REGULATORY INTERPRETATION 2001-RI-03

Date: March 29, 2001

Subject: Accounting Issues: Effects of SFAS No. 133 on Dividends and AHP Contributions

Request Summary:

The 12 Federal Home Loan Banks (Banks) have requested a regulatory interpretation regarding the terms "previously retained earnings" and "current net earnings" as used in section 16(a) of the Federal Home Loan Bank Act (Bank Act), 12 U.S.C. § 1436(a), and section 917.9 of the Federal Housing Finance Board's (Finance Board) regulations, 12 C.F.R. § 917.9, and "net earnings" as used in section 10(j) of the Bank Act, 12 U.S.C. § 1430(j), and section 951.2 of the Finance Board's regulations, 12 C.F.R. § 951.2. They ask that the effects of "non-recurring timing related" adjustments to income required by Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended by SFAS No. 138, be excluded from calculations of previously retained earnings, current net earnings, and net earnings when applying the above cited provisions of the Bank Act and Finance Board regulations. Section 16(a) of the Bank Act, as implemented by 12 C.F.R. § 917.9, permits a Bank to declare and pay dividends only from "previously retained earnings" or "current net earnings." Section 10(j) of the Bank Act, as implemented by 12 C.F.R. § 951.2, requires each Bank to contribute annually 10 percent of its "net earnings" for the previous year to the Affordable Housing Program (AHP), subject currently to a minimum annual aggregate payment from all Banks of $100 million.

Background:

SFAS No. 133 establishes accounting and reporting standards for derivative financial instruments and for hedging activities. This standard is a part of generally accepted accounting principles in the United States (GAAP). The Statement requires entities to recognize all derivative financial instruments as either assets or liabilities on the balance sheet and to measure those instruments at their fair values. SFAS No. 133 further 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 generally the hedge has no net effect on the income statement. However, the ineffective portion of changes in the fair values of hedges (as well as changes in the fair value of derivatives that do not qualify for hedge accounting treatment) must flow through income. For entities that fail to demonstrate effectiveness of hedges using derivatives, or for derivative instruments that otherwise do not qualify for hedge accounting treatment, applying SFAS No. 133 can result in earnings volatility.

The Banks assert that SFAS No. 133 will result in "periodic volatility in reported financial performance [that] is not representative of the true economics of Bank hedge activity." They state that the positive and negative effects of SFAS No. 133 on income and retained earnings calculated under GAAP will affect the Banks' ability to pay dividends and make contributions to AHP. They argue that any disruption to dividends will likely be regarded as a "significant adverse signal both to shareholders and the capital markets" and that "any interruption to the consistent flow of AHP funding would be disruptive to the development of affordable housing."

The Banks also assert that the term "earnings" is not strictly an accounting term, and that "income" is the generally recognized accounting term. Further, the Banks note that "previously retained earnings" and "net earnings" are not defined by the Bank Act, that only the term "net earnings" is defined by the Finance Board's regulations, and that the definition of "net earnings" does not reference GAAP net income.[1] Thus, the Banks contend that:

> the dividend paying authority of the Banks and the obligation to make contributions to the AHP is distinct from the reporting requirements of GAAP. Both are founded in the Bank Act and Finance Board regulations.

The Banks conclude that the terms "previously retained earnings," "current net earnings" and "net earnings" may be interpreted consistent with the Bank Act and Finance Board regulations in a manner that disregards the effects of SFAS No. 133 on income and earnings.

Analysis or Discussion:

Neither the Bank Act nor Finance Board regulations define the terms "previously retained earnings" and "current net earnings." The Bank Act requires that for purposes of calculating a Bank's contribution to the AHP, a Bank's net earnings "shall be determined ... after reduction for any payments [to REFCORP] under section 1441a or 1441b of this title and before declaring any dividend under section 1436 of this title," 12 U.S.C. § 1430(j)(8). As already discussed, for purposes of AHP, Finance Board regulations define "net earnings of a Bank" consistent with this statutory requirement but do not otherwise define the term "net earnings." *See* note 2. In other situations, however, both the Finance Board's regulations and policies and the Bank Act specifically require the Banks to apply GAAP for all financial reporting and accounting.

The Finance Board's Financial Management Policy (FMP) requires the Banks to "[a]ccount for financial transactions executed under the FMP in accordance with" GAAP. *See* FMP § VII.B.5. Section 985.6(b) of the Finance Board's regulations, 12 C.F.R. § 985.6(b), also requires that the scope, form and content of the Federal Home Loan Bank System combined financial reports be generally consistent with the requirements of the Securities and Exchange Commission's Regulations S-K and S-X, 17 C.F.R. parts 229 and 210, which generally require financial statements to be prepared in accordance with GAAP. *See* 17 C.F.R. § 210.4-01(a)(1).

---

[1] More correctly, for purposes of AHP, the Finance Board's regulations define the term "net earnings of a Bank" to mean "the net earnings of a Bank for a calendar year after deducting the Bank's annual contribution to the Resolution Funding Corporation [REFCORP] required under sections 21A or 21B of the [Bank] Act (12 U.S.C. §§ 1441a and 1441b), and before declaring any dividend under section 16 of the [Bank] Act (12 U.S.C. § 1436)," 12 C.F.R. § 951.1. The term "net earnings" as used in the definition is not further defined in the Finance Board's regulations. The Bank Act requires that, for purposes of the AHP, a Bank's "net earnings" be calculated after a reduction for any statutorily required payment to REFCORP, and before declaring any dividend allowed under the statute, 12 U.S.C. § 1430(j)(8).

Furthermore, under the Bank Act, a Bank's annual payments to REFCORP and its AHP contribution are simultaneously determined. 12 U.S.C. §§ 1430(j) and 1441b(f). Authority to adopt rules governing the assessment of the REFCORP payment is vested in the Department of the Treasury (Treasury).[2] Rules adopted by Treasury state that REFCORP must obtain from each Bank a report of the Bank's "actual net earnings for that quarter" and then inform each Bank of its quarterly REFCORP requirement, which is equal to 20 percent of each Bank's net earnings, 12 C.F.R. § 1510.5(d). The required REFCORP payments have been assessed based on net earnings calculated in accordance with GAAP. If Treasury continues to base the net earnings calculation for the REFCORP payment on GAAP, Finance Board staff question whether it would be possible to calculate the AHP payment on a different basis, given the statutory simultaneity of the determination of the REFCORP payment and the AHP contribution.

More importantly, under the amendments to the capital provisions of the Bank Act made by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 608, 113 Stat. 1456-63 (Nov. 12, 1999), total and permanent capital, as defined in the statute, will have to be calculated and reported to the Finance Board based on GAAP. 12 U.S.C. § 1426(a)(5). These amendments further prohibit a Bank from distributing retained earnings, including a distribution through a payment of dividends, if such distributions result in a Bank's permanent or total capital falling below its minimum requirements, 12 U.S.C. § 1426(h)(3). To be consistent with the statutory definitions of capital, retained earnings, for purposes of demonstrating compliance with the capital requirements, would have to be calculated on a GAAP basis. If previously retained earnings were calculated using non-GAAP standards, a Bank, in theory, could pay dividends from negative retained earnings but would still need to assure that such payments did not cause a Bank's total and permanent capital, calculated on a GAAP basis, to fall below required minimum levels.

In addition, the Banks did not provide estimates of the anticipated effect of SFAS No. 133 on the Banks' income to support their arguments about the impact of SFAS No. 133 on dividend payments and the consistent flow of AHP funding. However, the Finance Board recognizes that it is difficult to obtain hedge accounting treatment for Acquired Member Assets (AMA), as that term is used in 12 C.F.R. § 955.2, and the changes in fair value of AMA hedges generally will flow into current income because of the AMA's prepayment options. Nevertheless, a Bank could have anticipated, to some extent, this potential earnings volatility and guarded against its effects by building up its retained earnings before the implementation of SFAS No. 133 to provide a cushion for dividend payments. Also, a Bank can build retained earnings as a safeguard against future earnings volatility. Concerning the AHP contribution, the Bank Act establishes an aggregate payment floor of $100 million annually, which is intended to guarantee some consistency in the flow of funding for affordable housing in light of any volatility in net earnings arising from any source, including changes in GAAP. *See* 12 U.S.C. § 1430(j)(5)(C). Thus, Finance Board staff is not convinced that the requested regulatory interpretation is needed to address any possible effects of SFAS No. 133 on AHP.

---

[2] Section 21b(l) of the Bank Act, 12 U.S.C. § 1441b(l), vests authority to issue rules under section 21b, which includes authority to calculate the Bank's payment to REFCORP, in the Thrift Depositor Protection Oversight Board. When the Thrift Depositor Protection Oversight Board was abolished, this authority was transferred to the Treasury. Pub. L. No. 105-214 § 14, 112 Stat. 909 (1998).

When viewed as a whole, both the Bank Act and Finance Board regulations and policy require that calculations of a Bank's income or earnings be made in accordance with GAAP.[3] The Banks' request to disregard certain requirements of SFAS No. 133 when determining earnings would be a departure from GAAP and would be inconsistent with the general approach under the Bank Act and Finance Board regulations to apply GAAP.[4] In addition, use of a non-GAAP basis for calculating earnings for certain purposes may create practical difficulties, given that other calculations such as those of total capital and of the required payment to REFCORP must be based on, and reported consistent with, GAAP. Thus, to assure consistent application of the statute and Finance Board regulations, Finance Board staff believe that terms such as "previously retained earnings," "current net earnings," and "net earnings," which in effect are derived from a Bank's income calculations, should not be interpreted in a manner that would allow their values to be derived from anything other than income calculations made using GAAP. Finance Board staff believes that such consistent application of GAAP is in accordance with sections 10(j) and 16(a) of the Bank Act.

Interpretation:

For the reasons set forth in the preceding section, Finance Board staff believes that previously retained earnings, current net earnings, and net earnings should be derived from income calculations that are consistent with GAAP.

[3] The preamble to the Finance Board's new capital rule discusses the issue of SFAS 133 and its effect on earnings, leverage, and AHP and REFCORP contributions. In that discussion the Finance Board indicated a preference that, despite the effects of SFAS 133, these items be calculated in accordance with GAAP. *See* 66 Fed. Reg. 8262, 8281-82 (Jan. 30, 2001).

[4] The Banks acknowledge in their request letter that, while the earnings volatility associated with SFAS 133 "is not representative of the true economics of Bank hedge activity," it does represent earnings measured in accordance with GAAP.