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October 22, 2004

Mr. Lawrence Smith
Chairman
Emerging Issues Task Force
Financial Accounting Standards Board
401 Merritt 7
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Letter of Comment No: 62-A
File Reference: EITF03-1A

RE: Emerging Issues Task Force Issue No. 03-1A, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments"

Dear Mr. Smith,

Thank you for the opportunity to comment on the proposed FASB Staff Position No. EITF Issue 03-1. We are writing this letter in our capacity as research analysts at Goldman Sachs & Company covering the life insurance companies.

Having covered the life insurance companies for over 20 years, the aim or this letter is to provide the Board with the unique perspective of the life insurance company financial statement analyst/user. In general, we understand the direction sought by EITF 03-1 as we believe providing more specific guidelines on impairing assets through income for both credit and interest rate risk is appropriate. For a life insurance company in particular, liquidity and credit are key risks that determine yield and margins and the failure of an asset strategy should be reflected in the financial statements. Where we diverge with the Board is in the application of EITF 03-1 – as the rules specifically relate to life insurance companies. In our view, generic application of the rules could lead to negative unintended consequences for life insurance companies given – their specialized business model, a unique approach to managing/matching assets/liabilities, and customized analyst valuation metrics. As such, we believe that application of the rule should take into account these life-insurance specific issues.

We provide a detailed rationale supporting each of our comments below. A summary of our key conclusions are as follows:

- A bright-line carve-out rule for minor impairments less than some given threshold (scaled for duration) is appropriate

- Beyond the safe-harbor for "minor impairment", an asset/liability duration matching carve-out to the evaluation of whether an impairment is other than temporary should exist
- The security unit level (versus portfolio) is appropriate, but would go further to allow for review at the sub-security unit level
- Accreted investment income on impaired debt should be disclosed separately from other investment interest income

#1 – "Safe harbor" excluding minor impairments – We believe a bright-line carve-out rule for minor impairments less than some given threshold (scaled for duration) is appropriate

* **Background/proposed rule** – The first step in determining whether impairments should be considered "other than temporary" is simply to consider those assets where fair value of the security is less than its carrying value. The Board has indicated a willingness to deem that "minor impairments" can be considered temporary without further analysis. In this regard, a decline in fair value relative to amortized cost of less than 5% has been discussed. The Board is considering whether a bright-line rule – such as a 5% threshold – or a judgment-based rule interpreting "minor impairment" is appropriate.

* **Our perspective** – While we generally would not favor "bright line" rules, this situation is different in that the rule is really meant to offer a safe harbor to eliminate *de minimus* losses from the bucket of assets considered for impairment avoiding unnecessary effort based on short term interest rate volatility rather than a secular move in yield. We further recognize that any single number (e.g. - 5%) may be inappropriate because it would not reflect the impact of different durations. One solution would be a scaled bright line test proportionate with duration.

The effect of such a bright line test would not *automatically* require a company to impair securities through the income statement with fair value less than the bright line threshold percent of amortized cost. Indeed, securities which don't fall within the safe-harbor would simply undergo a case-by-case, facts and circumstances review. Given no security would be prejudiced - and would simply require further review – we believe that a bright-line test would be appropriate.

#2 – Evaluation of whether an impairment is other than temporary – We believe an asset/liability duration matching carve-out should be implemented

* **Background/Analyst Perspective** – From the financial statement user/analyst perspective, we are concerned when assets are mismatched with liabilities. This is particularly the case today, given that many insurers have increased the amount of duration mismatch to help mitigate the historically low interest rate environment that has existed in the last few years. Especially at this time, when interest rates are poised to potentially move higher over time, it will be important for analysts to be aware of the company-specific liquidity risks.

* **Proposed rule** – Assuming a security does not fall under the safe-harbor for minor impairment, the next step applied calls on companies to evaluate whether the impairment is other than temporary. As written, the rule says that:

> "...investors should make an evidence-based judgment about a recovery of fair value up to (or beyond) the cost of the investment by considering the severity of and duration of the impairment in relation to the forecasted recovery of fair value"

Providing further guidance, paragraph 16 of Issue 03-1 states

> "...impairment should be deemed other than temporary if (a) the investor does not have the ability and intent to hold an investment until a forecast recovery of fair value up to the cost of investment ...".

* **Our perspective** – Companies with duration matched assets could evidence an affirmative ability but not the intent to hold a security to recovery. As such, we propose an asset/liability duration matching "carve-out" in situations where no liquidity risk is present, as assets are matched to offsetting liabilities. Specifically, a security could fall within the proposed carve-out if a company could evidence to its auditor that the asset(s) in question are matched to offset liabilities of functionally equivalent duration (and currency). Under such circumstances, we believe that any impairment to the assets in question should be deemed temporary and not impaired through income.

For example, without the carve-out proposed, in a rising rate environment, even if anticipated, life insurance companies (regardless having tight asset/liability matching), could conceivably have assets impairments deemed "other than temporary". Since the matching of assets and liabilities is precisely the charge of the typical life insurance company, we don't think insurers earnings should be penalized for such impairments. To be sure, impaired assets which do not properly match offsetting liabilities are precisely the assets that analysts care about – and impairments to these riskier assets should be incurred through income and should be transparent. Application of the "intent and ability" test to such securities could prescribe such an outcome.

We strongly believe that application of this carve-out is not just appropriate, but is necessary to avoid the unintended negative consequences that could result from application of the proposed rule. Should the rule apply with no such carve-out, we ultimately believe that analysts will have a more difficult time in assessing the quality of returns on equity (ROE) and other key metrics by the life insurance analysts. Book value excluding FAS 115 (as key metric used by life insurance analysts[1]) will be a less comparable metric across companies. Companies with a greater level of interest rate impairments – reflecting more than just impairments due to liquidity risk – will have relatively depressed equity levels excluding FAS 115, inflated operating earnings (from accreted interest income on impaired assets – see below for further discussion), and

[1] Life insurance analysts usually back out FAS 115 unrealized gains and losses from shareholders' equity for ROE calculations to avoid the volatility of marking assets to market without a similar discipline for liabilities strictly based on interest rate swings.

inflated ROEs. Ultimately, financial statement analysts would have a more difficult time assessing whether or not interest rate impairments are a reflection of the greater risks associated with asset liability mismatching. One key goal of accounting rules is to enable financial statement users to understand the risks inherent in a company to assess ultimate health of the enterprise. With respect to the life insurance analyst, as currently proposed, we believe the rule will do just the opposite.

#3 – At what unit must an insurance company assert ability and intent – We believe the security unit level (versus portfolio) is appropriate, but would go further to allow for review at the sub-security unit level

* **Background** – The unit level at which insurers apply the ability and intent test is one of the most critical issues for the life insurance companies. The original draft was vague when interpreting the potential tainting of an entire portfolio if a specific security was sold (similar to risks for bonds classified as held-to-maturity). Auditors indicated that without further clarification, they would take a strict view and consider a company's decision to sell a portion of the bonds that have losses due to interest rate moves as proof that there is no intent to keep any of the bonds in that asset class long enough to regain par value. This caused the life insurance industry to respond aggressively against the proposal.

* **Proposed rule** – Following the September hearing, we understand that the Board is leaning toward requiring impairments to be done at the specific security level, as opposed to on a portfolio basis.

* **Our perspective** – At a minimum, we agree with the direction of the Board, and believe the correct application should be at the security level, though we would extend this view to allow for different results for the same security. Considering first the portfolio versus security unit level case, if the rule were applied at the portfolio level, we believe that individual security sales could lead to draconian outcomes whereby a whole portfolio could be tainted. We think the EITF is correctly leaning toward security level analysis to avoid such harsh outcomes, and further to avoid a rule which could hinder companies from making sensible economic decisions where a sale of a specific security could lead to impairments related to the entire asset class. The most obvious example would have an insurer concerned that an unanticipated decision to sell a portion of a specific asset class of securities to reposition into higher yielding assets, to adjust durations, or to capture a tax benefit, may risk tainting the intent on an entire block of securities.

Applying this same logic, we take the further view that analysis of specific securities should allow the impairment of a portion of a specific security, while not tainting the entire block of said security. At the most basic level, a company could hold the same security in two separately run divisions or in two different portfolios. A lack of intent or inability to hold the security in one division/portfolio should not, by definition, taint the remaining holdings of the security in the other division. We could envision an insurer making a sound decision to sell some of the security in one division/portfolio, while at

the same time, holding the remaining portion as part of an asset/liability duration match in another division/portfolio. There are many more examples which would highlight the need for this less restrictive sub-security unit level review. Should the EITF not allow exceptions for portions of securities, the unintended consequence could be to hinder companies from making appropriate, value creating decisions. For the very same reasons the EITF is leaning toward security versus portfolio unit level application, we believe the proper treatment should allow for sub-security unit level application, or at least consider the same security differently where said security is held in different divisions/portfolios.

#4 – Accounting for other than temporary impairments – We believe that accreted investment income on impaired debt should be disclosed separately from other investment income

* **Background/proposed rule** – Once a security is deemed "other than temporarily" impaired, the asset is marked-to-market, with an unrealized loss flowing through the income statement and reducing retained earnings, similar to realized losses and credit impairments. Should interest rates reverse, the recovery in fair value of that impaired bond would not be reflected in AOCI. Instead, in future periods, the impaired asset would regain value having nothing to do with interest rate movements and will actually generate extra investment income. This result follows the accounting/logic of buying a bond at a discount and accreting the discount as interest to investment income. In theory, if the impaired bond were ultimately held to maturity, the amount of the impairment would be offset by recycled income through this accreted interest.

* **Our perspective** – We have no disagreement with the substance of the rule, our dispute however is with the form. By way of background, life insurance analysts tend to focus on the non-GAAP-defined "operating earnings" (net income less realized gains/losses) and not on the GAAP-defined "net income". The realized losses from the security impairment, reported in its own line, "realized gains/losses"(and not in investment income) is excluded from operating earnings in order to focus on long term strategies of sales, spreads, revenue growth, benefit trends, and expenses . However, if accretion from impaired bonds were to mix in with investment income, a major impairment due to rising interest rate moves can distort investment income and portfolio yields making comparisons across companies less valuable. As such, we believe if accretion on impaired bonds is going to be recognized on the income statement at all, that the recognition takes place in a manner such that analysts can appropriately exclude such interest income from operating income and portfolio yields. We suggest reporting the interest on a separate line – "accreted interest from impaired securities".

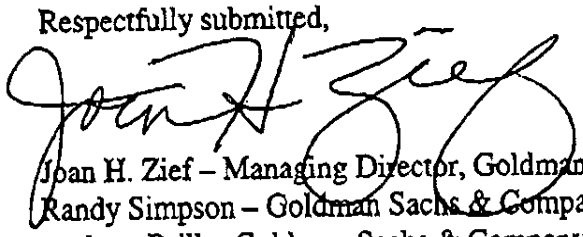
Without such a requirement, stand-alone analysis and comparability across companies of key metrics would become much more difficult. For example, if accretion from impaired bonds were mixed with investment income, the portfolio yields will be adjusted upward and operating income would be arbitrarily higher. Putting numbers around the example, consider, a bond purchased at face value and impaired as a result of interest rates at 90% of face value of $100 with 9 years left to maturity and a 5% annual coupon. Such a bond would have investment income reflected on the income statement in the first year

following impairment of $5.90 on an increased account value of $90.90 (an effective yield of 6.5%), 18% greater than the $5.00 in investment income that would have otherwise been recognized. Both earnings and spreads will be distorted and distortion will increase with the life of the impaired bonds. Moreover, a spike in interest rates resulting in multiple impairments could result in materially enhanced yields that are not reflective of the economic fundamentals and statutory results of the business.

If these unintended consequences weren't reason enough to adopt our perspective, we highlight the further unintended result that future revenue growth could be managed through interest rate impairments. If the impaired asset value can be accreted back into investment income, insurers would be in a position to enhance investment income and reported earnings growth by being conservative in their intent assumptions and impairing an inflated amount of available for sale securities materially adversely affected by rising interest rates. In addition to complicating the ability for an analyst to evaluate results on a stand-alone basis, comparability across companies would also be hindered as different companies could, with minimal transparency, adopt differing policies in this regard.

If you would like to discuss this letter with us in more detail, please feel free to contact us at (212) 902-6778.

Respectfully submitted,



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