

Credit Union National Association, Inc.

CUNA & Affiliates

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Letter of Comment No:

TA&I Director – Setoff and Isolation 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116 File Reference: 1200-SRI
Date Received: 5/11/04

Via E-mail: director@fasb.org

Re.: Setoff and Isolation in the Context of Loan Participations

To Whom It May Concern:

The Credit Union National Association (CUNA) is pleased to provide comments to the Financial Accounting Standards Board (FASB) in response to the FASB Staff Request for Information concerning setoff rights related to isolation of transferred assets, specifically in the context of loan participations. CUNA's comments were developed under the auspices of our Accounting Task Force as well as from views of attorneys who work with credit unions. By way of background, CUNA is the largest credit union trade association, representing more than 90% of our nation's nearly 9,800 state and federal credit unions.

Many of our members currently engage in loan participations, either as the originating institution or as an investor, and FASB's project to review FASB Statement (FAS) No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, is of great concern to the credit union system. Participations are important financial and management tools that are increasingly used by credit unions, and by other financial institutions, to control interest rate risk, credit risk, balance sheet growth, and maintain net worth. Participations enable credit unions to utilize assets to make more credit available to their membership than they would be able to do without the use of loan participations.

SUMMARY OF CUNA'S POSITION

 CUNA strongly opposes any guidance from FASB that would render loan participations unusable, and we urge FASB not to move forward with contemplated changes to FAS 140.



- Requiring institutions to run participations through a qualified special purpose entity (QSPE) in order for the participations to receive true sale treatment is a needless and costly expense, which we oppose.
- Rather than adopting universally applicable provisions, FASB should recognize provisions incorporated into loan participation agreements that would alleviate FASB's concerns about legal isolation.

CUNA'S VIEWS

As we understand the issue, FASB is concerned that in a loan participation situation in which the borrower has shares or deposits at the originating institution, if that institution is liquidated, the participating institution would not be able to recover its prorata portion of the members' shares/deposits within the originating institution that are setoff.

As FASB has indicated, it is considering amendments to FAS 140 that would expressly state that because the right of setoff between the originating institution and the member/depositor/borrower¹ exists (setting up the potential that the participating institution would not have any claim against the member/depositors' funds in the originating institution) the loan transaction does not meet the isolation requirements of FAS 140. Because of this concern, instead of transferring the portion of the loan participated off of its books as a sale, the transaction would be reflected on the originating credit union's financial statements and records as a secured borrowing.

In order for participations to continue being treated as sales for accounting purposes, the amendments would further change the existing accounting standards by requiring an institution to transfer participations through a qualified special purpose entity (QSPE). This is a needless and costly expense that would make it virtually impossible for credit unions to use participation loans as a management tool. Further, it would drastically limit the ability of credit unions to provide low-cost, economical financing for their membership through loan participations.

In our view, there are sufficient safeguards already in place that address FASB's concerns about isolating the loan particpation asset from the reach of the originating credit union and its creditors in liquidation, without the need for changes to FAS 140 of the nature FASB is contemplating.

CUNA strongly opposes the changes FASB has signaled it is considering because they are unnecessary and would render the use of loan participations impracticable.

¹ Credit union members are generally shareholders, not depositors, although under some state laws, credit union members' funds in state credit unions are termed, "deposits."

Credit Union Distinction

FASB's contemplated rule change is based in part on a concern about the impact of the right of setoff on the legal isolation of the portion of a loan that has been transferred as a participation. We feel it is important to note that credit unions are legally distinguishable from banks for several reasons and pertinent to this FASB matter is the fact that, under the Federal Credit Union Act, there is no right of setoff. In light of this distinction, we question whether FASB's concerns should apply to credit unions. In any event, we do not believe that FASB's concerns justify a new accounting rule that would severely damage credit unions in the marketplace.

The National Credit Union Administration has taken the view that setoff does not exist because in order for such rights to apply, a mutual debtor-creditor relationship must exist between the institution and the member/shareholder.²

In the case of credit unions, while a member's debt on a loan made by a credit union causes the credit union to be a creditor, the member is not a creditor with respect to its share account. Rather, the member's shares represent the member's equity in the credit union. ³

Rather than a right of setoff, under the statute credit unions may exercise a statutory lien. The requirements for impressing the lien, such as proper notice, and enforcement must be satisfied before the statutory lien may be asserted. 4

The Typical Credit Union Loan Participation Agreement Establishes a Trust Relationship Between the Originating Credit Union and the Participating Credit Union

As we understand it, the typical credit union participation agreement between the originating credit union and the participating credit union with respect to the sale of a portion of a member's loan (a participation interest) protects the claims of the participating credit union.

4 12 CFR 701.30, Statutory Lien

² The National Credit Union Administration's view is expressed in a September 30, 1983 Legal Opinion to Joseph S. Melchione, Esq.: "The Federal Credit Union Act, which governs the relationship between a Federal credit union and its members, establishes not a debtor-creditor relationship but rather a debt-equity relationship, similar to the relationship between a shareholder and a corporation. The common law doctrine of offset applies only between persons occupying the relation of debtor and creditor and between whom there exist mutual demands. Mutuality is essential to the valid exercise of offset and it must exist in order for one demand to offset another. Some mutuality exists between a bank/creditor and its depositor/borrower but not between a credit union and its member. This lack of mutuality is the reason that Federal credit unions lack offset authority even though banks possess it."

³ While the Federal Credit Union Act recognizes that shares are equity, FASB has taken the position that for the purposes of Generally Accepted Accounting Principles, shares in a credit union are liabilities.

That is because the protection derives from a trust/fiduciary relationship that is created between the seller and purchaser of the participation interest. The seller is recognized as having legal title to the entire loan and the power to retain physical possession of the loan documents. The purchaser of the participation interest has a beneficial ownership interest in that portion/percentage of the whole loan it purchases with equitable title to its share of the loan. The seller, as servicer of the loan, is a trustee with fiduciary duties to hold the participation interests in the loans and the loan receipts for the benefit of the beneficiary(ies) (the purchasers/participating credit unions). The agreement requires the selling credit union (which is servicing the loan) to segregate and deliver the payments on the loan to the purchaser on a monthly basis. Additionally, the agreement expressly addresses the allocation of funds recovered under the statutory lien (in the event that it was necessary to exercise such).

Provisions in Loan Participation Documents Could Address FASB's Concerns

We believe there is a sound legal foundation for concluding that a legal agreement can isolate a participation interest and protect the interests of the participating institution. In FHLMC v. FDIC, 1985 U.S. Dist. Lexis 19725 (E.D. KY 1985), issues arose that involved the servicing of mortgage loans sold to the Federal Home Loan Mortgage Corporation (FHLMC) by a bank that was placed into receivership. FDIC claimed that the FHLMC was not entitled to more than the FDIC insurance coverage for those monies (that is, monthly principal and interest payments, etc. collected on the loans being serviced) since the account in which they were placed did not meet the legal standard as a special deposit in order to provide a preference for FHLMC, as compared to others making claims against the bank. The Court cited the leading case on the issue of special deposits, (Keyers v. Paducah, 61 F.2d 611, 6th Cir. 1932), to address "the issue of whether a fund deposited with a bank is a trust fund, either because it is a special, as distinguished from a general, deposit, or because it must be construed as a trust by reason of its being a deposit for a specific" purpose.

The Court stated: "Whether a deposit in a bank is general or special depends upon the mutual understanding and intention of the parties at the time such deposit is made." In this case, the Court found that there was no special deposit but did state that "there are cases wherein trusts have been impressed upon funds which are not strictly special deposits where there is an intention expressed or clearly implied that the funds deposited should be segregated and not commingled with the bank's general funds." The concept that trust monies are to be "special deposits," that is, separate funds, is also carried through in the bankruptcy context. Section 541(b) of the Bankruptcy Code provides that if a debtor holds property in trust for the benefit of another, it is not part of the debtor's bankruptcy estate.

In our view, legal agreements among the parties can be structured to include the criteria addressed by the courts that will provide sufficient indicia of legal isolation, which is FASB's concern.

Rather than amending FAS 140 to treat loan participations as secured borrowings or requiring the formation of a QSPE, we believe the concerns of FASB could more reasonably be addressed through the loan documentation process. More specifically, we believe agreements between the originating institution and the participating institution should clearly address the rights of both parties to the funds in the borrower's funds in the originating institution on a pro rata basis, as well as clearly address the rights of the borrower.

Conclusion

In conclusion, we urge the Board to consider the public policy ramifications of its decisions on the accounting treatment of loan participations and to recognize the problems its proposed course of action would create.

Rather than addressing the matter of isolation of interests through a new accounting standard that will have a deleterious impact on financial institutions, FASB's concerns would be more reasonably addressed through legal agreements among the parties, as we have suggested above.

Thank you for the opportunity to share our comments, and we hope our letter helps your process. We would be pleased to participate in roundtable forums you are organizing on the contemplated changes to FAS 140. If you have questions about this letter, please feel free to contact me or Senior Regulatory Counsel Catherine Orr at (202) 638-5777.

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Sincerely,

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