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Via E-mail

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Setoff and Isolation

Ladies and Gentlemen:

The Banking Law Committee of the Association of the Bar of the City of New York (the "Committee")[1] is pleased to respond to the Request for Information dated April 9, 2004 (the "Request") of the staff of the Financial Accounting Standards Board (the "FASB"). The Committee consists of 36 attorneys representing many of the largest financial institutions and law firms.

The FASB has asked persons submitting comments to respond to five specific questions. The first of these asks if the Request accurately describes setoff rights. The

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[1] The Association is one of the oldest and largest local bar associations in the United States, with a current membership of over 22,000 lawyers. The Association serves not only as a professional association, but also a leader and advocate in the legal community on a local, state, national and international level. The Association pursues its advocacy role through the work of over 170 committees, each devoted to a substantive area of the law. Among other activities, the Association's committees prepare comments for legislative bodies and regulatory agencies on pending and existing laws and regulations that have broad legal, regulatory or policy implications. Further information regarding the Association can be found at the Association's website, www.abcny.org.

Committee believes that the FASB has generally described these rights accurately. We understand that other organizations that represent financial institutions – such as the American Bankers Association and the Loan Syndications and Trading Association – plan to submit detailed comment letters that that focus on the specific questions in the Request. We do not seek to replicate these submissions. Instead, the Committee wishes to provide guidance to the FASB based on the accumulated experience of the Committee members as the FASB considers the issues reflected in those questions and information received from other respondents. In particular, the Committee would like to discuss what we have entitled the "ex-post" issue, which refers to events that can occur after a completed transfer of assets to create rights of setoff.

The Committee notes that the Request reveals that the FASB has 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. However the FASB ultimately defines the term "isolation of financial assets," the Committee strongly believes that the FASB should not define the term in any way that results in a right of setoff by any creditor of a transferor causing the transferor to be required to leave the transferred obligation on its balance sheet.

Unlike other factors that can lead to a transferor having to retain a transferred asset on its balance sheet, the existence of a right of setoff will frequently be a matter of random chance beyond the control of the transferor. Under State and Federal law, a defendant in a civil court action generally may assert a counterclaim against a claimant for any cause of action the defendant may have against the claimant, whether or not related to the claimant's cause of action. Further, under State and Federal law, where the claimant is an assignee a defendant may assert a counterclaim against the assignee at least to the extent of any damages recoverable from the assignor.

As the FASB acknowledges, for example, a setoff right would exist even if the customer had no deposit at the time of the sale of an interest in a loan through a participation agreement, but deposits funds with the originating bank subsequent to the execution of the participation. The same would be true if the sale occurred through a securitization. Short of refusing to take deposits or otherwise transact business with a customer whose loan had been sold via a participation or securitization, or demanding that a customer waive setoff rights as a condition to continuing to do business with the institution (which might be construed as a contract of adhesion or the exercise of unfair market power), the originating bank cannot do anything to prevent the creation of the setoff right after the transfer of the interest in the loan.

Surely, the FASB cannot be suggesting that an asset, once sold and recognized as having been sold, can spring back on to the balance sheet of the originating institution. Such a rule would be economically destructive, as an institution would never know when it sells a loan via a participation or in a securitization whether the asset will return to its balance sheet. In fact, the originating institution might not even have actual knowledge when a setoff right against it has been created.

Other events could create similar problems. A customer of the transferor could have a problem with another loan originated after the sale or securitization of the first loan. The transferor probably would not even know the customer believes it has a cause of action until it is asserted as a counterclaim to an action brought by or on behalf of the transferee. It would be an absurd result to require a transferor to keep a large number of transferred loans on its books because of the potential for a handful of them to be subject to the assertion of setoff rights.

The fact that there are so few cases dealing with setoff rights asserted against transferees – and virtually none in the past 15 years – despite the exponential growth in the loan participation and securitization markets strongly suggests that the right of setoff presents at most a theoretical problem with few practical effects. On the other hand, adoption of a rule that would discourage the participation or securitization of loans would have far-reaching effects on the banking system. The growth of the loan participation and securitization markets has permitted financial institutions to avoid concentrations of risk to single customers that has enabled the banking system to achieve an unprecedented level of stability. It is unlikely that the system would have withstood as well the shocks of the collapse of the technology markets and the Russian economy had institutions not been able to efficiently spread risks. While this comment technically may not be deemed to be legal in nature, the Committee is comprised of attorneys in a variety of banking-related disciplines – transactional, bankruptcy, and regulatory – that requires them to consider the policy implications of various categories of transactions. It is from this pool of experience that the Committee urges the FASB to consider the practical effects of a rule limiting the ability of financial institutions to continue to sell loans in participation and securitization transactions.

For these reasons, the Committee urges the FASB not to adopt any rule that would make the absence of setoff rights a pre-requisite for achieving "isolation" necessary to enable an institution to successfully treat the transfer of a loan in a participation or securitization as a sale. The Committee believes that the random nature of events leading to the possible existence of a setoff claim by the obligor on a transferred asset is such that such rights should not be considered as impediments to true sale treatment. In this regard, setoff rights differ markedly from other events generally recognized as leaving a transferee with risk relating to the transferor. The Committee believes that persons purchasing participation and securitization interests generally understand that there is the risk of the assertion of setoff rights by obligors of the transferor. This issue is best dealt with by an investor conducting due diligence into the general reputation and operational capabilities of the transferor, allocating the economic risk of an unlikely assertion of setoff rights against a material amount of transferred assets to the transferor based on price.

The Committee notes the plan of the FASB to invite only attorneys and representatives of regulatory and rating agencies to participate in a public roundtable to discuss setoff rights and other issues relating to isolation of transferred financial assets. We believe that representatives of accounting and investment banking firms familiar with

the operations of financial institutions in the participation and securitization markets would be critical in assisting the FASB to obtain a full understanding of current market practices and the impact on the banking system of various alternatives it may consider.

The Committee thanks you for the opportunity to comment and appreciates your consideration of our recommendations. We would be pleased to further assist the FASB by participating in the May 25 roundtable discussion, should you find our participation helpful. We would also be happy to respond to any requests you may have for additional information.

If you have any questions regarding this letter or wish to discuss our comments further, please contact the Chair of the Committee, Bradley K. Sabel, at 212-848-8410, or Douglas Landy, Committee Secretary, at 212-848-8826.

Very truly yours,

Bradley K. Sabel

Bradley K. Sabel
Chair, Committee on Banking Law

ABCNY COMMITTEE ON BANKING LAW MEMBERSHIP

Not all of the Committee members participated in the preparation of this letter, nor did the participation of a member mean that he or she supported the views expressed in this letter. Moreover, the Committee members acted only as individuals and not as representatives of the organizations to which they belong or by which they are employed, and therefore the views expressed in the letter are not to be considered the views of any governmental, commercial or private organization other than the Association.

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