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October 29, 2004

Mr. Robert Herz, Chairman Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, Connecticut 06856-5116

Letter of Comment No: // 7
File Reference: EITF03-1A

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

RE:

Emerging Issues Task Force Issue No. 03-1-a, "The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments"

Dear Sirs:

The Independent Community Bankers of America¹ (ICBA) welcomes the opportunity to comment on the proposed new clarifications to EITF Issue 03-1 which provides guidance on the meaning of the phrase "other-than-temporary impairment" and its application to several types of investments, including debt securities classified as "available for sale" under FASB Statement 115, *Accounting for Certain Investments in Debt and Equity Securities.* ICBA thanks the Financial Accounting Standards Board (FASB) for postponing the

¹ The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to promoting the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

implementation date of EITF 03-1 and proposing additional clarification of the guidance with this opportunity for public comment.

General Comments

Community banks are uniformly very concerned about the potential need to recognize impairments on investments classified as "available-for-sale" due solely to changes in interest rates. It appears to ICBA that virtually all community banks (along with many other financial institutions) will likely be affected by this accounting guidance. Community banks question the need to recognize in earnings "other-than-temporary" impairments that are due to interest rate changes on investments that they classify to indicate they may sell them, but also have the ability to hold them to maturity. Consider that in past years under the FAS 115 and SAB 59 guidance on other-than-temporary impairment, which gave banks the flexibility of selling securities at a loss without the ramifications or limitations introduced by EITF 03-1, actual realized losses were quite small. For example, in 2000 banks liquidated many securities at losses to fund loan demand and for other needs but aggregate realized losses were immeasurable.

Community banks do not believe that the EITF 03-1 view of "other-than-temporary" impairments and the resulting impact to earnings gives a truer picture of earnings. Earnings would reflect losses that may not occur because the securities are held until they mature. Whether recoveries of losses due to changes in interest rates are recognized or not, earnings would be more volatile and less reflective of reality as impairments are recorded and amortization/accretion schedules constantly changed. The result would be confusing and misleading information for financial statement users. Rather, they see the current treatment of reflecting value changes as a component of capital and a litany of disclosures as a more accurate portrait of earnings and financial condition.

Community bankers have also told ICBA that this guidance will significantly impede their asset/liability and liquidity management practices. Having investments that can be liquidated to meet loan demand or for deposit withdrawals is intrinsic to the business of banking. To meet customer needs, they must have the ability to liquidate these funds easily and quickly, yet if unneeded, the investments typically are held until maturity. If liquidity is needed, banks do not automatically chose an impaired or the most impaired security to sell to provide needed liquidity, due to other considerations such as asset/liability management constraints. Consequently, for flexibility community banks predominately classify their investment securities as "available-for-sale," as provided in FAS 115, and chose to sell or hold a security for a variety of reasons.

ICBA believes that any guidance contained in EITF 03-1 must remain true to FAS 115 and the purpose of the available for sale classification. The wrong guidance in EITF 03-1 has the danger of nullifying available-for-sale status, to which ICBA would strongly object. Community banks have been using FAS 115 for a number of years now and find it workable and that its application provides an accurate

picture of the investment portfolio for financial statement users. We believe that EITF 03-1 should not replace or change the guidance in FAS 115 as, in our view, it would necessitate a significant change in how community banks account for investments—a change that we see as unnecessary.

Additional comments and suggestions are contained below.

Background

EITF 03-1 would require impairment mark-downs on "available-for-sale" securities if they were impaired and the impairment is "other-than-temporary." "Other-than-temporary" means that the holder of the securities does not have the ability and intent to hold the securities until a forecasted recovery of fair value occurs up to or beyond the cost of the investment. This could be until maturity. A pattern of selling securities prior to the forecasted recovery of fair value may call into question the investor's intent to hold the securities. An impairment determined to be "other-than-temporary" must be written down to market value, with the loss recognized in current income, resulting in a reduction of regulatory capital in the case of banks.

Minor Impairment

While EITF 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, it does not specify the severity of impairment. There could be a level of impairment, a "minor impairment," that could be considered temporary that would not necessitate an assertion about the ability and intent to hold an investment until a forecasted recovery.

FASB considered defining "minor impairment" as an impairment of 5 percent or less. The guidance proposed in EITF 03-1 allows that a minor impairment can be considered temporary without further analysis because normal interest rate and/or sector spread volatility is expected to eliminate it. Some FASB board members disagreed with defining minor impairment as an impairment of 5 percent or less because that definition embodies assumptions about the volatility of the applicable interest rate. Some prefer that the guidance not provide a "bright-line" test.

We find that community banks are split as to whether there should be a bright line test, in part because 5 percent is viewed by them as too low a level to be useful for the range of securities that a bank might hold. Some see a bright line test as providing very clear guidance, ease of compliance and comparability, while others believe more flexibility should be available to recognize the decisions that must be made about each security. The bright line test must be applied to a variety of securities, some with more volatility than others due to their duration and convexity. The test amount that may work well for a very short-term security such as a one-year Treasury security may be inappropriate for a very long-term security that by its nature experiences more volatility, such as a 30-year zero coupon Treasury security.

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However, many other community banks would prefer more certainty and prefer a bright line test for impairments. Should FASB choose to provide a bright line test, banks are in agreement that the 5 percent threshold suggested in FASB discussions is too low. According to research conducted by ICBA Securities, a broker/dealer subsidiary of ICBA that provides investment services to ICBA members, a five-year Treasury bond, a common investment for a wide variety of investor types, has experienced a median price move of just over 12 percent during twelve-month periods over the past twenty years. Almost identical numbers result from an analysis of the past ten years. So, it is easy to conclude that, for common debt securities, losses of up to 12 percent have frequently been recovered within a year, a relatively short period of time that can easily be considered "temporary." Thus, we believe that 10-15 percent is more reflective of security movements than the suggested 5 percent level and strongly recommend that FASB adopt at least 10 percent as the bright line if it provides such a test. ICBA believes that more community banks would support a bright line test if it were greater than 5 percent so that it could be more appropriately applied to a wider range of securities.

We also strongly encourage FASB to clarify that a decline in the unrealized loss of a security to within the parameters set as "temporary impairment" be considered a recovery. A security should not be permanently tainted or considered permanently impaired when a recovery in value has occurred. Also, as maturity dates move closer, impairments inherently diminish, regardless of the interest rate environment.

Pattern of Sales

Some accounting firms have suggested that as few as two sales of impaired securities would call into question the investor's intent to hold other securities, thus triggering a requirement to write down all impaired securities. If FASB decides to provide a bright line test for minor impairments, it must make clear that sales of those securities that pass the test do not taint similar securities as is discussed in paragraph 8 of the proposed guidance. If no bright line test is provided, we believe that a "pattern" of sales is difficult to determine with any consistency or comparability. The sale of two securities may be considered a "pattern" for an institution that holds 5 securities, but would it be a pattern for an institution that holds 50 or 100 securities? We also believe that suggesting that as few as two sales of impaired securities should taint similar securities is unworkable and inconsistent with the concept of "available for sale." When FASB issued FAS 115, bankers understood that this was the category that was appropriate to use for securities that may need to be sold prior to maturity to meet daily business needs or other reasons.

Circumstance Changes

FASB has recognized several circumstances where a sale of impaired securities would not necessarily call into question the ability or intent to hold to recovery other debt securities that are impaired because of interest rate and/or sector spread increases. Paragraphs 8 and 11 of FAS 115 discuss such circumstances

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that would not call into question the "held-to-maturity" classification. In addition, EITF 03-1 provides that, for debt securities, sales may not taint for reasons including unexpected and significant changes in liquidity needs, unexpected and significant increases in interest rates and/or sector spread that significantly extend the period that a security would need to be held by the investor, and a de minimis volume of sales of securities. ICBA strongly supports this position.

Debt Versus Equity Securities

FASB generally believes that it is appropriate to limit the notion of "minor impairments" that would not require an ability-and-intent assertion to debt securities that are impaired because of interest rate and/or sector spread increases since, absent a sale prior to the recovery or maturity, such impairments will be recovered. Because the same cannot be said for a) debt securities that can be contractually prepaid or otherwise settled in such a way that the investor would not recover substantially all of its cost, or b) equity securities, FASB generally does not support extending the exclusion to such investments analyzed for impairment. However, some FASB members support expanding the notion of "minor impairments" to all investments because they acknowledge that normal price volatility may eliminate an impairment.

ICBA supports counting as "temporary" losses on securities covered by paragraphs 10-15 within the bright-line test which is set for debt securities subject to paragraph 16. In addition, ICBA requests that FASB allow debt-like equity securities, such as agency issued preferred stocks, to be treated like the debt securities they resemble.

Implementation Date

ICBA requests that FASB allow a sufficient period of time for investors to review and make necessary changes to their portfolios, prior to implementation. Implementation of new guidance contained in EITF 03-1 may well significantly affect how community banks manage their investment portfolios and their liquidity investments. Also, implementing the guidance change is likely to cause community banks to readjust portfolio holdings, develop new investment strategies and amend investment policies.

Community banks have investments policies, based on regulatory requirements, that outline investment objectives, permissible types of investments and provide guidelines for portfolio quality, maturity and diversification. The investment policy also addresses the maximum allowable maturity of investments to be held by the institution. These policies are approved by the institution's board of directors and an institution's compliance with its policy is subject to regulatory examination. All community banks will need to review and likely revise their policies following publication of the final guidance on "other-than-temporary" impairment. Making such changes will require a reasonable period of time. Thus, to allow banks to make the necessary changes, we ask that this statement not be effective until at least three full quarters after it is approved by FASB.

Summary

Community banks are very concerned about the need to recognize in earnings "other-than-temporary impairments" on available for sale securities due to changes in interest rates and question whether such recognition will really provide a truer picture of earnings. Institutions would be forced to recognize in earnings declines in security values that would disappear when held to maturity. ICBA believes that EITF 03-1 must remain true to FAS 115 and the purpose of the available-for-sale classification.

Community banks are mixed as to whether FASB should include in its guidance a "bright line" test to identify a "minor impairment." Some believe such a test would facilitate compliance with the guidance, while others believe that each security must be analyzed for impairment. However, it is clear that, should FASB guidance include a bright line test, the suggested 5 percent amount is too low. Instead, ICBA urges FASB to adopt at least a 10 percent threshold instead, a level that more accurately reflects historic investment price volatility. Also, FASB should provide a sufficiently long implementation period to allow banks to take all the steps needed to implement the change in guidance.

We appreciate this additional opportunity to comment on EITF 03-1 guidance. Please contact Ann M. Grochala at (202) 659-8111 or ann.grochala@icba.org to further discuss our views.

Sincerely,

Charles L. Saeman

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Chairman,

Lending Committee