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March 3, 2010

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John Bowman
Acting Director
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

The Honorable Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System
20th and C Streets, NW, (Mail Stop 54)
Washington, DC 20551

The Honorable Ben S. Bernanke
Chairman
Federal Reserve Board
20th and C Streets, NW
Washington, DC 20551

Mr. Neil Milner
President and CEO
Conference of State Bank Supervisors
1155 Connecticut Ave NW, 5th Floor
Washington, DC 20036-4306

RE: Regulatory Requirements for Loan Participations Affected by FASB Statement No. 166

Ladies and Gentlemen:

We are writing to express concerns we have regarding the implementation of FASB Statement No. 166 *Accounting for Transfers of Financial Assets* ("FAS 166", now defined within the FASB Accounting Standards Codification Topic 860: Transfers and Servicing) for regulatory compliance purposes. There is much confusion on many fronts relating to FAS 166, but the focus of this letter is limited to LIFO (Last-in, First-out) and FIFO (First-in, First-out) loan participations and sales of portions of loans guaranteed by the Small Business Administration (SBA). We respectfully request that the agencies provide some much needed transition information regarding capital and legal lending limits.

FAS 166 changes the criteria for which transfers of financial assets may be accounted for as a sale. An integral part of FAS 166 is the concept of the "participating interest". When a portion of a financial asset is transferred, that portion must have certain characteristics in order to qualify for sale accounting. If that portion does not have all the required characteristics, the transfer will not qualify as a sale and the applicable portion remains on the balance sheet of the transferor.

Many community banks have LIFO or FIFO loan participations. As a result of implementing FAS 166, LIFO and FIFO loan participations will no longer be treated as sales for GAAP purposes. Additionally, because the new regulatory capital guidance relating to FAS 166 and FAS 167 (issued by the agencies in January 2010, though it does not specifically address loan participations) does not depart from GAAP, community banks will be forced to maintain capital for these loans – even though they have been sold for legal purposes. This treatment results in unnecessarily higher capital requirements and a reduction in capital that has no economic justification. Further, if used as the basis for legal lending limits, FAS 166 obfuscates the true risk exposures to borrowing parties, rendering both lending limits and capital requirements effectively meaningless.

LIFO and FIFO Loan Participations

The use of "LIFO" (Last-in, First-out) and "FIFO" (First-in, First-out) loan participations is integral to the operations of many small banks in the U.S., especially those that provide agricultural lending in the Midwest. (For the remainder of this letter, unless specifically noted, we will refer to both kinds of loans participations as LIFO). Loan participations are executed so that community bankers may issue loans to customers that the bank, because of legal lending limits and other risk-based reasons, might not otherwise be able to make.

In the case of LIFO loan participations, the originating bank advances funds to its customer until the bank reaches its legal lending limit for that borrower; afterwards, the participating bank buys the amount of the loan that exceeds this limit. Per the participation agreement, the participating bank is repaid its principal prior to repaying the originating bank (thus, the participating bank is the last-in to lend and first-out with regard to being repaid – FIFO participations work in the reverse). However, in the event of default, the originating bank and the participating bank share any losses on a pro-rata basis.

Loan participations allow the originating bank to serve the needs of its local community, while retaining its customer relationship and obeying the legal lending limits, and provides borrowers with broader access to credit. LIFO and FIFO loan participations are very efficient:

- Servicing LIFO participations is significantly streamlined as opposed to pro rata loan participations, particularly for loans that are cyclical (that is, they have ongoing advances and repayments). The process for individual loan accounting, interest accrual, and disbursement services is more efficient and cost-effective than traditional loan participations.

- LIFO participations provide banks with a simple way to provide large loans to customers and to easily monitor legal lending limits. The originating bank is able to issue loans of an amount well above the bank's lending limits to the borrower, something that is not possible if the originating bank were required to strictly maintain pro rata loan participations. Using LIFO participations, the community bank is able to easily maintain its exclusive relationship with its large customers.

- LIFO participations enable the bank to maximize income on low-risk loans, since it may earn interest on the full amounts of loans up to a certain threshold.

Accounting for LIFO Participations

Historically, LIFO loan participations have been treated in the same manner as other loan participations – they were sales by the originating bank to the participating bank. Under FAS 166, however, LIFO participations do not qualify as sales, as FAS 166 requires that the loan's cash flows be proportional among interest holders. Because LIFO participations repay principal to the participating bank prior to the originating bank, the cash flows are not proportional. It should be noted that, while the cash flow is not proportional, upon credit default, any remaining credit risk is shared proportionately. This is in contrast to structured securities where cash flows, including credit losses, are not shared proportionately.

LIFO participations must be recorded as secured borrowings. The result is that the originating bank's balance sheet is grossed up to include the participating bank's portion of the loan. The participating bank's balance sheet also includes the participating bank's portion of the loan, thus resulting in the amount of the participation being reported on both banks' books. Additionally, *the originating bank must include provisions for loan and lease losses for the participating bank's share of the credit losses, without being able to offset it for the loss the participating bank contractually assumes*. (This is because FASB views this as a contingent asset, and contingent assets may not be recorded.) Thus, in addition to providing regulatory capital for the portion of the loan sold (in a legal sale) to the participant, the originating bank must also record an expense that is actually the expense of the participating bank (per the LIFO contract). This both increases the capital requirement and reduces capital, and as a result reduces lending capacity. Because the participating bank will also record its share of the loan as a receivable from the originating bank and will record loan loss reserves against its share of the participation, the banking agencies effectively are requiring capital twice for the same loan.

The effective date for FAS 166 is for transfers executed after December 31, 2009. Many people, including banking examiners and public accountants, understood this effective date to mean that participation agreements outstanding prior to 2010 were "grandfathered" as sales. This is because the transfers have legally been executed (via the loan agreement) prior to the effective date, even though the advances have not been made. However, the term "transfers", as defined by FASB, applies to any advance or draw on a loan commitment. Therefore, as is common with revolving loan agreements and construction loans, 2010 advances on commitments previously participated out through LIFO agreements made prior to 2010 will fail sale accounting.

At least two significant problems exist:

(1) Because the treatment of LIFO loans was not clear and/or was not directly communicated to community banks, their auditors and their examiners, many have been caught unaware. Banks have continued to make transfers under their existing agreements.

(2) The vast majority of these revolving lines of credit have a maturity of one year, which means all LIFO agreements must be renegotiated with all LIFO participants in order to achieve sale accounting – even though the time period of any renegotiated agreements are likely to last only a few months.

Legal Lending Limits

Legal lending limits should not be based on FAS 166. It is our understanding that this is, in fact, the agencies' views. However, it is important that banks be made aware of this.

FAS 166 is not a logical basis for legal lending limits, because it does not reflect the risks. To use FAS 166 for determining compliance with legal lending limits could place both the originating and participating banks in jeopardy without reason. For example, the originating bank may exceed its limit because it will add the participating bank's share of the loan to its loan balance, even though the originating bank's exposure to credit risk is still contractually limited to the amount defined in the participation agreement. Correspondingly, under FAS 166, the participating bank no longer has a loan to the borrower, but to the originating bank – even though by contract the participating bank's loan is with the borrower. Thus, FAS 166 does not properly reflect the credit risk for either the originating or the participating bank.

Sales of SBA-Guaranteed Loans

Banks that participate in the SBA 7(a) loan program often sell the guaranteed portion of the loan to third parties. SBA requires these secondary market sales to maintain a 90-day warranty, or recourse period, in the event of a prepayment or default. FAS 166 specifically states that participating interests may not contain recourse to the transferor. Therefore, banks that participate in the program and sell these guaranteed portions to third parties must wait until the recourse period expires before they can recognize the sale. Regulatory capital must be held for these amounts in the meantime.

Sales of portions of SBA-guaranteed loans are performed in compliance with strict guidelines, are legal sales transactions, and effectively take the credit risk off the books of the originating bank. In substance, since this portion is guaranteed by the SBA, it is only the premium received upon the sale that is at risk. Therefore, holding capital against these amounts – amounts that can vary greatly from quarter to quarter, only serves to restrain overall lending.

Recommendations

The ABA strongly believes there are technical problems with using FAS 166 as a basis for regulatory compliance. The originating bank contractually sells the credit risk to the participant in LIFO loan participations. While we understand that there is an incremental risk for the portion maintained by the originating bank due to the "first out" nature of the cash flows (compared to a similar portion of a participation that qualifies for sale accounting under FAS 166), the risk is nominal.

Further, we believe that confusion around the effective date of 2010 advances on loans subject to LIFO loan participations creates unreasonable administrative burdens to change these agreements. Indeed, in discussions with loan processing system vendors, the changes required to comply with the complexities of FAS 166 will take, at a minimum, several months to implement.

In regards to sales of portions of SBA-guaranteed loans, the credit risk maintained by selling banks is limited only to the amount of the purchase premium. Therefore, using FAS 166 to risk-weight the loan undermines the logic of the system to provide for risk-based capital.

With this in mind, we recommend that:

1. The agencies clarify that, for legal lending limit purposes, FAS 166 is not to be followed for either the originating bank or the participating bank. Compliance with such limits should apply on the basis of the contractual borrower.

2. For regulatory capital purposes, the portion of loans subject to LIFO participations that will be recorded on the originating bank's books under FAS 166, but which belong to the participating bank, be assigned a zero risk weighting.

3. For Tier 1 capital purposes for originating banks, the amount of allowance for loan and lease losses should be added back into capital if allowances are recorded for portions of LIFO participations that belong to participating banks and do not qualify for sale accounting.

4. For Tier 1 capital purposes, the portion of SBA-guaranteed loans that remains on the books of a bank due to the 90-day recourse period should be assigned a zero risk-weighting.

We should note that the Notice of Proposed Rulemaking that preceded the final rule regarding risk-based capital guidelines and the Final Rule itself, issued in January 2010, ignored loan participations and focused solely on securitizations. As a result, many organizations are just learning the impact of FAS 166 and will need time to review business practices and implement these rules. With that in mind, and in order to not disrupt these lending arrangements, we further recommend that any implementation of FAS 166 for risk-based capital weightings be delayed until 2011. This will enable lenders to renegotiate their LIFO agreements, which are generally renewed on an annual basis, in a more orderly fashion and will enable lenders to work with the SBA in structuring the SBA 7(a) lending program.

Thank you for considering our request. Please contact Mike Gullette (202-663-4986 or mgullette@aba.com) or me if you have any questions or would like to discuss these issues in greater detail.

Sincerely,

Robert R. Davis