



Community
Bankers
Association
of Illinois®



Representing Illinois' Real Community Banks

May 21, 2004

Letter of Comment No: 26
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Date Received: 5/27/04

TA & I Director - Setoff and Isolation
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Setoff and Isolation

Dear Director:

By this letter, the Community Bankers Association of Illinois ("CBAI") wishes to express its concerns about proposed revisions to Financial Accounting Standards Board ("FASB") Statement No. 140 (*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*) and the possible impact of such revisions on loan participations. With more than 500 financial institution members and 143 Associate Members, CBAI is the largest Illinois trade association representing the interests of financial institutions and is the third largest state-organized bank trade association in the United States. CBAI's members are found in each of Illinois' 102 counties and do business in markets ranging from the smallest villages and rural areas to the largest cities in Illinois.

CBAI realizes that the focal point of FASB's most recent request for information dealt with the issue of the right of setoff, particularly in receivership or bankruptcy circumstances. However, it is a primary concern of CBAI that FASB must take into account the impact, intended or otherwise, that the proposed changes to FASB 140 will have on loan participations by community banks.

In states such as Illinois, where population is widely dispersed and large cities with large banking institutions may be one hundred or more miles away from a consumer or a small business, it is imperative that the availability and use of the loan participation process by community banks must be protected. Community banks frequently have statutory lending limits that require the use of loan participations in order to meet the credit needs of their customers. A FASB 140 interpretation or application that would impair the long-standing ability of community banks to service those credit needs in their local markets would have a dramatic and adverse impact on community banks that is disproportionate to any issue that FASB was attempting to address through the proposed change.

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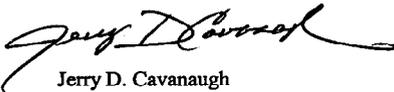
Community banks have, for decades, relied upon the loan participation process that has been sanctioned by their regulators. That process already allows for diversification of risk and compliance with applicable state and federal laws. To the extent that any anecdotal evidence or specific incidents have suggested to FASB that such a decades-old process needs to be revised, CBAI urges that FASB not impose unnecessary burdens on community banks in order to address a very limited issue. Mandating the use of special purpose entities, for example, would be an unnecessary step that would impair the manner in which community banks do business and would impair the ability of consumers and small businesses to obtain adequate credit in their local markets.

CBAI is aware of the comment letter dated May 19, 2004, that was submitted by the Independent Community Bankers of America (a copy of said letter is attached for ease of reference). CBAI concurs in both the practical and legal assessments set forth in that comment letter, and so it is not necessary for us to add anything further regarding the right of setoff issues addressed therein.

Once again, it cannot be overemphasized that FASB must understand the importance of loan participations to community banks in Illinois and throughout the nation, as well as the impact that changes to FASB140 might have on community banks, consumers and small business borrowers. No "solution" or "improvement" to the language or application of FASB 140 will be worthwhile if it has the unintended consequence of disrupting the flow of credit from community banks to their borrowers.

CBAI appreciates your consideration of these comments and concerns. If you have any questions or would like any additional information from CBAI, please feel free to contact me at the address, telephone number or e-mail address indicated below.

Sincerely,



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INDEPENDENT COMMUNITY BANKERS of AMERICA

DALE L. LEIGHTY
Chairman
DAVID HANCOCK
DALE L. LEIGHTY
Chairman

May 19, 2004

TA&I Director—Setoff and Isolation
401 Merritt 7
Post Office Box 5116
Norwalk, Connecticut 06856-5116

Re: Setoff and Isolation

Dear Director:

The Independent Community Bankers of America (ICBA)¹ appreciates the opportunity to respond to Financial Accounting Standards Board's (FASB) requests for information concerning loan participations and setoffs.

Background

As part of its project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, FASB is reviewing loan participations and whether banks are properly accounting for these transactions. Under FASB Statement No. 140, before a bank or other entity can report the sale of an asset, that asset must be legally "isolated" or beyond the reach of the transferor or its creditors even in bankruptcy or receivership. Based on information it has learned from the Federal Deposit Insurance Corporation (FDIC) and others, FASB is concerned that a transfer of assets may not take place when banks enter into loan participation agreements due to the fact that if the originating bank in a participation arrangement were to fail and the FDIC took over as the Receiver, the FDIC would have setoff rights that would allow it to set off the entire amount of the loan (including the part that the originating bank sold to the participating bank) from any money that the debtor had on deposit with the originating bank. Similarly, the debtor would also have the right to set off his/her loan with the failed/originating bank. The issue that FASB raises is whether the setoff rights of the FDIC or the debtor, prevents the transferred asset from being considered completely "isolated" from the transferor, and whether the bank should account for the transfer as a borrowing instead of a sale.

¹ ICBA is the nation's leading voice for community banks and the only national trade association dedicated exclusively to protecting the interests of the community banking industry. ICBA has nearly 4,600 members with branches in more than 17,000 locations nationwide. Our members hold more than \$526 billion in insured deposits, \$728 billion in assets and more than \$405 billion in loans for consumers, small businesses, and farms. They employ more than 231,000 people in the communities they serve.

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FASB uses the following example to illustrate the problem. Originating Bank has a \$1,000,000 loan outstanding to Customer. Customer also has a \$1,000,000 deposit with Originating Bank. Originating Bank sells 50% of its loan to Participating Bank. Originating Bank subsequently fails, Customer is in default, and the FDIC acquires Originating Bank's assets and assumes its liabilities as the Receiver. At the Customer's request, the FDIC could set off 100% of the loan amount to Customer with Customer's existing \$1,000,000 deposit. The Participating Bank would not be entitled to receive a payment as a result of the setoff. Instead, it would only have a Receiver's certificate--an unsecured general claim against the Originating Bank-- and would have no claim against the Customer.

FASB is seeking information from members of the legal community, regulatory agencies, and rating agencies about setoff rights and loan participations.

Benefits of Loan Participations

Loan participations are extensively used by community banks and play an important role in our economy and our banking system by reducing concentration risks and enhancing the availability of credit. Small businesses, for instance, frequently look to community banks for their financing needs particularly in those areas where large institutions are not active small business lenders.² Quite often, community banks do not have the capacity on their own to fully meet the needs of small businesses due to legal lending or concentration limits.³ Loan participations allow these institutions to provide credit they would otherwise be unable to provide, thereby fueling economic activity and growth.

For example, if a bank's customer requests a loan that is greater than the bank's legal lending limit, the bank often sells a portion of the loan as a participation to another bank. A participation allows the originating bank to make the loan to its customer, meet legal lending limits and any leverage ratio requirements, and provide credit to its customer. Loan participations are therefore essential to providing credit to small business customers, as well as being a tool community banks use to comply with lending limits.

Community banks also use loan participations to diversify their risks. By participating an interest in a loan, a community bank can meet a borrower's needs without creating an overexposure to a particular borrower or to a sector or geographic region. For instance, community banks frequently participate out loans to hotels and restaurants to diversify the risks associated with those types of loans. Also, community banks located in manufacturing areas may enter into participation arrangements with banks in more rural areas to diversify the risks associated with manufacturing loans or to avoid excessive concentration in those loans.

² Community banks are disproportionate lenders to small businesses. Banks with less than \$1 billion in assets make 37% of bank small business loans, though they account for only 13% of bank industry assets.

³ For example, under 12 CFR part 32, national banks are allowed to make a loan in an amount up to 15% of its unimpaired capital and surplus to a single borrower. State banks must comply with state lending limits.

If consummating loan participations became more complex, this would become a competitive problem and a burden for community banks. Community banks would find it very burdensome if they were required, for instance, to include the borrower as a party to the loan participation every time they attempted to participate a loan or if they were required to obtain a legal opinion or a true sale opinion on each participation. Similarly, requiring community banks to form qualifying special purpose entities in order to receive sale treatment would be unnecessarily burdensome and prohibitively expensive, critically impairing their ability to engage in loan participations.

ICBA's General Concerns

ICBA is concerned about the impact revisions to loan participation accounting by FASB could have on credit availability. As noted above, loan participations are a fundamental tool used by community banks to provide credit to small businesses and consumers. If FASB were to change its accounting rules to disqualify participations as sales, this could have an adverse impact on credit availability in certain markets and could lead to an overall liquidity problem in the economy.

Furthermore, the inability of community banks to sell participations and derecognize the portion of the loans participated would significantly limit the ability of community banks to manage and disperse credit risk, negatively impacting their safety and soundness. The growth of loan participations has permitted banks to avoid concentrations of risk and has allowed the industry to achieve a high degree of stability and prosperity. It is important that the issue of setoff not be interpreted such that community banks, and the economy as a whole, could no longer benefit from the use of this important credit tool.

Response to FASB's Questions

ICBA's answers to FASB's questions are organized below in the order in which FASB has posed them in its Request for Information.

(1) Is the information about setoff rights in FASB's paper accurate for transferors subject to receivership?

The information about the legal position of a participating bank when the originating bank fails and the FDIC sets off a loan appears to be consistent with case law that originated from the failure of Penn Square Bank in the early 1980s. In four different decisions, courts held that both the debtor and the originating bank had the right to set off the debtor's loan with the debtor's deposit, that the FDIC as Receiver of the failed bank, was authorized under the Federal Reserve Act (12 U.S.C. Section 1822(d)) to set off the loan, that loan participations created no property interest in the participating bank nor any fiduciary relationship between the originating and participating bank, and that the only interest participating bank had as a result of the setoff was a Receiver's certificate.⁴

⁴ See *The Northern Trust Company v. FDIC*, 619 F.Supp.1340 (D.C. Okla. 1985); *Seattle-First National Bank v. FDIC*, 619 F.Supp. 1351 (D.C. Okla.1985); *Hibernia National Bank v. FDIC, et al.*, 733 F.2d 1403 (10th Cir. 1984); *Chase-Manhattan Bank, N.A. v. FDIC*, 554 F. Supp. 251 (W.D. Okla. 1983).

However, it is important to point out that these decisions are almost twenty years old. Since the failure of the Penn Square Bank, the FDIC has been involved in numerous bank liquidations and no litigation has arisen over loan participations and the right of the FDIC to set off an originating bank's loan. The fact that there are so few cases dealing with setoff rights since the Penn Square decisions—notwithstanding the large number of bank and S&L insolvencies in the late 80's and early 90's— suggests that the right of setoff presents mainly a theoretical issue with few practical effects.

In connection with this letter, ICBA contacted several bankers banks as well as the FDIC.⁵ Many of the bankers banks stated that they had never run into an instance where the FDIC, as Receiver of a failed/originating bank, used the debtor's deposit to set off a loan that was subject to a participation agreement. In just about every instance, they said that the FDIC sold loans subject to a participation agreement either to one of the participating banks or to a third party.

According to the FDIC, it is their policy to sell all loans (including those subject to participation agreements) as soon as they are appointed as Receiver of a failed bank and not to exercise the right of setoff. If setoff is demanded by the debtor, the amount that is set off (e.g., the debtor's deposit at the lead bank) is usually then distributed to the buyer of the loan as part of the sale.

Based on this information, ICBA believes that FASB is excessively concerned with a situation that rarely, if ever, occurs. The existence of setoff defenses should not preclude the sales accounting of a loan participation, particularly when the participation evidences a clear intent by the originating bank/transferor to sell a beneficial interest in the loan.

(2) How are setoff rights considered in true sale analyses performed by attorneys?

As noted above, community banks rarely use an attorney for a routine loan participation. While community banks rely on standardized forms that have been prepared by attorneys, they generally do not use attorneys to close on routine loan participations. On more complex loan participations, attorneys may be used but they rarely perform a "true sale" analysis that addresses setoff issues.

Furthermore, it is ICBA's understanding that attorneys do not consider transferor or debtor setoff defenses to be a determining factor in a true sale analysis. Instead, attorneys concentrate on whether the assets have been sold or pledged and whether the assets are beyond the reach of the transferor's creditors generally.

⁵ Bankers banks are correspondent banks that provide services only to other banks. One of their primary functions is to facilitate loan participations.

(3) What additional information about setoff rights should be considered?

Although the right of setoff, in general, is a common law defense, FASB should consider the interplay between state statutory law and, in particular, the state Uniform Commercial Code provisions, and the common law right of setoff. State UCC statutes generally allow “negotiable instruments” to be transferred free of obligor setoff defenses.⁶ However, most loan participations do not involve “negotiable instruments” being “negotiated” between the originating bank and the participating bank. Instead, loan participations are usually the sale of a beneficial interest in a loan.

ICBA believes that most participation agreements should be viewed as sales as long as they evidence a clear intent by the transferor to sell a beneficial interest in a loan and do not include provisions that allow recourse against the transferor. The existence of setoff defenses should not preclude the sales accounting of a loan participation.

(4) Can setoff rights be eliminated and, if so, how can the elimination be accomplished?

As noted above, ICBA does not believe that the existence of setoff defenses should preclude sales accounting of loan participations. However, if setoff rights need to be eliminated to preserve existing accounting treatment, ICBA believes that FASB should consider acceptable ways to eliminate them that would not complicate the loan participation process and increase the burden on community banks. For instance, if necessary, we would recommend that FASB consider the following:

- (a) Waiver of setoff rights by the debtor. Waivers are generally enforceable under state law and should be effective to cut off setoff defenses of the debtor. A waiver would also be relatively easy for community banks to add to their participation agreements. However, we do not know how effective this type of waiver would be in the case of an action by the FDIC, as Receiver of the originating bank.
- (b) Waiver of setoff rights by both the debtor and the originating bank. This type of waiver should also be enforceable and might be more effective against the FDIC, as Receiver for the originating bank than merely a waiver by the debtor.
- (c) Notification to the debtor that the originating bank has sold the debt. Under the UCC, notice to the debtor generally will cut off setoff defenses that accrue after notification but not setoff defenses that accrue prior to notification.

ICBA strongly urges FASB not to require a transferring of assets to a bankruptcy-remote special purpose entity in order to qualify for sales accounting treatment. This

⁶ For instance, see Virginia Code Section 8.9A-403 that explains the holder in due course rule in Virginia.

would unnecessarily complicate the loan participation process and be very burdensome and expensive for community banks.

- (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 credit worthiness 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 the transferred assets from the transferor and its affiliates?**

As we noted above, attorneys focus on whether the assets have been sold and not pledged when they render true sale opinions. FASB's proposal represents a radical change to that focus. Attorneys would have to analyze whether the value of the transferred assets depends on the financial performance of the transferor or would be affected by bankruptcy, receivership, or changes in the creditworthiness of the transferor. This unnecessarily complicates the concept of a sale and broadens the inquiry an attorney would have to perform for a true sale opinion. True sale opinions should concentrate on those factors that are relevant to whether a sale has occurred and not on the financial performance of the transferor or what happens under bankruptcy or receivership.

Conclusion

In our view, small community banks and smaller businesses would be disproportionately affected and competitively disadvantaged by FASB's proposed treatment as compared to larger banks and larger businesses. Smaller businesses that prefer to work closely with their local community banks may not be able to obtain loans from larger banks that are unwilling to take the time to understand the unique needs of a small business.

As a result, serious credit disruptions could occur due to a change in accounting treatment of loan participations. Disallowance of sale accounting treatment could redirect the flow of credit, making it very difficult or impossible for community banks to play a role in loan participations.

ICBA appreciates the opportunity to respond to FASB's requests for information concerning loan participations and setoffs. Loan participations are an important credit tool for community banks and the economy and we urge FASB not to change its accounting treatment for loan participations based on remote hypothetical concerns about setoff and isolation.

If you have questions or need any additional information, please do not hesitate to contact me at 202-659-8111 or at Chris.Cole@icba.org.

Sincerely,

Christopher Cole
Regulatory Counsel

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