



October 26, 2004

Letter of Comment No: 67
File Reference: EITF03-1A

Financial Accounting Standards Board Attention: Director, TA&I - FSP 401 Merritt 7 Norwalk, CT 06856-5116

Re: FSP EITF Issue 03-1-a, Implementation Guidance for the Application of Paragraph 16 of EITF Issue No. 03-1

Ladies and Gentlemen:

We appreciate this opportunity to comment on this pending FSP. In this letter we specifically address both the points raised in the FSP and related issues, as well as our basic position on the question of interest rate related impairments.

Because our comments are lengthy, we thought it would be helpful to first provide you with the summary below. Each major point below is discussed in more detail in the attachments.

Executive Summary

- Unrealized losses related to a change in interest rates should not be a part of the impairment discussions. (Attachment One)
- The effective date should be delayed at least one year to provide time to get adequate systems and strategies in place. (Attachment One)
- Accounting at the unit level is appropriate. (No attachment needed)
- The Board should adopt a bright line approach AND a qualitative approach for measuring minor impairment. (Attachment Two)
- We believe the notion of minor impairment should be expanded to other securities. (Attachment Two)
- Intent to hold is <u>not</u> the proper approach for determining when to book an interest rate related impairment (an intent to <u>sell</u> is the established practice under FAS 115). (Attachment Three)
- The guidance offered with respect to tainting is helpful but we need more examples to guide practitioners. (Attachment Four)
- We also need guidance on segmenting the portfolio (to avoid inadvertently tainting the whole AFS portfolio). (Attachment Four)

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- We need more guidance for a sale of an OTTI security after it has subsequently recovered to a minor impairment level. (Attachment Five)
- The board should adopt a longer time frame that is considered reasonable for recovering a loss for securities covered under paragraphs 10-15. (Attachment Six)
- Clarification is needed for prepayable mortgage securities and callable bonds that are owned at a premium. (Attachment Seven)

In summary, we believe interest rate related market price changes should be excluded from the recognition aspect of 03-1 because this would be a total departure from current industry practice with respect to SFAS 115.

If interest rate related price changes are not excluded from the recognition aspect of 03-1, we believe the current wording of 03-1, without additional guidance and a specific "bright line" loss threshold, will result in a significant burden to depository institutions, uneven application of the rule and cause accounting firms to overly focus on "normal" interest rate related losses. By adopting the changes proposed above, we believe the broad goal of 03-1 can be achieved while limiting the application burden and providing a more even and consistent application.

Very truly yours,

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Attachments:

One - Our Basic Position - Remove Interest Rate Changes from Consideration and Delay Until December 2005

Two - Minor Impairments - Adopt a Bright Line and a Qualitative Approach

Three - Intent to Hold Versus Intent to Sell

Four - Tainting

- Subsequent Recovery of Other-Than-Temporary Losses

- What is a Reasonable Period of Time for Recovery?

Seven - Premium Securities



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ATTACHMENT ONE

Our Basic Position - Remove Interest Rate Changes from Consideration and Delay Until December 2005

As experienced CPAs that have worked with community banks on a daily basis for many years, we are very familiar with SFAS 115 and related accounting pronouncements and concepts. In fact, one of us had the opportunity to testify before the FASB in the initial development of SFAS 115 in 1992 and 1993. We understand that many of the concepts addressed in EITF 03-1 are not new and have been contemplated in previous pronouncements. However, we believe that this document is so complete a departure from current industry practices under SFAS 115, that the EITF has gone far beyond their mission of "addressing narrow implementation, application, or other emerging issues that can be analyzed within existing GAAP."

Many of the same issues that the EITF addresses in 03-1, were discussed extensively in the development of SFAS 115, however, with much different conclusions. One of the key reasons it was decided that the AFS mark to market adjustment would be applied against comprehensive income (and go directly to capital thus bypassing the income statement) was that there was no corresponding mark to market on liabilities. For financial institutions, loans and investments are funded with and matched against deposits and borrowings. As rates rise, the decline in asset values is typically offset, to some degree, by the increase in the value of deposits and borrowings. Until we fully move to fair value accounting, how can one justify potentially marking one major asset class to market through the income statement, without any mark-to-market on the liability side?

We believe the end result of adopting this uneven approach would lead readers of financial statements to either 1) not see a true overall picture of the institution, or 2) disregard the income statement entirely since it is no longer meaningful.

Additionally, we believe the extensive ongoing burden this rule would place on banks needs to be considered. On an AICPA web cast earlier this month, one partner at a "big 4" firm noted banks will need to do a better job planning their liquidity needs so they can identify securities that may have to be sold in the future. This grossly oversimplifies the way most banks manage their investment portfolios. Liquidity is only one of the many reasons AFS securities are sold. The average bank classifies the vast majority of their investments as AFS not because they expect to sell all these, but to maintain flexibility to react to market, economic and internal changes. The enormous ongoing burden of continually addressing and re-addressing the long term strategy of each and every holding with an unrealized loss



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ATTACHMENT ONE (Continued)

is almost unfathomable, particularly given the bond accounting systems most banks now have in place For this reason, we believe a longer phase-in period needs to be adopted, where parties have at least one full year to understand and apply these new guidelines (effective date no earlier than 12/31/05).

Is there a solution to the inconsistent and highly burdensome approach under the current framework of 03-1? We believe there is. The solution is to take interest rate related market price changes out of consideration for other-than-temporary impairment under paragraphs 10 through 16 of 03-1. The disclosure requirements already in effect under 03-1 provide ample information on all unrealized losses in the investment portfolio.



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ATTACHMENT TWO

Minor Impairments - Adopt a Bright Line and a Qualitative Approach

Question 2: Although Issue 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, paragraph 16 does not refer to the severity of the impairment. Is there a level of impairment that can effectively be considered temporary that would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery?

We believe there should be a safe harbor level of impairment under which an investor need not declare an intent and ability to hold until a forecasted recovery. Furthermore, we believe there should be both a "bright line" quantitative threshold as well as a qualitative approach toward determining this level of "minor impairment."

"Bright Line" Approach

We believe the establishment of a bright line test is vital to make this a workable rule for depository institutions. Given normal volatility in interest rates, the market value of even short-term government bonds can quickly move below cost basis. Tracking these "minor" market value moves and declaring intent on any loss security would create an enormous burden on accounting and management reporting systems. Additionally, this process would require ongoing management involvement that would likely take time away from other important areas, such as risk management.

An additional concern with excluding a quantitative test is the potential uneven application of 03-1 that could occur among different accounting firms. It should be no surprise that the accounting industry is very sensitive to subjective issues given some of the abuses that have occurred in recent years. We have recently seen instances where firms have shown very little flexibility in applying accounting rules and simply took the "easy out" of the most conservative stance. Our concern is that if a quantitative threshold isn't established, some accounting firms will effectively take the position that no degree of loss can conclusively be treated as other-than-temporary.

With respect to understanding and defining "normal volatility," we thought the 15-year history of U.S. Treasury yields summarized in the following table would be helpful.



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ATTACHMENT TWO (Continued)

This table shows the large impact "normal" interest rate movements can have on bond prices. For example, an 10% decline in the value of the 10-year Treasury would fall within one standard deviation of the average 12-month change in its yield. The largest 12-month decline in the value of the 10-year during this fifteen year period was actually 15.2%.

These statistics suggest to us that the 5% threshold contained in the FSP is much too limiting. We believe the threshold should be set at a higher level such as 10% or 15%. This will remove much of the "noise" from normal interest rate movements, and allow banks to truly focus on assets with more fundamental impairments, which we believe is the ultimate goal of the EITF and the FASB.

15 Year Yield History

	Treasury Maturity			
	2уг	5yr	10уг	30yr
Current Yield	2.52	3.26	3.99	4.76
High	8.99	9.04	9.06	9.13
Low	1.07	2.02	3.10	4.17
Average 12 Month Yield Movement (bps)	112	98	84	64
Standard Deviation (bps)	83	65	54	46
Average Change in Rates				
Average 12 Month Yield Movement (bps)	112	98	84	64
Percentage Price Decline	-2.1%	-4.4%	-6.6%	-8.7%
1 Standard Deviation Rise in Rates			····-	
Average 12 Month Yield Movement (bps)	195	163	138	110
Percentage Price Decline	-3.6%	-7.2%	-10.5%	-14.3%
2 Standard Deviations Rise in Rates				
Average 12 Month Yield Movement (bps)	278	228	192	156
Percentage Price Decline	-5.1%	-9.8%	-14.3%	-19.4%



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ATTACHMENT TWO (Continued)

Qualitative Approach

While we support the establishment of the quantitative test as outlined above, we believe the rules should also contain qualitative language in order to allow one to determine what is considered "normal." Where the goal of the quantitative test would be to eliminate some degree of normal losses from the process, the goal of the qualitative test would be to potentially address more complex or unique issues. For example, a 10% bright line test might be appropriate for a financial institution, but be totally inappropriate for a life insurance company.

Furthermore, we ask that this issue be applied not only to securities identified in paragraph 16, but also to securities identified in paragraph 10-15.

We believe a consistent application of the changes made as a result of the FSP to all security holdings is preferable and would create less confusion in the implementation of these rules.

One specific type of security held by many depository institutions that is covered under paragraphs 10-15 are US Agency issued preferred stocks. These are one of the few equity holdings allowed to be held by banks under national banking laws. Agency preferreds have many of the same attributes of straight debentures and we believe it is logical to apply the same approach for these under 03-1 as with agency debentures. A typical issue is highlighted below:

Federal Home Loan Mortgage Corp Perpetual Preferred CUSIP 313400855
Fixed dividend rate of 5.1%
Payable quarterly
Callable anytime at par
Aa3 rated (Moody's)



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ATTACHMENT THREE

Intent to Hold Versus Intent to Sell

Question 3(a): If an interest-rate-impaired and/or sector-spread impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, when is the impairment considered other-than-temporary?

This question, by extension, asks "When is the loss recognized through the income statement?" EITF 03-1 would require a loss be recognized when the investor can no longer state the intent and ability to hold until recovery. We believe this is inconsistent with the answer to question 47 of FASB's Implementation Guide on SFAS 115, dated November 1995. This answer, a portion of which is excerpted below, suggests the loss would not need to be recognized in earnings until a specific decision to sell has been made. As stated earlier, we believe this change in approach did not follow due process and should require an amendment to SFAS 115.

"the write-down for other-than-temporary impairment would be recognized in earnings in the period in which the decision to sell is made"



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ATTACHMENT FOUR

Tainting

Question 3(b): If an interest-rate-impaired and/or sector-spread-impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, are there circumstances for such a change in ability or intent that would not necessarily call into question the investor's ability or intent to hold other securities to recovery?

We agree with the FSP that the following circumstances also would not necessarily call into question the investor's ability or intent to hold other securities to recovery:

- a. Unexpected and significant changes in liquidity needs,
- b. Unexpected and significant increases in interest rates and/or sectors spreads that significantly extend the period that a security would need to be held by the investor, and
- c. A de minimis volume of sales of securities.

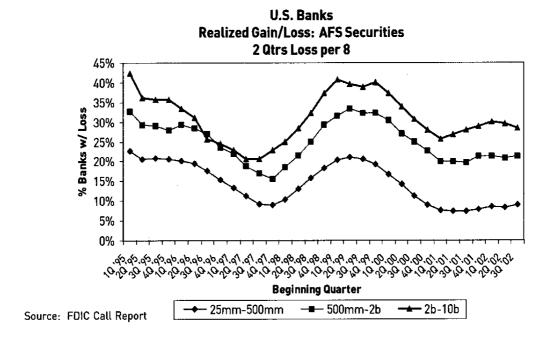
We do, however, ask that more guidance be given as to what circumstances might qualify under these exceptions. Specific examples would be very helpful and would help to ensure a more consistent application by accounting firms.

We also ask that more guidance be given with respect to the tainting issue, as this could significantly change the way banks manage their portfolio and overall balance sheet risk. Because banks generally invest in highly liquid securities, the investment portfolio is typically where they look to make changes for interest rate risk management purposes. While some banks will tend to book gains on securities, a surprisingly large percentage will also book losses. The graph below shows the percent of banks (in three asset size groups) that booked losses on securities for two of eight running consecutive quarters beginning in January 1995.



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ATTACHMENT FOUR (Continued)



Given this history, the "pattern of sales" sentence at the end of paragraphs 12 and 16 is totally out of sync with the reality of how banks manage the investment portfolio. It's ironic that this tainting issue would, in and of itself, move banks towards a practice that is discouraged by the regulators, and that is gains-trading. Rather than make the best choice for economic or risk management purposes, they would be forced to make it from an arbitrary accounting standpoint.

We ask that the board specifically address this tainting issue. Ideally, as we stated in the first part of this letter, we would like to see interest rate related market value changes excluded from the mark-to-market and tainting aspects of 03-1. This would allow banks to retain much of the ability they now have to manage the portfolio under SFAS 115.

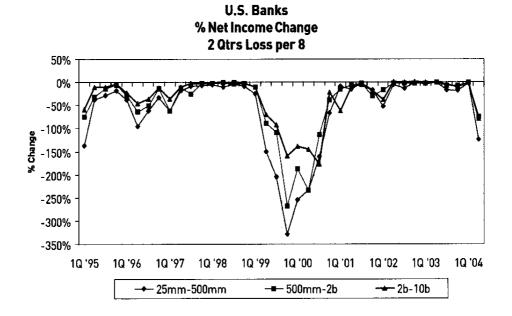
If this is not possible, we ask that the board address the notion of segmenting the portfolio. As we listened to the board meeting on September 8, there seemed to be a high degree of consensus among the members that a tainting event might impact only a portion of the portfolio. Any number of straightforward methodologies could be employed to prevent this approach from being abused. For example, the portfolio could be limited to a maximum number of segments.



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ATTACHMENT FOUR (Continued)

We also thought it might be helpful to examine how the tainting issue might have affected those banks that had been identified above as booking losses in two out of eight consecutive quarters. The graph below shows the percentage decrease in the reported net income of these banks (broken down into the same three asset size peer groups) assuming unrealized portfolio losses had been recorded in net income on an after-tax basis. Note that the impact is somewhat understated because we are applying any net loss that existed at quarter end. Assuming some holdings were owned at unrealized gains, the gross loss would have been greater.





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ATTACHMENT FIVE

Subsequent Recovery of Other-Than-Temporary Losses

We think additional clarification is needed to address the subsequent recovery of a loss on a security where the investor has stated their intent to hold until recovery. For example, assume an investor declared intent to hold to recovery a security where the value was below the "minor impairment" threshold. Subsequently, the market value recovers to where the security now has a "minor impairment." We believe that once the loss recovers to a point above the minor impairment threshold, a stated intent position is no longer necessary and the previously stated intent to hold no longer applies. Our rationale is that at this point, the loss has been effectively recovered as it is now back in a "normal" range.

This is likely to be a common situation and additional guidance would be helpful to all.



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ATTACHMENT SIX

What is a Reasonable Period of Time for Recovery?

One inconsistency between bonds and equities that we ask be addressed is the issue of a reasonable recovery period. If a high quality bond is other-than-temporarily impaired, paragraph 16 of 03-1 says a stated intent and ability to hold until maturity will generally avoid loss recognition, even if the maturity is very long. However, paragraph 12, which covers equities (such as the Agency Preferred Securities highlighted above), requires the intent and ability to hold for a "reasonable period of time sufficient for a forecasted recovery of fair value" to avoid loss recognition. We have seen this interpreted to mean as little as six months. We believe, to be consistent, a much longer time horizon should be used on the equity securities.



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ATTACHMENT SEVEN

Premium Securities

One additional area where we would ask for clarification relates to prepayable mortgage related securities and callable bonds that are owned at a premium to par. Example 5 of Issue 03-1 (Exhibit B) describes a situation in which an investor owns a mortgage security at a dollar price of \$111, and it can be repaid at \$100 or par if all homeowners choose to payoff or refinance their mortgage. This is used as an example of a situation in which the investor is not able to recover substantially all of his amortized cost. The example notes that the investor can only recover \$100 versus the \$111 invested (or 90.09%).

This example and its implications have generated an enormous amount of confusion and misinformation among interested parties. For instance, one Wall Street firm has literature explaining that the only premium securities affected are those owned at a price of 5% or more over cost. Another respected regional dealer published educational literature stating that "substantially all" was intended to mean a cost recovery of 90% or more was necessary. And they used this example 5 to support their conclusion even though Issue 03-1 concludes otherwise. Finally, we were told by a Big Four CPA firm that "substantially all" means a cost recovery of 85% or more, and they cited paragraph 11 b of SFAS 115 as their support (after contacting their national office).

While we find the last assertion the most supportable, not only are they all different, each ignores the reality that any recovery calculation should address the likelihood of prepayment and include the interest to be received in addition to the principal (as the fact that there is a premium price implies that the coupon received is above market and a key factor in the investment equation).

There is substantial confusion in this area, and we have just experienced a three-year period of declining interest rates, which means that today many bonds in investor portfolios are owned at a price over par. This is an important area that deserves better implementation guidance before Issue 03-1 is applied.

We ask that the following two issues be addressed:

- 1. We believe the *likelihood* of prepayment should be the key issue, not the possibility of prepayment. This is an important distinction because as interest rates rise and the loss in a prepayable security grows, prepayment becomes less and less likely (this is true whether it is a callable bond or a mortgage related security).
- 2. At what level is the premium a problem? Without further guidance on this issue, it is very likely there will continue to be major differences in treatment.