

Financial Accounting Standards Board October 9, 2008

<u>Director@FASB.org</u> Via email

Re: FSP FAS 157-d

* F S P F A S 1 5 7 D *

LETTER OF COMMENT NO.

HOA

Dear FASB,

The Performance Trust Companies consist of approximately 90 professionals who are dedicated to developing and teaching analytics and strategy for disciplined, responsible portfolio management in the fixed-income marketplace all across the country.

FSP FAS 157-d primarily deals with determining fair value in an inactive market. Fair value is important to financial institutions as many auditors consider fair value a leading indicator in whether a security is *Other Than Temporary Impairment (OTTI)*. If *OTTI*, the charge is directly to earnings and reduces the institution's regulatory capital. If not OTTI, there is no affect on the primary regulatory capital ratios. While FSP FAS 157-d does not directly deal with OTTI, the joint statement issued by the FASB and SEC on September 30 did. However, the statement primarily focused on fair value as a means to determine if a security is OTTI and ignored virtually all the existing guidance in the accounting literature directly from or approved by the FASB. FAS 157-d proposes that in calculating fair value of a security, the liquidity premiums of a distressed market need to be considered and applied to performing assets. The significant risk to the financial industry is that if the FASB and SEC use fair value as proposed to determine OTTI, bank capital would be reduced significantly.

There already is a lot of fear as to how regulators and accountants will interpret the accounting guidance involving impairment and fair value, and FSP FAS 157-d would add more. The accounting guidance for OTTI is covered in different areas of the literature and when pulled together with common sense, a clear theme or principle can be established. OTTI is based on whether the investor believes it is probable that they will get the cash flows expected at purchase (OTTI is primarily cash flow based, not market value).



This letter will summarize the relevant accounting guidance on evaluating and measuring securities for OTTI and how we would interpret the principle or intent of the literature. The primary accounting guidance on OTTI is founds in the following areas:

- Statement of Financial Accounting Standards No. 115 (As Amended)

 Accounting for Certain Investments in Debt and Equity Securities ("SFAS 115")
- FASB Staff Position Nos. FAS 115-1 and FAS 124-1 (As Amended)

 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain
 Investments ("FAS 115-1")
- EITF Issue No. 99-20 Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets. ("EITF 99-20")
- SEC Staff Accounting Bulletin No. 59 Accounting for Noncurrent Marketable Equity Securities ("SAB 59")
- AICPA's Statement of Position 03-3 Accounting for Certain Loans or Debt Securities Acquired in a Transfer ("SOP 03-3")

Determining if a Debt Security is Other Than Temporarily Impaired

Paragraph 16 of SFAS 115, which was issued in 1993, provides the standard on measuring securities for OTTI but does not provide comprehensive guidance. FAS 115-1, a FASB Staff Position issued in 2005 and SAB 59 from the SEC were both issued to provide additional guidance on the issue. The purpose of both EITF 99-20 and SOP 03-3 was to address broader accounting considerations specific to debt securities of lesser credit quality but include the most specific application guidance on OTTI, particularly relevant to whole loans. While there has been much debate in the industry on what accounting guidance applies to what type of security, it really is not significant in the OTTI evaluation as they all are consistent on the key principle which is simply that a security is OTTI when it becomes probable that the investor will not get the cash flows they expected at purchase.

Paragraph 16 of SFAS 115 says it this way:

"For example, if it is **probable** that the investor will be unable to **collect all amounts due** according to the contractual terms of a debt security **not impaired at acquisition**, an other-than-temporary impairment shall be considered to have occurred." [Emphasis added]

EITF 99-20 paragraph 12b says it like this:

"The fair value of the beneficial interest has declined below its reference amount, an enterprise should determine whether the decline is other-than-temporary. An entity should apply the



impairment of securities guidance in paragraph 16 of Statement 115. If, based on a holder's best estimate of cash flows that a market participant would use in determining the current fair value of the beneficial interest, ...there has been an adverse change in estimated cash flows an other-than-temporary impairment should be considered to have occur." [Emphasis added]

SOP 03-3 paragraph 7 states:

"The fair value of the debt security has declined below its amortized cost basis, an entity should determine whether the decline is other than temporary. An entity should apply the impairment of securities guidance in paragraph 16 of FASB Statement No. 115. For example, if it is probable, based on current information and events, that the investor is unable to collect all cash flows expected at acquisition plus any additional cash flows expected to be collected arising from changes in estimate after acquisition (in accordance with paragraph .07b, an other-than-temporary impairment should be considered to have occurred." [Emphasis added]

FAS 115-1 paragraph 13 simply refers to SFAS 115, EITF 99-20 and SAB 59 to help determine if a debt-security is OTTI. However, in Appendix A to FAS 115-1 they provide the following two example financial statement disclosures:

"The unrealized losses on the Company's investment in federal agency mortgage-backed securities were caused by interest rate increases. The Company purchased those investments at a discount relative to their face amount, and the contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold those investments until a recovery of fair value, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 20X3.

While Manufacturing Company's credit rating has decreased from A to BBB (S&P), the Company currently does not believe it is probable that it will be unable to collect all amounts due according to the contractual terms of the investment. Therefore, it is expected that the debentures would not be settled at a price less than the amortized cost of the investment. Because the Company has the ability and intent to hold this investment until a recovery of fair value, which may be maturity, it does not consider the investment in Manufacturing Company's debentures to be other-than-temporarily impaired at December 31, 20X3." [Emphasis added]

The first example compares the expected cash flow to the amortized cost and not the contractual amount of the security. The second example is a downgraded security which most likely would trade below the cost of the investment until it nears maturity. However, in both examples, the security is not considered OTTI as the investor analysis indicates it is probable they will get the



expected cash flows.

SAB 59 issued by the SEC focuses on fair value as evidence to help determine if a security is OTTI. Two important factors are the length of time and the degree to which fair value has been below amortized cost. However, SAB 59 recognizes that fair value could be below amortized cost for other reasons such as distressed markets or changes in interest rates among other things. Thus, SAB 59 puts the responsibility on the investor to investigate and understand the reasons for the decline in fair value to assess whether a security is OTTI.

A credit rating downgrade is also evidence to consider. However, many credit downgrades indicate simply that the risk has increased that the investor may not get the contractual cash flows but not necessarily that it is probable. For example, Fitch describes a BB rated security as "possibility of credit risk developing." Further and perhaps most importantly, the credit rating essentially assumes all securities were purchased at par. They do not consider the price the investor bought the security or what cash flows the investor expected at purchase.

Thus, downgraded securities or securities whose fair value is significantly below cost are not by definition OTTI but do require further analysis and evidence to support the carrying value. The investor must have support that the cash flows expected at purchase are still probable AND that they have the ability and intent to hold the security long enough for fair value to recover or until they receive the cash flows. SAB 59 closes with the following:

"Unless evidence exists to support a **realizable value** equal to or greater than the **carrying value** of the investment, a write-down to fair value accounted for as a realized loss should be recorded." [Emphasis added]

All of the guidance is consistent with paragraph 16 of SFAS 115. For securities with fair value below amortized cost, the investor must have support that it is probable that they will receive the cash flows expected at purchase. Further, they must have the intent and ability to hold the security until either fair value recovers or the cash is received.

For all securities that do not fall under the scope of SOP 03-3, the security is written down to its fair value with a direct charge to earnings and the fair value becomes the new cost basis. For securities that fall under the scope of SOP 03-3, the impairment charge is significantly different. Here are some of the key scope provisions to determine if a security falls under SOP 03-3:

1. "This Statement of Position (SOP) addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities (loans) acquired in a transfer if those differences are attributable, at least in part, to credit quality."



2. "It applies to a loan with evidence of deterioration of credit quality since origination¹ acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable." [Emphasis added]

For securities that fall under the scope of SOP 03-3, the impairment charge is the difference between the net present value of the current cash flows discounted at the purchase yield less the amortized cost.

Appendix B of SOP 03-3 titled, "Basis for Conclusions" makes it clear that it is intended that the impairment accounting be different for securities under SOP 03-3. When discussing why the scope was expanded to require evidence of credit deterioration since origination, paragraph B-9 includes the following:

"Further, without evidence of deterioration of credit quality since origination added to the scope criteria in paragraph .03, a difference in recognition of interest income and impairment accounting would exist when there has been no intervening change in the credit quality of the debtor for an originated loan versus a loan acquired shortly after origination or at any subsequent time."

Summary

As mentioned in the beginning, there are a lot of different opinions on the intent and application of the accounting guidance regarding fair value and OTTI in the profession. As the accounting guidance moves toward a more principle based system, the purpose of this letter was to break down the key principle themes of OTTI and how FAS 157-d (as proposed) could inappropriately affect OTTI assessments if those principles are ignored.

James V. Lorentsen, CPA Senior Vice-President Vice President and Chief Financial Officer