



Letter of Comment No: 151
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October 29, 2004

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

By email to: director@fasb.org

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

Dear Mr. Smith:

As a diversified financial institution with approximately \$1.8 billion in available-for-sale and held-to-maturity securities, First Horizon National Corporation appreciates the opportunity to comment on the Proposed FASB Staff Position No. 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"* (respectively the "Proposed FSP" and "EITF 03-1"). We believe that EITF 03-1 does not adequately address the issues associated with other-than-temporary impairment of investments in debt and equity securities. Further, we believe that EITF 03-1 could be interpreted as changing the current accounting requirements of Statement of Financial Accounting Standards No. 115, *Accounting for Investments in Debt and Equity Securities* ("SFAS 115"), and Staff Accounting Bulletin No. 59, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities* ("SAB 59") rather than solely providing additional guidance regarding the recognition of other-than-temporary impairment.

The Proposed FSP's attempt at clarifying the guidance of EITF 03-1 is a positive step for ensuring that interpretations of EITF 03-1 are consistent between preparers, auditors and users of financial statements. However, we believe that enhancements can be made to the Proposed FSP to ensure a more appropriate presentation of financial statements. As a result, we request that the guidance of the Proposed FSP be revised in consideration of the following comments.

Asset-Liability Management

We believe that the guidance of EITF 03-1 fails to consider the basis for creation of the available-for-sale classification when SFAS 115 was developed. As reproduced below, SFAS 115 indicates that the primary reason for creation of the available-for-sale classification was to ensure that changes in value of such securities should not be recognized through earnings because similar changes in the value of interest-rate sensitive liabilities (e.g., time deposits) were not recognized through earnings. If changes in the value of assets were

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recognized through earnings but no similar changes were recognized for changes in the value of liabilities, the resulting financial statements would not be internally consistent and therefore would provide reduced value to users.

54. Because the Board was unable to develop a workable approach for identifying specific related liabilities and determining their fair value once identified, it decided not to require that all investments in debt securities be reported at fair value and, in replacing the LOCOM method with fair value for certain securities, decided not to include their unrealized changes in fair value in earnings. Instead, the Board agreed to an approach that would introduce more fair value into the financial reporting for investments in debt and equity securities but not change the valuation of related liabilities. The Board believes that the approach in this standard is appropriate because it is built on existing practice, which does not involve the valuation of liabilities.

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 no liabilities, in earnings, the Board determined that the unrealized holding gains and losses for available-for-sale securities should be excluded from earnings.

In assessing the impairment of available-for-sale securities for a financial institution, it must be noted that reductions in value solely due to interest rate movements are offset through similar increases in value for interest bearing liabilities. Since an acceptable model for determination of the fair value of liabilities has not been addressed by the FASB, we believe that any requirement to recognize other-than-temporary impairment on available-for-sale investment securities solely due to changes in interest rates is not consistent with the FASB's reasoning in creation of the available-for-sale classification and results in a flawed financial reporting model for such securities. However, this accounting treatment was partially implemented as part of SFAS 115's requirement to address other-than-temporary impairment for available-for-sale securities. Now, as EITF 03-1 attempts to "clarify" the definition of other-than-temporary impairment, it appears that an attempt to move closer to fair value accounting for investment securities, but not interest-rate sensitive liabilities, is being made.

Management Intent

In reviewing the guidance of Question 3(a) of the Proposed FSP, we believe that it contains a change in accounting related to management's intent regarding impaired securities. As presented in SFAS 115, only those securities for which management has the ability and intent to hold to maturity should be classified as held-to-maturity. Securities that are acquired principally for the purpose of a future sale should be classified as trading securities. All other securities should be classified as available-for-sale. We believe that this indicates that management has neither the intent to sell nor the intent to hold such securities to maturity. As discussed above, this classification was created because financial institutions use available-for-sale securities to manage interest rate risk associated with interest rate sensitive liabilities and/or balance sheet mix as driven by customer preferences.

It is our understanding that Question 3(a) would require recognition of other-than-temporary impairment at the point that management no longer positively asserts its intent to hold an impaired available-for-sale security to an expected recovery. This is a significant change from existing guidance as presented in the FASB's Staff Implementation Guidance, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and*

Equity Securities: Questions and Answers (the "Staff Guide") and EITF Topic D-44, *Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value* ("Issue D-44"). The applicable sections of each are presented below.

Staff Guide

47. Q – Should an enterprise recognize other-than-temporary impairment when it decides to sell a specific available-for-sale debt security at a loss shortly after the balance sheet date?

A – Generally, yes, if the enterprise does not expect the fair value of the security to recover prior to the expected time of sale. In that case, the write-down for other-than-temporary impairment would be recognized in earnings in the period in which the *decision to sell* is made, not the period in which the sale occurs.

Issue D-44

The FASB staff has been asked whether an entity should recognize other-than-temporary impairment when it intends to sell a specifically identified available-for-sale debt security at a loss shortly after the balance sheet date. The decline in the security's value may be due to an increase in market interest rates since acquisition, a deterioration in the issuer's creditworthiness, or a change in foreign exchange rates.

The FASB staff believes that when an entity has decided to sell an available-for-sale security whose fair value is less than its cost basis and the entity does not expect the fair value of the security to recover prior to the expected time of sale, a write-down for other-than-temporary impairment should be recognized in earnings in the period in which the decision to sell is made.

The staff also notes that an entity's decision to sell a security is only one of the circumstances that needs to be considered in determining when an other-than-temporary impairment exists.

Both the Staff Guide and Issue D-44 clearly indicate that a decision to sell is the appropriate time for recognition of other-than-temporary impairment for securities. While Issue D-44 indicates, consistent with the SAB 59, that other circumstances should be considered in evaluating whether an impairment is other-than-temporary, when considered *vis-à-vis* the basis for available-for-sale classification (i.e., management is using the security to mitigate interest rate risk) a positive decision to sell is the most appropriate time for recognition of any associated impairment for available-for-sale securities. At the point a decision to sell is made, management no longer has the intent to utilize the security in its future interest rate risk mitigation processes. Recognizing impairment on available-for-sale securities solely because management is no longer able to positively assert its intent to hold to an expected recovery fails to note that a security classified as available-for-sale was never represented as being held for any specific period of time (i.e., the security is **available for sale**, not intended for either sale or holding to maturity from the date of acquisition). (See our comments below regarding situations in which it may become necessary for management to declare its intent regarding available-for-sale securities.) Rather, these securities are used to offset balance sheet exposure related to interest rate sensitive liabilities.

In order to reflect the economic use of available-for-sale securities, we submit that a more appropriate measure of management's intent is whether the securities are intended for future

mitigation of interest rate risk rather than management having the intent to hold until a forecasted recovery. This is consistent with a decision to sell being the trigger point for recognition of impairment through earnings because a decision to sell reflects a lack of intent to use a security in future interest rate risk mitigation strategies. We support the continued application of the ability to hold the security as a requirement for available-for-sale impairment considerations since such ability is necessary for management to utilize a security in its risk management processes.

Minor Impairments

We support the concept that certain levels of impairment are sufficiently small so as to preclude the necessity of considering management's intent to hold the security to recovery or maturity. However, we believe that this exemption would be more reasonable if it included the normal cycle of interest rate movements. To the extent that fluctuations in conjunction with the normal cycle of interest rates result in impairments in the value of securities, management should not be required to positively assert its intent to hold to recovery or maturity. If interest rates move outside of historical bands, such an assertion should be required. This is consistent with the use of available-for-sale securities to mitigate interest rate risk. When interest rates shift outside of historical bands, management's interest rate risk mitigation strategies may be changed to reflect the unique interest rate environment.

As currently presented, the Proposed FSP indicated that the concept of "minor impairment" would be limited to debt securities that cannot be contractually prepaid in a manner resulting in an investor failing to recover its cost. We believe that, if retained in its proposed form, the concept of "minor impairment" should be extended to all equity and debt securities. Equity securities and debt securities that can be contractually prepaid in a manner resulting in an investor failing to recover its cost are also subject to fluctuations that are minor in nature. These normally are the result of general market or sector valuation movements that may or may not reflect on the true value of the underlying business. Decisions regarding recognition of other-than-temporary impairment under a "minor impairment" concept should be made when these fluctuations are outside the historical volatility of the applicable security price.

Similar to the interest rate cycles effect on the valuation of debt securities, general market movements result in significant effects in the valuation of equity securities. As seen in the most recent bear market, these fluctuations can extend for multiple years and exceed 30% for a business whose underlying operations are otherwise unchanged. As market valuations have recently increased, many equity securities have recovered their values, which we believe is indicative that equity securities, by their nature, require an extended time horizon for recognition of impairment. Therefore, we believe that a "minor impairment" concept for equity securities should also incorporate consideration of general equity market movements within its framework.

Tainting

Question 3(b) of the Proposed FSP provides three situations (in addition to those detailed in paragraphs 8 and 11 of SFAS 115) in which a sale of impaired debt securities would not call into question management's intent regarding debt securities remaining in the available-for-sale portfolio. These include 1) unexpected and significant changes in liquidity needs, 2) 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 an investor, and 3) a *de minimis* volume of sales of securities. Based on this guidance, a sale of impaired debt securities in response to the occurrence of a previously anticipated increase in interest rates would "taint"

the remainder of the available-for-sale debt securities portfolio. We believe that this is inconsistent with the original intent for the creation of the available-for-sale classification. As discussed above, the available-for-sale classification was created because recognizing changes in value for interest-rate sensitive assets, but not interest-rate sensitive liabilities, through earnings would result in internally inconsistent financial statements.

When a financial institution sells an impaired debt security, it is often in response to specific movements of interest rates after these movements have occurred. Management regularly projects interest rate movements, but no company has the ability to know with a high degree of certainty the actual timing, magnitude or even direction of those movements. Simply put, there are too many external, non-controllable factors that affect interest rates. The inherent uncertainty involved with predicting interest rate changes results in "unexpected" increases in interest rates being very difficult to evaluate. For this reason, we believe that "unexpected" should be removed from the second criterion of the Proposed FSP's Question 3(b). This is consistent with our previously stated view that a decision to sell a security is the appropriate time for recognition of impairment through earnings. Once a significant increase in rates is experienced, management may well decide to sell certain securities, at which point any impairment would be recognized through earnings.

Additionally, since an investment portfolio is constructed over time, there are multiple tiers (based on the fixed rate in existence at acquisition) and types (e.g., fixed or floating rate) of securities within the portfolio. Given their different acquisition dates, some fixed rate securities may have a greater impairment due to interest rate increases than others. Upon occurrence of an interest rate movement, the sale of a security within one tier or type should not cast doubt on other tiers and types of debt securities remaining in the portfolio, which may or may not be sold in the future. Given these considerations, we believe that the Proposed FSP should be revised to indicate that only securities with characteristics similar to those being sold should be considered for potential "tainting". Dissimilar securities should not be subject to a "tainting" evaluation (which could require them to also be marked to fair value through earnings). Essentially, this is a "facts and circumstances" determination of whether a sale of securities at a loss results in tainting of the remainder of the investment securities portfolio.

Perpetual Preferred Stock

In reviewing paragraph 10 of EITF 03-1, we noted that certain instruments having many of the characteristics of debt securities, but which are considered equity securities by the issuer under the guidance of Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, would be considered equity securities for purposes of evaluating whether an impairment is other-than-temporary. Thus, paragraph 16 of EITF 03-1 would not apply to these investments. These securities include perpetual preferred stock issued by the Federal National Mortgage Association ("FNMA") and Federal Home Loan Mortgage Corporation ("FHLMC"). Presented below are the relevant descriptions of the key attributes of the perpetual preferred shares issued by FNMA and FHLMC which have been reproduced from their most recent Form 10-K filings.

FNMA

In general, our preferred stock has no par value, has a stated value and liquidation preference of \$50 per share, and is not convertible or exchangeable for any of our other stock or obligations. Holders of preferred stock are entitled to receive noncumulative, quarterly dividends when, and if, declared by our Board of Directors, but will have no right to require redemption of any shares of preferred stock. Payment of dividends on preferred stock is not mandatory, but has priority over payment of dividends on common stock. After a specified period, we have the option to redeem preferred stock at its stated value. All outstanding preferred stock is nonvoting.

FHMLC

During 2002, Freddie Mac completed one preferred stock offering, raising approximately \$300 million All 17 classes of preferred stock outstanding at December 31, 2002 have a par value of \$1 per share, and are redeemable, on specified dates, at the company's option at their redemption price (or redemption value) plus dividends accrued through the redemption date. In addition, all 17 classes of preferred stock are perpetual and non-cumulative and carry no significant voting rights or rights to purchase additional Freddie Mac stock or securities. Costs incurred in connection with the issuance of preferred stock are charged to "Additional paid-in capital."

From an investor's perspective, these preferred shares are more closely related to debt securities than equity securities. While the primary characteristics requiring treatment as equity by the issuer are the perpetual nature of the shares and the non-cumulative dividend, an investor receives a liquidation preference, a stated redemption value equal to original issue price, and a dividend preference. These rights are more consistent with the status of an unsecured debt holder rather than an equity holder. Further, an investor has no significant voting rights or rights to purchase additional stock or securities of the issuer. The lack of voting rights and inability to avoid dilution of ownership interest are inherently inconsistent with the concept that an investor is holding a meaningful equity interest in an issuer.

When electing to invest in perpetual preferred stock of FNMA or FHMLC, financial institutions value the shares to be acquired based upon methodologies consistent with those used for investments in debt securities (e.g., interest rate risk, projected cash flows, credit risk). Therefore, interest rate movements can be the sole cause of a decline in value of the securities, resulting in impairment of the preferred shares. Upon review of the offering circulars for all FNMA and FHMLC perpetual preferred stock issuances, we noted that every publicly traded issuance since 1997 received investment-grade debt ratings from Standard & Poor's and/or Moody's. This clearly indicates that both FNMA and FHMLC understand that investors view the perpetual preferred stock as a form of debt security rather than an equity security.

Given these facts, we believe that paragraph 10 of EITF 03-1 should be modified to indicate that the phrase "contractually prepaid or otherwise settled in such a way that the investor would not recover substantially all of its cost" is applied to both equity and debt securities. Under this expansion, investors paying amounts over redemption value for perpetual preferred stock would still be compelled to meet the "substantially all" threshold before qualifying for use of paragraph 16. However, investors acquiring perpetual preferred stock at or below redemption value would qualify for paragraph 16 without further analysis because redemption of the securities would ensure recovery of the original cost basis.

If expansion of the "substantially all" concept to all equity securities is not acceptable, we propose that preferred shares classified as equity by the issuer should be evaluated based on the facts and circumstances of individual situations to evaluate the relevance of paragraph 10 with respect to positions held by an investor. If it is possible for an investor to recover "substantially all" of its cost upon redemption of the preferred shares, paragraph 10 should not be applicable.

Held-to-Maturity Considerations

If a specific debt security is significantly impaired due to interest rate increases, it is conceivable that EITF 03-1 could require management to assert that it intends to hold certain available-for-sale debt securities until their maturity because a recovery of interest rates is not probable (due to the severity of the rate increase). Given the guidance of SFAS 115, if management has the intent to hold a security to maturity, then those securities should be classified as held-to-maturity and accounted for using amortized cost. However, management's true intent regarding the securities (e.g., mitigation of interest rate risk) has not changed. Therefore, the current guidance of EITF 03-1 could be interpreted to effectively compel the increased use of the held-to-maturity classification for debt securities despite the fact that the economic use of the securities has not been altered.

Effective Date

Given the significant nature of potential changes to current accounting under SFAS 115 and SAB 59, we believe that the effective date of EITF 03-1 should be deferred until 2005. Since there has been significant confusion regarding the actual requirements of EITF 03-1, we have experienced significant difficulty in determining the appropriate revisions, if any, to make in our internal control procedures. If EITF 03-1 is made effective on December 31, 2004, then its provisions must be included in our 2004 internal control assertion despite the fact that we may only have thirty to sixty days to implement and test any required control environment revisions. We do not believe that this is a sufficient amount of time to obtain a high degree of assurance that all internal accounting and reporting processes are functioning in an acceptable manner. Therefore, we believe that the effective date of paragraphs 10 through 20 of EITF 03-1 should be deferred until 2005.

If you have any questions or comments regarding the positions presented in this letter, please contact me at (901) 537-1937.

Sincerely,

/s/ Shawn P. Luke

Shawn P. Luke
Manager-Accounting Research
First Horizon National Corporation