FHLBank ATLANTA
A FEDERAL HOME LOAN BANK

August 14, 2008

1590-100

LETTER OF COMMENT NO. 44

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

File Reference: 1590-100 Exposure Draft
Accounting for Hedging Activities – an Amendment of SFAS 133

Dear Mr. Golden:

The 12 Federal Home Loan Banks (the "FHLBanks") appreciate the opportunity to comment on the Financial Accounting Standards Board's (the "FASB" or "Board") Exposure Draft of Proposed Statement of Financial Accounting Standards: *Accounting for Hedging Activities – an Amendment of FASB Statement No. 133* (hereinafter referred to as the "proposed Statement"). We commend the Board for its continued efforts in addressing implementation issues with Statement of Financial Accounting Standards No. 133, as amended ("SFAS 133"). The FHLBanks have expended substantial resources, both prior and subsequent to adoption, to ensure their accounting for derivative instruments complies with SFAS 133.

Derivative instruments are an integral part of each FHLBank's financial and risk management strategies. As such, the impact of these instruments permeates each FHLBank's financial statements. At December 31, 2007, the combined notional amount of derivative instruments held by the FHLBanks was $959 billion. The FHLBanks believe that changes to SFAS 133 that simplify the application of the standard continue to be warranted; however, certain of the proposed changes do not appear to accomplish that objective or other stated objectives of the proposed Statement. For example, the proposed Statement would eliminate the FHLBanks' ability to hedge changes in an asset's fair value attributable solely to movements in benchmark interest rates. This change in particular would require the FHLBanks to recognize effects of market influences that are unrelated to their hedging strategy, and would render the FHLBanks' financial statements significantly less useful to users of those statements because they would not faithfully represent the FHLBanks' ability to manage interest rate risk. This result would not accomplish the Board's objective of improving financial reporting for hedging activities. The alternative views expressed by the minority of Board members in the proposed Statement outline several areas where the proposed Statement falls short of achieving its stated objectives and discusses other reasons why certain of the proposed changes may not be desirable. In general, the FHLBanks strongly support the alternative views and request the Board reconsider those remarks during the redeliberation process.

Background information on the FHLBanks and their extensive use of derivatives and the FHLBanks' comments regarding the proposed elimination of the ability to designate individual risks as the hedged risk are presented below. The FHLBanks' responses to other issues outlined in the proposed Statement and other comments are presented in Appendix A.

Background Information—The FHLBanks and Their Use of Derivatives

The FHLBanks were created by the Federal Home Loan Bank Act of 1932 to enhance the availability of credit for residential mortgages, community lending, and targeted community development. The FHLBanks are cooperatives, which means that only members and (in certain circumstances) former members own the capital stock in each of the FHLBanks. FHLBank members receive dividends on their investment in capital stock from the earnings of their respective FHLBank. Today, there are approximately 8,100 FHLBank members, including commercial banks, thrifts, credit unions and insurance companies.

The FHLBanks play a critical role in the continuous flow of funds to the residential mortgage market by providing loans (known as advances) to their members. The FHLBanks raise funds through the issuance of bonds and discount notes (known as consolidated obligations) in the capital markets. These funds are loaned to member financial institutions, which in turn provide mortgage credit to homebuyers. In keeping with their cooperative philosophy, the FHLBanks price their advances at relatively small mark-ups over their cost of funds and return the majority of their net income to their members in the form of dividends. Accordingly, the FHLBanks' net income and balance of retained earnings are small relative to total assets and total liabilities. The FHLBanks' combined net income for the year ended December 31, 2007 and retained earnings as of December 31, 2007 were $2.8 billion and $3.7 billion, respectively. As of December 31, 2007, combined total assets and total liabilities were $1.27 trillion and $1.22 trillion, respectively. As of that same date, combined advances and consolidated obligations were approximately $875 billion and $1.18 trillion, respectively.

Proposed Elimination of the Designation of Individual Risks as the Hedged Risk

It is not possible for a FHLBank to consistently issue debt simultaneously with the issuance of an advance in the same amount and with the same terms as the advance, or to predict what types of advances members might need or what types of consolidated obligations investors might be willing to buy. Therefore, in order to mitigate the mismatches between advances and consolidated obligations, both with a wide range of terms, the FHLBanks typically convert both assets and liabilities to a variable-rate index such as LIBOR, and manage the interest spread between the pools of variable-rate assets and liabilities. This process of aligning the timing, structure, and amount of a FHLBank member's credit needs with the investment requirements of a FHLBank's creditors is made possible by the extensive use of interest rate exchange agreements. At December 31, 2007, the notional amount of interest rate exchange agreements whereby the FHLBanks were hedging changes in fair value or probable future cash flows due to changes in a benchmark interest rate designated in qualifying SFAS 133 hedging relationships with advances and consolidated obligations was approximately $336 billion and $430 billion, respectively. Given the volume of these instruments relative to FHLBank levels of net income, the proposed elimination of the bifurcation-by-risk approach for assets could cause substantial earnings volatility for even minor movements in fair value due to risks other than interest rate risk that the FHLBanks would be unable to hedge using interest rate swaps. Because the FHLBanks issue advances with the intention of holding them until maturity, any such volatility would be transitory and would only distort the results of the FHLBanks' ability to effectively manage interest rate risk.

The FHLBanks strongly support the alternative views expressed by the minority of Board members in the proposed Statement regarding the decision to eliminate the bifurcation-by-risk approach (specifically those in paragraphs A54 – A59) and believe that hedging only interest rate risk should continue to be permitted for both assets and liabilities.

Under the proposed Statement, it is unlikely that an interest rate swap would qualify for use as the hedging instrument in a full fair value hedge of an advance. Even if it could be demonstrated at inception that an interest rate swap would be reasonably effective at hedging total changes in the fair value of an advance, the proposed Statement would likely require a more complex ongoing assessment of effectiveness. The proposed Statement requires an effectiveness evaluation at inception of the hedging relationship. Thereafter, an effectiveness evaluation would be required only if circumstances suggest that the hedging relationship may no longer be reasonably effective. As discussed in the alternative views, in a volatile interest rate environment but stable credit market, it would be expected that changes in interest rates would drive changes in the fair value of a loan, resulting in a reasonably effective hedge. In a stable interest rate environment but volatile credit market, it is less likely that an interest rate swap would be reasonably effective at offsetting the change in the full fair value of a loan. Therefore, an assessment process to monitor interest rate movements versus credit movements would likely need to be developed. Based on the outcome of such an assessment, an entity would know whether a quantitative effectiveness assessment was necessary. Alternatively, an entity may consider it simpler to continue performing ongoing periodic quantitative assessments of hedge effectiveness similar to those currently being performed under SFAS 133 for long-haul hedging relationships. Neither the creation of a more complex assessment process nor the continued performance of a periodic quantitative assessment is consistent with the Board's objective of simplifying the accounting for hedging activities.

Another of the Board's objectives is to improve the financial reporting of hedging activities to make the accounting model and associated disclosures more useful and easier to understand for users of financial statements. Consistent with the alternative views, the FHLBanks believe that some of the ramifications of limiting hedge accounting to full fair value (in most cases), would be inconsistent with this objective as well. Paragraph A18 of the proposed Statement discusses the Board's decision to permit an exception from the proposed general hedge accounting approach which would permit an entity to designate only interest rate risk as the hedged risk in a fair value or cash flow hedge associated with an entity's own issued or borrowed debt if the hedging relationship is entered into at inception of the debt. Both the FHLBanks' hedged assets and hedged liabilities are interest earning/bearing financial instruments hedged with interest rate swaps to create synthetic variable rate assets and liabilities. The elimination of the bifurcation-by-risk approach for assets would require the FHLBanks to recognize changes in the fair value of an advance (and, in some cases, other assets) related to unhedged risks that would not be recognized if hedge accounting were not elected (assuming hedge accounting under the proposed Statement could be achieved). This diversity in accounting would increase the complexity of interpreting the FHLBanks' financial statements. The FHLBanks would have to explain different methods of attempting to manage the same risk, different methods of hedging assets and liabilities and different impacts on earnings due to the inability to hedge only interest rate risk for financial assets. Creating synthetic variable rate assets is just as common a practical interest rate risk management technique as creating synthetic variable rate liabilities, and therefore, should be afforded consistent treatment.

Furthermore, while the FHLBanks are aware of the Board's goal of accounting for all financial instruments at fair value, the FHLBanks do not believe that an amendment to hedge accounting is the appropriate means to further that goal. In FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ("SFAS 159"), the Board concluded that it has more work to do before fair value measurement can be required for all financial instruments due to several unresolved issues. Until there is a comprehensive project that addresses the merits of different measurement attributes for financial instruments used in different activities, issues related to fair value accounting for many financial instruments will remain unresolved. Consistent

with the alternative views, the FHLBanks believe a broader project on the accounting for financial instruments is a better way to address the application of fair value accounting.

The FHLBanks believe that convergence between United States generally accepted accounting principles and International Financial Reporting Standards ("IFRS") in the near future is inevitable and appears well supported by the Board as evidenced by the numerous joint projects between the Board and the International Accounting Standards Board ("IASB"), and the recently renewed Memorandum of Understanding between the Board and the IASB. In light of the anticipated convergence, the FHLBanks are unable to support an approach that would result in additional complexity in applying and interpreting the impact of hedge accounting for what may be a temporary change (i.e., the IASB currently permits and may ultimately continue to permit hedging of discrete risks).

As stated previously, the FHLBanks have expended substantial resources to ensure their accounting complies with SFAS 133. The FHLBanks believe that the disclosures required by Statement of Financial Accounting Standards No. 161 *Disclosures about Derivative Instruments and Hedging Activities* ("SFAS 161") will provide users with an enhanced understanding of an entity's objectives for using derivative instruments and the effects of those instruments on the financial statements. Accordingly, the FHLBanks believe it is unreasonable to ask entities to expend the resources to interpret and comply with guidance which diverges from IFRS. Furthermore, for the same reasons stated above, the FHLBanks would not support any proposed changes to IFRS that would result in the elimination of the bifurcation-by-risk approach.

We thank the Board for its consideration of the FHLBanks' views and welcome the opportunity to discuss this matter with the Board and its staff. Please do not hesitate to contact me at (404) 888-8148.

Sincerely,

J. Daniel Counce
First Vice President and Controller
Federal Home Loan Bank of Atlanta
(On behalf of the 12 Federal Home Loan Banks as Chair of the Controllers' Committee)

Appendix A: The FHLBanks' Responses to Other Issues Outlined in the proposed Statement and Other Comments

Hedged Risk

Issue 1: ***For the reasons stated in paragraph A16 of this proposed Statement, the Board decided to eliminate (with two exceptions) the ability of an entity to designate individual risks as the hedged risk in a fair value or cash flow hedge. As a result of that change, the financial statements would reflect information about the risks in the hedged item or transaction that an entity both chooses to manage and not to manage as part of a particular hedging relationship. Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the ability of an entity to designate individual risks and requiring the reporting of the risks inherent in the hedged item or transaction?***

Hedging changes in fair value or probable future cash flows attributable solely to changes in a benchmark interest rate for both assets and liabilities is one of the most common, straightforward and effective hedging strategies used by a multitude of entities. Elimination of this strategy for assets may result in some entities abandoning prudent risk management strategies for which the accounting has been thoroughly vetted and agreed upon by preparers, auditors and regulators. Further, the elimination of this simple and effective strategy will increase the complexity in applying hedge accounting which will only lead to additional complexity in an entity's financial statements and disclosures. This result would impair the usefulness of an entity's financial statements and is inconsistent with the Board's goal of improving financial reporting for hedging activities. For additional information, please refer to the FHLBanks' response in the body of the letter.

Issue 2: ***For the reasons stated in paragraphs A18–A20, the Board decided to continue to permit an entity the ability to designate the following individual risks as the hedged risk in a fair value or cash flow hedge: (a) interest rate risk related to its own issued debt (that is, its liability for funds borrowed), if hedged at inception, and (b) foreign currency exchange risk. For those two exceptions, the financial statements would not reflect information about the risks that an entity chooses not to manage as part of a particular hedging relationship. Do you believe the Board should continue to permit an entity to designate those individual risks as a hedged risk?***

Paragraph 17 of the proposed Statement permits an entity that designates its own issued debt or other borrowings as the hedged item at inception of that debt to designate interest rate risk, foreign exchange risk, or a combination of the two as the hedged risk in a hedging relationship. However, after inception of the debt, an entity may not designate only interest rate risk or a combination of interest rate risk and foreign exchange risk as the hedged risk.

The FHLBanks enter into interest rate swaps to convert fixed rate debt into synthetic floating rate debt. The purpose of this strategy is to adjust the interest rate risk sensitivity of a portfolio of debt to better match the interest rate risk sensitivity of an asset portfolio, which may change over time due to changes in interest rates and prepayment assumptions. This is a simple and prudent strategy that has allowed the FHLBanks to effectively manage interest rate risk. However, as interest rates and the FHLBanks' risk profiles change so does the structure of their asset portfolios and therefore their need for certain debt, including synthetically created variable rate debt, also changes. To address this issue, a FHLBank may terminate a hedging relationship involving a particular debt issue and subsequently designate that debt in a new hedging relationship (i.e., a late hedge).

According to paragraph A19, "the Board believes that entering into a hedging relationship after inception of the debt would not result in synthetically creating variable-rate debt or fixed-rate debt but would result

in either an entity transforming fair value risk to cash flow risk or vice versa for asset/liability management purposes or risk management purposes or an entity taking a position on the future movement of interest rates." The FHLBanks agree with the Board that the strategy is consistent with asset/liability management; however, the current proposal to eliminate this flexibility would create accounting results that are inconsistent with risk management strategies. This would result in additional complexity and inconsistency due to the different methodologies employed within an entity to manage the same risks in different periods as well as different methodologies employed across entities (i.e., hedging only interest rate risk if designated at inception, hedging changes in total fair value if designated later, assuming a relationship would be effective, or not designating the relationship). This is inconsistent with the Board's objectives of simplifying accounting for, and improving financial reporting of, hedging activities.

Furthermore, the "at inception" criterion eliminates an entity's ability to hedge changes in a benchmark interest rate prior to the issuance of debt (i.e., forecasted issuances of debt). The FHLBanks agree that locking in a fixed rate prior to the issuance of debt is done for asset/liability management purposes. However, the FHLBanks fail to understand why this is not a suitable reason for permitting the designation of interest rate risk as the hedged risk and suggest that the Board reconsider the alternative views expressed by the minority of Board members in paragraph A58 of the proposed Statement.

The FHLBanks urge the Board to eliminate the "at inception" criterion for designating interest rate risk as the hedged risk in a hedge of its own issued debt or other borrowings. This would allow for consistency between prudent risk management strategies and accounting results as well as better reflect the economics of these transactions. Additionally, the Board may wish to consider whether enhanced disclosures regarding why entities redesignate hedging relationships may be a more appropriate way to address its concerns.

Hedge Effectiveness

Issue 3: ***Do you foresee any significant operational concerns or constraints in calculating ineffectiveness for fair value hedging relationships and cash flow hedging relationships? Do you believe that the proposed Statement would improve or impair the usefulness of financial statements by eliminating the shortcut method and critical terms matching, which would eliminate the ability of an entity to assume a hedging relationship is highly effective and to recognize no ineffectiveness in earnings?***

Hedging changes in a benchmark interest rate for assets and liabilities is a very common, simple and effective hedging strategy. The shortcut method allows entities to easily adjust the interest rate on assets and liabilities using the simplest form of derivative instruments without having to invest the substantial resources necessary to apply the long-haul method. If the bifurcation-by-risk approach is retained, as suggested by the FHLBanks in the body of the letter, the FHLBanks would be able to transition their shortcut hedging relationships to the long-haul method and would also be able to absorb the additional operational burdens. Further, because these relationships were expected to be highly effective at inception and met all the requirements for the application of the shortcut method, the FHLBanks would expect any ineffectiveness recorded as a result of applying the long-haul method to be insignificant. While the FHLBanks do not believe the elimination of the shortcut method would impair the usefulness of financial statements (assuming the bifurcation-by-risk approach is retained), we do not understand why the Board would elect to eliminate the simplest application of hedge accounting in light of its stated objective to simplify accounting for hedging activities. For hedging relationships that currently meet the qualifications for the shortcut method, the insignificant amount of ineffectiveness that would be recorded using the long-haul method does not warrant the elimination of this approach altogether. If the Board has specific concerns regarding the shortcut method, the Board should consider additional modifications as was done recently in Implementation Issue No. E23, *Issues Involving the Application of the Shortcut Method under*

Paragraph 68. Accordingly, the FHLBanks suggest that the Board reconsider the proposed elimination of the shortcut method.

Issue 4/Question 4a: This proposed Statement would modify the effectiveness threshold necessary for applying hedge accounting from highly effective to reasonably effective at offsetting changes in fair value or variability in cash flows. Do you believe that modifying the effectiveness threshold from highly effective to reasonably effective is appropriate? Why or why not?

The FHLBanks strongly support the Board's intent to lower the threshold for qualifying for hedge accounting and to simplify the current hedge effectiveness requirements under SFAS 133. However, because the proposed Statement does not include an adequate definition of what constitutes demonstrating a sufficient qualitative assessment, including meeting the criteria of being reasonably effective, the FHLBanks are unable to assess the appropriateness of modifying the threshold in the manner suggested.

The proposed Statement requires that at inception of a hedging relationship, an entity shall qualitatively assess the effectiveness by demonstrating the following: (i) an economic relationship exists between the hedging instrument and the hedged item (hedged forecasted transaction) and (ii) changes in the fair value of the hedging instrument would be reasonably effective in offsetting changes in the hedged item's fair value (variability in the hedged cash flows). However, in certain situations, an entity may have to perform a quantitative assessment in order to conclude that the hedging relationship would be reasonably effective.

As described previously, the FHLBanks typically utilize interest rate swaps to convert both assets and liabilities to a variable-rate index such as LIBOR. These derivatives are designed to manage the discrete risk of changes in interest rates, and not all risks of the hedged item. Therefore, the FHLBanks are unclear as to how they would demonstrate that an economic relationship exists between the derivative and all the risks of the hedged item without providing a quantitative assessment of effectiveness. These hedging relationships would likely also require ongoing periodic quantitative assessments of hedge effectiveness similar to those currently being performed under SFAS 133 for long-haul hedging relationships. This would be inconsistent with the Board's objective of simplifying the accounting for hedging activities.

Additionally, because reasonably effective is not defined, it is unclear how the FHLBanks would demonstrate that changes in the fair value of the hedging instrument would be "reasonably effective" in offsetting changes in the fair value of the hedged item. Accordingly, the FHLBanks recommend that the Board provide additional clarification on the meaning of "reasonably effective." Without additional clarification, this terminology is subject to interpretation and could lead to future challenges of an entity's application by auditors, regulators or other authoritative bodies (similar to the interpretation inconsistencies of SFAS 133).

Further, the FHLBanks suggest that the Board provide some criteria or guidelines in the final statement that will assist entities in determining when only a qualitative evaluation is necessary. Such guidelines might include some of the criteria set forth in paragraphs 65 and 68 of SFAS 133 (e.g., matching of critical terms). The FHLBanks believe that supplemental guidelines would be helpful to avoid divergence in practice because auditors and regulators may develop differing opinions with regard to when quantitative assessments are necessary, which could lead to future challenges of an entity's application of the guidance.

The FHLBanks also suggest that the final statement include additional examples illustrating when a qualitative assessment is sufficient and when it is not for some of the most common hedging strategies utilizing interest rate swaps. At a minimum, these examples should include: (1) an interest rate swap converting callable, fixed rate debt to floating; (2) an interest rate swap converting fixed rate debt

(qualifying for a hedge of the interest rate risk only) to floating (or floating rate debt to fixed); and (3) an interest rate swap converting fixed rate debt (not qualifying for a hedge of the interest rate risk only) or a fixed rate financial asset to floating. The examples should illustrate situations in which qualitative assessments are sufficient, situations that would require quantitative assessments, and situations requiring subsequent assessments. The final statement could explicitly state that the examples illustrate the application of the underlying principles and are not intended to illustrate all acceptable applications.

Issue 4/Question 4b: For situations in which interest rate risk is currently designated as the hedged risk for financial instruments but would no longer be permitted under this proposed Statement (except for an entity's own issued debt at inception), do you believe you would continue to qualify for hedge accounting utilizing your current hedging strategy?

This will depend in part on the definition of reasonably effective. For additional information, please refer to the FHLBanks' response in the body of the letter.

Issue 4/Question 4c: If not, would you (a) modify your hedging strategy to incorporate other derivative instruments, (b) stop applying hedge accounting, (c) elect the fair value option for those financial instruments, or (d) adopt some other strategy for managing risk?

As previously described, the FHLBanks primarily utilize interest rate swaps to hedge the interest rate risk in financial assets (primarily advances) and consolidated obligations. If the bifurcation-by-risk approach is eliminated, each of the FHLBanks would have to re-evaluate their financial and risk management strategies to assess potential alternatives that may be available to maintain their current hedging objectives and minimize volatility in earnings as well as the operational burdens. The time and effort to perform these evaluations will be significant for the FHLBanks. Accordingly, it is not possible for the FHLBanks to complete this process prior to the comment deadline of the proposed Statement. However, the FHLBanks are certain that the elimination of the bifurcation-by-risk approach (in most cases) will result in earnings volatility that is not representative of the FHLBanks' ability to manage interest rate risk. This volatility and potential for volatility are the primary reasons that the FHLBanks did not elect to transition the majority of hedged items in SFAS 133 hedging relationships to the fair value option upon adoption of SFAS 159, *The Fair Value Option*, and are not utilizing the fair value option extensively today.

Issue 5/Question 5a: Do you foresee any significant operational concerns in creating processes that will determine when circumstances suggest that a hedging relationship may no longer be reasonably effective without requiring reassessment of the hedge effectiveness each reporting period?

Assuming additional clarity is provided for determining when a qualitative assessment is sufficient and a quantitative assessment is not required, the FHLBanks do not foresee any significant operational issues in determining when circumstances would suggest that a hedging relationship may no longer be reasonably effective. However, if the final statement eliminates the bifurcation-by-risk approach (in most cases), the number of hedging relationships where a qualitative effectiveness evaluation alone will suffice may be very limited. As described previously, the FHLBanks typically utilize interest rate swaps to manage the discrete risk of changes in interest rates, and not all risks associated with the hedged item. Therefore, the FHLBanks would likely need to continue performing quantitative assessments on a regular basis in order to be able to assert that the change in fair value of an interest rate swap would be reasonably effective in offsetting the change in the overall fair value of the hedged item. This continued performance of a periodic quantitative assessment would not be consistent with the Board's objective of simplifying the accounting for hedging activities.

Issue 5/Question 5b: 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? If so, why?

As discussed above, if the final statement eliminates the bifurcation-by-risk approach (in most cases), the FHLBanks would likely need to continue performing quantitative assessments on a regular basis to the extent they elect to apply hedge accounting as contemplated in the proposed Statement. Despite the elimination of the bifurcation-by-risk approach, it is likely that some of the FHLBanks will continue to manage their interest rate risk exposures in a similar manner. Without the ability to purchase derivatives that would hedge changes in the overall fair values of hedged items, the FHLBanks would have to designate interest rate swaps in overall fair value hedging relationships, assuming it could be demonstrated at inception that the interest rate swap would be reasonably effective at hedging total changes in the fair value of the hedged item. Because interest rate swaps are designed to manage the discrete risk of changes in interest rates, and not all risks of the hedged item, it is likely that this hedging strategy would be less effective than the FHLBanks' current benchmark hedging strategies and, accordingly, the FHLBanks would expect an increase in the number of discontinued hedging relationships.

Issue 6: Do you agree with the Board's decision to continue to require that hedge accounting be discontinued if a hedge becomes ineffective? Alternatively, should an effectiveness evaluation not 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?

In order to meet the Board's objective of simplifying hedge accounting, the Board should retain the bifurcation-by-risk approach, and the final statement should not include a requirement to evaluate effectiveness under any circumstances after inception of a hedging relationship if it had been determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term. If the bifurcation-by-risk approach is eliminated, the final statement should include a requirement to evaluate effectiveness only in the event that circumstances change such that the relationship may no longer be expected to be reasonably effective over the remaining hedge term.

Presentation of Hedging Gains and Losses

Issue 7/Question 7: Do you believe that Statement 133 should be amended to prescribe the presentation of these amounts? For example, the Statement could require that the effective portion of derivatives hedging the interest rate risk in issued debt be classified within interest expense and that the ineffective portion and any amounts excluded from the evaluation of effectiveness be presented within other income or loss.

It is not necessary to record the effective and ineffective portions of a derivative in separate line items in the income statement. Presumably, the effective portion of the derivative is offset by the change in fair value of the hedged item and therefore only the ineffective portion is reflected in earnings. Currently, the FHLBanks record any ineffectiveness in other income (loss). The FHLBanks would, however, appreciate the Board addressing the income statement geography of net interest settlements associated with derivatives that are not designated in hedging relationships under SFAS 133. The FHLBanks are not aware of any specific literature which addresses the presentation of these amounts and have historically recorded these amounts in other income or expense consistent with the recognition of any gain or loss on the derivative. However, if an entity has entered into an interest rate swap, regardless of whether the swap has been designated in a qualifying hedging relationship or was entered into to effectively hedge interest rate risk associated with a financial instrument for which the fair value option has been elected, net

interest settlements should be recorded in interest income or expense consistent with the underlying economics of the transaction. This is of particular concern for financial institutions. In contrast to many other industries, interest income and interest expense are not "other income" for financial institutions. They are the primary revenue and expense items and like other industries, financial institutions manage their businesses with the goal of increasing revenues and decreasing expenses (i.e., increasing their margin). Requiring entities to record net interest settlements on derivative instruments in other income or expense does not faithfully represent a financial institution's net interest income. Therefore, the FHLBanks request that the Board address the income statement presentation of net interest settlements for derivatives that are not designated in hedging relationships.

Effective Date and Transition

Issue 8: The Board's goal is to issue a final Statement by December 31, 2008. The proposed Statement would require application of the amended hedging requirements for financial statements issued for fiscal years beginning after June 15, 2009, and interim periods within those fiscal years. Do you believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement? Why or why not?

Effective Date

Due to the complexity of the proposed changes to hedge accounting, the FHLBanks do not believe that the proposed effective date would provide enough time for entities to adopt the proposed Statement. If the final statement is substantially the same as the proposed Statement, the magnitude and nature of the proposed amendments will require entities to develop new risk management strategies, interpret and implement new guidance, modify policies and procedures and develop and/or change internal controls, which will require a substantial amount of time. Because the FHLBanks are cooperatives and are federally regulated any such actions could not be easily or quickly undertaken. Further, because of the lack of clarity in several areas of the proposed Statement (e.g., the definition of "reasonably effective" and quantitative assessment requirements), considerable time will be needed to evaluate the guidance with auditors and regulators to ensure consistent interpretation. Accordingly, the FHLBanks recommend that the Board extend the effective date of the proposed Statement.

Transition

The FHLBanks urge the Board to reconsider the transition guidance provided in paragraph 32. Paragraph 32 states, "At the date of initial application, an entity shall dedesignate, with one exception, all hedging relationships designated under Statement 133.... An entity is not required to dedesignate a hedging relationship if the designated risk or risks being hedged are permitted before and after the effective date of this Statement (such as benchmark interest rate risk hedges of an entity's own debt)." Under this guidance, if an entity is hedging changes in fair value due to changes in a benchmark interest rate and upon adoption will utilize the same derivative to hedge the overall changes in the fair value of the hedged item, an entity would be required to dedesignate and redesignate the hedging relationship. At adoption, the carrying amount of the hedged item will include an amount which reflects the cumulative effect of changes in fair value that are attributable to changes in a benchmark interest rate (i.e., a basis adjustment). Paragraph 24 of SFAS 133 requires an entity to begin amortizing such an adjustment no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. The FHLBanks are unclear how to apply this guidance to a newly redesignated hedging relationship where the risk being hedged has changed from only interest rate risk to the risk of changes in overall fair value. Amortization of the basis adjustment would result in a one-time adjustment to earnings upon maturity of the hedged item which could be significant. To illustrate this point, assume the carrying value of an advance equals its overall fair value at adoption (i.e., the cumulative basis adjustment equals the

total change in fair value). Because advances are generally issued and mature at par, the basis adjustment would naturally reverse as changes in fair value are recorded over the remaining life of the advance. If the basis adjustment is also amortized, at maturity the carrying value will differ from the fair value by the amount of the basis adjustment (i.e., the basis adjustment will have effectively been reversed twice). Upon receipt of the fair value at maturity, a gain or loss equal to the basis adjustment would be recognized. In addition, such amortization would result in a substantial operational burden and would not result in the hedged item being recorded at fair value throughout the life of the hedging relationship. For these reasons, and because the hedged item will continue to be adjusted for changes in its fair value (a component of which will include changes that are attributable to changes in interest rates), the FHLBanks request the Board consider permitting an exception from the amortization requirements of paragraph 24 for such relationships.

In addition to the exception discussed in the preceding paragraph, if the final statement eliminates benchmark interest rate risk hedges of certain instruments, the FHLBanks recommend that the Board also consider revising the transition guidance in paragraph 33, which states, "This Statement does not require any adjustments to the statement of financial position on the date of initial application for fair value hedges." For hedged items designated in full fair value hedging relationships that were previously designated in benchmark interest rate risk hedging relationships there will be a difference between the overall fair value of the hedged item and its current carrying value at the time of adoption (i.e., the cumulative basis adjustment will not equal the total change in fair value). Paragraph 19 requires an entity to record the change in the overall fair value of the hedged item as an adjustment to its carrying amount and recognize that change in earnings during the hedge period. Because the difference between the carrying value and the overall fair value at the time of adoption is not the result of the change in overall fair value during the hedge period, but rather is the cumulative change in fair value not recognized under the previous hedging relationship, the proposed Statement does not appear to address the treatment of this difference. Because there is no guidance, differing accounting may be applied. For example, some entities may assume they should amortize this difference to earnings over the remaining life of the hedged item, while others may choose to recognize it upon maturity of the hedged item, resulting in a one-time adjustment to earnings which could be significant. Therefore, the FHLBanks recommend that the final statement require a transition adjustment whereby the hedged item is adjusted to its overall fair value with the adjustment recorded directly to retained earnings. This treatment would be consistent with the requirement in paragraph 38 for entities electing to account for assets or liabilities at fair value under SFAS 159. In addition, this cumulative-effect type adjustment would avoid (i) the substantial operational burden of capturing and amortizing this difference for each hedged item where the hedged risk has changed, or alternatively (ii) the impact of this difference being recorded through earnings at maturity of the hedging relationship, neither of which would result in the hedged item being recorded at fair value throughout the life of the hedging relationship.

Issue 9: The Board did not prescribe any specific transition disclosures upon the adoption of this Statement. Do you believe that there are specific disclosures that should be required during transition? If so, what? Please be specific as to how any suggested disclosures would be used.

As discussed previously, the FHLBanks believe that the disclosures required by SFAS 161 will provide users with an enhanced understanding of an entity's objectives for using derivative instruments and the effects of those instruments on the financial statements. Accordingly, the FHLBanks do not believe that additional disclosures are necessary during transition. Furthermore, in light of the requirements of SFAS 161, the FHLBanks believe that the additional disclosures required by paragraph 29 of the proposed Statement are unnecessary and that the costs of developing systems and processes to provide the information required by paragraphs 29b and 29c would outweigh any benefits of the information provided.

Issue 10: Do you agree with the Board's decision to allow a one-time fair value option at the initial adoption of this proposed Statement? Do you agree with the Board's decision to limit the option to assets and liabilities that are currently designated as hedged items under Statement 133?

The FHLBanks support the Board's decision to allow a one-time fair value option at the initial adoption of the proposed Statement. However, the option should not be limited to assets and liabilities that are currently designated as hedged items under SFAS 133 but rather should be provided for all items which would be eligible as hedged items under SFAS 133. This would provide for a more comprehensive approach to managing risk, rather than managing risk separately for hedged items and items not in a hedging relationship on the date immediately preceding initial application of the proposed Statement. Additionally, this would provide an opportunity to account for similar assets and liabilities consistently (i.e., an entity could elect the fair value option for all eligible assets and/or all eligible liabilities).

Benefit-Cost Considerations

Issue 11: Do you believe the Board identified the appropriate benefits and costs related to this proposed Statement? If not, what additional benefits or costs should the Board consider?

Paragraph A44 lists perceived benefits from the proposed Statement including financial statements being more representative of the economics of instruments included in hedge accounting and comparability of financial statements between entities. As described previously, despite the elimination of the bifurcation-by-risk approach (in most cases), it is likely that the FHLBanks will continue to manage their businesses by hedging interest rate risk through the use of interest rate swaps. This will require the FHLBanks to recognize effects of market influences that are unrelated to their hedging activities and the economics of the transactions will not be faithfully represented in the financial statements. Rather, the FHLBanks' intention and ability to effectively hedge changes in interest rate risk will be indistinguishable. Further, the proposed Statement would result in reduced comparability because there would be different methodologies employed within an entity to manage the same risks in different periods as well as different methodologies employed across entities (i.e., hedging only interest rate risk for liabilities, if designated at inception, versus hedging changes in total fair value if designated later, assuming a relationship would be effective, or not designating the relationship).

Paragraphs A45 through A50 discuss the costs of complying with the proposed Statement. Absent from this discussion are the substantial costs involved in analyzing the FHLBanks' cooperative business models to determine how to mitigate earnings volatility due to the proposed elimination of the bifurcation-by-risk approach. Additional costs that must be considered include dedesignating existing hedging relationships and performing initial qualitative effectiveness assessments of newly redesignated hedging relationships as well as the costs that will be incurred by financial statement preparers and accounting firms struggling to interpret the new provisions because the proposed Statement introduces, rather than eliminates, complexity in several areas.

In light of the anticipated convergence with IFRS, the FHLBanks are unable to support an approach that would result in additional complexity in applying and interpreting the impact of hedge accounting for what may be a temporary change (i.e., the IASB may ultimately reach different conclusions than the FASB). Entities will be forced to incur the substantial costs of interpreting and implementing new guidance, modifying policies and procedures, developing and/or changing internal controls, as well as the potential costs of changing asset/liability and risk management practices for what may be a temporary change in accounting. The FHLBanks do not believe that the benefits of the proposed Statement would outweigh these costs.

Other Comments

Dedesignation/Redesignation

The FHLBanks believe that the proposed conditions for a permissible dedesignation are unnecessarily restrictive and would eliminate the use of certain practical and effective hedging strategies. When hedging duration and convexity resulting from the prepayment risk associated with mortgage loans, some FHLBanks utilize dynamic or delta hedging strategies to hedge their net interest exposure attributable to a pool of mortgage loans and the related funding. Because SFAS 133 requires hedge accounting to be applied at a transaction level, a transaction is selected to represent the portfolio risk for designation purposes. As changes occur in the risk profile of the underlying mortgage assets and the related debt, new hedging relationships are established and existing hedging relationships are dedesignated. The proposed Statement provides that terminating the hedging instrument or entering into an offsetting derivative instrument are means by which an entity may effectively dedesignate a hedging relationship. However, in many situations, these may not be feasible alternatives. For example, terminating a derivative may have significant negative liquidity impacts as a result of having to settle a derivative liability prior to its scheduled maturity; entering into an offsetting derivative is a costly expense which is unnecessary when an existing derivative may be reused and possibly redesignated for other purposes including risk management in a qualifying hedging relationship. Additionally, the FHLBanks disagree with the Board's basis for conclusions regarding dedesignation. Because hedging relationships must be designated in advance of market movements, the FHLBanks do not understand how an earnings recognition-based intent could ever be realized. Accordingly, rather than restrict prudent risk management strategies, the FHLBanks suggest the Board consider whether enhanced disclosures regarding why entities redesignate and/or dedesignate hedging relationships may be a more appropriate way to address its concerns.