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Betzold Investment Group, Inc.

Letter of Comment No: 181
File Reference: EITF03-1A

Mr. Lawrence Smith
Director—Technical Application and Implementation Activities
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 and its application to Certain Investments" (EITF 03-1)

Dear Mr. Smith,

The Betzold Companies is a group of over 60 professionals who are dedicated to developing and teaching analytics and strategy for disciplined, responsible portfolio management in the fixed-income marketplace at Bond Math University® all across the country.

We are writing regarding the Proposed FASB Staff Position (FSP) on EITF 03-1a. While we recognize that the Board has responded to the significant concerns from the industry and is working to resolve those concerns we still believe EITF 03-1 has conceptual flaws that could result in inconsistent industry practice and misleading financial reporting.

Our primary concerns regarding EITF 03-1 relate to the implication that a gain or loss related to the changes in interest rates on a debt security should be accounted for differently depending on whether you **may** sell or hold a security along with the practical issues of making the assessment regarding ability and intent to hold securities until maturity. Additionally, we have significant concerns that applying accounting rules related to interest rate changes to one part of a balance sheet that is made up entirely of interest rate sensitive instruments when many of the portfolio decisions are interrelated ***(and applying these measures in only one direction – i.e. mark-to-market losses)***, will result in misleading financial statements.

One of the points that we drive home to fixed-income managers across the country at our Bond Math University® is that ***market value matters whether you sell a bond or not.*** Market value measures future income. If a bond is at a loss or a gain due to changes in interest rates, an investor could recognize the loss or gain immediately through earnings by selling the bond or the investor could recognize the loss or gain over the life of the bond through lower-than or higher-than market income. In either scenario however, a change in market value represents a real change in shareholder wealth, with only the ***timing*** of its recognition having changed. The OCC made the same type of distinction earlier this year when addressing interest rate risk using the term "earnings event" to discuss current interest income and the term "capital event" to discuss changes in market value. SFAS 115 first addressed the accounting for changes in market value by requiring institutions to record unrealized losses AND gains through the equity accounts by an adjustment to "comprehensive income" for securities classified as available-for-sale (AFS). Thus, existing accounting guidance essentially sets a sale as the standard as to when gains and losses properly flow through earnings. Unrealized gains or losses representing future income advantages or disadvantages are recorded as adjustments to equity (available-for-sale) or disclosed in the footnotes (for securities classified as held-to-maturity). In our opinion, this accounting guidance is clear and enjoys some degree of economic validity.

Thus, in addressing question number 3 of FSP EITF 03-1a, we believe it is important that the standards for assessing the ability and intent to hold a security until recovery and the circumstances that call in to question this ability or intent, should be such that result in an impairment charge only when it is highly probable a sale of an individual security unit would take place. If those standards are left to ***subjective*** interpretations, there is a ***significant risk*** of inconsistent industry practice. Circumstances change daily at financial institutions, particularly with its mix of interest rate sensitive assets and liabilities. An institution may take on a large time deposit from a local municipality, a significant loan may pay off early, or new loan and deposit products may be added. Additionally, securities' interest-rate profile changes over time and with rate changes. For example, one year later, a three-year bullet becomes a two-year bullet, and CMOs become longer or shorter. A portfolio manager's job is to manage the investment portfolio in light of these and other changes. A change in the wisdom of a buy-and-hold decision arises often and should invite review of ***all*** the securities in a portfolio as part of normal everyday portfolio management.

Secondly, it is our experience, that the knowledgeable financial institutions manage their portfolios on a total portfolio centric basis. In pursuing a focused longer term total return strategy they populate their portfolios on the basis of buying fixed income securities whose performance may be interrelated. The expectation may be that over a period of time or group of horizons certain parts of a portfolio may increase or decrease in value relative to other portions. Thus decisions to sell may not be made based on how a single instrument performs at a given time but on relative relationships to how a group of instruments has performed over a period of time coupled with how the group of instruments may be expected to perform over a variety of possible interest rate scenarios over various future time horizons.

Under these circumstances the decrease in value of some of the instruments cannot be appropriately divorced from the increase in value of other of the instruments. Any buy or sell decision remains linked to more than a single instrument that may currently have a loss and to what other instruments may be available under then-current market conditions. There are a host of significant factors that go into evaluating both the group and each individual security within the group as well as alternative instruments currently available in the market that must be taken into account in making portfolio decisions. Thus impairment charges without reflecting an interrelated gain would cause misleading financial results of the portfolio.

Additionally, the rest of the balance sheets of financial institutions are primarily comprised of interest-rate sensitive financial instruments. Many portfolio decisions are also made based on the interest-rate sensitivity of the other instruments on the balance sheet, whether loans or liabilities. By changing the accounting treatment of ***only one part of the balance sheet***, when virtually all assets and liabilities are affected by changes in interest rates, it creates the significant possibility of reporting ***technically accurate*** albeit **misleading** earnings results. To illustrate this, we prepared a Pro-Forma Income Statement (Attachment A) of a financial institution with $5,000,000 in capital whose sole asset is a 3-Year bullet agency with a par value of $100,000,000 and a coupon rate of 3% while its sole liability is a $95,000,000 time deposit with a 3-Year maturity and a coupon of 2.65%. Over the three year period, we test a scenario where rates increase 100 basis points over the first year, another 200 points the second year and remained at that level through the third year (when both the asset and liability mature).

In the attachment, we provide pro-forma income statements to illustrate and compare two treatments. First, we demonstrate how current practice would treat this situation assuming the security is classified AFS, and then we demonstrate how the proposed guidance would treat the situation. Obviously at the end of three years (and assuming no reinvestment interest), the institution will be in the exact same financial position in either scenario. However, under EITF 3-01, if an impairment charge is taken in years 1 and 2 and then the discount is accreted into income in year 3, the net earnings of the institution incur wild fluctuations ranging from a significant loss of $1.5 million in year 1 (-31.63 ROE) to income of $3.1 million in year 3 (115% ROE). By taking an impairment charge against the asset while ignoring the liability, which has virtually the same interest rate risk, earnings are distorted and the basic accounting principal of matching income and expenses is violated. Additionally, this institution would probably fall below regulatory capital issues simply due the accounting change of EITF 03-1. Both the dramatic losses in years 1 and 2 and the dramatic gains in year 3 are misleading to the financial statement reader about the economic condition of the institution!

As another start example, compare Institution A that originates a 30-year 6% mortgage to one customer with Institution B who invests in a debt security which is collateralized by a pool of 6% mortgages. Say the institutions fund the investments by issuing 5-year identical time deposits. All three instruments are subject to interest rate risk and are saleable in the market, and more particularly, both assets are subject to identical interest rate risk (actually the debt security is less volatile) yet only the debt security (pool) is subject to an interest rate impairment charge under EITF 03-1.

Because of these difficulties, we believe that EITF 03-1 creates significant issues that raise the probability that institutions will be forced to report misleading financial results and the probability that the industry will suffer inconsistent reporting from period to period. Because of the issues stated above, we believe significant review of EITF 03-1 is necessary particularly with respect to recording interest-rate impairments on one part of an institution's balance sheet. Alternatively, if the key question regarding an interest rate impairment charge was changed to whether an institution had an intent to **sell** as opposed to **hold**, an impairment loss could be recognized and be consistent with current accounting guidance regarding when security losses should flow through earnings. Additionally, in responding to question # 3 in the FSP EITF 03-1, any guidance should recognize that there are regular circumstances that change the intent of whether a security should be sold and a pattern of sales should not necessarily call into question the intent to sell other securities that are classified as available-for-sale.

We appreciate your consideration of our comments and recommendations.

Sincerely,

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Chief Financial Officer and Vice President
The Betzold Companies

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Pro Forma Income Statement
3 Year Horizon
Comparison of Results of a Financial Institution under SFAS 115 accounting and EITF 03-1 (assuming impairment charge)

PROFORMA STATEMENT OF INCOME	SFAS 115 Year 1	Year 2	Year 3	Summary
INTEREST INCOME				
Securities - Accretion on Impaired Securities				
Securities - Accrued Interest (Coupon)	3,000,000	3,000,000	3,000,000	9,000,000
Total interest income	3,000,000	3,000,000	3,000,000	9,000,000
INTEREST EXPENSE				
Deposits	2,517,500	2,517,500	2,517,500	7,552,500
Total interest expense	2,517,500	2,517,500	2,517,500	7,552,500
NET INTEREST INCOME	**482,500**	**482,500**	**482,500**	**1,447,500**
IMPAIRMENT CHARGE	0	0	0	0
Income before income taxes	482,500	482,500	482,500	1,447,500
INCOME TAX PROVISION	164,050	164,050	164,050	492,150
Net income	318,450	318,450	318,450	955,350
BEGINNING EQUITY	5,000,000	5,318,450	5,636,900	5,000,000
Net Income	318,450	318,450	318,450	955,350
ENDING EQUITY (Before Comprehensive income)	5,318,450	5,636,900	5,955,350	5,955,350
Comprehensive income	(1,900,000)	(970,000)	2,870,000	0
	3,418,450	4,666,900	8,825,350	5,955,350
RETURN ON BEGINNING EQUITY	6.37%	5.99%	5.65%	

	EITF 03-01 Year 1	Year 2	Year 3	Summary
INTEREST INCOME				
Securities - Accretion on Impaired Securities			2,870,000	2,870,000
Securities - Accrued Interest (Coupon)	3,000,000	3,000,000	3,000,000	9,000,000
Total interest income	3,000,000	3,000,000	5,870,000	11,870,000
INTEREST EXPENSE				
Deposits	2,517,500	2,517,500	2,517,500	7,552,500
Total interest expense	2,517,500	2,517,500	2,517,500	7,552,500
NET INTEREST INCOME	**482,500**	**482,500**	**3,352,500**	**4,317,500**
IMPAIRMENT CHARGE	-1,900,000	-970,000	0	-2,870,000
Income before income taxes	-1,417,500	-487,500	3,352,500	1,447,500
INCOME TAX PROVISION	164,050	164,050	164,050	492,150
Net income	(1,581,550)	(651,550)	3,188,450	955,350
BEGINNING EQUITY	5,000,000	3,418,450	2,766,900	5,000,000
Net Income	-1,581,550	-651,550	3,188,450	955,350
ENDING EQUITY (Before Comprehensive income)	3,418,450	2,766,900	5,955,350	5,955,350
Comprehensive income	0	0	0	0
	3,418,450	2,766,900	5,955,350	5,955,350
RETURN ON BEGINNING EQUITY	-31.63%	-19.06%	115.24%	

Summary of Assumptions

1. $5,000,000 of beginning capital
2. Purchase 1 3-Year bullet agency with $100,000,000 par and a 3% coupon
3. Issued 1 3-Year CD with a $95,000,000 par and a 2.65% coupon
4. Assume no reinvestment rate
5. Federal tax rate at 34%