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September 3, 2004

Mr. Robert Herz  
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Mr. Lawrence Smith  
Chairman  
Emerging Issues Task Force  
Financial Accounting Standards Board  
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**Re: Emerging Issues Task Force Issue No. 03-1, “*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*”**

Dear Mr. Herz and Mr. Smith:

We understand that the FASB has recently received a number of letters from its constituents expressing concerns with regard to the application of EITF Issue No. 03-1, “*The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*” (EITF 03-1). Our members share many of the concerns that have been expressed, as we believe that the way the guidance in EITF 03-1 is currently being interpreted represents a fundamental change in the accounting for available-for-sale (AFS) securities under SFAS No. 115, “*Accounting for Certain Investments in Debt and Equity Securities*” (FAS 115) that was not anticipated by the EITF during deliberations. Because we believe that this interpretation is inconsistent with SFAS No. 115, we are pleased to see that the FASB is considering revisiting the issue at its Board meeting next week. We would like to take this opportunity to briefly summarize our concerns and to provide a possible solution for the FASB and/or EITF to evaluate as it reconsiders this issue.

Specifically, we are concerned with what we believe are extreme interpretations of EITF 03-1 that have been recently espoused by independent audit firms. Under these interpretations, sales of AFS securities at a price below cost could quickly establish a “pattern” that would make it very difficult for enterprises to purport that they have the intent to hold other securities in their AFS portfolio to recovery. In fact, it has been stated by at least one of the largest audit firms that even *one* sale of an AFS security below cost could establish such a pattern. To overcome the presumption of a pattern,

the very restrictive list of permitted sales of held-to-maturity (HTM) securities has been proposed by some as the means to determine the types of sales that would not be considered inconsistent with an intent to hold until the security recovers.

We strongly disagree with the idea that just a few sales of AFS securities below cost demonstrates a “pattern” and that such a pattern would “taint” the remainder of the securities in the AFS portfolio. For larger institutions, an AFS portfolio can easily consist of many thousands of individual securities and amount to many billions of dollars worth of high quality assets. To suggest that a sale of a single security, or even two sales, at a price below cost can taint the rest of the portfolio and thereby necessitate an other-than-temporary impairment (OTTI) charge for all other securities below cost is neither rational nor consistent with the guidance in FAS 115, which has always permitted a certain level of sales in the AFS portfolio.

Further, we do not believe that it was the EITF’s intent to apply only the permissible sales criteria for HTM securities to the guidance in paragraph 12 of the Issue regarding a “pattern of selling investments” - if it were, we believe the EITF should have referenced such criteria in the guidance. We believe that applying these criteria to AFS sales is inconsistent with FAS 115, because FAS 115 so clearly imposes these requirements only on the HTM portfolio.

FAS 115 clearly states that if an enterprise has the intent to hold the security for only an indefinite period of time, it would not classify such security as HTM; rather, it should be classified as AFS. Paragraph 9 of FAS 115 also states that the following intended sales are inconsistent with classification of a security in an HTM portfolio: the sale of a debt security in response to changes in market interest rates, needs for liquidity, changes in the availability and yield on alternative investments, changes in funding sources, changes in foreign currency risk, changes in credit quality, or changes in asset-liability management. By extension, then, these types of sales *are* permissible if the security is held in an AFS portfolio. In actual practice, investors typically manage their AFS portfolio without regard to recovery of market value as a condition for sale. As a result, most enterprises could not, in good faith, represent that they have the intent and ability to hold until the forecasted recovery period, and that is why they chose the AFS category.

Accordingly, it is our opinion that imposing HTM criteria on AFS securities trading below cost would make the management of an AFS portfolio untenable. Because the interpretation is so far from current practice, we believe that if this was indeed the intent of the EITF, then the change is in reality an amendment to FAS 115 without the appropriate due process.

In addition to our concerns about the consistency of the EITF 03-1 guidance with other US GAAP guidance, a subset of our members with international presence and reporting responsibilities have expressed great concern over the continuing divergence of US and International Accounting Standards, while at the same time espousing an objective of convergence. As a part of the FASB’s response to industry’s request for clarification, we strongly encourage the Board to address

implications of further constraining an impairment model based on a subjective evaluation of recoverability versus the IASB's impairment model based on objective evidence of impairment. We would also appreciate insight into the FASB's strategy for convergence on this issue.

### **Proposed Solutions**

Under the currently espoused application of EITF 03-1, AFS securities would be deemed other-than-temporarily impaired if management does not have the express intent and ability to hold the securities until a forecasted recovery as demonstrated by the practice of virtually never selling securities that are below cost. This is much stronger than the language in EITF 03-1, which states that "although not presumptive, a pattern of selling investments prior to the forecasted recovery of fair value may call into question the investor's intent." EITF 03-1 has no concept of a materiality threshold for selling investments, before any risk of "tainting" the remainder of the "hold-to-recovery" portfolio would arise. It is our view that a "pattern of selling" should be based on the volume of activity compared with the size and number of positions, and that parameters regarding what an acceptable volume of sales of securities below cost should be defined by enterprises based on the size of their portfolio and the management of their AFS portfolio as demonstrated by past practice.

More fundamentally, however, we believe that the real source of the difference in interpretation lies in the definition of "impairment" in paragraph 6 of EITF 03-1, which essentially defines a security as impaired if its value is below cost, regardless of the severity or duration of such a decline. We respectfully submit the following as a potential alternative method for evaluating OTTI. This alternative would retain the three-step impairment model in EITF 03-1, but would change some of the procedures in Steps 1 and 2.

First, we recommend modifying the definition of impairment. As noted above, when determining whether an investment is impaired in Step 1, paragraph 6 of EITF 03-1 states that an investment is impaired if the fair value of the investment is less than its cost. We do not believe that all investments below cost should be defined as impaired. Rather, we believe that investments that are *significantly* below cost for an *extended period of time* should be considered impaired. We feel the severity of the impairment and the duration of the impairment are important factors in assessing whether or not a security is impaired. Further, we believe this approach is consistent with the criteria in paragraph 8 used to assess cost method investments, which look to whether there has been an event that has had a "*significant* adverse effect on the fair value of the investment" – citing, among other factors, a *significant deterioration* in earning performance, credit rating, or asset quality of the borrower; or a *significant adverse change* in the regulatory, economic, or technological environment or the general market condition of the borrower's geographic area or industry.

Therefore we recommend adding these factors to step 1, and rewording paragraph 6 to read, "An investment is potentially other-than-temporarily-impaired if the fair value of the investment is significantly below its cost for an extended period of time"

(or words to this effect). This approach would most likely include AFS securities that have declined in value due to deterioration in the issuer's creditworthiness or significant interest rate and credit spread movement, but will exclude most highly rated securities that have declined in value due to moderate changes in interest rates.

Next, the securities in this potentially impaired pool should be evaluated for recovery. The evaluation of whether these securities are other-than-temporarily impaired would take into account the enterprise's ability and intent to hold an investment for a reasonable period of time sufficient for a forecasted recovery of fair value up to or beyond the cost of the investment. At this point, the ability and intent criteria would be applied to securities that have been identified as impaired because they are significantly below cost, have been for an extended duration, but are expected to recover based on supportable evidence. This pool of potentially impaired securities becomes the pool where the investor's ability and intent to hold the securities through the recovery period is evaluated. And it is in this step that the sale of a certain amount of securities could result in an investor's inability to assert its intent to hold through to recovery. If it is unlikely that the security will recover other than through maturity, the security is other-than-temporarily impaired and the difference between cost and fair value should be reflected in income.

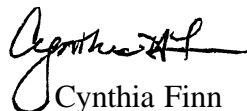
We believe that this approach, while necessitating a change to the published guidance, would resolve the different interpretations that have been promulgated regarding an investor's ability and intent to retain a security through the recovery period. In the meantime, we note that FASB will be considering postponing the effective date of EITF 03-1 at its Board meeting next week and strongly encourage the Board to pursue this course of action. A deferral would enable the FASB and EITF to ensure that the application of the guidance is consistent with FAS 115, and to consider the implications of its approach with respect to International Accounting Standards. Even if a change to the current guidance is not effected, we believe that a deferral is necessary to give investors sufficient time to implement the current consensus, given the systems constraints and operational difficulties of applying this guidance to portfolios that may contain thousands of individual securities and amount to many billions of dollars.

If you have any questions regarding this letter, please do not hesitate to contact either Esther Mills at 212-449-2048, Cynthia Finn at 770-690-4706, or George Miller of The Bond Market Association at 646-637-9216.

Sincerely,



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Douglas Taggart, *The Asset Managers Forum*  
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