360 Madison Avenue New York, NY 10017-7111 Telephone 646.637.9200 Fax 646.637.9126 www.bondmarkets.com

1399 New York Avenue, NW Washington, DC 20005-4711 Telephone 202.434.8400 Fax 202.434.8456 St. Michael's House 1 George Yard London EC3V 9DH England Telephone 44.20.77 43 93 00 Fax 44.20.77 43 93 01



May 10, 2004

VIA E-MAIL

director@fasb.org

TA&I Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116 Letter of Comment No: File Reference: 1200-SRI Date Received: 5/11/04

Re: Setoff and Isolation

Ladies and Gentlemen:

The Bond Market Association (the "Association") wishes to express its appreciation for the opportunity to comment on the setoff and legal isolation issues described in the Request for Information dated April 9, 2004 (the "White Paper") of the staff of the Financial Accounting Standards Board (the "Board").

Since publication of the White Paper, Association members have actively participated in discussions concerning the setoff and legal isolation issues internally, as well as with members of other financial market trade organizations and individual firms that are submitting comments. We believe those questions have been addressed comprehensively in other industry group responses. We particularly support and align our views with letters submitted to you by the American Securitization Forum and the Loan Syndications and Trading Association. Rather than simply repeat the answers and analysis presented in those letters, we felt it would be more helpful to the Board to highlight what we consider to be several key points in responding to the White Paper:

1. Paragraph 9 of Statement 140 requires that transferred assets must be "isolated from the transferor – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership," in order for the transfer of those assets to be considered a sale for financial reporting purposes. In the broader legal context, "isolation" has been widely and consistently interpreted to require an evaluation of whether, upon the transferor's bankruptcy or insolvency, the general creditors (as opposed to one particular creditor) of the transferor would have rights to the transferred assets. We believe that the interpretation of the legal isolation criterion of Statement 140

¹ The Association represents securities firms and banks that underwrite, distribute and trade fixed income securities and other credit market instruments in the U.S. and globally. This letter was prepared with substantial input from the Association's Accounting Policy Committee, as well as legal and business professionals within the Association's broader membership. Additional information about the Association and its members and activities is located at www.bondmarkets.com.

Financial Accounting Standards Board May 10, 2004 Page 2

has been consistent with this prevailing legal analytical framework for distinguishing between sales and financing transactions. We further believe that the application of this analytical framework produces appropriate results for accounting derecognition purposes. If, following a transfer of assets, the general creditors of the transferor no longer have rights under law to reach those assets, it is because the transferor no longer has ownership interests in those assets. Under such circumstances, the transferor should not be required to reflect ownership of those assets on its balance sheet. To require the transferor to reflect ownership of assets on its balance sheet when the transferor's general creditors would have no rights to reach those assets would mislead the parties who rely on the transferor's financial statements in engaging in transactions or making investment decisions.

2. The Board has asked whether the isolation of financial assets should require that the value of those assets to the transferee not depend on the financial performance of the transferor and not be affected by the bankruptcy, receivership, or changes in the creditworthiness of the transferor. The Board is apparently concerned about certain potential attachments to the assets that might be retained by the transferor that might, in one way or another, affect the value of the transferred assets after the transfer. For the reasons set forth below, we think that expanding the isolation concept under Statement 140 to this degree would convert the current "legal isolation" standard into a "complete isolation" criterion in a way that fundamentally changes the Statement 140 paradigm for accounting derecognition. We believe that such a change would lead to seriously undesirable policy results and intractable practical difficulties.

One of the potential attachments the Board considered was setoff defenses. Since responses submitted by the other trade associations have provided detailed responses on this topic, we do not repeat those answers but instead would like to make three observations about the law of setoff defenses and its applicability to financial asset transfers generally.

First, as described in detail in other submissions, the likelihood that a transferr or obligor may be able to exercise setoff against the transferred assets upon transferor's insolvency is remote, and the impact on actual transactions reflects mainly theoretical, and not practical, concerns. Notwithstanding the remoteness of this risk, derecognition may be precluded for a range of financial asset transfers where setoff defenses may theoretically be asserted.

Second, assuming setoff defenses exist, it is not possible to eliminate all setoff defenses in all circumstances. For example, consumer protection laws do not permit waivers of obligors' defenses related to goods sold under consumer credit contracts. If the existence of setoff defenses prevents assets from being derecognized, it would create misleading financial statements to continue to treat consumer credit loans as transferor's assets in its financial statement when in fact such assets have been sold and securitized. Even where it may be possible to eliminate such defenses via notification and waiver, requiring elimination of such defenses as a condition to sales accounting treatment would require actions that often run counter to commercial expectations and market practice. This is particularly true in situations where the transferor's setoff defenses accrue from non-contractual claims, such as environmental or tort liabilities subsequent to the transfer of assets. In such situations, there is no reasonable basis to

Financial Accounting Standards Board May 10, 2004 Page 3

anticipate the rise of setoff defenses for which notification could be given at the time the assets were transferred.

Finally, setoff defenses are taken into account in attorneys' true sale analyses but have no substantive effect on that analysis. True sale opinions focus on whether a transfer of assets would be characterized as a sale (and therefore beyond reach of the transferor's general creditors) or would be characterized as a secured loan (i.e., with the assets treated as security for a loan but still owned by the transferor and therefore still subject to the claims of the transferor's creditors). Assets may be transferred and removed from the transferor's estate and yet still be subject to a particular creditor's setoff defenses. Setoff defenses are thus a consideration that may affect the value of the transferred assets, but that have no bearing on the question of whether a sale has occurred. Transferees of assets take into account the risks related to setoff defenses and other potential attachments (e.g., "real" defenses such as fraud; warranty buybacks and indemnities, fraudulent conveyance and voidable preference remedies, among others) when evaluating the value of the assets and negotiating the purchase price.

Other potential risks to the value of transferred assets that may be occasioned by changes in the creditworthiness of a transferror are not relevant to the question of whether a transfer is a sale or a pledge, or whether the transferred assets are subject to the claims of creditors generally.

For the foregoing reasons, we do not believe that the presence of setoff risks or other potential risks to the value of transferred assets should preclude accounting derecognition.

We thank the Board for the opportunity to comment on setoff and legal isolation. We request an opportunity for one of our members to participate in the roundtable discussions that the Board has scheduled on these topics. If you have any questions or need additional information, please contact George Miller, Deputy General Counsel of The Bond Market Association, at (646) 637-9216 or gmiller@bondmarkets.com.

Sincerely.

/s/ Esther Mills

Chair, Accounting Policy Committee of The Bond Market Association