FHLB STOCK ACCOUNTING ISSUES*
American Bankers Association
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GENERAL

The current economic environment has resulted in a high volume of discussion and debate about "other than temporary impairment" (OTTI) for many types of investments. Although Federal Home Loan Bank (FHLB) stock has unique characteristics that make it unlike many other types of investments, discussions about OTTI have included FHLB stock. Banks and auditors are concluding that OTTI does not currently exist for FHLB stock, and the purpose of this paper is to provide banking institutions with some of the analysis that leads banks to that conclusion.

WHY THERE IS CONCERN ABOUT OTTI

The FHLBs are experiencing higher levels of OTTI in their investments in private label mortgage backed securities (MBS) and home equity loans, which has raised concerns about whether their capital levels could be reduced to below regulatory requirements. Additionally, some FHLBs have temporarily suspended or limited cash dividend payments or repurchases of excess capital stock. Concerns also exist about the increase in FHLBs' wholesale funding costs and about the joint and several liability for the FHLBs' debt obligations.

WHY BANKS INVEST IN FHLB STOCK

The FHLB is in cooperative that provides services to member banking institutions. The primary reason for joining the FHLB is to obtain funding (known as "advances") from the FHLB. The purchase of stock is required in order to receive advances. FHLB stock is an activity based stock that is directionally proportional to the volume of advances. Unlike other types of stock, it is acquired primarily for the right to receive advances rather than for the purpose of maximizing dividends or stock growth. (Clearly, FHLB stock is not acquired for stock growth, as it is bought and sold at par.)

From the FHLB's perspective, the cooperative nature of the business means that retained earnings need to be sufficient to be safe and sound, but a certain amount of retained earnings is returned to members through dividends. The pricing of advances can be done either by higher interest rates and lower dividend rates or lower interest rates and higher dividend rates. This is managed by the FHLB.

From the member banks' perspective, the goal is to minimize the net cost of services received.

Thus, FHLB stock is not a traditional stock investment. Instead, the purchase of FHLB stock provides banks with the right to be a member of a cooperative that provides products and services to its members. The stock is typically held for a long period of time.

GAAP FOR FHLB STOCK

There are several areas of the accounting literature that address the accounting for FHLB stock.[1] FHLB stock has somewhat unique characteristics:

- restricted ownership – FHLB stock can only be sold to/from FHLBs or a member institution.
- par stock – FHLB stock is sold and redeemed at par.
- lacks a market – Because of the ownership structure, there is no real "market" for the stock, other than the FHLBs or member institutions.

Thus, according the AICPA Audit Guide, FHLB stock does not have readily determinable fair value for purposes of FASB Statement No. 115 (*Accounting for Certain Investments in Debt and Equity Securities)* and the equity ownership rights are more limited than would be the case for a public company because of the FHFA's oversight role in budgeting and approving dividends. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost. Thus, ***when evaluating FHLB stock for impairment, its value should be determined based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value***.

According to the AICPA Audit Guide, the determination of whether a decline affects the ultimate recoverability is influenced by criteria such as the following:

- The significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted
- Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs
- The impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLBs
- The liquidity position of the FHLBs

[1] The primary GAAP references are:

- AICPA Audit and Accounting Guide: *Depository and Lending Institutions – Banks and Savings Institutions, Credit Unions, Finance Companies and Mortgage Companies* ("AICPA Audit Guide"); May 1, 1007; paragraphs 12.20-12.26. Specifically describes accounting FHLB stock.
- Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* ("APB 18"); paragraph 6a. Generally applies to investment securities carried under the cost method of accounting.
- AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others* ("SOP 01-6").
- FASB Staff Position FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* ("FSP 115-1 and 124-1"). Provides OTTI guidance.

The evaluation of whether a decline is temporary or whether it affects the ultimate recoverability is influenced by:

- The materiality of the carrying amount to the member institution, and
- Whether an assessment of the institution's operational needs for the foreseeable future would require and allow management to dispose of the stock.

ANALYSIS: APPLICATION OF GAAP TO FHLB STOCK

As mentioned earlier in this paper, FHLB stock does not have a readily determinable fair value and is, therefore, not covered by SFAS 115. Still, it is important to review FHLB stock to determine whether OTTI exists, and the AICPA Audit Guide brings together the literature for making that determination. As described above, the analysis as to whether FHLB stock is impaired should be based on the "ultimate recoverability of the par value".

One of the ratings agencies prepared a recent analysis of the FHLBs for ratings purposes. Moody's Global Banking Special Report: *Rating Implications on the Federal Home Loan Banks from Other-than-Temporary Impairments* (January 2009) notes that the FHLBs "are currently facing the potential for substantial accounting impairments" on their private label mortgage-backed securities (MBS) portfolios. Moody's assessment is that although the gross unrealized losses related to these securities was $13.5 billion, "the true economic losses embedded in these securities total less than $1 billion and are manageable given the FHLBanks' capital levels". Although Moody's believes losses in excess of the economic loss may materialize that could have implications from a regulatory and markets confidence/access standpoint, Moody's also notes its "expectations that these firms have a very high degree of government support". Moody's concludes that "although declines in capital and the potential regulatory and financial effects could result in reductions of the FHLBanks' Baseline Credit Assessments, the FHLBanks' Aaa senior debt rating and Prime-1 short-term debt rating…are likely to remain unchanged.

As described above (in the section "Why Banks Invest in FHLB Stock"), FHLB stock is unlike other types of stock, including Fannie Mae and Freddie Mac stock. Additional evidence of this is the testimony of James B. Lockhart III, Director Federal Housing Finance Agency, before the Senate Committee on Banking, Housing, and urban Affairs:

> "The Federal Home Loan Banks…have a different business model than Fannie Mae and Freddie Mac and a different capital structure that grows as their lending activity grows."

Below are points that are being considered when evaluating the criteria that may influence ultimate collectability of FHLB stock.

Significance of the decline in net assets of the FHLBs as compared to the capital stock amount for the FHLBs and the length of time this situation has persisted

As indicated in the Moody's report, a decline in market values of the FHLBs' assets does not necessarily equate to an economic decline in net assets. The focus is on economic losses rather than market losses, which Moody's notes can be absorbed.

Included in the American Bankers Association letter to the SEC (regarding the SEC's congressionally mandated study on mark to market accounting, letter dated November 13, 2008), ABA notes that in the current market environment, market value simply has not worked properly. For example, ABA notes that:

- "Mark to market based on exit price in an illiquid market results in an unrealistic downward bias, which reduces transparency…"
- OTTI has been controversial for many years, due to "recording losses that are based on the market's perception of value…which often results in recognizing losses that exceed credit losses or recording losses for instruments that have experienced no credit problems and are fully performing in accordance with their terms. The erosion of earnings and capital due to a market's perception of losses or due to a lack of liquidity that drives values lower is *misleading to investors and other users of financial statements*." (Emphasis added.)
- The SEC has acknowledged that there are problems with OTTI and requested, that FASB (October 14, 2008 letter to FASB) "expeditiously address issues that have arisen in the application of the OTTI model in Statement 115".
- "Basing OTTI on credit risk would result in more logical financial statements."
- "The U.S. GAAP model for OTTI simply has not worked well and has not served investors well. We strongly encourage the SEC to ensure that a proposal is issued quickly that would utilize credit risk rather than fair value to determine OTTI. Fair value fluctuations – as demonstrated in today's market – generally do not provide either a true fair value or economic value."

Thus, banks are concluding the losses in economic values can be absorbed.

Commitments by the FHLBs to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBs

FHLBs are meeting their debt obligations. Although the responsibility to repay debt may be shared among FHLBs in the event that one FHLB cannot pay, to date, an FHLB has never been required to pay the consolidated obligation of another FHLB.

The impact of legislative and regulatory changes on the institutions and, accordingly, on the customer base of the FHLBs

With the exception of the Housing Act, enacted July 20, 2008, there are no pending legislative or regulatory changes that would impact the customer base of the FHLBs.

The liquidity position of the FHLBs

Because the FHLBs' primary source of funds is debt obligations, the Moody's conclusion – that the credit ratings are not expected to change – is one of the important factors to consider.

There has been a preference in the market for shorter-term, high-quality investments, resulting in the FHLB discount notes trading at lower rates relative to LIBOR and reducing short-term funding costs. Although this investor preference for shorter-term investments has been an increase in longer-term FHLB debt costs, FHLBs have been issuing long-term debt and are obtaining funding on terms that appear to be acceptable to them.

Additionally, if needed, the FHLBs have an additional source of liquidity beyond traditional debt obligations: the secured funding available to the GSEs through the U.S. Treasury. Under their lending agreements, the FHLB may borrow based on pledging eligible collateral.

For the reasons stated above, banks are concluding that FHLB stock is not currently impaired and they will ultimately recover the par value of their investments in this stock, which is held for long periods of time.

***Disclaimer: This memorandum contains general information on accounting issues and should not be relied on for purposes of any institution's financial statements. Consult with your accounting professionals for the application of these principles in specific situations.**

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