Letter of Comment No: 140
File Reference: 1200-SRI

Date Received: 6/14/04



June 14, 2004

VIA E-MAIL

Director@fasb.org

TA&I Director – Setoff and Isolation Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06851-5116

Re: Setoff and Isolation

Ladies and Gentlemen:

The Loan Syndications and Trading Association (the "LSTA") appreciates the opportunity to respond to further questions that were raised at the May 25, 2004 roundtable regarding the Request for Information dated April 9, 2004 (the "White Paper") of the staff of the Financial Accounting Standards Board (the "FASB" or the "Board"). This letter assumes familiarity with our letter of May 10, 2004 regarding the White Paper (the "Original LSTA Letter").

We have attached to this letter a memorandum of Seth Grosshandler and Kate Sawyer of Cleary, Gottlieb, Steen & Hamilton (the "Cleary Gottlieb Memorandum") addressing the questions of what is a "good" (or "true") participation; what property interest is conveyed by a "true participation" and the effect of that conveyance in an insolvency of the transferor; and how that property interest compares to a non-recourse secured loan from the point of view of the transferor, transferee and obligor.

The Cleary Gottlieb Memorandum concludes that, in a true participation, an interest in the underlying loan is sold by the transferor to the transferee. Accordingly, in an insolvency proceeding of the transferor, the participant's share of the proceeds of the underlying loan is not property of the transferor available to creditors generally. That being said, the interest in the underlying loan transferred to the transferee is not a complete interest in the loan and is less of an interest than would be transferred in a full assignment of the loan: the transferee cannot enforce the loan directly against the obligor – it is dependent on the transferor for the

collection of the proceeds of the loan; and the transferee cannot offset amounts owed by it to the obligor against amounts owed by the obligor under the loan. In the absence of an enforceable waiver (and unlike in the case of a full assignment of a loan), the transferor may be able to offset amounts owed by it to the obligor against the amounts owed under the participated loan.

The question then becomes whether these three factors – the inability of the transferee to enforce the loan directly, the inability of the transferee to offset against the obligor, and the ability of the transferor to offset against the obligor (if there is not an enforceable waiver) – should result in the loan remaining on the balance sheet of the transferor and being accounted for as a secured borrowing. This is not a legal issue but an accounting issue.

We do not believe that accounting for a participation as a secured borrowing as a result of these factors would be an appropriate presentation. The inability of the transferee to enforce the loan directly and the concomitant inability of the transferee to exercise offset rights does not convert the transferor into an owner of the loan or the transferee into a secured lender. The transferor does not have rights in any excess over the amount sold or an equitable right of redemption (the primary characteristics that would distinguish a true participation from a loan, including a non-recourse secured loan). Nor does the inability of the transferee to enforce the loan directly or the possible ability of the transferor to exercise setoff defenses rise to the level of control over the asset that we believe would be inconsistent with sales accounting. In a true participation (as set forth in the Cleary Gottlieb Memorandum) the transferor is constrained by contract from enforcing the loan with unfettered discretion. Furthermore, the transferor cannot unilaterally create setoff defenses that would impair the transferee's interest; the creation of setoff defenses would almost always require action by the obligor. And, most importantly, the

Even in a complete assignment of a loan, in the absence of waiver, notice or a negotiable instrument, the transferee will take subject to the obligor's defenses, including setoff defenses relating to obligations of the transferor that accrue prior to notice. (The American Securitization Forum has submitted a letter on this point. We endorse the analysis in the ASF letter.) A transferee of a participation will also take subject to obligor setoff defenses (unless waived). We thus do not believe that obligor setoff defenses form a basis to distinguish between assignments of, and participations of interests in, loans.

As discussed at the May 25th roundtable discussion, the exercise of setoff defenses by either the obligor or the transferor will result, in an insolvency of the transferor, in an unsecured claim of the transferee for the amount set off. In this way, the liability of the transferor to the obligor is replaced with a liability to the transferee. In the case of FDIC-insured institutions, the priority of the transferee's claim will be of a lesser priority than the obligor's claim, if the obligor had a deposit claim.

The participant's claim to the offset amounts would be an unsecured claim against the transferor. Again, we do not believe this distinguishes participations from assignments, because an assignee would also have an unsecured claim to the extent of any offset (in the case of an assignment, by the obligor). A participant's (or an assignee's) claim in this case would likely be an unsecured claim because it cannot trace any property as a result of the offset.

The letter of Frederick L. Feldkamp dated May 10, 2004 takes the position that <u>because</u> a participation does not transfer transferor setoff rights, there is no sale of any interest in the loan. We believe, as discussed in the Cleary Gottlieb Memorandum, that a participation is a sale of an interest in a loan, but does not transfer the right to enforce the loan directly against the obligor and may not transfer transferor setoff rights. The fact that these rights are not transferred does not mean that there is no sale of an interest in the loan; if there were no sale, then a participant would merely be an unsecured creditor of the transferor as to the proceeds of the loan, which is not the case in a true participation. A full review of the <u>Okura</u> case that Mr. Feldkamp relies on so prominently makes this distinction clear.

In the typical case – a deposit by the obligor – the transferor's ability to obtain a setoff defense that might be exercised to the detriment of the transferee is dependent on the obligor's actions, namely, the making of the deposit with the transferor.

transferor would not have unilateral control over the exercise of any setoff defenses – the obligor would have to default (as to which the transferor would have little or no control) in order to exercise transferor setoff defenses.⁵ For these reasons, we do not believe that a true participation should be accounted for as a secured borrowing, or otherwise as not a sale.

If the Board believes that the existence of these three factors – the inability of the transferee to enforce the loan directly, the inability of the transferee to offset, and the ability of the transferor to offset (if there is not an enforceable waiver) – require some other presentation on a transferor's financial statements, we would be happy to discuss what those requirements might be.⁶

We thank the Board for the opportunity to participate in this process.

Very truly yours,

The Loan Syndications and Trading Association

By:

Jane Summers General Counsel

Furthermore, as discussed in the Original LSTA Letter, the exercise of transferor setoff defenses against a defaulting obligor would only possibly negatively affect a transferee if the transferor were also insolvent at the time.

For example, it has been suggested that the liability to the obligor that is replaced by a liability to the transferee be reclassified at the time of setoff (and that the possibility of such a reclassification, if material, be disclosed if the liability to the transferee would have a different priority than the liability to the obligor). The Board might also determine that some other form of disclosure of these risks, if material, might be appropriate.