



Letter of Comment No: 92
File Reference: EITF03-1A

October 28, 2004

Mr. Lawrence Smith
Director of Technical Application and Implementation Activities
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:

Citigroup appreciates the opportunity to comment on the 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"* ("Issue 03-1"). We thank the Board for delaying the effective date of this Issue as the Board seeks to provide constituents more guidance with respect to the evaluation of interest rate and sector spread impairments for debt securities analyzed under paragraph 16. The following discussion addresses questions that the Board has posed to constituents, and provides Citigroup's views on other actions we ask the Board to consider as this issue impacts our asset liability management practices, particularly for our Life Insurance and Annuities business.

We address the specific matters that the Board has requested feedback on below. However, we would like to observe that there are other implementation issues that constituents will be required to address when applying the provisions of Issue 03-1. For example, constituents must make assertions concerning holding securities until their "forecasted recovery" when there are unrealized losses that exceed the "minor" threshold. These requirements will place considerable burdens on entities to document decisions, produce forecasts, and audit compliance with assertions about intent relative to those forecasts. Questions surrounding sales of those securities during this forecasted holding period ("tainting") are the inevitable outgrowth of intent-based frameworks and achieving non-tainting sales are unlikely to be workable. For many companies, the procedural restrictions required to prevent tainting events will likely prove not to be operational due to business and administrative issues.

As a result, some observers have correctly noted that the matters raised in Issue 03-1 cannot be fully resolved without marking many securities to market through income. We agree. Citigroup does not, however, believe it is appropriate for entities to mark many of

its assets to market with changes in value recorded in earnings when the associated liabilities are recorded on a cost basis. Therefore, we believe that the Board should permit entities to irrevocably elect to (a) transfer securities from the available-for-sale (“AFS”) category to trading during a transition period, and (b) mark certain liabilities to fair value through earnings. This option will serve to mitigate implementation challenges and will result in more assets and liabilities being carried at fair value, with those instruments’ changes in value recorded in earnings, consistent with the Board’s stated long-term goals. Such treatment would also provide users of financial statements with more meaningful information concerning earnings, in contrast to results that misrepresent the company’s economic investment activities that will occur when following the accounting model for assets, liabilities and impairments under Issue 03-1.

We elaborate on each of these matters in the attachment to this letter.

We would be pleased to discuss our comments with you at your convenience. Please contact me at (212) 559-7721.

Regards,

A handwritten signature in cursive script that reads "Bob Traficanti".

Robert Traficanti
Vice President and Deputy Controller

Minor Impairments

For purposes of applying paragraph 16 of EITF Issue 03-1, we support the Board's view that a minor impairment caused by interest rate and/or sector spread increases should be considered temporary and would not create the need for either an assertion about the ability and intent to hold an investment until a forecasted recovery or a need to record impairment.

Although we believe that financial statement preparers and auditors will be able to apply the notion of "minor impairment" without any additional guidance from the FASB, such guidance would be beneficial to eliminate diversity in practice. We oppose a simple bright-line test, but we recommend that the Board provide language that would further clarify how to determine what is minor.

The reason that we do not support the insertion of a bright line test is that it is arbitrary. Almost any bright line will result in certain shorter-term securities never (or very rarely) crossing the threshold, while other longer-term securities will exceed it even when "normal" volatility occurs.

In the table that follows, we show estimates of one standard deviation moves in selected benchmark U.S. Treasuries whose initial value is par.

	One standard deviation over a 6-month horizon		One standard deviation over a 12-month horizon	
	Low	High	Low	High
2-year	99.1	100.9	98.2	101.8
5-year	97.9	102.1	95.8	104.2
10-year	96.2	103.8	92.6	107.4
30-year	92.9	107.1	86.5	113.5

The table should be interpreted as follows. Approximately 68% of the time, a par bond's price at the end of the stated horizon will be in the range provided¹ and would, in our judgment, meet the *minor* parameter. If a bright-line test of 5% were used, one can easily see that some bonds would be likely to breach the *minor* threshold even though the price change is the result of normal interest rate volatility. Therefore, we think it would be helpful if the Board further clarified its intent with respect to minor impairments. The draft FSP currently reads:

¹ This table does not, and is not intended to address, more complex issues affecting bond prices, such as the "roll down" effect that occurs naturally as a bond nears maturity or the impact of different coupons on price sensitivity. The table also does not incorporate complexities related to convexity (particularly affecting callable bonds and mortgages) or credit/sector spreads that particularly affect corporate and emerging markets securities. Our purpose here is only to illustrate a sense of magnitude. Should the Board desire more extensive data, we would be pleased to provide it.

ATTACHMENT

For purposes of applying paragraph 16, a minor impairment caused by interest rate and/or sector spread increases can be considered temporary and would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery.

As drafted, the term “minor” could be interpreted as “minor in absolute size” or “minor relative to normal interest rate and/or sector spread volatility.” We believe that the second interpretation is what the Board both should and does have in mind. Modifying the language as follows will help.

For purposes of applying paragraph 16, a minor impairment caused by interest rate and/or sector spread ~~increases~~ volatility over a short time horizon can be considered temporary and would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery.

Many constituents, including Citigroup, are likely to implement such an approach using a statistical framework, perhaps like the “one standard deviation” measure described above. Although we think it would be helpful for the draft FSP to say so, if the Board were comfortable with such an approach, we do not believe it necessary for the Board to prescribe or proscribe any reasonable approach chosen by constituents. We want to be clear, however, that we do not currently use such a statistical approach to evaluate other-than-temporary impairment and such an approach would need to be developed if this would be acceptable under the final FSP.

It would also be helpful if the Board provided an example of “short horizon” – we believe that either six months or one year would be appropriate. The time horizon used is extremely important as a parameter in any statistical measure (volatility tends to increase as the time period expands) and guidance on this matter will significantly reduce inconsistencies in practice.

Clarifying the guidance in the manner we suggest above should help clarify the Board’s intent and improve consistency of application without unduly restricting constituents in tailoring their implementation to their respective needs.

Foreign Currency Issues

The fair value of securities denominated in a currency other than the entity’s functional currency will reflect both currency and interest rate and other market conditions. It is not uncommon for even stable currencies, such as the Euro, Yen and Canadian dollar; to exhibit significant short-term fluctuations in exchange rates. When currency movements do not reflect significant underlying economic and political concerns, we believe the fluctuations in value due to foreign exchange rate movements should be considered when determining whether impairment is “minor”, because such fluctuations are not different than fluctuations due to changes in interest rates.

ATTACHMENT

Limiting the Notion of Minor Impairments to Debt Securities Evaluated for Impairment Pursuant to Paragraph 16 of Issue 03-1

Although paragraph 11 of the FSP currently allows the use of judgment in determining whether there is other-than-temporary impairment, we believe it would be desirable, but not essential, to apply the concept of “minor impairment” to all securities subject to Issue 03-1. Such a change is desirable because it would result in a single concept of minor impairment to be applied to all debt securities. A change is not necessary because we believe that the vast majority of AFS debt securities are addressed by paragraph 16 of Issue 03-1.

Although not all debt securities subject to the provisions of paragraph 11 are subject to the provisions of EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*,” securities that are subject to Issue 99-20’s impairment provisions should not also be subject to EITF 03-1. This constitutes double jeopardy, and there is no other instance in U.S. generally accepted accounting principles (GAAP) of which we are aware that subjects an asset to impairment testing under more than one accounting standard.

Sales of Other Than Temporarily Impaired Securities Identified As Held-For-Recovery (“Tainting”)

The Board has asked for input as to additional circumstances that would not call into question, when sales of held-to-recovery securities occur, the investor’s assertion that such securities would be held over a forecasted recovery period. For example, the Board has provided guidance that for debt securities that are impaired because of interest rate and/or sector spread increases and that are analyzed for impairment under paragraph 16 of Issue 03-1, the following circumstances would not necessarily call into question the investor’s ability or intent to hold other securities to recovery:

- Unexpected and significant changes in liquidity needs,
- 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,
- A de minimis volume of sales of securities, and
- The held-to-maturity classification non-tainting sales provisions, discussed in paragraphs 8 and 11 of Statement 115. (We have excerpted paragraphs 8 and 11 of Statement 115 at the end of this attachment.)

Citigroup agrees that the above circumstances should not taint future and existing assertions to hold impaired available-for-sale securities over a forecasted recovery period. We also recommend that changes in internal credit rating be included in this group. For example, an extensive analysis by a company’s internal risk management group indicates that certain securities suffered credit rating deterioration, but the securities have not been publicly downgraded. In that situation, it would be reasonable and prudent for management to reduce exposure by selling the security without triggering a tainting event.

We also believe that it is clearly reasonable to sell securities that have suffered a rating downgrade of even one notch.

Option to Mark Liabilities To Market

In a rising interest rate environment, Issue 03-1 will drastically impact asset/liability management practices in businesses that match the interest rate sensitivity (also referred to as immunization) of their assets and liabilities. For example, in our Life Insurance and Annuity businesses, asset portfolio cash inflows must support liability cash outflows. Portfolio managers are responsible for actively managing their asset portfolios to maintain this balance as the risk profiles (credit and interest rate) change through time. Oftentimes, a rebalancing will require sales of securities that have been historically classified as available-for-sale.

A rising interest rate environment, combined with the application of EITF Issue 03-1 will result in portfolio managers' needing to decide either to classify new security purchases as *trading*, with the associated changes in value recorded in earnings, or to retain an *available-for-sale* classification, with its associated impairment guidelines. These guidelines require that when impairment occurs, a decision must be made to record the impairment, but not subsequent recoveries, through earnings (effectively a lower-of-cost-or-market approach), or assert an intent to hold-to-recovery over a reasonable recovery period. Since these assets may need to be sold as part of rebalancing the portfolio's risk profile or duration or adjusting a hedge program, our portfolio managers will likely be forced to record the impairment and not assert a recovery period, because they cannot lose the flexibility to manage their portfolios.

The equally unattractive alternative is to assert hold to recovery periods – resulting in diminished liquidity and portfolio management flexibility. These restrictions would need to be explained to and considered by ratings agencies, regulators and other users of the financial statements. This action will produce an unrealistic earnings profile, primarily because U.S. GAAP does not permit a marking-to-market of the associated liabilities. Those liabilities have corresponding unrealized gains as interest rates increase. However, such gains cannot currently be recognized in earnings, resulting in net income that is totally unrelated to and misrepresents the underlying economic situation.

To resolve this issue, we ask that the Board consider permitting marking certain associated liabilities to market. We believe this action would be consistent with the Board's goal of requiring fair value accounting for all financial instruments. Moreover, systems and processes exist in practice to reliably perform the needed valuations. A one-time election to reclassify related AFS securities to trading, like the one permitted upon the adoption of Statement 133, would also be necessary.

Should the Board choose to pursue this request, we would be pleased to further describe the nature of the liabilities and to work with the Board to describe boundaries and develop appropriate disclosures so that users of financial statements can understand the underlying accounting.

Other Matters

Unit of Account Measures For Impaired Available-For-Sale Securities

The Board believes that an investor should assert its ability and intent to hold for a forecasted recovery period on an individual Statement 115, available-for-sale security level. The Board has asked if constituents agree with this conclusion.

We agree with the Board's conclusion, although we do not believe constituents should be either required or precluded from evaluating impairments at a more granular level than the security or CUSIP level. Impairment evaluation on a lot-by-lot basis or by separately managed portfolios should be permitted where such data is available.

Consequences of Tainting

The FSP is unclear with regard to the consequence when a tainting event occurs.

- Some organizations manage their investment portfolios on a decentralized basis across different legal vehicles. If based on the facts and circumstances, it is determined that a separately managed portfolio is tainted by unsupported sales of securities designated as hold-to-recovery in one segment of a large organization, would the "tainting" event in that portfolio affect or contaminate another portfolio of similar securities in another segment of the company with a different portfolio manager or investment objective or is the tainting limited to that portfolio? In a large decentralized organization such as Citigroup, we believe the consequence of tainting should be limited to the specific portfolio that violated its assertions.
- Also, once a tainting event occurs, how long does the taint last before new assertions of intent and ability to hold to recovery will be considered valid? Inappropriate sales of held-to-maturity securities under Statement 115 result in a two-year penalty period. Certainly, sales of held-to-recovery securities should not result in a more severe penalty.

Other Items Needing Clarification

- If an impaired security is still underwater at the end of a forecasted recovery period, are we required to make a new assertion of our intention to hold the security for a new recovery period or, if not, immediately recognize impairment? We believe it would be necessary to reassert our intent and ability to hold that security or immediately recognize an other-than-temporary impairment.
- Following on the example in the preceding paragraph, if no new recovery period is asserted and an other than temporary impairment loss is recognized in earnings thereby establishing a new cost basis in the security, would the security then be subject to the "minor" provisions of the standard? We believe that the security would be subject to the "minor" provisions of the standard and if the security were subsequently sold at a "minor" loss, that sale would not constitute a tainting event.
- It is not clear why the EITF thinks AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, should be applied subsequent to many impairments taken under Issue 03-1. The accrual of discounts on

ATTACHMENT

at least some securities addressed by Issue 03-1 is specifically discussed by other accounting literature – one example is FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, which addresses the accounting for high quality debt securities. The Board should either remove the “Day 2” guidance from Issue 03-1 or completely articulate the various alternatives that may apply.

**SFAS 115's Paragraph 8 and 11
HELD-TO-MATURITY SECURITIES**

8. The following changes in circumstances, however, may cause the enterprise to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances shall not be considered to be inconsistent with its original classification:

- a. Evidence of a significant deterioration in the issuer's creditworthiness.
- b. A change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income).
- c. A major business combination or major disposition that necessitates the sale or transfer of held-to-maturity securities to maintain the enterprise's existing interest rate risk position or credit risk policy.
- d. A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment or the maximum level of investments in certain kinds of securities, thereby causing an enterprise to dispose of a held-to-maturity security.
- e. A significant increase by the regulator in the industry's capital requirements that causes the enterprise to downsize by selling held-to-maturity securities.
- f. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes.

In addition to the foregoing changes in circumstances, other events that are isolated, nonrecurring, and unusual for the reporting enterprise that could not have been reasonably anticipated may cause the enterprise to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity.

11. Sales of debt securities that meet either of the following two conditions may be considered as maturities for purposes of the classification of securities under paragraphs 7 and 12 and the disclosure requirements under paragraph 22:

- a. The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable) that interest rate risk is substantially eliminated as a pricing factor. That is, the date of sale is so near the maturity or call date (for example, within three months) that changes in market interest rates would not have a significant effect on the security's fair value.

ATTACHMENT

b. The sale of a security occurs after the enterprise has already collected a substantial portion (at least 85 percent) of the principal outstanding at acquisition due either to prepayments on the debt security or to scheduled payments on a debt security payable in equal installments (both principal and interest) over its term. For variable-rate securities, the scheduled payments need not be equal.