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Letter of Comment No: 2
File Reference: EITF03-1A

October 15, 2004

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

Re: 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:

Southwest Corporate Federal Credit Union is a wholesale provider of investments and investment services to over 1,300 credit unions nationwide, and the owner of more than \$5 billion of fixed income securities. We are very interested in the final outcome of EITF Issue 03-1, and the impact that it will have on our operations and the operations of our member credit unions.

Southwest Corporate commends the Board for its recent decision to delay the effective date of paragraphs 10-20 of EITF 03-1. We believe that the Board needs to carefully consider all of the issues raised during this comment process because of the potential for EITF 03-1 to cause significant changes to investment practices. The following comments regarding FSP 03-1-a are provided for your consideration.

Additional Guidance Needed Regarding Minor Impairments

We believe that additional guidance is required from FASB to enable financial statement preparers and auditors to apply the notion of minor impairments. The qualitative approach adopted by the Board in paragraph 5 of FSP 03-1-a is not sufficiently clear to ensure consistent application of other than temporary impairments. Although it seems logical that the determination of a minor impairment would be made relative to the circumstances of each security and investor, the Board's apparent willingness to consider a 5 percent bright-line test may indicate that such a determination is meant to be unconditional.

We recommend that the Board insert additional language into FSP 03-1-a to clarify that the determination of a minor impairment should be made relative to a security's characteristics and an investor's asset-liability management (ALM) practices.

Impairments should not be caused by levels of market volatility that are normal relative to a security's characteristics and an investor's ALM practices. We believe that the inclusion of such factors in the determination of minor impairments will properly screen out impairments caused by relatively normal levels of market volatility. Such clarifying language will enable financial statement preparers and auditors to exercise the proper amount of judgment necessary to apply EITF 03-1 on a consistent basis.

As an owner of more than \$5 billion of fixed income securities, the main implementation question that we have concerning FSP 03-1-a is whether the determination of minor impairments considers such factors as the duration (and convexity) of a security and an investor's ALM practices. For example, if a minor impairment determination is unconditional, a 3 percent impairment would likely be deemed as minor and an 8 percent impairment would likely be deemed as not minor for any debt security regardless of its duration. However, if a minor impairment determination is made relative to the duration of a security, an 8 percent impairment would likely be deemed as not minor for a debt security with a 2 year duration, but would likely be deemed as minor for a debt security with a 10 year duration.

If a minor impairment determination is made relative to ALM practices, investors would need to consider how an individual security fits within its ALM structure and process. For instance, in the preceding example of the 8 percent impairment of a security with a 10 year duration, such an impairment may be considered as not minor if the investor generally has a 2 year investment horizon. In addition, other ALM indicators such as the output of rate risk models and security sales trends should be considered when analyzing if the impairment of a certain debt security is minor.

As previously noted, we believe that impairments should not be caused by levels of market volatility that are normal relative to a security's characteristics and an investor's ALM practices. Therefore, we are concerned that the Board's openness to adopt the quantitative approach with a 5 percent bright-line test may indicate that the Board views the determination of minor impairments to be isolated from such factors as security duration and an investor's ALM practices. Among the negative consequences that we see if these factors are not considered in the minor impairment determination are: frequent impairments of longer-duration investments, impairments of securities in which all principal is ultimately recovered, and investors being forced to abandon the available-for-sale investment classification in favor of trading account assets.

Minor Impairments Should Also Extend to Credit-Related Impairments

We strongly believe that minor impairments should also pertain to debt securities that are impaired due to credit factors. Trading volatility does occur in the securities market because of credit considerations. Impairments should not be caused by relatively normal levels of market volatility, regardless of whether the volatility is due to interest rate or credit factors.

Mr. Lawrence W. Smith
October 15, 2004
Page 3 of 5

As previously noted in our comments regarding minor impairment guidance, we recommend that the Board insert additional language into FSP 03-1-a to clarify that the determination of a minor impairment should be made relative to a security's characteristics and an investor's ALM practices. The security characteristics that should be considered when determining if a credit impairment is minor include security duration (and convexity) and issuer creditworthiness. This means that the shorter the duration and the higher the credit rating of a security, the more likely an investor will determine that a credit impairment is minor.

Among the many negative consequences that we see if minor impairments do not include credit considerations are: other than temporary impairments being recognized on investment grade bonds (including those with short durations), other than temporary impairments being determined by regulatory influences instead of an investor's ability and intent, increased potential for tainting of securities that investors assert to have the ability and intent to hold, impairments of securities in which all principal is ultimately recovered, and investors being forced to abandon the available-for-sale investment classification in favor of trading account assets. An expanded use of the trading account classification will lead to unnecessary earnings volatility and potential shortfalls in regulatory-mandated capital levels.

The following example illustrates our concerns. Assume that Southwest Corporate holds a corporate bond that is rated AA- and matures in 2 years. The security experiences a modest price decline because the market perceives that the issuer's financial condition is closer to an A- entity. (Another common scenario would be a modest price decline in corporate bonds in a specific industry sector.) We would need to state our ability and intent to hold the security until forecasted recovery or maturity, or the impairment would be deemed as other than temporary. However, it would be difficult to assert that we have the ability to hold the security until recovery or maturity because federal regulations require that we sell the bond if the issuer rating falls to BBB-. This regulatory influence over the ability assertion is the same reason why Southwest Corporate and similar investors classify investments with credit risk as available-for-sale instead of held-to-maturity.

Southwest Corporate could assert that it has the ability and intent to hold the corporate bond if future downgrades were deemed unlikely, but such an assertion has substantial risk. If Southwest Corporate subsequently sold the impaired security because of actual or potential downgrades to a rating approaching the regulatory minimum, then all credit-impaired securities that we claimed we would hold until recovery would be tainted. If we decided to recognize an other than temporary impairment, we would probably still hold the bond until recovery and collect all principal. If we decided to classify the security as a trading account asset, our earnings would experience volatility. If this example was extended over our entire portfolio, the impact of classifying our securities with credit risk as trading account assets would result in significant volatility in our earnings, and could lower our capital ratios below regulatory-mandated minimums. We believe that reporting

Mr. Lawrence W. Smith
October 15, 2004
Page 4 of 5

a large portion of our investment portfolio as trading account assets would present very misleading results to the readers of our financial statements.

We have two final reasons supporting the inclusion of credit impairments within the notion of a minor impairment. First, variations that exist in debt security prices should not cause impairments. Bond pricing differences exist between pricing models and among security dealers. If minor impairments do not include credit impairments, even a small variance in a bond price could be enough to cause an impairment. Second, extending the notion of minor impairments to include foreign exchange rate impairments (per September 8, 2004 FASB board minutes) but not credit impairments leads to inconsistent results. For example, an investor would not recognize a foreign exchange rate impairment that eventually results in a realized loss, but would recognize an impairment of an investment grade debt security in which no loss of principal ever occurs.

Should Minor Impairments be Limited to Paragraph 16

We need further guidance from the Board defining debt securities described in paragraph 10 in order to decide whether minor impairments should be limited to paragraph 16. Some audit firms and market participants have indicated that they believe a paragraph 10 debt security is a pre-payable security with a par value of 90 percent or less of its purchase price (i.e., purchase premium in excess of 11 percent of par). Other sources have indicated that this threshold is equal to a par value of 85 percent or less of cost. Although a 90 percent par value threshold can be implied from Example 5 of EITF 03-1, Note 14 of the same document contradicts such a threshold as it refers to purchasing a security at any premium. If an 85 percent to 90 percent par value threshold is accurate, we believe that the Board must make this clearer within the body of FSP 03-1-a. For example, terminology could be added to further define a paragraph 10 debt security as having a significant premium. Such language would better define the Board's intent while not specifying a bright-line measurement.

If paragraph 10 debt securities are not limited to pre-payable securities with significant premiums, then we are concerned that Example 5 seems to indicate that any mortgage or asset-backed security with a premium would be deemed as a debt security described in paragraph 10. The Board needs to clarify whether debt securities described in paragraph 10 include mortgage and asset-backed securities in which the purchase premium is amortized in accordance with paragraph 19 of SFAS 91.

We believe that mortgage and asset-backed securities accounted for under paragraph 19 of SFAS 91 should fall under the definition of debt securities described in paragraph 16 because the impact of prepayments is factored into their premium amortization calculation. It is not possible for a significant premium balance to exist when a mortgage or asset-backed security has been prepaid if the security is accounted for under paragraph 19 of SFAS 91. By comparison, the premium amortization calculation of a callable

Mr. Lawrence W. Smith
October 15, 2004
Page 5 of 5

corporate bond would not address its prepayment impact, so such a bond could have an unamortized premium balance remaining when it is prepaid in full.

In conclusion, if paragraph 10 debt securities refer to pre-payable securities with significant premiums or if mortgage and asset-backed securities accounted for under paragraph 19 of SFAS 91 fall under paragraph 16, then we agree with the Board in limiting minor impairments to paragraph 16.

Other Comments

1. The Board needs to clarify the meaning of the term de minimis as used in paragraph 7 of FSP 03-1-a. The FASB board minutes of the September 8, 2004 meeting include a comment by a board member indicating that the term de minimis applied to mistakes. We believe that tying the term de minimis to trading mistakes represents a significant limitation to the guidance provided in paragraph 7. Did the Board intend for the term de minimis to apply solely to trading mistakes?
2. The Board needs to state within FSP 03-1-a that transfers of securities into trading account assets are permissible upon the adoption of EITF 03-1.

I appreciate having the opportunity to comment on FSP 03-1-a. If you have any questions regarding this letter, please feel free to contact me at 972-861-3160.

Sincerely,



John P. Cassidy
Senior Vice President, CFO