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EITF 03-1

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❖Executive Summary

- We commend the FASB for its decision to delay the implementation of EITF 03-1 for securities falling within the scope of paragraphs 10 to 20.
- Procedurally, we believe the FASB should address a number of significant issues prior to issuing any final interpretive standard for determining whether an impairment is temporary or other than temporary.
- FSP EITF 03-1-a does not address many of the issues identified in the FSP EITF 03-1-b comment letter process and as such should be formally amended and re-distributed to constituents to ensure the FASB, in its re-deliberation process, solicits views on all items affecting the application of the proposed guidance.
- Significant issues that should be addressed include, but are not limited to, the following:
  - Relevance of the guidance set forth in FASB Statement No. 115 (SFAS 115) regarding available-for-sale securities (AFS). **See Page 5**
  - Application of the "intent" to hold impaired securities classified as AFS. **See Pages 6 and 7**
  - If the AFS designation will be eliminated for impaired securities the FASB should consider the following: **See Pages 8 and 9**
    - The desirability of re-introducing a lower of cost or market-like (LOCOM-like) standard which was previously eliminated by SFAS 115, and
    - The need to allow reporting entities, most of which classify the majority of securities in their investment portfolios as AFS, at least a one-time ability to reclassify AFS securities to trading without the threat of triggering a tainting event.

❖Executive Summary - continued

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- Significant issues that should be addressed – continued:
  - If a LOCOM-like standard is re-introduced, the impact of that re-introduction on reported results assuming the concurrent implementation of SOP 03-3. **See Page 10**
  - How to distinguish between fixed income securities that fall within the scope of paragraphs 10 and 16 of EITF 03-1. **See Page 11**
  - How to distinguish impairments caused by company-specific (idiosyncratic) risk from those caused by increases in interest rates and/or the widening of credit sector spreads. **See Page 12**
  - The concept of minor impairments set forth in FSP EITF 03-1-a and its operational practicality. **See Page 12**

- As the FASB moves forward to address the outstanding issues we also urge you to consider the following guiding principles: **See Page 13**
  - Principles based guidance is preferable to rules based guidance.
  - Consistent interpretation and application should be achieved.
  - Financial reporting should reflect management's intent and should not cause reporting entities to take un-natural actions (e.g. pre-emptively writing-down temporarily impaired securities) that are inconsistent with their intent.
  - Financial reporting should not lead to the economic penalization of a class of securities.
  - Depending on the complexity of the final standard, reporting entities should be allowed sufficient time to appropriately implement the standard.

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❖ Issues

- **Relevance of SFAS 115 guidance regarding AFS securities**
  - SFAS 115 specifically created the AFS designation for those securities that a reporting entity did not have the intent to either actively trade or hold to maturity. SFAS 115 allows AFS securities to be sold for reasons including, but not limited to, the following:
    - Changes in market interest rates and related changes in a security's prepayment risk.
    - Needs for liquidity (e.g. due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims).
    - Changes in the availability of, and the yield on, alternative investments.
  - For most financial services companies with investment securities that fall within the scope of SFAS 115, the securities are primarily used for liquidity and to meet financial obligations and are managed pursuant to a comprehensive asset-liability management framework.
  - The dynamic nature of both liquidity needs and asset-liability management requires financial services companies to retain the ability to sell securities in the future, as to forgo that right could significantly impair the economic value of the reporting entity.
  - Moreover, reporting entities should have the ability to sell temporarily impaired AFS securities (without the threat of tainting) as long as a change in intent is substantiated by a change in facts and circumstances consistent with the AFS designation (e.g. unexpected changes in interest rates, liquidity needs, etc.).
  - A decision to eliminate (except in very limited circumstances) a reporting entity's ability to sell temporarily impaired AFS securities until their full recovery or maturity (without triggering a tainting event) is wholly inconsistent with the spirit and intent of the AFS designation in SFAS 115.
  - Moreover, temporary impairments are already reported in Other Comprehensive Income pursuant to the requirements of SFAS 130, a standard designed to focus on items such as unrealized losses that affect shareholders' equity but not reported income.

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❖ Issues - continued

- **“Intent” to hold temporarily impaired AFS securities**
  - Designation of the requisite intent to hold impaired securities until recovery is the cornerstone of the impairment guidance in SFAS 115.
  - Historically, the intent to hold impaired AFS securities until recovery has been applied in a manner consistent with the AFS designation. That is, impaired AFS securities might be sold in the future (prior to a full recovery or maturity) but only due to a change in intent caused by a change in the facts and circumstances (e.g. change in liquidity needs, asset-liability management, etc.).
  - As currently written, SFAS 115 does not require reporting entities to designate a “quasi-permanent” intent (i.e. an intent that extends through future periods regardless of changes in most circumstances) to hold temporarily impaired AFS securities. The only “quasi-permanent” intent in SFAS 115 is that related to held-to-maturity securities. In that case, the designation is appropriate. In contrast, for temporarily impaired AFS securities, requiring the designation of a “quasi permanent” intent to hold to full recovery or maturity is fundamentally inconsistent with the AFS designation.
  - Most reporting entities regularly review inventories of securities with unrealized losses and assess whether any impairments are temporary or other than temporary. The assessment includes an evaluation of whether the security will be sold in the foreseeable future and in situations where there are plans to sell the security, impairments are recognized. In contrast, if there is no intent to sell an impaired security, and the impairment is believed to be temporary, no other than temporary impairment is recognized as to recognize a loss in that situation is inconsistent with management’s intent and would likely lead to the recognition of a current period loss only to be off-set by future gains which would only serve to distort income trends.

❖ Issues - continued

- **"Intent" to hold temporarily impaired AFS securities – continued**
  - We understand the relevance of the "pattern of selling" statement as it relates to securities that are designated as held to maturity. In contrast, we do not believe the "pattern of selling" statement currently in paragraphs 12 and 16 of EITF 03-1 should be applied to temporarily impaired AFS securities except with respect to sales of temporarily impaired AFS securities where a change in intent is not substantiated by a change in facts and circumstances as set forth in SFAS 115.
  - Accordingly, we believe the intent to hold temporarily impaired AFS securities should be required to be designated at each reporting period but should not result in a tainting event if such securities are subsequently sold before fully recovering (or maturing) so long as there was no intent to sell as of the most recent reporting date and the reason for the sale is consistent with the criteria set forth in SFAS 115 for AFS securities.

❖ Issues - continued

- **Consequences of eliminating the AFS designation for temporarily impaired securities**
  - If the AFS designation is eliminated for impaired securities, the FASB should consider the following:
    - The desirability of re-introducing a LOCOM-like standard which was formally eliminated by SFAS 115.
      - SFAS 115 concluded very definitively that LOCOM-like accounting is uneven-handed and undesirable and as such eliminated its use. It is our belief that in the time since SFAS 115 was introduced there has been no modifications to LOCOM-like accounting to render it a preferable model to that set forth in SFAS 115.
      - In most instances, reporting entities that would adopt a LOCOM-like policy, would do so to preserve the ability to sell temporarily impaired securities in the future without the threat of tainting. Stated differently, a reporting entity may consider an impairment to be temporary and have the current intent to hold the security until recovery but may nonetheless recognize a "pre-emptive" write-down if it has a desire to retain the ability to sell the temporarily impaired security in the future if the need arises due to liquidity needs, asset-liability management purposes, etc. without the threat of triggering a "tainting" event.
      - We do not believe that having reporting entities account for securities in a manner that is inconsistent with both the spirit and intent of SFAS 115 and their own intent is a desirable outcome.

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❖ Issues - continued

- **Consequences of eliminating the AFS distinction for temporarily impaired securities - continued**

  - The need to allow reporting entities, most of which classify the majority of their investment securities as AFS, at least a one-time ability to reclassify AFS securities to trading without triggering a tainting event.

    - If the FASB agrees that re-introducing a LOCOM-like standard is undesirable (as it would require reporting entities to account for securities in a manner inconsistent with their intent) but at the same time effectively suspends application of the AFS criteria to impaired securities, it should allow reporting entities to re-designate AFS securities to trading without triggering a tainting event.
    - Although a trading designation would also be undesirable inasmuch as it would also be inconsistent with the intent of the investor (i.e. it would not be the intent of the investor to trade temporarily impaired securities in a manner designed to take advantage of short-term market movements), it would be preferable inasmuch as it would recognize both gains and losses, in contrast to the distortions that would accompany a LOCOM-like standard.
    - As a result of the preceding, we believe the FASB should retain use of the AFS designation for temporarily impaired AFS securities and allow reporting entities to sell temporarily impaired securities provided the sale is executed pursuant to the criteria set forth in SFAS 115 for AFS securities. However, if it decides to eliminate the use of the AFS designation for temporarily impaired AFS securities then it should allow at least a one-time re-designation to trading (without risk of tainting) as this would be superior to the LOCOM-like accounting that would likely emerge.

❖ Issues - continued

- **Re-introducing a LOCOM-like standard would degrade the quality of reported earnings**
  - As previously stated, a LOCOM-like standard would likely result in the recognition of "pre-emptive" write-downs designed to preserve reporting entities' ability to sell temporarily impaired AFS securities in the future (without the threat of triggering a tainting event) consistent with the rationale underlying the AFS designation in SFAS 115.
  - In the event of the preceding, the affected securities would be written down, however, due to the reporting entity's belief that the cost of the security is fully recoverable, the amount of the write-down would immediately begin to be accreted into investment income pursuant to the guidance in SOP 03-3.
  - We believe this accounting consequence would be undesirable inasmuch as it would lead to a distortion of both realized capital losses and investment income and would not allow financial statement users to accurately assess either credit trends or trends in investment income and any associated margin analyses that are presented.

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❖ Issues - continued

- **Distinguishing between fixed income securities that fall within the scope of paragraphs 10 and 16**
  - With respect to the key issue of intent, we believe it applies equally to securities that fall within the scope of paragraphs 10 and 16.
  - With respect to the issue of debt securities that can or cannot be contractually pre-paid or otherwise settled in such a way that the investor would not recover substantially all its cost, it is unclear what criteria should be used (e.g. contractual terms, security ratings, etc.) to distinguish securities that fall within the scope of paragraph 10 versus 16.
  - Accordingly, as the FASB moves forward with the re-consideration of EITF 03-1 we suggest that further consideration be given to providing more definitive guidance on how to clearly distinguish between fixed income securities that fall within the scope of paragraph 10 and paragraph 16, and furthermore, whether (or why) those distinctions continue to be necessary.
  - It is our belief that the majority of fixed income securities fall within the scope of paragraph 16.
  - In terms of paragraph 10, we believe it is difficult to determine what was meant by phrase "debt securities that can be pre-paid or otherwise settled in such a way that the investor would not recover substantially all its cost". More specifically, Example 5 makes no reference to an assessment of the value of the collateral. It is unclear as to whether this omission was intentional and reporting entities should assume that all MBS, ABS, CMBS, CDO's, CLO's, etc. fall within the scope of paragraph 16 unless they were purchased at a significant premium (which has been interpreted inconsistently as either 5% or 10%) or whether further guidance is necessary.

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❖ Issues - continued

- **Distinguishing between impairments caused by idiosyncratic risk and those caused by increases in interest rates or the widening of credit sector spreads.**
  - For impairments that fall within the scope of paragraph 16, if the FASB intends to retain its proposed guidance that would allow reporting entities to designate as temporary, impairments attributable to increases in interest rates or credit sector spreads, it will need to provide further guidance on how to identify the portion, if any, of an impairment that is caused by idiosyncratic risk as opposed to increases in interest rates or credit sector spreads. In the event no further guidance is provided on how to identify the portion of an impairment attributable to idiosyncratic risk we believe there will be substantial diversity in practice on how to identify idiosyncratic risk. Moreover, this will lead to the undesirable consequence of inconsistencies in the recognition of other than temporary impairments on similar securities among reporting entities.

- **Minor impairments as set forth in FSP EITF 03-1-a and its operational practicality.**
  - The issue above also highlights the need to identify a "reasonable" level of impairment that is deemed to be temporary. If the unofficial threshold is 5%, that would require reporting entities to individually review all securities with an impairment greater than 5% to determine first whether any idiosyncratic factors are contributing to the total impairment and if so whether those factors are significant enough to be suggestive of impairment that is other than temporary. We believe that any such requirement would be wholly impractical to implement on an individual security basis and therefore would not meet the cost-benefit test. Accordingly, we believe there should be no "bright line" minor impairment threshold, but rather, reporting entities should be required to substantiate their judgments with respect to impairments they deem temporary.

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❖ Other Issues

- **Principles based guidance is preferable to rules based guidance.**
  - Given the unique characteristics of investment securities we believe the other than temporary impairment guidance should be principles as opposed to rules based to preserve its "shelf life".
- **Consistent interpretation and application must be achieved.**
  - All significant implementation issues as identified herein should be addressed to avoid the potential for inconsistent application.
- **Financial reporting should be consistent with management's intent.**
  - Before issuing a final standard the FASB should consider whether the guidance will result in reporting entities reporting impairments in a manner consistent with their intent (as opposed to reporting pre-emptive write-downs to maintain the ability to sell securities without causing a tainting event), and if not, reconsider the guidance.
- **Financial reporting should not economically penalize a class of securities.**
  - Before issuing a final standard, the FASB should consider whether the guidance will lead to the economic penalization of a class of securities which may be the case if the proposed guidance in paragraph 16 regarding temporary impairments is not extended to securities within the scope of paragraph 10.
- **Depending on the complexity of the final standard, reporting entities should be allowed sufficient time to appropriately implement the standard.**
  - Depending on the final guidance set forth in the standard the FASB should solicit comments from the industry to determine the time necessary to implement the revised guidance. If significant system and process changes are necessary, the FASB should consider giving reporting entities six to twelve months to implement the guidance.