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Letter of Comment No: 171
File Reference: EITF03-1A

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

Re: EITF Issue 03-1

Ladies and Gentlemen:

1. Thank you for the opportunity to comment on EITF 03-1. Financial Management Services, Inc. (FMSI) provides consulting advice to financial institutions such as community banks and thrifts. That consulting advice includes the entire balance sheet for interest rate spread management, interest rate risk, investment portfolio management, etc. My comments are from a community bank perspective, but apply to all financial institutions.

2. FMSI believes that EITF 03-1 should be withdrawn as it has been proposed and ratified. A bank needs the current AFS investment flexibility provided in FASB 115 to manage its daily operations. The FASB 115 AFS investments as implemented for the last 11 years have proven to be very acceptable to banks, regulators and the accounting profession. The implementation of EITF 03-1 has the potential to have an unintended disastrous impact on the banking community and how it manages its day-to-day operations.

3. Community banks utilize their AFS investment portfolio in a number of ways as listed below. The EITF 03-1 could substantially limit a bank's ability to manage their risk and maximize their value. Some of ways a bank utilizes the AFS investment portfolio are:

A. Need for liquidity (increased loan demand, withdrawal of deposits, etc.)
B. Managing a bank's balance sheet price sensitivity (interest rate risk / duration). The investment portfolio is used (on a macro basis) to manage the interest rate risk. This requires periodic adjustment as 1) interest rates change, 2) prepayments change, 3) the balance sheet mix of types of assets and liabilities change, 4) the yield curve changes, etc.
C. Changes in liability funding sources and terms
D. Temporary leverage
E. Profit enhancement by seeking the best relative value debt securities. Different debt security sectors become rich and cheap to other sectors for a variety of reasons. Banks utilize this in conjunction with other needs and factors to enhance the bank and shareholder profitability. This includes selling securities at a loss.

4. The future event or conditions that will require a bank to manage its business are not known today (or obviously it would not need flexibility for the future). The needed bank management flexibility comes from the AFS investment portfolio. The above paragraph #3 are legitimate business management needs, which seem to have already been addressed in FASB 115, paragraph 9.

5. The securities being discussed are AAA type securities of Treasuries, agencies, MBS of agency and AAA private issues, CMOs, etc. These are basically securities with no credit risk, but would have price risk due to interest rate changes.

Explanation and Topic Discussion

Management Flexibility

6. A bank needs management flexibility by the very nature of the institution. A bank offers many different retail products on the asset and liability side of the balance sheet. The balance sheet composition is constantly changing for a variety of reasons. The dynamic balance sheet changes require management to adjust their balance sheet (macro) risk on a dynamic basis. The major segment of the balance sheet that accomplishes these adjustments is the AFS investment portfolio. Flexibility to adjust to future changes is a must. The EITF 03-1 that would reduce that flexibility is a detriment to the banking system (and to all financial institutions).

7. Reduced liquidity and interest rate risk flexibility will have the impact of putting a bank at more risk. The EITF 03-1 implementation is at time of 40 year lows in interest rates. Banks will have **increased risk** merely because of an implementation of EITF 03-1.

8. FASB 115, paragraph 82, states ...Additionally, the available-for-sale category will include debt securities that are being held for an unspecified period of time, such as those that the enterprise would consider selling to meet liquidity needs or as part of an enterprise's risk management program. It appears that FASB 115 has already provided for the bank flexibility discussed above. **Further, it appears that the AFS designation of FASB 115 does not impose any limit on the bank to sell only securities with gains and hold securities with losses till those losses are recovered.**

9. The AFS categorization by its definition says that the securities **may** be for sale at some future undetermined date. If AFS securities are sold, that should not require the remaining AFS portfolio to be determined that they will be sold or when they would be sold. Securities that **may** be sold should not be required to recognize losses in current earnings and accrete the loss back to income over time.

The AFS Issue and Its Integrated Impact on a Bank

10. CAMELS is the regulatory acronym for rating a bank. EITF 03-1 has the potential to affect every rating component except the A (investments are assumed to have no credit issues).
C is capital. A required write down of AFS securities would decrease capital. Regulators are required to follow GAAP accounting and thus regulatory capital would be impaired.
A is asset / credit quality. This is not an issue in the FMSI discussion.
M is management. Management's ability to deal with an AFS portfolio that has written down losses and the loss of management flexibility to run the bank could be an issue.
E is for earnings. This would be directly and negatively affected by the final implementation of EITF 03-1.
L is liquidity. This would be directly and negatively affected by the final implementation of EITF 03-1.
S is sensitivity or interest rate risk. This would be directly and negatively affected by the final implementation of EITF 03-1.

The final implementation of EITF 03-1 will have substantial impact on a bank as the AFS investment portfolio is deeply engrained in a bank's operations.

The EITF 03-1 and FASB 115 Only Address the Asset and Not The Liability Funding

11. An obvious statement is that there are two sides to the balance sheet. It is single entry accounting to only address one side of the balance sheet. It is true that an AFS security **asset** may have a market **loss**. It is also true that the **liability** funding the asset may have a market **gain**. It hardly makes sense to require a bank to record the asset loss in current earnings while requiring the bank to record the liability gain over time.

This creates earnings and capital volatility based on accounting journal entries rather than the economics of the bank. The economics of the bank are the real reportable earnings and capital. A required current recognition of asset losses and a deferral of liability gains is a distortion of the current financial condition of a bank (or other financial institution).

This was recognized in FASB 115 and specifically addressed in paragraph 79. "The Board decided that those investments in debt and equity securities should be reported at fair value. However, because of concerns about the potential **volatility** that would result from reporting the fair value changes of **only some assets**, and **not liabilities**, in earnings, the Board determined that the **unrealized holding gains and losses** from **available-for-sale** securities should be **excluded from earnings**. The basis for that conclusion is discussed in paragraphs 90-95. (emphasis added.)

The proposed and ratified EITF 03-1 appears to directly contradict FASB 115, paragraph 79.

Example Bank	Bal. Sheet	Market Value	Market Gain (Loss)
AFS security- 5 year maturity	200.0MM	175.0MM	(25.0MM)
Liability – 5 year maturity	200.0MM	175.0MM	+25.0MM

(assumes a +300 bps rate shock)
Should the EITF 03-1 find the asset security impaired, it requires the loss recognition without recording the liability gain recognition. Earnings and capital volatility are an extremely important concern of management. They are also very important to the regulators. (Anybody that has had to explain volatile earnings or capital to a regulator deeply understands this.) Regulators use this as a tool for examining and reviewing banks' performance.

12. **Economic Reality vs. Accounting Classifications.** EITF 03-1 could have the impact of causing a bank to fail and another to be a going concern merely by accounting classification. Assume two banks with $100 million size, $8 million capital and an interest rate increase of 3.0%. The economics of the two banks are identical but accounting entries make one fail and the other one survive.

Example Bank A	Bal. Sheet	Market Value	Market Gain (Loss)
AFS security- 5 year maturity	100.0MM	87.0MM	(13.0MM)
Liability – 5 year maturity	92.0MM	80.0MM	+12.0MM
Capital	8.0MM	7.0MM	(1.0MM)

(assumes a +300 bps rate shock)

Bank A is required by EITF 03-1 (because of impaired AFS due to interest rate change) to record a $13 million loss in current earnings. After recording the $13 million loss to capital, Example Bank A has a capital deficit position of $5 million. Example Bank A fails due to lack of GAAP and regulatory capital and earnings.

In reality, Example Bank A's capital has only suffered a $1 million decline in market value. (An aside is the bank only has to have less than a 1% net interest margin to earn back the $1 million market decline in 12 months.)

Example Bank B	Bal. Sheet	Market Value	Market Gain (Loss)
HTM security- 5 year maturity	100.0MM	87.0MM	(13.0MM)
Liability – 5 year maturity	92.0MM	80.0MM	+12.0MM
Capital	8.0MM	7.0MM	(1.0MM)

(assumes a +300 bps rate shock)

Bank B is not required by EITF 03-1 to record a $13 million loss in current earnings. Bank B has suffered the identical economic realities that Bank A did. But Bank B does not have to deal with market valuations on securities other than disclosure. Bank B continues in business because it continues to report $8 million of GAAP and regulatory capital along with positive current earnings.

In reality, Example Bank B's capital has suffered a $1 million decline in market value.

Minor Impairment

13. Minor impairment must be well defined. The industry and accounting profession need a more defined guideline for consistent application.

14. A quantitative measurement of 5% or less of cost is not a large enough measurement for impairment. The price decline of 5% is only a 2-year maturity with a 3% increase in market rates (rate shock of +300 bps) or a 3-year maturity with a 2% increase in market rates. Also, the FASB should be cognizant that much of this asset price decline would be offset by the liability gains discussed above. Exhibit B and paragraph 15 tables show that a 5% price decline in an AFS security is very easily obtained with a small change in interest rates. **Therefore, if a "5% bright line" was used, a very large amount of securities are likely to be determined to have an impaired value.**

15. The table below shows the price % change for US Treasuries by maturity per Bloomberg. The purpose of the table is to give the FASB a sense of price sensitivity by maturity. A 5% decline in price is easily obtained with fairly small changes in interest rates.

% PRICE CHANGE FOR US TREASURIES							
		Rates Down			**Rates Up**		
Maturity	Yield	-300 bp	-200 bp	-100 bp	+100 bp	+200 bp	+300 bp
1 year	2.22%	3.0%	2.0%	1.0%	-1.0%	-2.0%	-3.0%
2 year	2.58%	6.0%	4.0%	2.0%	-1.9%	-3.8%	-5.6%
3 year	2.84%	9.1%	6.0%	2.9%	-2.8%	-5.6%	-8.2%
5 year	3.32%	14.7%	9.5%	4.6%	-4.4%	-8.6%	-12.6%
7 year	3.69%	19.2%	12.4%	6.0%	-5.6%	-10.8%	-15.7%
10 year	4.06%	27.7%	17.5%	8.4%	-7.6%	-14.5%	-20.8%
20 year	4.80%	45.4%	27.7%	12.7%	-10.8%	-20.0%	-27.9%
30 year	4.84%	60.7%	36.0%	16.1%	-13.1%	-23.8%	-32.6%

16. **Exhibit A**—Bank Investment Portfolio Composition. This exhibit table gives a broad view of the composition of bank portfolios by different sizes. It reflects that most banks hold less than 7% of their portfolios in Treasury securities. Their investment portfolios are more dominated by Agency securities (bullet and callable), Municipal bonds, mortgage backed securities in the form of pass throughs and CMOs. **Exhibit B** has been prepared to provide a sense of price sensitivity of for different types of investments that might be found in a bank's AFS investment portfolio. A 5% price decline is easily attained with small movement in interest rates. **Exhibit A** also provides some maturity percentages to give a broad maturity perspective of bank portfolios.

17. Conclusion: A bright line quantification test should be 20-25% decline in value. This is consistent with the decline in a variety of securities for a +300 bps change in rates. The price declines of the assets discussed are being offset by liability gains as interest rates change.

<u>Ability and Intent to Hold the Securities until a forecasted recovery of fair value (up to or beyond the cost of the investment.)</u>

18. This will require an investor to make an evidence-based judgment about the market price recovery by considering the severity and duration of the impairment. This is subjective accounting, which will open up a lot of room for inaccurate accounting. The subjectivity deals with judgment about the future. Second, it deals with the subjectivity of the investor and the accountant reviewing the investor's judgment. Thirdly, it places a regulator in the role of judgment and subjectivity. Fourth, it provides the potential of a lack of comparability of one bank vs. another bank as judgments and evidence may differ on the same security.

19. An example of items that would be subjective and based upon judgment would be the further path of interest rates. What will the future yield curve be: steep, flat, inverted, humped, etc.? How well does the security "ride the yield curve"? This only deals with the yield curve. What about the prepayment speeds of a security? Prepayment speeds on MBS related securities are not an exact science and there is room for legitimate disagreement.

20. The EITF has discussed AFS securities that are impaired due to a "normal" interest rate cycle as a possible exemption. Would the EITF please define a "normal" interest rate cycle? My personal 30+ years in the financial markets and financial services industry does not allow me to define a "normal" interest rate cycle. This will require a very in-depth study, which will end up being pretty subjective. FMSI's study of interest rate cycles has been that there are no 2 cycles alike. Currently, there are some new factors bearing on the market that have not been there in the last 50 years. The current / future rate cycle may not be calculated just based upon historical data.

Conclusion: FASB is going down a slippery slope to have every security require a judgment and some future projections made. This will not help the reader of financial statements to better understand a bank's financial position nor does it help the bank to better reflect its financial position.

<u>Sales of Securities from An Impaired AFS Portfolio</u>

20. The sale of securities at a loss from a proposed Impaired AFS portfolio should not taint the remaining Impaired AFS Portfolio. A bank needs the flexibility to manage its risks and the sale of AFS securities at a loss should not affect the remaining AFS portfolio whether the securities are at a loss or gain. Management's intent and ability to hold to recovery will need to change over time to meet the bank's risk management needs.

<u>EITF Generalization versus Bank Specificity</u>

21. The EITF has sent forth in their documents broad generalizations. The implementation of EITF 03-1 can have broad interpretations as well. However, the requirements being set forth for the bank are to be able to be very specific about its intent and ability to hold a security for a specified period of time. By being designated as AFS, the bank has already acknowledged that it "may" sell the security at some future point in time. That future point in time is a moving target that the bank needs to manage its risk and maximize shareholder value. Because of the changing future, neither the EITF providing guidelines nor the bank for management purposes can reasonably be expected to be as specific as the EITF has proposed.

Conclusion and Recommendation

22. FASB 115 has already addressed AFS classification and the appropriate date of write-down of those securities. The loss write-down is at the reporting date "IF" the bank plans to sell them; not at any reporting date that the market value is less than cost and the bank "may" sell them at some future date.

23. FASB 115 has recognized that AFS securities market value changes should not create earnings volatility. FASB 115 recognizes that the market value gains from liability funding of AFS securities has not been recognized.

24. One sided or single entry accounting is not an acceptable practice.

25. FMSI recommends that the EITF 03-1 implementation be withdrawn for further consideration.

Alternatively:

26. The "bright line" for impairment needs to be sufficiently large enough to allow a bank to manage its risk (liquidity, interest rate risk, etc.) that it can do so without the fear of an accounting issue adversely impacting their earnings. Accounting issues, by themselves, should not be allowed to effectively raise the risk profiles at banks and other financial institutions.

27. EITF needs to develop a practical solution to allow banks to manage their liquidity and interest rate risk needs. It is impossible for banks to determine today the exact bonds they will sell tomorrow or in the future to manage their liquidity and interest rate risk. (FMSI believes that the current FASB 115, its 11 years of implementation, and its specifics has allowed that to happen and to provide proper accounting for AFS securities.)

27. EITF should look at paragraphs 10-15 as well as paragraph 16, which has drawn the most focus. The issues of paragraph 10-15 are every bit as important as paragraph 16.

28. Should the EITF and FASB proceed with EITF 03-1, the implementation should be delayed for further study and effective, specific implementation guidelines should be developed and well understood by all parties. The guidelines and EITF 03-1 language as it now stands needs substantial improvement.

Thank you for the opportunity to comment on EITF 03-1. Should you have any questions, please contact Douglas Williams at the address and phone numbers listed on the letterhead.

Sincerely,

Douglas Williams, CPA
President

CC: Federal Reserve
OCC
FDIC

FTN FINANCIAL
WHAT'S WORKING
800.456.5460 June 24, 2004
CAPITAL MARKETS
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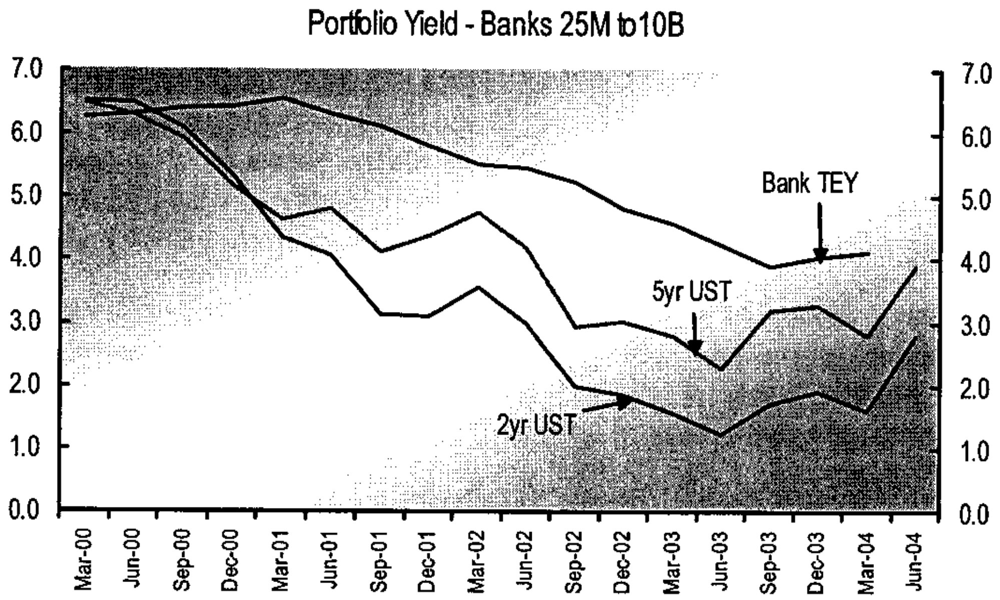
Portfolio Yields Slowly Trending Higher

The 1st quarter call report data shows bank yields increased only slightly from the previous quarter. This is not surprising given that interest rates trended lower during the 1st quarter. This not only reduced purchase yields but also kept the pressure on premium amortization of mortgage related securities. Of course, a lot has changed since the 1st quarter.

The graph below shows the average quarter-by-quarter yield for banks with assets between $25 million and $10 billion. Also highlighted are the quarter-end yields for the 2- and 5-year Treasury (as well as their current levels).



While portfolio yields increased only slightly from the previous quarter, we would expect the increase during the 2nd quarter will be greater. Market yields reversed their trend from the first quarter and increased sharply during the month of April, as you can see in the Treasury yields in the graph above. While this forced us to deal with declining market values, it also created an opportunity to add short, defensive bonds at yields that are higher than the current portfolio yield. For example, the MBS structures below all provide a good pickup over the average portfolio yield:

7-year 4% Balloon	4.50% yield
10-year 4% Pool	4.38% yield
15-year 4.5% Pool	4.92% yield

I think it is also noteworthy to mention the continued trend we see with respect to municipals. As in previous quarters, there is a consistent increase in the allocation to this sector as you move from the lowest to the highest yielding quartiles (this holds true for all three asset size peer groups).

In today's environment, Municipals provide one of the best options for the long end of a barbell strategy. Many banks are considering a modified barbell approach to position for the expected flattening in the yield curve. Beyond their very high relative yields, municipals work well in this strategy given the long call protection generally available. Here are the current yields available in longer term BQ municipals:

10-year maturity	4.00% nominal,	5.83% taxable equivalent
15-year maturity	4.50% nominal,	6.59% taxable equivalent
20-year maturity	4.75% nominal,	6.97% taxable equivalent

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1st Quarter 2004 Portfolio Performance

U.S. Bank Data from Call Reports

FTN FINANCIAL
CAPITAL MARKETS

RANKINGS

Quartile	Yield High	Low	Median	Loan / Asset	UST	Agcy	Muni	MBS	CMO	ABS	Corp	Equity	Bonds w/ Rem Mat < 5 yrs	MBS w/ Rem Mat < 15 yrs	CMO w/ Avg Life < 3 yrs
					Percent of Portfolio Invested by Sector								Bond Maturities (% of portfolio)		
U.S. Banks 25 Million - 500 Million in Assets															
1ST	6.96	4.62	**5.08**	61.5	1	34	34	18	7	0	5	1	36	12	5
2ND	4.62	3.99	**4.27**	59.3	2	41	20	24	8	0	4	1	44	19	5
3RD	3.99	3.39	**3.72**	61.7	3	48	13	24	8	0	3	1	52	21	5
4TH	3.39	1.10	**2.95**	64.3	8	58	7	15	5	0	3	4	70	13	4
U.S. Banks 500 Million - 2 Billion in Assets															
1ST	7.59	4.59	**4.96**	64.5	2	23	24	27	15	0	7	2	27	17	9
2ND	4.59	4.13	**4.35**	64.6	2	31	15	30	14	0	6	2	33	23	7
3RD	4.13	3.59	**3.86**	63.9	4	35	10	31	12	1	5	2	43	25	7
4TH	3.59	1.75	**3.16**	65.7	7	43	8	22	10	1	5	4	58	18	6
U.S. Banks 2 Billion - 10 Billion in Assets															
1ST	6.46	4.56	**4.84**	59.3	2	15	12	33	22	3	12	1	24	19	11
2ND	4.56	4.19	**4.38**	61.7	3	19	11	33	27	1	4	2	22	25	15
3RD	4.17	3.75	**4.03**	59.0	5	19	7	40	22	0	5	2	27	34	11
4TH	3.72	1.99	**3.19**	60.4	7	34	4	25	20	2	5	3	50	22	14

CHANGE FROM 1st QUARTER 2003

Quartile	Yield Median	Loan / Asset	UST	Agcy	Muni	MBS	CMO	ABS	Corp	Equity	Bonds w/ Rem Mat < 5 yrs	MBS w/ Rem Mat < 15 yrs	CMO w/ Avg Life < 3 yrs
U.S. Banks 25 Million - 500 Million in Assets													
1ST	(0.64)	(0.1)	(1)	5	2	(0)	(4)	(0)	(2)	(0)	8	3	(3)
2ND	(0.60)	0.7	(1)	5	1	(1)	(3)	(0)	(1)	(1)	2	4	(2)
3RD	(0.54)	1.6	(1)	10	(0)	(2)	(4)	0	(2)	(1)	(1)	7	(1)
4TH	(0.45)	1.3	1	15	(0)	(6)	(6)	(1)	(2)	(1)	8	2	(1)
U.S. Banks 500 Million - 2 Billion in Assets													
1ST	(0.54)	(0.7)	0	(1)	4	1	(1)	(1)	(3)	0	3	7	0
2ND	(0.48)	2.7	0	4	1	0	(2)	(0)	(1)	(1)	2	7	(5)
3RD	(0.47)	3.8	(2)	4	2	(0)	(5)	1	1	(0)	3	11	(2)
4TH	(0.47)	0.9	(1)	13	2	(1)	(12)	(1)	(1)	(0)	7	5	(3)
U.S. Banks 2 Billion - 10 Billion in Assets													
1ST	(0.87)	1.9	(2)	2	0	(3)	(7)	2	7	0	16	9	(1)
2ND	(0.65)	2.0	1	4	1	(7)	4	(0)	(3)	1	2	10	4
3RD	(0.32)	1.7	1	3	1	2	(6)	(1)	(1)	0	(5)	13	5
4TH	(0.46)	2.9	2	3	0	4	(4)	1	(8)	2	(5)	12	5

EXHIBIT B

% Price Change for Various Debt Securities

Security	Rates Down -300	-200	-100	Rates Up 100	200	300
Agency - 2 YR	5.9%	3.9%	1.9%	-1.9%	-3.7%	-5.5%
Agency - 5 YR	14.1%	9.2%	4.5%	-4.2%	-8.3%	-12.1%
Agency - 10 YR	27.5%	17.5%	8.3%	-7.6%	-14.4%	-20.7%
Agency - Callable 5/1 Yr	3.0%	2.0%	1.0%	-1.0%	-5.3%	-9.4%
Agency - Callable 10/3 Yr	8.7%	5.7%	2.8%	-3.9%	-11.0%	-17.5%
MBS - 5 YR Balloon	1.5%	1.1%	0.9%	-2.2%	-4.5%	-6.7%
MBS - 7 YR Balloon	3.8%	2.8%	2.1%	-3.3%	-7.1%	-10.7%
MBS - 3x1 Hybrid Arm	2.3%	2.2%	1.3%	-1.9%	-4.1%	-6.4%
CMO SEQ 2.67 YR WAL	0.5%	0.1%	0.3%	-3.2%	-7.0%	-10.8%
CMO 5.3 YR PAC	2.5%	2.3%	1.7%	-4.5%	-8.8%	-12.8%
MBS - 15 YR	3.3%	2.5%	2.6%	-4.9%	-9.6%	-14.0%
MBS - 30 YR	4.2%	3.0%	2.8%	-7.4%	-13.7%	-19.5%
Municipal - 20 YR	22.5%	16.5%	9.3%	-8.3%	-15.8%	-22.4%

Exact % changes will depend on specific security and other factors. Table is intended to give a general representation of broad category of securities.