



# Federal Farm Credit Banks Funding Corporation

10 Exchange Place, Suite 1401  
Jersey City, New Jersey 07302  
201/200-8000  
<http://www.farmcredit-ffc.com>

September 30, 2010

Technical Director  
Financial Accounting Standards Board  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116  
File Reference No.: 1810-100

**Re: “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities”**

Dear Director:

On behalf of the Banks and Associations of the Farm Credit System (FCS), we welcome the opportunity to express the FCS’s views with respect to the FASB proposed Accounting Standards Update, “Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.”

## Background Information about the Farm Credit System

The Farm Credit System is a federally chartered network of borrower-owned lending institutions comprised of cooperatives and related service organizations. Through its five Banks and 87 Associations, the FCS provides sound and dependable credit to American farmers, ranchers, producers or harvesters of aquatic products, their cooperatives, and farm-related businesses. The Associations are cooperatives owned by their borrowers, and the Banks are cooperatives owned by their affiliated Associations or principally owned by cooperatives and other eligible borrowers. As of June 30, 2010, the FCS's combined assets totaled \$216.3 billion, with \$160.7 billion of the assets consisting of net loans, and liabilities of \$184.5 billion, with \$176.8 billion of the liabilities being Systemwide debt obligations that are publicly traded.

The comments that follow are the result of consideration of issues related to the accounting changes proposed by the FASB. Some FCS institutions may be submitting comments separate from this letter in order to address specific issues not discussed or to clarify or emphasize positions expressed herein.

## General Comments

The FCS supports the FASB’s efforts to converge accounting standards with those set forth by the IASB but notes that the proposed guidance for the accounting for financial

instruments differs from IASB standards. We encourage the FASB to reconsider its position so that the objective of convergence is met.

As financial institutions, the FCS is an extensive user of financial statements as well as a preparer of financial statements. We strongly oppose the proposed guidance that requires most financial assets and financial liabilities, specifically loans held for investment and the corresponding debt issued to fund those loans, to be measured at fair value. In addition, the FCS does not believe that the objective of the proposed guidance "to provide an improved and consistent financial reporting model for recognition, measurement and presentation of financial instruments in an entity's financial statements" will be achieved by requiring financial instruments to be recognized at fair value. We believe the IASB approach to financial instruments under IFRS 9 would be a more reasonable approach, as it provides for all financial assets to be classified on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset.

However, the FCS agrees with the goal to replace the highly complex, quantitative-based hedging requirements with more qualitative-based assessments for hedge accounting.

#### Measurement and Classification of Financial Instruments

The FCS does not agree with the proposed change to require all financial instruments to be measured at fair value with changes in fair value recognized in net income. It is our belief that the accounting should follow the business strategy, which in our case is to originate loans to borrowers in the agricultural and rural related sectors and certain related entities and to continue to hold the loan to maturity. Amortized cost is the most appropriate measure for these financial assets and the corresponding financial liabilities since it reflects the expected cash flows consistent with the basis at origination.

Fair value is defined as a market-based measurement that reflects the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. If loans that are originated and held to maturity (and investments in debt securities for which an entity intends to hold until maturity) have no readily available market, how meaningful would any determination of fair value be? The FCS believes that the financial statements would be misleading and not reflect the economics of the transaction. We believe the accounting that follows the business strategy (i.e., hold-to-maturity) would provide more useful information to users of the financial statements. In addition, the determination of fair value would be based on "Level 3" valuation techniques that require significant management judgment. While we recognize that those judgments are necessary for valuations, placing them on the face of the financial statements could serve to reduce the integrity and comparability among entities.

As lending institutions, FCS institutions make extensive use of financial statements to analyze the credit worthiness of potential borrowers. In general, while fair value for some financial instruments is a relevant data point, repayment capacity and collateral values provide the most relevant information in support of a lending decision. A portion of our borrowers' financial statements contain loans and all of our borrowers reflect debt on their balance sheets. There is generally no ready market for these financial assets or financial liabilities. As a result, the fair values that would be included in these borrowers' financial statements under this proposal would be based on their own internal estimates. Given the

varying levels of sophistication at borrower entities, and the resulting inconsistencies, we would generally view those fair value estimates with a high degree of skepticism. As a result, we do not believe that the inclusion of those fair values on the face of the balance sheet would result in more useful information to us as a lender and would likely cause confusion instead. While the current approach, which is to display loans and debt on the balance sheet at amortized cost, may have certain inherent weaknesses, it is at least closely aligned with the contractual cash flows that have occurred or will occur in the future. The introduction of fair value as the primary measurement attribute for financial assets and financial liabilities weakens the alignment between contractual amounts and the amounts displayed in the financial statements.

Under the current mixed-attribute approach, financial assets and financial liabilities are measured at either amortized cost or fair value. We believe the current approach reflects the appropriate accounting and measurement, and is understood by readers of financial statements. Displaying both measures on the face of the balance sheet implies that both are equally reliable. Amortized cost based on actual cash flows is a known measure, while fair value, at least in most cases, is an estimate and can be very volatile period to period. From a qualitative standpoint, the historical measure deserves more prominence on the balance sheet, especially for entities whose intent and business purpose is to hold loans for collection of cash flows. We do not believe that using fair value estimates as the primary measurement attribute for loans and corresponding debt would improve the quality, transparency and reliability of financial statements.

#### Impairment and Interest Income Recognition

The Board's proposed guidance would remove the existing "probable" threshold for recognizing impairments on loans and proposes a common approach to providing for credit losses on loans and debt instruments. The proposed guidance would require an entity to recognize 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 FCS welcomes the change in the impairment model so that the same guidance relates to loans and investments, including the evaluation of assets on a collective (pool) basis. However, while we support the Board's efforts in addressing the current impairment model, we do not agree with recognizing the entire life of asset credit loss in the first reporting period after origination. This would not reflect the economics of the loan transaction.

The proposed guidance would also require that interest income 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. The FCS does not support the approach to interest income recognition. The effective interest approach would be confusing to users of the financial statements since interest income would no longer reflect the contractual interest rate. In addition, the proposed approach would introduce subjectivity and fluctuations since it would take into account the allowance for loan losses.

In addition, the proposed guidance provides for reversals of impairment losses related to investment securities recognized in net income in circumstances when the cash flows expected to be collected on the debt securities improve subsequent to the initial

impairment. The FCS strongly supports impairment reversals classified in net income for debt securities as this change from historical practice will provide more consistency with the impairment accounting model for loans. Reversals of impairments on loans are effectively reflected in net income as a result of loan loss reversals; therefore, the FCS believes reversals of debt security impairments should not be treated more conservatively and accreted back to net income over their life, rather reversals of impairments on debt securities and loans should both be classified in net income.

#### Accounting for Derivative Instruments and Hedging Activities

The FCS has been an active user of OTC interest rate swaps and other OTC interest rate derivatives and relies on hedge accounting treatment in order to be able to use these tools to obtain lower cost funding, lengthen maturities of floating rate funding and manage interest rate risk. Receive fixed – pay Libor floating interest rate swaps comprise approximately 80% of the derivatives that are utilized by the FCS and have proven to be a valuable means for reducing the cost of and increasing the maturity of floating rate debt. These dual benefits are achieved by entering into a receive fixed – pay Libor floating interest rate swap that converts the fixed coupon on a fixed rate bullet or callable bond issuance to a floating rate that is indexed to Libor.

Overall, the FCS agrees with the proposed changes for hedge accounting and welcomes the move to a more principles based approach for the assessment of hedge effectiveness. In particular, the FCS supports the amendments to the hedge effectiveness guidance to no longer require that a hedging relationship be highly effective and to no longer require a quantitative assessment of the effectiveness of a hedging relationship or an ongoing effectiveness test. The FCS welcomes these changes and would like to see these changes implemented as soon as possible and recommends that the Board not wait until the other proposed changes in the ED for Financial Instruments are implemented.

The FCS supports the provisions that the hedging entity would only need to reassess effectiveness if changes in circumstances suggest that the hedging relationship may no longer be reasonably effective, and that ongoing effectiveness testing would be eliminated unless changes in circumstances suggest that a hedging relationship may no longer be reasonably effective. The FCS also welcomes the preservation of the benchmark rate method and the ability of entities to hedge interest rate risk due to changes in Libor as the sole risk being hedged in a fair value or cash flow hedge with Libor designated as the benchmark rate.

In summary, the FCS supports the recommended changes to hedge accounting, as discussed above, and recommends that the Board bifurcate this portion of the Exposure Draft and make the changes to hedge accounting as soon as is feasible without regard to the timing of the other proposed changes regarding accounting for financial instruments. In addition to the above general comments on accounting for derivatives and hedging activities, the following answers reflect the FCS's response to certain of the questions posed in the exposure draft for all respondents regarding hedge accounting:

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

The FCS agrees with modifying the effectiveness threshold from highly effective to reasonably effective and agrees with the Board's objective to limit quantitative prospective and retrospective testing to rare cases. The FCS agrees that the judgment of the hedging entity should be the determining factor regarding whether a hedge relationship is reasonably effective and can be subjected to qualitative testing only. The FCS welcomes this move to a more principles based method for the assessment of hedge effectiveness.

**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?

The FCS believes that there are circumstances that might result in a hedge relationship becoming ineffective after its inception such as for hedge relationships that involve cross market basis risk between the hedge and the hedged item. However, the Board should clarify that entities can expect hedge relationships consisting of a fixed rate bond and a receive fixed-pay Libor interest rate swap, with Libor designated as the sole risk being hedged per the benchmark rate method to be reasonably effective over the expected hedge term.

**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?

Yes. The FCS believes that requiring an effectiveness evaluation only if circumstances suggest that the hedging relationship may no longer be effective would result in a reduction in the number of times that hedging relationships would be discontinued.

\*\*\*\*\*

We appreciate this opportunity to respond and hope our comments prove useful to the Board. If you have any questions with respect to the contents of this response, please call me at (201) 200-8071.

Respectfully,

*H. John Marsh, Jr.*

H. John Marsh, Jr.  
Managing Director -  
Financial Management Division