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Letter of Comment No: /6 >

Mr. Lawrence W. Smith
Director, Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed FASB Staff Position FSP 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:

Prudential applauds the FASB's decision to broaden the deferral of the application of paragraphs 10-20 of EITF Issue No. 03-1 to provide an opportunity for further discussion, leading hopefully to a common understanding among financial statement preparers, users, and auditors of the meaning of 'other than temporary' in its application to impaired investments. We urge the Board to use this opportunity to consider the issues at a higher level than the Emerging Issues Task Force did in reaching their consensus positions.

We believe that many of the implementation issues arising from EITF 03-1 stem from a lack of a clearly stated principle. In our letter of September 27, 2004 commenting on FSP EITF Issue No. 03-1-b, we introduced this concept and recommended that the Board:

- 1. Describe the principle that should underlie impairment considerations;
- 2. Share that description in the implementation guidance to be published; and
- 3. Ensure that any implementation guidance provided follows that principle.

This letter augments that discussion, and recommends that the statement of principle follow along the lines of, "Impairment losses shall be recognized in earnings when it is <u>probable a loss will be realized</u>."

Further, we provide recommendations on other aspects of FSP EITF Issue No. 03-1-a (the Draft FSP), including recommendations that:

- Companies continue to be permitted to determine the level at which temporary impairments may be considered "minor", without a need for further review.
- The final guidance should address all debt and equity securities, not only those debt securities addressed by EITF 03-1 paragraph 16.

 Some level of "bucketing" should be permitted in determining whether a change in a company's previous assertion to hold one security would impact the impairment decision of other securities.

### Need for a statement of principle

There is an apparent inconsistency between the guidance applicable to losses stemming from uncollectible contractual amounts ("16(b) impairments"), and the guidance applicable to losses stemming from other causes, such as changes in interest rates ("16(a) impairments"). When it is <u>probable</u> that an investor will be unable to collect all amounts contractually due, an other than temporary impairment (OTTI) loss must be recognized – a 16(b) impairment. For 16(a) impairments, the EITF Issue states that, "... an impairment should be deemed other than temporary if ... the investor does not have the ability and intent to hold an investment until a forecasted recovery." That passage is being interpreted by some as requiring the same high level of certainty and permanence as an investor's ability and intent to hold a Held to maturity ("HTM") security to maturity. In other words, a loss should be recorded unless it is <u>nearly</u> certain that a loss will <u>not</u> be incurred.

We are unable to reconcile the higher threshold being applied to impairments arising from collectibility concerns, with the lower threshold suggested for other causes of declines in value. We believe that both thresholds should spring from a common principle. Resolving this inconsistency with a statement of principle along the lines we propose below, (and then applying that principle in any implementation guidance) will reduce preparers' concerns and will assist in resolving implementation issues.

## Current interpretation of 16(a) is inconsistent with CON 5

FASB Concepts Statement 5 (CON 5) sets forth recognition criteria and guidance on what information should be incorporated into financial statements. In addition to general recognition issues, CON 5 provides additional considerations applicable to determining whether recognition in earnings is appropriate. While Available for sale ("AFS") securities accounted for under FAS 115 meet the general recognition criteria for determining whether to recognize the asset in the financial statements (i.e., AFS securities are assets measurable at fair value with sufficient reliability, and market value is the relevant measure), the question of when to record an OTTI loss in earnings, is subject to the additional earnings recognition considerations, which are concerned with identifying which "cash-to-cash" cycles are "substantially complete" (paragraph 80).

CON 5 states that losses should be recognized in earnings, "... if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated..." (paragraph 87). If an investor has made a positive determination that an asset will be sold prior to an anticipated recovery, it is clear that the investment should be written down. If an investor has made a positive determination that an asset will be held until an anticipated recovery, it is clear that the investment should not be written down. However, this leaves a vast middle ground, including those assets for which the investor has no current intent to divest, but which it may choose to divest in response to future market changes or opportunities, or in response to future changes in the investor's investment management strategies.

Under the current interpretation of the 'intent' concept, investments in this middle ground would be written down. The existence of some possibility of realization of a loss in the future does not make it evident that future economic benefits have been reduced. Future events, such as changes in the market or the identification of a new investment opportunity may make it evident that a loss will be incurred, and loss recognition would then become appropriate.

# Current interpretation of 16(a) introduces conservative bias contrary to CON 2

We understand that recognizing OTTI losses in earnings for the 'middle ground' assets is more conservative than not recognizing such losses. FASB Concepts Statement 2 (CON 2) indicates there is a place in financial reporting for a conservatism convention, but warns that conservatism must be applied with care. In particular, excessive conservatism conflicts with significant qualitative characteristics such as representational faithfulness, neutrality, comparability and consistency. Application of the overly conservative current interpretation of the 16(a) impairment considerations would have a negative effect on the reliability and integrity of reported earnings, as such an interpretation leads to loss recognition in advance of adequate evidence that a loss will be incurred. Furthermore, this excess conservatism may lead to an overstatement in profits in future periods for those assets that, while the investor had no specific, positive intent to hold the asset until a recovery, the asset is held anyway.

### Our recommendation

A statement of fundamental principle must therefore be made, against which all rules applicable to OTTI loss recognition would be measured. We believe a brief version of an appropriate principle may be stated:

# "OTTI losses shall be recognized when it is probable they will be realized."

Such a statement would be consistent with other FASB statements concerning the recognition of losses in the face of uncertainty – principally FAS 5, which provides general concepts on the subject of contingencies, and FAS 114, which provides guidance related to impairments of loans that do not meet the definition of 'security', and which forms the basis of the discussion in FAS 115 of recognizing OTTI impairment losses when it is probable that the investor will not collect all amounts contractually due (which became the 16(b) impairments).

Our proposed principle, the 'probable loss concept', fits well with FAS 115. Use of the AFS classification by an investor indicates that the security is available to be sold in response to future market changes, but that the investor did not acquire the security with a primary purpose of trading it in response to short-term market changes. Until a market change occurs in response to which the investor will likely sell the asset, the investor would still say the asset is available to be sold in response to <u>future</u> market changes. Until that future market change occurs, such that a sale prior to a recovery in value becomes probable, it is not yet appropriate to record a loss. The investor's intent and ability are considerations for determining whether a sale is likely to occur, not a threshold on their own.

We recognize that the words 'ability and intent' would imply a different level of certainty and permanence when classifying an investment as HTM under FAS 115, versus determining

whether to recognize an OTTI impairment loss under EITF 03-1 and SAB 59. However, we see those words being used in two fundamentally different questions – one is a question of the relevant measurement attribute; the other is a question of loss recognition.

Further, it should be noted that our review of internal processes and procedures (prior to modifications brought about by EITF 03-1), have indicated that implementation of our probable loss concept would result in an increased level of impairment losses. We recognize that EITF 03-1 highlighted (but did not change) a requirement that interest-related impairments should always have been carefully considered. However, practice developed around Question 47 of the FASB Implementation Guide to FASB Statement 115, such that a decision as of the end of a period to sell a security at a loss, shortly after the balance sheet date, is an indication of when it is appropriate to record a loss, rather than an indication of the latest moment it is appropriate to record a loss. In other words, a positive decision as of the end of a period to sell a security at a loss, shortly after the balance sheet date indicates that the incurrence of a loss is almost certain. Application of our probable loss concept to this situation may accelerate the loss recognition to an earlier period, when a sale in advance of an anticipated recovery first becomes likely to occur (i.e., the FAS 5 definition of probable), regardless of whether the sale would occur 'shortly' after the assessment date or in some later period.

#### Minor impairments

The Draft FSP states that 'minor impairments' can be considered temporary, and would not require further consideration. In exposing the Draft FSP, the Board has asked whether additional guidance or a bright line test for 'minor' should be provided as part of the implementation guidance.

First, we note that FAS 115 did not explicitly provide for such an exception, and yet practice developed in this area along the lines of what the Board has described. Each individual company, in conjunction with their independent auditor, determined where the line should be drawn for their portfolios, such that only securities over a certain percentage impaired, and in some cases those securities so impaired for a certain period of time, were further reviewed. We believe that the threshold we have established for ourselves captures those securities most likely to be other than temporarily impaired, while at the same time appropriately reduces the burden of reviewing every security in an unrealized loss position.

We further note that the EITF did not address the question of whether such practices are appropriate. That question only arose as financial statement preparers and auditors began to try to implement and interpret the new EITF guidance. We are glad the FASB agrees that some form of the current practice should continue.

We do not think a bright line needs to be established in the guidance. However, because of the questions that have already been raised, some discussion in the implementation guidance will be needed. Without anything further than what the FASB has proposed in the Draft FSP, we fear that auditing firms will determine there is an implicit 5% bright line based on the FASB's discussion on the subject. In the current environment, auditors have every incentive to be conservative, even given our discussion of CON 2, above.

The form of the additional guidance could be as limited as an affirmation by the Board that companies should establish reasonable limits for their reviews. An entity's goal should be to ensure that those instruments most likely to be other than temporarily impaired are reviewed. In particular, the Board's discussion should specifically clarify that it is not appropriate to apply a bright line of 5% without regard to other considerations. A 5% limit does not incorporate all factors, and with the longer duration of most insurance companies' bond portfolio, a limit of 5% will not provide much relief. What is important is that securities that are reviewed are truly scrutinized. Subjecting to that process a significant number of additional securities, which companies have previously concluded are less likely to require OTTI loss recognition, will not improve financial reporting for an appropriate cost.

If the Board chooses, it could provide a list of factors that companies should consider in establishing a reasonable limit. Such a list might include the following:

- Sensitivity of fair value to potential interest rate changes, considering the duration of the asset;
- The length of time for which the fair value of the asset has been below its amortized cost;
- The significance of the aggregate unrealized losses of the assets deemed to have 'minor impairments' relative to the total aggregate unrealized losses.
- As discussed below, we believe the Draft FSP should be expanded to apply to equity securities and to debt securities not within the scope of paragraph 16. For such securities, sensitivity of fair value might more appropriately be measured against other relevant benchmarks, instead of to potential interest rate changes.

#### Permitted changes in intent

A prudent insurance company's investment management strategy is necessarily geared towards matching its asset profile to its liability profile, in terms of risk, return (including desired spread) and duration. Changes in the liability profile would necessitate changes in the asset profile. This strategy makes it difficult for a prudent insurance company to make a positive assertion of an intent to hold a given security until a forecasted recovery. The same concepts are outlined in paragraph 9 of FAS 115, which provides specific examples of situations that are not consistent with the classification of a security as HTM. Changes in liquidity needs, market interest rates and other available investment opportunities are examples of such situations, which generally preclude insurance companies from classifying much of their investment portfolios as HTM. However, FAS 115 did not qualify the changes in liquidity needs or interest rates as being 'significant' or 'unexpected'.

Without some changes to modify the approach (e.g., our proposed principle) or changes to expand the situations in which intent or ability may change without calling other assertions into questions, the application of AFS accounting to life insurance companies would become even more one-sided than a LOCOM approach, which we note the Board had specifically disregarded as not evenhanded when it developed FAS 115. While the balance sheet measure for AFS securities is the same whether or not an OTTI loss is recorded, loss recognition through earnings under the Draft FSP would result in a new, "Lowest Historical Fair Value" approach.

If the Board adopts our recommendation and establishes a principle as we have discussed above, the 'permitted changes in intent' should generally require only that the investor identify

a change during the period since the assertion was made, that now indicates that it is probable the asset will be sold prior to the recovery. Such changes may arise from policyholders electing to rebalance among their investment options (changing the insurer's liability profile); modifications to products or the introduction of new product features; new investment opportunities; etc. The focus should be on the timing of that event or change, and matching the loss resulting from that event to the period in which that event occurred.

On the other hand, if the Board does not adopt our recommendation, and instead follows the current interpretation of the 16(a) impairment consideration, insurance companies will have a difficult time managing their investment portfolios prudently, without 'tainting' their ability to make assertions of an intent to hold a security. Insurance companies would be faced with a decision between reducing the investment manager's flexibility in managing the portfolio, to the detriment of investors and policyholders, or applying the Lowest Historical Fair Value model to all securities. As discussed above, such impairments would introduce an excessive conservative bias that would reduce the meaningfulness of the reported earnings information. Therefore, it is important that the list of 'permitted changes in assertion' be expanded to incorporate asset - liability matching strategies. One way of doing this could be to specifically list ALM strategies as a permitted item. Alternatively, the current list in the Draft FSP paragraphs 7 a.-c. could be replaced by a reference to the situations in paragraph 9 of FAS 115. While either of the approaches described in this paragraph would resolve our problem, we continue to believe that the statement of principle is a better approach. In particular, we believe that adding additional situations to the list of permitted changes in assertions, would move us further away from having rules that are guided by common, fundamental principles.

## OTTI losses following a 'tainting' disposal

Leading up to the Draft FSP, the Board discussed what the result might be of a 'tainted' assertion – whether every security in an unrealized loss position for which an assertion of an ability to hold had previously been made would need to be written down, or whether some amount of 'walling off' or 'bucketing' may be permitted. The Board did not include this concept in the Draft FSP. The Board seemed generally supportive of bucketing, but was fearful of abuse.

We believe this concept should be addressed. The Board should describe an overall principle, and provide factors companies should consider when they develop the appropriate 'buckets', which may include:

- Legal entity considerations: Changes of intent within one legal entity should not 'taint' assertions within a separate legal entity. For example, Prudential's insurance business is comprised of many insurance companies, developed or acquired over time and in multiple countries, many of which require stand-alone GAAP-basis financial statements. We do not believe that an assertion made previously in preparing the stand-alone financial statements of one company to be called into question based upon an action in a sister-company. A decision made at a subsidiary level not to write down an asset should survive consolidation.
- Segment or portfolio management considerations: Even within a legal entity, where more than one portfolio is managed separately, with different objectives, or in support of

different reportable segments or products, a tainting event in one portfolio should not taint other portfolios.

- Investment type: The Board had discussed a potential view that a tainting event involving
  the sale of a treasury security would not necessarily taint assertions regarding a corporate
  bond. We believe duration may also form part of such a distinction.
- Liquidity: Private placement securities are far less liquid than publicly traded securities.
   The sale of a public debt security should not 'taint' the assertions regarding private debt securities.

### Applicability of guidance

Many of the same issues addressed by the Draft FSP, which applies only to investments considered for impairment under paragraph 16, arise when considering whether to impair an equity security, and many of the same issues arise when an investor changes its assertion regarding an ability and intent to hold an equity security. Therefore, the implementation guidance should be applicable to impairment considerations of all securities.

Any statement of principle should necessarily be applicable to all securities.

In addition, relatively short market movements could reverse unrealized losses on equity securities or those debt securities not accounted for under paragraph 16. Therefore, 'minor impairments' of such securities should also be deemed to be temporary; as stated above, the determination about what comprises a 'minor impairment' of equity securities may be subject to different considerations than debt securities.

Finally, implementation question 3 in the Draft FSP addresses the timing of recognition of an OTTI loss for a security impaired due to interest rates and sector spread movements only. However, the issues addressed by question 3 may impact all 16(a) impairment situations. We have identified foreign exchange rate movements and certain issuer credit downgrades (e.g., a downgrade from AA to A, which may increase the risk of default, but not to a level that would be deemed to result in a 'probable' default under paragraph 16(b)) as other potential causes of impairments that should fall within the scope of question 3.

We are pleased to have had this opportunity to share our views with you. If you believe discussion with us on any of these points may be of assistance to the Board or its staff as it reconsiders these issues, please contact Frank Reda, Vice President, Accounting Policy, at (973) 802-2443 or myself.

Sincerely,