



Letter of Comment No: 4  
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September 20, 2004

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

Re: FSP EITF Issue 03-1-b, Effective Date of Paragraph 16 of EITF Issue No. 03-1

Ladies and Gentlemen:

We are writing to express our comments regarding this FSP. We are in agreement with the recommendation to delay the effective date for application of paragraph 16 of Issue 03-1. It is a logical step to defer application until the implementation guidance of FSP 03-1-a is finalized. We applaud you for moving quickly to get this done.

However, we don't believe this goes far enough. We suggest broadening the delay because there are very difficult issues involved which represent a departure from present practice. We highlight two of these issues below and will address these and others more fully in our forthcoming letter on FSP EITF Issue 03-1-a.

Furthermore, financial statement preparers, their auditors, and the investment community are simply not ready from a systems or a knowledge standpoint. There are too many unanswered questions and, in some cases, questions that aren't being asked simply because many haven't had time to fully consider the implications and application of this change. Judging from comments made during the September 8 FASB Board meeting, we think the Board was surprised that some of these issues were being raised so near to the effective date. They should recognize this as an indicator of the need to postpone application of Issue 03-1.

We represent a large broker/dealer that deals with a wide range of bond investors, both depository and non-depository. We have prepared a substantial amount of portfolio analytics and educational literature for clients and have had many conversations and conference calls to help them understand how this issue might affect their investment and risk management strategies. Based on everything we know about this topic and the parties involved, we don't think the universe of interested parties understands these rules well enough to apply them effectively at September 30, and we understand our experience mirrors that of others in the investment community.

FTN FINANCIAL GROUP  
845 Crossover Lane, Suite 150  
Memphis, Tennessee 38117  
901.435.8080 / 800.456.5460  
www.ftnfinancial.com

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Our comments follow on two particular areas of concern that justify a broad delay for application of Issue 03-1.

### **Premium Securities**

One area of particular confusion concerns the application to mortgage related securities 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 FAS 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.

### **Agency Issued Preferred Stocks**

Another area that is generating a particular amount of interest by depository investors is a type of hybrid equity security issued by the two large GSEs - Fannie Mae and Freddie Mac. These are investment grade (AA rated), perpetual equity securities that qualify for the 70% dividends-received deduction for federal income tax purposes. Some were issued with a fixed rate dividend, while others are floating rate with a dividend reset generally every two years. The market price on many of these is below the investor's cost as a result of a change in interest rates and sector spreads since the time of purchase.

We believe the application of Issue 03-1 to these DRD preferred securities should be delayed. One argument supporting a delay is the interaction with Issue 2 in your Request for Comments. Specifically, it asked whether the notion of minor impairments should be expanded beyond the securities covered under paragraph 16. That is, should the "safe harbor" for minor impairments include all investments analyzed under paragraphs 10-15? Or, should it be expanded to include all investments analyzed under Issue 03-1?

We believe it should be expanded and will explain our rationale in detail in our comment letter on FSP EITF Issue 03-1-a. But even if we are successful in convincing you to expand the application of this notion, the point will be moot for some if they are required to record an impairment charge at September 30 for these securities.

We think it is illogical and impractical to begin applying parts of Issue 03-1 as of September 30, 2004, if there may be additional guidance forthcoming that would effectively change how those rules will be applied. Otherwise, there may be investors who are forced to record an impairment charge on September 30 which might have been considered minor and therefore temporary under the later guidance.

Of course, at this point we don't know exactly what that new guidance might be. So, we think you have an obligation to delay application until a later date. This will allow interested parties to prepare their comments on the issue in time for the October 29 deadline for FSP EITF Issue 03-1-a.

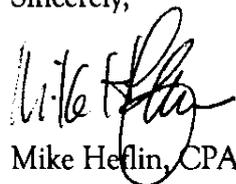
#### Conclusion

We believe a broad delay will allow two important things to occur:

- the process for public comment will take place in a fashion that the respondents' comments actually matter, and
- it will highlight for you the additional areas where we need and deserve more thoughtful implementation guidance.

We hope you find this helpful. If you have questions, feel free to contact us at 800.456.5460.

Sincerely,



Mike Heflin, CPA  
Senior Vice President  
Portfolio Strategies  
[mike.heflin@ftnfinancial.com](mailto:mike.heflin@ftnfinancial.com)

MH:pkp

#### Contributing Authors:

Steven B. Twersky, CPA, Senior Vice President - [steve.twersky@ftnfinancial.com](mailto:steve.twersky@ftnfinancial.com)  
Andrew C. Tetlow, CPA, Vice President - [andrew.tetlow@ftnfinancial.com](mailto:andrew.tetlow@ftnfinancial.com)