Dear Ms. Susan Cosper:

We appreciate the opportunity to provide comments to the FASB Invitation to Comment, “Agenda Consultation”. Our comments are limited to Topic-Specific Questions for Respondents—Distinguishing Liabilities from Equity – Question 3.1 as shown below.

Question 3.1: Is the accounting for distinguishing liabilities from equity a major financial reporting issue that the FASB should consider for improvement? Please explain why. In making your assessment, what criteria were used (for example, is the issue not sufficiently addressed in current GAAP, or is it addressed in a way that makes compliance costly or creates diversity in practice because the guidance is conceptually or economically flawed)?

Background Relevant to Our Comments:

On January 20, 2016, the Federal Housing Finance Agency (FHFA) issued a rule effective February 19, 2016, that, among other things:

- makes captive insurance companies ineligible for Federal Home Loan Bank (FHLB) membership; and
- defines the “principal place of business” of an institution eligible for FHLB membership to be the state in which it maintains its home office and from which the institution conducts business operations.

The rule defines a captive insurance company as a company that is authorized under state law to conduct insurance business but whose primary business is the underwriting of insurance for affiliated persons or entities. Captive insurance company members that were admitted as FHLB members prior to September 12, 2014, (the date the FHFA proposed this rule) will have their memberships terminated by February 19, 2021. Captive insurance company members that were admitted as FHLB members after September 12, 2014, will have their memberships terminated by February 19, 2017. There are restrictions on the level and maturity of advances that FHLB can make to these members during the sunset periods.

As a result of the above mentioned FHFA rule, a discussion among FHLBs ensued as to whether to apply **FASB ASC Topic 480, Distinguishing Liabilities from Equity** or **SEC ASR 268, “Accounting for Redeemable Equity Securities,”** when determining the accounting for
our captive insurance members capital stock as of the rule’s effective date. These discussions highlighted to us why diversity and confusion exist in practice! In this regard, our comments are outlined below.

Comments:

We believe the accounting for distinguishing liabilities from equity represents a major financial reporting issue that the FASB should consider for improvement. Our specific areas of concern that need improvement are outlined below.

Scope:

Determining whether a transaction or event is governed by FASB ASC Topic 480, Distinguishing Liabilities from Equity or SEC ASR 268,“Accounting for Redeemable Equity Securities,” may represent a significant challenge. In the case of the FHFA rule, interpreting the definition of mandatorily redeemable financial instrument (see Excerpt 1 below) is the primary challenge. Specifically, should a redemption resulting from a third party action be viewed as an embodied (i.e., embedded) unconditional obligation of an entity’s capital stock, and therefore, within the scope of FASB ASC Topic 480.

View 1:

One view is that the “obligation” resulting from the FHFA Rule is not “embodied” (i.e., embedded) in an FHLB’s capital stock. This view is based on the following:

- FASB ASC Topic 480 Implementation guidance (see Excerpt 2 below). Outstanding shares of stock by themselves do not fall within the scope of FASB ASC Topic 480. There needs to be an embedded option between the entity and its counterparty within the terms of the capital stock. In fact, such an embedded option does exist within the terms of its capital stock; however, that embedded option relates to put option between a FHLB Member and an FHLB, which is not the embedded option triggering the redemption. Under this view, the determination of what governs the accounting is the embodied unconditional obligation – that is, if a member exercises their put option there is no question that FASB ASC Topic 480 applies but if redemption is not driven by an embodied unconditional obligation, then FASB ASC Topic 480 should not be applied. Multiple redemption triggers represent a secondary scope challenge that needs to be addressed by the FASB.

- The FHFA rule represents an involuntary redemption that is more akin to a liquidation event pursuant to SEC ASR 268 (see Excerpt 3 below) rather than an embedded derivative in its entirety.

Excerpt 1 - GAAP Definition of “Mandatory Redeemable Financial Instrument”:

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its
assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

**Excerpt 2 – Implementation Guidance - Three Freestanding Instruments:**

**FASB ASC 480-10-55-34** An issuer has the following three freestanding instruments with the same counterparty, entered into contemporaneously:

a. A written put option on its equity shares

b. A purchased call option on its equity shares

c. Outstanding shares of stock.

55-35 Under this Subtopic those three contracts would be separately evaluated. The written put option is reported as a liability under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. The purchased call option does not embody an obligation and, therefore, is not within the scope of this Subtopic. The outstanding shares of stock also are not within the scope of this Subtopic, because the shares do not embody an obligation for the issuer. Under paragraph 480-10-25-15, neither the purchased call option nor the shares of stock are to be combined with the written put option in applying paragraphs 480-10-25-4 through 25-14 unless otherwise required by Topic 815. If that Topic required the freestanding written put option and purchased call option to be combined and viewed as a unit, the unit would be accounted for as a combination of options, following the guidance in paragraphs 480-10-55-18 through 55-20.

**Excerpt 3 – Certain redemptions upon liquidation events from ASR 268:**

f. **Certain redemptions upon liquidation events.** Ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying SEC ASR 268. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to SEC ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders
of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

**View 2:**

Opponents of the above view argue that **FASB ASC Topic 480** applies primarily for the reasons outlined below.

- The FHFA rule is implicitly part of the terms (i.e., an embodied unconditional obligation) of FHLB capital stock.
- The FHFA rule meets the “legal” definition of an unconditional obligation.
- Since FHLB capital stock does have an embodied unconditional obligation, any redemption is governed by **FASB ASC Topic 480** with the exception of repurchases initiated by an FHLB Bank.

**Meaning of Virtually Certain to Occur:**

Concluding the FHFA rule is within the scope of **FASB ASC Topic 480** still presents a challenge. Specifically, it requires reclassification from equity to liabilities when an event has become certain to occur pursuant to **FASB ASC 480-10-25-7**. Based on the FASB’s implementation guidance (see Excerpt 4 below) shown below **FASB ASC 480-10-55-3 and 4**, the FASB’s meaning behind the phrase event has become certain to occur is that there is a 100% probability of the event occurring.

**View 1:**

The FASB’s intent should drive the accounting in this matter, which based on the examples may be interpreted as the phrase “certain to occur” in mathematics or 100%. In this regard, the FHFA Rule has a unique fact pattern. Specifically, a sunset period exists for the purpose of allowing Congress time to amend the Final Rule. The sunset provision raises sufficient uncertainty to have less than 100% probability of the event certain to occur or assets being transferred at a specified or determinable date or dates. For example, it is possible that Congress may amend the FHFA Rule within the five year sunset period or a capital insurance member may restructure its business within the five year sunset period to qualify as an FHLB member. Additionally, this view assumes that the vote required at the end of the sunset period by an FHLB Board of Directors to terminate a captive insurance member is substantive rather than perfunctory in nature, and accordingly, “certain to occur” does not exist until after the Board of Directors vote to terminate a captive insurance member.

**Excerpt 4 – Implementation Guidance for Mandatorily Redeemable Financial Instruments**

“**FASB ASC 480-10-55-3** Various financial instruments issued in the form of shares
embody unconditional obligations of the issuer to redeem the instruments by transferring its assets at a specified or determinable date or dates or upon an event that is certain to occur."

“FASB ASC 480-10-55-4 This Section presents two examples of mandatorily redeemable financial instruments:

a. Certain forms of trust-preferred securities (those that are required to be redeemed at specified or determinable dates)

b. Stock that must be redeemed upon the death or termination of the individual who holds it, which is an event that is certain to occur.”

View 2:

Opponents of the above view argue that the FHFA rule is “certain to occur” primarily for the reasons outlined below.

- Certain to occur may only be interpreted by the existing FHFA rule. Factoring in future potential actions by Congress is not appropriate.

- The legal definition of an unconditional obligation should be utilized rather than the “certain to occur” condition outlined by the FASB.

Other Implications – Statement of Cash Flows:

The inappropriate classification of mandatorily redeemable capital stock may have a ripple effect on an entity’s statement of cash flows with respect to its classification of dividends paid. Specifically, from a rules based perspective, many interpret the classification of dividends paid on mandatorily redeemable capital stock that has been reclassified from equity to a liability based on its income statement classification as interest expense or operating activities. From a principles based perspective, others interpret classification of dividends paid on such mandatorily redeemable capital stock as a financing activity in the statement of cash flows. Each view is discussed in detail below.

View 1:

Cash dividends paid on mandatorily redeemable capital stock that is classified as a liability should be classified as an operating activity. Those who favor this view literally apply existing GAAP (i.e., rules based accounting) as discussed below.

- **FASB ASC 230-10-45-17** “All of the following are cash outflows for operating activities:

  a. ....
d. **Cash payments to lenders and other creditors for interest.**

- A literal read of the guidance shown below suggests that classification as a financing activity is only required for entities that have no equity instruments outstanding. As a result, entities that have equity instruments outstanding do not have to follow the guidance shown below.

“The FASB ASC 480-10-45-2 Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.”

**View 2:**

Cash dividends paid on mandatorily redeemable capital stock that is classified as a liability should be combined with cash dividends paid on capital stock in stockholders’ equity and should be classified as a financing activity. Those who favor this view apply principles based accounting as discussed below.

- **FASB ASC 230-10-45-15** “All of the following are cash outflows for financing activities:

  a. Payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments....”

- **FASB ASC 480-10-45-2** Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

- More than One Class of Cash Flows – although classified as interest expense, in substance, the payment of a dividend on capital stock is still a financing activity.

  - **FASB ASC 230-10-45-22** “Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item ...”
FASB ASC 230-10-45-23 “Another example where cash receipts and payments include more than one class of cash flows involves a derivative instrument that includes a financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments, because the borrower’s cash flows are associated with both the financing element and the derivative instrument. For that derivative instrument, all cash inflows and outflows shall be considered cash flows from financing activities by the borrower.”

- Precedent exists within GAAP that a change in purchase does not result in a change in classification within the statement of cash flows. Specifically, FASB ASC 230-10-45-12 indicates the following:

  “All of the following are cash inflows from investing activities:

  a. …

  e. Receipts from sales of loans that were not specifically acquired for resale. That is, if loans were acquired as investments, cash receipts from sales of those loans shall be classified as investing cash inflows regardless of a change in the purpose for holding those loans.”

Thank you again for the opportunity to comment on the FASB’s Invitation to Comment, “Agenda Consultation”. Please contact either our Controller James Potter at 312-552-2767 or myself at 312-565-5284 if you wish to further discuss our comments.

Regards,

Claude Edelson
Director of Accounting Policy
Federal Home Loan Bank of Chicago

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