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Via e-mail

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Re: Setoff & Isolation

Ladies and Gentlemen:

This letter is submitted by J.P. Morgan Chase & Co. (together with its affiliates, "JPMorgan") in response to the FASB Staff Request for Information dated April 9, 2004 (the "White Paper"). JPMorgan appreciates the opportunity to address the questions raised by the Board with respect to isolation of transferred assets as described in Statement 140. A change in approach of the Board, to consider rights of offset as precluding satisfaction of the legal isolation criteria of paragraph 9a of Statement 140, would have a far-reaching and adverse effect on a broad range of transactions conducted by the banking industry.

As set forth below, this impact would be far-reaching because numerous financial products use participations and securitization structures in connection with transfers of financial assets and credit exposure. (See Annex I regarding the variety of credit-related products that customarily use such structures.) Adoption of the definition of isolation of financial assets being considered by the Board would greatly diminish the significant value added to financial markets through use of these forms of asset transfer. JPMorgan submits that the potential detriment to participants of retained defenses in the remote case of the transferor's insolvency or receivership and the remote case that the exercise of such defenses will affect the transferee adversely should not impair the ability to receive sales accounting treatment for transfers of interests in financial assets.

JPMorgan is a member of trade associations submitting responses to the FASB Staff Request for Information including the Loan Syndications and Trading Association ("LSTA") and the American Securitization Forum ("ASF"). We agree with the analyses presented with respect to participations in the LSTA comment letter and with respect to securitizations in the ASF letter. We have submitted this comment letter to the Board to highlight the perspective of a financial institution offering many products potentially affected by the questions posed in the White Paper.

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1. Is the information about setoff rights in this paper accurate for transferors subject to the U.S. Bankruptcy Code as well as for transferors subject to receivership by the FDIC or other regulatory agencies?

The detailed analyses of setoff rights set out in the LSTA and ASF comment letters provide useful summaries of the legal principles and statutory provisions applicable to this question. The separate discussion of the impact of setoff rights of obligors and transferors on transferees helps clarify how in each such case these rights do not affect the legal conclusion that a sale has occurred and therefore should not affect sales accounting treatment of the underlying payment obligation.

Obligor setoff rights. As discussed in the LSTA and ASF comment letters, a sale of a payment obligation can occur under state law notwithstanding the retention of setoff or other defenses of the obligor. In the context of assignments of payment obligations, Uniform Commercial Code Section 9-404 provides that generally an assignee (transferee) of an account or payment intangible (a right to payment of a monetary obligation) takes an assignment subject to an obligor's defenses and claims. If the obligor's defenses arise from the transaction that gave rise to the payment obligation with the assignor/transferor (i.e. recoupment defenses), the transferee purchases its interest subject to all such claims, absent an enforceable waiver by the obligor. Setoff rights (which arise outside the contract giving rise to the payment obligation) can be cut off by notice to the obligor, but only to the extent they accrue after the notice. In the context of participations in payment obligations, it would be inconsistent with these principles to deny accounting sales treatment simply because the obligor retains a setoff defense that could be exercised against the transferor and affect the participant.

Transferor setoff rights. If an FDIC-insured entity goes into receivership, the FDIC may apply or set off deposit accounts of an obligor that has defaulted on its payment obligations to the insured institution, to or against such payment obligation. Even if the insured institution had waived its offset rights against the obligor prior to this "double default", as discussed in the response to Question 4 below, the FDIC might not give effect to a waiver of the transferor's setoff rights to the extent of the insured portion of a deposit. If the insured institution had sold a participation in the payment obligation, the participant may then have an unsecured claim against the transferor to the extent of its pro rata share of the offset amount. The Board has expressed concerns that legal isolation could not occur in such a circumstance because the credit condition of the transferor could adversely affect the transferee's ability to recover such a claim.

However, even in the case of a sale of a payment obligation via assignment, the transferee may have risk (somewhat analogous to the risk associated with transferor setoff rights) that the assigned asset could become less valuable due to actions or status of a transferor who has failed. For example, buyers of distressed loans customarily receive certain indemnities from sellers to protect the buyer against receiving a disproportionately smaller recovery from the obligor than other lenders holding comparable claims, due to acts or omissions of the seller. Under Section 547 of the U.S.

Bankruptcy Code, a trustee in bankruptcy for the obligor could require a return of a payment from the buyer if the seller was found to have received a preferential payment from the obligor while the obligor was insolvent. If such requirement is imposed because the seller had received the payment while it was an insider of the obligor (with the result that the relevant period to measure receipt of preferential payments is one year rather than the 90-day preference period generally applicable to creditors), the buyer could be entitled to recover from the seller under the indemnity. If the seller also goes into bankruptcy or receivership, the buyer's indemnity claim would have decreased value. However, a change in the value to the buyer of the indemnity claim does not alter buyer's legal ownership of the debt acquired from the seller by assignment. In its response to Question 5, the LSTA's letter contains other examples of credit-related issues that do not affect whether an asset has been sold.

2. How are rights of setoff currently considered in true sale analyses performed by attorneys? If they are not considered, why not?

The legal isolation criteria as understood by the financial industry since development of FAS 140 require a "true sale" to have occurred. A "true sale" analysis for a transfer of the financial asset looks at the criteria distinguishing a sale from a loan transaction. A true sale opinion expresses two conclusions: that the transfer is a sale and that in bankruptcy or insolvency proceedings of a transferor, the transferred assets would not be available to satisfy its creditors generally.

A right of setoff allows an obligor to reduce a payment obligation owed to a particular creditor by applying another liability owed to it by that creditor (such as a deposit liability). Exercise of such a right by the obligor does not affect the creditor's ownership of its right to payment from the obligor; setoff is merely another means of paying that creditor. If the creditor had previously transferred an interest in such payment obligation by means of a participation, its receipt of payment by means of setoff would not affect the analysis of whether the participated portion of such payment obligation had been sold to the transferee and put beyond the reach of the transferor's creditors. For these reasons and the others articulated in the LSTA letter, setoff does not change the conclusions reached in a true sale opinion.

3. What additional information about setoff rights should the Board consider?

In the case of a participation, the existence of transferor offset rights against the obligor is generally beneficial to the transferee/participant. By contrast, the potential for a transferee to be adversely affected by the circumstance of a "double default" by both a transferor and obligor is remote. If the Board concludes that in order to achieve isolation the transferor may not retain offset rights against the obligor, participants would be denied such benefits unnecessarily even where the transferor is a well capitalized, creditworthy counterparty.

If the obligor has deposits at the transferor, and those deposits are set off and applied by the transferor toward repayment of participated obligations, the participant will be entitled under the terms of the participation contract to receive its proportionate share of such recoveries. It is to the participant's advantage to have a broader source of recoveries available to it by means of a participating interest than would be available to it as assignee if it does not have a depositary or other direct contractual relationship with the obligor.

In addition, if the Board concludes that legal isolation cannot be achieved in the absence of an enforceable waiver of obligor offset rights, lending institutions that request such waivers may discourage obligors who have not customarily provided them from maintaining deposits with those institutions. This would disrupt the lending institution's access to an important source of funding to the disadvantage of the lending institution as well as any participants.

At the inception of the participation transaction, a participant can and should evaluate the potential risks of its participation relationship with the transferor that could arise in the event of a "double default", and decide whether they are sufficiently remote to be outweighed by the benefits of the transaction. The transferee can and should consider the creditworthiness of the transferor as well as the obligor and the tenor of the obligation in deciding whether to purchase its participation. A standard provision of participation contracts requires the participant to do its own due diligence with respect to the obligor and transaction documentation which can include a review of whether waivers of obligor or transferor setoff rights have been provided.

Participations provide an opportunity to acquire a pro rata interest in payment obligations of an obligor even though the transferee does not have a direct business relationship with the obligor or the means to administer the loan or other participated obligation on its own. In some cases the obligor only wants to deal with a single lender and participations are necessary to enable that lender to make the requested amount of credit available to the obligor. Participations permit distribution of small amounts of obligor risk under a credit facility where transfer restrictions impose minimum assignment amounts. Participations enhance market liquidity in that, unlike assignments, they typically do not require obligor or administrative agent consents and thereby permit faster settlement of transactions.

In their joint letter to the Board dated December 1, 2003 with respect to Statement 140, federal regulators for banks, thrift institutions and credit unions recognized that it was important that Statement 140 not be revised in a manner which could impede the management and dispersion of credit risk within the financial system or restrict the availability of credit to obligors. Participations are an important tool of the originating institution to manage concentration risk in a safe and sound manner. JPMorgan submits that there will be an adverse affect on these important aspects of our financial system if use of participations is discouraged as a result of the proposed redefinition of the legal isolation standard.

4. Can setoff rights be eliminated, and, if so, how can the elimination be accomplished? Are the legal aspects the same for transferors subject to the U.S. Bankruptcy Code as for transferors subject to receivership by the FDIC or other regulatory agencies? If not, what are the differences?

As set forth in detail in the LSTA and ASF comment letters, in certain circumstances it is not possible to obtain enforceable waivers of obligor setoff rights. In addition, transferor setoff rights cannot always be waived.

In many financial transactions obligors provide enforceable waivers of setoff rights by agreeing to pay their obligations without setoff or counterclaim. However, that is not true across all transactions in which there is a transfer of financial assets. There are statutory impediments in certain consumer transactions to obtaining waivers of claims of the obligor arising under sales or lending contracts (for example, retail auto or credit card transactions). The laws of some foreign jurisdictions (including English law) provide that upon bankruptcy, setoff is mandatory if available (perhaps even if there is a contractual waiver of setoff which was binding pre-bankruptcy). In situations such as these where waiver of setoff is limited by foreign law, financial transactions between US reporting companies and foreign debtors, or involving transferors that are foreign subsidiaries or branches of US reporting companies, would be adversely affected if obligor and transferor setoff rights must be waived to achieve legal isolation. The FDIC also has taken the position in the context of loan participations that its statutory right of offset under the Federal Deposit Insurance Act cannot be impaired by a waiver by the transferor, at least to the extent of $100,000 per obligor.

In other cases the transaction documentation may not provide for waiver of setoff rights by the obligor. In transactions where this is not customary there may be resistance to providing such waivers.

Transferor waiver of setoff rights would represent a significant change that would diminish potential rights of recovery against an obligor. To require such a waiver as a condition of sales treatment would force lenders to give up access to potential sources of repayment and thereby disadvantage both transferors and transferees who would have benefited on a pro rata basis from the application of such funds.

In the absence of an enforceable waiver, notification of an obligor of the transfer of its payment obligation would not eliminate all defenses of the obligor with respect to the transferred obligation. Assuming transfer of a non-negotiable interest, which would be the case for a participation, notice to the obligor of the transfer would cut off defenses of the obligor such as setoff rights arising after notification, but not recoupment claims. There are frequently sound business reasons for not providing such a notice. Silent participations allow the transferor to distribute its credit exposure to transferees without notice or consent by the borrower. This may avoid relationship issues with particular obligors who want to deal exclusively with the lender of record. They also assist in faster

settlement of transfers. Where there are multiple obligors as in the case of a securitization, notification may prove impractical and expensive.

5. The Board recently discussed defining isolation of financial assets to mean that the value of those assets to the transferee does not depend on the financial performance of the transferor and is not affected by bankruptcy, receivership, or changes in the creditworthiness of the transferor. Given that definition of isolation, what factors other than setoff rights are not typically considered by attorneys in rendering true sale opinions that may interfere with isolation of transferred assets from the transferor and its affiliates (except bankruptcy-remote SPEs)? Please explain why those factors are not considered.

As discussed above in response to question 1, setoff and recoupment defenses do not affect the conclusions of a true sale opinion.

With respect to the proposed definition of legal isolation, it should be emphasized that even if the obstacles to eliminating setoff rights or other defenses to payment could be overcome, obtaining a legal opinion as to complete elimination of such setoff rights or other defenses in all circumstances would not be possible because it would not be feasible for counsel to be certain it had examined every conceivably relevant document required to render such an opinion. It is not in the interest of any market participant if the Board sets an unattainable standard as a prerequisite for sales treatment for transfer of financial assets.

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In conclusion, JPMorgan requests that the Board reconsider amending the current definition of legal isolation within SFAS 140. In the event that the Board pursues this amendment, we would request an ample transition period, because numerous changes in documentation and practices would need to be implemented before it would be appropriate to apply such definition. Any such change should also be limited to new transactions entered into after such transition period.

We hope the foregoing assists the Board in its deliberations. JPMorgan would be pleased to have a representative included in further discussions on this topic. If you have any questions, please feel free to contact Harriette Resnick at (212) 270-5026.

Very truly yours,

/s/ Harriette I. Resnick

Vice President and
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J.P. Morgan Chase & Co.

Sample List of Products Potentially Affected by the Proposed Change to Statement 140 Legal Isolation Standard

The following have been identified as business activities that would be significantly affected should FASB adopt its current proposal:

1. Secondary market transactions in syndicated loans – where outright assignment cannot be accomplished, transfer of ownership by sale of a participation interest is commonly used.
2. Credit exposure to borrowers by "swingline" lenders is dispersed by the purchase of participations by the other lenders in the syndicate for the duration of the swingline loan. Swingline loans are short-term loans (typically in the range of 5 days) made by a single lender in the syndicate. They can be repaid and re-borrowed, but if unpaid at the end of the intended duration, the other members of the syndicate fund under their revolving loan commitments to share ratably in the swingline lender's exposure.
3. Primary syndications of revolving credit loan facilities containing letter of credit subfacilities. There are typically one or a few lenders that issue letters of credit for the borrower's account, and the other revolving credit lenders in the syndicate purchase risk participations from the issuing bank of the letters of credit. If there is a drawing under a participated letter of credit, and the borrower does not reimburse the issuing bank, the other lenders are required to fund their pro rata share of the drawn amount. In some agreements, the lenders then have a direct right of repayment of such amounts from the borrower as part of its revolving loan obligations, but other agreements may not be structured in that manner.
4. Primary syndications of syndicated letter of credit facilities involving a fronting bank or single letter of credit issuer. This involves a similar risk participation structure to item 3 and similar requirement for funding by the participating banks if the borrower does not reimburse the issuing bank.
5. Primary syndications of certain U.S. government supported financings (such as syndicated government receivable financings). The facility may be structured with a single lender having direct rights against and recourse to the government. The risk is then distributed to other financial institutions through participations.
6. Secondary market participations of U.S. government guaranteed or insured emerging market paper. For example, U.S. Eximbank-guaranteed loans are often made by a single lender because Eximbank wants to deal with a single entity as to guarantee claims and administration of the loans. The lender then sells participations in the secondary market to distribute its risk.
7. Secondary market participations of trade finance obligations. The risk of certain funded trade obligations (acceptance financing or trade loans) and bilateral letter of credit arrangements (the risk of the account party or issuing bank reimbursement) is often distributed by means of silent participations.
8. Emerging markets – a significant portion of emerging markets debt (both sovereign and corporate), is comprised of loans. Many such loans are transferred by means of participation because the borrower consent that would be required for an assignment is difficult to obtain.
9. Participations of bilateral loans and promissory notes.
10. Syndications customarily achieved through participation:
    a. Construction loans
    b. SBA loans
    c. loans originated by community/smaller banks
    d. loans to individuals
11. Credit card receivables securitizations (if the borrower is not notified of the transfer of the credit card accounts by a credit card bank to the master trust and can set off deposits

against credit card account, and the credit card account is a non-negotiable instrument so that the transfer doesn't cut off offset right by the borrower).

12. Home equity lines securitizations (if similar to #11)
13. Auto loan securitizations if the borrower is not notified of the transfer.