



Joseph L. Sciafani
Executive Vice President and Controller

Letter of Comment No: 144
File Reference: EITF03-1A

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 Financial Accounting Standards Board ("FASB") Staff Position No. Emerging Issues Task Force ("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:

JP Morgan Chase ("JPMC" or the "Firm") appreciates the opportunity to comment on the FASB's 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"* ("FSP"). JPMC currently manages several proprietary investment portfolios affected by the proposed FSP including a \$60 billion dollar available-for-sale portfolio composed of very high-credit grade securities used primarily to manage the structural interest rate risk exposure of the Firm.

JPMC applauds the FASB recognizing that the guidance provided in EITF 03-1 as currently drafted does not provide an adequate framework in determining if other-than-temporary impairment exists for debt securities possessing little or no underlying credit risk. The Firm also appreciates the FASB providing the broad based deferral of EITF 03-1 until many of these issues can be appropriately addressed.

Our letter is divided into the following three sections:

- The first provides background related to the use of available-for-sale portfolios by financial institutions as part of their risk management activities.

- The second highlights our overall concerns with the proposed guidance and why we believe the current accounting model relating to other-than-temporary impairment is sufficient.
- The third provides specific comments on the proposed FSP and its transition provisions.

Background Information

As part of the management of the Firm's structural interest rate risk, JPMC maintains and actively manages a large available-for-sale portfolio of high credit-grade securities (predominantly U.S. Treasuries and agency mortgage-backed securities). The Firm is exposed to continually changing interest rate profiles through the fluctuation of customer loans, deposits, financings and other transactions which create or reduce interest rate risk. Using an available-for-sale securities portfolio consisting of highly liquid and high credit-grade securities provides our Firm an efficient means to manage this risk.

Given the Firm's continually changing balance sheet, repositioning the security portfolio – through purchases and sales of securities – is often necessary to manage interest rate risk exposure. Two examples of events that would require the Firm to sell securities from the available-for-sale portfolio include:

1. a change in the interest rate profile of the Firm's asset and liability composition (such as an increase in fixed-rate loans extended by the Firm or the extinguishment of fixed-rate debt); and
2. an increase in interest rates causing the Firm to experience less, or slower, prepayments on interest bearing assets such as fixed rate home mortgages. This lengthening of the "duration" of these loans creates an incremental risk position for the Firm to manage.

Securities are sold in these situations to maintain duration neutrality, or stated differently, to maintain the appropriate economic hedge against the changing interest rate risk position of the Firm. The Firm's historic practice has been to maintain an appropriately sized available-for-sale portfolio to adequately risk manage Firmwide structural interest rate risk, regardless of whether interest rates are increasing or decreasing.

By appropriately accounting for our portfolio as available-for-sale we are able to achieve accounting symmetry as the interest rate exposure we are managing originates from assets and liabilities that are primarily accounted for on an accrual basis; neither the underlying assets/liabilities nor the available-for-sale securities are marked to market through the income statement. The Firm believes this accounting symmetry provides the most useful and transparent results for users of our financial statements. Furthermore, the value of the available-for-sale securities is recorded in stockholders' equity and is transparently disclosed to the readers of the financial statements.

JPMC's approach is not unique as many sizeable financial institutions use available-for-sale portfolios in a similar manner as part of their core interest rate risk management activities.

Overall Concerns

Current Accounting Model is Sufficient

Overall, we strongly believe the current accounting framework relating to other-than-temporary impairment, as it specifically relates to available-for-sale securities, provides the most transparent accounting without incurring the unnecessary operational burden of applying EITF 03-1. Both Statement of Financial Accounting Standards ("Statement") No. 115 and SEC Staff Accounting Bulletin ("SAB") Topic 5.M. provide clearer guidance than EITF 03-1 when considering the nature and severity of impairment in determining whether other-than-temporary impairment exists. EITF Topic D-44 also supplements the guidance in Statement No. 115 and SAB Topic 5.M. by effectively requiring management to affirm their intent as of each balance sheet date as it relates to future sales of securities with unrealized losses. JPMC does however support the disclosure requirements of EITF 03-1, as we believe they provide users of financial statements useful additional insight to the nature and severity of unrealized losses within an entity's various investment portfolios.

Our most significant concern with EITF 03-1 is the notion that sales of securities with unrealized losses within an available-for-sale portfolio possibly taint other securities held within the same portfolio, thereby requiring the recognition of additional impairments through earnings. This contradicts the available-for-sale definition in Statement No. 115 which anticipates sales activity to occur. We also believe the guidance included in EITF 03-1 as it is currently drafted would effectively cause entities to change how they manage their portfolios by requiring the holding of securities with aged unrealized losses.

"Day Two" Accounting

We are also concerned with the effect that recognition of impairment on securities of high credit quality can have on "Day Two" accounting when securities deemed to be other-than-temporarily impaired remain within a portfolio. Debt securities that have no, or very little, underlying credit risk have virtually no risk that par will not be recovered. Therefore, if an entity were to recognize an impairment loss on a high-credit grade security, it will benefit in enhanced yield on that security in future periods.

The resulting effect would be similar to an institution selling its securities in the market and then subsequently buying securities with a higher coupon. However, by recognizing impairment versus "recouping" a portfolio, an entity avoids the transaction costs of selling current security positions and buying replacement securities at the current coupon. Further, in the case of prepayable securities such as mortgage-backed securities, the duration of the impaired securities would be synthetically longer than a security with a

current and higher coupon. This is because there would be less prepayment risk on the security impaired.

We believe it is important for the FASB staff to understand these “Day Two” accounting issues as they could very well have a dramatic effect on future years’ earnings. In our opinion, allowing an entity to synthetically benefit in future years for unnecessary write-downs taken in previous years does not enhance financial reporting nor reflect the underlying economic substance of the securities held within a portfolio. The effect of such recognition would reduce the transparency of financial statements as users would have difficulty in understanding the risk management practices employed by the entity. The “Day Two” issues highlighted above may occur if EITF 03-1 overextends the definition of other-than temporary impairment.

Recommendation Based on Overall Concerns

Based on our overall views and concerns as outlined above, we recommend that the FASB and EITF limit the issuance of EITF 03-1 to include only the disclosure requirements as currently required. Our Firm strongly believes that the current accounting framework (Statement No. 115, SAB Topic 5.M. and EITF Topic D-44) with the added disclosure requirements provides the most transparent and useful information for users of financial statements.

Specific Comments – Proposed FSP

If the Board decides to proceed with issuing guidance through the proposed FSP, we urge the Board to consider the following recommendations:

Definition of “Temporary”

We fully supports the FASB staff allowing entities to exclude a portion of their investment portfolios from the operational burden of review for other-than-temporary impairment where the impairment is clearly temporary. The notion of temporary is consistent with SAB Topic 5.M. addressing the severity and duration of impairment as being an indicator of whether other-than-temporary impairment exists. However, we are concerned with the establishment of a “bright line” in defining what constitutes “temporary” impairment. “Temporary” impairment should be defined by entities using historical data based on changes in market interest rates and the resulting effects on their securities portfolios. Further, a 5% threshold would clearly be too low in establishing the definition of “temporary.” We have tracked our portfolios historically and have noted many temporary interest rate movements occurring outside of the proposed 5% threshold currently being considered.

To enhance the FASB staff’s understanding of our views, we have compiled historical data for the past twelve years related to the price volatility of a 10 year U.S. Treasury Bond using one-year time horizons. The data illustrates that over this period price sensitivity moved well beyond a 5% volatility threshold. In fact, in several periods the

volatility exceeded 20% and was most often in the range of 10% to 15%. Therefore, the data compiled here suggests that establishing a bright line would not only be inappropriate, but also that a 5% threshold is too low based on actual historical experience.

Further, market interest rates constantly fluctuate and go through sustained periods of increased and decreased volatility. Therefore, depending on the volatility of the interest rate markets, temporary impairment might be defined differently from one period to the next. We believe entities should have the ability to change their definition of temporary when justified by market changes.

Overall, allowing entities the ability to establish their own definition of “temporary” is justified and will further alleviate the unnecessary burden of entities in having to review securities for other-than-temporary impairment when it is clear that the impairment is both minor and temporary. Further, this allows entities to appropriately consider the risk characteristics of the securities held in a portfolio when establishing their threshold of “temporary” impairment. This is especially important for entities similar to our own that maintain investment portfolios with a significant number of underlying securities.

Allowable Sales of Securities

The circumstances provided of when sales can occur without the risk of taint in Question 3.b. of the proposed FSP are far too restrictive. Institutions sell securities for a variety of reasons beyond what is outlined in Question 3.b. and paragraph 8 of Statement No. 115 and the mere selling of securities alone should not raise the question of taint. Other factors, including the nature and severity of impairment and the underlying business purpose requiring the sale should also be considered. For example, sales of securities in response to an entity’s changing risk profile do not, in and of themselves, taint the intent and ability to hold other securities until forecasted recovery.

We strongly urge the Board to eliminate the notion of taint altogether or, at a minimum, explicitly acknowledge additional circumstances where sales effected as part of an entity’s defined risk management practices can occur without tainting other securities.

Transition

Similar to the provision granted in Statement No. 133, the Board should consider allowing a transitional window for entities to transfer securities between the classifications included in Statement No. 115. Given the potential effect of applying the guidance in EITF 03-1 to large available-for-sale portfolios, our Firm believes providing transitional guidance allowing for these transfers is warranted.

Effective Date

The Board should also strongly consider extending the effective date of any guidance to at least six months after the issuance of the proposed FSP. The requirements of EITF 03-

1 and the proposed FSP present significant operational burdens that will require extensive systems enhancement and procedural changes. Such a delay in the effective date is imperative for institutions similar to ours, who maintain a substantial number of security positions within their various portfolios.

Other

Given that available-for-sale securities are often used to hedge mortgage servicing rights ("MSRs") the Board should consider coordinating the timing of the implementation of any EITF 03-1 guidance with the optional fair value accounting proposal for MSRs.

.....

Once again we again thank the FASB for addressing these significant and difficult issues in a timely manner. We also hope the FASB will consider our comments in drafting the final FSP. If you should have any questions, please do not hesitate to contact Joe Sclafani at (212) 270-7559 or Shannon Warren at (212) 648-0906.

Very Truly Yours,

Joseph S. Sclafani
Executive Vice President and Controller