We set out below, in our capacity as English counsel to a US seller of loan participations in the London secondary loan market, comments on the proposed amendments to paragraphs 9 and 27 of FASB Statement 140 in the Exposure Draft of August 11, 2005.

In summary, the proposed requirement for true sale opinions to be obtainable under paragraphs 9 and 27 of FASB Statement 140 will have far reaching implications for US institutions that sell loans in markets outside the US. The primary concern is that "legal isolation" can be achieved under the laws of jurisdictions outside the US without a true sale. The requirement for a true sale analysis imposes an unnecessary burden on US Sellers in markets outside the US and places them at a competitive disadvantage. These points are further expanded upon below. As we are only able to comment on English law, our comments are limited to the impact of the proposed changes on US institutions selling loans under English law sub-participation agreements in the London market.

Background

1. In the London market, sub-participations are typically sold under English law governed sub-participation agreements. English law sub-participation agreements are conceptually and legally different from the typical New York law governed form of participation agreement.
2. A New York law governed participation agreement transfers a beneficial (or equitable) interest in the proceeds of the participated loan to the transferee. The agreement is expressed to be a sale of a propriety interest and not a debtor/creditor relationship between the transferor and the transferee.

3. An English law governed participation agreement, by contrast, is constructed as a limited recourse back-to-back loan between the transferee and the transferor. A properly drafted English law participation agreement will specifically state that the arrangement does not constitute a transfer of a proprietary interest in the underlying loan (or the proceeds of the loan) to the participant. The agreement will also specifically provide that the relationship between the parties is that of a debtor and a creditor. The transferor transfers the risks and rewards of its interest in the participated loan by agreeing to pay to the transferee amounts equal to the amounts actually received from the borrower/obligor (less any spread representing servicing or other compensation and any retained interest). The transferee takes the risk of the borrower/obligor not paying in accordance with the terms of the participated loan. While an English law participation agreement will not transfer a proprietary interest in the underlying loan, a properly drafted English law participation agreement will not limit the transferee's right to transfer or pledge the "purchased assets", therefore satisfying paragraph 9(b) in its current unamended form. Furthermore, a properly drafted English law participation agreement will not include provisions entitling or obligating the transferor to "reacquire" the "purchased assets", thereby satisfying the requirement of paragraph 9(c) in its current unamended form.

Impact of the Proposed Amendments

4. The amendments to paragraphs 9 and 27 of FASB Statement 140 introduce a specific requirement that the isolation test in paragraph 9(a) be only satisfied if the transfer is legally a sale under the laws of the applicable jurisdiction. This adds to the separate requirement for an analysis that, in the event of the transferor's bankruptcy, receivership or other insolvency, the transferred asset would not be deemed to be part of the estate of the transferor.

5. We understand that US legal counsel are able to provide true sale opinions on properly drafted New York law participation agreements, such that New York law governed participations will be treated as sales for the purposes of FASB Statement 140.

6. An English law sub-participation agreement, being a back-to-back limited recourse loan, does not qualify for a true sale opinion under English law as there is no sale/transfer of any propriety interest in the participated loan. Furthermore, as there is no sale, unless other arrangements are entered into, the transferred loan will not be isolated from the transferor's estate in its insolvency. Therefore, in the absence of other arrangements (see below), an English law sub-participation will not qualify for derecognition under FASB Statement 140.

7. It is possible as a matter of English law to isolate a loan sub-participated under an English law sub-participation agreement from the estate of an English incorporated
transferor in its insolvency using a secured loan arrangement. Secured loan arrangements can be structured such that on the transferor's insolvency, the transferee has recourse to the underlying participated loan in priority to claims of the transferor's other creditors. The isolation is achieved without a "legal sale".

8. If the requirement for a true sale opinion is imposed as contemplated by paragraphs 27A and 27B of the Exposure Draft, US institutions who sell participations in the London market through English incorporated consolidated subsidiaries using an English law secured loan structure will not be able to obtain off balance sheet treatment despite technically meeting the isolation requirement. This significantly disadvantages US institutions operating in the London market as non-US institutions in the London market typically account under International Accounting Standard 39 (Financial Instruments: Recognition and Measurement) ("IAS 39").

9. The proposed amendments to FASB Statement 140 will result in a significant divergence in the treatment of sub-participation arrangements under FASB Statement 140 and IAS 39. FASB Statement 140 (as amended) focuses on whether a proprietary interest in the transferred asset has been passed to the transferee. IAS 39 focuses on whether all risks and rewards of ownership of the transferred asset have been transferred from the transferor to the transferee.

10. Under IAS 39, an entity will be entitled to derecognise a financial asset if it either:

   (a) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets the following three specified conditions:

      (i) the transferor has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset;

      (ii) the transferor is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows from the transferred asset; and

      (iii) the transferor has an obligation to remit any cash flows it collects on behalf of the original recipients without material delay; or

   (b) transfers the contractual rights to receive the cash flows of a financial asset (i.e. the transferor ceases to be the lender of record).

11. We understand that the London Loan Market Association form of English law participation agreement (which is the typical form of participation agreement used in the London market) meets the criteria of IAS 39 and so off-balance sheet treatment will be given to non-US sellers of participations in the London market - whereas off-balance sheet treatment will not be available to US sellers using English law documentation under FASB Statement 140. This places US sellers at a distinct competitive disadvantage.
12. We are of the view that it would be unrealistic to suggest that US sellers of participations require UK market participants to accept New York law governed sub-participation agreements which meet the requirements of FASB Statement 140 (as amended). There are a number of reasons for this. The most significant reasons are:

(a) Firstly, a New York law sub-participation agreement is treated under English law as an "equitable assignment" of the underlying loan proceeds, which typically requires borrower consent under English law standard loan agreements. This defeats one of the primary commercial rationales of the sub-participation arrangement - lenders use sub-participation arrangements to sell down lending commitments on a silent basis. There is no requirement as a matter of law nor generally as a matter of contract or market practice for the borrower to be aware that the lender of record has participated its commitment.

(b) Secondly, where UK tax law applies to the payment of interest on the underlying loan, the grant of a participation under New York law can potentially result in the borrower being under an obligation to withhold or deduct tax from payments of interest (and, subject to the terms of the relevant loan, be under an obligation to gross-up such amounts). This would be unpalatable to the London market.

(c) Thirdly, there is a long established tradition of using English law sub-participation agreements in the London market and any attempt to impose US law governed documentation is for the most part strongly resisted by market counterparties.

Summary

13. The requirement under paragraphs 9 and 27 of FASB Statement 140 (as amended) for a true sale opinion will significantly inhibit the ability of US institutions (or consolidated subsidiaries thereof) to compete in non-US markets where different legal considerations apply.

14. It is possible for transferred assets to be isolated under English law from a transferor’s estate in its insolvency using secured loan structures - without a “legal sale”. There is a divergence of approach between FASB Statement 140 and IAS 39 that results in US sellers of loan participations in markets outside the US being discriminated against where “isolation” is achievable without a "legal sale".

15. The use of a New York law governed sub-participation agreement in the London market is not a feasible alternative for US sellers.

16. We urge FASB to reconsider the imposition of the requirement for a true sale opinion where legal isolation is possible without a "legal sale" of participated loans.
We thank you for the opportunity to make these comments.

Yours faithfully,

Clifford Chance LLP

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