



LETTER OF COMMENT NO. 107

1:54 AM

Statement 107 (FSP FAS 107-a) - Request for Technical Clarifications

File Reference: Proposed FSP FAS 107-a

-----Original Message-----

From: Edelson, Claude [mailto:CEdelson@fhllbc.com]

Sent: Wednesday, January 21, 2009 11:44 AM

To: Mark Trench

Cc: Potter, James; Director - FASB; Upaasna Laungani

Subject: Proposed FSP on Statement 107 (FSP FAS 107-a) - Request for Technical

Clarifications File Reference: Proposed FSP FAS 107-a

Dear Mr. Trench:

I would appreciate your help. Specifically, I would appreciate if you could have the FASB provide technical clarifications for the items discussed below pertaining to the proposed FSP FAS 107-a, Disclosures about Certain Financial Assets: An Amendment of FASB Statement No. 107

(hereinafter referred to as the "proposed FSP"). This request from FHLB of Chicago is separate from the comment letter sent by all Federal Home Loan Banks on this proposed FSP, which dealt with the more fundamental issues in the proposed FSP. This email deals with more granular application issues.

Calculation of Incurred Loss Amount for Unimpaired Financial Assets:

I would appreciate if you could clarify how to calculate the incurred loss amount for unimpaired financial assets.

The proposed FSP defines the calculation of the incurred loss amount as follows:

"11. The incurred loss amount represents the reported or pro forma carrying amount of the investment under an incurred loss model. For loans and receivables, an entity shall disclose the reported carrying amount based on their existing accounting policies under Statement 114 and Statement 5. For debt securities classified as held-to-maturity and available-for-sale, an entity shall measure the incurred loss amount based on the present value of expected future cash flows discounted at the security's effective interest rate (consistent with Statement 114)."

The Statement 114 approach focuses on determining the incurred loss amount on impaired loans that are carried at historical cost. The approach uses the original effective interest rate (or allows current rate for variable rate loans) to avoid recognizing market rate changes as part of an allowance calculation. Its focus is impairment and it does not allow recognition above the recorded investment. In effect, the incurred loss focuses on historical cost and does not allow for changes in market rate to be recognized. As a result, the approach is designed for only impaired loans. Accordingly, this suggests that an unimpaired financial asset, even an investment security, cannot have an incurred loss that is below its amortized cost basis; otherwise, that financial asset is impaired and would need to be written down to its fair value.

In effect, the objective of the incurred loss approach appears to be to carve out the impairment due to liquidity and other factors from credit impairment. Accordingly, if there is no credit impairment, the difference between amortized cost and fair value represents the total effect of liquidity and other factors. The excerpt below is from Statement 114, which explains the objective of the incurred loss approach. The need for technical clarification arises as a result of paragraph 11 language indicating that the expected cash flows of investment securities should be present valued using the effective interest rate on the investment security. The proposed FSP does not explicitly indicate how to apply the incurred loss model to unimpaired financial assets. As a result, some

may interpret that this language in paragraph 11 as applying to unimpaired financial assets. The application of this language may result in an incurred loss amount that is less than the amortized cost basis of the financial asset even though there is no credit issues. I do not believe this is the intent of the FASB. Alternatively, paragraph 11 also indicates that the incurred loss model should be applied in a manner that is consistent with Statement 114. This implicitly suggests that if a financial asset is performing, then contractual future cash flows should be used as indicated in the excerpt of paragraph 52 below rather than expected cash flows. In effect, I believe the incurred loss amount for an unimpaired financial asset should be its amortized cost basis.

"51. The Board concluded that a loan impairment measurement should reflect only a deterioration of credit quality, which is evidenced by a decrease in the estimate of expected future cash flows to be received from the loan. The Board believes that the measure of an impaired loan should recognize the change in the net carrying amount of the loan based on new information about expected future cash flows rather than record a new direct measurement. The Board, therefore, concluded that the loan impairment measurement should not reflect changes in market rates of interest that may cause a change in the fair value of an impaired loan.

52. Because the Board believes that only the loss due to credit deterioration should be measured, the Board concluded that the expected future cash flows should be discounted at the loan's effective interest rate. The effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount). The Board observed that the recorded amount of an unimpaired loan, as long as the loan performs according to its contractual terms, is the present value of the contractual future cash inflows—both those designated as principal and as interest—discounted at the loan's historical or effective interest rate. Thus, the measurement basis for an impaired loan will be the same as the measurement basis for the same loan before it became impaired. As a practical expedient, the Board concluded that for a loan whose stated rate varies based on subsequent changes in an independent factor, creditors should be permitted to fix the rate at the rate in effect at the date the loan meets the impairment criterion."

Interaction of Statement 133 and Statement 114 when applying Incurred Loss Model:

I would appreciate if you could clarify whether DIG Issue F4 would apply to the incurred loss model. Specifically, DIG Issue F4 (excerpt below) indicates that the discount rate should not be original effective interest rate but the adjusted effective interest rate based on hedge results.

"Yes. Statement 133 has implicitly affected the measurement of impairment under Statement 114 by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted recorded investment in a hedged loan. When the recorded investment of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted recorded investment. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Statement 133 should be considered to be an adjustment of the loan's recorded investment.

The loan's original effective interest rate becomes irrelevant once the recorded amount of the loan is adjusted for any changes in its fair value. Since paragraph 27 requires that the loan's carrying amount be adjusted for hedge accounting before the impairment requirements of Statement 114 are applied, Statement 133 implicitly supports using the new effective rate and the adjusted recorded investment."

Discount Rate for Application of Fair Value Accounting for Pro Forma Income:

Flanks are not in favor of disclosing pro form income. However, if the FASB requires this disclosure, I would appreciate if you could clarify the following application issues related to fair value accounting:

* SFAS 133, Accounting for Derivative Instruments and Hedging Activities, Hedging Adjustments - If an asset is carried at fair value, then it is not eligible to be designated as the hedged item in a SFAS 133 fair value or cash flow hedge. As a result, pro forma income would need to include adjustments to eliminate the effects of fair value and cash flow hedge activity. In effect, all derivatives related to loans and HTM and AFS investment securities would be accounted for on a standalone basis. Any amortization of hedge basis adjustments would need to be reversed. Further, any amounts deferred in accumulated OCI related to these assets would need to be immediately recognized.

* SFAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, Amortization/Accretion Adjustments - If loans are carried at fair value, loan origination fees would be immediately recognized rather than amortized/accreted and premiums and discounts on loans would not be amortized/accreted. As a result, pro forma income would need to include adjustments for SFAS 91 amortization/accretion and the recognition of origination fees.

* SFAS 114, Accounting by Creditors for Impairment of a Loan, and SFAS 118, Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures, Loan Loss Adjustments - If loans are carried at fair value, there would be no provision for loan losses. As a result, pro forma income would need to include adjustments to reverse any provisions for loan losses.

* Whether a pro forma disclosure of the effect on January 1, 2008 retained earnings is required to properly reflect the application of fair value accounting. For example, if fair value accounting were applied, then the allowance for loan losses related to December 31, 2007 also should be reversed. Such reversal should be an adjustment to January 1, 2008 retained earnings in order to correctly calculate changes in fair value attributable to the year ending 2008.

Please contact me at 312-565-5284 if you have any questions concerning the above request for technical clarifications.

Regards,

Claude Edelson
Assistant Director of Accounting Policy

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