

Morgan Keegan
Morgan Keegan & Company, Inc.
Fixed Income Capital Markets

Letter of Comment No: 184
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October 29, 2004

Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: FSP EITF Issue 03-1-a

Ladies and Gentlemen:

It remains our belief that there exists a fundamental difference in a financial institution's ownership of fixed income securities versus the ownership of fixed income securities in any other business or industry. To financial institutions, fixed income portfolios comprise a significant portion of their balance sheets (on average, greater than 20%) and are important tools, if not the most important tool available, in liquidity and interest rate risk (IRR) management. Banks currently make every effort to accurately predict their cashflow and IRR needs, but changing demands for credit and deposit products, as well as changing interest rates, necessitate constant adjustments in those forecasts. This guidance as written substantially limits a financial institution's ability to mitigate those risks inherent in the business of banking and finance. Further, it seems contradictory to the regulatory guidance of the last several years. Taking away a financial institution's ability to adjust one of its largest earning assets by limiting its ability to sell securities exactly when prudent risk management dictates such action is counter to the position that regulators have proffered, i.e. that financial institutions must measure, monitor and control interest rate risk. In response to FSP EITF Issue 03-1-a, we re-present our comment letter submitted on September 29, 2004 in response to FSP EITF Issue 03-1-b (Attachment 1). Further to that letter, we ask that the FASB consider the following in deliberating EITF Issue 03-1.

First, regarding the Paragraph 10 guidance applicable to high-premium callable debt securities, it seems that the very mechanism that is being reviewed as a cause of other-than-temporary impairment, i.e. rising interest rates, also serves to mute the definition of the debt securities covered under the Paragraph. If rising interest rates cause the market value of a security to decline below its cost basis, those very same rising interest rates decrease the likelihood of the security's call, lowering the risk of unexpected premium amortization. Clearly, there could exist some level of interest rates above the security's yield-at-purchase but below the security's coupon where a call remains likely, but that would seem better treated as an exception to Paragraph 16. Paragraph 10 treatment seems better left to account for the decline in value of securities where no explicit maturity date exists that, barring credit quality issues, ensures the return of principal.

Second, as the guidance is currently written, the FASB has attempted to exempt a class of securities from the declaration of ability and intent. Assuming that in the final guidance the FASB continues to recognize the importance of exempting a class of securities (again see our previous letter, Attachment 1), we do believe that this exemption should extend to both securities currently classified under Paragraph 16 as well as those classified under Paragraph 10. Further, we believe that this exemption should be determined using a historical interest rate cycle, providing both subjective agreement between auditor and client as to what represents that cycle and objective application to the institution's portfolio of the boundaries defined by that cycle. However that exempt class of

securities is ultimately defined, further clarity is required as to treatment of securities as they leave and re-enter the "exemption zone". For example, a security with cost of 100 has a market value of 96 at financial statement period 1 and is determined to be exempt by client and auditor. At financial statement period 2, that security's cost remains at 100, but the market value is now 94. The security is determined by client and auditor to no longer be exempt and client has to declare ability and intent to hold the security to recovery in order to avoid the Step 3 write-down to market value. At financial statement period 3, the market value has returned to 96 (cost is 100). Has the client met its ability and intent obligation, i.e. is that security eligible to be sold now that its market value is within the "exemption zone"? Or does the security have to return to cost of 100 in order for the institution's ability and intent obligation to be met?

Third, some clarification is required as to the application of a forced write-down of impaired securities due to a "pattern of selling". If an institution has placed a security in Held-to-Maturity (HTM), it has implicitly stated that its intent is to hold that security at least until recovery (in fact, until maturity) if it becomes impaired. That fact, in conjunction with the fact that any sale that would create a pattern of selling must, by definition, come from the AFS portfolio (lest the institution risk violating FAS 115 tainting parameters as well), argues for a distinction that the write-down at risk by a pattern of selling is strictly the unrealized loss in the AFS portfolio. Should the institution be penalized for sales of impaired AFS securities in HTM, where intent to hold is clear and unchallenged? We believe not, and further believe that clarification of this issue is required.

Fourth, it is evident that treatment of other-than-temporary impairment is of particular importance to the financial services industry and that specific application to that industry may require additional review by the FASB and EITF. We, therefore, believe it is in the best interest of all affected by this new guidance to delay its implementation and remand it to the EITF for further review. An industry focus group should be convened in order to fully discuss and evaluate the impact of this guidance. Then, in light of the output from this focus group, this guidance should be reconsidered to arrive at a solution that reconciles the FASB's intended treatment of other-than-temporary impairment with the financial services industry's need to use its investment portfolio to effectively manage liquidity and IRR. To this end, implementation should be delayed until such study is complete.

Please contact us with any questions regarding the above positions. We sincerely believe that the needs of both FASB and industry can be met with the proper guidance, and offer any assistance we can provide to reach that end.

Sincerely,

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Attachment 1

Morgan Keegan
Morgan Keegan & Company, Inc.
Fixed Income Capital Markets

September 29, 2004

Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

Re: FSP EITF Issue 03-1-b

Ladies and Gentlemen:

Please accept this letter as our endorsement of the delay in implementation of Paragraph 16 of EITF 03-1 proposed in FSP EITF Issue 03-1-b. In light of the application of FSP EITF Issue 03-1-a to Paragraph 16, its comment period ending October 29 and issuance of the final FSP subsequent to that date, the delay in implementation is required.

Additionally, we would like to take this opportunity to comment on Issues 1 and 2 in the Requests for Comments Introduction.

Since the advent of FAS 115, fixed income securities have been classified into either Held-to-Maturity, Available-for-Sale or Trading portfolios. Held-to-Maturity required no mark-to-market, Available-for-Sale was marked to market through balance sheet equity and trading through the income statement. Financial institution fixed income portfolio managers were able to work within this framework to use the investment portfolio to effectively manage their business' liquidity needs and offset interest rate risk in other parts of the balance sheet. Further, the flexibility of the FAS 115 framework as applied allowed portfolio managers to structure and restructure portfolios without fear of unintended consequences. This capability supported the maximization of firm equity and ultimately shareholder value.

EITF 03-1 and its proposed Implementation Guidance in FSP EITF Issue 03-1-a will cause a fundamental shift in the way fixed income portfolio managers subject to GAAP financial statement reporting go about the business of portfolio management. With the threat of earnings risk accompanying securities of duration longer than a few years, portfolio managers will be forced to shorten portfolios, potentially limiting demand for longer securities in the market. Further along this line of thought, asset/liability management will be negatively impacted because of the portfolio's inability to act as an offset for other interest rate risks on the balance sheet, effectively RAISING interest rate risk by disallowing one tool for its mitigation. EITF 03-1, by forcing some group of AFS securities to be classified as held-to-recovery, will also tie the hands of fixed income portfolio managers, no longer allowing them to provide valuable liquidity to their businesses through the sale of securities, without risking earnings. While FASB has attempted to exempt some class of AFS securities from the ability and intent declaration, that exemption as written does not go far enough. We do recognize the desire of the FASB to further interpret language that has existed in FAS 115 since its inception, but all in all, EITF 03-1, even considering its proposed Implementation Guidance, is too restrictive and unreasonably impinges on a financial institution's ability to manage its portfolio.

The FASB Staff, at the September 8, 2004 meeting, suggested methods that carve out a portion of a fixed income portfolio as not requiring a declaration of ability and intent, thereby not triggering a write-down to fair value of all impaired securities with their sale. Further, this exemption allows portfolio managers to use these securities to manage their firm's liquidity and interest rate risk. Three methods of exemption from declaration of ability and intent were suggested.

The first was language that stated that any security impaired due to the normal interest rate cycle would be exempt. This would presumably require some agreement as to a time period that represents a full interest rate cycle and a subsequent statistical analysis of a similar security to determine what an appropriate impairment expectation may be. While putting bounds on impairment, this option recognizes that declines in market value of fixed income securities during the regular interest rate cycle are inevitable and, barring extraordinary events, not an impact to earnings until sold. Further, it presupposes a discourse between auditor and client regarding a significant portion of the balance sheet, as well as additional portfolio analysis that can only serve to enhance shareholder value.

The FAS Board did approve the issuance of an FSP providing implementation guidance, but chose to include the language "minor impairment" in defining those impairments exempt from declaration of ability and intent. However, they also chose to ask that respondents answer whether or not they believe practice and industry will be able to effectively apply the qualitative "minor impairment" determination, or whether a quantitative measure, like 5% or less of cost, was necessary.

In lieu of the "minor impairment" language, our recommendation is that impairments judged to be within the normal interest rate cycle be exempted from declaration of ability and intent. This approach, originally offered as one of the FASB staff's three recommendations at the September 8 meeting, recognizes that there is a level above which interest rates can cause other-than-temporary impairment and that securities are impaired when they fall outside of a lower price limit established by historical price changes during recognized interest rate cycles. It fosters analytical agreement between auditor and client in arriving at appropriate interest rate cycles and subsequent application of the analytical result to the client's portfolio. And, finally, and perhaps most importantly, it implicitly recognizes that, within the bounds of historical norms, portfolio managers are free to manage their interest rate risk without fear of an accounting construct adversely impacting their earnings.

Further, we recommend that the FASB explicitly state that no arbitrary level has been established as a "rule of thumb", and that none is endorsed by the FASB. Since the FASB Staff had held out 5% or less of cost as one of the suggested methods to determine the group of securities exempt from declaration of ability and intent, this arbitrary level has often been alluded to as the de facto "bright line". In fact, as shown in the following table, a 5% price change is relatively easy to achieve. If practice and industry are allowed to use this arbitrary level as even a rule of thumb, portfolio managers will have to shorten their portfolios inordinately to avoid the potential for other-than-temporary impairment. In the absence of an explicit statement from the FASB that they do not in any way endorse a 5% test, we would recommend that the FASB explicitly recognize that, based on analytical review of the potential price demonstrated by US Treasury securities in a regulatory shock environment, that 5% is, in fact, too limiting a bound, and that 20%, the approximate price change of a 10 year US Treasury in +300 rate shock, is a more suitable application to gain quantitative perspective.

| % Price Change - US Treasuries | | | | | | |
|---------------------------------------|-------------------|----------------|----------------|-----------------|----------------|----------------|
| | Rates Down | | | Rates Up | | |
| | -300 bp | -200 bp | -100 bp | +100 bp | +200 bp | +300 bp |
| 1 Year US1N | 2.80% | 1.85% | 0.92% | (0.91%) | (1.80%) | (2.69%) |
| 2 Year US1N | 5.71% | 3.76% | 1.86% | (1.82%) | (3.59%) | (5.32%) |
| 3 Year US1N | 9.62% | 6.29% | 3.09% | (2.98%) | (5.85%) | (8.62%) |
| 5 Year US1N | 13.86% | 9.00% | 4.39% | (4.17%) | (8.14%) | (11.91%) |
| 10 Year US1N | 26.10% | 16.57% | 7.90% | (7.20%) | (13.77%) | (19.76%) |
| 30 Year US1N | 60.64% | 35.63% | 15.82% | (12.73%) | (23.05%) | (31.50%) |

Finally, we urge the FASB to consider that the notion we suggest to determine exemption from declaration of ability and intent, namely that impairments judged to be within the normal interest rate cycle be exempted, be extended to Paragraphs 10-15 in addition to application to Paragraph 16. Paragraphs 10-15 seek to deal with impaired equity securities and impaired debt securities at high premiums and at risk of prepayment at par. The fundamental notion that financial institution portfolio managers use their investment portfolios to manage their institutions' liquidity and interest rate risk is equally applicable to Paragraph 10-15 securities.

In conclusion, it is our position that the ability of financial institutions to effectively manage their liquidity and interest rate risk will be significantly impacted by EITF 03-1 and the subsequent implementation guidance currently under review. Implementation of the guidance as currently suggested would tie the hands of portfolio managers and effectively increase the risk on the balance sheets of owners of significant fixed income portfolios. While we recognize FASB's desire to enact guidance that furthers the principal of conservatism in accounting, it is impractical to expect that financial institutions can manage liquidity needs so exactly that they can determine today what bonds they will need to liquidate in the future in order to fund expected liquidity needs. This is the principal underlying the theory of ability and intent as outlined in the guidance. Financial institutions require more flexibility and latitude in the types of securities that are available to them for liquidity and interest rate risk management than the guidance currently suggests. In that light, please review and accept our recommendations but do not hesitate to call if any clarification is needed.

Sincerely,

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