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October 29, 2004

Letter of Comment No: 175
File Reference: EITF03-1A

Mr. Lawrence W. Smith
Chairman of Emerging Issues Task Force
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116

VIA E-MAIL

Reference: **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" ("FSP EITF 03-1-a")**

Dear Mr. Smith:

We are writing to you concerning EITF Issue No. 03-1 ("EITF 03-1"), "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments." We submitted previous letters to you on EITF 03-1, dated August 26, 2004 and September 29, 2004.

We remain concerned about the issues that we articulated in our previous letters to you. We believe that, without significant changes, the requirements of paragraphs 10-20 of EITF 03-1 will result in adverse financial reporting consequences, including –

(a) impairment loss recognition for some securities that will never experience a realized loss, with subsequent accretion of the impairment discount into interest income over time as an increased effective yield,

(b) possible incentives for "gains trading" as companies avoid selling loss securities due to tainting concerns,

(c) introduction of unusual financial reporting incentives, as a declaration of "ability and intent" to hold becomes the deciding factor in whether or not to recognize impairment losses that may be less than probable of realization, and

(d) extension of an interest income recognition model (in SOP 03-3) intended and designed for credit impairments to interest-related impairments under EITF 03-1.

We strongly encourage you to repeal the consensus in paragraphs 10-20 of EITF 03-1, and instead deliberate these issues in the context of a SFAS 115 amendment if desired.

If the Board decides not to repeal the EITF 03-1 measurement consensus, we ask that you –

(a) extend the effective date of the EITF 03-1 measurement consensus to at least six months after issuance of final guidance, given the significant operational burden that will be placed on entities to implement this consensus. This will allow for a well-controlled implementation, and

(b) approve the "minor impairment" safe harbor and specify a quantitative threshold of 10%. The notion of "minor impairments" should be extended not only to paragraph 16 securities but to all investments subject to EITF 03-1.

I. WE ASK YOU TO REPEAL THE MEASUREMENT CONSENSUS (PARAGRAPHS 10-20) OF EITF 03-1.

The following discussion explains our views about the conceptual difficulties presented by the EITF 03-1 guidance, which effectively amends the SFAS 115 requirements for AFS securities. In light of these conceptual issues (and the practical, operational troubles that they introduce), we ask you to repeal the EITF 03-1 measurement guidance and instead follow the due process of considering a SFAS 115 amendment, if desired.

Many companies have business models that involve opportunistic sales of securities. Sales decisions are based on economic or risk management factors present at the time of the sale. A company may decide to make a sale of an individual security or resecuritize that instrument with others, selling or retaining portions of the cash flows in resecuritized form.

At any period-end prior to the transaction date, a sale transaction may be *reasonably possible* but not *probable*. The company cannot forecast which individual trade lots will be subsequently sold or the timing of the sales. Management's intent with regard to subsequent disposition of the security (hold versus sell) is influenced by many factors subsequent to the period-end date, including changes in interest rates and other market conditions that affect asset liability management decisions, availability of other securities to use in structuring or sales, and willingness of counterparties to purchase securitized or resecuritized assets. Transaction decisions are finalized based on conditions that exist at the trade date rather than the previous period-end. Also, decisions to sell or hold a security should be made based on economic drivers, which often do not coincide with accounting unrealized gain or loss of an individual trade lot at a previous period-end (e.g., after considering factors such as accounting basis adjustments, or a transaction strategy involving resecuritization with partial sale/partial retention of resecuritized cash flows).

EITF 03-1's requirement to make an affirmative assertion of intent at any interim period-end (sell or hold) implies that management's decisions about future transactions can be known with any certainty at that period-end. This implication contradicts the reality of the business practice as described above: opportunistic sales that are based on decision factors present at trade date (after the period end) and that should be independent of whether an accounting gain or loss is triggered. SFAS 115 acknowledged and accommodated this business practice in the accounting requirements for AFS securities, to be applied to business activities that do not meet the definition of trading activities under SFAS 115. Per SFAS 115, the AFS category includes "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 an enterprise's risk management program."[1] SFAS 115 required no affirmative assertion of intent.

EITF 03-1 effectively amends the SFAS 115 AFS requirements by requiring management to make an affirmative assertion about uncertain future transaction decisions if the company wishes to avoid impairment loss recognition. Imposing this artificial intent assertion produces some undesirable business and financial reporting outcomes (whether the company chooses to make an assertion of intent to hold or not).

A. The "assertion of intent to hold" requirement forces management to choose between potentially misleading financial reporting results (if no assertion is made) or unreasonable business constraints (if assertion is made).

Path 1: Make no assertion about ability and intent to hold until forecasted recovery.

The "no assertion" choice avoids constraints on the company's selection of trade lots for potential future transactions. The company may choose to sell securities at a later date at an accounting loss, without risk of tainting a prior assertion of intent to hold. If the company desires to maintain the flexibility to sell a security in the future through the opportunistic sales or structuring activities described above (without facing tainting risks), the company will likely choose the "no assertion" route. Note that even though the company chooses not to make an affirmative assertion about its intent to hold at any given period-end, it is still only *reasonably possible* that the company will sell the security before recovery (just as it is reasonably possible that the company will actually hold all or a part of the security until recovery).

The "no assertion" route produces some troublesome financial reporting results.

(a) *Required impairment loss recognition for a point-in-time unrealized loss, before a probable loss has been incurred.* Throughout GAAP guidance, the notion that losses should be recognized when they are probable is well-established. As we discuss below, the EITF 03-1 requirement to recognize losses when reasonably possible instead of when probable contradicts GAAP, including concepts articulated in CON 5, SFAS 5, SFAS 115 and SFAS 133.

CON 5 contains relevant discussion of losses.

> "Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits."[2] Further, "An expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits."[3]

Under the EITF 03-1 guidance, impairment losses must be recognized when no assertion of intent to hold is made (even though in reality the assertion does not change the fact that declines in fair value are not yet probable of being realized through a sale, as we discussed previously). Though the AFS securities are not "expected to provide reduced

[1] SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities,* paragraph 82.
[2] CON 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* paragraph 85.
[3] CON 5, paragraph 87.

or no further benefits" under the CON 5 principles, EITF 03-1 mandates that an impairment loss must be recognized in earnings.

Similarly, the "no assertion" alternative also contradicts the SFAS 5 guidelines for the timing of recognition of loss contingencies by requiring impairment losses before they are probable. While we recognize that the scope of SFAS 5 does not include impairment losses on securities held, SFAS 5 is well-recognized as providing guiding principles for the timing of loss recognition.

We also observe that SFAS 115's original credit impairment guidance is premised on the notion of "probability," as follows: "if it is *probable* [emphasis added] 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."[4] Therefore, EITF 03-1 effectively sets up a double standard for impairment loss recognition: recognize credit impairments in earnings when they are *probable*, but recognize interest impairments in earnings when they are less than probable (*reasonably possible* or *remote).*

Finally, the SFAS 133 *Basis for Conclusions* also acknowledges the potential for manipulation of earnings when income statement recognition is permitted for an uncertain event that is less than probable. In discussing when unrealized gains and losses should be reclassified from equity into earnings upon hedged forecasted transactions becoming less than certain, the FASB stated the following.

> "The Board also was concerned that requiring a gain or loss in accumulated other comprehensive income to be reported in earnings when a forecasted transaction is no longer probable but still is reasonably possible (paragraph 464 describes the range of probability [as corresponding to SFAS 5 definitions]) would provide an entity with the opportunity to manage earnings by changing its estimate of probability. For those reasons, the Board decided to require earnings recognition of a related gain or loss in accumulated other comprehensive income only when an entity determines it is probable that the transaction will *not* occur."[5]

We ask that the Board consider our parallel argument to the principle outlined in SFAS 133: EITF 03-1 should not require impairment loss recognition until the loss is probable.

(b) *Where impairment loss must be recognized under EITF 03-1 but a realized loss is not experienced, the company must accrete the impairment discount into interest income over time as an increased effective yield.* This requirement distorts the timing of income recognition and its classification (impairment loss versus net interest income). Companies would recognize impairment losses immediately and then subsequently, in a different income statement line item, recognize interest income through accretion of the impairment discount. This practice introduces an artificial upward bias for future interest income recognition, as impairment discounts are accreted back into earnings. We believe this requirement does not represent an improvement in financial reporting.

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[4] SFAS 115, paragraph 16.

[5] SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, paragraph 493.

Path 2: Make an affirmative assertion about ability and intent to hold until forecasted recovery.

The "assertion" choice allows the company to continue to record unrealized losses in other comprehensive income. Maintaining unrealized losses in equity (rather than earnings recognition) makes sense for losses that are only reasonably possible of becoming realized through subsequent transaction activity. Furthermore, disclosure requirements in SFAS 115 and the EITF 03-1 disclosure consensus provide useful information to financial statement users about both unrealized losses recorded in equity and realized losses.

Although the "assertion" route makes sense for financial reporting, it has negative consequences for companies' transaction decisions.

(a) *The assertions could encourage "gains trading."* Because of the risk and consequences of tainting, companies may choose unrealized gain positions for use in subsequent sale transactions. This behavior would defeat one of the Board's original objectives in improving financial reporting through SFAS 115 related to resolving the gains trading issue.[6]

(b) *The specter of tainting may constrain companies from transacting in reaction to subsequent developments.* The draft FSP proposes to provide guidance about when companies may change their intent to hold until recovery without creating a tainting event. This guidance is broad and general; in order to implement it, companies must make interpretations to apply the guidance to actual fact patterns. Will companies take the risk that their tainting event interpretations might be judged as invalid, in the face of the significant consequences associated with a tainting event? On a practical basis, companies may choose to be constrained from executing transactions that make good business sense, to avoid the financial reporting risk associated with tainting interpretations. We believe that the concept of "tainting" that is associated with securities for which an assertion has been made introduces unnecessary operational complexity and burden.

B. The "assertion of intent to hold" requirement can introduce unusual financial reporting incentives.

As explained above, for companies that pursue strategies of actively managing portfolios to achieve risk management objectives and to take advantage of opportunistic sales or structuring opportunities, the notion of an affirmative "intent to hold" at any particular period-end is artificial. At any period-end, it might be reasonably possible that a particular security will be subsequently sold before recovery and, conversely, reasonably possible that the security will be held until recovery. Actual subsequent transactions are influenced by events and market conditions subsequent to the period-end date.

Under paragraph 16(a) requirements, however, this artificial declaration of "ability and intent to hold" becomes the deciding factor in whether or not to recognize impairment losses in earnings. Companies may have the ability to control how much impairment loss is recognized in a period by simply making (or choosing not to make) an affirmative assertion of intent. We note that under this model, companies can choose to recognize impairment losses before they are

[6] SFAS 115, paragraph 84: SFAS 115 was expected to "help resolve the gains trading issue, not aggravate it."

considered probable of realization and without any transaction with a third-party which would confirm the loss.

In our view, impairment losses should be recognized in earnings when realized or probable of realization. Instead, EITF 03-1 creates a situation where management can choose which less-than-probable *(reasonably possible* or *remote)* unrealized losses will be recognized in earnings, based purely on a declaration of intent (at period-end) that is unconnected to how business transaction decisions would ordinarily be made (at subsequent trade date). Companies must choose how many assertions to make (and thus how much loss will be retained in equity rather than recognized in earnings). In making this decision, companies will balance the competing interests of flexibility to execute future transactions without tainting (a positive consequence of making no assertion) with the earnings and capital adequacy consequences of impairment loss recognition for *reasonably possible* or *remote* losses (a negative consequence of making no assertion).

C. The requirement to apply SOP 03-3 for interest income recognition subsequent to impairment presents conceptual conflicts.

The interest income recognition model in SOP 03-3 was specifically intended and designed for credit impairments. Extending this model to interest-impaired securities as required under EITF 03-1 presents both conceptual and operational problems.

(a) The requirement in EITF 03-1, paragraph 20 is effectively an expansion of the scope of SOP 03-3, which specifically relates only to loans and debt securities acquired with evidence of deterioration of credit quality since origination.[7] The scope of SOP 03-3 does <u>not</u> address securities with credit deterioration that occurs after acquisition (as would be the case with EITF 03-1 paragraph 10 or 16(b) impairments). The scope of SOP 03-3 also does <u>not</u> address declines in fair value driven solely by interest rate changes.

(b) This paragraph 20 requirement also effectively expands the scope of SOP 03-3 by including beneficial interests, which are subject to EITF 03-1. SOP 03-3 explicitly <u>excludes</u> retained interests from its scope.[8]

(c) EITF 03-1 paragraph 20 requires application of SOP 03-3 <u>prospective</u> amortization after recognition of an impairment loss. For those companies with significant portfolios that are amortized pursuant to SFAS 91 and use the <u>retrospective</u> cumulative catch-up method as required in certain circumstances under SFAS 91, it is unclear how to address the interaction between SOP 03-3 and SFAS 91 (particularly with regard to changes in prepayment estimates). Even if implementation issues can be resolved, the resulting operational complexities that result from requiring two different amortization models within the same portfolio are significant.

Changes in expected future cash flows on debt securities for which an interest-related impairment is measured under EITF 03-1 are not attributable to changes in credit quality. Rather, such changes may correspond to changes in prepayment expectations due to changes in interest rates. SOP 03-3 directly states that SFAS 91 addresses "accounting

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[7] SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer,* paragraphs 3 and B9-B10.

[8] SOP 03-3, paragraph 3.

for differences in prepayments and interest rates that are not attributable to credit quality."[9] Therefore, in absence of a credit-related impairment for a debt security, SFAS 91 should continue to be applied for interest income recognition.

In light of these conceptual issues and the corresponding practical difficulties that they present, we ask you to repeal the EITF 03-1 measurement guidance and instead follow the due process of considering a SFAS 115 amendment, if desired.

II. IF THE EITF 03-1 MEASUREMENT CONSENSUS IS NOT REPEALED -

If the Board decides not to repeal the EITF 03-1 measurement consensus in favor of pursuing the due process of a SFAS 115 amendment, we request the following.

A. We ask that you extend the effective date of the final EITF 03-1 measurement consensus to at least six months after issuance of final guidance.

Please consider a transition period of at least six months before the implementation guidance becomes effective. Per the proposed FSP EITF 03-1-a, we understand that the implementation guidance contained in FSP EITF 03-1-a would be effective "on the last reporting date for reporting periods ending after the final FSP is posted to the FASB website."[10] As discussed in the FASB meeting on September 8, 2004 and reiterated in the September 30, 2004 issue of "The FASB Report," we understand that the effective date could be as early as December 31, 2004.

As we stated in our previous comment letters, the implementation of the paragraph 16(a) requirements for interest-rate driven impairments will require significant interpretation as well as operational changes related to systems and processes. We think that a span of potentially only a few weeks to implement such a significant change would not allow for a well-controlled implementation. The short implementation period will handicap companies' abilities to implement this guidance effectively, especially in light of the competing priorities of routine year-end close efforts and efforts currently underway to complete required internal controls-related initiatives.

B. We support the concept of "minor impairment" and believe that the Board should specify a quantitative threshold of 10%.

We support the concept of a "minor impairment" that would be considered temporary and thus would not require an assertion of ability and intent to hold until forecasted recovery. Additionally, we support the FASB's establishment of a quantitative threshold for this safe harbor "minor impairment." Because companies will have to select quantitative threshold(s) to apply the notion of "minor impairment" on a practical basis, we believe that having the FASB establish the threshold will reduce the uncertainty associated with this judgment and lead to increased comparability among companies. We believe a 10% threshold would simplify operational impacts.

Furthermore, we believe the notion of "minor impairments" should be extended to all investments analyzed under Issue 03-1 (including investments analyzed for impairment under paragraphs 10-

[9] SOP 03-3, paragraph 2.
[10] FSP EITF 03-1-a, paragraph 9.

15 of Issue 03-1) because normal price volatility may likewise eliminate temporary impairments for these instruments as it would for paragraph 16 securities.

If you would like to discuss any of these ideas, please feel free to call Marty Baumann at (703) 903-3940 or John Woods at (571) 382-3900. We would also be happy to meet with you at your convenience to further discuss these issues.

Sincerely,

Martin F. Baumann
Executive Vice President – Finance & Chief Financial Officer

John F. Woods
Senior Vice President – Principal Accounting Officer

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