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Letter of Comment No: 87
File Reference: EITF03-1A

Mr. Lawrence W. Smith
Director, TA&I - FSP
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Mr. Smith,

We appreciate the opportunity to provide comments on 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"*.

We are concerned that the guidance of paragraph 16 of EITF 03-1 is being interpreted to mean that an investor should apply the same "intent and ability to hold" language for the held-to-maturity category to securities that are classified as available-for-sale. We believe this is inconsistent with the current guidance in FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Specifically, paragraphs 9 and 10 of FAS 115 indicate that an entity may not classify a security as held-to-maturity if the security may be sold by the entity in response to various factors in managing assets and liabilities. These securities are generally classified as available-for-sale.

Insurance companies usually categorize their debt securities as available-for-sale because they may desire to sell them in the future to respond to market conditions, portfolio balancing, or asset liability management strategies. A company needs the flexibility to proactively respond to market changes because it cannot predict future market conditions and therefore cannot determine which assets will be sold in the future. The requirement to make such a forecast seems to contradict the requirements originally specified in FAS 115 for the available-for-sale category. Specifically, paragraph 82 of FAS 115 states that the available-for-sale category includes "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." Further, SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities,* cites intent and ability to hold until anticipated recovery as *one* factor that may be helpful in indicating whether a decline is other-than-temporary. SAB 59 acknowledges that there are "numerous factors to be considered in such an evaluation and their relative significance will vary from case to case."

We firmly believe that an other than temporary impairment categorization is inappropriate accounting treatment for price changes due solely to changes in interest rates because there is no credit risk. However, if it is probable that a loss will be incurred because the security is expected to be sold, we believe that an impairment should be recognized at that time that the decision to sell is made.

Further, accounting for interest related impaired securities will move accounting losses into realized losses only to be recycled back through net investment income under the guidance of SOP 03-3, "*Accounting for Certain Loans or Debt Securities Acquired in a Transfer.*" Specifically, SOP 03-3 requires determination of a new effective interest rate on impaired securities and accreting the difference between the written down value and the recovery value through net investment income using the interest method over the recovery period. Furthermore, in periods of rapidly rising interest rates, a series of successive impairments in realized losses and a recycling back through net investment income could occur. We believe that such accounting would produce more confusion (if not distortion) than transparency in the financial statements and lead to a proliferation of "non-GAAP" measures as users of the financial statements seek to understand the difference between interest-related and credit-related impairments.

Following are comments to the specific issues identified in the proposed FSP:

Issue 1: At what unit of accounting should an investor assert its ability and intent to hold to a forecasted recovery?

We agree that an investor should assert its ability and intent to hold to a forecasted recovery at the individual security level. However, it should be noted that this conflicts with the guidance in EITF 03-1 which states that "a pattern of selling investments prior to the forecasted recovery of fair value may call into question the investor's intent." The definition of a pattern is not addressed in the guidance. If this assertion of ability and intent is made at an individual security level, how does selling an individual security ever create a pattern?

Issue 2: Although Issue 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, paragraph 16 does not refer to the "severity" of the impairment. Is there a level of impairment that can effectively be considered temporary that would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery?

We agree that each company should prepare a qualitative analysis on what is considered to be "small/minor" as it relates to the severity of the impairment. If the severity of the impairment is small/minor, the impairment can effectively be considered temporary and should not call into question the investor's ability and intent to hold that investment. This notion of "minor" should be extended to all investments analyzed, not just to debt securities as described in paragraph 16.

We also believe that each company should prepare a qualitative analysis of what is considered to be a minor "pattern". If the "pattern" of selling investments is minor, the impairment can effectively be considered temporary and should not call into question the investor's ability and intent to hold that investment. Further, if the assertion of ability and intent is made at the individual security level, it would always be a "*pattern of one.*"

Issue 3(a): If an interest rate impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, when is the impairment considered other-than-temporary?

EITF 03-1 states that an impairment is triggered when there is no longer an "intent to hold" as opposed to when there is a "decision to sell." We believe this will be difficult to implement in practice. We believe that an impairment loss should only be recognized when it is probable that a loss will be incurred (i.e., when the decision to sell is made) which is in essence the guidance in Topic D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value.* This is consistent with paragraph 16(b) which specifically calls for "probable" losses to be recognized as other than temporary.

Issue 3(b): If an interest rate impaired and/or sector-spread-impaired security for which the investor previously had asserted its ability and intent to hold to a forecasted recovery is expected to be sold prior to recovery, are there circumstances for such a change in intent that do not call into question the investor's intent to hold other securities to recovery?

We agree that changes in circumstances, such as discussed in paragraphs 8 and 11 of FAS 115 and the additional three items added by the FSP should not call into question the investor's ability and intent to hold other securities to recovery. Specifically, the following circumstances should not call into question an investor's ability and intent to hold to recovery:

1. Evidence of a significant deterioration in the issuer's creditworthiness,
2. 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),
3. A major business combination or 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,
4. A change in statutory or regulatory requirements significantly modifying what constitutes a permissible investment or the maximum level of investment in certain kinds of securities, thereby causing an enterprise to dispose of a held-to-maturity security,
5. A significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes,
6. Unexpected and significant changes in liquidity needs,
7. Unexpected and significant increases in interest rates that significantly extend the period that a security would need to be held by the investor, and
8. A de minimus volume of sales of securities.

Following is one other circumstance we believe should not call into question the investor's intent to hold other securities to recovery:

- Changes in strategy/tax position because of a business combination.

Transition

We recommend that this guidance be effective for periods ending after January 1, 2006 to allow companies sufficient time to develop appropriate systems, controls and staff training. Implementation of the requirements for interest rate driven impairments will require significant interpretation as well as operational changes. The operational difficulties will be significant because of the severity of the "tainting" provisions and the loss of portfolio management flexibility.

Companies will have to design and implement a model to distinguish between different buckets of securities (i.e., those that we assert to hold and those we do not assert to hold) and also differentiate credit versus interest rate impairment factors via the investment accounting system. Daily price changes would need to be tracked so that the company would be able to determine the severity and duration of the price declines. Companies will also need to track sale rationale or strategies in the system to avoid tainting the portfolio.

Further, companies will have to design a model to forecast fair value recovery for securities for which it has asserted its intent and ability to hold. Companies will also be required to address how SOP 03-3 requirements interact with EITF 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*, requirements, including the methodology of amortization calculations. Specifically, system changes would have to be made to accommodate the accretion to an expected value, rather than to par value. Currently, systems will only allow accretion to a par value. Of additional concern to the insurance industry is the difference in accounting principles for GAAP and statutory (regulatory) reporting. We would need to address how the system changes noted above would impact the differences between statutory and GAAP reporting and address those system issues. Further, the FASB may learn through the comment process of various other implementation issues that may need additional clarification.

The short implementation period will hinder companies' abilities to implement this guidance effectively, especially in light of the competing priorities of year end closing efforts and required internal controls related efforts (i.e., Sarbanes Oxley). Therefore, since the implementation of this standard would cause significant system and process changes, the FASB should consider giving entities at least six to twelve months to implement the guidance. Further, we recommend that a one-time transfer to the trading category from the available for sale category be permissible in the period of adoption. Since the adoption of additional guidance on an accounting pronouncement is unusual, we believe that it should be an instance where a transfer to the trading category be allowed under paragraph 15 of FAS 115 similar to the transition provision of FAS 133, *Accounting for Derivative Instruments and Hedging Activities.*

We appreciate the opportunity to express our views. If you have any questions regarding our comments, please feel free to contact me at (860)277-7499.

Sincerely,

Paula Panik

Paula Panik

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FIAC

Financial Institutions Accounting Committee

October 27, 2004

Mr. Lawrence W. Smith
Director—Technical Application and Implementation Activities
and EITF Chair
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position No. EITF Issue 03-1-a

Dear Mr. Smith:

The Financial Institutions Accounting Committee (FIAC) is a group of 11 financial professionals working in executive level positions in the banking and thrift industries and is a standing committee of the Financial Managers Society. FIAC's primary responsibility is to evaluate those accounting and regulatory matters that affect financial institutions. The comments within this letter are representative of FIAC as a whole and do not necessarily reflect views of the individual institutions represented on the Committee.

We appreciate the opportunity to comment on the Proposed FASB Staff Position (FSP) No. EITF Issue 03-1-a. While we commend the Board and the FASB staff in its efforts to make much needed improvements to the consensus reached in Emerging Issues Task Force Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," we strongly believe that the consensus is flawed beyond repair and undermines the principles of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, with respect to securities classified as *available for sale*. Consequently, we believe that it should be rescinded in its entirety. If that is not the case, then we believe that it is essential for the Board to move forward with the guidance in the FSP in order to permit EITF 03-1 to be reasonably applied in practice.

EITF 03-1

Despite the Board's efforts to improve the consensus in EITF 03-1, we believe that the manner in which the guidance in paragraph 16 is being interpreted in practice would not apply the concept of *other-than-temporary* impairment fairly. Rather than considering the severity or duration of an unrealized loss (as suggested by SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*), an entity would need to assert its plans and ability to hold a debt security to recovery whenever an unrealized loss exists. Even if a security were held for a short period or the size of the loss was well within the range of normal price volatility, a positive assertion to hold that security to recovery would be required to avoid an impairment loss. For companies that have significant portfolios of such securities and use them to manage risks associated with interest spreads between loan portfolios and funding sources or mortgage servicing rights, such a requirement would inflict a heavy operational burden and significantly limit the use of such securities for risk mitigation purposes. Consequently, we fear that companies might be forced to assume more risk by maintaining smaller portfolios of risk mitigating securities, which is a result that would not bode well for the banking industry.

We believe that the consensus in EITF 03-1 is inconsistent with and redefines the notion of *other than temporary* impairment provided in Statement 115. Statement 115 requires marketable debt and equity securities to be reported at fair value. For securities classified as *available for sale*, unrealized losses are required to be recognized in Other Comprehensive Income. As such, readers of financial statements already are well informed of any unrealized losses in the value of those securities. In our opinion, the focus of *other than temporary* impairment should be to flow through earnings only those losses that are probable of not being recovered in the foreseeable future. We believe that the consensus in EITF 03-1 fails to achieve that result.

The consensus in EITF 03-1 does not require a company to seek evidence of a probable loss (e.g., severity and duration) before being recognized. Instead, it requires an assessment whenever an unrealized loss exists, which represents a much lower threshold. Further, the consensus does not allow a company to consider whether an unrealized loss might recover in the foreseeable future (e.g., whether the loss is within the range of normal price volatility). Finally, the consensus requires a company to recognize the entire existing unrealized loss rather than only the portion expected to be realized, giving no consideration to any future expected recovery in value.

In substance, we believe that the consensus in EITF 03-1 represents an amendment to Statement 115. Accordingly, it should be subjected to the more thorough consideration process required for a change to an existing accounting pronouncement. If the consensus is not rescinded, then below are our comments regarding the much needed modifications proposed in the FSP.

Impairment that is Minor in Nature

We support a change that would spare companies the burden of having to declare and monitor their intentions and ability to hold securities for minor unrealized losses until recovery. Assessing minor unrealized losses for *other than temporary* impairment creates a heavy operational burden in which the costs far outweigh the benefits. In addition, we do not support the use of a bright-line test (e.g., five percent) to determine whether an unrealized loss is minor unless such a test is used only as a minimum safe harbor. We are concerned that a pure bright-line test would not be appropriate in every situation.

Application of FSP to Paragraph 10

We believe that the modifications proposed for paragraph 16 also should apply to paragraph 10 of the consensus for EITF 03-1. The costs of evaluating small unrealized losses in equity or prepayable securities for *other than temporary* impairment also outweigh the benefits. As noted above, such securities already are recorded at fair value with any unrealized losses recognized in Other

Comprehensive Income. Consequently, those losses should be transparent to the readers of the financial statements and the benefits of recognizing such losses in earnings would be minimal.

Sales that Would not Indicate a Lack of Intent to Hold Securities to Recovery

We strongly support the guidance in Question 3(b) of the proposed FSP. In today's rapidly changing economic conditions, companies cannot be expected to anticipate unusual changes in liquidity needs or interest rates. Consequently, it might be necessary for a company to sell securities previously designated for sale even though the original intent to hold was valid at the time it was made (and would have continued to be valid were it not for the occurrence of an unusual change in economic or market conditions). We also believe that unanticipated isolated sales should not taint a company's ability to assert its intention to hold other securities to expected recovery. Such a stringent application of the consensus would be punitive and would not result in significant benefits to readers of financial statements.

Summary

We seriously question whether the benefits of the consensus in EITF 03-1 truly outweigh the costs of application. The operational burden of evaluating a security every time it incurs an unrealized loss, evaluating whether a positive assertion can be made regarding the company's ability to hold it to recovery, and then monitoring the status of that security will be costly. In addition, there will be added costs to track and amortize back into income any discount recorded for *other than temporary* impairment.

Available for sale securities already are recorded at fair value and unrealized losses already are recognized in Other Comprehensive Income. Consequently, the recognition of *other than temporary* impairment amounts to little more than a reclassification in equity between Other Comprehensive Income and Retained Earnings on the balance sheet. Guidance already exists regarding the recognition of *other than temporary* impairment and companies have been recognizing *other than temporary* impairment under that guidance. Therefore, we believe that the incremental benefits of this approach are minimal at best.

We also believe that EITF 03-1 undermines and effectively amends the guidance in FAS 115 with respect to *other than temporary* impairment. Consequently, the Board should apply the proper process for considering an amendment to an existing accounting standard.

If the Board refuses to rescind EITF 03-1, then we believe that the changes proposed in the FSP are essential for the fair application of the consensus and support the proposed FSP.

Very truly yours,

Bill Nunan

Bill Nunan
Chairman
Financial Institutions Accounting Committee