

Letter of Comment No: 176  
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**WACHOVIA**

October 29, 2004

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

**Subject: Comment Letter on 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:

Wachovia Corporation is pleased to have the opportunity to comment to the Financial Accounting Standards Board (the "FASB") on the proposed FASB Staff Position EITF Issue 03-1-a, that provides additional guidance on the application of paragraph 16 of Emerging Issues Task Force Issue No. 03-1 ("EITF 03-1"), *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, to debt securities that are impaired solely because of interest rate and/or sector spread increases (the "Proposed FSP").

At September 30, 2004, Wachovia had a securities portfolio amounting to approximately \$102 billion, comprised of over 90,000 positions. For a significant portion of this portfolio, changes in fair value are attributable to changes in interest rates and/or sector spreads. Accordingly, we are very interested in the additional guidance that the FASB plans to issue.

We commend the FASB for its timely response to the questions that have arisen regarding implementation of EITF 03-1 and for its decision to delay the effective date

until such guidance can be issued. The ramifications of the varying interpretations of EITF 03-1 can be very significant to both the financial statements and to balance sheet management practices of individual companies as well as to the capital markets in general. We strongly disagree with the provisions of paragraph 16 of EITF 03-1 as it is currently being interpreted. We believe that it is inconsistent with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ("Statement 115"), and that it would represent a significant change to current practice. Further we believe it would significantly impact a financial institution's ability to effectively and efficiently manage the interest rate risk in its balance sheet. Prudent and well-established interest rate risk management strategies would be very difficult to maintain under the EITF 03-1 model. As background information on interest rate risk management, we have included as an attachment to this letter an excerpt from our second quarter 2003 Form 10-Q where we describe in some detail our policies and practices around interest rate risk management.

Before outlining our specific comments on the Proposed FSP, we would like to comment on the overall model in the Proposed FSP. Paragraph 82 in the Background Information and Basis for Conclusions section of Statement 115 states, ". . . the available-for-sale category will include debt securities that are being held **for an unspecified period of time**, such as those that the enterprise **would consider selling** to meet liquidity needs or as part of the enterprise's risk management program" [emphasis added]. Statement 115 specifically acknowledges that available-for-sale ("AFS") securities can be held for an indeterminate period of time. Therefore, a requirement to further classify certain AFS securities as either "hold-to-recovery" ("HTR") or "hold-for-sale" ("HFS"), as is required under EITF 03-1, would be inconsistent with the provisions of Statement 115.

Paragraph 16 of Statement 115 defines impairment as a situation where the investor, ". . . will be unable to collect all amounts due according to the contractual terms of a debt security." No mention is made of declines in fair value solely attributable to increases in interest rates and/or sector spreads. Under EITF 03-1, a Treasury security and certain U.S. government-sponsored mortgage-backed securities -- instruments generally agreed to have essentially no credit risk -- would be subject to an impairment write-down unless an entity had made an affirmative decision to hold the security through its forecasted recovery period. In EITF Issue No. 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Assets*, the EITF provided measurement guidance for impairment of securities that can be contractually prepaid or otherwise settled in a manner such that the holder would not recover substantially all of its recorded investment. EITF 99-20 specifically excludes from its scope financial instruments that are high credit quality.

In response to questions that arose a number of years ago, the FASB staff addressed in EITF Topic D-44 the issue of a planned sale of a security in situations where cost

exceeds fair value, and concluded that an entity should recognize impairment when a decision to sell a security is made. This is clearly an "intent to sell" model, which is very different than the "hold-to-recovery" model in the proposed FSP. The absence of a positive intent to hold a security to its forecasted recovery date does not mean that an entity has the intent to sell. Rather it simply means that the entity is keeping its options open, as prudent interest risk management policies would dictate. The current "intent to sell" model is well understood. It is a model that allows a financial institution the flexibility necessary to manage the interest rate and foreign currency risk in its balance sheet while still ensuring that the financial statements are representationally faithful and transparent.

The Background Information and Basis for Conclusions section of Statement 115 addresses the ramifications of having unrealized gains and losses on available-for-sale securities included in earnings, and states in paragraph 79, ". . . because of concerns about the volatility that would result from reporting the fair value changes of only some assets, and no liabilities, in earnings, the Board determined that the unrealized holding gains and losses for available-for-sale securities should be excluded from earnings." EITF 03-1 would re-introduce this volatility, but only on the downside for securities that management does not necessarily even plan to sell. The ramifications of this are numerous, including:

- Introduces the opportunity for earnings management by simply reclassifying a security to HFS or purposefully tainting a class of securities.
- Has the effect of constantly re-setting securities on which there is an unrealized loss to fair value via an impairment write-down followed by accretion of the discount, which has the same effect as the sale of a security followed by reinvestment in the same security.
- May increase the use of derivatives to manage interest rate risk because a financial institution may choose to enter into short-term fixed-rate securities and then manage duration with derivatives. This would certainly be a less efficient and potentially more costly way to achieve the same risk management objective.
- Could significantly impact regulatory capital. Shortly after the finalization of Statement 115, the banking regulators issued guidance which called for the exclusion of the component of stockholders' equity representing the net unrealized gain or loss on AFS securities from the calculation of the regulatory capital ratios. EITF 03-1 would reintroduce the unrealized losses into the calculation of regulatory capital ratios.

Further, paragraph 96 of Statement 115 states, "[Statement 115] eliminates the unevenhandedness of LOCOM, which recognized the net diminution in value of

securities but not the net appreciation in value.” It is clear that, in connection with the deliberations on Statement 115, the FASB specifically rejected a lower-of-cost-or-market-value (“LOCOM”) model, yet EITF 03-1 would reinstate just such a model with all of its pitfalls.

We would like to remind the FASB that the EITF 03-1 model as currently being interpreted would result in a *modified* LOCOM model for securities classified as HFS. We refer to it as a “modified” LOCOM model because under a LOCOM model, gains can be recorded to the extent of previous write-downs. This apparently would not be the case for securities on which an impairment charge has been taken under EITF 03-1.

We strongly encourage the FASB to limit the scope of EITF 03-1 to two areas: (1) guidance on the definition and measurement of impairment on equity securities accounted for under the cost method, which is the issue that originally prompted the addition of securities impairment issues to the EITF’s agenda several years ago, and (2) disclosure. We believe the disclosure provisions of EITF 03-1 that were effective beginning with the 2003 annual report, were very useful disclosures about securities where the fair value was less than book value, and measurably added to financial statement transparency.

Should the FASB decide to issue the additional guidance on EITF 03-1, the following are our specific comments on the provision of the Proposed FSP.

**Question 1: At what unit of account should an investor assert its ability and intent to hold to a forecasted recovery?**

We agree with the Staff’s conclusion that the assertion should be made at the level of the individual security. This gives the investor the flexibility necessary to manage a portfolio at the individual security level and is consistent with the requirement in Statement 115 to classify each individual security at the time of acquisition.

It is important to recognize that large financial institutions may have multiple securities portfolios. An entity may have separate portfolios by legal entity, by country, by segment, or any combination thereof. Accordingly, the same security may be held in multiple portfolios within the same consolidated entity. We recommend that the final FSP specifically acknowledge that the assertion of ability and intent to hold a security to a forecasted recovery date is portfolio specific. Accordingly, each portfolio manager will make their assertion independent of the assertion made for the same security by other portfolio managers within the same consolidated entity.

**Question 2: Although Issue 03-1 states that an investment is impaired if the fair value of the investment is less than its cost, paragraph 16 does not refer to the severity of the impairment. Is there a level of impairment that can be considered**

**temporary that would not create the need for an assertion about the ability and intent to hold an investment until a forecasted recovery?**

We agree with the Staff's conclusion that minor impairments can be considered temporary and would not create the need for an assertion about the ability and intent to hold to a forecasted recovery. However, we believe that this evaluation should be made based NOT on a bright line, but rather on an appropriate combination of qualitative and quantitative factors. A bright line would not give appropriate recognition to the fact that the extent to which a change in interest rates impacts the fair value of a particular security depends on a number of factors, including both security specific and general market factors.

The following is an example, just one of many, of the pitfalls of using a bright line test for impairment, and uses actual market data.

A 10-year Treasury with a 4% coupon is issued and purchased in February 2004 at par (100).

By June, interest rates had increased, and at June 29, 2004, the closing price for this Treasury security was 94.78125 (10-year Treasury yield of 4.70%), which is a decline greater than a 5% bright line.

At September 22, 2004, the price for this Treasury security had rebounded to 100.265625 (10-year Treasury yield of 4%), or to an unrealized gain position as compared to the original book value.

Please refer to the graphs we have included as an attachment to this letter that show the historical volatility of a variety of financial instruments that could be subject to EITF 03-1. The significant level of volatility in these instruments further argues against a bright line test and in fact calls into question one of the basis premises in the EITF 03-1 model, the ability to forecast a recovery date.

**Question 3(a): 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 is expected to be sold prior to its recovery, when is the impairment considered other than temporary?**

The answer that flows from the EITF 03-1 model is that impairment would be considered other than temporary when management no longer intends to hold the security to its forecasted recovery date. As described in the first section of our letter, we believe that a security should be considered impaired when management has made the decision to sell the security ("intent to sell" model).

**Question 3(b): 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 is expected to be sold prior to its 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?**

Because the process of managing interest rate risk involves very granular decisions, we believe that the sale or intent to sell a security previously classified as HTR should NOT call into question ("taint") the HTR assertion of any other securities.

The first two of the three criteria in the Proposed FSP, both of which rely on an understanding of what the terms "unexpected" and "significant" mean, are essentially unworkable in practice. For example, when interest rates rise, the duration of mortgage securities extends. If the liability structure of the balance sheet has remained constant, then the bank should sell some of the longer duration mortgage securities as part of prudent interest rate risk management. In this situation, the investor clearly has the ability, and may have had the intent to hold the securities, but should sell to match duration. Under the current interpretation of EITF 03-1, this sale could possibly "taint" certain other securities in the portfolio.

### **Other Matters**

The following are comments we would like to make on other matters in the Proposed FSP:

#### Transition Provisions

While many portfolio systems may be able to handle the process of recording an impairment write-down and accreting the resulting discount through earnings in future periods, there are numerous other operational issues that could potentially require a significant amount of time to address. These include, but certainly are not limited to:

- Tracking for each individual security its classification as either HTR or HFS.
- Tracking the forecasted recovery date for each security.
- Extending current corporate governance policies and procedures to cover this additional process.
- Operationally defining the terms "significant" and "unexpected" relating to the conditions for the sale of a security classified as HTR.

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- Tracking the impact on the net interest margin of subsequent accretion of the discount after an impairment write-down, which is not a required disclosure, but one that management will want to track and in which analysts will be interested.

Accordingly, we recommend that the effective date of the final FSP be no earlier than June 30, 2005.

#### Reclassification of Securities

Paragraph 15 of Statement 115 states that, "... transfers into or from the trading category also should be rare." However, if the FASB codifies a HFS category, we believe that it may be appropriate for financial institutions to reclassify certain of the securities that might otherwise be classified as HFS from the available-for-sale category to trading. While arguably the implementation of EITF 03-1 may be one of the "rare" events contemplated by paragraph 15 of Statement 115, we encourage the FASB to specifically provide a window of opportunity for companies to reclassify securities from available-for-sale to trading in connection with the adoption of EITF 03-1. There is certainly precedent in the recent past and a similar window of opportunity was provided in connection with the adoption of Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

\* \* \* \* \*

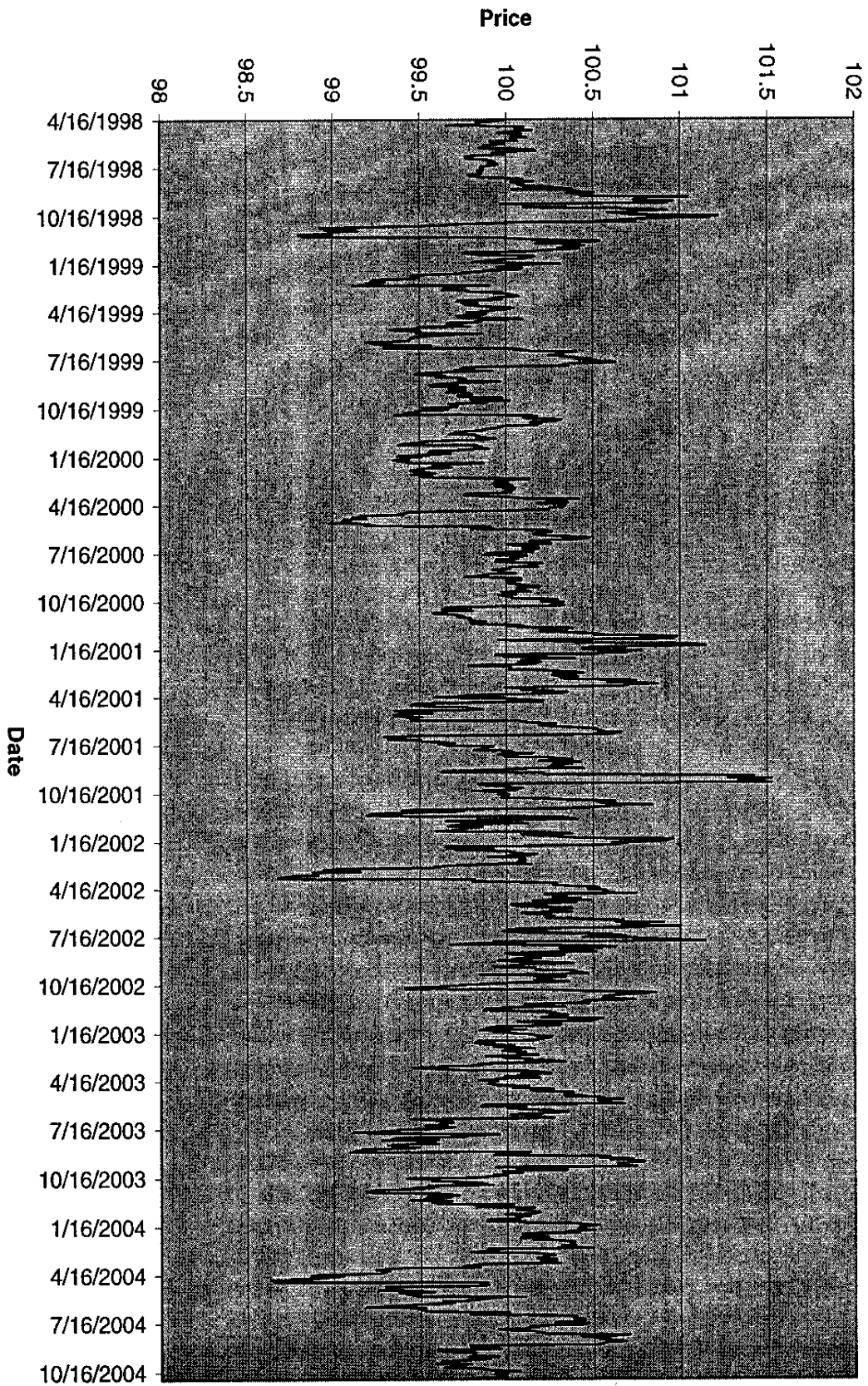
Again, we believe that the Proposed FSP represents a significant change to the provisions of Statement 115 and if the FASB decides to proceed with this model, we encourage you to add a project to your agenda and embark on the full due process normally associated with amendments to existing standards.

We would be pleased to address any questions you may have regarding the comments in this letter or to discuss our position in more detail, at your convenience. I can be reached at 704-383-6101, or by email at david.julian@wachovia.com.

Sincerely,

David M. Julian  
Executive Vice President and Controller

cc: Robert P. Kelly  
Senior Executive Vice President and Chief Financial Officer



2yr Treasury

Series 1



**Interest Rate Risk Management** One of the fundamental roles in banking is the management of interest rate risk, or the risk that changes in interest rates may diminish the income that we earn on loans, securities and other earning assets. The following discussion explains how we oversee the interest rate risk management process, and the actions we take to protect earnings from interest rate risk.

A balance sheet is considered asset sensitive when its assets (loans and securities) reprice faster or to a greater extent than liabilities (deposits and borrowings). An asset-sensitive balance sheet will produce more net interest income when interest rates rise and less net interest income when interest rates decline. Our large and relatively rate-insensitive deposit base funds a portfolio of primarily floating rate commercial and consumer loans. This mix naturally creates a highly asset-sensitive balance sheet. Over the past two years, deposit growth has far outpaced loan growth, significantly adding to our naturally asset-sensitive position. To achieve more neutrality, we maintain a large portfolio of fixed rate discretionary instruments such as loans, securities and derivatives.

We often elect to use derivatives to protect assets, liabilities and future financial transactions from changes in interest rates. When deciding whether to use derivatives instead of investing in securities to reach the same goal, we consider a number of factors, such as cost, efficiency, the effect on our liquidity and capital, and our overall interest rate risk management strategy. We choose to use derivatives when they provide greater relative value or more efficient execution of our strategy than securities. The derivatives we use for interest rate risk management include various interest rate swaps, futures, forwards and options. We fully incorporate the market risk associated with interest rate risk management derivatives into our earnings simulation model in the same manner as other on-balance sheet financial instruments.

As economic conditions improve and loan demand increases, we expect to rely to a larger extent on our large base of low-cost core deposits to fund lending activities. The characteristics of the loans we add will prompt different strategies. Fixed rate loans, for example, diminish the need to buy discretionary investments, so if we add more fixed rate loans to our loan portfolio, we would likely allow existing discretionary investments to mature or be liquidated. If we add more variable rate loans, we would likely allow fixed rate securities to mature or be liquidated, and then add new derivatives that, in effect, would convert the incremental variable rate loans to fixed rate loans.

We analyze and manage the amount of risk we are taking to changes in interest rates by forecasting a wide range of interest rate scenarios and for time periods as long as 36 months. However, in analyzing interest rate sensitivity for policy measurement, we compare forecasted earnings per share in both "high rate" and "low rate" scenarios to the "market forward rate" and "flat rate" scenarios. The policy measurement period is 12 months in length, beginning with the first month of the forecast. Our objective is to ensure that we prudently manage our interest-bearing assets and liabilities in ways that improve our financial performance without unduly putting earnings at risk. Our policy is to limit the risk

we can take through balance sheet management actions to 5 percent of earnings per share in both falling and rising rate environments.

Our "market forward rate" is constructed using currently implied market forward rate estimates for all points on the yield curve over the next 36 months. Our standard approach evaluates expected earnings in a 200 basis point range both above and below the "market forward rate" scenario. However, due to the currently low absolute level of the federal funds rate, we modified the "low rate" scenario to measure a decline of only 50 basis points.

We simultaneously measure the impact of a parallel and nonparallel shift in rates on each of our interest rate scenarios. A parallel shift would, as the term implies, shift all points on the yield curve by the same increments. For example, by the twelfth month in our policy measurement period, short-term rates such as the federal funds rate would increase by 200 basis points over the "market forward rate," while longer term rates such as the 10-year and 30-year treasury note rates would increase by 200 basis points as well. A nonparallel shift would consist of a 200 basis point increase in short-term rates, while long-term rates would increase by a different amount. A rate shift in which short-term rates rise to a greater degree than long-term rates is referred to as a "flattening" of the yield curve. Conversely long-term rates rising to a greater degree than short-term rates would lead to a "steepening" of the yield curve.

The impact of a nonparallel shift in rates depends on the types of assets in which funds are invested and the shape of the curve implicit in the "market forward rate" scenario. For example, at June 30, 2004, the spread between the 10-year and two-year treasury note rates was 190 basis points, which historically would be considered very wide. The average spread between the 10-year and two-year treasury note rates since 1980 has been approximately 82 basis points, including periods of inversion.

In this historically steep yield curve environment, we believe prudent risk management practices dictate the evaluation of rate shifts that include a "flattening" of the yield curve where short-term rates rise faster and to a greater degree than long-term rates. Accordingly, in June 2004 we evaluated scenarios that measure the impact of a "moderate flattening" and a "severe flattening" of the yield curve. Interest rate risk management decisions are based on a composite view of sensitivity considering parallel and nonparallel shifts.

**Earnings Sensitivity** In June 2004, our earnings simulation model indicated earnings would be positively affected by 0.3 percent in a "high rate composite" scenario relative to the "market forward rate" over the policy period. Additionally, we measure a scenario where rates gradually decline 50 basis points over a 12-month period relative to the "market forward rate" scenario. The model indicates earnings would be negatively affected in this scenario by 0.3 percent, which indicates an asset sensitive position to changes in interest rates.

Our sensitivity to the "market forward rate" scenario is measured using three different yield curve shapes. The first is a gradual 200 basis point increase at each point on the yield curve over a 12-month period. This is referred to as a parallel shift in the curve and would follow the "market forward rate" scenario's expected flattening. Next we measure the exposure to nonparallel shifts by allowing short-term rates to rise by 200 basis points, while allowing rates of terms longer than one year to increase by a lesser degree. This approach creates incrementally flatter curves. This has the impact of stressing liability costs by a full 200 basis points, while new fixed rate lending and investment rates receive less than a 200 basis point increase. The focal point is the spread between the 10-year and two-year treasury note rates. In our "moderate flattening" scenario, this spread declines from 140 basis points in the "market forward rate" scenario to 83 basis points. This flattening is quite significant in relation to the most likely scenario; however, it is still above the historical average. Our "severe flattening" scenario reduces the spread between the 10-year and two-year treasury note rates to 26 basis points by the end of the measurement period. This approach fully stresses expected earnings to the risks of nonparallel curve shifts. The reported sensitivity is a composite of these three scenarios.

Our "flat rate" scenario holds the federal funds rate constant at 1.00 percent through May 2005. Based on our June 2004 outlook, if interest rates were to follow our "high rate" scenario (i.e., a 200 basis point increase in short-term rates from our "flat rate" scenario) with a parallel shift in the yield curve, our earnings sensitivity model indicates earnings during the 12-month policy measurement period would increase by 1.8 percent.

Typically, we analyze a 200 basis point decline for our "low rate" scenario. However, because of the current federal funds rate level, we believe a 50 basis point decline in rates is more appropriate. If rates were to follow the "low rate" scenario relative to our "flat rate" scenario, our earnings would decrease by 0.8 percent. For our "most likely rate" scenario, we believe the "market forward rate" is the most appropriate. The "market forward rate" scenario assumes the federal funds rate of 1.02 percent at June 1, 2004, gradually rises to 2.90 percent through the end of our policy measurement period.

While our interest rate sensitivity modeling assumes that management takes no action, we regularly assess the viability of strategies to reduce unacceptable risks to earnings and we implement such strategies when we believe those actions are prudent. As new monthly outlooks become available, we formulate strategies aimed at protecting earnings from the potential negative effects of changes in interest rates.