



ADVISORY BULLETIN 2007-AB-02

October 23, 2007

*Federal Housing Finance Board
Office of Supervision*

To: Federal Home Loan Bank Chairs, Presidents, and
Directors of Internal Audit
Managing Director, Office of Finance

From: Stephen M. Cross
Director
Office of Supervision

Subject: Implementation of Fair Value Accounting Standards

Background

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (FAS) No. 157, *Fair Value Measurements (FVM)*. This statement defines fair value for accounting purposes as the exchange price in an orderly transaction to sell an asset or to transfer a liability in the principal or most advantageous market for the asset or liability. In February 2007, the FASB issued FAS No. 159, *The Fair Value Option for Financial Assets and Liabilities (FVO)*, which allows entities to elect, on an instrument-by-instrument basis, to carry many financial assets and liabilities on the balance sheet at fair value, with changes reported through income. All Federal Home Loan Banks (FHLBanks) and the Office of Finance (OF) must implement these standards as of the beginning of 2008.

Implementing the FVM standard represents a substantial technical challenge, requiring the FHLBanks to review their valuation inputs and methods for nearly all of the financial assets and liabilities on their books, to make appropriate changes to those inputs and methods to conform with the definition of fair value in the standard, and to prepare the expanded disclosures required by the standard. The FVM standard will apply to fair value measurements made under existing accounting rules, such as for derivatives under FAS 133, investment securities in the trading account, measurements (but not disclosures) made for the fair value financial statement footnote, and to fair value elections made under the FVO standard.

The FVO standard provides a one-time election to carry certain existing assets and liabilities, now reported at historical cost or available-for-sale, at fair value with a transition adjustment reported through retained earnings, and with future fair value changes reported through income. Entities will have the option to make similar elections for newly acquired financial assets and liabilities at acquisition.

Guidance

The FHLBanks' use of fair value accounting for eligible financial instruments must comply with applicable generally accepted accounting principles (GAAP) and should be fully integrated into the FHLBank's risk management policies and practices. In implementing the FVM and FVO standards, FHLBank and OF management and directors should review the *Summary of Recommended 17 Best Practices Regarding Governance, Control, Price Verification, and Audit Practices* from the G30 Report, *Enhancing Public Confidence in Public Reporting (Processes and Controls for Estimating More Reliable Fair Values)* (<http://www.bis.org/publ/bcbs114.pdf>) and consider the best practices it describes when establishing and revising policies and procedures for their application of fair value accounting.

In particular, the FHLBanks must (i) maintain adequate internal controls over financial instrument valuation and financial reporting, (ii) periodically verify their fair value measurements, (iii) independently validate any models used to generate fair value measurements, and (iv) ensure that their auditors review fair value measurements regularly. FHLBank management must document the rationale for elections to carry individual instruments or portfolios at fair value, and the FHLBank's board of directors should review and ratify those elections.

In addition, we expect each FHLBank to report its progress toward FVM and FVO implementation to its Examiner-in-Charge (EIC) by November 30, 2007, and subsequently as conditions or developments warrant. After the initial submission, we expect each FHLBank to provide its EIC a full and timely explanation of any significant changes in its policies, strategies, projections, or practices regarding fair value accounting. Each FHLBank must also timely inform its EIC of likely or projected significant changes in its retained earnings due to (i) valuation methodology or input changes related to their implementation of the FVM standard or (ii) the FHLBank's planned FVO implementation strategy—particularly should any FHLBank plan to use FVO implementation as part of a financial restructuring strategy.

We expect each FHLBank's November submission to include its schedule for implementing FAS 157 and FAS 159. The schedule should identify outstanding implementation issues, identify target dates for key remaining implementation activities, and ensure that the FHLBank's board has adequate time and information to make or ratify implementation decisions. We also expect the November submission to include the FHLBank's:

- Estimate of its expected FAS 157 and FAS 159 transition adjustments, incorporating and documenting the FHLBank's most-likely assumptions regarding planned elections for existing assets and liabilities under the FVO standard;

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- Changes to its interest accrual and reporting policies and practices for those instruments it plans to carry at fair value, organized by major classes of assets and liabilities; and
 - Plans to measure and disclose changes in liabilities carried at fair value as a result of changes in instrument-specific credit risk, including how and on what basis it plans to measure and disclose, as required by Paragraph 19(d) of FAS 159, if the FHLBank plans to elect the FVO for any of its own debt at transition or thereafter.

The issues and activities related to FVM implementation that we expect each FHLBank to communicate to its EIC include, but are not limited to:

- Reviewing valuation inputs for assets and liabilities to be carried at fair value to determine which category and level of disclosure the standard requires; and
- Making any changes to the FHLBank's financial instrument valuation inputs, models, and methods needed to comply with the FVM standard.

The issues and activities related to FVO implementation that we expect each FHLBank to communicate to its EIC include, but are not limited to:

- Identifying existing and to-be-acquired assets and liabilities to be accounted for under the FVO standard;
- Performing income and balance sheet projections reflecting the FHLBank's planned elections to include projected cumulative effect adjustments at transition and effects on risk measures and future income;
- Resolving financial reporting geography issues; and
- Preparing to make all required disclosures, including instances of different FVO elections for some but not all eligible items from a group of similar eligible items, and documenting the reasons for those differences should they exist.

The FHLBanks must also be responsive to the OF regarding FVO and FVM implementation to facilitate timely production of the System's combined financial reports and to contribute to disclosures that are meaningful and complete. Section 989.3 of the Finance Board regulations requires the FHLBanks to provide, in such form and within such timeframes as the Finance Board or the Office of Finance shall specify, all information and assistance that the OF shall request for the purpose of producing combined reports. Following FVM and FVO implementation, we expect the FHLBanks to meet all monthly and quarterly regulatory reporting requirements.

We expect the OF to communicate its progress toward FVM and FVO implementation to the Finance Board's chief accountant. The OF, recognizing its role in reporting system-wide financial information, must provide its schedule for completing its implementation of FAS 157

and FAS 159 to the Finance Board's chief accountant, by November 30, 2007. This schedule should identify outstanding implementation issues, identify target dates for remaining key implementation activities, and ensure that the OF's board has adequate time and information to make or ratify implementation decisions. The OF's submission should specifically address financial data collection issues, and the form and content of planned combined financial statement line items and disclosures related to FVM and FVO implementation. The OF should also highlight and discuss the anticipated effects of differences among the individual FHLBanks' planned implementation of FAS 157 and FAS 159 on the combined financial statements, disclosures, and the combining process in its submissions to the chief accountant.

The FASB continues to study and deliberate certain elements of the guidance in the fair value accounting standards. Should the FASB issue new or revised guidance that affects the issues addressed in this Advisory Bulletin, the Finance Board will review that issuance and consider whether to issue additional guidance.

Principal Finance Board Contact

David R. Poston, Chief Accountant, (202) 408-5976, postond@fhfb.gov.

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