



VIA Electronic Mail (director@fasb.org)

August 30, 2010

Technical Director
Financial Accounting Standards Board
401 Merritt 7, P. O. Box 5116
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Dear Board Members and FASB Staff:

The Mortgage Bankers Association¹ (MBA) appreciates the opportunity to comment on the Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivatives Instruments and Hedging Activities* (Proposed Update). The stated objective of the Proposed Update is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments, while reducing the complexity in accounting for those instruments.

Background Information

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working on a joint project to improve their respective standards on accounting for financial instruments. The FASB and IASB also have agreed to a timetable to converge U.S. accounting standards and international accounting standards. IASB is creating IFRS 9, *Financial Instruments*, which will replace IASB 39, *Financial Instruments: Recognition and Measurement*, in phases. It has issued final chapters pertaining to classification and measurement of financial assets and has issued or is preparing to issue exposure drafts pertaining to classification and measurement of liabilities, amortized cost and impairment, and

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

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hedging. FASB, in contrast, is exposing its proposed financial instruments and hedging standards in the Proposed Update.

The Proposed Update would require all financial instruments to be carried at fair value in the balance sheet. Financial instruments for which the entity's business strategy is to hold for collection or payment of contractual cash flows would be carried at fair value with changes in fair value going to other comprehensive income (OCI). Other financial instruments would be carried at fair value with changes in fair value going through net income. Amortized cost for all financial instruments recorded at fair value through OCI would be disclosed. The impairment model in the Proposed Update would remove the existing "probable" threshold for recognizing impairments on loans and debt instruments. In many instances, the Proposed Update would require a reporting entity to record life of loan allowance for loan losses through net income at the time of origination. The present highly complex, quantitative-based hedging requirements would be replaced with a qualitative assessment of hedge effectiveness, and the threshold for hedge effectiveness would be reduced from highly effective to reasonably effective.

Executive Summary

MBA disagrees with many of the principles set forth in the Proposed Update. MBA notes that there are significant differences between the proposed FASB and IASB models for classification and measurement and for impairment. MBA believes that FASB and IASB should continue to work together toward one standard before any additional standards are finalized or implemented. Otherwise, there would be significant costs to preparers and unnecessary confusion for users of financial statements if they have to go through back-to-back conversions.

In general, MBA asserts that existing GAAP related to classification and measurement and the recognition of interest income is working and understood by the user community. Therefore, overhauling those principles appears unnecessary. MBA does acknowledge that the incurred loss model should be changed and should be the primary objective of the Proposed Update. The following highlights MBA's most significant concerns with the Proposed Update:

- The Proposed Update would unnecessarily increase the complexity in financial statements that would adversely impact preparers, users and regulators.
- MBA believes that the accounting should follow the business model. Fair value is not the most relevant measurement for assets and liabilities for which the business strategy is to collect or pay contractual cash flows.
- MBA agrees with removing the probability threshold for impairment loss recognition. However, several aspects of the impairment recognition model should be reconsidered, including but not limited to (1) recognizing through earnings the entire estimated allowance at origination (2) limiting the expected loss estimation process to today's economic and market assumptions, and (3) the coupling of credit and interest.

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- MBA disagrees with FASB's interest recognition model. MBA believes that the existing accounting model whereby interest impairment is recognized through separate reserves works well and allows for the reporting of net interest margin before provisions for credit losses, a key metric for users including analysts and regulators. In addition, the non-accrual designation proposal would characterize far fewer assets as non-accrual and at a far later date than is current practice.
- MBA generally agrees with the proposed hedge accounting, but believes that de-designation of a hedge relationship should be allowed in a dynamic hedge situation.
- MBA disagrees with FASB that the default measurement for financial liabilities should be fair value. MBA points out that amortized cost better reflects expected cash flows. MBA especially disagrees with the notion of including in the fair value of an entity's liabilities the change in the entity's own creditworthiness through earnings.
- MBA disagrees with the proposed measurement criteria for core deposits. Such value is neither fair value nor amortized cost, and it would be highly subjective.

The following General Comments expands on these concerns and provides MBA's proposed alternatives and recommendations.

General Comments

FASB's Proposed Fair Value for All Financial Instruments

MBA's Observations on Classification and Measurement:

MBA disagrees with FASB's proposal for entities to present all financial instruments at fair value in the balance sheet. MBA agrees with FASB Board members Ms. Seidman and Mr. Smith in their dissenting opinion where they "...dissent from several aspects of the proposed guidance, primarily because it would introduce fair value accounting for some nonmarketable, plain-vanilla debt instruments that are held for collection (long-term investment), and most liabilities held for payment, which they believe would not reflect the likely realization of those items in cash and, therefore, would not be the most relevant way to measure those items in the statement of financial position and comprehensive income."² MBA points out that existing accounting rules already contain a mixed measurement model (some assets at fair value and some at amortized cost), and the newly issued chapters of IFRS 9 likewise include a mixed measurement model. MBA does not see any advantages to users of financial statements of the fair value model for all financial assets and liabilities, but it does see numerous concerns and shortfalls:

- The proposal would result in more assets and liabilities measured based primarily on Level 3 inputs which are less reliable and more subjective.
- Fair value is not the most relevant balance sheet measurement for assets and liabilities for which the business strategy is to collect or pay the contractual cash

² FASB Exposure Draft, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, page 177.

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flows. MBA believes that fair value is appropriate for financial instruments that are held for trading or for short-term changes in market value. MBA believes that if management's intent is to hold an asset for long-term cash flows or to hold a liability for contractual cash payment, amortized cost should be the primary yardstick for measurement. In fact, amortized cost is a more accurate depiction of the expected cash flows for most financial liabilities.

- MBA is a firm believer that the accounting principles should closely follow an entity's business model. The Proposed Update would highlight a measurement attribute that is contrary to the way banks manage a significant portion of their business. MBA notes that financial institutions have three business strategies for financial instruments: 1) held for trading or short-term profit-taking, 2) held for long-term cash flows but available for sale in the event needed for liquidity or other prudent asset/liability management purposes, and 3) held for long-term cash flows. Specifically, MBA is concerned that the Proposed Update would require a significant portion of securities that are presently accounted for as Available-for-Sale (AFS) to be accounted for at fair value through net income. Prudent asset/liability management calls for a portion of more liquid long-term investments to be held for long-term cash flows but available for short-term liquidity purposes or asset/liability duration rebalancing purposes, if needed. These should be carried at fair value with changes in fair value going to OCI. However, MBA is concerned that they would not meet the proposed criteria for measurement at fair value through OCI, as presently drafted in the Proposed Update.
- The Proposed Update requires that financial assets held for cash flows to have only occasional or infrequent sales. Although MBA understands that the FASB is trying to be principles-based, these rules are so subjective that companies with the same business model could have vastly different accounting results, depending in large part on management's and their auditors' perceptions of occasional or infrequent.
- MBA also points out that if assets classified as AFS were required to be carried at fair value with changes in fair value reported in net income, many banks would have experienced significant net losses during the recent credit cycle despite the fact that those changes in fair value were temporary, and the banks had no intention or requirement to sell the assets.
- Many reporting entities hire an outside consultant to provide fair value for assets, especially when there are few observable trades for a specific asset. Requiring assets to be recorded at fair value on the balance sheet, instead of in the notes to financial statements, would accelerate the date by which fair value information is needed as most companies release balance sheets and income statements with the quarterly press release. Notes to financial statements are published later as part of quarterly reporting on SEC Form 10-Q. MBA does not believe that the proposed fair value accounting for assets will be operational because of the compressed timeframe by which outside consultants must estimate fair value. Many companies will be forced to report operating results to shareholders at a later date. In addition, many companies will have to expend significant sums of

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money to set up and maintain the infrastructure to bring the valuation process in-house.

MBA Recommends: MBA believes that the current rules, which provide for three classifications of financial instruments appear to be working and need no major overhaul. MBA therefore recommends that FASB retain the existing classification and measurement accounting model for financial assets and liabilities, including the existing fair value option. However, if FASB insists on moving to a two classification model, it needs to 1) broaden the definition of the fair value through OCI category to accommodate AFS assets and 2) allow the assets and liabilities held for collection or payment of cash flows to be measured at amortized cost in the balance sheet.

Majority of Users Do Not Want All Financial Instruments to be Carried at Fair Value

FASB cites the main objective of the Proposed Update is to provide users with a more timely and representative depiction of an entity's involvement in financial instruments. FASB consistently points to users as the main reason for proposing fair value accounting in the balance sheet for all financial instruments. PricewaterhouseCoopers (PwC) earlier this year³ conducted a study that included 62 users in the financial services area. The PwC study concluded that a majority of respondents favored a mixed measurement model, with fair value reporting for short-term instruments and amortized cost reporting for instruments that the reporting entity intends to hold for long-term cash flows. A similar but less formal survey⁴ of institutional investors was conducted by Barclays Capital and yielded similar results: 90 percent of respondents disagreed with FASB's financial instruments exposure draft on fair value accounting and credit loss recognition.

MBA acknowledges that a certain group of users advised the FASB on this Proposed Update. However, it appears that it may be a small subset of the overall user community. In MBA's view, any proposed standard should consider the impact on all constituents, including a broad range of users, auditors, and preparers.

Impairment Recognition

MBA's Observations on Impairment Recognition:

MBA disagrees with the impairment model in the Proposed Update. The following is a summary of MBA's concerns and recommendations with respect to impairment of financial assets:

- MBA is not opposed to the proposed elimination of the probability threshold for reporting losses.
- The proposed model requires impairment estimates based on today's economic conditions and historic loss information. MBA observes that this model removes some of the subjectivity in estimating future events when determining the amount of impairment to record in earnings. At the same time, the Proposed Update

³ PriceWaterhouseCoopers, *What Investment Professionals Say About Financial Instrument Reporting*, June 2010.

⁴ ABA, *Daily Newsbites: Investors Say 'No' on Mark-to-Market Proposal*, June 25, 2010.

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would expand Level 3 measurements (which are more subjective) for groups of assets and liabilities that are typically carried at amortized cost today. These concepts are in stark contrast with each other. MBA believes that preparers should include expectations about future events when projecting future cash flows. The inability to include future events would distort the loss allowance, since in “good times” losses would be recognized too late and in “bad times” losses would be recognized too early in a cycle. MBA believes that this change is necessary to ensure that impairment estimates are appropriate and are not understated when economic conditions are expected to decline.

- The FASB model would require a reporting entity to establish an allowance for loan losses at origination if there is adequate history for that class of loans to estimate life of loan losses. MBA points out that such accounting is contrary to the matching principle that underlies much of GAAP. The interest rate assigned to a loan includes a premium related to credit. Accordingly, proper matching would require the provision for loan losses to be spread out over the life of the loan. From a practical standpoint, providing for loan losses at origination will result in a bank taking a loss upon origination without reflecting the economic reality of a loan origination decision. This may reduce incentives to produce new loans.
- MBA also believes that the Proposed Update will be very costly, requiring significant changes in loan accounting systems and processes. This is especially true for the switch from reserving for principal losses only to modeling impairment for both principal and interest cash flows.
- MBA notes that paragraph 83 of the Proposed Update would require charge-offs to go against the allowance for credit losses while recoveries would be taken directly to net income. MBA disagrees with this approach and believes that recoveries should be recorded as an adjustment to the allowance for credit losses. To do otherwise would distort the income statements of financial institutions. Most historic loss curves have charge-offs, net of recoveries. The industry would have to disaggregate this information (which is often published by external third parties) in order for such information to be useful in establishing expected loss estimates. MBA asks for further clarification of this aspect of the Proposed Update.
- Present accounting principles require recognition of impairment for principal losses. An estimate of uncollectible interest should continue to be accounted for by companies separate from the reserve and non-accrual policy. The Proposed Update would require the provision and allowance for loan losses to include both principal and interest cash flows. MBA believes that the distinction between principal and interest cash flows is important to financial statement users and, therefore, that distinction should be maintained in financial reporting.

MBA Recommends:

MBA recommends that FASB use the following principles in finalizing the impairment portion of the Proposed Update. MBA notes that many of these principles are embodied in a number of alternative proposals being considered by various groups with respect to the recognition of impairment.

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- Future credit losses should be estimated at loan origination and at each period thereafter.
- Impairment should be recognized over the life of the financial assets. This will provide for appropriate matching of an expense with the appropriate periods the entity benefits from the asset.
- MBA generally agrees with the elimination of the probability threshold for reporting losses. Impairment should be recognized on an expected loss basis.
- MBA defines an estimate of expected losses to be an entity's estimate of future events including expected future economic and market conditions. Use of a static assumption based upon today's economic and market conditions would likely have a pro-cyclical impact.
- Estimates of credit losses may be made on a pool level or an individual loan level as an entity deems appropriate. Pools should be "open" allowing the inclusion of future assets or the removal of assets as appropriate.
- The estimate and reporting of credit loss should not be commingled with interest income. Lost interest should be accounted for using the current non-accrual model.
- In recognizing expected losses over the life of a loan, a situation may arise when the provisioning falls behind actual losses. In those situations MBA recommends that entities must maintain in the allowance for credit losses a floor (for example, an amount of either incurred losses or one year of estimated charge-offs).

Hedge Accounting

MBA supports the proposed qualitative measurement for hedge effectiveness using the yardstick of "reasonably effective." MBA believes that this will go a long way toward solving many of the issues associated with existing hedge accounting. MBA also strongly supports the continuation of "bifurcation by risk" since it recognizes that entities frequently hedge a specific risk like changes in a benchmark interest rate in hedging many assets, including servicing assets.

The Proposed Update would prohibit the de-designation of an effective hedging relationship after it has been established. Many of MBA's members use a dynamic hedging strategy whereby a servicing portfolio is hedged by a number of derivative contracts. As the components of the servicing portfolio or the derivatives hedging that portfolio change, the hedge is de-designated and then re-designated. The Proposed Update would require entities to unwind all hedges each time the position is re-balanced, resulting in significant cost to the entity. MBA therefore recommends that de-designation be allowed in a dynamic hedge situation.

Valuation of Financial Liabilities

The Proposed Rule would require the majority of all financial liabilities to be measured at fair value, but would allow a financial liability to be measured at amortized cost in certain circumstances. The Proposed Rule would require an entity to write down its own debt and report a profit for adverse changes in its own creditworthiness. Most liabilities are held for contractual repayment making amortized cost a more relevant measure than fair values since most debt must be contractually repaid at par. Fair value measures of most liabilities would be very senseless since most debt is, in

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practice, not transferred and frequently debt is not subject to prepayment. Even if the entity could theoretically repurchase its own debt at fair value in the market place, the entity may not have the liquidity to do so. MBA strongly believes that the default measurement attribute for financial liabilities, other than trading and derivative liabilities, should be amortized cost. MBA also believes that the fair value option should be available for financial liabilities to enable better matching with financial assets carried at fair value.

MBA believes that amortized cost is the most representative measure of expected cash flows for financial liabilities. Accordingly, if FASB moves forward with fair value measures for financial liabilities other than trading and derivative liabilities, MBA believes that changes in fair value due to changes in an entity's own creditworthiness should be recorded through OCI rather than net income.

Valuation of Core Deposit Intangibles

MBA also opposes the proposed valuation of core deposits. Deposits are normally not traded. When deposits are transferred as part of a business combination, the deposits are typically recorded at their stated amount and the fair value of the core deposit intangible is recorded. The Proposed Update would create a new measurement that is neither fair value nor amortized cost. The result of this would be to place on the balance sheet of banks a value previously thought by most to be an intangible asset. The proposed valuation would be highly subjective and not comparable from bank to bank. MBA recommends that this part of the Proposed Rule be deferred and considered when the FASB addresses intangible asset recognition and measurement.

Expansion of SOP 03-3 Model

The MBA is concerned with the apparent expansion of the provisions of Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3). To the best of MBA's knowledge, most SOP 03-3 accounting to date is managed through Excel spreadsheets as commercially-available loan accounting systems do not meet all of its requirements and it would be enormously costly to revise and re-design proprietary systems to perform the complex calculations required under SOP 03-3. Given the drastic changes that are being made in the Proposed Update, it does not appear that a separate credit impairment model for purchased assets is necessary. The usefulness of an SOP 03-3 model does not outweigh the significant costs and complexities.

Recognition of Interest Income on Financial Assets

MBA's Observations on Recognition of Interest:

Under the Proposed Update, the amount of interest income to be recognized in net income for the period would be calculated by applying the asset's effective interest rate to the amortized cost balance net of any allowance for credit losses. To the extent that cash received exceeds the interest accrued, the reporting entity would credit the allowance for credit losses for the difference. MBA notes the following concerns with the proposed accrual method:

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- MBA does not agree with the proposal to record interest income on the loan balance net of the allowance. This would distort the net interest margin, which is a key measurement used by analysts. As noted above, MBA believes that the allowance should represent principal losses only.
- The Proposed Update also includes a dramatic change in the present rules for suspending accrual on delinquent loans. The Proposed Update states, “An entity shall cease accruing interest income on a financial asset only if the entity’s expectations about future cash flows expected to be collected indicate that the overall yield on the financial asset will be negative.”⁵ This is much less conservative than present non-accrual practice. The Proposed Update is also not in accordance with existing regulatory accounting procedures which generally call for non-accrual of loans when a loan is 90 days or more past due.
- Likewise, it is unclear how the accrual of interest income works for loans where the unit of account is a pool of loans. It appears that the Proposed Update would require impairment recognition at the pool level but interest accrual would be done on an individual loan level. FASB needs to clarify this in the final rule so that if the unit of account is pool level, all accounting for that pool is to be done on a pool basis.

MBA Recommends: MBA believes that interest income should be accrued in essentially the same manner as is done today, using contractual terms adjusted for amortization or accretion of purchase discounts or premiums or direct origination fees or costs. This method is easy to understand and provides users with useful information about the net interest margin earned on a financial institution’s portfolio of financial instruments. MBA recommends that the Proposed Update should not disturb existing practice for placing loans on non-accrual status. MBA believes FASB should also maintain the current reporting distinction between credit events and interest income. This will ensure that users continue to be provided with data that has historically been important to their analysis of financial institutions.

MBS Purchased at a Premium

The Proposed Update would not permit investments in financial assets purchased at a significant premium to be classified at fair value with changes in fair value going to OCI. Although uncommon, an entity may occasionally purchase a mortgage loan or mortgage-backed security at a significant premium due to exceptional credit quality, coupon, or market appetite for this type of asset. The probability and timing of prepayments would be considered in that premium. Within the context of a portfolio that is carried at fair value through OCI, we believe that it would be operationally complex to require that selected instruments be carried at fair value through net income due solely to the existence of a significant purchase premium. MBA therefore recommends that the Proposed Update allow financial assets purchased at a significant premium to be accounted for at fair value through OCI.

Balance Sheet Presentation Would Be Overly Complex

⁵ Ibid Proposed Update, page 51, paragraph 82.

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MBA believes that the Proposed Update will result in a balance sheet presentation that is complex, confusing, and unrecognizable. The following are examples:

- The proposed update would require that financial assets and financial liabilities that are at fair value with changes in fair value recognized in net income be presented separately from those carried at fair value through OCI in the balance sheet.
- For financial assets and financial liabilities for which changes in fair value are recognized in OCI, the reporting entity will have to present separately on the face of the balance sheet the following: amortized cost, allowance for credit losses, accumulated amount needed to reconcile amortized cost less allowance for credit losses to fair value, and fair value.
- A reporting entity will have to present for its core deposit liabilities the amortized cost, amount needed to adjust amortized cost to the core deposit remeasurement value, and the remeasurement value.
- Further, the reporting entity will also have to present separately on the face of the balance sheet amounts included in accumulated OCI related to qualifying changes in the remeasurement amount for financial instruments for which those changes are recognized in other comprehensive income.

MBA believes that the result would be overly complex for financial statements users to review and understand. MBA believes qualitative along with quantitative information is more user-friendly which is why the MBA believes the current balance sheet presentation along with robust footnote disclosures is preferable.

The MBA appreciates the opportunity to share these comments with FASB. Any questions about MBA's comments should be directed to Jim Gross, Associate Vice President and Staff Representative to MBA's Financial Management Committee, at (202) 557-2860 or jgross@mortgagebankers.org.

Sincerely,



John A. Courson
President and Chief Executive Officer

Appendix A- FASB Questions

Scope

Questions for All Respondents

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

MBA's Response: MBA generally agrees with the scope of financial instruments included in the Proposed Update with the exception that MBA believes that all financial guarantees that are not derivatives should be excluded from the scope.

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

MBA's Response: This specific question is not applicable to mortgage banking. However, MBA believes that the Proposed Update should articulate a principle instead of a scope exception for a specific product. For example, the principle could be that any commitment in which the lender has the unilateral right to terminate the line at any time should be excluded from the scope of the Proposed Update. Another example would be that the accounting for loan commitments should be consistent with the subsequent measurement of the loan once funded.

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

MBA's Response: N/A to mortgage banking

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity's consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why?

MBA's Response: MBA disagrees. This proposed language would add significantly to the complexity of accounting for equity investments. Even when applying the consolidation model, there is no related business test. MBA questions the operability of the proposed guidance.

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Initial Measurement

Questions for All Respondents

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

MBA's Response: MBA does not agree that significant differences between fair value and transaction price should be recorded in net income. See our response to Question 9.

MBA also recommends that the FASB modify the definition of "transaction price." Paragraph 78 states that transaction price "includes amounts that qualify as loan origination fees and direct loan origination costs." This suggests that the transaction price for loans is calculated on a different basis than the transaction price for other financial instruments. MBA sees no conceptual merit in deferring costs incurred to issue loans but not, for example, costs incurred to issue debt. To improve consistency, MBA believes that the transaction price should include transaction fees and costs for all originated or issued financial instruments.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

MBA's Response: MBA does not agree that differences between the transaction price and fair value of transactions arising in the course of customary lending activities of financial institutions should be recognized in net income. Financial institutions may originate loans at below-market interest rates to build or improve customer relationships and to generate goodwill in the communities within which the institutions do business. In addition, banking institutions may originate loans at below-market interest rates to comply with the Community Reinvestment Act. Requiring financial institutions to record a loss in net income as the result of originating such loans could have a negative impact on 1. the availability of credit in general and 2. specifically on loans to low-to-moderate income consumers.

A second example would be a situation where a financial institution originates a mortgage loan that it intends to hold for investment. The Proposed Update would appear to require the excess of fair value above amortized cost, including the recognition of inherent servicing value through net income. MBA believes that such value should only be recognized for loans originated for sale and not for loans originated for investment.

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Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

MBA's Response: MBA does not believe that there should be a single initial measurement principle for all financial instruments. See General Comment, *FASB's Proposed Fair Value for All Financial Instruments*.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

MBA's Response: MBA agrees. The proposed treatment of fees and expenses is consistent with fair value and amortized cost measurements, respectively.

Question for Preparers and Auditors

Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

MBA's Response

As noted in our response to Question 9, MBA believes that customary lending activities of financial institutions should be exempt from this requirement. However, if this recommendation is not adopted, we do not believe that the proposed guidance will be operational. Instead, MBA believes that preparers will be unduly burdened by the requirement to determine whether there is a significant difference between the transaction price and fair value.

Paragraph 14 suggests that an entity is required to assess a newly-acquired financial instrument only if the entity "has reason to expect" that the transaction price may differ significantly from fair value. However, paragraph IG 7 states that "when an entity initially recognizes a financial asset or financial liability . . . the entity must determine whether there is reliable evidence to indicate that the transaction price may be significantly different from the fair value of the financial instrument" (emphasis added). MBA is concerned that financial institutions will face pressure from auditors to proactively assess all financial instruments; regardless of whether the entity has "reason to believe" there may be a significant difference.

Paragraph IG8 identifies certain factors that an entity should consider in performing the assessment, including "prevailing rates offered to other borrowers or offered by other lenders." While this approach is conceptually sound, given that fair value is based on an exit price notion, it would require that one lender understand the business objectives and motivations behind other lenders' pricing strategies. For example, one lender may

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offer low credit card rates in an effort to attract new demand deposits. Another lender may offer preferential rates on a host of products in an effort to increase their market share.

To reduce the burden on preparers, MBA believes there should be a stated presumption that transaction price equals fair value, unless there is clear and compelling evidence that another element (other than an intangible benefit) exists and that element can be specifically identified.

Subsequent Measurement

Questions for All Respondents

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase (decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

MBA's Response: See MBA's General Comments, *FASB's Proposed Fair Value for All Financial Instruments and Balance Sheet Presentation Would Be Overly Complex*, above. MBA does not agree with the use of fair value accounting for financial instruments that an entity intends to hold for collection or payment of contractual cash flows, including those financial instruments held for emergency liquidity or other prudent asset/liability management purposes. MBA further believes that having fair value and amortized cost on the face of the balance sheet would only serve to make the balance sheet less understandable. Fair value vs. cost information belongs in the notes to financial statements not on the face of the balance sheet.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

MBA's Response: MBA does not agree with the use of fair value accounting for financial instruments that an entity intends to hold for collection or payment of contractual cash flows, including those financial instruments presently held at fair value

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with changes in fair value going to OCI. See General Comment, *FASB's Proposed Fair Value for All Financial Instruments*, above. However, if FASB moves forward with fair value accounting for these assets and liabilities, the above list appears to cover those specific transactions that should be included in net income and not changes in OCI.

Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why?

MBA's Response: MBA disagrees. See General Comment, *Valuation of Financial Liabilities*, above.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?

MBA's Response: An entity may decide to change its business strategy for a specific portfolio due to changes in economic conditions, regulations, the need for liquidity, or in connection with a larger corporate strategy shift. MBA believes that the "accounting tail should not wag the dog." Thus, reclassifications should be permitted. The accounting for a portfolio should reflect the reporting entity's business model. See General Comment, *FASB's Proposed Fair Value for All Financial Instruments*, above regarding the treatment of assets presently classified as AFS.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost- to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

MBA's Response: MBA believes that this measurement approach is inappropriate. See General Comment, *Valuation of Core Deposit Intangibles*, above.

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

MBA's Response: MBA disagrees with the proposed treatment of financial liabilities in the Proposed Update. As noted in our General Comment, *Valuation of Financial Liabilities*, MBA believes that the default measurement attribute for liabilities (other than

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trading liabilities) should be amortized cost. We do not believe that the use of amortized cost should be contingent upon the existence of an accounting mismatch.

Question 19: Do you believe that the correct financial instruments are captured by the criteria in the proposed guidance to qualify for measurement at the redemption amount for certain investments that can be redeemed only for a specified amount (such as an investment in the stock of the Federal Home Loan Bank or an investment in the Federal Reserve Bank)? If not, are there any financial instruments that should qualify but do not meet the criteria? Why?

MBA's Response: MBA agrees with the proposed valuation guidance at redemption amount for investments that can only be redeemed for a specified amount.

Question 20: Do you agree that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income in combination with other deferred tax assets of the entity (rather than segregated and analyzed separately)? If not, why?

MBA's Response: MBA does not believe that deferred tax assets related to unrealized losses on debt instruments that are recorded in OCI should be evaluated in combination with other deferred tax assets. These deferred tax assets are expected to reverse as the instruments move toward maturity. Requiring evaluation of the need for a valuation allowance on the related deferred tax assets in combination with other deferred tax assets may result in a larger temporary net charge to OCI which would be expected to fully reverse in the future and could, therefore, lead to unwarranted and potentially misleading volatility in OCI.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

MBA's Response: MBA's members will wait to respond to the FASB when FASB issues a request for comment on its project on financial instruments with characteristics of equity.

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Questions for Preparers and Auditors

Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

MBA's Response: See MBA's General Comment, *FASB's Proposed Fair Value for All Financial Instruments*, above.

Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why?

MBA's Response: MBA does not agree with measuring financial liabilities at fair value. See MBA's General Comment, *Valuation of Financial Liabilities*, above. If financial liabilities must be measured at fair value, the primary operational concern will be price discovery, especially as it related to financial liabilities that are not transferrable or otherwise traded.

Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

MBA's Response: MBA disagrees. See MBA's General Comment, *Valuation of Financial Liabilities*, above.

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in cost- to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any, additional guidance is needed?

MBA's Response: MBA disagrees with the Proposed Update with respect to the valuation of core deposits. See MBA's General Comment, *Valuation of Core Deposit Intangibles*, above. MBA believes that the proposed valuation method will be highly subjective and not comparable from bank to bank.

Presentation

Questions for All Respondents

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB's tentative decisions on financial liabilities measured at fair value under the fair value option? Why?

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MBA's Response: See MBA's General Comment, *Valuation of Financial Liabilities*, above. MBA believes that it is inappropriate to include the effect of changes in an entity's credit standing in the valuation of an entity's own liabilities. MBA believes that this proposal would require a reporting entity to understate the deterioration of its financial position at a time when it is most important for stockholders, creditors, regulators and other interested parties to have a realistic snapshot of financial position. MBA believes that if FASB goes forward with this, such changes should be reflected in OCI not net income.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

MBA's Response: See MBA's General Comments, *Valuation of Financial Liabilities*, above for its disagreement with the proposed measurement of financial liabilities at fair value. MBA does not agree that an entity should bifurcate the change in fair value due to credit risk into two components. This methodology assumes that a distinction can be made between general changes in the price of credit within an industry and changes in the price of credit for a specific entity. MBA believes that the two factors are interrelated and cannot be separately measured with any degree of reliability. MBA therefore believes that the entire change in fair value due to credit should be viewed as a change in fair value due to an entity's own credit. To the extent that liabilities, excluding trading and derivative liabilities, are measured at fair value through net income, MBA believes that changes in fair value due to credit risk should be recorded in OCI.

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

MBA's Response: MBA does not believe that any method should be specified. The separation required by the Proposed Update is not observable in the market and highly subjective. Therefore, MBA believes the total credit spread above the risk free rate should be disclosed rather than trying to identify a portion of the credit spread.

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Credit Impairment

Questions for All Respondents

Question 37: Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

MBA's Response: MBA believes that the objective stated in paragraph 38 on page 40 of the exposure draft is clear, "An entity shall recognize a credit impairment in net income for a financial asset (or a group of financial assets) when it does not expect to collect all contractual amounts due for originated financial assets and all amounts originally expected to be collected upon acquisition for purchased financial assets." MBA disagrees with the recognition of expected losses through net income at origination. See MBA's General Comment, *Impairment Recognition*, above.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s). The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss. Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

MBA's Response: MBA prefers the IASB model over the FASB model. It better matches the impairment expense with the periods of benefit from the underlying financial asset. However, MBA believes that the IASB model, which calls for estimation of future cash flows, not just projections of principal losses, is unduly complicated and not operational. See General Comments, *Impairment Recognition*, above for the principles MBA believes should be present in an alternative model.

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign exchange rates, changes in expected prepayments, or changes in a variable interest rate? If not, why?

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MBA's Response: MBA agrees that changes in foreign exchange rates, changes in expected prepayments, and changes in variable interest rates have nothing to do with credit risk. Accordingly, they should not be included in impairment charges.

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

MBA's Response: MBA strongly believes in principles-based vs. rules-based accounting principles. Accordingly, we agree that the guidance should not specify a particular methodology for determining specific loss rates for a financial asset evaluated in a pool. The methodology chosen should be the most appropriate in the circumstances.

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

MBA's Response: MBA's members were not unanimous on the response to this question, but a majority of members agree with the proposed treatment.

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

MBA's Response: MBA generally agrees with this for groups of financial assets that have homogeneous credit characteristics.

Questions for Preparers and Auditors

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectability of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss

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approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes. Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

MBA's Response: Although both models could be made operational, MBA does not agree with using only existing economic and market conditions. See MBA's General Comment, *Impairment Recognition*, above.

Question 47: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool. Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool or some shorter period)?

MBA's Response: Historic loss rates typically reflect principal amount expected not to be collected not cash flows. MBA believes that users of financial statements are, likewise, accustomed to thinking in terms of principal loss not cash flow loss in thinking about impairment. Combining both principal and interest income in impairment analysis overly complicates the process and would add significantly to cost with no added value. See MBA's General Comments, *Impairment Recognition*, above.

Interest Income

Questions for All Respondents

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

MBA's Response: MBA disagrees. See MBA's General Comments, *Recognition of Interest Income on Financial Assets*, above.

Question 49: Do you agree that the difference in the amount of interest contractually due that exceeds interest accrued on the basis of an entity's current estimate of cash flows expected to be collected for financial assets should be recognized as an increase to the allowance for credit losses? If not, why?

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MBA's Response: MBA disagrees. See MBA's General Comments, *Recognition of Interest Income on Financial Assets*, above.

Question 50: The proposed guidance would permit, but would not require, separate presentation of interest income on the statement of comprehensive income for financial assets measured at fair value with all changes in fair value recognized in net income. If an entity chooses to present separately interest income for those financial assets, the proposed guidance does not specify a particular method for determining the amount of interest income to be recognized on the face of the statement of comprehensive income. Do you believe that the interest income recognition guidance should be the same for all financial assets?

MBA's Response: MBA believes that interest income recognition should be the same for all financial assets to increase comparability amongst preparers.

Question 51: Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient to understand the proposed credit impairment and interest income models? If not, what additional guidance or examples are needed?

MBA's Response: MBA believes that implementation guidance is reasonably robust and comprehensive for interest income related to assets that are individually evaluated for impairment. However, guidance needs to be provided for assets evaluated for impairment as part of a pool.

Hedge Accounting

Questions for All Respondents

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

MBA's Response: MBA strongly agrees with the proposed modification of the effectiveness threshold from *highly effective* to *reasonably effective*.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

MBA's Response: MBA agrees with the proposed guidance requiring an entity to reassess effectiveness only if changes in circumstances suggest that a hedging relationship is no longer reasonably effective.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be

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reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

MBA's Response: MBA believes that preparers would continue to do a conscientious job in reviewing hedge effectiveness after inception under the proposed guidance.

Questions for Preparers and Auditors

Question 61: Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for cash flow hedging relationships? If yes, what constraints do you foresee and how would you alleviate them?

MBA's Response: MBA sees no significant operational concerns in the proposed guidance for calculating ineffectiveness for cash flow hedging relationships.

Question 62: Do you foresee any significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness at each reporting period? If yes, what constraints do you foresee and how would you alleviate them?

MBA's Response: MBA foresees no significant operational concerns or constraints in creating processes that will determine when changes in circumstances suggest that a hedging relationship may no longer be reasonably effective.

Question 63: Do you foresee any significant operational concerns or constraints arising from the inability to discontinue fair value hedge accounting or cash flow hedge accounting by simply de-designating the hedging relationship? If yes, what constraints do you foresee and how would you alleviate them?

MBA's Response: MBA strongly disagrees with the Proposed Update as to the prohibition on de-designating a hedging relationship. See MBA's General Comments, *Hedge Accounting*, above about the dynamic hedge of servicing assets and the cost and operational expense of not being able to de-designate and re-designate as components of the hedge change over time.

Question 64: Do you foresee any significant operational concerns or constraints arising from the required concurrent documentation of the effective termination of a hedging derivative attributable to the entity's entering into an offsetting derivative instrument? If yes, what constraints do you foresee and how would you alleviate them?

MBA's Response: MBA foresees no significant concerns or constraints arising from the requirements for concurrent documentation.

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Disclosures

Question for All Respondents

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

MBA's Response: MBA believes that many of the proposed disclosures would be onerous and not operational. For example, paragraph 102. b. would require that if interest income is calculated on a pool basis, the amortized cost basis, allowance for credit losses, and weighted average interest rate must be disclosed for each individual pool. For a large entity, this information would be extremely voluminous.

MBA also notes that disclosure of contractual maturities required by paragraph 99 would be superfluous for long-term financial assets that can be prepaid. Likewise, the disclosures required under paragraph 105. b. and c. are onerous.

MBA also believes that the onerous disclosures required by paragraphs 106 through 108 are the result of the flaws in the proposed accounting model for financial liabilities discussed above in General Comments, *Valuation of Financial Liabilities* and *Valuation of Core Deposit Intangibles*, above.

Effective Date and Transition

Questions for All Respondents

Question 68: Do you agree with the transition provision in this proposed Update? If not, why?

MBA's Response: MBA agrees with the proposed cumulative effect adjustment approach to transition of the Proposed Update.

Question 69: Do you agree with the proposed delayed effective date for certain aspects of the proposed guidance for nonpublic entities with less than \$1 billion in total consolidated assets? If not, why?

MBA's Response: MBA generally is not opposed to a delayed effective date for small, non-public entities.

Questions for Preparers and Auditors

Question 70: How much time do you believe is needed to implement the proposed guidance?

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MBA's Response: If some of the less operational portions of the Proposed Update (noted in MBA's General Comments above) are left in, MBA recommends at least 3 years for implementation.

Question 71: Do you believe the proposed transition provision is operational? If not, why?

MBA's Response: See response to question 68.