

Massachusetts Bankers Association

November 9, 2004

Lawrence Smith
Director
Emerging Issues Task Force – FSP
Financial Accounting Standards Board
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Letter of Comment No: 241
File Reference: EITF03-1A

SUBJECT: EITF Issue 03-1-a, “Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”

Dear Director Smith:

The Massachusetts Bankers Association (MBA), which represents 220 commercial, savings, and cooperative banks and savings and loan members in Massachusetts and New England, appreciates the opportunity to comment on the above referenced FASB Staff Position: Issue 03-1-a, which provides guidance for the application of paragraph 16 relative to debt securities that are impaired because of interest rate and/or sector spread increases. We thank FASB and the EITF for delaying the June 15, 2004 effective date to allow additional input from banks, national trade organizations, and regulatory agencies on the impact of EITF 03-1 on bank financial statements.

Our members, primarily regional and community banks, have significant holdings in both debt and equity investment securities. These investments are an integral and essential tool in the banks’ asset/liability management strategies. The guidance with respect to debt securities represents a major change because it could require financial institutions to recognize unrealized losses of debt investments categorized as “available for sale” (AFS) due to rising interest rates.

Background

EITF Issue No. 03-1 is meant to clarify when impairment of interest-sensitive debt securities held in an AFS portfolio should be recorded on the income statement. EITF 03-1, “Other-Than-Temporary Impairment”, issued as final in March 2004 could require banks to recognize losses when the value of securities is affected by changes in interest rates. In times when securities in the AFS portfolio become impaired or are “underwater” as a result of an interest rate change, a financial institution must record that loss in income, unless it states an “intent and ability” to hold the security until the value recovers to par or it matures, in which case, the losses are held in shareholder’s equity on the balance sheet. Strict interpretations by some accounting firms have suggested that as few as two sales of impaired securities would call into question or “taint” the bank’s intent to hold similar securities, leading to a requirement to recognize losses to impaired securities affected by changes in interest rates regardless of intent to sell. FASB has issued a FASB staff position (FSP) which proposes changes to EITF 03-1 to clarify its intent.

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General Position

Issue 03-1-a is of major concern to our member institutions because it would have a significant impact on their ability to manage their balance sheets and would create more ambiguity in applying existing guidance. The Association believes that the guidance related to paragraph 16 should be withdrawn because it creates too many negative consequences without increasing transparency for investors. We discuss many of our specific concerns below:

Association Concerns

The proposed guidance would require that a bank recognize an impairment when it has decided to sell an impaired security but states that it is not to be interpreted to mean that a bank should wait to recognize an other-than-temporary impairment until it has decided to sell an impaired security. The selling of "underwater" securities is the triggering event for much of the confusion surrounding what many in the industry perceive to be a misapplication of EITF 03-1. Following the release of EITF 03-1 some accounting firms stated that the sale of "underwater" securities will likely lead to a determination that the entire portfolio is "tainted," because the bank appears to have developed a "pattern" of selling securities for which it previously asserted that it intended to hold until full recovery. In some cases, it was determined that as few as two sales would constitute a pattern. We believe that this notion is flawed. This view severely limits the ability of a bank to "change" intentions of an AFS security as well as takes away much of the flexibility needed to adjust financial strategies to compensate for unanticipated market forces. Furthermore, such an interpretation would adversely impact banks' regulatory capital positions. The Association does not believe that this result was intended with the EITF 03-1 impairment model.

FAS 115 states, "investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities." The AFS category means that these securities are "available" to be sold by institutions as part of their asset/liability management strategies. To conclude otherwise not only contradicts existing guidance in FAS 115 but effectively ties the hands of bankers in prudently managing their balance sheets as well as interest rate risk. When management deems necessary, it will at times change its intention regarding a security in order to better manage the bank's portfolio. Banks need the flexibility to sell securities designated in the AFS at a profit or loss for legitimate business purposes without risking a write-down of other securities in the AFS portfolio. Most banks have the ability to hold securities for an indefinite period of time, which could mean maturity.

Current interpretations by some accounting firms modify and overrule existing generally accepted accounting principles (GAAP). GAAP requires that unrealized losses on AFS securities that are determined to be temporary or recoverable be accounted for as an adjustment to equity, rather than income, as long as the bank has the ability and intent to hold the "impaired" securities to such time that the remaining book value is recoverable (e.g. could be held until maturity). We believe a more appropriate definition of when an impairment is considered other-than-temporary is when the bank no longer intends (or has the capacity) to hold until recovery.

The proposed guidance states if a bank previously asserted the intent and ability to hold a security to a forecasted recovery period, the following would not necessarily call into question the bank's intent and ability to hold other securities to recovery: unexpected and significant changes in liquidity needs,

unexpected and significant increases in interest rates that significantly extend the period that a security would need to be held by an investor, and/or a de minimis volume of sale of securities.

While the Association agrees with the above assertions, there are other reasons which should not call into question a bank's intent such as the sale of securities due to a cash need such as business consolidation, settlement of litigation or other non-routine needs. It is important to realize that "intent" can change based on the circumstances and legitimate business purposes of the institution. Such a change in intent typically involves rational methodology that includes documentation of the factors used by management in reaching its conclusion regarding whether or not a write-down is required. Thus, we believe that more focus should be placed on "ability" than "intent" to hold in the AFS category. Also, sales for risk management purposes should be acceptable and not "taint" the remaining securities in the portfolio.

The Association agrees with the FASB EITF staff that an impairment deemed "minor" or "insignificant" as a result of lower interest rates, should be deemed temporary and not necessitate a write-down to the income statement because as FASB has acknowledged, normal price volatility may eliminate an impairment. However, the Board is considering whether some "minor" level of impairment or safe harbor should automatically be deemed temporary and has requested comments as to whether it should provide such a "bright-line" test and, if so, whether 5 percent is the right numerical threshold.

A 5 percent threshold is extremely low. For example, an interest rate increase of as little as 125 basis points would cause a 5-year US Treasury to lose more than 5 percent of its value. Such a small increase in rates is only cyclical in nature and therefore, easily recoverable over its term. The Association believes that a numerical threshold would not capture all the information needed to determine whether a debt security is other-than-temporary impaired. Bank management can not adequately conclude whether an "underwater" security is other-than-temporary impaired without consideration of other key factors such as credit ratings, interest payment history, ability to repay and ability to borrow against the security. We are also concerned that the 5 percent or any similar "bright-line" test would cause financial statement preparers and auditors to consider percentage alone rather than all the facts and circumstances associated with a security.

Although FASB staff has indicated that a bank should assert its ability and intent to hold to a forecasted recovery at the individual security level, the Association believes that it should be done at the portfolio level. A bank may hold hundreds of securities in its portfolio and a requirement to assert intent and ability on each security would be operationally cumbersome. In addition, banks would have to document intent for each security which would be extremely burdensome, as well as expose the bank to increased liability under the Sarbanes-Oxley Act.

Equity Securities

The Association would like to confirm that this guidance is not intended to address equity securities. However, there are similarities. We wish to echo concerns previously outlined in our comment letter dated May 12, 2003 (see attached). Community banks in the northeast have been investing in equities since their very founding in the 1840s. Some of these equities have significant unrealized gains which are accessed to prudently manage portfolios through volatile market cycles. Management is able to exercise appropriate judgment in determining to buy, sell or hold. Over time, patience and strategies such as these

Larry Smith, Director
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have served our industry well. Again, strict definitions of other-than-temporary impaired will only be counterproductive. As with these securities, it would be inappropriate to force bankers to make a decision to take an income statement loss on unrealized losses when they have the intent and ability to hold until recovery.

Effective Date

The guidance in the FSP would make this rule effective on the last reporting date for reporting periods ending after the final FSP is posted to the FASB Web site (most likely by year end 2004). We would reassert that implementation by the end of the year is too soon for banks to make changes in their asset/liability process. A more realistic implementation date would be January 1, 2006.

Thank you for the opportunity to comment on the proposed guidance.

Sincerely,

A handwritten signature in black ink that reads "Tanya M. Duncan". The signature is written in a cursive, flowing style.

Tanya M. Duncan
Director, Housing and Federal Policy

TMD:aam

Massachusetts Bankers Association

May 12, 2003

Lawrence W. Smith
Chairman – Emerging Issues Tax Force
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Dear Chairman Smith:

Thank you for the opportunity to bring our collective concerns before your committee regarding Issue 03-01, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments”. We represent over 350 community banks in the Northeast. A majority of those banks presently hold equity securities in their investment portfolio. We recognize that your responsibility is to provide a working model for assessing other-than-temporary impairment and hope that the issues identified below assist you in executing that charge.

Our comments are related specifically to the proposed accounting treatment of equity securities. We will identify the reasons banks hold equity securities, from both a historical and financial prospective, the bank regulatory environment and the impact your currently proposed treatment would have on those banks that continue to hold equity securities. Lastly, we hope you will consider treating the issue of other-than-temporary impairment as described in the Statement on Auditing Standards #92.

Historical reasons for maintaining an equity securities portfolio

As we pointed out in our meeting last Friday, community banks have been investing in equities since their very founding in the 1840s. Over that period of time, equity holdings have become an integral and essential tool in the banks’ asset management strategies. They are managed with a long-term horizon, therefore as strategic holdings as opposed to tactical to capture short-term gains. As our banks have employed this investment strategy, they have literally held some equities for decades in their portfolios, through all kinds of market cycles, ignoring the vicissitudes of the market and its impact on sectors and specific stocks. They did not feel compelled to sell based on run-downs or run ups in the market, which were reflected in the values of their respective holdings. Rather, they evaluated the cause of the market volatility, the exposure and impact on a given equity in the portfolio and made an investment decision to buy, sell or hold.

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Over time, patience and strategies such as these have served our industry well. As a result, many of our banks have built up significant unrealized gains in their portfolios to be accessed judiciously and prudently, always being aware that the portfolio has been constructed for long-term benefits not just short-term gains. This has allowed them to significantly lower book costs through splits as well as add to positions in down markets to one day reap the rewards of their patience through long term appreciation.

While it is difficult to estimate the exact dollar amount our members presently hold in equities, the FDIC reported that on a national basis, for the period ending 12/31/01, the community bank industry had in excess of \$10.3 billion invested in equities.

Financial reasons for maintaining an equity securities portfolio

Community banks also maintain equities for several important financial reasons, including asset diversification, earnings performance, creation of a strategic reserve and for liquidity and leverage considerations.

Asset Diversification The concentration of investments in any single asset type implies greater risk, since the performance of similar assets increases and decreases together. Diversification embodies the idea of spreading investment risk across varied asset types in an effort to lower total portfolio, or balance sheet, risk. Sound banking (risk management) practice requires asset diversification at the macro and micro levels of the balance sheet.

To manage investment risk in its loan portfolio, the Bank loan portfolio is diversified by type, collateral, geographic distribution and borrower. The debt portfolio is diversified by type, coupon, collateral, index and repricing schedule.

By adding another asset class comprised of equity securities to its balance sheet, banks further reduce non-market, or diversifiable, risk.

Earnings Performance Common stock is the one asset class that has clearly outperformed all others over time. The table below includes pre-tax rates of return for different bank-related asset classes. These returns cover the 15 year period December 31, 1987 through December 31, 2002 (earliest full year data available on Bloomberg for all indices used).

<u>Asset Class</u>	<u>Index</u>	<u>Avg. Annualized Returns</u>
Residential Mortgages	FNMA 30 Year Mortgage	7.8%
Commercial Loans	Prime + 1 (8.0% + 1.0%)	9.0%
Bonds	5 Year Treasury Yield	6.3%
Common Stocks	S&P 500	11.5%

It should be noted that the S&P 500 total return includes dividend yields. Banks enjoy a favorable dividend received deduction of 70% for income tax purposes that is not included in the

rate of return. Also, from time to time, laws provide favorable tax rates for capital gains and enhance the after-tax rate of return for common stocks. Both of these issues strengthen the performance of common stocks relative to alternatives.

Strategic Reserve The asset appreciation created by long-term investing in common stocks provides a significant cushion for both tactical and strategic initiatives. Specifically, some banks have created private foundations from appreciated equity portfolios in order to provide for continued charitable giving in their communities.

Even more critical, net unrealized gains could provide a bank with a much needed infusion of earnings if significant loan losses occurred, like those experienced in the early part of the 90s.

During the 1980s, when the core earnings trend at community banks was under extreme pressure due to intense interest rate risk, realized gains supplemented otherwise modest core earnings, providing capital to margin bank asset growth, providing loans to their communities.

Leverage & Liquidity In the extreme, the equity portfolio could be used to generate immediate and significant liquidity. The net gain would increase leverage, providing capital for an M&A transaction.

Bank regulatory environment

The principal function of banking regulations is to maintain the stability of and public confidence in the nation's financial system.

Accordingly, banks are highly regulated and must undergo a rigorous annual safety & soundness examination by their regulator(s). Consequently, those banks that invest in equity securities do so with standards of quality reserved for the most prudent investor.

As mentioned previously, the number of community banks with equity investment powers is relatively small, as compared to the total number of banking institutions in the country, especially after the passage of the FDIC Improvement Act of 1991. In the aftermath of that sweeping banking law, regulations were enacted to prohibit banks from holding equity securities in excess of 100% of capital.

Since essentially only well capitalized banks may invest in equity securities, these banks have both the ability and intent to hold all equity positions that have a fair value significantly below cost for a period sufficient to allow for any anticipated recovery in fair value. Community bank CFOs are not equities traders.

It should be noted that many of the community banks that presently have equity investment powers are mutually owned, not shareholder owned, and therefore are not SEC registrants.

Capital impact on banks under the proposed accounting treatment

A bank's capital ratio is the principal basis for its financial strength and for all meaningful regulatory categorization. The FDIC Improvement Act of 1991 and subsequent regulations established specific minimum capital levels to be maintained. Failure to do so can mean enforcement actions, including cease & desist orders, or, in the extreme, failure.

By virtue of the calculation used to determine a bank's Tier 1 Leverage capital ratio¹, the accounting treatment presently being considered by the EITF would negatively impact a bank's Tier 1 Leverage capital. Presently, bank regulation requires that net unrealized losses (where unrealized losses exceed unrealized gains) in marketable equity securities be subtracted from capital in order to determine the bank's regulatory capital. Banks rely on the unrealized gains in their portfolio to offset unrealized losses, either in part or whole. Requiring that unrealized losses flow through the income statement, leaving only unrealized gains, capital becomes unjustly weakened.

Example Bank's portfolio contains the following equity securities:

	Gain/(Loss)
General Electric	\$ 20
General Motors	(10)
IBM	(8)
Net unrealized gain	<u>\$ 2</u>

Without proposed EITF Accounting Treatment Example Bank's Tier 1 capital ratio would be as follows:

GAP Capital	\$ 60
Total Assets	<u>\$ 1,000</u>
Capital Ratio	<u>6.00%</u>

¹ The appropriate portion of the regulation reads as follows:

Tier 1 Capital or Core Capital is defined in Part 325 and means the sum of common stockholders' equity less net unrealized losses on available-for-sale equity securities with readily determinable fair values.

With Proposed EITF Accounting Treatment Example Bank's Tier 1 capital ratio would be as follows:

General Electric and General Motors would be considered impaired and written down.

Loss to income statement	\$ (18)
Tax benefit @ 40%	<u>7</u>
Net reduction to GAP capital	<u>\$ (11)</u>
GAP Capital	\$ 49
Total Assets	<u>\$ 989</u>
Capital Ratio	<u>4.95%</u>

Tier 1 Capital Ratio of less than 5% would precipitate regulatory action as the Bank would no longer be considered well capitalized

Statement on Auditing Standards #92

Similar to your proposal for the treatment of debt securities, it is our hope that you will consider adopting a model that closely resembles SAS # 92.

“These judgments are based on subjective as well as objective factors, including knowledge and experience about current events and assumptions about future events. The following are examples of such factors.

1. Fair value is significantly below cost and --
 - a. The decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
 - b. The decline has existed for an extended period of time.
 - c. Management does not possess both the intent and the ability to hold the security for a period sufficient to allow for any anticipated recovery in fair value.
2. The security has been downgraded by a rating agency.
3. The financial condition of the issuer has deteriorated.
4. Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
5. The entity recorded losses from the security subsequent to the end of the reporting period.”

This model draws data from various sources, both objective and subjective, while allowing for continued management judgment and the interpretation of facts.

Summary Statement

We believe that community banks will suffer reduced earnings and regulatory capital levels under the proposed accounting treatment. This in turn may force some or all of them to exit a profitable earning asset class, one that overtime, has out-performed all other bank assets, while helping to reduce diversifiable risk on their balance sheets. Additionally, we feel it is necessary that the model you choose clearly allows for management judgment without imposing arbitrary time periods that do not accurately reflect the investment horizon of banks that hold equity securities.

While we recognize that the EITF process on this particular issue has been accomplished to date in complete accordance with FASB policy, we would ask for more time to enable other state and national bank trade associations, state and national bank regulators and other interested parties to comment on your proposal and the possible implementation timeline you disclosed.

If you need more information as you deliberate our concerns, please do not hesitate to call either Dan Forte (617-523-7595) at the Massachusetts Bankers Association or Lindsey Pinkham (860-677-5060) at the Connecticut Bankers Association. If they can not answer your questions, we will put you in touch with bankers that can.

We sincerely appreciate the time you and your associates have afforded us.

Sincerely,

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Connecticut Bankers Association

Daniel J. Forte
President & CEO
Massachusetts Bankers Association

Christopher W. Pinkham
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