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Mr. Lawrence W. Smith
Director, Technical Application and Implementation Issues
File Reference No. 1200-0001
Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Proposed Amendments to FAS No. 140

Dear Mr. Smith:

The Conference of State Bank Supervisors (CSBS)¹ is pleased to have the opportunity to comment to the Financial Accounting Standards Board (FASB) on Proposed Statement (Proposal) of Financial Accounting Standards on *Qualifying Special Purpose Entities (QSPE) and Isolation of Transferred Assets*, which would be an amendment to FASB Statement No. 140.

The Proposal is largely aimed at the abuses of the QSPE structures in the well publicized financial collapse of Enron and other publicly traded companies. Enron had an elaborate network of QSPEs that had direct financial interrelationships with the parent company, and the purpose of the exposure draft is to limit the possibility of such a structure being abused in the future. Most of the provisions of the exposure draft are to limit these abuses by prohibiting liquidity commitments, financial guarantees, derivative instruments and other tying arrangements between a QSPE and the entity transferring assets to a QSPE and a prohibition of a QSPE from holding equity investments. Our comment letter does not highlight or address these highly targeted changes that will impact a relatively few large financial institutions.

CSBS is, however, concerned about the impact of the Proposal on all loan participations and securitizations in financial institutions, particularly community banks. Of special concern is language that would be added to Paragraph 83 of FAS 140:

¹ CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation's 6,500 state chartered commercial and savings banks and over 400 state-licensed branches and agencies of foreign banks.

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Unless the transfer (loan participation or securitization) is to a QSPE, the transfer shall be deemed not to meet the requirements in paragraph 9(b) that the transferee has the right to pledge or exchange the transferred assets.

It appears the Proposal is indicating that, unless a loan is transferred to a QSPE, the transaction shall not be considered to be a sale for accounting purposes. Presumably, then, a participation transferred to an entity that is not a QSPE would be treated in the same manner that participation with recourse is currently treated. That is, the participation would be considered a secured borrowing on the balance sheet of the transferring entity.

Definition of a QSPE in FAS 140

A QSPE is defined in Paragraph 35 of FAS 140 as a trust or other legal entity that meets all of the following characteristics:

1. Is demonstrably distinct from the transferor;
2. Has limited permitted activities established by the majority of the beneficial interest holders; and
3. Is limited to certain specified financial assets (and these holdings would be impacted by the provisions of the current exposure draft, including limitations on derivative and equity holdings.)

Essentially, a QSPE is a separate, distinct and limited legal entity. The establishment of such a structure in order to facilitate loan participations and securitizations would involve a greater amount of time and cost and would be especially burdensome to community banks involved with loan participations.

Single-Step Versus Two-Step Transactions

The criteria for a 'single-step' versus a 'two-step' transaction are discussed in Paragraphs 80-84 of FAS 140. The terminology refers to the transactional structure of a "sale" of assets and whether a true and complete transfer of beneficial interest has occurred in the transfer of an asset.

Single-step transactions, which are typical for most participation and securitization transactions, involve the transfer of financial assets from a corporation to another entity in exchange for cash (or cash and beneficial interests in the transferred assets.) The Proposal seems to assume the single-step transactions do not sufficiently isolate the transferred assets to exclude creditors of the transferring corporation from seeking these assets under U.S. bankruptcy law.

Two-step transactions are structured to eliminate this possibility of legal accessibility under U.S. bankruptcy law. This transaction involves a corporate transfer to a special purpose entity, which although wholly owned by the transferring corporation, is structurally designed to constitute a remote transfer.

The first step of the transfer is designed to be a true sale under law, because the transferring entity does not provide excessive credit or yield protection to the special purpose entity, and the Board of the transferring entity recognizes that the assets transferred are beyond the reach of the transferring entity in bankruptcy.

In the second step of the transfer, the special purpose entity transfers the assets to a trust or other legal vehicle that provides a sufficient increase in credit or yield enhancement on the second transfer to merit a higher credit rating sought by a third-party investor.

In essence, the Proposal, if adopted, would require financial institutions that currently use loan participations or securitizations as a tool for risk diversification and statutory compliance, to utilize the two-step transactional structure, including the establishment of QSPEs, in order for these transactions to be accorded sale treatment under Generally Accepted Accounting Principles. This two-step process would be extremely difficult to accomplish with a single loan participation, done to make certain that a financial institution does not exceed statutory loan limits, if this complex structure were required for each credit transaction.

Practical Effect on the Banking Industry, if Adopted

CSBS is concerned that the Proposal would add significant operational and financial costs to loan participations, with a disproportionate impact upon smaller community banks. Larger financial institutions will have the financial ability to absorb the cost and will be better able to structure the large transactions needed to make two-step transactions economically viable. However, as nation's state banking departments are the primary chartering authority of 75 percent of the community banks in the U.S., we believe this Proposal will serve as a serious disincentive for smaller banks to use loan participations to diversify their credit risk and limit loss exposure. The Proposal could ultimately increase credit and concentration risk in these smaller community banks. Furthermore, as a consequence of these requirements, rural and inner city communities that are largely served by community banks, could experience diminishing credit availability.

State banking departments have raised additional concerns that financial institutions may be hesitant to address credit deterioration if doing so would impact the QSPE status of an entity. It also appears the Proposal could lessen the disclosure and transparency in financial accounting for loan participations when the existence of setoff rights is a determinative factor in the distinction between a sale and a secured borrowing, while all other criteria required in accounting for a sale under FAS 140 remain relatively equal.

Accordingly, based on these concerns and potential for concentration and credit risk, CSBS believes the Proposal is flawed as written and could result in possible safety and soundness difficulties for financial institutions.

Recommended Action

CSBS recommends that financial institutions be provided an exemption for loan participations without recourse that contain provisions to share rights and cash flows on a pro-rata basis. FASB may want to consider a distinction between individual loan participations and loan securitizations where a pool of loans is being sold. Such securitizations could better support the structural, operational and financial costs associated with a two-step transaction and a QSPE.

Conclusion

CSBS understands that the FSAB has held a public roundtable discussion with attorneys to discuss this Proposal. To the extent that such roundtables are held in the future, CSBS strongly urges the FASB to invite at least one representative from the state banking departments. Commissioners at the state level have a broad range of experience and expertise. Generally, state regulators are responsible for the examination of a wide range of financial institutions, including banks, thrifts, credit unions, securities firms, and other financial service providers. CSBS and various state bank regulators have worked with the FASB in the past and stand ready to contribute our expertise in the future.

As the FASB considers this and future proposals that apply to heavily supervised insured depositories, we believe it is most constructive to have a dialogue with the state and Federal agencies that have direct supervision over such institutions. This consultation may provide additional insight and perspectives that could be helpful in resolving outstanding questions or concerns.

Thank you for the opportunity to provide these comments. We look forward to further discussion on this and other topics in the future.

Best personal regards,



Neil Milner
President and CEO