



Letter of Comment No: 182
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October 29, 2004

Mr. Lawrence Smith
Director and Chairman of the Emerging Issues Task Force
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

RE: Proposed FASB Staff Position, 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 Mr. Smith:

We appreciate the opportunity to comment on the proposed FASB Staff Position ("FSP EITF Issue 03-1-a") issued on September 15, 2004 by the staff of the Financial Accounting Standards Board. We also appreciate the FASB's decision to defer application of the recognition and measurement provisions of EITF 03-1 until further guidance can be issued.

I. About Fannie Mae

Fannie Mae is the nation's largest source of financing for home mortgages. We are a shareholder-owned corporation, chartered by the U.S. Congress to provide liquidity in the secondary mortgage market to increase the availability and affordability of homeownership for low-, moderate-, and middle-income Americans.

As of June 30, 2004, Fannie Mae had over \$989 billion in total assets, including over \$242 billion in securities classified as available-for-sale that had unrealized losses and gains of \$1.4 billion and \$2.5 billion, respectively. The unrealized losses were due primarily to interest rate changes and not credit. Recognizing unrealized losses in earnings without recognizing unrealized gains would have regulatory capital implications.

II. Executive Summary

We commend the EITF for providing guidance in EITF 03-1 on assessing impairment on cost method investments and establishing disclosure requirements. The guidance for cost method investments provides entities with much needed clarification on when and how to assess other-than-temporary impairments. The disclosure requirements provide additional information to enable investors and analysts to assess each entity's other-than-temporary impairment policies and potential exposure, which enhances the transparency of financial reporting.

While we support certain provisions of EITF 03-1, we have the following concerns:

- It contradicts Statement of Financial Accounting Standard No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, ("FAS 115") by creating a new "held-to-recovery" category and by reinstating the use of lower of cost or market (LOCOM)

accounting, which distorts earnings and does not reflect the economics of available-for-sale portfolios.

- It changes, rather than clarifies, the criteria for other-than-temporary loss recognition from “probable” to one based on “ability and intent”.
- The existing guidance in SEC Staff Accounting Bulletin (SAB) 59 and EITF Topic D-44, *Recognition of Other-Than-Temporary Impairment Upon the Planned Sale of a Security Whose Cost Exceeds Fair Value*, provides sufficient criteria for recognizing other-than-temporary impairment.
- It creates operational complexity and results in additional costs that outweigh the benefits provided to financial statement users.

EITF 03-1 significantly changes current accounting principles and practice. We recommend that the FASB retain the cost method investments guidance and disclosure requirements in EITF 03-1 and eliminate the other guidance in EITF 03-1 to allow existing guidance to stand.

If the FASB chooses to continue with all of EITF 03-1 and the proposed FSP, we recommend that the FASB consider our comments on minor impairment and suggestions to enhance EITF 03-1 and FSP EITF 03-1-a. Specifically, we recommend that the FASB:

- Include the concept of “minor impairment” but allow entities to apply judgment rather than providing a “bright-line” threshold.
- Change the required assertion of ability and intent from *complete* recovery to hold to *substantial* recovery.
- Enhance the allowable circumstances for a change in intent from “unexpected and significant increases in interest rates and/or sector spreads...” to a “change in the interest rate and/or sector spread environment that significantly extends the investment’s recovery period”.
- Provide implementation guidance on quantitative and qualitative factors entities should consider when assessing whether a “pattern of sales” or a “de minimus volume of sales” has occurred.
- Provide implementation guidance on whether a security must be held until *actual* recovery or *forecasted* recovery.
- Define the term “sector spread” in the FSP.
- Establish an effective date one year from the issuance of the final guidance to allow entities adequate time for implementation of systems and controls.
- Allow a “one-time” transfer of available-for-sale securities to the trading category.
- Require the adoption of EITF 03-1 to be accounted for as a cumulative effect of a change in accounting principle.

We provide additional detail on our comments and recommendations in the remainder of this letter.

III. Comments on EITF 03-1

We believe EITF 03-1 contradicts existing guidance in Statement of FAS 115 and other pronouncements, which will result in unintended negative consequences on the operations and financial reporting of entities.

A. EITF 03-1 contradicts FAS 115 by creating a new “held-to-recovery” category and by reinstating the use of LOCOM accounting, which distorts earnings and does not reflect the economics of available-for-sale portfolios.

Fannie Mae generally invests in high-quality securities and does not actively sell them. However, we may classify securities as available-for-sale to provide additional flexibility in meeting liquidity or business needs. Fannie Mae’s intent is consistent with that anticipated by FASB in FAS 115, which is to hold these securities for “an unspecified period of time, such as [securities] that the enterprise would consider selling to meet liquidity needs or as part of an enterprise’s risk management program.”¹ If our intent were to hold the securities to maturity, we would classify them as such when purchased. EITF 03-1 requires Fannie Mae to either (i) change our intent for securities in an unrealized loss position to held-to-recovery or maturity from the standard of “held for an unspecified period of time”, or (ii) recognize other-than-temporary impairment.

For those securities for which we have not asserted our intent to hold to recovery or maturity, EITF 03-1 would require that we measure them at lower of cost or market (“LOCOM”). LOCOM accounting for investments was specifically rejected by the FASB in FAS 115 as not evenhanded because “it recognizes the net diminution in value but not the net appreciation in the value of those securities.”² In addition to distorting current period earnings by recording unrealized losses and not gains, accounting under EITF 03-1 will distort future years’ earnings as impairments related to interest rate changes would be accreted into income as an adjustment to each security’s yield. This accounting would misrepresent the economics of Fannie Mae’s available-for-sale portfolio and provides less meaningful information to the users of our financial statements.

B. EITF 03-1 changes, rather than clarifies, the criteria for other-than-temporary loss recognition from “probable” to one based on “ability and intent.”

There should be a distinction between impairment that results from credit deterioration and temporary fluctuations in the value of securities. If an entity is unable or unwilling to assert its ability and intent to hold an investment until forecasted recovery, which may mean maturity, EITF 03-1 would result in recording other-than-temporary impairment even though it is not probable the losses will be realized. Changing the criteria from “probable”³ as specified in FAS 115⁴ to criteria that is based upon the investor’s “ability and intent to hold an investment until a forecasted recovery”⁵ lowers the threshold for recognizing other-than-temporary impairment on securities.

¹ FAS 115, paragraph 82.

² FAS 115, paragraph 27(b).

³ FAS 5, *Accounting for Contingencies*, has defined probable as the “future event or events are likely to occur”.

⁴ FAS 115, paragraph 114 notes that “the Board believes that other-than-temporary impairment exists if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of the security”.

⁵ EITF 03-1, paragraph 16, requires an investor to record other-than-temporary impairment if the investor “does not have the ability and intent to hold an investment until a forecasted recovery of fair value up to (or beyond) the cost of the investment”.

This change creates inconsistent criteria for recording impairment between securities classified as available-for sale and loans classified as held-for-investment. In FAS 114, *Accounting by Creditors for Impairment of a Loan*, and FAS 5, *Accounting for Contingencies*, impairment of an asset is recognized when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms. The criterion of “probable” was also adopted in FAS 115 for the assessment of other-than-temporary impairment on held-to-maturity and available-for-sale investments. EITF 03-1 changes (rather than clarifies) the standard’s existing criteria for recording other-than-temporary impairment.

C. Existing guidance in SAB 59 and EITF Topic D-44 provides sufficient criteria for recognizing other-than-temporary impairment.

SAB 59 provides the following examples of a few factors that should be considered individually or in combination to determine if a decline in value is other-than-temporary:

- A. The length of time and extent to which the market value has been less than cost;
- B. The financial condition and near term prospects of the issuer, including any specific events which may influence the operation of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or
- C. The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

In practice, factors A, B and C generally are evaluated in combination with other factors when there has been deterioration in an investment’s creditworthiness. Factor C, however, is generally never considered to be the primary factor in evaluating impairment. Consequently, under current practice other-than-temporary impairment generally is not recorded on securities that have unrealized losses attributable solely to interest rate changes. EITF D-44, *Recognition of Other-Than-Temporary Impairment Upon the Planned Sale of a Security Whose Cost Exceeds Fair Value* (“Topic D-44”) provides criteria for recording interest rate related impairment in earnings. Specifically, Topic D-44 indicates that the decision to sell a security is one of the criteria for the recognition of an unrealized loss that is due to either a change in interest rates, a change in foreign exchange rates or deterioration in credit quality. Existing criteria in SAB 59 and Topic D-44 are better than those in EITF 03-1 because they do not require recognition of losses before they are probable of occurring, they allow for management judgment, and do not include one-size-fits-all “bright-line” criteria.

D. EITF 03-1 creates operational complexity and results in additional costs that outweigh the benefits provided to financial statement users.

Implementing the proposed requirements EITF 03-1 would require development of models to predict forecasted recovery periods, documentation of forecasted recovery periods, formal communication between portfolio managers and the accounting department regarding ability and intent, documentation of ability and intent, and the

monitoring of subsequent actions and changing conditions against documented intent. Additionally, EITF 03-1 and the related proposed FASB Staff Position create implementation issues that would require clarification in order to design systems with the appropriate functionality, document and implement appropriate controls, and test the controls in accordance with Section 404 of the Sarbanes-Oxley Act (“SOX 404”). We have described some of these implementation issues in Section V, *Suggested Enhancements to EITF 03-1 and the proposed FSP*, and Section VI, *Requested Implementation Guidance*, of this letter.

IV. “Minor Impairment”

Impairments due to interest rate increases are temporary unless an entity has the intent to sell the security in the foreseeable future or it is probable that all contractual payments will not be collected. The ability and intent to hold a security until forecasted recovery should not be a requirement for an unrealized loss to be considered temporary.

If the FASB changes existing guidance to require entities to assert their ability and intent to hold investments until forecasted recovery, then we agree the guidance should allow for minor impairment that would not require assertion of ability and intent. Permitting entities to use judgment in considering the composition of their available-for-sale portfolio and assessing current market conditions to determine a range of minor impairment is consistent with a principles-based approach, which we believe is better than a rules-based approach.⁶ Within the range of minor impairment, it would be presumed that the impairment loss is not probable of being realized and that the impairment is temporary, unless credit-related impairment is known to exist or the entity has made the decision to sell the security.

If FASB continues with the concept of minor impairment, we do not believe that any one range would be appropriate for all asset types in all interest rate environments. For example, a range of zero to 5 percent may be inappropriately broad for a flat forward yield curve environment or for short-term or variable rate securities. Whereas a zero to 5 percent range may be inappropriately narrow for a steep forward yield curve environment or for long-term U.S. Treasury securities.

It would be appropriate for a minor impairment range to change over time, as the market and other circumstances change (such as the type of investments in the portfolio). By adopting a principles-based approach and not dictating a “bright-line” threshold, FASB would provide entities with the flexibility to react to changing market conditions and to establish a range that is appropriate for current market conditions and the composition of their portfolio.

We would welcome additional principles-based guidance on the establishment of a range for minor impairment.

⁶ This statement is consistent with the view of the FASB and SEC, as noted in the [FASB Response to SEC Study on the Adoption of a Principles-Based Accounting System \(July 2004\)](#), which is available at www.fasb.org.

V. *Suggested Enhancements to EITF 03-1 and the proposed FSP*

A. *Forecasted Recovery*

EITF 03-1, paragraph 16, requires the assertion of ability and intent to hold an investment until a forecasted recovery of fair value “up to (or beyond) the cost of the investment, which in certain circumstances may mean until maturity”. If FASB maintains the requirement for management to assert ability and intent, we recommend that the assertion involve the intent to hold the security until substantial recovery rather than complete recovery. This modification would provide investment managers with the flexibility to sell securities or take advantage of market opportunities when securities have substantially recovered. The notion of substantial recovery is prudent and consistent with notion of “minor impairment” and other guidance. For example, paragraph 14 of SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, requires that assets be recorded at fair value if they can be contractually prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment. Requiring substantial recovery instead of complete recovery would eliminate efforts that would add little or no value to financial reporting. For example, an investor holds a security in an available-for-sale portfolio. At December 31, 2004, the security has an unrealized loss of 10 percent. The unrealized loss is solely due to unfavorable movements in interest rates. The investor makes an assertion that he will hold the security until recovery. At March 31, 2005, the security has an unrealized loss of 1 percent or a loss of \$100. Under EITF 03-1, we understand that the sale of the security at March 31, 2005 would be considered a change in intent that would call into question the investor’s ability to hold other securities until recovery. This rules-based outcome would seem unreasonable and would not provide meaningful information to the users of the financial statements.

B. *Allowable Circumstances for a Change in Intent*

The proposed FSP outlines circumstances for a change in ability or intent that would not necessarily call into question the investor’s ability and intent to hold other securities to recovery. For example, paragraph 7b of the proposed FSP provides “unexpected and significant increases in interest rates and/or sector spreads that significantly extend the period that a security would need to be held by the investor” as an allowable circumstance. Other scenarios beyond increases in interest rates and/or sector spreads that are out of the control of management should be considered acceptable reasons for selling a security.

For example, assume we hold a 5 percent fixed rate security when current market rates are 7 percent, and we expect rates to decrease so that we forecast the recovery of the security’s fair value in one year. If interest rates stay flat, it would significantly extend the period in which the security would need to be held by the investor. Neither the direction nor the significance of the change in interest rates and/or sector spreads should be the relevant factor. Instead, the effect on the recovery period of a change in the forecasted interest rate environment should be the relevant factor. Therefore, we recommend that the circumstance in paragraph 7b be revised to state a “change in the interest rate and/or sector spread environment that significantly extends the investment’s recovery period.”

C. Pattern of Selling Investments Prior to their Forecasted Recovery

The FASB needs to provide more guidance to explain what is meant by “a pattern of selling investments prior to the forecasted recovery.” We recommend that the FASB provide principles-based guidance on what qualitative and quantitative factors entities and auditors should consider in making this assessment.

Quantitative Factors:

Prior to the issuance of the proposed FSP, we understand that certain of the multinational audit firms suggested that the sale of as few as two or three securities could represent a pattern of selling forecasted investments prior to their recovery. In a portfolio that might include several thousand securities, such a threshold appears to be arbitrary. However, paragraph 7c of the proposed FSP indicates that a de minimus volume of sales would not taint an investors’ assertion to hold other securities to their forecasted recovery. We understand this guidance to be a relative percentage of the available-for-sale portfolio rather than an absolute number of sales. However, FASB’s intent is not clear on this matter. Therefore, we suggest that the FASB consider clarifying the guidance to minimize diversity in practice.

Qualitative Factors:

We believe that the following factors should be among those considered when determining if there is a pattern in selling securities prior to their forecasted recovery:

- the business or operating circumstances that led the entity to the decision to sell securities;
- whether an entity has sold securities for different or recurring reasons;
- whether the circumstances or events that led to the decision to sell the securities were within the control of the entity;
- the frequency of such sales;
- whether the entity anticipates similar circumstances within the near future.

VI. Requested Implementation Guidance

If the proposed rule is adopted in its current form, we believe the FASB or EITF should address and clarify the following implementation issues.

- A. Paragraph 16 of EITF 03-1 requires investors to assert their ability and intent to hold an investment until a forecasted recovery of fair value “up to (or beyond) the cost of the investment, which in certain circumstances may mean until maturity”. It is not clear from the proposed FSP or EITF 03-1 if it was the FASB’s intent to establish a portfolio that is held to forecasted or actual recovery.

For example, an investor holds an available-for-sale debt security that falls within the scope of paragraph 16 of EITF 03-1. At December 31, 2004, the security has an unrealized loss that exceeds “minor impairment”. The unrealized loss is solely due to unfavorable movements in interest rates. The investor makes the assertion that he will

hold the security until its forecasted recovery. The investor's initial forecast projects that it is likely that the security will recover by December 31, 2005. The investor's forecast is updated in March 2005 using the most recent market data. The updated forecast indicates that it is now likely that the security will recover in December of 2006. The change in the recovery period was not the result of a significant and unexpected increase in interest rates. The investor still plans to hold the security through December 31, 2005; however, it is no longer likely that the security will have recovered on that date. Would the investor need to record other-than-temporary impairment at March 31, 2005 since he cannot assert his intent to hold the security until the revised forecasted recovery, or would the loss be considered temporary since the investor still intends to hold the security until the original forecasted recovery date?

- B. Although the term "sector spread" is probably well known to portfolio managers, it is not defined in accounting literature nor is it a frequently used term by accountants and auditors. We recommend that FASB define the term in the FSP to assist accountants who will be required to apply the guidance.

VII. Effective date and transition

We request that sufficient time be allowed for implementation to provide entities the opportunity to implement or enhance systems and controls, particularly in light of SOX 404 and other competing system priorities (including system changes required for SOP 03-3 and the FAS 123 amendment on Share-Based Payments). We also believe additional FSPs may be required to help entities interpret the guidance. We recommend that the FASB consider an effective date of at least one year after the final FSP is issued.

If FASB retains the requirement of management's assertion of ability and intent, we recommend the FASB allow a "one-time" transfer of available-for-sale securities to the trading category and that adoption of EITF 03-1 be accounted for as a cumulative effect of a change in accounting principle.

VIII. Concluding Remarks

Existing guidance regarding impairment of debt securities is principles-based and is sufficient. The guidance in EITF 03-1 related to debt securities is not only unclear, but also is an unnecessary change to existing guidance that would not serve to enhance the transparency of financial reporting. We recommend that FASB allow existing guidance to stand with regard to impairment of debt securities.

We appreciate the opportunity to comment on the proposed FSP. Thank you for considering our views. If you have any questions concerning our comments, please contact me at (202) 752-6549.

Respectfully,

Gregory N. Ramsey
Vice President for Financial Accounting Standards