

October 22, 2004

Mr. Robert Herz  
Chairman  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, Connecticut 06856-5166

Letter of Comment No: 72  
File Reference: EITF03-1A

Mr. Lawrence Smith  
Chairman  
Emerging Issues Task Force  
Financial Accounting Standards Board  
401 Merritt 7  
Norwalk, Connecticut 06856-5166

Re: EITF 03-1 "The Meaning of Other Than Temporary Impairment and its Application to Certain Investment"; and Proposed FSP EITF Issue 03-1-a.

Dear Messrs. Herz and Smith,

Darling Consulting Group (DCG) appreciates the opportunity to comment on Emerging Issues Task Force Issue 03-1 "The Meaning of Other Than Temporary Impairment and Its' Application to Certain Investments" ("EITF 03-1") and Proposed FSP EITF Issue 03-1-a. As a balance sheet management advisor to over 250 financial institutions throughout the United States, DCG assists clients in all aspects of balance sheet management. This includes activities in the investment portfolio that are closely coordinated with the financial institution's ("Bank's") liquidity needs, and also closely related to the overall management of their interest rate risk (IRR) profile. Given our role, we are well-positioned to understand the technical, accounting and business issues related to the above.

## Introduction

We concur with the FASB that further guidance needs to be provided with respect to evaluating and measuring Other Than Temporary Impairment ("OTTI") as it relates to various investment holdings. The guidance as provided by Opinion 18, SFAS No. 115 and SAB 59, has been deemed by most accountants and industry professionals as somewhat broad-based and subjective, and therefore has led to an inconsistent application of accounting rules in this area. We are concerned, however, that the current language in EITF 03-1 and Proposed FSP EITF Issue 03-1-a appear to *introduce* the concept of impairment for securities whose book value exceeds the current market value ("underwater" securities) due solely to changes in interest rates.

The current language of EITF 03-1 has left to interpretation by audit firms of what constitutes a pattern of selling (and, therefore, circumstances that might require a write-down); resulting in a broad array of conflicting opinions about how SFAS No. 115 is to be applied to underwater available for sale securities. This has added yet another dimension of ambiguity to an already highly-subjective area of accounting. In addition, we believe that its application to non-credit related impairments may ultimately have far-reaching, negative implications should the proposed EITF 03-1 be issued as a final pronouncement in its current state. The proposed EITF 03-1 could hinder Bank earnings and create unnecessary volatility to earnings and regulatory capital, ***ultimately limiting Banks' depository and lending capacities and forcing them to focus on protecting their volatile capital position rather than on the consumers and communities they serve.***

Along with our client Banks and the hundreds of others with whom we talk around the country, we are deeply concerned with the potential negative ramifications of EITF 03-1. For example:

- reported financial statements that do not accurately reflect the results of a Bank's business activities (inaccurate earnings volatility, asset carrying values, capital levels, risk profiles, etc.);
- as a result of above, many of our SEC registered clients have expressed very real concerns relating to their exposures under Sarbanes-Oxley; especially related to the required signatures by senior Bank officers on financial statements that might be "technically correct" from an accounting perspective, yet materially misleading as to the true financial performance and risk profile of their Bank;
- ability to prudently manage risks, such as liquidity and interest rate sensitivity, at the enterprise level;
- a systemic lowering of banking industry earnings as Banks move to shorten the duration of their investment portfolios purely in response to GAAP accounting-related concerns;
- an increase in credit risk on Bank balance sheets as they substitute purchases of whole loans for mortgage-backed securities;
- inappropriately reduced and volatile regulatory capital levels that constrain the banking industry's ability to support economic growth (especially for community Banks);
- negative impact on Bank stock valuations due to increased earnings and capital volatility;
- decreased availability and/or higher cost of raising capital; and
- significantly reduced demand for mid to longer term bonds, thereby increasing the cost of issuing and/or negatively affecting the ability of longer term debt issuers to raise necessary capital in a fiscally responsible manner (e.g. municipalities, U.S. treasury, U.S. Agencies).

In this regard our primary concern is the introduction of Other Than Temporary Impairment (OTTI) accounting treatment on fixed income investment securities that have a diminished market value due solely to changes in interest rates (levels or yield curve shape), market volatility variables, and/or sector spreads.

### **Inconsistent with Bank performance and risk management**

Most importantly, the proposed accounting application is in conflict with the way that the vast majority of Banks: 1) generate earnings, and 2) measure and manage the liquidity and interest rate risks of their balance sheet. As managers of balance sheet spread, the focus is appropriately on total portfolio risk (enterprise level), not individual financial instrument risk.

It has not been uncommon for Banks to take losses opportunistically on some security holdings (or loan portfolios, which are not covered by EITF 03-1), in order to better position their risk profile (liquidity and/or interest rate risks) and, therefore, earnings behavior in future periods. One of the issues here is that some public accounting firms have begun to advise our clients that virtually any sale may be deemed part of a "pattern" of sales and thus become a "triggering event" under the current draft of EITF 03-1. If this interpretation were accurate, this would cause these institutions to mark all AFS securities with losses to market (without, at the very least, a netting of unrealized gains) through the Statement of Operations, and realize a potentially significant loss and impairment of capital.

Currently, Bank regulators do not adjust capital for securities for which there is an unfavorable market value adjustment. This has been based on a principle that the book value of these securities will be recovered over time, provided there is not a defined plan in place to sell them before recovery. The alternative for Banks that do not want to risk such earnings and capital volatility due to the implementation of EITF 03-1, as currently drafted, would be to re-designate many of these securities as "held to maturity." Doing so would materially inhibit their ability to proactively manage their balance sheet risk positions.

By incorporating interest rate issues more broadly for OTTI purposes, a situation may develop in which write-downs could be triggered due to market movements in one reporting period. Ironically, these same write-downs of "impaired" value would begin to recover immediately through yield adjustments. This would occur systemically with the passage of time.

This differs from those circumstances under which OTTI write-downs are considered for equity securities and/or corporate bonds, as a variety of “other factors” are considered in addition to the level that those securities are underwater and whether or not the holder has the ability and intent to hold the issue until recovery. These “other factors” have limited the potential for “material swings” in valuation that impact reported earnings.

As OTTI is broadened to incorporate interest rate only issues, the risk of volatility is much greater (interest rate movements can change values both positively or negatively to a much greater degree over rather short periods of time as compared to credit related changes) and incorporates a much larger portion of Bank holdings. In essence, this could result in a portion of a Bank’s balance sheet, one that is neither the most predominant asset holding (generally represents 15-35% of bank assets) nor considered part of core business activities, driving wide fluctuations in earnings and distorting financial positions. We don’t believe this was the FASB’s intent when it issued FAS 115.

Some Banks will avoid buying mortgage-backed securities entirely, and instead acquire whole loans. Others will simply throw up their hands and only buy shorter term securities. In effect, this unintended forcing of Banks to alter prudent investment portfolio strategy doesn’t seem to be consistent with the original intent of FAS 115; and clearly will restrict the ability of Banks to prudently manage investment portfolios for fear that they may put regulatory capital at risk.

As a result, broadening the concept of OTTI to interest rate only issues invites a level of volatility into most Bank financial statements that will diminish the value of the related information for the industry as a whole. Why not let the current FAS 115 disclosures within Other Comprehensive Income (OCI) continue as is, also avoiding the unnecessary and problematic reduction in regulatory capital? If the user, including Bank regulators, “doubts” the carrying values it is quite easy for them to make the corresponding adjustments to earnings/capital, and act accordingly.

Given this potential impact, we feel that interest rate only issues should be eliminated from the scope of EITF 03-1, and considered part of a broader public discussion on fair market value accounting rather than being inferred by an EITF or FSP issuance.

### **Fair Value Accounting and piecemeal application thereof**

One of our broader concerns with EITF 03-1 is the continued trend in accounting literature towards mark-to-market accounting on only portions of the balance sheet.

We believe this in itself will lead to misleading representations of financial performance for Banks; especially Banks *whose primary business model* relates to managing the stability of total balance sheet spread over interest rate cycles as opposed to variations in monthly prices of financial instruments. Again, we encourage FASB to enable the accounting to reflect how earnings are created and managed vs. "dictating" it.

More importantly, we do not believe that the solution rests in full fair market value accounting for the entire balance sheet for similar reasons; notwithstanding the inherent inconsistencies associated with "estimating" fair values for Bank deposit bases.

### **Trickle down effect**

There could be a number of undesirable "trickle down" economic impacts of the proposed EITF 03-1.

As capital measures become more volatile, and if portfolios are more broadly marked to market for other than temporary impairment as described above, Banks will be very reluctant to leverage their current capital as current standards have allowed. As a result, they will become more selective about how and where they lend money to avoid putting capital levels at risk for changes that might occur in the market value of the available for sale portfolio. Accordingly, Bank earnings will suffer as they alter their investment portfolio management strategies; thus reducing capital growth levels across the industry.

Also, financial institutions comprise a large portion of the buyers and sellers of mortgage and mortgage-related products on the secondary market. If Banks are forced to change the manner in which they buy or sell securities in an effort to avoid these strict interpretations of the proposed EITF 03-1, we would likely see a trickle-down impact on the securities industry, and the volume of trades it currently handles. Consequently, it will likely drive current market values even lower, which would then only trigger further impairment.

At the same time one would think that this would ultimately be a cost borne by the consumer as the market for buyers of their mortgages will no longer be as effective and/or efficient.

### **Ability and Intent**

The EITF guidance implies that ability and intent is a one-time “permanent” declaration as it relates to underwater securities.

We believe that ability and intent is a dynamic set of variables that can change over time when market conditions change, risk positions (e.g. interest rate and liquidity) change, strategic direction changes, senior management teams change, etc.

Accordingly, we believe that a narrow and static interpretation of ability and intent is inherently problematic.

### **Changing of the rules**

Notwithstanding our specific concerns (some of which were noted above), the proposed guidance appears to reflect more of a “breaking of new ground” (establishing new accounting principles) than a clarifying of existing accounting principles. Since the inception of FAS115, we are not aware of any confusion or inconsistency regarding the use of the Available-For-Sale classification as a vehicle for managing Bank fixed income portfolios. The proposed guidance clearly creates a new category of securities within the Available for Sale classification: Held to Recovery (i.e. AFS securities with market values less than book values). We do not believe that FAS 115 was intended to nor understood to include securities that could be Available-For-Sale “at gains only”.

*Candidly, we view this as a severely problematic unwarranted changing of the rules. A change whose timing exacerbates the potential cost to a Banking industry whose unprecedented levels of security purchases in the last few years would likely have taken a very materially different tact if the “new rules” had been known. Many of our clients would have altered their investment strategy and/or accounting related classifications. Unfortunately, this amounts to accounting, in effect, determining how businesses act, as opposed to measuring accurately how they act.*

## **Recommendations**

Our recommendation is to clarify FAS115 by excluding other than temporary impairment accounting from situations where there have been market value declines due solely to interest rate related changes; unless an entity's actions speak clearly to exception treatment. For example, in situations where there is a definitive plan for sale (voluntary or otherwise), Banks should record a charge at the time of determination of the plan and not wait for the transaction to occur. Similarly, if there was an "egregious" pattern of selling that would seem to indicate that a portion or all of a portfolio was misclassified as available for sale rather than trading.

If FASB moves forward with EITF 03-1, then at the very least it should provide clear examples of the intended accounting treatment for likely situations to be encountered by most Banks. This is especially important when considering the accounting profession's (e.g. "Big 4") recent tendencies to try to interpret anything FASB puts into writing as if it were "tax law"; analyzing every word as if it were inserted with a singular exact meaning in mind with little room for application of common sense and materiality. We do not believe that FASB's intent is to be intentionally vague leaving it to the accountants to figure out FASB's desired outcome. Some of the more salient issues requiring a more definitive clarification include:

- Enable sales to be conducted for documented strategies related to prudent risk management such as interest rate sensitivity and liquidity management.
- Provide a "bright-line" test for minor impairment that covers a more normal range of expected interest rate cycles as it relates to a "typical" Bank investment portfolio. For example, it is quite common for Bank portfolio durations to be in the 3-4 year range. As a result, the proposed 5% level would result in most portfolios being "impaired" after a 125-170 basis point increase in interest rates. Accordingly, a "bright-line" test covering a broader range of likely business cycle interest rate movements closer to a 250-300bp range would be preferable. This would require a higher level such as 10-15% whereby impairment would be assumed to be temporary without requiring further analysis/documentation.

Also, requiring formal analysis/documentation for every security with an unrealized loss would be an extreme burden. With Bank portfolios skewed heavily towards AFS classifications, this could result in most if not all securities requiring specific documentation in a rising interest rate environment.

- For pre-payable/callable premium securities with book prices above the “bright-line” test, provide concrete examples of typical securities and how they would be accounted for under the “new rule”. For example, premium Mortgage-Backed Securities (MBS) and Collateralized Mortgage Obligations (CMO), callable bonds priced at premiums and amortized to call date, long-term municipal bonds with long dated calls, *premium commercial MBS and other types of premium bonds with yield maintenance agreements and/or prepayment penalties*. On thing is clear, industry experts (accounting firms, broker-dealers, investment advisors/specialists) are inconsistent with their interpretations.

Also, are there limits to the potential impairment on pre-payable/callable premium securities? For example, if they are callable at par then the maximum exposure if they are intended to be held to maturity would seem to equal the level of unamortized premium. In fact, an argument can be made to limit the loss to the bright line test level.

To conclude that a purchaser cannot, by definition, make an assertion of ability and intent to hold to recovery a callable premium security exceeding the bright-line test; and then hold their P&L “accountable” for any and all future valuation declines regardless of their actual ability and intent seems unreasonable and misleading. Consider two institutions owning the same premium mortgage-backed bond in AFS at 104.5 and 105.5, respectively, in a 5% bright-line test world. Concluding that the latter cannot assert ability and intent, by definition, thereby requiring write-downs of any unrealized losses, and enabling the former to carry the same bond at amortized cost (assuming no tainting issues) lacks intuitive appeal. Some market experts have interpreted EITF 03-1 to imply such accounting treatment.

For premium callable bonds, the industry practice is to amortize premiums to the call date. Therefore, these bonds should be treated no differently than bullet maturity bonds for purposes of assessing the intent and ability assertion

- Allow rate related impairments to be recovered up to amortized cost as is done for mortgage servicing rights. Why create a new “permanent” cost basis that implies a low probability of recovery for a financial instrument whose value changes daily and is expected to increase with business cycles (when rates decline) and/or as time passes (the security moves closer to maturity)?

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- Provide tangible guidance on what constitutes a pattern of selling (e.g. relative level of sales either in number of transactions or \$ volume; time period over which activity analyzed, etc.). Interpretations from the accounting profession have varied greatly.

In conclusion, we do feel that it is imperative that the FASB step in and remove some of the ambiguity surrounding the interpretations of other than temporary impairment and the scope of its application. As we have explained, the absence of more detailed guidance may have far reaching effects not only on the Banking, Brokerage and Insurance industries but also on consumers.

We strongly urge the FASB/EITF to gather additional input from the Financial Services Industry, Regulatory Agencies and accounting practitioners on the likely ramifications that EITF 03-1, as proposed, will have on financial statement preparers and their readers. Leaving these matters unaddressed may trigger any number of adverse consequences that are not likely the FASB's/EITF's intent.

We are available to discuss these issues in greater detail and to assist the FASB and EITF to reach a more suitable conclusion. Please feel free to contact us at (978) 463-0400.

Thank you for taking the time to consider our comments.

Sincerely,

DARLING CONSULTING GROUP, INC.

*Darling Consulting Group, Inc.*