MINUTES

Financial Accounting
Standards Board

To: Board Members

From: Statement 140 Amendment Team
(Gagon, Ext. 322)

Subject: Minutes of the June 17, 2004 Public Roundtable **Date:** June 28, 2004

cc: Bielstein, Smith, Petrone, Leisenring, Project Team, Mahoney, Thompson, Getz, Vincent, Sutay, Gabriele, Swift, Polley, FASB Intranet (e-mail)

Topic:	Qualifying Special-Purpose Entities: Legal Isolation and Setoff Rights
Basis for Discussion:	FASB Staff Request for Information Relating to the Isolation of Transferred Assets in Connection with Its Qualifying Special-Purpose Entity Project to Amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* dated April 9, 2004
Length of Discussion:	9:00 a.m. to 11:40 a.m.
Attendance:	
Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Smith
Other staff at Board table:	Donoghue, Lott, Lusniak, and Gagon
Outside participants:	Refer to the Attachment

<u>Summary of Decisions Reached</u>:

The Board held a public roundtable discussion with attorneys and regulators to discuss issues related to the isolation requirement of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* including the impact of setoff rights. Board members and participants expressed their views, but no decisions were reached.

<u>Objective of the Roundtable</u>

The objective of this second of two roundtables was to gather additional information on legal and regulatory issues affecting the isolation of financial assets. The objective of the meeting was met.

<u>Matters Discussed and Decisions Reached:</u>

The following text summarizes participant responses to questions posed by Board members and topics discussed at the public roundtable; however, this summary does not include direct quotes from the meeting. The questions may not be in the specific order in which they were discussed at the meeting.

It should also be noted that most participants provided disclaimers that the views they expressed at the roundtable were their own and did not necessarily represent the views of the organizations with which they are associated.

1. What Are the Characteristics of a “Good” or “True” Participation from a Legal Prospective?

Mr. Grosshandler summarized the characteristics of a “good” or “true” participation that from a legal perspective would place the transferred assets generally beyond the reach of the originating bank and its creditors and would not be the property of the estate of the originating bank in bankruptcy or receivership. The most important characteristics of a true participation, which are described in detail on page 10 of the Cleary, Gottlieb, Steen and Hamilton memorandum (CGSH, comment letter number 27) are:

1. The participant has no recourse to the originating bank.
2. The participation purports to be a sale of a property interest.

3. The originating bank is not permitted to commingle for any significant period of time collections on the loans.

4. The originating bank agrees to act in a custodial capacity (on behalf of or in trust for the participant) with respect to its holding of any notes or collateral and in holding any collections on the loans.

5. The originating bank agrees to administer the loans under a standard that does not give it unfettered discretion as to all matters.

Mr. Grosshandler explained that property rights in the cash proceeds of a loan can be recognized as being transferred under state laws even though certain rights associated with the loan such as setoff rights or enforcement rights are not transferred. A participation may transfer property rights to the cash proceeds of a loan even though it may not transfer setoff enforcement rights.

2. What Characteristics Are Necessary for a true participation to Be Sufficiently Isolated to Achieve Sale Accounting?

Mr. Trott stated that a “true” participation as described by Mr. Grosshandler may not meet the criteria for sale accounting under the guidance provided by Statement 140. Mr. Trott stated that in order to account for a participation as a sale, the originating bank must not hold rights of setoff on the portion of the asset purportedly owned by the participating bank, and the originating bank must pay the participating bank the amounts it is due even if the obligor sets off.

Mr. Grosshandler agreed that from a legal perspective, a participating bank that owns a property interest in the cash proceeds of the loan may not own the right to enforce the loan or the right to setoff. Mr. Grosshandler further stated that state law makes it perfectly clear that an entity can own an asset but not have the right to directly enforce certain rights associated with the asset, which include setoff rights. Mr. Grosshandler stated that the participating bank in a true participation would have a preferred claim against the originating bank as to the identifiable proceeds of the loan; however, that does not include any amounts that are setoff by an obligor.

Impact of Setoff Rights

Mr. Grosshandler stated that the fact that a participating bank is subject to the right of obligor setoff against the originating bank is not unusual with financial assets. What is unique to participations is that a participating bank may be subject to the originating bank's right to setoff against the obligor. In the opinion of Mr. Grosshandler, retention by the originating bank of setoff rights does not give the originating bank control over the loans because the ability to set off depends on the obligor being insolvent or defaulting.

Mr. Trott stated his understanding that even an outright transfer to a third party of an entire receivable will not eliminate obligor setoff rights that existed prior to notification of the transfer to the obligor. Except for certain consumer transactions and assets subject to transfer restrictions, setoff rights no longer accrue after notice has been given to the obligor. Ms. Seidman stated her understanding that setoff rights that accrued prior to notice would not be severed even if the transfer was to a special-purpose entity. The roundtable participants agreed with both Mr. Trott and Ms. Seidman.

Ms. Schipper asked if any of the attorneys present was aware of any circumstances under which a participant would reduce the amount it paid for an interest in a participation due to setoff risk. Several attorneys stated that they were aware of instances where participants had discounted the amount paid for the participation interest. Ms. Schipper stated that it seems that setoff, like other types of risk, is impounded in the amount paid for the participation. Mr. Grosshandler agreed and noted that there should be a greater price effect if the credit rating of the originating bank is weak.

Preferred Claims

Mr. Feldkamp and Mr. Grosshandler agreed that one of the key characteristics of a true loan participation is that the originating bank agrees to hold the loan "on behalf of or in trust for" the owners of interests in the loan. The originating bank also must agree not to commingle the cash proceeds of a participated loan with assets of the originating bank so that if the originating bank were to enter receivership, those cash proceeds could be identified by a court as collective property of the owners of interests in the loan. A custodial arrangement and segregation of cash proceeds, in conjunction with the other features listed in the CGSH letter would give the participant a preferred ownership claim on the cash proceeds related to its interest in the underlying loan because this custodial arrangement can effectively isolate a loan from a legal perspective. Under the law, the creation of the custodial arrangement gives the participant a preferred claim to its share of the proceeds of the underlying loan. Mr. Grosshandler and Mr. Feldkamp analogized the custodial arrangement to a “virtual entity” even though it is not a legal entity (like a corporation or a natural person)

Mr. Feldkamp stated that when an originating bank acts as a proper custodian for holders of interests in a loan, the participants’ rights in the loan will not be assets of the receivership in the event of the originating bank’s insolvency. Mr. Feldkamp also stated that case law supports the notion that a custodial arrangement can be found to be demonstrably distinct from the originating bank and could meet the definition of a qualifying special-purpose entity as described in Statement 140.

3. How Is a True Participation Handled in Receivership by the FDIC?

The FDIC General Counsel indicated that the FDIC recognizes a participation as a sale if it qualifies as a true sale. He defined a participation as a transfer or assignment of an undivided interest in all or part of a loan from an originating bank to a participant without recourse to the originating bank. He stated that it is the FDIC’s policy to sell loans in bulk immediately upon receivership. The purchaser of the loans takes them net of preexisting participation interests and the FDIC agrees to pay to the purchaser any amounts eliminated due to the exercise of obligor setoff rights, thus effectively eliminating setoff issues from the perspective of the purchaser. Although one could hypothesize situations in which the FDIC would be required to exercise its setoff rights as receiver to meet the statutory requirement that the assets be liquidated at the lowest cost to the FDIC, the FDIC has seldom encountered that situation. The FDIC staff could identify only one instance since 1983 in which setoff reduced the value of a participant's interest in a loan (out of approximately 2800 bank failures during that period).

Mr. Trott asked what the FDIC was selling when it says it sells loans in bulk in the case of receivership. If a failed bank subject to FDIC receivership held a $100 loan in which a participating bank held a 30 percent participation, the FDIC would sell the $100 loan net of the participation, and the buyer of the loan would have rights to the net proceeds of $70 when and if collected. The FDIC would guarantee that the purchaser would receive cash equal to the proceeds of the loan, if rather than paying the loan, the borrower set off against a deposit in the failed bank, and the purchaser would be obligated to pass through the $30 to the participating bank.

Ms. Schipper asked if the FDIC has the *right* to retain individual loans and exercise setoff. The FDIC attorney stated that under existing regulations, the FDIC has that right; he also stated that he believes the FDIC would be willing to legally constrain itself to follow current policy except where otherwise required by law. (Current law requires the FDIC to liquidate a failed bank in a manner that imposes the least cost on the insurance fund. Although circumstances generally favor bulk sales as the least-cost method, it is possible to hypothesize circumstances in which individual setoff would have a lower cost.)

4. If Participations Were Not Accounted for as Sales, How Would Lending Limits and Capital Requirements Be Affected?

The FDIC General Counsel stated that lending limits for regulated financial institutions are determined by each institution's chartering authority. (He explained that there are 54 chartering authorities, including one in each state and the District of Columbia, the Office of Thrift Supervision, the National Credit Union Association (NCUA), and the Office of the Comptroller of the Currency (the OCC)). The OCC, which is the chartering authority for national banks, has chartered the most banks. He also noted that 47 of the state chartering authorities have established lending limits consistent with those established by the OCC.

A representative from the OCC stated that for an OCC-chartered bank, participations with no recourse to the originating bank are not counted against the originating bank's lending limit provided that the participation results in the pro rata sharing of credit risk among all participants, including the originating bank. The existence of setoff rights is not a factor in the lending limit calculation. Therefore, the OCC could continue to allow the deduction of participations from lending limits even if Statement 140 were changed in a manner that prohibited accounting for participations as sales.

However, the OCC attorney opposed a change to the accounting for loan participations. He stated that keeping one set of books for GAAP and another set for lending limit calculations would be confusing and burdensome. He also stated that if loan participations cease to be accounted for as sales and the OCC continues to treat participations as sales, state chartering authorities that currently use the same formula as OCC may decide to follow the GAAP treatment instead of the OCC treatment.

A change in accounting would affect the leverage capital ratios of the originating bank, which would cause significant concern for the FDIC. There would be a gross-up of assets on the balance sheet because the originating bank would not be deemed to have sold those assets to the participating bank. This, in turn, would affect the denominator of the leveraged capital ratio without a reciprocal adjustment to the numerator. The FDIC General Counsel stated that the FDIC could make adjustments to the definition of capital (the numerator), but it would be more difficult to change the definition of an asset (denominator) because that would conflict with an FDIC provision that requires that regulatory assets be calculated in a manner that is no less stringent than GAAP.

An attorney from the Federal Reserve Bank of New York stated that accounting for a loan participation as a loan from the participating bank to the originating bank would affect the risk-based capital calculation for the participating bank. Currently, the capital requirement for a participating bank is to treat a loan participation as a loan to the original borrower. If a loan participation were to be accounted for as a borrowing by the originating bank from the participating bank (which is the alternative to sale accounting), the participating bank would be deemed to have made a secured loan to the originating bank instead of making a loan to the original borrower/obligor. That could reduce the capital requirement for the participating bank because an interbank loan generally gets a lower risk capital weight than a loan to a nonbank borrower.

5. What Characteristics of Credit Unions Are Unique, and How Do Credit Unions View Setoff and Legal Isolation?

An attorney from the NCUA stated that setoff rights do not exist in most cases for deposits in credit unions because “deposits” in credit unions are legally member shares and not liabilities of the credit union. Thus, those deposits cannot create a right of setoff because, since they are not liabilities, they cannot be a part of a mutual debtor-creditor relationship. The NCUA attorney also stated that, in the event of liquidation of a credit union, depositors (members) have the most subordinate claim to the assets of the credit union. That is, they are entitled to receive a return of the money on deposit only after all creditors have been paid. (That is very different from bank deposits, which are the most senior liabilities of the bank.)

The NCUA attorney acknowledged that even though deposits in a credit union do not give setoff rights to the members (depositors) even if the member also is a borrower, a liability to a member for services rendered or other reasons could be eligible to be set off against a loan to that member.

The NCUA attorney also stated that capital requirements for credit unions are based on GAAP retained earnings divided by total assets. If loan participations were treated as borrowings by the originating credit union, the credit union’s total assets would increase, which, in turn, would cause the ratio of capital to assets to decline and could cause some credit unions to fail to meet their capital requirements.

6. Other Significant Items Raised by Board Members

Mr. Herz stated that the difference between a loan participation and a collateralized nonrecourse borrowing, other than intent and the right to enforce the loan, is that loan participants have an ownership interest in the cash proceeds of the loan and can share in any upside associated with the loan if there is any. In a collateralized borrowing, the originating bank that posts the collateral still has economic and legal ownership of the asset and is the only beneficiary of any upside potential.

Follow-up Items:

None

General Announcements:

None.

Attachment

QSPE Roundtable

June 17, 2004

9:00 a.m.–12:00 noon

Participants	**Affiliation/Representing**	**Letter Number**
Steve Bisker	Credit Union National Association	17
Fred Feldkamp	Fred Feldkamp	5
Seth Grosshandler	Loan Syndication and Trading Association	14
Robert Hugi	American Securitization Forum	20
William F. Kroener III	Federal Deposit Insurance Corporation	25
Jennifer Minke-Girard	SEC	N/A
Jonathan Fink	Office of the Comptroller of the Currency	25
Paul Peterson	National Credit Union Administration	25
Michael J. Pappone	American Bankers Association	28
Steven Rosenberg	Office of Thrift Supervision	25
Diane Virzera	Federal Reserve Bank of New York	25
Robert H. Herz	FASB Chairman	
George J. Batavick	FASB Board	
G. Michael Crooch	FASB Board	
Gary S. Schieneman	FASB Board	
Leslie F. Seidman	FASB Board	
Edward W. Trott	FASB Board	
Katherine Schipper	FASB Board	
Jim Leisenring	IASB Board	
Lawrence W. Smith	FASB Director of Technical Application & Implementation Activities	
Patricia A. Donoghue	FASB Project Manager	
Ron Lott	FASB Senior Technical Advisor	
Victoria A. Lusniak	FASB Staff	
Joshua G. Gagon	FASB Staff	