October 10, 2005

Technical Director—File Reference 1225-001
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Via E-mail: director@fasb.org

Re.: Accounting for Transfers of Financial Assets Exposure Draft (Revised)

Dear Sir or Madam:

The Association of Corporate Credit Unions (ACCU) is pleased to provide comments in response to the Financial Accounting Standards Board’s (FASB) revised Exposure Draft (proposed Statement or proposal) – Accounting for Transfers of Financial Assets (amendment of FASB Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities). The proposed Statement would make changes to the accounting rules that govern loan participations and state how loan participations should be conducted to qualify for accounting treatment as a sale.

By way of background, ACCU is the primary trade association for the country’s corporate credit unions (corporates) located around the country. Corporates provide liquidity, investment products, payments settlement and other financial services to the nation’s federal and state-chartered credit unions.

A number of our members currently conduct loan participations; therefore, this accounting rule is of great importance to them. Further, the natural person credit unions our members serve conduct them as well. Under the proposed Statement, the transferred portion(s) and any portion retained by the transferor must meet the definition of participating interests. Sales accounting treatment is advantageous for originating institutions because it allows the institution to deduct the transferred portion of the loan from its balance sheet. If the transaction involves the transfer of a member business loan (MBL), the loan balance would be excluded when calculating compliance with the MBL cap (even if servicing the loan is retained). In contrast, loan participations that do not qualify for sales accounting treatment would have to be shown on the books of the originating financial institution as a collateralized borrowing subject to the MBL cap. Loan participations are an important tool for credit unions and other financial institutions to control interest rate risk, credit risk, balance sheet growth, and maintain net worth. In addition,
Loan participation arrangements are an effective balance sheet management tool for credit unions to manage liquidity, diversification of geographic risk and regulatory capital constraints. A typical loan participation transaction that credit unions enter into is where the originating credit union sells a 90% participation in its loans and retains the servicing rights as well as a 10% interest in the loans. All the rights to the underlying loans are conveyed consistent with the respective ownership percentages of 90% and 10%. However, the originating credit union may retain a small subordinated interest, generally 5%, in the pool of loans against which losses are initially allocated and will provide reserves for the expected losses, which is usually significantly less than the limited subordination.

There are several reasons why this structure is commonly used by credit unions. First, because credit unions are mutual-enterprise organizations and are owned by their members (borrowers), the credit quality of credit union loans often is much higher than similar loans of other financial institutions. While the general marketplace does not recognize this distinction, the credit union industry does. Therefore, the originating credit union is able to obtain significantly better pricing on participations sold within the industry. Originating credit unions would much rather retain the minimal credit risk associated with these loans and receive the higher selling price similar to loans sold with full recourse.

Another reason this structure is commonly used is because it meets the legal isolation test under National Credit Union Administration (NCUA) regulations. Section 709.10(6) of the NCUA regulations provides language that protects assets transferred in conjunction with a securitization or participation, provided that the transfer meets all conditions for sale accounting treatment under generally accepted principles, other than the legal isolation condition which is addressed by this regulation. While Section 709.10(4) of the NCUA regulations defines participations as loans sold without recourse, NCUA has issued a legal opinion letter (consistent with its Commentary to the Final Rule creating Section 709.10 – see 65 Federal Register 55349, September 14, 2000 – and the similar FDIC Commentary to its mirror-image Regulation at 12 CFR Section 360.6 - see 65 Federal Register 49189, August 11, 2000) that affirms that the retention of a limited subordinated interest against which losses are initially allocated will not, by itself, make the transfer a recourse participation for purposes of Section 709.10(a)(4). Therefore, credit unions using limited subordination have been able to receive more favorable pricing by retaining the credit risk while meeting the legal isolation test under SFAS No. 140 for sale accounting treatment within the regulatory environment in which they operate.

SUMMARY OF ACCU’S POSITION

- As there are credit unions that are interested in loan participations with recourse or have a portfolio of such loans, ACCU requests FASB to consider revising the definition of participation interest to include loans with limited recourse thus enabling them to achieve sales accounting treatment. This would help many of those institutions avoid the costly and time-consuming process of setting up and running a qualifying special purpose entity, or SPE.
• To retroactively change the accounting treatment carried on a credit union’s books could cause the credit union’s balance sheet to suddenly be inflated. The credit union would wind up with decreased net worth and corresponding potential regulatory capital problems. ACCU requests that the provision requiring loan participation transactions with recourse shown on an institution’s books as a sale to be recharacterized as a secured borrowing upon issuance of the final rule be modified so that it is prospective instead of retroactive. A delayed implementation would allow institutions time for implementation of the rule, including establishment of an SPE.

• ACCU believes that the exposure draft, as currently written, unfairly penalizes credit unions and other entities in its attempt to control practices that it deems to be outside of the original intent of SFAS No. 140.

DISCUSSION OF ACCU’S VIEWS

During its deliberations, FASB considered disallowing sales treatment for loan participations marked by rights of setoff (the common law right of debtors and creditors to set off – that is, net amounts due to one another if one of the parties defaults, becomes insolvent, or enters into bankruptcy or receivership.) Based on FASB’s review of the comments, the proposal now does not stipulate that rights of setoff preclude the use of sales accounting treatment.

In addition, earlier this year FASB had tentatively decided that in order to receive sales treatment, a loan participation must pass a “true-sale-at-law” test rather than simply receive a “true-sale-at-law” attorney’s opinion. If the loan participation did not pass the test, then the financial institution would have been required to use an SPE to transfer the participation. In this new revised Exposure Draft, FASB opted for the more flexible approach of an attorney opinion rather than a strict test. Furthermore, the proposal indicates that the originating financial institution would not necessarily need to obtain a “true-sale-at-law” opinion in every case. According to the proposal, a “true-sale-at-law” opinion is not required if the transferring institution has a reasonable basis to conclude that the appropriate legal opinion would be given if requested. This would occur where the originating credit union might reach a conclusion without consulting an attorney if it had experience with other transfers with the same facts and circumstances.

ACCU believes it is important to clarify when sales accounting treatment is appropriate and when secured borrowing treatment is required as well as to clarify the definition of participating interest. It is ACCU’s understanding the some loan participations in the credit union industry involve first mortgages and are conducted without recourse. We believe that as the proposal now stands these credit unions will be able to continue conducting loan participations as they have done with the added benefit from the provision alleviating them of the burden of obtaining a true-sale-at-law opinion for every participation transaction. This provision would also serve to lessen the cost of the transaction for loan participation agreements with the same deal structure.

However, ACCU is concerned with the restrictive definition of participating interest in the proposed Statement. To employ sales accounting treatment, a participation interest could involve absolutely no recourse or subordination to the originator. This proposed Statement would effectively eliminate loan participations with recourse as a business product. For the credit unions that conduct loan participations with recourse, they would be forced to either
restructure the deal so there is no recourse to the originator, or else run the transaction through an SPE. We cannot endorse a proposal that could lead to either outcome. The outcome would be to severely limit this type of transaction.

We strongly urge FASB to modify the definition in the final rule to allow for loan participations with limited recourse so they may obtain sales accounting treatment as well. This approach limits the losses that can be borne by the originator while at the same time still allows for favorable pricing of loan participation deals.

Further, ACCU is also concerned with the effective date and transition provisions in the proposed Statement. Under the proposal, if a credit union has an ongoing obligation in connection with a loan participation that does not meet the surrender of control criterion dealing with isolation (for example, a limited recourse obligation), then when the final Statement is issued the credit union may be required to reclassify these transactions as secured borrowings rather than sales. The credit unions that entered into loan participation agreements with recourse certainly did so with the expectation that they could show the transaction on their balance sheets as sales. To retroactively change the accounting treatment on the books could cause the credit union’s balance sheet to suddenly be inflated; and the credit union would wind up with decreased net worth. Consequently, we encourage FASB to amend this provision so that the rule is effective prospectively and not retrospectively.

However, if FASB determines that the provision should remain retroactive in the final rule, then we request a delay in the effective date of the final rule so that credit unions and other institutions have ample time to implement this provision. Such a delay would also provide institutions with time to set up SPEs if they so choose.

Entering into loan participation transactions that qualify for sale accounting treatment has allowed credit unions to effectively serve their members as well as manage their balance sheets and liquidity needs without impairing their regulatory capital ratios as would be the case if they were to simply enter into borrowings for their liquidity needs. The presence of a limited subordination feature that qualifies for sale accounting treatment has allowed credit unions to receive pricing more commensurate with the credit risk that exists in their portfolios rather than sell participations in what they believe to be below-market prices. In addition, these transactions have other benefits to the safety and soundness of credit unions as they result in diversification of credit risk and geographic risk inherent in loan portfolios. We believe the exposure draft, as currently written, unfairly penalizes credit unions and other entities in its attempt to control practices that it deems to be outside of the original intent of SFAS No. 140.

Please feel free to contact me with any questions you may have.

Sincerely,

Michael F. Canning, Esq., CAE
Executive Director