

November 4, 2016

Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

File Reference: 2016-310

Dear Ms. Cosper:

The Federal Home Loan Bank of Chicago (“FHLBC”) appreciates this opportunity to provide comments on the Financial Accounting Standards Board’s (the “FASB” or “Board”) Exposure Draft of a Proposed Accounting Standards Update, *Derivatives and Hedging (Topic 815) Targeted Improvements to Accounting for Hedging Activities* (hereinafter referred to as the “proposed Update”). Our comments are limited in nature since the Federal Home Loan Banks (the “FHLBanks”) have sent a more comprehensive comment letter. Our specific comments are outlined below.

Impediment to Applying Shortcut Method to Swapped Callable Bonds:

Currently, the shortcut method of accounting is not available for FHLBC’s swapped callable consolidated obligation bonds because either transaction fees are paid upfront or included in the swap cash flows – see excerpt from SEC Staff guidance below. The SEC objection was based on the fact that there are multiple components embedded in the derivative. In this regard, we do not see a difference between an implicit premium on call or put options and an implicit transaction fee. Accordingly, we believe that an exception similar to the premiums paid for call or put options should be made for such transaction fees included in a swapped callable obligation bonds hedges – see footnote 6 from SEC Staff speech and current GAAP guidance **FASB ASC 815-20-25-104c** below.

Excerpt from FASB ASC 815 20-25-104c:

“...c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:

1. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).

2. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.

Excerpt from SEC Staff Speech:

Mark Northan
Professional Accounting Fellow
U.S. Securities and Exchange Commission

Washington, DC

December 5, 2005

“...The other example focuses on the requirement that interest rate swaps must have a fair value of zero at the inception of the hedging relationship.⁶ In some situations, companies have incorporated a financing element in the interest rate swap that results in a fair value other than zero. The financing element is included as an adjustment to the "pay or "receive legs of the interest rate swap. **These adjustments are often made in lieu of paying or receiving a dealer or broker fee or some other component of the transaction** that was being exchanged. **Companies have argued that the fair value must have been zero since no cash was paid or received when the swap was entered into. The staff has rejected this argument because there were multiple components involved in the transaction with the financing element causing the swap to have a fair value other than zero at inception.” [Emphasis added].**

⁶ The fair value might not need to be zero if a premium has been exchanged for a mirror-image call or put option. Refer to paragraph 68(b) of Statement 133 [Emphasis added].

Effect of Settled to Market versus Collateralized to Market on Hedge Effectiveness Testing:

On December 18, 2015, the Securities Industry and Financial Markets Association (“SIMFA”) sent a letter to banking regulators discussing several issues related to settled to market and collateralized to market clearing transactions. Refer to Appendix A for background information in the SIMFA pertaining to settled to market and collateralized to market. One of the issues is the accounting treatment attributable to each approach. In this regard, FHLBC requests that the FASB provide additional guidance pertaining to hedge effectiveness testing. Specifically, we do not believe a hedge should become ineffective simply because the price alignment amount is now legally part of the derivative agreement (rather than interest accrued on collateral) and therefore part of the hedging instruments fair value. Effectively, the economics have not changed and hedge accounting should not be at risk. Accordingly, we request the FASB to permit the price alignment adjustment to be excluded from hedge effectiveness testing.

Swaption Hedging Termination Option Value:

FHLBC believes that a hedge of a one-sided risk exposure to declines in variable future cash flows over a defined period attributed to the benchmark one-month or three-month LIBOR interest rate qualifies for cash flow hedge accounting treatment. This is because as LIBOR changes so do the cash flows associated with the floating rate assets. In this regard, we request clarification regarding the application of hedge account criteria with respect to a swaption hedging termination option value. We believe that the cash flow hedge strategy defined above qualifies for hedge accounting pursuant to the conditions in **FASB ASC 815-20-25-126** as shown below. Specifically, the hedging instrument is a purchased option, the exposure being hedged is the variability in expected future cash flows attributed to the one month or three month LIBOR index over the hedge period, and the assessment of effectiveness will be documented based on the total changes in the swaption(s) cash flows.

“The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

- The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar.
- The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).
- The assessment of effectiveness is documented as being based on total changes in the option’s cash flows (that is, the assessment will include the hedging instrument’s entire change in fair value, not just changes in intrinsic value).”

However, there is an alternative view that the above hedge strategy would not qualify for cash flow hedge accounting. This alternative view assumes that if the actual swaption is in the money at the expiry date, then a cash settlement at the expiry date would cause a mismatch between the actual swaption (i.e., cash is received at the time of expiry) and the settlement of cash flows of the hedged item – that is, the remaining life of the floating rate loan being hedged. We believe, however, that any ineffectiveness caused by the different settlement periods would be captured if the actual swaption is cash settled and the hypothetical swaption converts to a swap.

We thank the Board for its consideration of our views and welcome the opportunity to discuss this matter with the Board and its staff. Please do not hesitate to contact James Potter (FHLBC Controller) at 312-552-2767 or me at 312-565-5284

Sincerely,

Claude Edelson, Director of Accounting Policy

Federal Home Loan Bank of Chicago

Appendix A:

Excerpt from SIMFA to Banking Regulators: ‘...Background on Settled to Market OTC Derivative Contracts

Standard market practice in cleared OTC derivatives markets involves the regular (typically daily) exchange of payments between the parties to a derivative to protect the parties from the risk of loss of the current positive mark-to-market value of that derivative in the event of a default by one of the parties. Such payments can be made under either a collateralized to market (“CTM”) or settled to market (“STM”) model. Although both models achieve the same exposure-mitigating objective, they differ in their implications for the rights and obligations of the counterparties.

- Under the CTM model, parties exchange periodic payments (typically daily) of VM collateral. While payments of VM collateralize a party’s mark-to-market exposure on a given day, the derivative exposure between counterparties carries forward through the life of the derivative contract, with its value moving over time and being collateralized by consequent VM payments. If the exposure of the party that has received VM collateral on one day decreases over the course of the next day, that party will be obligated to return collateral to its counterparty and, depending on the amount by which its exposure has decreased, may need itself to provide further collateral to its counterparty.¹
- Under the STM model, parties also exchange daily payments.² Unlike the CTM model, however, these payments settle the outstanding exposure of the counterparties. Over the course of the next day, the outstanding exposure of the parties will change, and while a new payment will be needed to settle the new end-of-day exposure, neither party will be required to return any amount paid to it to settle a previous day’s exposure. Outstanding exposures are settled daily, and the terms of the derivative contracts are reset so that the fair values of the contracts are zero.³ The STM model is recognized as preferable to the CTM model within the regulatory capital framework.⁴

While historically, cleared OTC derivatives that have been entered into between clearing member firms and CCPs have been treated under the CTM model rather than the STM model, a number of CCPs have been working with market participants to amend or clarify their terms, rules, and procedures to allow for clearing member firms to transition to the STM model. External counsel has been engaged by those CCPs to evaluate and advise on the legal aspects of the STM treatment; further, these amendments are subject to regulatory approval by each CCP’s primary regulator. As clearing member firms assess whether, for legal and accounting purposes, cleared OTC derivative contracts are in fact executed under the STM model for each relevant CCP, each clearing member firm may begin to record new OTC derivative contracts as STM contracts and to adjust its treatment of existing CTM model OTC derivative contracts to reflect the legal changes to the terms, rules, and procedures governing such contracts that cause them to become STM contracts.

¹ In addition, it is typical for a party that has received collateral to pay interest (Price Alignment Interest or “PAI”) to its counterparty on that collateral.

² Additionally, in order to fully replicate the economics of the CTM model, the parties exchange amounts equal to the PAI payments they would exchange under CTM model derivatives (at some CCPs, currently referred to as Price Alignment Amount or “PAA”).

³ There may be certain timing differences between when the fair value of the contract is reset to zero and when the settlement payment is made, *e.g.*, in cases where variation margin payments are made on the following morning. Such timing differences are operational in nature.

⁴ *See* Regulatory Capital Implications section below.”

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