🔭 Chicago FHLB

November 14, 2008

LETTER OF COMMENT NO. 7



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

File Reference: 1610-100 Exposure Draft

Accounting for Transfers of Financial Assets - an Amendment of FASB

Statement No. 140

Dear Mr. Golden:

The Federal Home Loan Bank of Chicago ("FHLBC") appreciates 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 Transfers of Financial Assets - an Amendment of FASB Statement No. 140 (hereinafter referred to as the "proposed Statement").

The FHLBC's responses to other issues outlined in the proposed Statement are presented in Appendix A.

Background Information—FHLBC

The Federal Home Loan Bank of Chicago is a federally chartered corporation and one of 12 Federal Home Loan Banks (the "FHLBs") that with the Office of Finance, comprise the Federal Home Loan Bank System (the "System"). The FHLBs are government-sponsored enterprises ("GSE") of the United States of America and were organized under the Federal Home Loan Bank Act of 1932, as amended ("FHLB Act"), in order to improve the availability of funds to support home ownership. Each FHLB operates as a separate entity with its own management, employees, and board of directors. Each FHLB is a member-owned cooperative with members from a specifically defined geographic district. Our defined geographic district consists of the states of Illinois and Wisconsin.

We provide credit to members principally in the form of secured loans called "advances." We also provide funding for home mortgage loans to members approved as Participating Financial Institutions ("PFIs") through the Mortgage Partnership Finance ("MPF") Program.

These programs help us accomplish our mission to deliver value to our members, and promote and support their growth and success, by providing:

highly reliable liquidity;

[&]quot;Mortgage Partnership Finance," "MPF," "MPF Shared Funding," and "eMPF" are registered trademarks and "MPF Xtra" is a trademark of the Federal Home Loan Bank of Chicago.

- secured advances, wholesale mortgage financing, and other products and services designed to meet members' needs; and
- direct financial support for members' affordable housing and community investment programs.

Background Information - Overview of MPF Program

The MPF Program is designed to allocate the risks of MPF Loans among the FHLBanks and its members or participating financial institutions ("PFIs) and to take advantage of their respective strengths in managing these risks. PFIs have direct knowledge of their mortgage markets and have developed expertise in underwriting and servicing residential mortgage loans. By allowing PFIs to originate MPF Loans, whether through retail or wholesale operations, and to retain or acquire servicing of MPF Loans, the MPF Program gives control of those functions that most impact credit quality to PFIs. The MPF Banks are responsible for managing the interest rate risk, prepayment risk, and liquidity risk associated with owning MPF Loans.

Under the MPF Program, FHLBanks purchase conforming conventional and government fixed-rate mortgage loans secured by one-to-four family residential properties with maturities from five to 30 years or participations in such mortgage loans. FHLBanks do not purchase or fund sub-prime or non-traditional mortgages through the MPF Program. The transfer by PFIs to FHLBanks is accounted for as a sale under SFAS 140.

Finance Board regulations require that MPF Loans be credit enhanced so that FHLBank risk of loss is limited to the losses of an investor in an AA rated mortgage-backed security, unless the FHLBank maintains additional retained carnings in addition to a general allowance for losses. PFIs account for these credit enhancements as financial guarantees rather than credit derivatives pursuant to FAS 133, paragraph 10d.

The FHLBank and PFI share the risk of credit losses on MPF Loans by structuring potential losses on conventional MPF Loans into layers with respect to each master commitment. The FHLBank is obligated to incur the first layer or portion of credit losses not absorbed by the borrower's equity and after any primary mortgage insurance ("PMI") which is called the First Loss Account ("FLA"). The FLA functions as a tracking mechanism for determining the point after which the PFI, in its role as credit enhancer, would be required to cover losses. The FLA is not a cash collateral account, and does not give an FHLBank any right or obligation to receive or pay cash or any other collateral. For MPF products with performance based CE Fees, the FHLBank may withhold CE Fees to recover losses at the FLA level essentially transferring a portion of the first layer risk of credit loss to the PFI.

Need to Clarify Definition of Participating Interest

Under the proposed Statement, we believe that clarification is required so that it is clear that a transfer of a whole loan with a credit enhancement from a PFI to an FHLBank is not governed by the sales accounting conditions for participating interests. We are concerned that the credit enhancement held by the PFI may be viewed as a participating interest involving recourse. As such, on the surface, one may think that a secured borrowing should be recorded. We do not believe this would be appropriate nor do we believe that this was the FASB's intent. Accordingly, we believe that the definition of a participating interest needs to be clarified such that the sales accounting conditions related to participating interest would not apply when a new

financial asset is obtained in a whole loan sale. Please refer to our response to Issue 1 in Appendix A for a more detailed discussion.

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 (312) 565-5714.

Sincerely,

Koser D Kundstrom (ii)

Executive Vice President and Chief Financial Officer

Federal Home Loan Bank of Chicago

Appendix A: Specific Issues for Comment

Proposed Statement does not meet FASB's Objective

1. Will the proposed Statement meet the project's objective to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about (a) a transfer of financial assets, (b) the effects of a transfer on its financial position, financial performance, and cash flows, and (c) a transferor's continuing involvement in transferred financial assets?

Response:

We do not believe the proposed Statement meets the project's objective to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about (a) a transfer of financial assets, (b) the effects of a transfer on its financial position, financial performance, and cash flows, and (c) a transferor's continuing involvement in transferred financial assets. In particular, we believe that the objective is not met for the following reasons:

- It does not provide an integrated consistent derecognition accounting model for transfers of financial assets.
- It needs to clarify definition of participating interest.
- It creates a fair value measurement issue for certain transactions.
- It does not distinguish between financial guarantees and secured borrowings.

Each of these points is discussed in further detail below.

Need for Integrated Consistent Derecognition Accounting Model

We strongly recommend that a global derecognition project is needed similar to the FAS 157 fair value measurement project. Currently, several derecognition models exist under general accepted accounting principles that are inherently inconsistent with the proposed Statement. Outlined below are a few examples. Although some of the examples do not relate to transfers of financial assets, we believe derecognition accounting principles should be consistent for financial and nonfinancial assets.

• FIN 46 R and the proposed revision to FIN 46 R. We believe that derecognition accounting principles should be applied consistently to transfers of financial assets and variable interest entities. In particular, we believe that sales accounting conditions under the proposed Statement should be integrated with the qualitative and quantitative derecognition conditions applicable to variable interest entities. For example, the primary variable interest holder in the transferred financial asset or beneficial interest would be responsible for recognizing the financial asset on its balance sheet. Under such an approach, if the transferor retains recourse and such recourse made it the primary variable interest holder (e.g. they hold a subordinate interest and the amount of recourse is significant enough such that they have the majority risk in potential losses), derecognition would not be allowed. Active versus passive control of the financial asset also would need to be considered. In contrast, if the transferor retains recourse but is able to meet the legal isolation test (i.e. recourse is not significant) in the proposed Statement

(i.e., paragraph 9a) or alternatively, if transferee's is considered the primary variable interest holder because of the risks and rewards it has with respect to the transferred financial assets relative to those of the transferor, then the transferor would deconsolidate. The advantage of such an integrated approach is consistent accounting for similar situations – that is, based on the current FASB thinking, derecognition would not be allowed if there is any recourse related to participating interests but may be allowed for a variable interest holder in the same financial assets.

- On May 29, 2008, the FASB has issued a Preliminary Views document, "The Reporting Entity," that explores which model is appropriate for consolidating an entity control model, risks and rewards model or a common control model. It would seem appropriate to develop a derecognition model that is consistent with the consolidation model that is, if consolidation is not appropriate then derecognition is appropriate.
- EITF Issue No. 95-5, "Determination of What Risks and Rewards, If Any, Can Be Retained and Whether Any Unresolved Contingencies May Exist in a Sale of Mortgage Loan Servicing Rights," reached the consensus shown in the excerpt below. The consensus has a de minimis threshold ("substantially all" and minor and can be estimated) which is not available under the proposed Statement. We believe that such a threshold is appropriate as even a nominal amount of recourse could result in secured borrowing treatment.

Excerpt from EITF Issue No. 95-5

"The Task Force reached a consensus that sales of rights to service mortgage loans should be recognized when the following conditions have been met: (1) title has passed, (2) substantially all risks and rewards of ownership have irrevocably passed to the buyer, and (3) any protection provisions retained by the seller are minor and can be reasonably estimated. If a sale is recognized and minor protection provisions exist, a liability should be accrued for the estimated obligation associated with those provisions. The seller retains only minor protection provisions if (a) the obligation associated with those provisions is estimated to be no more than 10 percent of the sales price and (b) risk of prepayment is retained for no longer than 120 days."

- Statement of Financial Accounting Standards No. 28 (As Amended), "Accounting for Sales with Leasebacks," allows sales accounting in a participating interest if the interest is minor leaseback.
- Statement of Financial Accounting Standards No. 66 (As Amended), "Accounting for Sales of Real Estate," has a concept of substantially all of the risks and rewards that is, it does not have a no involvement bright line as the proposed Statement does. Further, SFAS 66, paragraph 28, indicates that a seller may guarantee a return for a limited time and that sale accounting is appropriate once the guarantee ends. The proposed Statement does not contemplate what the accounting should be if the credit enhancement is no longer owed by the PFI. For example, if the PFI recorded a secured borrowing and subsequently satisfied its entire obligation under the credit enhancement (i.e. as a result of incurred losses), then it should derecognize the financial assets transferred at that time.

Need to Clarify Definition of Participating Interest

Under the proposed Statement, we believe that clarification is required so that it is clear that a transfer of a whole loan with a credit enhancement from a PFI to an FHLBank is not governed by the sales accounting conditions for participating interests. We are concerned that the credit enhancement held by the PFI may be viewed as a participating interest involving recourse. As such, on the surface, one may think that a secured borrowing should be recorded. We do not believe this would be appropriate nor do we believe that this was the FASB's intent. Accordingly, we believe that the definition of a participating interest needs to be clarified such that the sales accounting conditions related to participating interest would not apply when a new financial asset is obtained in a whole loan sale. In particular, FASB 140 Implementation Guide, question 68, excerpt of proposed revision shown below, indicates that the source of cash flows should determine whether a beneficial interest in a financial asset is obtained versus when a separate liability is incurred. Under both the MPF Loan Program and the MPP Loan Program, the PFI is obtaining a new financial asset (i.e., obtaining a beneficial interest in the transferred financial asset pursuant to proposed revision to question 68) when it makes a whole loan sale rather than retaining a participating interest in the transferred financial asset. As a result, we believe that clarification is needed to distinguish whole loan sales, in which a new financial asset (i.e., the beneficial interest) is obtained, from a transfer of a participating interest in a financial asset, which results in a portion of the transferred financial asset being retained by the transferor. In summary, we believe that it was not the FASB's intent to make whole loan sales transactions subject to the participating interest sales accounting conditions. Accordingly, our request is for the FASB to explicitly state that whole loan sales are not subject to the participating interest sales accounting conditions.

68. Q—What should the transferor consider when determining whether retained credit risk is a separate liability or part of a beneficial interest that eontinues to be held has been obtained by the transferor? [Revised 3/06; X/08.]

A—The transferor should focus on the source of cash flows in the event of a claim by the transferee. If the transferee can only "look to" cash flows from the underlying financial assets, the transferor has retained-obtained a portion of the credit risk only through the interest it continues to hold obtained and a separate obligation should not be recognized. Credit losses from the underlying assets would affect the measurement of the interest that the transferor obtained continues to hold. In contrast, if the transferor could be obligated for more than the cash flows provided by the interest it continues to hold obtained and, therefore, could be required to "write a check" to reimburse the transferee for credit-related losses on the underlying assets, the transferor would record a separate liability rather than an asset valuation allowance on the date of the transfer. [Revised 3/06; X/08.]

Fair Value Measurement Issue

As previously discussed, by allowing PFIs to originate MPF Loans, whether through retail or wholesale operations, and to retain or acquire servicing of MPF Loans, the MPF Program gives control of those functions that most impact credit quality to PFIs. The MPF Banks are responsible for managing the interest rate risk, prepayment risk, and liquidity risk associated with owning MPF Loans. If the transfer by the PFIs is accounted for as a secured borrowing, the PFIs will have a mortgage asset that they do not control and for which they do not have market risk. We believe this creates a fair value measurement issue. Specifically, would representational faithfulness exist if a PFI were to carry these loans at fair value when they do not have control over them to sell them and they do not have market risk for them? We do not believe it is. This is why, as discussed below, we believe the credit enhancement should be accounted for as a guarantee.

Need to Distinguish Financial Guarantees from Secured Borrowings

We believe the element of control over an asset cannot be ignored when determining the accounting for a credit enhancement. Under the MPF Program, the FHLBank controls the mortgage loans. The PFI has no right or obligation to repurchase the mortgage loans, except when standard representations and warranties are not met. Further, the PFI has no ability to sell the mortgage loans. We also believe that the PFI has meet all the sales accounting conditions under the current Statement 140 (e.g., legal isolation, etc.). As a result, we do not believe it is appropriate for a PFI to continue to report the transferred assets on its books and treat the transfer as a secured borrowing. Instead, we believe the PFI has made a financial guarantee and should account for its credit enhancement to FHLBanks as such.

2. Do you agree with the Board's decisions to eliminate the qualifying SPE concept and to require that all securitization entities be evaluated for consolidation under applicable U.S. generally accepted accounting principles? If not, why not?

Response:

We agree with the Board's decision to eliminate the qualifying SPE concept as it will allow for a consistent derecognition accounting model for similar transactions.

3. Certain financial statement users suggested that the Board adopt a no continuing-involvement model (that is, if there is *any* continuing involvement, sale accounting would not be permitted). The Board decided to continue to permit derecognition of financial assets with continuing involvement as long as the conditions in paragraph 9 of Statement 140, as amended by this proposed Statement, are met, with the addition of enhanced disclosure requirements about a transferor's continuing involvement (see paragraph A28 of this proposed Statement). Do you agree with this decision? If not, why do you disagree and what approach would you recommend to meet the needs of financial statement users for additional information on transferred financial assets?

Response:

We agree with the Board's decision. Specifically, we do not believe that a no continuing-involvement model is appropriate. Further, we believe that the continuing involvement model needs to be consistent across all asset transfer transactions. This is why we support a global integrated consistent derecognition accounting model.

4. What costs do you expect to incur if the Board were to issue this proposed Statement in its current form as a final Statement? How could the Board further reduce the costs of applying these requirements without significantly reducing the benefits?

Response:

5. The Board decided to establish specific conditions for reporting a transfer of a portion of a financial asset as a sale. A transfer of a portion of a financial asset as a sale is eligible for derecognition only for a pro rata portion that meets the definition of a participating interest. Do you agree with this decision? If not, why do you disagree? If you agree with the Board's decision to limit the portions of a financial asset that are eligible for derecognition, do you agree with the

definition of a participating interest? If not, what alternative definition do you recommend and why?

Response:

We do not agree with the Board's decision. As discussed in our cover letter, we believe a global derecognition model is required that is consistently applied to all transactions. If the Board concludes that such a definition is required, we recommend that the definition of a participating interest needs to be clarified. Specifically, we request the FASB to explicitly state that whole loan sales are not subject to the participating interest sales accounting conditions. Please refer to our cover letter for a detailed discussion.

6. Paragraph 9(c) of Statement 140 and the related implementation guidance, as amended by this proposed Statement, require that the transferor (a) not maintain effective control over transferred financial assets to account for a transfer as a sale and (b) provide examples of effective control. The Board decided to incorporate many of the concepts from paragraph 9(b) of Statement 140 into paragraph 9(c), which results in the creation of the additional examples that are included in paragraphs 9(c)(3) and 9(c)(4). Do you believe that paragraph 9(c) of Statement 140 and the related implementation guidance, as amended by this proposed Statement, clearly explain how to determine if the transferor maintains effective control? If not, what additional guidance or examples are necessary? Do you believe that paragraph 9(c), as amended by this proposed Statement, is operational in its entirety in its current form? If not, what changes are necessary? Do you believe these additional examples of effective control in paragraphs 9(c)(3) and 9(c)(4) are operational in their current form? If not, what changes are necessary?

Response:

7. Certain financial statement users strongly recommended that the Board provide disclosure principles and require certain specific disclosures for both transferred financial assets treated as sales and those that are treated as secured borrowings. Do you agree that additional disclosures about transferred financial assets are necessary and operational? If not, what changes would you make to the requirements? Do you believe that the revisions to the disclosure requirements are sufficient? If not, what additional disclosures do you believe are necessary?

Response:

8. Appendix C includes significant amendments. primarily as a result of this proposed Statement, to related literature including (a) the FASB Special Report, A Guide to Implementation of Statement 140 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, (b) certain Emerging Issues Task Force (EITF) Issues and Topics, and (c) certain AICPA Audit and Accounting Guides. Do you agree that the related literature, as amended, is consistent with the proposed amendments to Statement 140? If not, why do you disagree and what changes would you make?

Response:

9. Due to differences in financial statement user needs and cost-benefit considerations, should any differences exist for recognition, measurement, disclosure, transition, or effective date for private companies? If yes, please articulate what differences should exist and the reasons for those differences.

Response:

Other Comments

We can appreciate the Board's concern for income manipulation with respect to the current accounting for guaranteed mortgage securitizations – that is, the ability to shift from a loan carried at amortized cost to an investment security carried at fair value. However, we still believe that a guaranteed mortgage securitization still transforms the loans into an investment security – that is, such securitized loans would meet the definition of a security pursuant to FAS 115, paragraph 137. Accordingly, we believe that reclassification of such loans to investment securities is appropriate. However, to address the Board's concern, we would agree that a servicing asset or liability should not be created. Further, the Board could limit the securities to the lower of cost or fair value similar to how loans held for investment are accounted for when they are transferred to loans held for sale.