



MERCANTILE BANKSHARES CORPORATION

October 1, 2004
Letter of Comment No: 157
File Reference: EITF03-1A

Mr. Lawrence Smith
Director and Chairman of the Emerging Issues Task Force
Financial Accounting Standards Board
401 Merrit 7
Norwalk, CT 06856

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,

The Mercantile Bankshares Corporation appreciates the opportunity to comment on the proposed Staff Position, issued on September 15, 2004 by the Financial Accounting Standards Board (FSP EITF Issue 03-1-a). Mercantile Bankshares Corporation (Bankshares) is a \$14 billion multi-bank holding company headquartered in Baltimore, Maryland. Our investment securities portfolio held as available-for-sale exceeds \$3 billion and will be directly affected by this proposed guidance.

We would like to express our appreciation to the FASB for delaying the effective date of this guidance and your willingness to take more time to consider the views of the banking industry.

Before addressing the specific issues outlined in Proposed FSP EITF Issue 03-1-a, we are requesting that the Emerging Issues Task Force reassess the guidance provided in EITF 03-1. It is our firm belief that debt securities held in the available for sale portfolio should not be written down with changes in market values that are due solely to increases in interest rates. In our view, interest rate movements by their very nature are always temporary. The result of this proposal will cause increased income and capital volatility by requiring permanent write-down of securities that are deemed impaired and subsequently generates incorrect recognition of revenue. Additionally, it will restrict Bankshares ability to practice day-to-day, prudent balance sheet and interest rate risk management activities.

The fact that an obligation of the United States Government would be deemed impaired and written-down in value is difficult to comprehend. If an entity has liquidity needs that will force it to sell securities at a loss, current reporting guidelines would require such to be disclosed in the issuer's discussion on capital and liquidity needs. Proper disclosure would cover any potential change to future earnings and the impact on capital. For high quality debt securities where there is no concern as to the issuer's ability to meet its contractual obligations, focusing on disclosure rather than taking impairment write-downs for transactions that may or may not actually happen seems more appropriate.

The current proposal modifies and overrules existing generally accepted accounting principles included in SFAS 115 and is inconsistent with EITF 03-3. When SFAS 115 was developed, the decision was made to expand to three categories to allow for flexibility that financial institutions and other organizations need with regard to balance sheet management. The utilization of lower of cost or market accounting for other than temporarily impaired securities is inconsistent with existing GAAP in SFAS 115 and EITF 03-3.

As stated earlier, Bankshares is a multi-bank holding company. Our \$3 billion available-for-sale portfolio is spread among 13 banks. It is not uncommon for these banks to own primarily the same security, but because the security was purchased at various times, with a different book value. We could have a security

deemed other-than-temporarily impaired at one bank and not at another. When impairment of a security is a result of purely a movement in interest rates, do we measure impairment in the aggregate or individually? Conceptually, we find it illogical to write-down a security for other-than-temporary impairment at one bank while the same security is not written-down at another bank because it passes a de minimus test or may even have a gain.

The proposal hinders bank's ability to practice prudent investment portfolio management. The available for sale portfolio is the primary tool with which we hedge the durations of our financial assets and liabilities. Banks need the flexibility to sell securities classified as available for sale at a profit or loss without risking the write-down of other securities in the AFS portfolio. The accounting risk of a write-down should not impede the appropriate economic decision to sell. Current GAAP includes the AFS classification to allow the necessary flexibility to manage interest rate risk.

The Board requested comments on FSP EITF Issue 03-1-a regarding "minor impairments" Issue 1. We believe that principles based accounting should apply to the determination of minor impairment rather than rules based accounting. The determination of minor impairment should be based on the facts and circumstances surrounding the specific security being evaluated for impairment. Current guidance exists for the evaluation of credit ratings, interest payment history, and the ability to repay as examples of factors that could cause a security to be other than temporarily impaired. A "bright-line" test of 5 percent or less is woefully inadequate. The chart below reflects the range of price changes in U.S. Treasury securities for the ten year-end periods of 1993-2003.

	+/- Price Change		
	Minimum	Maximum	Average
2 Yr Treasury	0.04%	6.38%	2.26%
3 Yr Treasury	0.06%	7.89%	3.32%
5 Yr Treasury	1.00%	9.00%	5.33%
7 Yr Treasury	0.07%	12.70%	7.04%
10 Yr Treasury	0.90%	18.00%	9.66%

By applying a 5% test, every security with a duration of 2 years and over runs the risk of being impaired at some point and on average any security over 5 years duration could be consistently impaired. This would suggest that banks should not purchase anything but US Treasury securities less than 2 years in duration to avoid to the possibility of impairment.

Additionally, different security types have various ranges of price volatility as their duration lives are significantly impacted by prepayments. For example, a CMO with a current effective duration of 3.6 years versus a U.S. Treasury with a 3.6-year effective duration could have the following price movements as rates rise or fall:

	CMO		U.S. Treasury	
	Price Change	Duration	Price Change	Duration
-50 Basis Points	2.92%	1.87 yrs	1.80%	3.60 yrs
Flat Rates	0.00%	3.60 yrs	0.00%	3.60 yrs
+100 Basis Points	-4.01%	4.34 yrs	-3.60%	3.60 yrs
+200 Basis Points	-8.21%	4.55 yrs	-7.20%	3.60 yrs
+300 Basis Points	-12.33%	4.61 yrs	-10.80%	3.60 yrs

Price volatility of differing securities can be evaluated by financial statement preparers and used to support the facts and circumstances underlying the temporary nature of interest rate movements on specific securities. Therefore, we do not support including additional guidance or a numerical threshold to be used in determining whether an impairment is minor.

The Board also requested comments on FSP EITF Issue 03-1-a regarding "limiting the notion of minor impairments to debt securities" Issue 2. We support the notion of "minor impairments" that would not create the need for an ability and intent assertion to debt securities analyzed for impairment under paragraph 16 that are impaired because of interest rate and/or sector spread increases, since, absent a sale prior to recovery or maturity, such impairments would be recovered. We also believe that the exclusion should be extended to securities that can be contractually prepaid or otherwise settled. The issue is whether the investor would recover substantially all of its cost for debt securities with prepayment features or equity securities. Authoritative literature exists under SAB 59 to cover impairment analysis of equity securities.

Mortgage-backed, asset-backed and other securities that can be prepaid that were purchased at a premium could be considered other than temporarily impaired if interest rates remain at levels above those at the purchase date. Effectively, there could be instances where these securities would never recover to their original price level. However, the premium impairment is addressed through current GAAP by amortizing the premium over the expected life of the security. If the security is held to maturity, the yield to maturity that was expected at purchase date will be obtained. If the security is sold before price recovery, a loss is recorded through the income statement. This scenario would be no different for a Treasury security that was purchased at a premium and yet the interpretive guidance would treat the accounting for impairment of these securities differently. Additionally, normal price volatility of these securities may eliminate the impairment altogether and should be included in the analysis of impairment for these types of securities.

The guidance provided for Question 3(b) should be expanded. Question 3(b) states "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 period is expected to be sold prior to recovery, are there circumstances for such a change in ability or intent that would not necessarily call into question the investor's ability or intent to hold other securities to recovery?" We would propose the following circumstances be allowed:

- a. Changes in liquidity needs
- b. Increases in interest rates and/or sector spreads that significantly extend the period that a security would need to be held by the investor,
- c. Documented asset/liability management actions taken with regard to securities
- d. Portfolio restructuring

Management of interest rate risk embedded in the balance sheet is heavily dependent upon the ability to restructure the investment portfolio. The table below demonstrates an example of how securities would be sold to effect a balance sheet strategy.

In year 1 the duration of the balance sheet structure is neutral, i.e. neither asset-sensitive nor liability sensitive.

	<u>Balance</u>	<u>Duration Years</u>
AFS Investments	\$ 500	2.5
Loans	1,000	1.0
Total Assets	<u>\$ 1,500</u>	<u>1.5</u>
Liabilities	<u>\$ 1,500</u>	<u>1.5</u>
Sensitivity		<u>0</u>

The AFS investment portfolio is structured as follows:

<u>Balance</u>	<u>Duration</u>	<u>Life</u>
\$ 100		0.5
100		1.5
100		2.5
100		3.5
100		4.5
<u>\$ 500</u>		<u>2.5</u>

In year 2, loan and deposit growth change the structure of the balance sheet.

	<u>Balance</u>	<u>Duration</u>	<u>Years</u>
AFS Investments	\$ 500		2.50
Loans	1,200		1.25
Total Assets	<u>\$ 1,700</u>		<u>1.62</u>
Liabilities	<u>\$ 1,700</u>		<u>1.5</u>
Sensitivity			<u>0.12</u>

In order to restructure the balance sheet to a neutral position the AFS investment portfolio would need to have a duration life of 2.1 years. To effect this rebalancing, \$100 of the 4.5-year duration securities would be sold and reinvested in securities with a 2.5-year duration life.

<u>Balance</u>	<u>Duration</u>	<u>Life</u>
\$ 100		0.5
100		1.5
200		2.5
100		3.5
-		4.5
<u>\$ 500</u>		<u>2.1</u>

This transaction would restructure the balance sheet to a neutral position.

	<u>Balance</u>	<u>Duration Years</u>
AFS Investments	\$ 500	2.10
Loans	1,200	1.25
Total Assets	<u>\$ 1,700</u>	<u>1.50</u>
Liabilities	<u>\$ 1,700</u>	<u>1.50</u>
Sensitivity		<u>0</u>

If interest rates had increased 150 basis points since the 4.5-year duration securities were purchased, a realized loss of \$6.75 would be incurred on the sale of \$100. If these securities had been designated as other-than-temporarily impaired, this transaction could potentially taint other securities in the AFS portfolio. Banks must have the flexibility to restructure the investment portfolio in order to manage the interest rate risk position of the balance sheet. Therefore we believe that an exception for risk management strategies should be included in the guidance.

Finally, if the Financial Accounting Standards Board deems it necessary to change current accounting and disclosure practices as drastically as the current proposal would entail, we ask that implementation be delayed to fiscal years beginning after December 15, 2005. We are still waiting on our investment portfolio accounting systems vendor to deliver changes to the software that will facilitate current disclosure requirements. The potential accounting changes are not simplistic and in order to meet a December 31, 2004 deadline, we would probably have to violate some of our disclosure and accounting controls that must be tested under Sarbanes/Oxley. We believe there is a high degree of risk with such a short implementation period.

Again, we appreciate the opportunity to comment on this proposal. Thank you for considering our views. If you would like to discuss this letter in more detail, please contact Kaye Simmons at (410) 237- 5799.

Sincerely,

Kaye Simmons, Senior Vice President & Treasurer
Terry Troupe, Executive Vice President & Chief Financial Officer