REGULATORY INTERPRETATION 2000-RI-07

Date: July 19, 2000

Subject: Accounting Issues: Valid Economic Hedges and Securities Carried at Fair Value

Request Summary:

By letter dated March 22, 2000, the chair of the Federal Home Loan Bank (Bank) Presidents' Conference Finance Committee, in conjunction with the 12 Banks, requested regulatory interpretations of two issues arising in anticipation of the implementation of Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*. The issues are:

1. The Banks' ability to have derivatives on their books that do not qualify for hedge accounting treatment under SFAS No. 133, but are valid economic hedges.

2. The Banks' ability to maintain a portfolio of investment securities classified as "securities carried at fair value," previously classified as "held-to-maturity" (HTM), that will be accounted for in the same manner as an investment defined in SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, as a "trading" investment.

Background:

Issue 1: SFAS 133 imposes limitations on hedge accounting treatment for hedges of certain assets and liabilities. As a result, the Banks are concerned that derivatives the Banks use to hedge certain assets, *e.g.*, purchased mortgages, as well as basis swaps used to hedge interest-rate risk, may not qualify for hedge accounting treatment under SFAS 133. The Federal Housing Finance Board's (Finance Board) regulations and Financial Management Policy (FMP) prohibit speculative derivative transactions. The Banks have requested that "the Finance Board provide a regulatory interpretation making it clear that transactions that may not qualify for hedge accounting under SFAS 133 will not be considered to be speculative, provided they achieve the financial objectives stated at the inception (or redesignation) of the hedge, such as to reduce the prepayment risk on mortgage assets, as defined by the FMP."

Issue 2: Most of the securities held by the Banks in their investment portfolios are classified as HTM, and a portion of those portfolios currently is hedged. SFAS 133 prohibits hedge accounting treatment for hedges of HTM securities. Failure to qualify for hedge accounting treatment will result in the derivatives hedging HTM securities being carried at fair value on the balance sheet with the resulting mark-to-market adjustments flowing through the income statement with no offsetting adjustments to the hedged items. The Banks are given the opportunity upon adoption of SFAS 133 to reclassify investments designated as HTM to either available-for-sale or trading without tainting their HTM portfolio. Therefore, they could reclassify the HTM securities as trading with the balance sheet caption securities carried at fair value, even though they do not anticipate trading the securities. PricewaterhouseCoopers (PwC), the Banks' independent auditor, has advised them that such a reclassification would result in those securities being carried at fair value in the same fashion as trading securities. The Banks have requested that "the Finance Board make it clear that the use of securities carried at fair value is an acceptable classification of investments and does not violate the FMP."

Analysis or Discussion:

Issue 1: Statements issued by the Financial Accounting Standards Board establish accounting and reporting standards. The Finance Board's regulations and the FMP provide the regulatory and policy framework within which the Banks implement prudent and responsible financial management strategies that assist them in accomplishing their mission, and in generating income sufficient to meet their financial obligations in a safe, sound and profitable manner. Compliance with regulations and the FMP is a determination (1) made initially and documented by Bank staff and management; (2) reviewed by the Bank's internal audit function; (3) reviewed with negative assurance provided by the Bank's independent auditor; and (4) examined by staff of the Finance Board. The Banks believe that the use of derivatives that do not qualify for hedge accounting treatment under SFAS 133 in some circumstances is a critical aspect of the interest rate management of the Banks and therefore represents a prudent financial management strategy. The Finance Board's proposed capital rule recognizes that the Banks may benefit from the ability to use certain instruments to hedge actual balance sheet risks, even if the instruments do not meet the hedge accounting requirements of SFAS 133. The proposed capital rule therefore permits a Bank to use such hedging instruments provided that the Bank documents that they are for a non-speculative use.

Issue 2: The Banks propose to reclassify a portion of their HTM investment portfolio to trading and to caption them as securities carried at fair value on the face of the statement of condition. The Banks desire to continue to hedge the interest rate risk of a portion of those portfolios even though SFAS 133 does not allow hedge accounting treatment for those hedges. Reclassifying the investment securities from HTM to trading will allow the Banks to obtain offsetting mark-to-market adjustments on the hedged items. Finance Board staff has identified no FMP issues that would result from such a reclassification. PwC has advised Finance Board staff that the reclassification proposed by the Banks is likely to be made by other financial institutions in similar circumstances and that they have identified no GAAP or auditing issues associated with such a reclassification.

Interpretation:

Issue 1: Derivatives that do not qualify for hedge accounting treatment under SFAS 133 will not be presumed to be speculative in nature, and may be used by a Bank, provided that the Bank adequately documents that the use of such derivatives are for non-speculative purposes.

Issue 2: The FMP does not preclude the reclassification of HTM investments to trading securities classified on the financial statements as securities carried at fair value.