



REGULATORY INTERPRETATION 2000-RI-09

Date: July 26, 2000

Subject: Accounting Issues: Hedge Accounting - Shortcut Method

Request Summary:

This is an interpretation of 12 CFR § 985.6(b)(1) of the Federal Housing Finance Board (Finance Board) regulations, which requires that the scope, form and content of the Federal Home Loan Bank (Bank) System's combined financial reports be consistent with the requirements of Securities and Exchange Commission (SEC) Regulations S-K and S-X (17 CFR parts 229 and 210). In addition, section 989.3 of the Finance Board's regulations requires each Bank to provide the preparer of the System's combined reports with financial and other information the preparer may request to facilitate the preparation of such reports. The Banks have asked the Finance Board to issue a "no-objection" letter to their election to use the "shortcut" method of hedge accounting (under paragraph 68 of Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*). This particular use of the shortcut method would apply to callable consolidated obligations that the Banks hedge with interest-rate swaps that have associated up-front fees. The Banks seek to adopt any of three alternatives that their independent auditor, PricewaterhouseCoopers (PwC), has indicated is acceptable under SFAS 133 and to which the Banks have agreed. The Banks also request a "no-objection" letter to implement any other alternative accounting for swapped callable debt that is mutually agreed upon between the Banks and PwC.

Background:

SFAS 133 requires certain standards of hedge effectiveness to be met if an entity seeks to claim that the change in the fair value of the hedge exactly offsets the change in the fair value of the hedged item. If this is the case, then the hedge has no income statement effect. The "shortcut" method deals with the documentation required to prove or assert hedge effectiveness. Entities can use the "long-haul" method as an alternative means of demonstrating hedge effectiveness. For entities that fail to assert effectiveness under the shortcut method or fail to demonstrate effectiveness under the long-haul method, derivatives can result in significant earnings volatility.

The requested regulatory interpretation deals only with swapped callable bonds. There is no ambiguity about the conditions under which the Banks can use the shortcut method for the derivatives associated with non-callable bonds. Furthermore, the requested interpretation deals only with a portion of the callable bonds of the Banks because a growing portion of the callable debt issuance is not swapped. For example, the Banks use non-swapped callable debt to fund a portion of MPF™ loans.

PwC was unable to determine with certainty that the Bank System's swapped callable debt would be eligible for the shortcut method because paragraph 68(b) of SFAS 133 requires that the fair

value of a swap must be zero at inception of the hedge. The Banks receive an up-front fee from counterparties on the interest-rate swaps associated with their callable debt. The up-front fee usually exactly offsets the concession paid to the underwriter of the bond. PwC believes these fees could render the swap ineligible for the shortcut method because at inception of the hedge the fair value of the swap is not zero.

PwC discussed with the Banks three alternatives that it believes would better qualify the transactions for the shortcut method of accounting under paragraph 68(b) of SFAS 133. These alternatives are:

1. Restructuring the swap to change the date of the payment of the fee to sometime after the settlement date.
2. Restructuring the swap to eliminate the fee.
3. Restructuring the swap into two different legal contracts - one is a market rate loan for the fee and the other is a market-rate swap.

PwC has placed additional requirements on the Banks to obtain PwC's concurrence about the use of the shortcut method for swapped callable debt transactions. One requirement is that the Banks must obtain pre-clearance of their strategy to qualify for the shortcut method from the Finance Board. PwC's requirement for Finance Board pre-clearance is analagous to the SEC pre-clearance requirement independent auditors may place on their clients who are SEC registrants. PwC declares that if the Banks were SEC registrants it would require pre-clearance from SEC's Division of Corporation Finance before allowing use of the shortcut method on swapped callable debt. Since the Finance Board is the regulator of the Banks, PwC has required the Banks to seek pre-clearance from the Finance Board.

Analysis or Discussion:

At year-end 1999, the Banks had \$185 billion of callable bonds, about 48 percent of the System's total bonds. The Banks have determined that it is prudent to hedge the interest-rate risk inherent in callable debt. The Banks use interest-rate swaps to hedge their callable debt by converting the fixed-rate interest stream of the debt to LIBOR and selling to the swap counterparty a call option that mirrors the call option on the bond. It has long been the practice of the Banks to require up-front fees from their counterparties on swaps associated with callable debt. To obtain hedge accounting treatment under SFAS 133, hedges must meet the criteria of paragraph 68(b). As discussed above PwC has determined that the up-front fee could render the swap ineligible for the shortcut method. The Banks are unwilling to give up the fees, but they want to have the option of using the shortcut method.

The shortcut method would allow the Banks to assert their hedges are effective throughout the life of the hedge. A hedge is defined as effective if its fair value is correlated with the fair value of the item it is hedging. When the debt is retired, its fair value and the fair value of the hedge should be equal. However, during the life of the debt there may be variations between its fair value and the fair value of the hedge. SFAS 133 requires that variations in fair values be recognized in the financial statements, hence volatility. The shortcut method eliminates volatility during the life of the debt because it allows the Banks to assume that their hedges are effective throughout the life of the debt. The Banks have demonstrated that their current practice of requiring up-front fees on the swaps associated with callable debt provides a more effective hedge (from an economic perspective) than a swap without a fee.

The Banks' business practice of obtaining up-front fees on swaps associated with callable debt predates SFAS 133. There does not appear to be any valid business reason why they should forego those fees. The Banks' use of the shortcut method will allow them to eliminate from their financial statements artificial volatility over the life of their hedged callable debt. Other alternatives to obtain the shortcut method the Banks might mutually agree on with PwC in the future would properly be the subject of future requests for regulatory interpretation.

Interpretation:

PwC has concluded that the three alternatives discussed in the Bank's submission would qualify for the shortcut method of accounting under paragraph 68(b) of SFAS 133. The Banks have accepted the options offered by PwC and have agreed to implement any or all of those options after receiving a "no-objection" letter from the Finance Board.

Based on the information provided and the opinion of PwC, the Finance Board will not object to the Banks' implementation of the three alternatives discussed. Any other alternatives to obtain the shortcut method must be submitted in a separate request for regulatory interpretation and are not addressed by or covered by this regulatory interpretation. This interpretation is limited to the facts and circumstances described in the letters and attachments accompanying this request for regulatory interpretation. In connection with any particular transaction involving complex issues such as these, the staff may reach a different conclusion based on the facts and circumstances disclosed in, or existing at the time of, the request.

<p>A <u>Regulatory Interpretation</u> applies only to the particular transaction or activity proposed by the requestor, may be relied upon only by the requestor, and is subject to modification or rescission by action of the Board of Directors of the Finance Board. See 12 CFR part 907.</p>
