special purpose entities (QSPEs), and loan participations surfaced as an area that this rule would address. Users of financial information, including customers, rating agencies and banking regulators, do not consider there to be abuse in the use of loan participations. After conversations with users of financial information, we believe that the market, rating agencies, regulators, investors, businesses, accounting firms, customers, and banks understand the right of setoff and that it is already considered as a part of doing business. The FASB made a wise decision in postponing the issuance of new rules and to take more time to study the facts and circumstances on this issue.

Since this issue has surfaced as a concern of the FASB, we have worked hard to better understand the law surrounding rights of setoff and handling of loan participations in receivership situations. Because the ABA is an association and not a law firm, we cannot offer detailed legal insight on all matters related to the right of setoff. That said, however, we are concerned that an overly theoretical view is being taken with regard to loan participations, and, instead, a practical approach should be considered. This letter is to provide the FASB with additional information on the following:

1. Benefits of loan participations
2. Applicability of setoff rights to loan participations
3. QSPEs as a solution
4. Case law on loan participations
5. Questions in FASB staff paper
6. Major changes to participations and lending

Benefits of loan participations

Loan participations play a fundamental role in the business of banking and are used as a basic funding tool that fuels liquidity in the financial market system. This liquidity is critical for companies of all sizes, helping small and mid-size businesses to expand and operate, and is necessary for large corporations to compete and expand both domestically and internationally. The use of loan participations is encouraged by banking regulators for banks of all sizes to manage credit risk, comply with regulatory lending limits, and meet the borrowing needs of all sizes of corporate and small business customers.

Participations are regularly used by banks and other lenders as a way of enabling the originating lender to meet the needs of corporate customers. Often, such loans could not otherwise be made, thus increasing the volume of business, diversification of credit risk, and liquidity in the market. Although the language in contracts can vary, through research we have learned that the language in most participation agreements supports the classification of the participation as a sale and assignment by the lead bank, and a purchase by the participanting bank of an undivided fractional interest in the underlying loan made by the lead bank.

The participation agreement represents an assignment of an interest in the underlying loan and collateral from the lead bank to the participating bank. Therefore, the participating bank possesses an ownership interest in the underlying loan and collateral.

Applicability of setoff rights to loan participations

We understand that the FASB is concerned that the existence of the right of setoff may prevent transfers of assets in loan participations from qualifying as sales. Although in a perfectly theoretical world, we understand how the FASB reaches this conclusion, in practice, loan participations are consistent with the intent and application of GAAP, including the handling of bank receiverships.

The staff paper states that the Board is considering changing the requirements of sale accounting to state that isolation of financial assets from a transferor means that the value of those assets to the transferee cannot depend on the financial performance of the transferor and is not affected by bankruptcy, receivership, or changes in the creditworthiness of the transferor. Also, if transferred financial assets are isolated from the transferor, the value of those assets to the transferee must depend solely on the financial performance of the issuer of the original transferred assets (the original debtor). We believe that this interpretation of GAAP expects sales to be "absolute" in nature, which would require legal and accounting advisors to consider every "what if" situation that could potentially occur at the time the transaction, or at any point in the future, in order for transfers of financial assets to qualify as sales. An interpretation that would require this level of certainty could prevent most, if not all, transfers of financial instruments from qualifying as sales, and we are concerned that this would strain the financial markets without good reason. We strongly discourage the Board from adopting this new definition, as it brings into play a host of new subjective determinations that would need to be considered and many new difficult issues with financial

reporting for practitioners and the Board without providing benefit to users of financial statements.

Banks are going concerns, and make accounting and legal decisions based on the idea that their businesses will continue to be in existence. Requiring companies to base business decisions on circumstances where the company is bankrupt or the bank is in receivership, along with predictions about subsequent events that are unlikely to occur, goes too far against the fundamental principle of financial accounting and reporting that the company is a going concern.

The right of setoff exists in consumer protection law and FDIC receivership. This right exists in business-to-business relationships and business-to-customer relationships, including banking to borrower relationships. Although this right exists in many types of business arrangements, including loan participations, it has such a remote possibility of being granted or enacted that the use of this right is highly unlikely to occur. Also, when the FDIC assumes the role of receiver for a failed bank, the FDIC immediately begins to work to sell the assets (loans) of the failed bank to maintain the integrity of the assets, and functions to service outstanding assets and liabilities.

We believe that a mere retention of a right of setoff should not be considered as retaining control over the entire loan. Such a small, highly remote risk should not preclude sale treatment when practically, the existence of rights to setoff are presumptively beyond the reach of the transferor and its creditors. We agree with interpretations made by some users of financial statements that the intent of SFAS 140 is that upon the insolvency of the transferor (i.e., the lead bank), *general creditors* of the transferor would not have access to the transferred assets to satisfy their claims against the transferor. Setoff is not available to the general creditors but only to a single party that is not, in fact, a creditor.

QSPEs as a solution

We believe that requiring a qualified-special purpose entity (QSPE) would either add exorbitant operational costs to loan participations, and ultimately to borrowers, or would eliminate the use of participations by community banks. The FASB has considered a possible way to resolve the right of setoff issue would be that a loan could be sold to a QSPE or trust before participating it out. To establish a QSPE between a selling bank and a buying bank, legal documents would need to be created, outside experts representing both the buying bank and selling bank would need to be involved (such as attorneys, investment bankers, and accounting firms), and unless commercial loan contracts are standardized with the same rates and covenants, each loan participation would likely require its own newly created QSPE. It is our understanding that the average cost to establish a QSPE begins at $100,000. Loans that are participated can be for any amount, and are often used by community banks for loans in the dollar range of the upper hundreds of thousands or low millions. A requirement to use a QSPE would add exorbitant cost and complexity, making it unfeasible for many banks to continue to do loan participations.

Case law on loan participations

We understand that the FASB requested information from the Financial Depository Insurance Corporation (FDIC) late last year, and the FDIC provided the FASB with case law dating back to the early 1980s that dealt with the right of setoff including: (1) FDIC v. Mademoiselle of California (the Mademoiselle Case) and (2) Seattle-First National Bank (Seafirst) v. FDIC. We believe that the treatment of loan participations and the right of setoff remains uncertain because the courts have rendered conflicting decisions. Further, the last time this issue reached the court systems was nearly 20 years ago.

Since the date of the Seafirst case, there has been a fundamental change in the law determining the application of ownership of rights to the payment of money. The revision of Article 9 of the Uniform Commercial Code, which has been adopted by all 50 states (effective July 1, 2001 or shortly thereafter in the case of a few states), greatly expanded its coverage beyond traditional secured transactions to include the sale of promissory notes. Prior to Revised UCC Article 9, there was no single law dealing with the transfer of ownership interests in payment obligations, and courts were forced to look on a state-by-state basis for the often not very clear legal principle. Revised UCC Article 9 not only addresses transfers of ownership in payment obligations, but provides that the ownership rights of a purchaser are automatically protected against the rights of the lien creditor, trustee in bankruptcy or receiver, without the need for filing, notice or other action.[1]

Questions in FASB staff paper

In the staff paper issued for comment on March 9, 2004, the FASB requested information from the legal community on matters related to the right of setoff under bankruptcy law. In particular, the FASB staff is interested in rights of setoff that might arise in situations involving a depositor at an insured financial institution that also received a loan from the same financial institution, and the loan was participated to other separate financial institutions.

To provide answers to the questions for comment in the FASB staff paper, we requested the assistance from the legal community. Below are comments we received as well as additional comments describing how sale transactions, legal interpretations, and business practices have evolved over several years.

Is the information about setoff rights in this paper accurate for transferors subject to the U.S. Bankruptcy Code as well as for transferors subject to receivership by the FDIC or other regulatory agencies?

The FASB assumes that a participation is not a true sale; however, the FASB's interpretation of its rule does not consider all of the facts and circumstances that can also be part of the contract, which could result in a different decision under bankruptcy and receivership law.

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[1] UCC, 9-309(3) & (4); UCC 9-317(a)(2)(A).

Under a bankrupt transferor scenario, the transferor (i.e., the lead bank) is the only party with a direct relationship to the obligor (i.e., the borrower). Consequently, the transferor and the obligor are the only parties with a mutual relationship that gives rise to common law rights of setoff. The obligor can set off the full amount of the remaining gross amount of the original debt against any deposit accounts in an insolvent bank's possession. Likewise, the insolvent bank can set off any of the obligor's deposit accounts against the full balance of any outstanding debt owed to it.

The Board's description of common law rights of setoff is accurate as it pertains to a lead bank's and participating bank's rights upon bankruptcy; however, this conclusion assumes a traditional participation arrangement. If precautions are taken to grant direct rights to the transferee as an owner of the underlying debt, or perhaps, the participation documents identify and segregate rights to offset on a shared basis, then the analysis may be different. We believe that in receivership, the ways that the FDIC or other authority may react or handle rights of setoff are not always predictable. Consequently, the analysis in the staff white paper, while broadly accurate, is subject to modification if either bank changes the structuring of a traditional participation.

How are rights of setoff currently considered in true sale analyses performed by attorneys? If they are not considered, why not?

Attorneys do not always consider rights of setoff in issuing true sale opinions for each loan participation. Attorneys are usually asked to issue an opinion on perfection issues, legality of the transaction, and the parties' ability to transact the deal. In some circumstances, an attorney may be asked to conclude if the participation as presented yields a true sale.

Because rights of setoff generally arise as a consequence of events foreign to the particular transaction (i.e., triggered by bankruptcy or receivership), they are not a primary area of consideration. If attorneys were required to consider things, such as the rights of setoff, the attorney would have to hypothesize and explore innumerable "what if" situations. Attorneys would be expected to explore undocumented possibilities that could arise in the future and would likely find it difficult, if not impossible, to be able to say that under no circumstance would any additional liability ever arise. We believe that this requirement would be impractical and beyond the scope for an attorney, and do not believe it should be expected in the normal course of business.

What additional information about setoff rights should the Board consider? Does a setoff right exist between the original debtor and the transferee? Do setoff rights exist if an affiliate of the transferor has a liability to the obligor? Do common law and statutory distinctions vary between jurisdictions?

Please refer to information provided earlier in this letter.

Can setoff rights be eliminated, and, if so, how can the elimination be accomplished? Are the legal aspects the same for transferors subject to the U.S. Bankruptcy Code as for transferors subject to receivership by the FDIC or other regulatory agencies? If not, what are the differences?

We have explored a number of options that could possibly accommodate a theoretical interpretation of SFAS 140 and address the rights of setoff. Rights of setoff exist in consumer protection law. The bottom line is that not all such rights can be eliminated in the absence of a contract between the transferor and transferee, and the transferee can potentially violate consumer protection laws with certain consumer assets. Differing conclusions could be reached in similar circumstances, allowing a right of setoff or disallowing a right of setoff, depending on the judge and legal representation. That said, although such rights could be allowed, the exercise of these rights is highly improbable (as previously indicated, it has been nearly 20 years since this right of setoff has been exercised).

We believe it is not appropriate to change the accounting rule based on outdatd case law that is based on very different and improbable facts. Case law evolves over time on a case-by-case basis, and change would need to be upheld by the courts. In the past, some courts have ruled that some rights cannot be waived in advance when each party believed that the rights were entirely waived. Even if a true sale opinion is given, there can be no assurance that an absolute definition of "legal isolation" would guarantee that in every receivership and bankruptcy case that any particular judge would find in favor of the financial asset being truly isolated from the transferor.

It would seem very hard to justify a requirement to set up additional trusts, modify loan contracts, or require notification to the borrower that a loan might be transferred, all to eliminate future setoff rights where there is no reasonable expectation that any liabilities giving rise to such rights will arise.

The Board recently discussed definitions defining isolation of financial assets to mean that the value of those assets to the transferee does not depend on the financial performance of the transferor and is not affected by bankruptcy, receivership, or changes in the creditworthiness of the transferor. Given that definition of isolation, what factors other than setoff rights are not typically considered by attorneys in rendering true sale opinions that may interfere with isolation of transferred assets from the transferor and its affiliates (except bankruptcy-remote SPEs)? Please explain why those factors are not considered.

It is not feasible to list all things that an attorney considers in developing a legal opinion, and there are some related areas with regard to the rights of setoff that are not normally part of the attorneys opinion. In developing legal opinions, attorneys often do not consider consequences that might occur in a subsequent assignment of the participated debt by the transferor or transferee, a borrower's sale, merger, acquisition, expansion or other changes in circumstances. The attorney will not delve into market trends or investigate the possibilities of

insolvency. Legal opinions typically opine on business evaluations and credit risks that do not change the snapshot legal picture on which the attorney is asked to opine.

Attorneys evaluate the legal significance of a transaction, not the long-term viability of the company based on risk or market driven forces. Transferor insolvency and the rights of setoff that might arise thereafter, as well as other speculative future circumstances are not part of the attorney's opinion.

Major changes to participations and lending

If any change is made to the structuring, operation, or accounting for loan participations, we believe that such a decision will significantly change the business of banking. We believe that in order to avoid any unintended consequences on the U.S. economy and financial markets, a change that is this significant must be discussed in depth among many vested parties, including the banking industry, the FASB, banking regulators, the Securities and Exchange Commission (SEC), accountants, attorneys, small and large companies, and users of financial statements. We would like the opportunity to continue to work with the FASB in advance of any changes being made to the current accounting for and structuring of loan participations.

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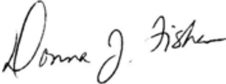
In conclusion, we urge the FASB to reconsider its tentative decision that loan participations are not true sales. The case law that is being relied on for this proposed change in the accounting for loan participations has not evolved and has not advanced in nearly 20 years. Users of financial statements are better served by the existing rules, which reflect the true economics of participations. Although rights of setoff exist in consumer protection law and FDIC receivership law, it is highly unlikely that exercise of these rights would occur.

Thank you for your consideration. Please contact Gwen Ritter (202-663-4986; gritter@aba.com) or me if you wish to discuss this letter in more detail.

Sincerely,



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