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Technical Director
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Attn: Mr Larry Smith

Via email: director@fasb.org

Subject: Proposed Statement of Financial Accounting Standards- Fair Value

Measurements (File reference No. 1201-100)

RBC Financial Group would like to thank the Financial Accounting Standards Board ("Board") for the opportunity to comment on the exposure draft for the proposed statement Fair Value Measurements (the "Statement" or the "ED").

We appreciate that the Board has considered the need for increased consistency and comparability in fair value measurements and enhanced the disclosure requirements in the process of developing this framework. We also support the Board's objective of developing formal guidance for fair value measurement; however, we believe that certain aspects of the ED may not result in a fair presentation of an entity's financial position. Our significant comments are summarized as follows:

• We are extremely concerned with the application and interpretation of the fair value hierarchy as proposed in the ED, in particular as they relate to Level 2 and Level 3. To qualify as a Level 2 estimate, the Board requires that the adjustments be "objectively determinable". Failure to reach such conclusion will default to Level 3 valuation technique, and would require use of multiple valuation models. The ED does not provide clear guidance on what is considered to be "objectively determinable" and thus, poses the risk of narrow interpretation. This will mostly impact the valuation of derivative instruments; current discussions with accounting firms indicate that they are viewing the estimates as Level 3 estimates. The firms seem to be taking this narrow view despite the fact that derivatives are valued based on accepted valuation models and have well developed markets. Classifying the valuation of derivative instruments as Level 3 estimates will most likely re-open significant valuation issues for financial institutions. Furthermore, the requirement to use multiple valuation techniques under Level 3 will impose

resource burdens and additional costs to entities. Significant expertise is required to design and vet these valuation models. Utilizing this expertise to build additional models for Level 3 valuations simply to allow for a range of different fair values, will negatively negative impact an entity's productivity and divert it from its business objectives. Thus, we request that the Board clarify its requirement to use multiple models under Level 3. This concern is further addressed in our detailed comments in the Appendix attached.

• We also question the impact this standard will have on accounting under EITF 02-3 "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities". This ED would require an entity to value derivatives using Level 3 estimates approach which may result in a different fair value from that contemplated under EITF 02-3. Thus, reporting the value under the EITF 02-3 approach will not be in compliance with the Fair Value Measurement standard. We understand the Board is aware of this issue but has decided to address this in its revenue recognition project. We believe this conceptual conflict needs to be resolved prior to finalizing the Fair Value Measurement standard.

Our responses to the specific questions contained in the Exposure Draft are included in the attached Appendix. Should you have any questions regarding our comments, please do not hesitate to contact me at 416-955-7876 to discuss our comments with you further.

Thank you.

Yours very truly,

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cc Robert Guignard, Senior Vice President, Finance & Chief Accountant

Definition of Fair Value

Issue 1: This proposed statement would define fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable unrelated willing parties" (paragraph 4). The objective of measurement is to estimate the price for an asset or liability in the absence of an actual exchange transaction for that asset or liability. Will entities be able to consistently apply the fair value measurement objective using the guidance provided by this proposed Statement together with other applicable valuation standards and generally accepted valuation practices? If not, what additional guidance is needed?

Response:

We agree with the definition of fair value and appreciate the guidance provided in the ED. However, the guidance does not address the fair value of financial liabilities with demand features, such as demand deposits that are common for deposit-taking financial institutions. IAS 39 Financial Instruments: Recognition and Measurement (December 2003) has addressed such a scenario and specifies that the fair value "is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid" (paragraph 49). Incorporating similar guidance in the ED will enhance the completeness of the Standard.

We also noted that the ED refers to quoted market values or prices in multiple active markets. However, the ED does not provide guidance on how an entity should assess the impact of fair value for those instruments that are denominated in foreign currencies, such as foreign securities. Since most entities will have assets or liabilities denominated in foreign currencies, the ED should provide guidance on how to treat the changes in exchange rates.

Valuation Techniques

Issue 2: This proposed Statement would clarify and incorporate the guidance in FASB Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements, for using present value techniques to estimate fair value (Appendix A). Is that guidance sufficient? If not, what additional guidance is needed?

Response:

We appreciate the Board's clarification of the present value approach under Concept 7 ("CON 7") but believe that further guidance is needed. As discussed in Appendix A of the ED, there are two present value techniques - a Discount Rate Adjustment ("DRA") technique and an Expected Present Value ("EPV") technique. Under the DRA technique, a single set of cash flows from a range of possible estimated amounts is discounted at a rate commensurate with the risk inherent in the cash flow(s) (risk-adjusted discount rate). Under the EPV technique, multiple sets of cash flows are used with associated probabilities to determine the expected cash flows. The expected cash flows are then either (a) adjusted for risk and discounted at a risk-free rate, similar to a certainty-equivalent cash flow for an asset (Method 1), or (b) discounted using a rate commensurate with the risk inherent in the cash flows (risk-adjusted discount rate).

Although the Appendix provides examples on how to apply these two techniques, we believe additional guidance is needed to assist entities in deciding the appropriate approach. The risk-adjusted discount rate used under the DRA technique is the same as the rate used in Method 2 of the

EPV technique. However, use of the same discount rate will undoubtedly generate a present value for a single set of cash flows based on estimated amount that would differ from that based on cash flows adjusted for probability of occurrence.

Additionally, we question what implications, if any, the valuation techniques proposed by this Standard have on determination of expected losses attributable to variable interests in Variable-Interest Entities ("VIE"). Appendix A of FIN 46R Consolidation of Variable Interest Entities (Revised December 2003) suggests the use of a risk-free rate to discount expected cash flows and expected losses. For practical reasons and due to a lack of observable data, it is not possible to translate the various risks affecting the fair value of a variable interest into multiple sets of cash flows. Use of a risk-free rate as suggested in Appendix A of FIN 46R in such circumstances does not result in the expected cash flows approximating the fair value of the variable interest. On the other hand, the addition of a premium to the risk-free rate under the CON 7 approach proposed in the Fair Value Measurement standard would force the expected cash flows to approximate the fair value of the variable interest, but would also result in different discount rates being used for different variable interests in the same VIE. We urge the Board to consider this anomaly and recommend that a risk-free rate be permitted as the discount rate when applying the requirements of FIN 46R in circumstances where it is not possible to objectively estimate certainty equivalent cash flows for certain risks inherent in a variable interest.

The revised CON 7 maintains the original framework of applying the present value techniques to measure liabilities through incorporating the entity's credit standing to the discount rate. Thus, if the entity's credit standing has deteriorated, the liabilities will have lower balances as a result of being discounted at higher interest rate. If these lower balances are used for reporting purposes, the entity will then recognize "income" with credit deterioration. Please confirm if this is the intended result of applying CON 7.

If CON 7 did imply for there to be income recognition when the credit standing of an entity deteriorates, we do not believe that such reporting will accurately present the entity's financial position. Since the credit standing of the entity has decreased, it is highly unlikely that it will be able to refinance the existing liabilities at the same or a lower rate. Thus, if the entity terminates the existing liabilities and 'realizes' the 'income', this "income" will be offset in future periods by higher interest expenses incurred upon refinancing at higher rates. Alternatively, if the entity has no plan to refinance these liabilities, then this "income' will never be realized, and thus should not be recognized at the outset.

We also recommend that if the Board decides to maintain the current position and requires the entity to mark to its own credit spread, then disclosures similar to those required by IAS 39 Financial Instruments: Recognition and Measurement (December 2003) should be required. Under IAS 39, entities are required to disclose the "changes in fair value of a financial liability that is not attributable to changes in a benchmark rate. ... The Board decided to clarify that this issue relates to the credit risk of the financial liability, rather than the creditworthiness of the entity" (para. BC 90 and BC 91). We believe this will facilitate the interpretation of the impact to the financial position of an entity due to changes in its credit standing.

Active Markets

Issue 3: This proposed Statement would clarify that valuation techniques used to estimate fair value should emphasize market inputs, including those derived from active markets. In this proposed Statement, active markets are those in which quoted prices are readily and regularly available; readily available means that pricing information is currently assessable and regularly available means that the transactions occur with sufficient frequency to provide pricing information on an ongoing basis. Is that guidance sufficient? If not, what additional guidance is needed?

Response:

We believe that the guidance for interpretation of "readily available" is appropriate as one can easily relate to pricing information from quoted exchanges. However, for the interpretation of "regularly available", we would appreciate more clarity on what is defined as sufficient frequency, especially for instruments that are not frequently traded. For example, if the instrument normally trades in the market every 6 months (or longer) and the frequency is supported by transactions in the past, is the 6-month interval considered to be of "sufficient frequency" and thus the prices are "regularly available"? If the entity also uses an industry wide accepted and highly accredited valuation technique to separately estimate the fair value which refutes the "regularly available" price, which would be the acceptable price to the Board? Would both be acceptable as long as the entity discloses the method used for valuation and price discrepancies under the alternative methods?

Valuation Premise

Issue 4: This proposed Statement would provide general guidance for selecting the valuation premise that should be used for estimates of fair value. Appendix B illustrates the application of that guidance (Example 3). Is that guidance sufficient? If not, what additional guidance is needed?

Response:

We believe the premise of "in-use" and "in-exchange" valuation is applicable only for non-financial assets (property, plant and equipment) but not for financial assets. It is unclear whether this valuation premise is relevant also for financial assets. If it is, then we do not understand how to apply this valuation premise concept to Level 1 Reference Market approach that does not allow for adjustment to quoted market prices. We recommend the Board clarify whether this "in-use" and "in-exchange" valuation premise is also applicable to financial instruments, and if so, provide guidance on its application under the various hierarchy levels, especially if one is not allowed to make adjustments to Level 1 estimates of quoted market prices.

Fair Value Hierarchy

Issue 5: This proposed Statement would establish a hierarchy for selecting the inputs that should be used in valuation techniques used to estimate fair value. Those inputs differ depending on whether assets and liabilities are identical, similar, or otherwise comparable. Appendix B provides general guidance for making those assessments (Example 4). Is that guidance sufficient? If not, what additional guidance is needed?

Response:

As currently drafted, for a Level 2 estimate, the price effect of the differences must be objectively determinable. However, there is no guidance on what is objectively determinable. Therefore, this determination is highly subject to interpretation and some, if not most, accounting firms will probably adopt a very narrow view in their interpretation of GAAP given the inherent risks. This is clearly the case with the implementation of EITF 03-1 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. We are aware that the American Bankers Association has already written to FASB on this issue and the banks in the United States are extremely concerned with the narrow interpretation of this EITF. We echo that concern with respect to that EITF and, at the same time, reiterate the same concern with respect to the interpretation of "objectively determinable", especially in the context of its application to derivative instruments. All financial institutions have a significant number of derivative contracts. Certain derivative contracts are traded on exchanges and thus quoted prices are available. However, the majority of derivative contracts are over-the-counter ("OTC") derivative contracts that are valued based on models that have been thoroughly vetted and widely accepted by industry practitioners. These values are also used in the trading of these OTC derivatives and thus, are accepted in quoting a market for these products. More importantly, these models have already been audited and accepted by external auditors. We are extremely concerned that a narrow interpretation of this "objectively determinable" term by accounting firms may cause the firms to conclude that the valuation of derivatives are Level 3 estimates rather then a subset of Level 2 estimates. Consequently, external auditors will likely revisit the models and question the data inputs; they may even require valuations to be done using more than one method in order to strictly comply with the spirit of Level 3, as proposed in the ED, which may create audit issues concerning valuations and modeling. We don't believe it is the Board's intention to create such a situation that will cause serious disruption to financial institutions. We recommend the Board clarify that fair value estimates based on valuation techniques that are accepted industry wide and have been rigorously vetted, are Level 2 estimates, and to provide more guidance on the interpretation of the term "objectively determinable".

Level 1 Reference Market

Issue 6: In this proposed Statement, the Level 1 reference market is the active market to which an entity has immediate access or, if the entity has immediate access to multiple markets, the most advantageous market. Appendix B provides general guidance for selecting the appropriate reference market (Example 5). Is that guidance sufficient? If not, what additional guidance is needed?

Response:

We agree with the Board's definition that the most advantageous market is one which the entity would maximize the net amount that would be received for an asset and minimize the amount that would be incurred for a liability. However, the ED also states that the price for fair value estimates under the Level 1 approach is "the price in the most advantageous market, shall not be adjusted for costs" (para. 16). We believe excluding transaction costs would cause unintended volatility in earnings as higher gains in earlier periods will be offset by transaction costs expensed in subsequent periods when realized.

It is also not clear whether this exclusion of transaction costs is also applicable to Level 2 and 3 estimates. The Level 2 estimate requires adjustments for differences when using prices of similar assets or liabilities (see para 19). Level 3 estimate requires price to be adjusted for "differences in the

unit of account, condition, or location, or to reflect the appropriate valuation premise" (para 23f). Thus if transaction costs were to be considered in Level 2 and Level 3 estimates, then it would seem logical that they should also be included for determination of Level 1 estimate to ensure consistency in approaches.

The impact of subsequent events in determining fair value is also addressed for Level 1 estimates, as para.18 states, "An entity should establish and consistently apply a policy for determining how those events affect estimates of fair value". We believe such adjustments are appropriate for all levels of estimates, whether based on quoted market prices or valuation techniques. The ED should be amended to clarify that policy for adjusting for subsequent events is applicable to all levels, not just Level 1 estimates.

Pricing in Active Dealer Market

Issue 7: This proposed Statement would require that the fair value of financial instruments traded in active dealer markets where bid and asked prices are more readily and regularly available than closing prices be estimated using the bid prices for long positions (assets) and asked prices for short positions (liabilities), except as otherwise specified for offsetting positions. Do you agree? If not, what alternative approaches should the Board consider?

Response:

Generally, we agree with the concept but would appreciate clarification for its application to exchange-traded equity securities. Unlike debt securities, the majority of the exchange-traded equities have "hard closed" prices which are provided by the stock exchanges at the end of each trading day. Thus, to apply the bid and asked prices concept under the ED to these equities would distort the normal mark to market inventory accounting process. We ask the Board to clarify their view so that the standard can be applied from a practical perspective.

Paragraph 17 under Level 1 estimates also states "For offsetting positions, mid-market prices shall be used for matched position". Does "offsetting positions" allow for matched positions using different products such as a security matched with a listed option? If different market prices from each respective exchange were used to value these instruments, it would lead to volatility in income and would not give a true fair value of the overall position or risks. If the security is matched with a forward, then there is no allowance for mid-market price for the forward if it is considered a Level 3 estimate. We believe guidance should be provided on what is defined as "offsetting positions" and whether the use of mid-market price is allowed for all levels of estimates.

Measurement of Blocks

Issue 8: For unrestricted securities with quoted prices in active markets, many FASB pronouncements (including FASB Statement No. 107, Disclosures about Fair Value of Financial Instruments) require that fair value be estimated as the product of a quoted price for an individual trading unit times the quantity held. In all cases, the unit of account is the individual trading unit. For large positions of such securities (blocks) held by broker-dealers and certain investment companies, the AICPA Audit and Accounting Guides for those industries (the Guides) permit fair value to be

estimated using blockage factors (adjustment to quoted prices) in limited circumstances. In those cases, the unit of account is a block.

The Board initially decided to address the inconsistency in this proposed Statement as it relates to broker-dealers and investment companies. The Board agreed that the threshold issue is one of determining the appropriate unit of account. However, the Board disagreed on whether the appropriate unit of account is the individual trading unit (requiring the use of quoted prices) or a block (permitting the use of blockage factors). The majority of the Board believes that the appropriate unit of account is a block. However, the Board was unable to define that unit or otherwise establish a threshold criterion for determining when a block exists as a basis for using a blockage factor. The Board subsequently decided that for measurement of blocks held by broker-dealers and certain investment companies, current practice, as permitted under the Guides, should remain unchanged until such time as the Board fully considers those issues.

For those measurements, do you agree with the Board's decision? If applicable, what approaches should the Board consider for defining a block? What, if any, additional guidance is needed for measuring a block?

Response:

We appreciate that the Board decided to continue existing practice of allowing broker-dealers and certain investment companies to apply blockage factors to their significant holdings. However, this allowance is not applicable to all other entities. An entity with significant holdings in a publicly traded security would, for example, recognize a gain using the quoted market bid price for the fair value of its asset positions. However, a portion of this gain would have to be reversed in a subsequent period when the entity disposed of the block since it is unable to sell the large holding at the current market price. We believe this approach will create unwarranted volatility in earnings. It will also result in different fair value positions for two entities that have exactly the same holdings because the broker-dealer/investment company would apply the blockage factor in its valuation whereas the non-broker/dealer entity would not.

The ED also introduces the concept of "unit of account". As explained in paragraph 6, this concept is used to define whether the asset/liability is being measured individually (for example, a single loan), or as part of a larger group (for example, a portfolio of loans). In applying this concept for significant holdings, is it acceptable for an entity to determine fair value for its significant holdings based on an aggregate basis (i.e., similar to portfolio of loans)? If so, the value for the 'portfolio' would likely take into account the size of the holdings. We believe the ED should clarify how this "unit of account" concept should be applied in these large holdings scenarios.

In view of the above discrepancies, we recommend that the Board reconsider the approach for the blockage factor before finalizing this ED as the impact of large holdings should be the same for all entities and not just to broker-dealers and investment companies.

Level 3 Estimates

Issue 9: This proposed Statement would require that in the absence of quoted prices for identical or similar assets or liabilities in active markets, fair value be measured using multiple valuation

techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort (Level 3 estimates). Appendix B provides general guidance for applying multiple valuation techniques (Example 6-8). Is that guidance sufficient? If not, what additional guidance is needed?

Response:

As currently drafted, the ED would require entities to consider more than one valuation technique for determining Level 3 estimates. As mentioned in our earlier comments to Issue 5, all financial institutions have significant positions in OTC derivative instruments. Financial institutions that trade OTC derivative contracts use sophisticated valuation techniques/models that have endured a rigorous vetting process performed by valuation/quantification experts, and are endorsed by market participants as valid pricing models. Thus, quotes on certain OTC derivatives that use currently approved valuation techniques will display pricing traits similar to exchange-traded products. As such, we believe that valuation of these OTC derivative contracts should be considered a Level 2 estimates, possibly as Level 2b estimates, and the current Level 2 estimates, as described in the ED, should be Level 2a estimates. Unfortunately, we understand that some accounting firms have indicated otherwise. They are of the view that these are Level 3 estimates and therefore, are subject to the application of several models for determining the appropriate fair value. We do not believe it is the Board's intent to question these accepted valuation models for derivatives. Please confirm.

In addition, most of the private placement securities are also Level 3 estimates. Most of these are related to investments in venture capital funds and information on their values is only available infrequently. Application of multi-valuation approaches to these instruments will be time intensive and require numerous management estimates without significantly adding to the reliability of the estimates. We would appreciate if the Board would reconsider the multi-valuation approaches to such type of instruments where any valuation premise will be highly judgment based. We also request the Board to clarify that when one valuation approach has been identified as more appropriate vis-à-vis others in the initial assessment of Level 3 estimates, the entity will be permitted to adopt that one as the chosen approach for subsequent valuations. Will this be agreeable to the Board if the entity revisits this "chosen" method approach and reverts back to the multiple approaches assessment when there are subsequent changes to facts or assumptions?

Restricted Securities

Issue 10: This proposed Statement would require that the fair value of restricted securities be estimated using the quoted price of an otherwise identical unrestricted security, adjusted for the effect of the restriction. Appendix B provides general guidance for developing those estimates, which incorporates the relevant guidance in SEC ASR No. 113, Statement Regarding "Restricted Securities." Is that guidance sufficient? If not, what additional guidance is needed?

Response:

We appreciate the guidance in Appendix B for valuation of restricted securities. However, the guidance is for identification of what would be improper, rather than what would be proper. In adjusting for the value of these securities, we would expect that duration of restriction would be the most significant determinant. As such, an alternative is to apply the present value technique

proposed under CON 7 to account for the restriction period. The ED should provide additional guidance and examples on how to adjust for these restrictions.

Fair Value Disclosures

Issue 11: This proposed Statement would require expanded disclosures about the use of fair value to remeasure assets and liabilities recognized in the statement of financial position. Appendix B illustrates those disclosures. This proposed Statement also would encourage disclosures about other similar remeasurements that, like fair value, represent current amounts. The Board concluded that those disclosures would improve the quality of information provided to users of financial statements. Do you agree? If not, why not?

Response:

We understand the intent of the additional requirements proposed but do not agree with some of these requirements. We believe that to disclose fair value amounts by how they were determined (whether based on quoted prices or on results of valuation techniques) will require significant system changes by entities for no substantial added value to users of financial statements since such information will not be relevant to the risk management strategies of the entities. It is also extremely difficult to gather the information required to disclose "the effect of remeasurement on earnings for the period (unrealized gains or losses) relating to those assets and liabilities still held at the reporting date". As an example, derivatives are widely used by entities as hedges, either as qualifying hedges under FAS 133 Accounting for Derivative Instruments and Hedging Activities, or as economic hedges. For those derivatives that are accounted for as hedges, only the amount of ineffectiveness and component of the derivatives excluded from assessment of hedge effectiveness are included in earnings. In this situation, would the Board require the entire change in derivative value to be disclosed, or only that portion which relates to ineffectiveness and is excluded from effectiveness assessment, as already required under FAS 133 paragraph 45a and 45b? For economic hedges, their change in value is netted against items that are being economically hedged, as in the case of using Total Return Swap to hedge compensation obligations that are accounted for at marked-to-market as indexed liabilities. Quantifying the impact on earnings during the period resulting from remeasurement of these economic hedges will require changes in data capturing systems which will be costly to the entities for no added value to users of financial statements as their main concern is the impact on net earnings.

We also noted that the ED does not require entities to disclose the impact of adjustments made to restricted securities. We believe these adjustments should be disclosed as the value recorded for these restricted securities are not representative of what the entity will be able to realize upon sales after the restriction periods. Similarly, we believe that if the Board decided not to allow other entities to apply blockage discount, the entities should be allowed to disclose such impact in the notes.

Effective Date

Issue 12: This proposed Statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. The Board believes that the effective date provides sufficient time for entities to make the changes necessary to implement

this proposed Statement. Do you agree? If not, please explain the types of changes that would be required and indicate the additional time that would be needed to make those changes.

Response:

In view of the implication of this ED, we believe the earliest date should be at least 12 months after the Standard has been finalized in order to allow sufficient time for entities to implement changes to their complex reporting systems. Extra time is also required to assess the valuation techniques where Level 3 estimates are used, as entities can no longer rely on a single valuation model for determination of fair values and are required to develop new alternative models for comparison purposes, as well as to ensure that the techniques incorporate market data input to the extent possible.

In addition, the ED also have discrepancies in the effective date, as The Effective Date of This Proposed Statement on page vii of the summary and Paragraph C68 both use June 15, 2004 versus June 15, 2005 as per Paragraph 27 under Effective Date and Transition.

Other Issues

Issue 13: This proposed Statement represents the completion of the initial phase of this project. In subsequent phases, the Board expects to address other issues, including issues relating to the relevance and reliability of fair value measurements and the unit of account that should be used for those measurements. What, if any, other issues should the Board address? How should the Board prioritize those issues?

- We believe the implementation of this Fair Value Measurement standard will be in conflict with the existing requirements under EITF 02-3 "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities". For example, the EITF requires an entity to record the fair value of an OTC written option at inception based on the premium received, but prohibits recognizing gains if the price is not supported by market. This ED would require the entity to value the OTC written option at inception using the Level 3 estimates approach which may result in a different fair value. Reporting the value under the EITF 02-3 approach will not be in compliance with the Fair Value Measurement standard. We understand the Board is aware of the issue related to this EITF but has decided to address this in its revenue recognition project. We believe this conceptual conflicts need to be resolved prior to finalization of the Fair Value Measurement standard.
- As indicated in Appendix E of this ED, there is a long list of existing pronouncements impacted by this Fair Value Measurement standard including complex standards like pensions, business combinations, goodwill and variable interest entities. We ask the Board to provide more guidance on how to apply this Standard to these pronouncements. The Board should incorporate the additional guidance in a Re-Exposure Draft in order that entities may fully comprehend the impact of this new requirement.