2011-175
Comment Letter No. 34

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Technical Director
Financial Accounting Standards Board
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File Reference: 2011-175 Discussion Paper, *Selected Issues about Hedge Accounting* (Including IASB Exposure Draft, *Hedge Accounting*)

Dear Ms. Cosper:

The 12 Federal Home Loan Banks (the "FHLBanks") appreciate the opportunity to comment on the Financial Accounting Standards Board's (the "FASB" or "Board") Discussion Paper, *Selected Issues about Hedge Accounting* (Including IASB Exposure Draft, *Hedge Accounting*), hereinafter referred to as the "Discussion Paper." We commend the Board for its continued efforts towards convergence with International Financial Reporting Standards ("IFRS"). However, we do not believe that the International Accounting Standards Board ("IASB") Exposure Draft provides a superior starting point for any changes to U.S. GAAP. The FHLBanks expressed their views regarding changes to U.S. GAAP in their comment letter on the Exposure Draft of Proposed Statement of Financial Accounting Standards: *Accounting for Hedging Activities – an Amendment of FASB Statement No. 133* in 2008. The subsequent 2010 Exposure Draft of a proposed Accounting Standards Update: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* was a move in the right direction and the FHLBanks provided their views to the Board by letter dated September 28, 2010. Of the key changes set forth in the FASB's proposed Update listed in paragraph 27 of the Discussion Paper, the FHLBanks take exception to only the elimination of the shortcut and critical terms match methods for assessing effectiveness and the inability to discontinue hedge accounting treatment by simply dedesignating the hedging relationship. Accordingly, the FHLBanks believe the Board should be making targeted changes to U.S. GAAP, rather than moving toward convergence of its overall standards on derivatives and hedging activities with the IASB's standards. The FHLBanks views on the IASB's Exposure Draft are discussed below.

<u>Risk Management – the Objective of Hedge Accounting</u>

The FHLBanks agree with the objective proposed by the IASB. The FHLBanks believe there should be a connection between the presentation of financial information and the activities undertaken to manage exposure to particular risks. Specifically, hedge accounting needs to reflect the purpose and effectiveness (or ineffectiveness) of an entity's risk management activities. However, the IASB Exposure Draft would prohibit entities from meeting that objective in many aspects. For example, the proposed, unnecessarily restrictive conditions required for the dedesignation of a hedging relationship would eliminate the use of certain effective and prudent risk management strategies. See additional discussion under "Hedged Items - Aggregated Exposures and Groups of Items."

Hedging Instruments

The FHLBanks agree that nonderivative financial assets and nonderivative financial liabilities measured at fair value with changes in fair value recognized in net income should be eligible as hedging instruments. Allowing the use of existing nonderivative financial assets and/or liabilities (e.g., cash instruments) that offer a natural offset to particular risks to be designated as hedging instruments may decrease hedging costs and therefore be beneficial to many entities.

Hedged Items - Risk Components

The FHLBanks would strongly object to the FASB adopting the IFRS rule that permits an entity to designate changes in the cash flows or fair value of an item attributable to a specific risk component, provided that the risk component includes a designation of only changes in the cash flows or the fair value of a hedged item above or below a specified price or rate (i.e., a "one-sided" risk). This rule contradicts the objective of the IFRS Exposure Draft that hedge accounting should represent an entity's ability to manage exposures arising from particular risks. 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. Placing unnecessary limitations on this strategy 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. Furthermore, limitations on 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 FASB's goal of improving financial reporting for hedging activities.

Hedged Items - Layer Component

The FHLBanks are concerned that the guidance in paragraph 36(e) would prohibit entities from hedging the risk of changes in fair value due to changes in a benchmark interest rate for prepayable instruments. Generally, voluntary prepayment is driven by changes in the underlying rate (e.g., a benchmark interest rate). Because the fair value of the prepayment options would be impacted by the hedged risk, a layer component of an overall group of such instruments would not be eligible for hedge accounting. A "bottom layer" is noted as an example of an ineligible layer; however, the guidance is not specific to any particular layer. Accordingly, the FHLBanks believe that if the Board does not intend to prohibit entities from hedging the risk of changes in fair value due to changes in a benchmark interest rate for prepayable instruments, then the language in paragraph 36 should be clarified.

Hedged Items - Aggregated Exposures and Groups of Items

Some entities utilize dynamic or delta hedging strategies to hedge their net interest exposure attributable to a pool of mortgage loans and the related funding. Because ASC 815 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 IASB Exposure Draft provides that terminating the hedging instrument or entering into an offsetting derivative instrument is a means by which an entity may effectively dedesignate a hedging relationship. However, in many situations, these may not be feasible alternatives. For example, entering into an offsetting derivative is an unnecessary expense when an existing derivative may be reused and possibly redesignated in a qualifying hedging relationship. Accounting guidance should not limit an entity's ability to manage its exposure to risks. The FHLBanks believe that enhanced disclosures explaining why a hedging relationship has been dedesignated and/or redesignated should adequately address any concerns of financial statement users.

Hedge Effectiveness

The FHLBanks agree with the elimination of the "bright line" hedge effectiveness criteria; however, the FHLBanks do not support the requirement to assess effectiveness at each reporting date, or more often if a significant change in circumstances occurs. Under proposed U.S. GAAP, an assessment would be performed at inception based on a reasonably effective threshold and thereafter only when a change in circumstances suggests that a hedging relationship may no longer be reasonably effective. The FHLBanks support the proposed changes to U.S. GAAP.

Changes to a Hedging Relationship

As stated above, under proposed U.S. GAAP, an effectiveness assessment would be performed at inception and thereafter only when a change in circumstances suggests that a hedging relationship may no longer be reasonably effective. The IASB Exposure Draft would require entities to perform effectiveness testing at each reporting date, or more often if a significant change in circumstances occurs. As a result of such testing, an entity may be required to rebalance a hedging relationship. However, an entity may also proactively rebalance a hedging relationship. The FHLBanks support providing entities with an option to modify a hedge accounting relationship based on their risk management objectives in order to improve the economic offset. However, the FHLBanks do not believe that an entity should be *required* to rebalance a hedging relationship to ensure its continued effectiveness. Rather, an entity should be permitted to dedesignate a hedging relationship that no longer meets its risk management objectives.

Hedge Accounting and Presentation

The FHLBanks do not believe that the presentation of gains or losses on the hedging instrument and the hedged item in a fair value hedging relationship should be presented in Other Comprehensive Income ("OCI"). The FHLBanks are concerned that the numerous proposals to present information in OCI will result in a complicated presentation that is confusing to users. The FHLBanks also do not believe that gains or losses on the hedged item attributable to the hedged risk should be presented as a separate line item in the statement of financial position. The FHLBanks believe that the presentation of gains and losses should reflect the underlying economics of the hedging relationship. To that end, the FHLBanks strongly agree with the concerns raised by others during the IASB's outreach activities, as presented in paragraph BC 120 (e.g., in a fair value hedge, there is an actual gain or loss on the hedged item, and a fair value hedge should not cause artificial volatility in OCI). However, the FHLBanks do not believe that the approach proposed by the IASB sufficiently addresses these concerns. Rather, the FHLBanks believe that current U.S. GAAP presentation requirements alleviate all of these concerns, including the appropriate reflection of the underlying economics of hedging relationships and, therefore, should be retained. Additionally, U.S. GAAP requires disclosure of the gains or losses on the hedged item attributable to the hedged risk. Separate presentation of these amounts on the statement of position would simply clutter that statement and render it less meaningful to users.

Disclosures

The FHLBanks believe that the disclosure requirements of ASC 815 *Derivatives and Hedging* coupled with the requirements of ASC 825 *Financial Instruments* are sufficient to address the needs of financial statement users.

While we have long supported the Board's efforts to converge U.S. GAAP with IFRS, we do not believe that current U.S. GAAP for derivatives and hedging activities should be conformed to IFRS. Rather, as articulated above, we believe there are a few areas where U.S. GAAP may be improved. 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 (214) 441-8535.

Sincerely,

Tom Lewis

Tom Lewis
Senior Vice President and Chief Accounting Officer
Federal Home Loan Bank of Dallas
(On behalf of the Federal Home Loan Banks as Chair of the Controllers' Committee)