OFHEO

EXAMINATION GUIDANCE

Issuance Date: April 21, 2008 **Doc. #: PG-08-002**

Subject: Standards for Enterprise Use of the Fair Value Option

To: OFHEO Director of Supervision
OFHEO Director and Associate Directors
OFHEO Examiners-in-Charge

I. Purpose and Scope

In February 2007, the Financial Accounting Standards Board adopted Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159, the fair value option or the FVO), which allows entities to report most financial assets and liabilities at fair value with changes in fair value reported through the income statement.

This document sets forth examination guidance and standards on the application of FAS 159 by the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (the Enterprises). It sets OFHEO's expectations for practices that will (1) promote sound risk management and controls, (2) support the integrity of OFHEO's regulatory capital measures, and (3) promote transparent and consistent financial reports by the Enterprises. In addition, this guidance discusses supplemental information OFHEO may require through supervisory reporting to assess how the Enterprises are using the FVO and its impact on their reporting of financial condition. General examination principles for supervisory personnel to assess accounting and disclosure are outlined separately in the *Office of Supervision Handbook*.

This guidance is based on existing accounting standards and regulatory literature, including the supervisory guidance of the Basel Committee on Banking Supervision, regarding the fair value option. However, as a general matter this guidance places additional emphasis on the Enterprises providing useful and transparent filings.

As with all GAAP, OFHEO expects the Enterprises to apply FAS 159 in a safe and sound manner. The transparency of the Enterprises' operations and results—facilitated by sound financial reporting and disclosure—is an important safety and soundness objective. OFHEO expects the Enterprises to implement the fair value option in a sound manner that results in financial reporting that accurately reflects the Enterprises' financial condition, operating results and risk exposure in as transparent a manner as possible.

II. References

A. OFHEO *Office of Supervision Handbook*, January 2007

B. Basel Committee on Banking Supervision, Bank for International Settlements, *Supervisory guidance on the use of the fair value option for financial instruments by banks,* June 2006

C. OFHEO Examination Guidance PG-06-003: *Examination for Accounting Practices*, November 2006

D. Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises,* November 1978

E. Center for Audit Quality Alert, *FAS 159 Early Adoption Date Approaching – Factors to Consider,* April 2007.

III. Standards

The following standards provide a framework that OFHEO will use to assess the Enterprises' use of the fair value option.

Standard 1
OFHEO expects the Enterprises' use of the fair value option to comply with FAS 159 in both form and substance.

The fair value option under FAS 159 permits companies to make an irrevocable decision to designate most financial assets and liabilities to be measured at fair value, with changes in fair value reflected in earnings.

OFHEO expects the Enterprises to make choices regarding the election of the FVO in a fully informed and controlled manner. The Enterprises should maintain documentation to support their choices and public disclosures about the use of the fair value option. The documentation should be contemporaneous with the decision to elect the option and should be sufficiently detailed for supervisory review purposes.

Standard 2
OFHEO expects the Enterprises' use of the fair value option to result in transparent financial reporting that accurately reflects the Enterprises' business practices, financial condition, operating results and risk exposure, to the extent practicable.

One of the primary objectives of financial reporting by a business enterprise is to provide useful information to its stakeholders.* Useful information increases transparency and thereby promotes market discipline. As such, transparency in financial reporting is a critical safety and soundness objective. When considering alternatives for financial instrument accounting available under GAAP, including the fair value option, the Enterprises should consider the implications their choices may have on transparency in reported financial condition, operating results and risk exposures. In this regard, if a portfolio of assets is held primarily for liquidity purposes, the most transparent reporting for that portfolio is fair value, with changes in fair value reported through earnings.

When the fair value option is used to eliminate or reduce an accounting mismatch of risk positions and, therefore, should reduce earnings volatility, other unhedged risk factors within the position may still result in earnings volatility (perhaps even increase volatility). If reporting such earnings volatility is indicative of unhedged risks inherent in the business model, OFHEO would generally view such reporting as sound, informative and transparent, provided the option is applied in a safe and sound manner.

Standard 3
OFHEO expects the Enterprises to have appropriate policies, procedures, controls, reports and systems in place upon the initial application of the fair value option and on an ongoing basis.

OFHEO expects the Enterprises to apply the FVO in accordance with sound risk management policies. When electing the fair value option, an Enterprise should have appropriate policies and procedures in place to ensure that: (a) objectives are clearly defined and consistent with the Enterprise's mission and business practices; (b) fair value estimates are prepared in accordance with the fair value measurement guidance under GAAP, and (c) risk management and control policies pertaining to the use of the fair value option and related valuation methodologies are being consistently applied.

Given the large number of individual transactions the Enterprises conduct, OFHEO expects the Enterprises to have policies and procedures that govern the election of the fair value option at time of purchase. These policies and procedures should be similar to those used to govern the decision at purchase as to whether investment securities are held-to-maturity, available-for-sale or trading under FAS 115.

The Enterprises should establish an adequate control environment including procedures for documenting and approving the use of the fair value option for new items, products or transactions. When determining whether to apply the fair value option to a particular new instrument or class of instruments, the Enterprises should ensure that fair values for

* FASB Statement of Financial Accounting Concepts No. 1 states in part, "Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of the business and economic activities and are willing to study the information with reasonable diligence."

those instruments can be estimated in accordance with GAAP fair value measurement standards.

The Enterprises should monitor the application of the fair value option for conformity with GAAP accounting and disclosure requirements. Such monitoring typically should be managed by individuals outside the risk-taking functions (e.g., by accounting control staff). In addition, the use of the fair value option should be subject to periodic review by internal audit.

Standard 4
For supervisory purposes, OFHEO may require the Enterprises to provide supplemental information regarding the impact of the Enterprises' use of the fair value option.

For financial reporting purposes, OFHEO notes that the Enterprises are required by FAS 159 to disclose certain information on the use of the fair value option. In addition to this publicly disclosed information, OFHEO may obtain supplemental information regarding the Enterprises' implementation of the fair value option and its impact. Such information may include, but is not limited to, accounting, risk management and valuation policies necessary for regulatory assessment of the FVO implementation. For regulatory reporting and analysis purposes, such supplemental information may be routinely collected by OFHEO.

Standard 5
OFHEO will consider the Enterprises' use of the fair value option, including supplemental information collected under Standard 4, when assessing safety and soundness. This assessment includes, but is not limited to, capital adequacy.

As a safety and soundness regulator, OFHEO must consider whether financial statement information is suitable for regulatory purposes and, when it is not, must take this into consideration when assessing safety and soundness, including capital adequacy.

Routinely collecting supplemental information on the Enterprises' use of the fair value option will provide a basis for assessing its impact on each Enterprise's risk, earnings and capital adequacy, and thereby its safety and soundness. To the extent that OFHEO has safety and soundness concerns about an Enterprise's use of the FVO, OFHEO will consider a range of supervisory responses.

For example, if an Enterprise elects the FVO for its own debt and its creditworthiness deteriorates, it will recognize a gain in earnings and an increase in the statutory measure of core capital. In such a circumstance, OFHEO will take into consideration this contrary or inappropriate adjustment to core capital in assessing capital adequacy.

Further, if OFHEO detects patterns of use of the fair value option that impair transparency or distort earnings or capital, OFHEO will evaluate whether such application of the FVO is unsafe and unsound.

OFHEO may take action to respond to an Enterprise's use of the fair value option in situations where risk management or controls are deficient or when it raises other safety and soundness issues, even if the option is being applied in a way that technically complies with the accounting standard.

Additional Matters

OFHEO expects the Enterprises to provide a full fair value balance sheet to OFHEO on a quarterly basis, at a minimum, and to continue to provide public disclosure of a full fair value balance sheet quarterly. OFHEO expects the Enterprises to engage independent auditors to provide assurance on the full fair value balance sheet annually.

IV. Preservation of Existing Authority

Nothing in this Examination Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation, or order. Action referencing this Examination Guidance may be taken separate from, in conjunction with or in addition to any other supervisory action available to OFHEO. Compliance with the Examination Guidance in general would not preclude OFHEO from determining that an Enterprise is otherwise engaged in unsafe or unsound conduct or practices or is in an unsafe or unsound condition, or from requiring corrective or remedial action with regard to such conduct, practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the Examination Guidance.