Letter of Comment No. 25 File Reference: 1100-163

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Director of Major Projects and Technical Activities Financial Accounting and Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

RE: File Reference No. 1100-163

Dear Ms. Bielstein:

The Federal Home Loan Banks ("FHLBanks") would like to take this opportunity to comment on the Exposure Draft of the Proposed Amendment, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. Our comments are directed to the portion of the amendment addressing option-based contracts.

Congress established the FHLBank System in 1932 under the Federal Home Loan Bank Act (12 U.S.C. 1421 et seq.). It consists of twelve district banks that have a combined \$697 billion in assets, \$34 billion in capital, and \$601 billion (notional) of derivative instruments. The FHLBanks operate under a comprehensive statutory and regulatory framework, serving the public through member institutions by providing members with liquidity and also enhancing the availability of residential mortgage and community investment credit through a variety of programs. FHLBanks use debt markets to accomplish this, with a total par amount of \$498 billion of debt outstanding.

The FHLBanks note three significant problems with this amendment:

- 1. The requirement in paragraph 6(b) that an option-based contract have an initial net investment equal to the fair value of the option component (as opposed to being paid for over time) is inconsistent with how many options markets operate, and
- 2. Hedge strategies using option-based contracts that were previously highly effective would have to be structured in ways that make them less effective or invalid.
- 3. The proposed deletion of paragraph 19 would eliminate the current guidance with respect to the calculation of changes in fair value.

The FHLBanks request that the Financial Accounting Standards Board ("Board") revise the proposed amendment language for paragraphs 6(b) and 68(b) to allow for option-based contracts with an initial net investment equal to an amount no more than the fair value of the option component.

The FHLBanks do not agree with the proposed amendments to paragraphs 6(b) which states that if the derivative "is an option-based contract, it has an initial net investment equal to the fair value of the option component" or paragraph 68(b) which states, "...except for an interest rate swap containing an embedded mirror-image call or put option as discussed in paragraph 68(d), in which case the fair value of the interest rate swap containing an embedded mirror-image call or put at the inception of the hedging relationship is equal to the time value of the embedded call or put option." Under the proposed amendment, these conditions only apply when there is an up-front cash transaction for the option.

Our rationale is explained below.

Analysis

The FHLBanks engage in option-based contracts in the form of interest rate swaps that contain an option to terminate prior to maturity, hereinafter referred to as callable swaps. The embedded call option in these instruments does not require bifurcation under paragraph 12. However, a callable swap can be described in the following manner:

Formula 1: Callable Swap = Non-callable Swap + Option to Terminate

The option to terminate the swap can be viewed as the right to enter into a non-callable swap that negates the underlying non-callable swap by assigning reverse pay and receive positions. The value of a callable swap can be described as follows:

Formula 2: Value_{Callable Swap} = Value_{Non-callable Swap} + Value_{Option to Terminate}

Under the amended paragraph 6(b), option-based contracts must have an initial net investment equal to the fair value of the option component. This condition, in turn, requires that the value of the option-based contract be solely attributable to the value of the embedded option. In the case of callable swaps, this initial condition can be expressed with the following formula:

Formula 3: Value_{Callable Swap} = Value_{Option to Terminate}

The only way that Formula 2 and Formula 3 can be simultaneously satisfied is if the value of the non-callable swap is zero. This condition, in turn, requires that the non-callable swap be structured with coupon and strike levels that would be assigned to a non-callable par swap at inception. However, as will be demonstrated below, this set of conditions is at odds with market practice concerning the issuance of callable debt by corporate debt issuers, including the FHLBanks, and would impose conditions that would

force the FHLBanks to enter into hedges that would provide an inferior economic offset to that provided by the transactions that the FHLBanks currently undertakes.

The FHLBanks recognize that in many options markets, the purchaser makes a net initial investment equal to the fair value of the option. However, the custom in the US Agency callable bond market, as well as in most corporate debt markets, is that the value of the option is conveyed by an adjustment to the coupons of the derivative, not by an up-front payment. This custom is consistent with that for callable debt that is issued by the FHLBanks. The FHLBanks issue debt callable by the FHLBanks. The FHLBanks simultaneously enter into interest rate swaps that are callable by the counterparty. The call options embedded in the interest rate swaps are mirror images of the call options embedded in the debt. This transaction is described in the following table (Table 1).

TABLE 1: CURRENT FHLB CALLABLE BOND-SWAP STRUCTURE

	Bond	Swap
Par/Notional Amount	\$100 MM	\$100 MM
Maturity Date	6/30/2007	6/30/2007
Coupon	4.86%	4.86% vs. 3 Month
-		LIBOR – 11 b.p.
Termination Option	Callable by	Callable by Swap
•	FHLBanks on	Dealer on 6/30/2003
	6/30/2003 and semi-	and semiannually
	annually thereafter	thereafter
Strike Price	Par	Par
Up-front Option Premium	None	None (Option initial
-		value = 1.27%)

With the clearance of DIG Issue E4, later incorporated into FASB Statement No. 138, the Board stated, "An entity is not precluded from applying the shortcut method to a fair value hedging relationship of interest rate risk involving and interest-bearing asset or liability that is prepayable due to an embedded call option provided that the hedging interest rate swap contains an embedded mirror-image call option." The interest rate swaps entered into by the FHLBanks to hedge their callable bonds currently meet the requirements of the mirror-image call options as prescribed under E4 and, as a result of adjusting the value of the options into the coupons of the swaps, have a fair value at inception of zero. The transactions currently meet all of the requirements for the shortcut method. Under the proposed amendments to paragraphs 6(b) and 68(b), these hedged transactions would no longer be eligible for the shortcut method simply because the option value of the swap was adjusted into the coupons of the swap instead of being received up-front.

We also note that conforming to these proposed amendments would require entering into transactions that are less effective than those under current practice, as the strike levels on the hedge and hedged items would no longer be "mirror-images" of one another. This would make it impossible to conform to paragraph 68(d) as well.

As noted in table 1, the FHLBanks can issue at par a five-year fixed-rate bond callable semiannually after one year at a coupon of 4.86%. Under market convention, the value of the option contract is embedded in the coupon. This relationship meets all of the current requirements of paragraph 68. In particular, it meets 68(b) because the callable swap has a fair value of zero at inception. It also meets the requirement of 68(d) that the "...terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called)..."

A key aspect of this mirror-image relationship is the relative coupon levels at which the bond and swap are transacted. Market convention dictates that the bond coupon is set at a level that compensates the investor for the implicit value of the option that allows the FHLBank to redeem the bond at par prior to its stated maturity date. It is never the case that the value of this option is paid to the investor by the FHLBank at the inception of the bond. As a result, the coupon on this bond is higher than that of a non-callable bond of the same stated maturity, which means that an option to terminate such a bond at par will become in-the-money at a different interest rate level than would be the case if the bond's coupon were originally set at the lower non-callable level. If the swap coupon is set at a par level for a non-callable swap, in accordance with our understanding of the requirement under amended paragraph 68(b), while the bond coupon is set at a par level for a callable swap, the effectiveness relationship between the bond and the swap is degraded and the hedge is less accurate, if not invalid. We believe that this would be inconsistent with the 68(d) condition that the options have mirror-image terms. Such a transaction is exhibited in Table 2 below:

TABLE 2 - PROPOSED CALLABLE BOND-SWAP STRUCTURE

	Bond	Swap
Par/Notional Amount	\$100 MM	\$100 MM
Maturity Date	6/30/2007	6/30/2007
Coupon	4.86%	4.46% vs. 3 Month
		LIBOR – 11 b.p.
Termination Option	Callable by	Callable by Swap
	FHLBanks on	Dealer on 6/30/2003
	6/30/2003 and semi-	and semiannually
	annually thereafter	thereafter
Strike Price	Par	Par (= 4.46%)
Up-front Option Premium	None	None (Option Initial
-		Value = 1.90%

In order to comply with the proposed changes to 6(b) and 68(b), the callable swap transaction would have to be structured so that the fixed coupon was that of a non-callable swap. In this case, the point of exercise of the call option would be dropped by

40 basis points. The drop in the swap coupon effectively changes the exercise behavior relative to that of the bond. This change would seem to imply a violation of the requirement in paragraph 68(d) that the strike prices of the mirror-image call options must match. It would also imply that the effectiveness of the hedge would be diminished relative to the first case.

The FHLBanks also do not agree with the deletion of paragraph 19 from the statement which states "In this Statement, the change in fair value of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or acquisition date) and the end of the period adjusted to exclude (a)changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability". This language, specifically in reference to the passage of time, provides guidance with respect to the fair value calculation for hedged items that have been dedesignated in a hedging relationship and subsequently redesignated. The FHLBanks question the Board's basis for eliminating this paragraph.

Conclusion

The FHLBanks have approximately \$180 billion (notional) in swapped callable debt transactions with perfectly offsetting cash flows and mirror-image call options where the option component in the swap is realized through the coupons of the swap. These hedged transactions currently are accounted for under the shortcut method based on the existing language in paragraphs 6 and 68, but would be precluded from assuming no ineffectiveness based on the proposed amendment language. As our example clearly illustrates, a typical market hedge that realizes the option value through the coupons of the swap has a fair value at inception of zero in accordance with the terms of the associated hedged bond under widely-accepted market practice. However, we recognize that in other circumstances, there may be an initial net investment associated with an embedded option in both the hedge and hedged items. We therefore request that both paragraphs 6(b) and 68(b) be revised to state that an option-based contract must have an initial net investment equal to an amount that is no more than the initial fair value of the option component. We also request that paragraph 19 remain in the standard as stated.

We would be pleased to discuss our comments with you at any time. If you have any questions, please call me at (312) 565-5327.

Sincerely,

Mark R. Szczepaniak Chair, Federal Home Loan Bank SFAS 133 Subcommittee