FASB Changes

Reporting for ‘other-than-temporary impairment’ rules

The Financial Accounting Standards Board’s Task Force on Emerging Issues has issued new guidance on equity and debt securities that are “other than temporarily impaired.” This new guidance is fairly general. However, in an overabundance of caution, several accounting firms have adopted extremely conservative interpretations of the new guidance and have effectively changed the rules set out in FAS 115.

The limited space for this column does not allow for extensive explanation of all the changes that have occurred. But it does allow for an explanation of a new tool that can help avoid some of the pitfalls that have been placed in the way of community bankers who occasionally or actively sell investment securities to raise liquidity, increase portfolio yields, or rid themselves of investments that no longer fit their needs.

A Quick Look

Although the task force was accepting comments on the new guidance when this column was written in October, several conditions are expected to remain in the accounting firms’ interpretations of the final issuance of Issue 03-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments.” A worst-case scenario is:

- For those investment securities that are categorized as available for sale (AFS) and that have book-to-market losses of greater than a certain percentage (5 percent is being considered), bankers will either mark these securities to market through income and capital, or bankers will be required to assert that they have the “intent and ability to hold” these securities until their market values return to book values.
- If, at a subsequent date, a
banker sells (at losses) as few as two of the securities identified above, it could "taint" the bank's "intent and ability to hold" the rest of the AFS securities. The bank may then be required to write down all the tainted AFS securities through income and capital.

- This effectively changes the intention of FAS 115's original guidance for AFS securities. Under the old rules, AFS security losses were reflected in GAAP capital, but not in income or regulatory capital. The new interpretations treat AFS securities more like trading account securities. For example, losses of tainted securities must be written down through GAAP income and regulatory capital (interestingly, gains cannot be taken).

**What Can Be Done?**

By press time, FASB will have gathered the industry's comments and, in all probability, will have issued its final guidance. The time for battling these changes will have come and gone. Hopefully, the final changes will not be as severe as described above, but there is little chance that the new guidance will take us back to the good old days.

The chart on page 96 shows one way that community bankers can track their institutional investments to meet the new requirements. The chart can be used to track historical gains/losses and to project gains/losses under rising and falling rates.

Assume that the new guidance says that a loss of 5.0 percent is the point at which a bank must assert that it has the "intent and ability to hold" the security until its market value returns to book value. Chart A shows rates rising through third quarter 2005 and then falling in the fourth quarter.

Bond A loses about 4.0 percent per quarter and, at the end of the third quarter, is below the 5.0 percent threshold. Prior to assertion of "intent and ability" at the end of the quarter, the bank can sell the security without tainting the other AFS securities. However, if the bank asserts "intent and ability to hold" and then later sells the bond at a loss, it could taint other AFS securities.

The following shows potential sales and the effects on the rest of the AFS portfolio. Remember that once a security has dropped below the 5.0 percent threshold and the bank has asserted "intent and ability to hold," selling the security at a loss could taint the rest of the AFS portfolio.

- **Sell A**—Although the loss in December is less than 5.0 percent, the 7.0 percent loss at the end of the third quarter means that the "intent and ability" has been asserted. The sale would taint bonds D and E. In other words, once the 5.0 percent threshold is reached, any loss on the sale of A could taint D and E. (Note that A could have been sold in September, prior to assertion, without tainting D and E).

- **Sell B or C**—These bonds have never reached the 5.0 percent threshold, so losses do not affect the other AFS investments.

- **Sell D**—The sale of D would taint A and E.

- **Sell E**—The sale of E at a gain would not taint the rest of the AFS investments since its losses have been fully recovered.

Note that if the AFS portfolio is tainted by the sale of a bond that the bank has asserted "intent and ability to hold," all the AFS bonds that were below the 5.0 percent threshold at the end of any quarter, are subject to being marked down to current market values and the losses reflected in the bank's GAAP and regulatory income and capital.

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**MORE INFORMATION**

- ICBA members are invited to call (800) 422-6442 for additional, complementary assistance:
  - ICBA Securities' "other-than-temporary impairment" reporting system (when available);

- A copy of the most current FASB guidance or accounting firms' interpretations; and

- Recommended policies and procedures for managing the bank's investment portfolio under the new rules (when available).