Letter of Comment No: 120
File Reference: EITF03-1A

SANDERS MORRIS HARRIS GROUP

October 28, 2004

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

Re: Proposed FASB Staff Position Number EITF Issue 03-1-a

Dear Mr. Smith:

Sanders Morris Harris is the largest investment banking firm headquartered in the Southwest and also manages a large broker/dealer operation. We advise and trade securities with banks, thrifts, insurance companies and money mangers throughout the country.

We appreciate the opportunity to comment on the 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". While we appreciate the hard work the Staff devoted to the issue, we are concerned that the effect of the proposed guidance will be similar to that of the now-departed FFIEC rules on high-risk securities, which were repealed after a number of years. We believe the proposals to be a solution in search of a problem.

EITF 03-1 Summarized

At the risk of over-simplifying, we believe the issue is this. Under FAS 115, unrealized gains and losses in an AFS portfolio are currently carried in the Other Comprehensive Income (OCI) account. Readers of the financial statements can readily identify any such gains and losses and make whatever adjustments to the financial statements may be desired. The accounting has no affect on income.

The proposal undoes much of the work of FAS 115 by differentiating between temporary and Other-Than-Temporary impairments. Treatment of a temporary impairment continues unchanged. However, OTT impairments are recognized in the **income statement** and consequently, can potentially increase earnings volatility. The benefit: movement of the unrealized loss from the balance sheet (already disclosed) to the income statement.

600 TRAVIS SUITE 3100 HOUSTON, TEXAS 77002 713.224.3100 FAX 713.993.4611
WWW.SMHGROUP.COM

Recognizing that the proposal is unlikely to be rescinded, Sanders Morris Harris would like to offer some thoughts about several specific issues raised by the Board.

Issue 1: Minor Impairments

We note that treatment of a temporary impairment is unchanged. Thus, a definition of "temporary" that maximizes the number of securities so classified is very beneficial, in our view. The Board was unable to reach a consensus on the topic, but did make clear its problems with a "bright-line" test. Undoubtedly, over the course of time, the accounting profession will zero in on an operational definition. Nevertheless, as generally happens, some firms will continually push the issue, diminishing the clarity of all financial statements and substantially decreasing any benefits from the proposal. We believe that a clear threshold will enhance uniformity in application and will minimize compliance costs.

In the interest of operational simplicity, SMH prefers a straightforward percentage price change rule of 10% (5% is too low – a 62 bp move or so on a 10-year security). The problem with a percentage change rule is that different securities are affected differently. A security with a two-year maturity is far less affected by a given change in rates than a thirty-year one. Thus, long maturity securities are much more at risk for OTTI classification than shorter ones. Accounting considerations should not drive security selection.

A related issue may occur when the market does exhibit a significant change in rates. Classification of unrealized losses to OTTI status will make the security less attractive to hold since the loss is now in income; the unrealized loss can't be "hidden" in OCI (presumably, a goal of the proposal). Since the firm must recognize the loss in earnings anyway, there is less gained by holding the bond. Any sales will create a larger supply of the security in the market and possibly exacerbating the price drop.

Issue 2: Limiting the Notion of Minor Impairments to Debt Securities Evaluated for Impairment Pursuant to Paragraph 16 of Issue 03-1

Limiting the concept of "minor" impairments only to securities whose value could be recovered if held to maturity is understandable from a strictly mechanical point of view. However, as changes in rates and/or sector spreads are an important component of security valuation, exclusion of such changes for a large sector of the fixed income puts at risk the ability of many financial institutions to hedge interest rate risk of other assets or liabilities. We believe that minor impairment classification should also be available for debt securities that can be contractually prepaid or settled in such a way that the investor would not recover substantially all of its cost and equity securities.

In a related issue, Question 3(b) of the FSP asks whether there are 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? The staff position, adopted by the EITF, provides three exceptions:

- ❑ Unexpected and significant changes in liquidity needs
- ❑ Unexpected and significant changes in interest rates and/or sector spreads that significantly extend the period that a security would need to be held by the investor, and
- ❑ A de minimis volume of sales of securities

SMH agrees with these exceptions, as far as they go. Like the old FFIEC high-risk security rules, the proposed rules look at securities in isolation. Most financial institutions create portfolios of investment securities, at least in part, to offset risk in liability portfolios (or in other assets). More buy/sell security decisions are made in the context of risk management than for liquidity or rate/spread changes. Similarly, institutions often make trade decisions on a relative value basis. It is poor public policy to force an institution to choose between "proper" accounting and economic reality. We strongly recommend a provision granting the ability to trade securities for risk management and relative value reasons without triggering negative accounting consequences.

Conclusion

Sanders Morris Harris questions the need for the implementation of EITF 03-1 and would prefer it to be rescinded because:

- ❑ Unrealized loss information is already available in the financial statements
- ❑ High operational and compliance costs
- ❑ Misleading financials as security prices recover

However, should the guidance be implemented, we offer the following suggestions:

- ❑ A clearly defined threshold (e.g., 10% price change) should be used to define "minor impairment"
- ❑ Risk management and relative value should be designated as exceptions to the "tainting" rule

Very respectfully yours,

Peter W. Badger
President
Fixed Income Division
Sanders Morris Harris

Lee A. Olver, CFA
Senior Vice President
Fixed Income Division
Sanders Morris Harris