

FEDERAL HOUSING FINANCE AGENCY

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

Office of the Chief Accountant

April 1, 2009

Mr. Russell Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116



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LETTER OF COMMENT NO.

File Reference: Proposed FSP FAS 115-a, FAS 124-a, and EITF 99-20-b

Dear Mr. Golden:

The Federal Housing Finance Agency (FHFA) welcomes the opportunity to comment on FASB's proposed FSP No. FAS 115-a, FAS 124-a, and EITF 99-20-b, Recognition and Presentation of Other-than-Temporary Impairments (proposed FSP). As the supervisor of the Federal Home Loan Bank System and the supervisor and conservator of Fannie Mae and Freddie Mac, we are deeply interested in transparency and disclosure in financial reporting as a means of fostering market discipline for the housing GSEs and financial institutions more generally.

Despite our long-standing support for expanding the use of fair value in financial reporting, we recognize the appeal to some constituents of dividing other-than-temporary impairment (OTTI) along credit and non-credit related lines in today's environment, with only management estimates of the incurred credit loss portion being recognized in earnings. However, we have concerns regarding the subjectivity and false sense of precision the proposed approach could introduce.

Our primary concern is the lack of clarity regarding what is meant by "credit losses" in the proposed FSP. It appears the proposal would move the current OTTI measure toward the incurred loss model as applied to loans, which by design is a lagging indicator of potential credit problems. Prudential supervisors have questioned whether the incurred loss model should evolve in favor of a "life of loan" or "expected loss" concept.\(^1\) As the proposed FSP is not clear in this regard, we expect preparers to gravitate to the loan loss approach.

The draft FSP is also responsive to preparers and others' arguments that today's markets for certain securities are inactive, that fair values in these markets are based on less observable evidence than in prior times, and that the fair values identified for instruments in these markets reflect not only probable and expected cash flow shortfalls, but also high risk premiums for

Remarks by John C. Dugan, Comptroller of the Currency before the Institute of International Bankers, March 2, 2009. Loan Loss Provisioning and Pro-cyclicality.

uncertainty and pricing factors including high liquidity premiums that these preparers and others believe are unlikely to be realized.

To this end, we understand the general direction taken by this proposed FSP. However, we have concerns regarding the combined effects of this proposed FSP and the proposed FSP FAS 157-e, which we comment on in a separate letter. We believe it is important to protect the informational value of fair value measurements for investors, and to preserve the comparability of total GAAP equity over time.

Additionally, we encourage the FASB to consider the recognition of OTTI on an investment security as a new basis event for the purpose of making a FAS 159 fair value option (FVO) election. This would provide entities the ability to recover OTTI when and if fair values improve. For HTM securities, the guidance could clarify that the event of recognizing OTTI would meet the exceptions provided for in FAS 115 such that there would be no tainting of the portfolio should a company elect the FVO for securities considered HTM prior to the OTTI event.

The proposed FSP would move the impairment measurement for investment securities a considerable distance toward the incurred-loss model for loans. When adopting the current impairment model in FAS 115, the Board explicitly addressed the difference between impairment measurement for loans and securities and determined that fair value was the appropriate measure for investment securities as reflected in paragraph 113 of FAS 115:

The Board recognizes that the impairment provisions of this Statement differ from those in FASB Statement No. 114, ... This Statement requires that the measure of impairment be based on the fair value of the security, whereas Statement 114 permits measurement of an unsecuritized loan's impairment based on either fair value (of the loan or the collateral) or the present value of the expected cash flows discounted at the loan's effective interest rate. The Board recognizes that a principal difference between securities and unsecuritized loans is the relatively greater and easier availability of reliable market prices for securities, which makes it more practical and less costly to require use of a fair value approach. In addition, some Board members believe that securities are distinct from receivables that are not securities and that securities warrant a different measure of impairment—one that reflects both current estimates of the expected cash flows from the security and current economic events and conditions. [emphasis added]

As noted, fair value measurement for loan impairments is currently permitted under FAS 114 and is required under FAS 115 for investment securities. Further the language suggests that fair value was appropriate for loans too, but since such information was easier to obtain for securities it was only required for securities. We further note the assertions by preparers and others that the availability of reliable market prices for securities has not held true in the current market. We believe the proposed FSP should address paragraph 113 and reconcile it to the current Board's view. Further, the final FSP should clarify whether it would still permit fair value to be an optional measure of credit impairment for investment securities as it is for loans under FAS 114.

We believe it is inconsistent for companies to assert that there is substantial difficulty in estimating fair value, while at the same time alleging there is substantial precision to estimates of the credit component of unrealized losses in fair value. Therefore, we are concerned that the approach contemplated in the FSP will provide to investors a false sense of precision regarding the preparer's ability to identify the portion of an impairment that is due to credit. To that end, the guidance should clearly define management's best estimate of the amount of the impairment that relates to an increase in the credit risk associated with a specific instrument as that amount that is more likely than not. The FASB should provide examples that clearly illustrate this critical element of the revised OTTI model.

We understand that some view the accretion of non-credit OTTI back into interest income over time as distorting net interest income. We do not share this view. This accretion simply recognizes the yield an investor would receive on the security had it been purchased at the fair value on the impairment date. This is consistent with the concept in paragraph 16 of FSP FAS 115-1 which indicates that "an investor shall account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment."

The balance of this letter is devoted to our specific responses to the questions in the FSP.

- 1. This proposed FSP would require entities to separate an OTTI of a debt security into two components when there are credit losses associated with an impaired debt security for which management asserts that it does not have the intent to sell the security and it is more likely than not that it will not have to sell the security before recovery of its cost basis. The two components would be (a) the credit component and (b) the noncredit component (residual related to other factors). Does this separate presentation provide decision-useful information?
 - Yes the separate presentation provides useful information so long as the credit measurement is more fully defined in the final FSP and reasonably captures management's best estimate of the portion of the impaired instrument's fair value decline that is attributable to credit losses. We believe that entities impairing securities should be required to make disclosures around the sensitivity of the estimate of the incurred-loss credit component to key drivers. We believe that the guidance should also require management analysis and disclosures of the noncredit components, including for held-to-maturity securities the estimated timing of future amortization back onto the balance sheet.
- 2. The proposed FSP would require that the credit component of the OTTI of a debt security be determined by the reporting entity using its best estimate of the amount of the impairment that relates to an increase in the credit risk associated with the specific instrument. One way of estimating that amount would be to consider the measurement methodology described in paragraphs 12-16 of FAS 114. For debt securities that are beneficial interests in securitized financial assets within the scope of 99-20, the amount of the total impairment related to credit losses would be determined considering the guidance in paragraph 12(b) of 99-20. Do you believe this guidance is clear and operational? Do you agree with the requirement to

recognize the credit component of an OTTI in income and the remaining portion in OCI? Under what circumstances should the remaining portion be recognized in earnings?

The guidance should clarify that the amount of impairment related to credit risk is that amount that management believes is more likely than not – or the most likely amount. The guidance should further clarify whether it only contemplates application of the discounted cash flow method described in FAS 114 for assessing impairment related to credit losses, or whether preparers may use fair value as a practical expedient. Finally, the final FSP should provide clear examples of the credit loss assessment and subsequent recording of credit-related and non-credit-related impairment under the revised guidance.

4. This proposed FSP would require that the portion of an impairment recognized in OCI for HTM securities be amortized (through OCI) over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows by offsetting the recorded value of the asset (that is, an entity would not be permitted to adjust the fair value of a HTM security for subsequent recoveries in the fair value of the security similar to the accounting for AFS securities). Do you agree?

We believe that the recognition of the non-credit impairment in AOCI to be accreted going forward is consistent with the concept of accounting for the security as though it had been purchased on the day of impairment. In our opinion, following the impairment the security investor is in the same position as a new investor taking a position in a distressed financial instrument.

5. Is the proposed effective date of interim and annual periods after March 15, 2009 operational?

No. We think the proximity of the proposed effective date to the first quarter filing date may not be operational for some companies given the significant changes the FSP would introduce. We recommend extending the required effective date by one quarter with early adoption permitted.

The Federal Housing Finance Agency appreciates the opportunity to comment on this proposed FSP.

Sincerely,

Wanda I. DeLeo

Senior Associate Director and Chief Accountant

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