

Mr. Russell G. Golden Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 August 30, 2010

Reference: FASB Reference No. 1810-100, Proposed Accounting Standards Update Accounting for

Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging

Activities Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815).

Dear Mr. Golden:

Duff & Phelps appreciates the opportunity to provide comments on the above referenced exposure draft and the associated questions raised by the Board.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques that are acceptable to the public accounting community. We believe that our unique perspective in the practical application of valuation related accounting principles -- both under United States generally accepted accounting principles and international financial reporting standards – has particular relevance to the Board and its constituency – as it relates to the proposed accounting standard referenced above.

Because of our unique expertise in the financial services industry, our application of fair value concepts, and our experience working with preparers and auditors, both of the undersigned would welcome the opportunity to participate in the Board's public roundtable meetings scheduled in October. We believe we could provide balanced input as all sides of these complex issues are discussed and considered.

We would be pleased to further discuss our comments with the Board and staff. Please direct any questions to either of us via the contact information set forth below.

Sincerely.

Jerry Arcy, CPA

Global Financial Service Leader

David L. Larsen, CPA Managing Director

Duff & Phelps Corporation (NYSE: DUF) is a leading independent valuation consultancy and financial advisory firm

DUFF&PHELPS

August 30, 2010

FASB Reference No. 1810-100

Response to ED: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)

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Overview

As an advisor to many of the world's largest global and domestic companies that prepare financial statements under U.S. generally accepted accounting principles (U.S. GAAP) or international financial reporting standards (IFRS), Duff & Phelps¹ understands that there are differences of opinion as to how accounting standards should be modified, interpreted and applied. In particular, we acknowledge the philosophical divide surrounding accounting for financial instruments.

In studying the Exposure Draft (ED), we find merit with many of the arguments for and against the FASB's (Board's) proposal. While our comments² include responses to the Board's questions, we feel strongly that the Board should further consider the concepts of business model, unit of account, convergence, complexity, fair value estimates and the resulting new accounting paradigm in finalizing its guidance on financial instruments.

Specifically, our observations on these concepts are as follows:

Business Model

In today's world, accounting is often used as a tool by all levels of an entity's management to understand the operating performance of its businesses and manage ongoing operations from a short-term to a longer-term horizon. Financial reporting bridges management's understanding of its business with the information needs of the investor community and other interested parties. Appropriate financial reporting balances the requirements of all parties by providing a suitable level of understanding of an entity's cash flows (and changes thereto), business operations and performance, and overall financial position that is relevant and reliable, so that informed decisions and/or recommendations can be made. As such, it

As one of the world's largest independent technical valuation specialists, Duff & Phelps provides a unique perspective in addressing complex valuation related accounting issues. We have firsthand knowledge of how accounting issues, with a valuation component, are addressed by a multitude of preparers, auditors, analysts, investors, and other technical valuation specialists. Our objective in working with preparers, auditors, regulators and standard setters is to render independent, objective advice to enhance best practices in financial reporting while ensuring pragmatism, relevance, consistency, quality, and compliance with fair value concepts.

Our commentary, as set forth herein, results from interaction of many of our managing directors and staff with a diverse and substantial client base. Over a rolling 24 month period, Duff & Phelps' client base typically consists of: one-half of the companies comprising the S&P 500, more than two-thirds of the 20 largest depository institutions in the US, more than two-thirds of the 50 largest private equity and hedge fund management firms in the world, and approximately one-half of the 10 largest public asset managers based in the US.

should be clear then that a market participant perspective encompasses an entity's business model.

The accounting treatment for financial instruments should integrate the underlying business model and operations with the assets and liabilities necessary to execute the business strategy. Reporting on the business model employed by management allows all interested parties to be more informed and better able to evaluate the entity's strategic decisions and operations on a consistent and comparable basis. That is, if the strategy of a business is to sell financial assets, all interested parties would benefit from information about the fair values of such assets along with the liabilities required to fund those assets. However, if an entity's business model and strategy is to hold and collect contractual cash flows on financial assets, then the optimal primary accounting for those assets may not be based on fair value. Amortized cost, presented net of expected credit losses, may better reflect the business model employed by management. Further, the accounting treatment for the financial liabilities directly associated with the funding of such assets should be consistent with the treatment of those assets, especially if the intent of the entity is not to liquidate those liabilities but to make orderly contractual payments. Utilizing an entity's business model to determine the appropriate accounting is consistent with the use of market participant assumptions in assessing fair value.

Fair value is a useful tool to measure an entity's underlying assets and liabilities. However, the fair values of an asset or liability, especially those of a financial nature, are often impacted by various external environmental factors, which, by their very nature make the fair value concept more volatile. Such volatility, when it results from accounting convention rather than market movements, can often distort the perception of management's effectiveness when their business model is the collection/payment of contractual cash flows. The financial crisis of 2008 reminded us that healthy stable businesses with sound business models can be misinterpreted if too much emphasis is placed on 'last trade' prices when trading is not even part of the business. This relearning was just as important as the fact that the amortized cost of instruments can be equally misleading if an enterprise cannot effectively exist long enough to capture/remit contractual cash flows on an orderly basis. Perhaps the safety and soundness of the business model (or overall financial health of the enterprise) is a necessary component of determining which basis of accounting – fair value or amortized cost – should be primary for certain financial instruments in certain business models.

In summary, financial reporting should convey how an entity operates its businesses and how it intends to use (and fund) the assets that are integral to its business model, which is also usually consistent with a market participant view of the business. In other words, while we strongly support fair value reporting in general, we believe that fair value reporting may not be helpful, relevant or consistent as the primary basis of accounting for certain financial instruments in certain business models.

We do believe, however, that rational and relevant disclosures, supplementing and expanding upon those set forth in ASC 825 would provide users of financial information with an improved understanding of how current market conditions could impact an entity's business if its business model was changed or called into question. In particular, additional disclosures relating to counterparty credit risk and an entity's underwriting policies would provide users with more decision-useful information. Because of the divergence in fair value estimates for similar assets and liabilities reported only in the notes to financial statements, it is clear that increased rigor is needed to provide consistently robust fair value disclosures.

Unit of Account

The unit of account concept is central to the Board's implementation of fair value. However, in practice, unit of account is inconsistently determined and often does not reflect a market participant perspective. Therefore, any new financial instrument guidance must clearly and appropriately articulate the unit of account. An entity's business model and how it manages the assets and associated liabilities that are integral to the business model should be a primary factor in exercising informed judgment to determine a market participants' perspective in establishing the appropriate unit of account and unit of valuation.

Through our work with clients implementing ASC Topic 310-30 (f/k/a SOP 03-3), we have seen the difficulty that exists in determining the appropriate unit of account. There are many misconceptions among both auditors and preparers of financial statements on this important topic. In our experience, the default unit of account generally used by the audit community is that of an individual asset or liability. This is reinforced by the fact that legal terms often are captured in automated accounting records at the specific contract level. The emphasis of some auditors, influenced by their regulators, tends to dominate even when market participants view a group of financial instruments as more important. Such unit of account interpretations are made without regard as to how the particular financial instrument transacts, is funded, or is settled between market participants. In short, we find that the determination of unit of

account often ignores both the market participant perspective and the related business model.

While operational considerations are important and in some situations may restrict an entity's ability to create robust and decision-useful financial statements, ignoring the importance of the market participant viewpoint, a cornerstone of fair value reporting, is troubling. Preparers, auditors and their regulators seem to be more focused on whether a group of financial instruments are "homogeneous" rather than whether the instrument is transacted or settled individually, in pools or combined with other assets or liabilities. This has implications for (i) the underlying assumptions that go into the measurement of the asset or liability, including inputs and premise (in-use or in-exchange), as well as other adjustments (e.g. blockage), and (ii) the usefulness of disclosures such as measurement uncertainty.

Many of these concepts are more applicable to the Board's fair value guidance. However, in finalizing this ED, we urge the Board to clarify the common misconceptions regarding the appropriate unit of account for financial instruments. For the most part, the market participant viewpoint should be readily apparent in whether a financial instrument is sold or settled individually, syndicated or pooled and sold in tranches. The market participant perspective, supported by management's perspective as illustrated by their business model, should provide the key to establishing the unit of account. More specifically, even though underlying systems capture information at an individual asset level, group level reporting may be more meaningful for financial statement users because this is how the instruments are managed and measured³ in terms of performance, and it better reflects a market participant perspective.

In particular, the removal of the highest and best use valuation premise for financial instruments is not congruent with taking a market participant view. Because the Fair Value ED seems to indicate that an individual financial instrument is generally the appropriate unit of account, we believe that preparers and auditors will need more explicit and pragmatic guidance on this subject to assure that financial statements are prepared consistently between entities and reporting periods, remain robust, and provide meaningful information.

The Board's Fair Value ED refers to other GAAP to make a determination of unit of account. Thus, it is imperative that this exposure draft outline the appropriate parameters and use of judgment acceptable in determining the unit of account.

Convergence

As we have communicated to the Financial Crisis Advisory Group, Valuation Resource Group, SEC Fair Value Roundtables, and the IASB and FASB, we strongly support the goal of establishing a single set of high quality financial reporting standards. In finalizing the Board's approach to financial instruments, it is of prime importance that agreement is reached with the IASB on a common accounting framework for reporting financial assets and liabilities.

While we strongly support adopting a converged U.S. GAAP/IFRS approach to accounting for financial instruments, we are concerned that the move toward convergence is focused primarily on the resultant accounting standards and related outcomes rather than the differences in legal, audit, and regulatory environments in which accounting standards are applied. Common accounting standards, while very important, will not achieve the goal of providing consistent, comparable high quality financial reporting, if they are interpreted and applied differently in various jurisdictions because of local laws or regulatory interpretations.

For example, the need for the Board to release FSP FAS 157-3 and 157-4 was in large part driven by the interpretations of auditors that in turn were driven by PCAOB review comments. As a result, prior to these FSPs there was an overemphasis on observable transaction prices ("last transaction price") even though in many cases such transaction data did not reflect "fair value" as defined (e.g., orderly transaction pricing). Independent auditors and regulators in the U.S. historically have operated in a rules-based accounting standards framework and until a level of comfort with the use of judgment in applying principles-based concepts increases, and a level of comfort with auditing judgment based estimates is achieved, we are likely to continue to encounter tension in the application of fair value concepts, specifically fair value measurement across jurisdictions.

Compliance with the proposed standard would require major changes to the accounting systems underlying the reporting process for financial statements, particularly for loans. The Board has acknowledged this in part by its contemplated phased approach to implementation. However, investing substantial time and money in new systems, only to see efforts adjusted or worse yet reversed through the convergence process is neither sound business guidance nor effective professional leadership. Therefore, we strongly encourage the Board to work through these issues with the IASB before finalizing this proposed standard.

Complexity

After spending months studying, digesting, and attempting to comprehend the ED and its implications and interactions with existing standards and proposed standards, we find that the proposed changes contain numerous exceptions and inconsistencies, changes many aspects of the principles of accounting that have been in place for decades, and brings substantial cost to the preparer community, the benefits of which are uncertain.

The Board is aware of this complexity, as the ED states:

"... the Board's decision to defer the application of the effective date of certain provisions ... raises significant questions about the operationality of the proposed standard ..."

We believe that a standard which cannot be understood and implemented within a reasonable period of time (e.g., less than three years) by all preparers runs the risk of being too complicated to be adopted in a cost effective and consistent manner.

We agree that a mixed attribute accounting model inherently includes inconsistencies and complexities. We agree that certain industry sectors, such as the alternative asset industry, have a business model that has historically used and is conducive to the use of "fair value" accounting. However, as decisions are made as to which assets and liabilities should be reported at fair value, the Board should seek to reduce perceived complexity by reducing the number of exceptions and the number of potential outcomes in both the statements of financial position and comprehensive income. In addition, the Board should provide specific guidance and interpretation through examples so that when judgment is applied by a preparer it is done to increase the appropriateness of the measurement process and to increase the level of consistency and comparability of financial statements among preparers.

Fair Value Estimates

As the financial crisis unfolded, many misconceptions about fair value arose. For example, some believed that fair value accounting caused the financial crisis. While, we acknowledge the Board's efforts to correct these misconceptions, we are concerned that such efforts distract from the discussions about the appropriate accounting model for reporting financial instruments. We encourage the Board to continue to embrace and promote key issues such as:

- Fair value accounting prohibits fire sale pricing;
- Topic 820 (f/k/a SFAS 157) does not require any asset or liability to be recorded at fair value;

As noted in paragraph BC252.

- Fair value concepts are understandable, yet require informed judgment to estimate and interpret;
- Disclosure guidance should be enhanced to support underlying attributes relied upon in the estimation process; and
- The use of judgment and rigor to balance the assessment of unit of account from a market participant perspective at either the individual asset or composite group level.

New Paradigm

Finally, as we step back and examine the totality of this ED, we come to the realization that the Board is proposing an entirely new financial reporting paradigm (i.e., ignoring historic cost accounting, and gross margin for spread management business models, in lieu of fair value reporting of asset positions – even though they will never be sold.) Such a change is monumental. We therefore must ask the following:

- Is the current framework so completely broken that it is necessary to implement such substantial, complex and costly changes?
- Given the volume and complexity of the information that will be disclosed, do investors and analysts (users) require this new paradigm and will they find the ultimate results decision-useful?

The changes being proposed are seismic in their scope for many in the financial services industry – both preparers and users – and certain other industries. Everything, from recognition of interest income to how credit losses are determined, is being modified. If the primary accounting for how entities view and operate their business models and underlying assets and liabilities are to be replaced with a fair value accounting model, should not all assets including identifiable intangible assets (which for many companies are significant to the ongoing operations and would be material to the balance sheet) be recognized for financial reporting purposes at fair value to better reconcile to the overall market capitalization of an entity? The answer should consider the level of relevant information that the users of financial statements require. During discussions with preparers and users, we have heard many express the feeling that the exposure draft is too complex in its current form to be decision-useful and that it strays so far from historic practices that significant effort will be required to adjust the information back to obtain a meaningful understanding of an entity's operating performance and financial position.

Conclusion

In summary, we have significant reservations about the proposed standard as currently drafted. Overall, our views can be summarized as follows:

We strongly support the development of a converged (FASB/IASB)
 comprehensive financial instrument accounting framework. Fair value

has a significant place in that framework, as the Board acts on achieving the goal of high quality, internationally recognized, implementable, investor helpful, accounting guidance.

- We applaud the Board's use of a "market participant" view in assessing the appropriate attributes for measuring fair value. However, we believe that a market participant view encompasses a business model view. The Board should consider this market participant / business model perspective in determining which financial instruments should be measured at fair value and which should be measured at amortized cost. We support the premise that it is more appropriate for certain financial instruments to be measured at amortized cost⁵, with fair value presented parenthetically on the face of the statement of financial position.
- We support the Board's initiatives to propose changes to the carrying value of financial instruments and the credit impairment model in particular, but believe the Board needs to expand the proposal to ensure that all adjustments to contractual terms take into account a market participants' perspective, including assessing future events, and that amounts known (i.e., credit losses) and amounts estimated (i.e., anticipated adjustment to cash flows based on probable events) are appropriately considered and separately disclosed.
- We support the concept that interest income should be recorded based on contractual terms of the individual financial instruments until an event occurs to call that approach into question. We also believe that adjustments to income to reflect anticipated shortfalls (both known and estimated and as adjusted for estimated recoveries) in contractual cash flows should be provided for, based on their present value impact as of the measurement date, and that such overall adjustments should be made on a portfolio basis.
- We support the Board's proposed simplification to the derivative and hedge accounting model.

* *

Following are our responses to certain of the Board's specific questions.

Throughout this document, when we refer to amortized cost, we generally mean amortized cost adjusted for collection risk for any debt instrument or pool of debt instruments.

Responses to Specific Questions

Scope

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?

Duff & Phelps response: We agree with the scope of financial instruments included in the ED. However, as more fully described throughout our response, we do not believe that the current proposal will result in consistently applied high quality financial reporting.

Question 5: The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Do you believe that the effect on net asset value will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why?

Duff & Phelps response: We do not believe that financial liabilities of investment companies should be measured at fair value because of the proposed change in the determination of fair value as outlined in the Fair Value ED currently out for public comment.

All assets of investment companies are required to be reported at fair value. Investors in investment companies are allowed, as a practical expedient, under ASU 2009-12 to use Net Asset Value ("NAV") as an estimate of the fair value of their interest. One of the conceptual reasons for allowing the use of NAV is because the underlying assets are reported at fair value, that is, at the value that would be received if the underlying asset (investment) were sold at the measurement date. Therefore, NAV represents the amount that an investor would receive on the measurement date if the underlying investments were sold. If liabilities of an investment company are reported at anything other than the value that would be repaid on the measurement date, NAV would not represent the cash flows that an investor would theoretically receive on the measurement date from the theoretical sale of the underlying investments.

Liabilities of investment companies are generally required to be repaid when underlying assets are sold. Because of the exit market premise of determining the fair value of the underlying investments, most investment companies would conclude that related debt could be called at any time because of the conceptual sale of all assets at each measurement date. Therefore, the term of the debt would be zero and the fair value of the debt would equal amortized cost, or the amount that would be repaid if all assets were sold on the measurement date. Unfortunately, the proposed changes to Topic 820 do not allow the liability to be valued in concert with

the related assets because the in-use valuation premise is eliminated. Therefore, to achieve consistency, either the proposed changes to Topic 820 require amendment or liabilities of investment companies should not be reported at fair value (using the proposed new fair value interpretation) to ensure that the financial reporting by investment companies properly reflects NAV as an indication of the cash flows an investor would receive in an exit transaction for the underlying investments.

Question 6: The proposed guidance would require money market funds that comply with Rule 2a-7 of the Investment Company Act of 1940 to measure their investments at fair value rather than amortized cost. Do you believe that reporting those investments at fair value rather than amortized cost will provide decision-useful information? If yes, how will the information provided influence your analysis of the fund? If not, why?

Duff & Phelps response: Because of the short-term nature of the investments made under the money market fund business model, we do not believe that fair value reporting for these investments will provide decision-useful information due to the relatively material delay between the measurement date and when financial statements become available to investors and other decision makers. We believe that requiring fair value for these instruments would increase complexity and would not meet the cost-benefit trade-off, given their short-term nature. Therefore, we believe that reporting at amortized cost is more appropriate for the investments of money market funds.

Initial Measurement

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

Duff & Phelps response: No, the proposed principles appear overly complicated and may create unintended consequences. For example, assume a financial instrument for which the qualifying portion of subsequent changes in fair value will be recognized in other comprehensive income. For this instrument, the proposed principles require initial measurement at the transaction price. When the subsequent measurement principle is fair value, the first subsequent mark to fair value could potentially include the initial difference between transaction price and fair value. Paragraphs 14 through 17 of the ED introduce further complexity by creating exceptions to the "transaction price" bucket. We would recommend simplifying the initial measurement principle by considering the use of fair value in this situation.

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?

Duff & Phelps response: Yes, however, we believe that the initial measurement principle for all financial instruments subsequently measured at fair value should also be fair value. If transaction price as an initial measurement principle appears in the final standards, then we would agree with the proposed treatment. A significant difference between the transaction price and fair value on the transaction date could occur because of a bargain purchase, because of a decision for some reason to pay more than the fair value of the instrument, or because the exit market differs from the market in which the instruments were acquired. In any case, the gain or loss would appropriately be recognized in income because it results from the negotiated non-fair value transaction price.

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?

Duff & Phelps response: We believe that there should be a single initial measurement principle, fair value, for all financial instruments that are subsequently measured at fair value. However, as noted later in our

response to Question 13, we believe there should be two subsequent measurement principles, fair value and amortized cost. Should the Board agree with our proposal, we would recommend that the initial measurement principle conform to the subsequent measurement principle.

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?

Duff & Phelps response: Yes, we agree with the proposal for those instruments applying fair value measurement as a primary basis of accounting.

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?

Duff & Phelps response: Not necessarily. Because of differences in the application of judgment and more importantly auditing the application of judgment, treatment will likely be inconsistent. Conceptually, the guidance is clear and we believe preparers would be able to exercise informed judgment and comply with it. However, we are concerned that inconsistent treatment will be an issue as auditors and their regulators, accustomed to operating in a rules-based accounting standards framework, begin to interpret the decisions of preparers made in a principles-based framework. For example, it is not uncommon for fixed income security transactions to be based on a negotiated yield with price derived. Therefore, the proposed guidance may not be operational because fees and commissions are not necessarily broken out separately as with equity securities, but rather 'buried' in the yield quoted.

Subsequent Measurement

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?

Duff & Phelps response: As noted in the Overview above, we believe that consistent international standards are of greatest importance. With that said, we believe that for qualifying entities amortized cost should be used as the principal method of reporting for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. We believe this treatment would generally provide more decision-useful information to all users of the financial statements and is more consistent with both a market participant perspective and an entity's business model.

For such financial instruments, providing fair value information parenthetically, on the face of the statement of financial position may provide all financial statement users, including investors, creditors and regulators, with a measured degree of transparency and decision-useful information. In addition, with regard to the assertion that this is merely a question of geography as fair value information is available currently in the notes to financial statements under U.S. GAAP, our experience indicates that users of financial statements often perceive that a different level of rigor is deployed by both management and their auditors between amounts set forth on the face of the financial statements. Having both measurement

Qualifying entities are those financial entities whose primary business model is to hold financial instruments for their collection or payment(s) of contractual cash flow, have a demonstrated history of holding the financial instruments to maturity and have either adequate capital (e.g., 125+ percent of the minimum required by regulators) or are those non-financial entities with substantial debt coverage ratios.

Recent SFAS 107 (ASC 825) disclosures (which present the fair value of loans) by the top 20 depository institutions indicate values ranging from mid 80s to par. Little commentary has occurred by the investor community on this wide dispersion of fair value estimates, raising the question as to what extent does the analyst community care about and use this information and whether the audit

attributes resident on the face of the statement of financial position might reduce such concerns.

However, if fair value of such financial instruments is presented on the face of the financial statements, either as the primary accounting method or parenthetically, we believe that preparers will require additional guidance to assure that consistency and comparability is achieved.

With respect to any short-term financial instruments, we believe that amortized cost should be the primary method of accounting, presented net of expected credit losses, unless the entity routinely transacts or trades such instruments at prices where amortized cost significantly deviates from fair value.

Finally, any discussion of an appropriate subsequent measurement attribute for all financial instruments requires some mention of a default unit of account as the current rules-based fixation on heterogeneity in the grouping of assets runs counter to the business models of many entities, and, more importantly, runs counter to the market participant perspective (based on a business model view) that is a cornerstone of fair value reporting. Even in situations where an entity's financial reporting system captures information at an individual asset level, group level accounting often is more meaningful for financial statement reporting because this is how market participants view assets which are managed and measured in terms of performance and how they are transacted or settled. For example, while many consumer loans are accounted for on a loan by loan basis, the fact remains that such instruments generally are bought, hedged and sold in pools.

Therefore, we recommend using amortized cost for qualifying financial instruments as described above. Regardless of the ultimate decision regarding fair value versus amortized cost as the default measurement attribute, we recommend that the primary method be presented on the statement of financial position and that the secondary measurement be set forth parenthetically.

and preparer communities subject it to the same rigor as amounts included on the face of the financial statements.

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?

Duff & Phelps response: Should the Board proceed with the fair value measurement of financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows rather than amortized cost, we believe that fair value changes related to interest, realized gains or losses or credit assumptions⁸ (i.e., delinquencies, defaults and recovery assumptions) should be recognized in net income. All other changes in fair value (i.e., illiquidity adjustments, or changes in assumptions related to the timing of repayments, forex, interest rates, etc.), which are generally market risks that cannot be managed, should be recognized in other comprehensive income.

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

Duff & Phelps response: The subsequent measurement principles should be the same for financial assets and financial liabilities that are specifically duration matched as a regulatory requirement, or those assets and liabilities that as a matter of demonstrated business practice are accounted for using a common primary method – either amortized cost or fair value.⁹

With that said, we generally agree with the criteria outlined in Paragraph 30 for measuring a financial liability at other than fair value, although the

Changes in future expected cash flows based on revisions to counterparty behaviors are credit events, even if such changes are merely a credit watch announcement.

For example, for loan pools with an average life of three years that are match funded by deposits with an average life of three years, then both the matched assets and deposits would be reported at fair value, or amortized cost depending on which is the primary method. Also, for insurance companies that have separate accounts (assets managed for others), the fact that those separate account assets and liabilities may be reported at fair value would not be considered when evaluating the relationship of the remaining assets and liabilities. Should the liability for future policy benefits be appropriately match funded by an identified corresponding investment portfolio then such portfolio may be presented at amortized cost, assuming the institution is a qualifying institution.

criteria require clarification. For example, consider an entity with \$1 million of debt on which the entity intends to make contractual payments and that uses the debt to finance \$600,000 of financial assets carried at fair value and \$400,000 of fixed assets that are carried at amortized cost, while it may be operationally challenging, it should be clear that measurement for the debt should be bifurcated such that \$600,000 of the debt is carried at fair value and \$400,000 at amortized cost.

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?

Duff & Phelps response: We believe that some flexibility should be left with management to allow changes, though exceptions would be infrequent. For example, management should have the flexibility to change the accounting for a financial instrument for a fundamental change in the entity's business model. However, when such a situation occurs, management should be required to disclose the change and the reasons for the change in accounting method in the notes to the financial statements and management discussion and analysis section. In addition, we believe that only the changes in fair value that are related to interest, realized gains or losses and counterparty credit should be recognized in net income. All other changes should be recognized in other comprehensive income.

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?

Duff & Phelps response: While core deposit liabilities ("CDL") are a relatively inexpensive source of funding for banks, ¹⁰ there are a number of potential concerns with the proposed treatment, not the least of which are that it:

- Moves away from the principles of fair value by introducing prescribed mathematics in calculating remeasurement value;
- May result in values that are not comparable and based on relatively subjective inputs;
- Does not reflect the economics of the funding correctly;
- Does not reflect the settlement or extinguishment aspects of the individual liability to the counterparty;
- May result in a disconnect with the business model and prudent risk management practices if not contemporaneously matched with the assets the deposits are funding, especially if such assets are presented at amortized cost; and
- May result in double counting of the implied benefit of such favorable financing when remeasurement occurs (a) to a limited extent with certain assets that are currently on the balance sheet, or (b) would be recorded shortly after an acquisition in which CDL are assumed;¹¹

Remeasurement Value: The remeasurement method introduces a new measurement attribute, remeasurement value, which is not fair value or amortized cost. This adds another level of complexity in financial reporting in general and accounting for financial instruments in particular. The intrinsic value of the right to use an alternative and presumably cheaper source of funding is a key intangible asset that is resident in a banking institution as a result of how these institutions operate their businesses. This intangible asset has been recognized by the preparers, users and regulators over a long period of time. Several issues arise from this point. Specifically, (i) should assets and liabilities be presented gross; and (ii) should other internally generated assets which are key to any business (e.g., customer relationships, technology created, brands, trade names, etc.) also be remeasured on a periodic basis?

There is statistical evidence that CDLs, in the aggregate, have a long useful life, and the effective economic cost to the banking institution is far less than alternative funding.

Under ASC 805, *Business Combinations*, the favorable financing benefit of core deposits is measured and an intangible asset is recorded when a deposit base is assumed as part of a transaction.

<u>Subjective Inputs</u>: The integrity of the remeasurement method may be called into question as the assumptions required to perform the math may be open to interpretation without further guidance. Thus, the application of the remeasurement approach may result in substantially differing values (relative to the face value) for the same CDL amount, depending on the preparing financial institution's perspective. This issue arises in that an entity would use its own assumptions based on information available to that entity. Moreover, there is no requirement that such assumptions would reflect a market participant perspective.

For example, while many financial institutions use the same alternative funding sources (e.g. brokered CDs rates or FHLB advances), and while interest rates paid on deposits are more a function of supply and demand (market-based) rather than bank-specific (particularly since core deposits are supposed to be non-interest rate sensitive), a larger bank/financial institution may have lower maintenance expenses due to economies of scale, operating efficiencies, etc. ¹² As such, a particular bank's all-in-cost-to-service rate may be materially lower than others and, therefore, can result in a higher discount rate and hence lower CDL value, resulting in non-comparability.

Further, certain banks/financial institutions may have 'better' information on their deposits and depositors, such as the ability to:

- Track activity by relationship which affects the underlying economics of the deposit accounts;
- Automatically adjust for account closures and openings for the same depositor (so that the transfer of funds from a money market account for a certain depositor, for example, to a savings account for the same depositor does not end up being reflected in the bank's attrition data as an account closure and a new account opening), which impacts the remaining useful lives of the depositors;¹³ and
- Allocate maintenance and overhead expenses to different deposit account types (i.e. by volume of deposit account activity - number of

¹² This may not be the case on a per deposit basis as large banks have more physical locations and more sophisticated systems, etc.

In our experience, this is a real world issue and as a result 'measured' turnover is overstated, and expected life of a customer relationship tends to be understated. However, quantification of this attribute is not effectively captured by substantially all institutions, and the migration of customer funds between products (different CDLs) also results in differing administrative costs. For example, the cost of servicing checking/savings is higher than that of a certificate of deposit.

checks cashed, deposits made, withdrawals, physical branch transactions, payments processed, etc. - and by number of branches, branch personnel, branch square footage, etc.), which impacts the net cost of funds.

Many banks do not track maintenance expenses and fee income by type of account and as such may end up using peer data to arrive at a maintenance expense and fee income percentage assumption. The level of maintenance expense and fee income may be very different than the bank's actual levels on an overall basis (meaning for all deposits combined), let alone for each core deposit category. The proposed guidance appears unclear as to whether such variables to the remeasurement formula should be entity specific, or market-participant based.

Misses Economics: As stated above, the alternative funds source for banks is typically insured brokered CDs or FHLB advances. However, we know from observed transactions in the marketplace that the cost of funding often varies with the size of the amount funded. Financings in excess of \$5 billion from one source cost more than the financing of a similar size that are made up of borrowings of smaller amounts from many sources. The volatility with this variable alone would more than offset the maintenance costs associated with servicing the core deposits. So if it is the Board's intent to propose guidance with a mathematical approach to 'model' the CDL in an effort to either (i) approximate its fair value or (ii) derive a market based implied interest cost, this approach fails to capture the true economics in the marketplace.

If the objective of the proposed guidance is to create a mathematical approach to measuring a liability, independent of legal contractual amounts and the associated market based characteristics for extinguishment of indebtedness, then we believe other more expedient and more comparable methods are available.

From an operational standpoint, the transfer pricing issues and adjustments can vary amongst banks and may lead to more detailed analyses, additional time, and extensive additional data/information for which adjustment may be required to affect comparability between entities.

For larger institutions, there may be a question whether alternative funding would be available to replace CDL, given the magnitude of the funds that would require replacement.

Our analysis of the TARP transactions indicated that financings of \$10 billion from one source were approximately 50 basis points higher.

<u>Ignores Settlement Concept:</u> As noted earlier, liabilities are often relieved when assets are sold or otherwise converted into cash. Moreover, presenting the legal settlement amount clearly is beneficial information to the creditor community.

Matching concept: We also are concerned that the Board's approach effectively eliminates the matching concept of the banking business model in which financial statements reflect an 'effective gross margin.' Banking institutions continue to conduct their basic business of originating loans to make an interest spread in excess of their funding costs (i.e., net interest margin). We would rather see an accounting principle that promotes comparability and consistency in interest spread comparisons to help the marketplace understand which institutions deserve more recognition as effectively well run businesses.

Disclosure of the remeasurement amount and its key assumptions in the notes to the financial statements (rather than on their face) would inform users of certain aspects of how interest rates may impact the liability side of the balance sheet. Also, through disclosure, financial statement users would have better information to identify asset-liability funding mismatches, enabling them to analyze the funding base of a financial institution more accurately. Having said that, there appear to be challenges for some entities to demonstrate a link between an asset and its funding source, thereby potentially creating operational problems that may confuse the users of the financial statements.

<u>Double counting</u>: Finally, given that the remeasurement value of CDL will capture some portion of the favorable financing characteristic within its value, additional guidance is required to clarify whether any carrying amount associated with a core deposit intangible asset ("CDI") that was recognized in a business combination should be removed from the face of the financial statements to avoid any double counting of the favorable financing.

<u>Conclusion:</u> If the remeasurement amount is required to be presented on the face of the statement of financial position, (subject to addressing the concerns outlined above and in our response to Question 31), we believe that it would be more appropriate to disclose these amounts as an integral part of Other Assets on the face of the statement of financial position, as we are very concerned that the proposed mathematical approach:

 Will not match or appropriately measure how an entity truly operates its business (i.e., margin spread) with its invested assets and associated funding;

- Ignores the contractual nature of CDL;
- May not consistently reflect the current market interest rate environment for these liabilities;
- Will net assets and liabilities;
- Creates additional equity upon adoption; and
- May impair the confidence level that financial statement users have in reported numbers by decreasing comparability between entities and increase the complexity required to value CDL.

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?

Duff & Phelps response: Where an entity has the demonstrated intent and ability to repay such a financial liability on its contractual terms, ¹⁶ the most useful presentation is at amortized cost, with fair value presented parenthetically.

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?

Duff & Phelps response: Yes.

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?

Duff & Phelps response: We believe that such deferred tax assets should be segregated and analyzed separately. We strongly believe that valuation allowances on deferred tax assets related to financial

¹⁶ i.e., more than adequately capitalized or substantial debt coverage ratios.

instruments should be treated consistently with the underlying asset or liability with regard to whether valuation allowances are run through net income or other comprehensive income. For example, if changes in the fair value of a financial instrument are reported in net income (rather than other comprehensive income), then the related changes in the deferred tax asset should be reported in net income as well.

The treatment of deferred tax assets for financial instruments that will be measured on a pooled basis requires clarification as well. This is particularly true for CDL, as the discount would theoretically continue to grow for a healthy bank yet there will never be a cash tax impact related to valuation changes in this financial liability.

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?

Duff & Phelps response: No. It is our experience that the terms and conditions vary greatly on convertible debt and we have seen many instances in which the equity conversion feature is materially out of the money such that the issue does not convert and principal is returned to the creditor (investor) at maturity or other settlement. Therefore, we would recommend that the Board retain the current accounting treatment until it is re-evaluated in its project on financial instruments with characteristics of equity.

If the Board decides to move forward, we would recommend that the Board provide guidance regarding how to determine whether an instrument qualifies for such treatment. One basis for which may be the relative value of the conversion feature versus the underlying debt. For example, if 90 percent of the value of a convertible instrument relates to the debt and 10 percent to the conversion feature, then the instrument may qualify for

treatment where changes in fair value are recognized in other comprehensive income.

Question 22: Do you believe that the recognition of qualifying changes in fair value in other comprehensive income (measuring the effects of subsequent changes in interest rates on fair value as well as reflecting differences between management's and the market's expectations about credit impairments) will provide decision-useful information for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows? If yes, how will the information provided influence your analysis of an entity? If not, why?

Duff & Phelps response: We find little evidence that the analyst community places any significant reliance on the fair value of financial instruments that an entity intends to hold for collection or payment(s) of contractual cash flows which are currently disclosed in the notes to the financial statements. Additionally, we refer the Board to our answers to Questions 48 to 51 in which we state that we do not support the proposed accounting for interest income and credit impairment.

Question 23: The proposed guidance would establish fair value with all changes in fair value recognized in net income as the default classification and measurement category for financial instruments. An entity can choose to measure any financial instrument within the scope of this proposed Update at fair value with all changes in fair value recognized in net income, except for core deposit liabilities which must be valued using a remeasurement approach. Do you believe that a default classification and measurement category should be provided for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income? If not, why?

Duff & Phelps response: We believe there should be a default category for financial instruments that would otherwise meet the criteria for qualifying changes to be recognized in other comprehensive income. As such securities that are essentially "held to maturity" and/or held based on their contractual terms, our preference would be that such instruments be carried at amortized cost with fair value presented parenthetically on the face of the statement of financial position for entities that are more than adequately capitalized or have substantial debt coverage ratios

Question 24: The proposed guidance would provide amortized cost and fair value information on the face of the financial statements. The Board believes that this would increase the likelihood that both measures are available to users of public entity financial statements on a timely basis and that both measures are given equal attention by preparers and

auditors. Do you believe that this approach will provide decision-useful information? If yes, how will the information provided be used in the analysis of an entity? If not, would you recommend another approach (for example, supplemental fair value financial statements in the notes to the financial statements or dual financial statements)?

Duff & Phelps response: Providing both amortized cost and fair value information, with the primary basis presented in the measurement date column and secondary measurement presented parenthetically, on the face of the financial statements may provide financial statement users and regulators with the greatest degree of transparency and decision-useful information. For example, a parenthetical presentation of fair value information (if amortized cost is the primary measurement basis for the applicable instruments) would allow users to easily perform alternative capital calculations by applying different measurement bases, without having to extract the necessary information from the notes to the financial statements. It would also allow users to focus on specific classes of assets or liabilities for which either amortized cost or fair value information may be more relevant depending on the specific circumstances or the purpose of the analysis. The parenthetical presentation of alternative measurement information would still allow the use of one measurement attribute as the primary measurement basis for the purpose of presenting total capital.

Additionally, providing both amortized cost and fair value information on the face of the financial statements will increase their respective importance and counter the perception of some financial statement users that a different level of rigor is applied by both management and their auditors between amounts set forth on the face of the financial statements and those set forth in the notes accompanying the financial statements, thereby providing more consistency and comparability between companies. Further, disclosures in the notes to the financial statements should be rationalized and made relevant with regard to the underlying key assumptions of fair value to provide incremental transparency and usefulness to the users for comparability purposes.

Question 25: For hybrid financial instruments that currently would require bifurcation and separate accounting under Subtopic 815-15, do you agree that recognizing the entire change in fair value in net income results in more decision-useful information than requiring the embedded derivative to be bifurcated and accounted for separately from the host contract? If yes, how will the information provided be used in the analysis of an entity? If not, for which types of hybrid financial instruments do you believe that it is more decision useful to account for the embedded derivative separately from the host contract? Why?

Duff & Phelps response: We agree that recognizing all changes in fair value in net income for hybrid financial instruments that are currently bifurcated provides more decision useful-information. Such treatment will be useful as is it will improve consistency between entities and will ease operational issues that result from the current treatment.

Question 26: IFRS 9 requires hybrid financial assets to be classified in their entirety on the basis of the overall classification approach for financial assets with specific guidance for applying the classification approach to investments in contractually linked instruments that create concentrations of credit risk. Also, for hybrid financial liabilities, the IASB, in order to address the effects of changes in the credit risk of a liability, tentatively has decided to retain existing guidance that requires embedded derivatives to be bifurcated and accounted for separately from a host liability contract if particular conditions are met. Do you believe that the proposed guidance for hybrid financial instruments or the IASB's model for accounting for financial hybrid contracts will provide more decision-useful information? Why?

Duff & Phelps response: We agree with the Board's proposed guidance for the reasons outlined in our response to Question 25. The IASB's model introduces significant complexity to the accounting for contractually linked instruments that create concentrations of credit risk by requiring a "look through" to the underlying pool of financial instruments. It also reduces the usefulness of the reporting for financial assets given the contractual cash flows of the instrument are ignored and one is required to look through to the composition of assets and liabilities of the issuing entity.

Question 27: Do you believe that measuring certain short-term receivables and payables at amortized cost (plus or minus any fair value hedging adjustments) will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Duff & Phelps response: We believe that measuring short-term financial instruments at amortized cost, adjusted for expected losses, provides decision-useful information. Given their short-term nature, amortized cost would generally approximate fair value considering the manner in which market participants typically look at such items as a component of working capital.

Requiring fair value for these types of instruments would introduce unnecessary complexity in their measurement and would not provide decision-useful information, given that these positions are unwound or monetized within a short time frame, typically at par or close to par. In

particular, as currently proposed in the Fair Value ED, the fair value measurement of such instruments would be in-exchange, requiring their analysis on a standalone basis and the use of specific inputs to reflect an in-exchange premise (e.g., factoring receivables). We believe that this does not meet the cost-benefit criterion for using fair value (under the proposed modified definition which prohibits considering the market participant perspective of" in-use" as a component of working capital) in the financial statements and is inconsistent with the way the marketplace views such instruments.

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?

Duff & Phelps response: At a pool level (e.g., most consumer loans), many large entities would generally be better prepared to follow the proposed criteria for financial years beginning after January 1, 2013, although such efforts would be more manual and introduce more control risk. From our interviews with clients, it will take even large entities more than three years to implement and prepare to report on a more granular level (e.g., loan by loan) on a systematic basis in a well controlled environment.

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

Duff & Phelps response: We yield our response to preparers. 17

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?

Duff & Phelps response: There are numerous issues that financial institutions will face in interpreting and applying the proposed remeasurement approach to value CDL, thereby making the proposed guidance non-operational as stated. Certain items of concern are set forth

While we are aware of very mixed reactions from preparers, our perception is that large entities could generally be prepared to follow the proposed criteria at a pool level for financial years beginning after January 1, 2013, albeit with much more manual effort and a higher control environment risk.

in our response to Question 17. At the risk of restating certain points, others include but are not limited to the following:

Measuring 'stable' balances: Financial institutions typically use historical data to estimate an average CDL balance; ¹⁸ they would then project how that balance would change in the future. Consideration would be given to current economic conditions, regulatory rules ¹⁹, and market forces in arriving at an average balance rather than simply calculating a daily average balance over the course of a specific period preceding the remeasurement date. In arriving at an average balance, it may be appropriate for the Board to provide additional guidance as to specific considerations and adjustments to arrive at a normalized level.

Additional guidance on how to project growth in the historically derived average balances would also be helpful. Since the CDL amount that would be subject to remeasurement results in the consideration of future deposits, additional guidance should be provided on how growth should be imputed into the projections. In short, guidance clarifying (i) whether average balance means the average balance of solely those customers existing at or before the measurement date or those balances from customers that can be relied upon to provide a stable alternative source of funding, and (ii) what assumptions should be made around growth over the remaining average life of each type of account.

<u>Number of major deposit product types:</u> Another issue that makes the remeasurement approach less operational – or at least one that requires further guidance in implementing – is the product types into which the core deposits to be measured should be separated. Too much aggregation or disaggregation may lead to either insufficient or excessive detail, making a

Average CDL balances are necessary as many institutions have municipal payroll deposits occurring periodically during the month for a 1-3 day period. Guidance on the desired use of 30, 90, or 365 day period to derive average daily balances would be helpful.

¹⁹ Regulatory rules have an impact on (i) the stable CDL balances available to use for funding operations through reserve requirements to maintain liquidity on specified deposit types, and (ii) the behavioral patterns of depositors through changes to the FDIC level of insurance on certain deposit types by institution. Reserve requirements represent those balances that a financial institution is required to maintain or hold on reserves on the CDL in liquid assets rather than investing these funds in a longer-term interest earning instrument. Therefore, the CDL balance needs to be adjusted downward to reflect this liquidity reserve that does not truly reflect a funding source. Additionally, changes in the FDIC depository insurance level on specific types of accounts per institution also needs to be considered as a factor in the calculation of a stable balance because of the impact it may have on the behavior of depositors in the current environment.

bank's deposit portfolio difficult to assess. However, this issue is not specific to this remeasurement method as it also applies in the valuation of CDI under ASC 805.

The above issues raise operational challenges at initial implementation that will require additional efforts (i) for many financial institutions to gather the necessary data for application, and (ii) for the review and audit procedures required to ensure compliance. Beyond this, the marginal costs in terms of time and resources needed to conduct and comply with the remeasurement analysis on a quarterly basis – once implemented initially – may be material; we yield our comments to banking institutions that will have to implement this on a quarterly basis.

<u>Interest rate projections:</u> Our experience indicates that forward yield curves should be applied to reflect future interest rate expectations. This mirrors the approach currently used in practice in valuing CDI (based on a cost savings/favorable financing approach). Because of the matched funding concept between loans and deposits, forward interest rate curves should be used consistently.

Revision of ASC 805 as it relates to CDI: Should the proposed guidance be accepted, the Board would need to consider the impact on valuation of CDI in accordance with ASC 805. The Board should consider providing additional guidance on the treatment of the carrying value of previously recorded amounts for CDI and whether and how they should be accounted for and presented (e.g., written-off).

Presentation

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?

Duff & Phelps response: We believe that changes in fair value arising from the entity's own credit standing should be separately recognized in other comprehensive income. The character of these fair value changes is different from that of counterparty risk, which we believe would appropriately flow through net income.

We believe it is a more useful presentation to separate operational factors from factors related to the entity's own credit standing, such that they do not both flow through net income. Combining the two obfuscates the results of the entity's business performance. In particular, as the underlying economic performance deteriorates, the credit rating of an entity may decline, resulting in a gain due to 'own credit' which counters the losses from operational factors. Therefore, given the choice between the two methods, we believe that the effect on fair value from changes in the entity's credit standing should be bifurcated and separately presented in other comprehensive income.

However, for a financial liability held to maturity it could be argued that including changes in the entity's own credit standing may be less relevant if the obligation is expected to be repaid as contractually agreed, unless an event is likely that would lead to a partial or full default, or if the entity is likely to monetize any changes in credit risk/interest rates by settling/refinancing the liability, in which case credit standing becomes relevant.²⁰ Unfortunately, the Board does not appear to be pursuing a path that would differentiate among the various implications of changes in the entity's own credit standing to the investor community.²¹ We remain

Perhaps the Board would be open to considering an entity's debt service coverage ratio or its Z-score as potential quantitative indicators as to the entity's financial health and ability to repay its liabilities. Those entities with sufficiently strong scores would be considered exempt from assessing their own credit standing on their debt, whereas those entities with deteriorating credit quality would then be required to provide a fair value adjustment relative to both changes in their credit quality and changes in the price of credit.

We believe the Board should also address the presentation of securitized debt, or obligations that are collateralized by and repaid solely from the cash flows

concerned that an entity with declining credit quality and increasing risk of a default event for its investors would have its balance sheet temporarily 'shored up' with an offsetting favorable adjustment to other comprehensive income through periods that an entity is experiencing severe financial problems, up to its immediate demise.

We also observe that to the extent that there is a trend towards one continuous statement of total comprehensive income which would continue to become more prominent relative to the statement of net income, the geography of recognizing changes in the entity's own credit standing may become less relevant, and may matter only to the extent it affects EPS calculations. Perhaps, the Board should reconsider providing guidance to preparers as to the nature and extent of disclosures relating to potential adjustments for an entity's own credit standing in the notes to the financial statements, which would present more clearly the 'true' equity (or overcollateralization, or lack thereof) associated with the business model.

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 2 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.

Duff & Phelps response: First, we observe that it is difficult to identify with precision changes in the fair value of a financial liability attributable to a

derived from segregated asset pools. These obligations are not general credit obligations of the sponsoring entity that presents them on its consolidated balance sheet. They are discrete obligations of the trust or special purpose vehicle ("SPV") that issued them and, moreover, the associated asset pools are not generally available to the sponsoring entity's creditors. Such consolidated assets and liabilities are not presented in a manner that communicates to the entity's creditors which assets are available to repay its obligations and which assets are segregated in trust for other obligations.

We recommend that consolidating 'securitized' assets and liabilities be presented as a part of Other Assets and Other Liabilities and not co-mingled with non-securitized asset pools (either loans or securities) and the entity's other debt obligations. In addition, these consolidated securitized assets and liabilities should be presented at amortized cost, as it is the intent that they will be held to term by the trust or SPV, until such time as a triggering or other event would indicate the assets/obligations may not go to term, and thus, fair value reporting would be warranted.

change in an entity's own credit standing; particularly for non-traded debt it is difficult to identify with precision changes in fair value and thus changes in yields. An estimate of the change in yield is very difficult to allocate with accuracy among changes in the base rate, changes in the market price of credit risk, changes in the individual entity's credit quality and any other factors such as marketability/illiquidity.

We do not believe that the method of determining the change in fair value due to changes in the entity's credit risk should be prescribed. However, it is instructive to provide an example such as that shown as Method 2. The guidance should explicitly allow the entity to use the method or methods that most faithfully represents the objective of this presentation requirement.

There is a conceptual difference between the entity's credit standing and its credit rating. The credit rating is provided by a rating agency (or imputed) within certain broad bands, whereas the entity's credit standing could vary within a certain band. The impact of this was made clear over the past several years when spreads on similar instruments issued by entities with similar credit ratings were materially different.

Method 1 focuses on changes in the entity's credit rating. The weaknesses of this method include:

- Not all entities are rated;
- There is sometimes a lag between changes in an entity's credit standing and in its credit rating; and
- The credit standing of the entity could move within the ratings band.

In the simplest scenario in which the entity's credit rating has not changed and interest rates have not changed, Method 1 would not pick up the movement of the entity's credit standing within the band. In addition, it will be difficult to develop accurate synthetic ratings. Focusing on the change in the price of credit (Method 2) is more sensitive as it picks up fluctuations within the band.

Deficiencies of Method 2 are that the results may be highly dependent on the:

- Selection of other entities in the same industry for benchmarking purposes, thus to a large degree the conclusion is a function of the comparability and relevance of the peer group;
- Ability to accurately divide changes in the yields of the peer group between changes in the prices of credit and changes in the average credit quality of the group; and

 Impact of other factors affecting the credit spread, such as liquidity and blockage issues.

With that said, we observe additional and potentially more material weaknesses in the proposed guidance contained within Appendix B as it appears to be a gross oversimplification of the mechanics of estimating the fair value of a debt instrument. The proposed guidance, without significant modification and clarification, will likely result in inconsistent financial reporting that will not be comparable between entities. To begin with, the unit of account is unclear. The valuation of a particular debt instrument is a function of the expectations of market participants with regard to probability of default of the issuing entity ("PD") and the expected loss given a default event on a particular instrument ("LGD"). LGD considers seniority (position of instrument within the "waterfall"), the level of collateralization (a point noted by the Board but with little guidance) and the time and cost of foreclosure, among others. While the cost (spread) of senior uncollateralized debt for similar entities with like credit standings/ratings will be generally consistent, the spread on a senior collateralized note issued by an entity rated BB may be less than that on a subordinated poorly collateralized note issued by an entity with an AA rating. Likewise, the fair value impact for two otherwise similar securities issued by an entity that undergoes a change in credit rating will differ based on how market participants view the LGD of each security.

The LGD discussion leads to two follow-on points. First, the guidance needs to be clear with regard to the unit of account. That is, should the impact of PD for an entity be presented separately from the LGD for individual financial instruments within an entity's financial statements, or, should the aggregate impact of PD and LGD be reflected collectively. Second, pragmatic guidance must also be provided with regard to Method 2 regarding treatment of the LGD component when evaluating entities and instruments for comparability within the industry to avoid significant issues in implementation, comparability and transparency.

Finally, we question whether using fair value as the primary remeasurement attribute for an entity's own debt is misleading in cases where the entity intends to and is capable of making the contractual payments and has no intention of refinancing. Under the guidance, an entity's statement of financial position would not be an accurate representation of the amount that is likely to be settled. Further, entities with a declining credit rating would be rewarded with a book gain that would never be realized. This is not logical and is potentially misleading.

In summary, we believe that management should be able to exercise judgment as to the best methodology or methodologies. A method should

be presented but not be mandatory and we believe that Method 2 is generally more appropriate than Method 1, although there are other alternatives as well (see response to Question 34). The proposed guidance oversimplifies a far more complex process. Therefore, additional guidance is required so that the results can be decision-useful. Additionally, we question whether the proposed treatment of an entity's own debt at fair value is decision-useful in many circumstances as it would likely deviate from the contractual obligation.

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.

Duff & Phelps response: As stated in our response to Question 33, the proposed guidance is a gross oversimplification as it generally ignores LGD and may be misrepresentative in certain situations.

With that said, the guidance should not restrict the benchmarks that entities may choose. It may be quite reasonable for entities to choose the yields on bond indices as relevant benchmarks for particular types of debt instruments. These indices have the disadvantage of being broad and possibly not closely related to the reporting entity or the terms of the subject instrument, but it would have the advantage of being objective and readily available. In contrast, the selection of a peer group of entities is more subjective and may be quite limited with respect to the available data. The process is further complicated and data would be even more limited when trying to match the LGD component of the entity's own instruments with comparable securities among the chosen peer group. Lastly, while the examples are generally clear and helpful, they promote an unrealistic perspective with respect to precision when they identify 10 basis points adjustments in variables.

Question 35: For financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income, do you believe that the presentation of amortized cost, the allowance for credit losses (for financial assets), the amount needed to reconcile amortized cost less the allowance for credit losses to fair value, and fair value on the face of the statement of financial position will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Duff & Phelps response: Yes. In general, there is a benefit to having better credit analysis information period-to-period, as this will help to identify trends that may signal an expected change in cash flows upon collection or settlement of the instruments. Amortized cost, adjusted for expected credit losses is most reflective of the business model of many entities and therefore represents the perspective of most market participants. The allowance for credit losses on financial assets provides information about the riskiness of the credit portfolio, while fair value is useful in a number of situations, including estimating the breakup value of an entity. However, this information should be balanced with considerations about operationality.

Question 36: Do you believe that separately presenting in the performance statement significant changes in the fair value of financial liabilities for changes in an entity's credit standing (excluding the changes in the price of credit) will provide decision-useful information? If yes, how will the information provided influence your analysis of the entity? If not, why? Do you believe that changes in the price of credit also should be included in this amount? If so, why?

Duff & Phelps response: In general, we believe that a separate presentation of the change in fair value due to a change in the entity's credit risk is appropriate to the extent that not all liabilities would be transferred or settled at fair value, but are held for payment.

Since a going concern, or in-use premise typically assumes holding and performing on many of the liabilities, separating the effect of the entity's credit standing on the fair value of its liabilities may be useful when viewing the enterprise and its cash flow requirements as a whole, unless the change in credit standing triggers contractual and other covenants that would alter the cash flow requirements, or would lead to a renegotiation of the liability.

The more important question is whether amortized cost or fair value should be the primary remeasurement attribute. As stated above, we question whether using fair value as the primary remeasurement attribute for an entity's own debt is misleading in cases where the entity intends to and is capable of making the contractual payments and has no intention of refinancing. Under the guidance, an entity's statement of financial position would not be an accurate representation of the amount that is likely to be settled. Further, an entity with a declining credit rating would be rewarded with a book gain that would never be realized. This is not logical and is potentially misleading.

Credit Impairment

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?

Duff & Phelps response: While the objective of the ED is clear and a significant step forward in many ways, we see significant issues in the proposed guidance with respect to operationality and decision-useful information. See our responses to Questions 38, 42, 44 and 46.

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?

Duff & Phelps response: We do not agree with either the Board's proposal or the IASB's approach to credit impairment.

First and foremost, both Boards have misidentified the appropriate unit of account for this issue. Specifically, interest income is earned and, most importantly, credit impairment occurs, at the individual asset level.

However, both Boards are proposing credit impairment models with losses being accounted for on a pool level. The commingling of these measurement concepts with the same nomenclature is confusing and may cause significant reporting issues.

We believe that interest income, which is earned from the financial instrument, should be presented gross and recorded pursuant to its contractual terms until such time as events call that practice into question. *Adjustments for counterparty risk* (e.g. estimates for anticipated changes in counterparty performance), however, should be reflected as a contraaccount to the associated financial instruments presented. These items should be displayed gross in the income statement and not netted, as interest generation is different from credit impairment.²²

In addition, both Boards appear to focus on the simplicity of what may be called the 'credit card' business model. While this business model does use pool level concepts for purposes of developing an estimate for loan losses, most lending within a banking institution is not as simple as the credit card model and pool concepts may present challenges – particularly with large unique commercial credits.

Nevertheless, as both Boards move to an "accrue in advance" model for loss estimation, it is critical to the user community that known credit losses are differentiated from anticipated credit losses.

Notwithstanding our comments above, and responding solely to the two methods presented, we would support an impairment model more similar to that being proposed by the IASB than the FASB. Assuming that the Board adopts the IASB approach, we believe that the concepts set forth in the IASB proposal should be modified by both Boards to reflect the time value of money as the credit impairment is accrued over time. That refinement would be more consistent with the (i) perspective of a market participant and (ii) associated fair value.²³

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?

Duff & Phelps response: While they clearly have an impact on value, gains and losses in foreign exchange rates, changes in expected prepayments and changes in variable interest rates are distinct from credit impairment. While they will have an impact on the value of a credit

²² In our view, these two events are as distinctly different as the revenue earned from the sale of a manufactured item and the possible cost of the warranty replacement if a sold item has a defect and must be replaced.

We will endeavor to submit an example in the near term for the Board's consideration.

portfolio, they are not "credit" losses. As such and to increase transparency and usefulness to readers, such changes should be reported separate from, but alongside counterparty credit impairment.

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?

Duff & Phelps response: While no method should be prescribed as management should be able to exercise judgment in selecting a methodology that is based on sufficient and supportable analytical rigor, we believe that best practices would indicate that dynamic expected loss curves, based on the analysis of static pools, as adjusted for and looking through economic cycles, are a more reliable indicative approach.²⁴

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?

Duff & Phelps response: To the extent the asset will be held for collection of contractual payments by a qualifying entity (please see notes to our response to Question 13 for a description of a qualifying entity), we agree with the proposed treatment, though we believe the financial asset should be presented at amortized cost (please see our response to Question 13). To the extent the asset or entity do not meet these criteria (e.g., the asset will not be held to term or there is a material question as to whether the entity is a going concern, etc.), then such changes should be immediately recognized in net income.

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

²⁴ Such analysis generally reflects that the amount of expected losses decline as a financial instrument seasons and gives effect for credit quality and the underlying collateral, if any. Moreover, we would recommend the notes to the financials set forth the underlying components in the measurement of anticipated counterparty risk (i.e., credit losses) specifically, probability of default, gross loss given default and net recoveries, among others, ideally segregated for different invested asset categories.

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?

Duff & Phelps response: We believe that the Board has again misidentified both the appropriate unit of account and nomenclature for this issue. We refer the Board to our response for Question 38 for the distinction between adjustments for known 'credit' and adjustments for estimated portfolio-level performance.

Question 43: The credit impairment model in this proposed Update would remove the probable threshold. Thus, an entity would no longer wait until a credit loss is probable to recognize a credit impairment. An entity would be required to recognize a credit impairment immediately in net income when an entity does not expect to collect all of the contractual cash flows (or, for purchased financial assets, the amount originally expected). This will result in credit impairments being recognized earlier than they are under existing U.S. GAAP. Do you believe that removing the probable threshold so that credit impairments are recognized earlier provides more decision-useful information?

Duff & Phelps response: Directionally, we believe that financial reporting should reflect management's estimate of future events rather than waiting to record 'known events', as a view including future events would reflect a market participant perspective and, therefore, be more decision useful. However, distinguishing between what is known and what is estimated also should be clearly presented. In addition, expectations naturally take into account assumptions as to the likelihood of future events and such assumptions warrant disclosure.

Question 44: 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 approach and would require an entity to estimate credit losses on the 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 provide more decision-useful information?

Duff & Phelps response: There is significant historical evidence of an "economic cycle." Ignoring such evidence significantly weakens the usefulness and transparency of financial statements and is inconsistent with both the entity's overall business model and a market participants' perspective. The Board's suggested approach also would contribute to the risk of artificially exaggerating short-term earnings volatility.

At the top of a cycle, when credit losses are at a minimum, it is sensible to assume that the economy and credit losses will revert to the mean; the reverse would be true at the bottom of the cycle. Most large entities have been gathering related data for a number of years and are quite advanced in analyzing and applying the data in their internal risk modeling and use this information to run their businesses. As such, a more sophisticated, transparent and meaningful approach should be attainable. An expected loss approach that includes forecasting future economic events or conditions that did not exist at the end of the reporting period would be more decision-useful.

Question 45: 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. Do you agree with that approach?

Duff & Phelps response: Yes. Where pooling of assets is possible, we agree with this approach conceptually. More specifically, we believe dynamic rates over the life of the financial instruments, based on historic and prospective loss curves, are more appropriate than a single rate.

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 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?

Duff & Phelps response: As discussed in our response to Question 44, there is significant historical evidence of an "economic cycle". Ignoring such evidence significantly weakens the usefulness and transparency of financial statements. At the top of a cycle, when credit losses are at a minimum, it is sensible to assume that the economy and credit losses will revert to the mean; the reverse would be true at the bottom of the cycle. Therefore, analyzing historic and prospective loss curves and supporting information are most appropriate and consistent with a market participant perspective. Most large entities have been gathering related data for a number of years and are quite advanced in analyzing and applying the data in their internal risk modeling and use this information to run their businesses. As such, a more sophisticated, transparent and meaningful approach should be attainable.

Moreover, market participants would give consideration to the cycle and likely use forward interest rate curves in pricing debt securities. We recommend that such curves are used in estimating the fair value of financial instruments where applicable.

In summary, subject to the arguments presented above, we believe that the IASB model is preferable to the proposed FASB model.

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)?

Duff & Phelps response: Yes, this will result in a significant change in practice as, in our experience, many preparers look out only 12 to 18 months rather than over the life of financial assets in a pool. As noted in our response to Question 40, best practices require that expected loss curves be based on the analysis of historical loss rates for static pools, as

adjusted for and looking through economic cycles. Such analysis generally reflects that the amount of expected losses decline as a loan seasons and gives effect for credit quality and the underlying collateral.

Interest Income

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?

Duff & Phelps response: No. Recognition of interest income should not be affected by the recognition or reversal of credit impairments. The two items, interest income and adjustments for counterparty performance risk, are as distinctly different as revenue earned from sales of manufactured items and the related costs of goods sold. Users of financial statements find informational value in having both amounts (i.e., interest income and credit losses or revenue and costs of goods sold) displayed gross in the income statement. We believe that presenting the net profit margin (i.e., interest income less credit losses), which is essentially what the ED is attempting to achieve, is potentially misleading and does not convey the complete story.

Additionally, as noted in our response to Question 38, we believe the Board has misidentified the appropriate unit of account. From both a theoretical and real world perspective, interest income is earned on each individual loan, and a credit loss only occurs on specific loans. Reducing interest income earned by applying an anticipated credit loss factor to a portfolio is an attempt to try to perform credit loss accounting on a pool basis. The distinction between the two should be readily identifiable by the user of the financial information.

We firmly believe that a pool of 10 loans, each loan being \$100, at a contractual rate of 18 percent should earn interest income at the rate of \$180 per annum until specific information surfaces that calls collection of that item into question. An estimate of a counterparty performance risk that is probable to occur during the year against the pool of loans should be reflected as a general reserve adjustment to the aggregate loan pool if it is not know which one of the ten individual loans' cash flows will not be collected with the offsetting amount charged to net income.

In summary, the charges for credit adjustments, both known and estimated, should be presented gross and immediately after interest income. Thus, interest income reflects the individual unit of account and reconciles to discrete loan accounting systems while net effective income is derived to reflect overall performance of the business model (i.e., an entity's loan book of business).

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?

Duff & Phelps response: Assuming the Board moves forward with accounting for credit losses on a pooled basis then we do agree that the excess cash flows received should be treated as an increase to the allowance for credit losses. There should be symmetry; both increases and decreases to the allowance for credit losses should be recorded in the same place in the income statement.

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?

Duff & Phelps response: For financial assets measured at fair value, we believe that the Board should specify an accounting and presentation format with all changes in fair value recognized in net income. This will provide a benefit to users who will not need to identify which method is being used by preparers and whether any adjustments are required to make the financial statements of two entities comparable.

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?

Duff & Phelps response: Aside from providing implementation guidance and illustrative examples on models that we believe are misguided (as noted in our previous responses), we believe what is included is too simplistic.

While we are not an accounting and auditing firm and are generally not involved in the day-to-day detailed computations and record keeping of our clients' loan systems, we nevertheless do become involved in many tangential matters when we perform financial reporting related work such as purchase price allocations or due diligence engagements. We feel

confident in saying that few, if any, financial institutions or corporate industrial companies will have the necessary systems or detailed records to perform the accounting being proposed by the Board at the current time. We simply cite the tremendous difficulties that our clients are having trying to cope with the accounting set forth in ASC Topic 310-30. The new accounting being proposed by the ED is far more complex than ASC Topic 310-30. Thus, we believe that the examples need to address this complexity so preparers will have guidance on how to handle the sheer burden and complexity that this change in accounting is proposing.

Question 52: Do you believe that the method for recognizing interest income on financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income will provide decision-useful information? If yes, how will the information provided be used in your analysis of an entity? If not, why?

Duff & Phelps response: We yield to the user community. However, as a reader of financial statements and analysts reports, we see diversity in practice with such disclosures and little, if any, commentary by the analyst community with respect to such disclosures. Moreover, we believe that with respect to changes in fair value, the components that relate to counterparty performance should be reflected in net income as an adjustment to credit performance while the components related to timing, such as prepayments, illiquidity and other factors should be reflected in other comprehensive income.

Question 53: The method of recognizing interest income will result in the allowance for credit impairments presented in the statement of financial position not equaling cumulative credit impairments recognized in net income because a portion of the allowance will reflect the excess of the amount of interest contractually due over interest income recognized. Do you believe that this is understandable and will provide decision-useful information? If yes, how will the information provided be used? If not, why?

Duff & Phelps response: While we yield to the user community, our perspective is that the estimated performance of the cash flows of a financial instrument is distinctly different from credit performance of the counterparty and is fairly well understood by the user community. Supplemental disclosures in the notes to financial statements should present the reconciliation between credit performance factors and other market factors and the implicit discount rate applied to such cash flows to derive fair value. For a complete discussion, we refer the Board to our responses to Questions 38 and 48.

Question 54: 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. Thus, the recognition of a credit loss would result in a decrease in interest income recognized. Similarly, a reversal of a previously recognized credit loss would increase the amount of interest income recognized. The IASB Exposure Draft on Impairment proposes that an entity calculate interest by multiplying the effective rate established at initial recognition by the amortized cost basis. The IASB's definition of amortized cost basis is the present value of expected future cash flows discounted by the effective interest rate established at initial recognition and, therefore, includes credit losses recognized to date. Thus, as initially expected credit losses are allocated over the life of the instrument, the amount of interest income decreases. Both the FASB's and the IASB's models for interest income recognition are similar in that the recognition of an impairment reduces the amount of interest income recognized. However, as noted in the questions above, the timing of credit impairments and the determination of the effective interest rate differ in the two proposed models. Thus, the amount of interest income recognized under the two proposed models will differ. Do you believe that the FASB's model or the IASB's model provides more decision-useful information? Why?

Duff & Phelps response: We refer the Board to our response to Questions 38 and 48 in which we identify the major issues with the models of both the FASB and the IASB and identify ways in which they could be improved to provide far more decision-useful information.

Question 55: Do you agree that an entity should cease accruing interest on a financial asset measured at fair value with qualifying changes in fair value recognized in other comprehensive income if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative? If not, why?

Duff & Phelps response: Yes.

Hedge Accounting

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

Duff & Phelps response: We believe this change in wording is intended to facilitate the adoption of hedge accounting for risk-reducing derivatives, and therefore, we believe that is a positive change. In our experience, an effective hedge has come to mean an R^2 in excess of 80 percent. It is also our experience that the vast majority of hedges based on a direct link between the exposure and the derivative, for example commodity hedges where the exposure and the derivative are both forms of oil, meet this standard handily. This also includes duration hedging in fixed income assets where there is no optionality.

When there were concerns with sound hedges qualifying, our experience is that it was typically because certain auditors' interpretations and requirements were overly formulaic. Accordingly, the Board should provide examples of the principles that satisfy the requirements for an effective hedge regardless of the adjective used. This should include hedges that do not require testing (e.g., interest rate swaps that differ only with respect to reset dates), hedges that may require a statistical test only at inception (e.g., commodities delivered at one location but hedged with futures contracts requiring delivery at another location), and hedges that may require quarterly testing (e.g., a bespoke portfolio of common stocks with turnover that is hedged by a stock index futures contract).

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?

Duff & Phelps response: We believe that the proposal that an effectiveness evaluation after inception be required only if circumstances suggest that the hedging relationship may no longer be effective is prudent. We think that this will lead to relatively few re-evaluations if sensibly applied. Our experience is that it is unusual for the effectiveness of a hedge to change dramatically over time provided there is no optionality.

We have seen few cases where sensible hedges have eliminated less than 80 percent of the variance of the exposure.

Question 58: Do you believe that requiring an effectiveness evaluation after inception only if circumstances suggest that the hedging relationship may no longer be reasonably effective would result in a reduction in the number of times hedging relationships would be discontinued? Why or why not?

Duff & Phelps response: No. We believe that few hedges lose their qualification for hedge accounting over time and therefore this change will not have a material effect on discontinuation of hedge accounting.

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?

Duff & Phelps response: No.

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?

Duff & Phelps response: Implementing hedge accounting effectively has been a significant challenge for all involved. Movement toward reducing testing and simplifying the process of qualifying hedges is highly desirable. It will be important for the Board to include guidance on how this may be accomplished. We recommend developing a rich set of examples of hedges that should require no detailed quantitative testing, those that require testing only at inception and when there are material changes and those that may require more frequent testing.

Disclosures

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

Duff & Phelps response: We believe that the sheer magnitude of disclosures set forth in the ED is overwhelming, which is continuing a recent trend in financial statement disclosures. Often, the level of aggregation for disclosures, as well as their volume, tends to make them difficult to interpret or at times meaningless.

For example, at the level of a single asset or a single investment, or a group of homogeneous financial instruments, measurement uncertainty disclosures referred to in the ED may make sense. However, when non-homogeneous financial instruments are aggregated, the resultant aggregate disclosures of fair value become unreasonable because aggregation causes the reasonable range to move multiple standard deviations away from the mean.

Therefore, on an aggregate basis it is unlikely, if not a remote possibility, that all of the individual financial instruments that make up the aggregate range would all fall at the top end or the bottom end of that range. In other words, the measurement uncertainty disclosure becomes unreasonable because there is a remote possibility that all of the applicable financial instruments would be realized in the aggregate at either end of the estimated range; that is, not all financial assets would be settled at the bottom (top) end of their individual distributions so the bottom (top) end of the aggregated range is relatively meaningless.

At the same time, requiring a lower level of aggregation is even less operational for preparers and overwhelming for users. An alternative way to look at disclosure is by focusing on risk metrics on a business level. Please see our response below to Question 67.

The approach suggested in our response to Question 67 would also introduce balance and insight through disclosure in places where the focus currently seems to be one-sided. For example, the ED requires extensive disclosures about the remeasurement value of core deposits (we have outlined our concerns about this measurement attribute elsewhere in our response), without focusing on the relationship to the assets it is funding. Yet, a macro analysis disclosure would be more helpful in understanding the business impact of the amount of core deposits liabilities, changes over time and sensitivity.

Question 66: For purchased financial assets, do you believe that the requirement to disclose the principal balance, the purchaser's assessment of the discount related to credit losses inherent in the financial instrument at acquisition, any additional difference between the amortized cost and the principal balance, and the amortized cost in each period will provide decision-useful information? If yes, how will the information provided influence your analysis of an entity? If not, why?

Duff & Phelps response: Disclosures that facilitate comparability with other preparers and consistency with an entity's accounting models that properly advise on the (i) extent of credit losses, (ii) price of credit, (iii) market liquidity and (iv) other factors are extremely helpful. In the absence of this information, the factors above get collapsed in the initial measurement for purchased financial assets.

In addition, actual credit losses incurred as compared to 'expected' credit losses since the preceding annual measurement date (either preceding 12 months or prior year-end) that served as an assumption in the preceding fair value measurement would also be helpful; we believe this would be decision-useful with regard to originated loans as well²⁶.

Question 67: Are there any other disclosures that you believe would provide decision-useful information and why?

Duff & Phelps response: We believe it may be more decision-useful to provide disclosures on a macro level focusing on risk metrics reflecting the manner in which the business is operated. For example, a sensitivity analysis could show how a shift in the market (e.g., a 10 percent change in a market based assumption) would affect the assets and liabilities of the business. Entities already perform such analyses for risk management purposes.

While we do not wish to add to the sheer volume of the notes to financial statements, we feel that disclosures such as this, which provide the reader with information about the quality of a particular preparer's estimates and measurements around financial instruments, are highly decision-useful in comparing the quality of such measurements between entities and in providing comfort in the related amounts shown on the face of financial statements.

Effective Date and Transition

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?

Duff & Phelps response: We have concluded that a standard which cannot be understood and implemented within a short period of time (i.e., less than three years) by *all preparers* runs the risk of being too complicated to be adopted in a cost effective and consistent manner. The very need to ask this question confirms that the proposed standards contain too many exceptions and inconsistencies and changes too many aspects of the principles of accounting that have been in place for decades, to be implemented timely and efficiently.

Other Considerations

Regulatory Oversight

Much of the push back on the current financial instruments proposal relates to its impact on regulation and regulatory capital in particular. We believe that the applicable regulatory communities must determine if IFRS or U.S. GAAP provide the proper basis for regulation. When they do not, financial statement results (either U.S. GAAP or IFRS) should be adjusted for regulation purposes. As Chairman Bernanke of the U.S. Federal Reserve stated on March 10, 2009 at the Council on Foreign Relations, Washington, D.C.:

"Because banks typically find raising capital to be difficult in economic downturns or periods of financial stress, their best means of boosting their regulatory capital ratios during difficult periods may be to reduce new lending, perhaps more so than is justified by the credit environment. We should review capital regulations to ensure that they are appropriately forward-looking, and that capital is allowed to serve its intended role as a buffer--one built up during good times and drawn down during bad times in a manner consistent with safety and soundness."

The U.S. GAAP and IFRS financial reporting systems do not necessarily provide a basis for easing and strengthening loan provisions through cycles, as their intended purpose is to meet the needs of investors, not regulators. Therefore, regulators should determine what actions are required based on the phase in the cycle and provide appropriate regulation independent of any U.S. GAAP or IFRS requirements.

Contractual Rights (Contingent Consideration Arrangements)

Paragraphs BC142 through BC146 discuss the Board's views on valuing contractual rights. Because the discussion focuses on business combinations and does not specifically address the issue from other perspectives, such as that of an investment company, the Board's conclusions are confusing and misleading. Further, the Board should reconsider the use of "observable" language – "observable market or observable index"—as it could be confused with the concept of "observable" used in determining the Level (1, 2, 3) of inputs used for fair value measurement.

ASU 2009-12 allows NAV to be used as the estimate of the fair value of an interest in an alternative investment fund, if all underlying investments of the fund are reported at fair value. "FASB ASC Topic 946-320 states that investment companies report investments in debt and equity securities at

fair value."²⁷ It is becoming increasingly common for an investment company to sell an underlying portfolio company investment, retaining the right for future contractual payments (contingent consideration) if certain milestones are met. Consistent with Topic 946 and ASU 2009-12, the investment company should report the contractual right at its fair value. Conceptually, valuing a contractual right is no different than valuing an option or a warrant. Estimating the value of contractual rights requires judgment and will generally use Level 3 inputs, but is no more difficult to estimate than estimating the fair value of other contingent cash flows such as those associated with options and warrants.

We recommend that the Board clearly articulate that investment companies should report all assets, including contractual rights arising from contingent consideration arrangements, at fair value. Without these clarifications, practice will continue to diverge and investors in alternative assets may not be able to apply ASU 2009-12 because reported NAV would not include all underlying assets at fair value.

Proposed Implementation Guidance

We appreciate the Board's efforts in providing examples to assist in implementation of the proposed guidance. While it may have been deemed beyond the scope of the ED, we believe that the implementation guidance could be significantly enhanced by providing further background and analysis explaining possible reasons and calculations behind changes in fair value and other estimates. For example:

- IG 129 conceptually, how was the \$75,000 fair value of the loan derived?
- IG 137 what factors caused fair value to move to \$72,000?
- IG 149 what factors caused fair value of the loan to change to \$3,200,000?

We understand that the purpose of providing the examples is to provide implementation guidance included in the ED and not to provide guidance on estimating fair value. However, adding descriptive language which supports why fair value changed to the amounts used in the examples would greatly benefit a reader's overall understanding of both the proposed financial instrument guidance and its interaction with Topic 820.

²⁷ AICPA Audit & Accounting Guide Investment Companies, paragraph 1.35

Income Statement/Balance Sheet Disconnect

We are concerned that the ED does not further the goal of achieving sound financial reporting. Specifically, we believe that the ED actually contributes to a serious disconnect between the income statement and the balance sheet. In our view, the income statement should reflect the actual results of operations arising from the business model used by management to conduct the entity's business, while the balance sheet should reflect assets and liabilities employed by the entity. These assets and liabilities should be reported at amounts that reflect how those assets are being used and liabilities are being incurred by the entity. By simply requiring that all financial assets and liabilities be measured and re-measured at fair value each reporting period, the ED is introducing volatility into the income statement that may not exist. This is especially true for those business models where the assets and liabilities are held for yield considerations over the anticipated term of their lives. The resultant new accounting paradigm appears to significantly deviate in many aspects from management's view and business model, and from the view that a market participant would take in assessing an entity's results, cash flows and financial position.

The Gross-Net Issue

It has been our observation that U.S. GAAP generally prefers to record items on a gross, rather than a net basis, both for balance sheet and income statement purposes. In many cases, it could be argued that this type of presentation provides more useful information to financial statement users. At the same time, recording an item gross or net is also a function of the defined unit of account, i.e., how the asset or liability is defined (described) for the purpose of financial reporting.

We observe that the remeasurement amount for CDL may imperfectly reflect and collapse two elements into one - the face value of the CDL and the related CDI (or portions thereof), which represents the benefit of favorable financing arising from the CDL presently on hand. CDI is routinely measured at fair value in business combinations. Thus, an alternative conceptual approach to recording CDL - the "gross view" - may be to separately identify the financial obligation (face amount of the deposits) and the related intangible (at fair value). This may also provide better and more transparent matching to the assets that the core deposits are funding, if the Board's decision to remeasure CDL is driven by such considerations. Meanwhile the "net view" combines the financial core deposit liability with the related intangible, which manifests itself as a discount to the face amount of the liability in transactions in the marketplace. The ED approach seems to promote such a net view, which has many shortcomings in its articulation in the ED, as discussed in our responses to Questions 17 and 31. Therefore, we recommend that the

Board re-examine whether a gross on net approach is more appropriate in reporting CDL under the new financial instruments accounting model.

The Mixed Attribute Model

Arguably, there are many shortcomings of a mixed attribute model in financial reporting. For one, valuable internally generated intangibles may remain unrecognized, and gains resulting from the entity's own declining credit may not be offset by losses on its assets which could be subject to the same intrinsic or extrinsic forces.

The deficiencies in inherent in a mixed attribute model, the appeal of fair value on a number of levels and the lessons learned from the financial crisis may be motivating a far-reaching and relatively speedy shift to fair value in the accounting for financial instruments. However, we believe that the Board should step back and ask if the proposed model, very heavily weighted towards fair value - but not full fair value for all assets and liabilities - would, on balance, provide a better depiction of the financial results and financial position of an enterprise. We think not. We believe that business models, and market participant views, differ among entities. In some cases amortized cost as the primary measurement attribute may be more relevant, as discussed elsewhere in our letter. So while conceptually an emphasis on a single measurement attribute may have appeal, it may not be practically meaningful or achievable.

Also as discussed elsewhere in our response, we see the Board infusing even more measurement attributes into the mix by introducing the notion of "remeasurement value" for CDL, while continuing to allow amortized cost for qualifying assets and liabilities (appropriately so). Thus, the model remains mixed, only in a new way and in new proportions.

Our conclusion is that while we see theoretical merit to a single attribute accounting model, because of differences in business models, and market participant perspectives, a single measurement basis may not be superior across the board. Further, a single attribute model may not provide a quick fix in and of itself to any perceived deficiencies in financial reporting. Thus, we believe that the Board should carefully evaluate the circumstances in which a change in the current measurement attribute model for financial instruments is warranted, and the circumstances in which it needs to be supplemented. The Board should refrain from introducing new measurement bases where not justified, and ultimately drive financial reporting principles that appropriately reflect an entity's business model and the manner in which market participants evaluate it.