Letter of Comment No: 25
File Reference: 1200-SRI
Date Received: 05/20/04

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration

May 20, 2004

Mr. Lawrence W. Smith
Director, Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Setoff and Isolation

Dear Mr. Smith:

We are pleased to take the opportunity to respond to your staff's request for information ("Request") about the effect of setoff rights on the legal isolation standard of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* ("SFAS 140"). We are concerned about this project because changes in the way SFAS 140 is applied to loan participations could have a significant adverse impact on the financial institutions the Agencies supervise.

We believe that accounting for loan participations as a sale for financial reporting purposes is consistent with the sale accounting criteria set forth in SFAS 140. Furthermore, a change to the current SFAS 140 accounting approach for loan participations would result in financial reporting that is less relevant and less transparent. In addition, such a change could create significant market dislocations. We would like to reiterate our concern (originally conveyed in our Chief Accountants' letter, dated December 1, 2003) about any change that: 1) may add significant operational and financial costs to loan participation transactions; 2) have adverse consequences for the management and dispersion of credit risk within the financial system; 3) restrict the availability of credit in certain markets; 4) create competitive inequities for community banks and other smaller depository institutions; or 5) negatively affect Small Business Administration lending practices.

We further believe that the existence of setoff rights on the part of a borrower or the FDIC as receiver should not preclude a loan participation – or any other financial asset transfer – from being accounted for as a sale. As discussed in more detail

below, with respect to loan participations engaged in by the institutions the Agencies supervise, the likelihood of setoff rights being exercised in such a way as to adversely affect a participant's interest in the participated loan is more hypothetical than real. We believe that this possibility is too remote to make the existence of setoff rights a determinative factor for the legal isolation standard of SFAS 140. More broadly, conditioning the availability of sale accounting treatment for any transferred financial asset on the nonexistence of setoff rights would create an inconsistent standard and competitive inequities.

In response to the Request, we make the following specific comments:

With respect to the institutions the Agencies supervise, the risk to a loan participant's interest caused by setoff rights is too remote to make the existence of setoff rights a determinative factor for legal isolation.

It has been virtually undisputed since the U.S. Supreme Court's decision in the 1892 case of Scott v. Armstrong that a depositor of a failed bank has the right to set off a deposit against indebtedness owed by the depositor to the institution.[2] In addition, the FDIC as receiver has an analogous right of setoff, which is derived from the rights of the failed institution,[3] or from provisions of the Federal Deposit Insurance Act.[4] Courts have held that the depositor and the FDIC as receiver may exercise setoff against participated loans.[5]

While a borrower may exercise setoff of a deposit solely because of the institution's insolvency, the FDIC as receiver may exercise setoff only when the loan by the insolvent institution to the borrower has matured or is in default. Hypothetically,

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[1] We are restricting our comments to the areas of our greatest concern and knowledge. We note that certain topics set forth in the Request are more appropriate for comment by parties other than the Agencies. Specifically, we believe that the treatment of setoff rights in cases arising under the U.S. Bankruptcy Code is best addressed by subject matter experts in the field of bankruptcy. Similarly, we defer to legal practitioners who routinely render true sale opinions to describe the scope and content of these opinions.

[2] 146 U.S. 499 (1892).

[3] Courts have recognized an institution's right to apply amounts on deposit to a debt owed to the institution by the depositor where the debt is due and owing and the deposit was not made for some specific purpose. The right is also provided by statute in some states.

[4] Specifically, see 12 U.S.C. 1822(d), which provides that the FDIC may withhold payment of an insured deposit "which is not offset against a claim due from such depository institution," as may be required to provide for the payment of any liability owed to the institution or its receiver. Courts have interpreted this statutory provision as creating a statutory right to setoff and as recognizing the FDIC right as receiver on behalf of a failed institution to effect a setoff against a depositor for a claim due the bank. See, e.g., Northern Trust Co. v. FDIC, 619 F.Supp. 1340 (W.D. Okla. 1985).

[5] See Mademoiselle of California v. FDIC, 379 F.2d 660 (9th Cir. 1967), and cases that arose from the 1982 receivership of Penn Square Bank, N.A., of Oklahoma City, namely, Hibernia Nat'l Bank v. FDIC, 733 F2d 1403 (10th Cir. 1984), Seattle-First Nat'l Bank v. FDIC, 619 F.Supp. 1351 (W.D. Okla. 1985), Northern Trust Co. v. FDIC, 619 F.Supp. 1340 (W.D. Okla. 1985), and Chase Manhattan Bank, N.A. v. FDIC, 554 F.Supp. 251 (1983).

then, the exercise of setoff rights may adversely affect a loan participant only when (i) the lead institution fails and (ii) the borrower has a deposit that he elects to set off against the loan, or the FDIC as receiver elects to set off a deposit against the loan because the loan has matured or is in default.

According to the implementation guidance in SFAS 140, available evidence must provide reasonable assurance that transferred financial assets have been legally isolated from the transferor and its creditors in order for derecognition of the assets by the transferor to be appropriate. The Agencies believe that the FDIC's receivership experience over the past 20 years offers sufficient evidence to satisfy the reasonable assurance standard as it relates to setoff. The last court decision regarding the setoff of deposits against participated loans in an FDIC receivership was rendered in 1985. Additionally, the FDIC has been unable to identify any receiverships since the 1982 receivership of Penn Square Bank that involved the setoff of a deposit against a participated loan.

Furthermore, the FDIC's current practice in receiverships is to sell as many of the failed institution's loans as possible. Under current FDIC loan sale policy, if the FDIC as receiver sells a loan and if the borrower/depositor elects to set off a deposit against the loan, the FDIC will pay the purchaser of the loan the amount of the setoff on a dollar-for-dollar basis. In the case of the sale by the FDIC of a participated loan, the loan purchaser, in the role of the lead institution, would then pass to each participant its share of those funds representing the amount of the setoff, thus eliminating any loss to the participant due to the setoff of the deposit.

In addition, it is the long-standing position of the National Credit Union Administration that the common law (or equitable) right of setoff does not apply to credit union shares. The Federal Credit Union Act ("FCU Act") states that shares are equity.[6] Purchases of credit union shares establish an equity relationship, not a debtor-creditor relationship, and so a share relationship lacks the necessary mutuality with a loan relationship to exercise common law (equitable) setoff.

From the Agencies' perspective, the remote likelihood of an adverse effect on a loan participant's interest caused by a deposit setoff suggests that this eventuality should be viewed on a par with similarly adverse but unlikely actions such as fraud or failure to adhere to proper servicing procedures. That is, it would be consistent with the reasonable assurance standard in SFAS 140 to determine that transferred financial assets potentially subject to setoff rights have been legally isolated from the transferor. A change in the long-standing sale accounting treatment of loan

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[6] See 12 U.S.C. §1757(6). The FCU Act also specifically distinguishes shareholders from creditors by providing that uninsured shareholders receive a distribution from a liquidated credit union only after all creditors are paid. 12 U.S.C. §1787(b)(11)(B). In the only case of which NCUA is aware examining setoff in the context of a credit union insolvency, the Supreme Court of Kansas held that credit union members do not have the right to set off shareholdings against debts owed to the credit union. Kansas Credit Union League, Receiver for Credit Union of Parsons v. Redmond, 532 P.2d 1032, 1042 (Kan. 1975).

participations is unnecessary conceptually and is not justified in light of associated burdens on the market and market participants.

Conditioning legal isolation on the nonexistence of setoff rights would create an inconsistent standard and competitive inequities.

Under common law, the right of setoff is predicated on the requirement of mutuality. Mutuality means that the obligor owes and is owed by the same party acting in the same capacity. While the mutuality requirement remains applicable to setoff, modern commercial law imposes other rules that affect the right of setoff. Under the Uniform Commercial Code ("UCC"), the transferee of any financial asset that is not a negotiable instrument generally takes the asset subject to the obligor's setoff rights. Therefore, using a special purpose entity as part of a financial asset transfer based on the notion of interposing a party with whom the obligor does not have mutuality may not be a viable approach for eliminating the obligor's setoff rights. The special purpose entity, like any transferee of a non-negotiable asset, generally would take the asset subject to the obligor's setoff rights and other defenses.

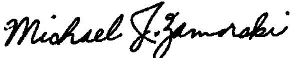
Under section 9-404(a) of the UCC, an obligor's setoff rights (also referred to as "setoff defenses") may be eliminated or limited if the obligor is given notice of the transfer (which will only eliminate setoff rights that arise after notice is given). Setoff rights may also be eliminated if they are waived by the obligor. Certainly, these approaches may be viable for many transferors of financial assets. But in some cases, such as transfers of certain receivables where formal written contracts are not used, notice of the transfer would be so impractical as to be impossible; in some other cases, consumer protection laws may preclude an obligor's waiver of setoff rights. We submit that conditioning legal isolation on the nonexistence of setoff rights when some transferors may successfully eliminate setoff rights but other transferors cannot do so would be inequitable.

Conditioning legal isolation on whether setoff rights exist would result in financial reporting that is less relevant and less transparent.

Clearly, it is important that financial asset transfers be accounted for in a way that is relevant and transparent. Under SFAS 140, a financial asset transfer that does not meet the criteria for a sale must be reported as a secured borrowing. Making the existence of setoff rights a determinative factor in the distinction between a sale and a secured borrowing would result in transfers that are sales in every ordinary sense of the term, and which otherwise meet all the other sales criteria under SFAS 140, being accounted for as secured borrowings. Such financial reporting would be less relevant and less transparent than the existing sale treatment.

Thank you for the opportunity to provide these comments. We look forward to further discussions on this important topic.

Sincerely,



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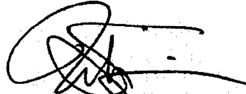

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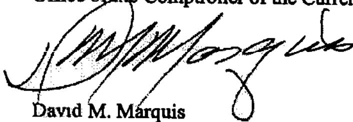

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