

Bank Asset/Liability Management

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Perspectives on the Proposed Accounting Update for Derivatives and Hedging

For those who've struggled with the challenges of applying hedge accounting rules, FASB has proposed some adjustments to their accounting standard, which, for some, might be a source of relief. Exactly when revised rules will go into effect is still unclear, but it's possible that companies could adopt the new rules, once officially released, as early as the start of their following fiscal year. The proposed revisions are offered in an exposure draft that was issued on September 8, 2016.

As is common practice, FASB solicited public comment before the rules are finalized, with the comment period ending November 22, 2016. The proposed adjustments are largely viewed as an attempt to liberalize the hedge accounting prerequisites, and in some cases to actually simplify the accounting. That said, for some portion of reporting entities, little may change.

In my judgement, the most significant proposed change pertains to accounting rules for cash flow hedges. Cash flow hedges are the most common types of hedges, relevant to the broadest class of derivatives hedgers. (Cash flow hedges address risks of uncertain forecasted transactions; fair value hedges address the price risk of recognized assets, liabilities, or firm commitments.) Current rules for cash flow hedges require segmenting hedge results between their *effective* and *ineffective* pieces. Ineffective results are immediately posted to current earnings, while effective results first go to other comprehensive income (OCI) and later are reclassified to earnings concurrently with the earnings recognition of their associated hedged items.

While existing hedgers have clearly accommodated to the current standard, it wasn't necessarily easy. The determination of the effective/ineffective split hasn't always been obvious, and considerable time and effort may have been expended to develop methodologies for making these measurements. Changing the accounting treatment at this point would necessarily impose some minor conversion costs for current hedges. However, for new hedgers, this change would likely represent a significant simplification. It's also worth noting that for perfect hedge relationships – not uncommon for many interest rate swap hedges where structuring perfect hedges is a fairly straightforward proposition – the same journal entries would arise, before and after.

A corollary of this rule change would be that it obviates the need to measure ineffectiveness. Critically, FASB differentiates between *assessing* effectiveness, or effectiveness testing, and *measuring* ineffectiveness. To qualify for hedge accounting, hedgers still need to demonstrate that hedges will be *highly effective* in offsetting the risks being hedged, i.e., they still need to

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perform effectiveness tests; and while this *highly effective* threshold has not been modified, the proposed guidance offers more flexibility, particularly in connection with retrospective effectiveness testing. However, to the extent that current effectiveness testing methods are working, in this observer's opinion, most hedgers will simply continue what they are doing. The new proposal doesn't necessarily mandate a change.

In any case, under the proposed guidance, ineffective and effective hedge results would not be differentiated, and the combined value would be posted to OCI. Additionally, the timing of the subsequent reclassification will be unchanged from current practice. While the proposed rule change is a clear step toward simplicity, it would require wide-scale system changes in legacy accounting systems.

Although the anticipated modifications obviate the need

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to measure hedge ineffectiveness, the same is not true for *excluded items*. In assessing hedge effectiveness for futures and forward contracts, hedgers may exclude the effect of forward points in their effectiveness tests. Similarly, for option hedges, including caps, floors, and collars, hedgers may exclude the effects of changes in option time values, again, in connection with assessing hedge effectiveness. Making either election in connection with effectiveness testing, however, continues to force these respective excluded values to be reported in current earnings, as opposed to allowing them to be deferred through OCI. Note — this treatment is a carry-over from current practice. Whereas disclosure requirements hadn't necessarily distinguished between *ineffective results* and *excluded results*, that distinction is now critical for meeting the accounting requirements.

One of the most significant of the proposed changes won't directly apply to banks, but it would apply to their customers who use commodity derivatives. Currently, most commodity hedges involve an inherent basis risk because hedging entities generally use derivatives that reference some industry-standard price for hedging their commodity price risk, and those industry-standard prices typically differ from the prices paid or received for commodities as a function of quality or location differences. Economically, these hedges should perform well as long as the prices paid or received for the commodity are highly correlated with the derivative's industry-standard price. However, if these two price series don't move in lock-step (literally), hedges won't generate perfect offsets, thereby giving rise to hedge ineffectiveness and possibly threatening the capacity to apply hedge accounting, altogether.

Under the proposed rules, hedgers *may* be able to hedge components of their commodity price risk, as opposed to the entire, all-in price, which is the current requirement. Unfortunately, the proposed change may not be as liberalizing as one might hope. To hedge a component of commodity price risk, that component must be *contractually specified* in the purchase or sales agreement. If not, commodity hedgers would be stuck with the status quo. To the extent that pricing with reference to an industry-standard price becomes more common, the prospect of failing hedge effectiveness tests and thus disallowing hedge accounting will likely be diminished; but the way many commodity purchase and sale contracts are currently drafted, this provision simply wouldn't apply. Bankers would be advised to alert their customers as to this pending change, so they might be able to adjust their contractual arrangements, accordingly.

FASB is also expanding the categories of *hedge-able* risks in the realm of interest rates. Under current rules pertaining to interest rate exposures, hedgers can designate *entire* fair value or cash flow exposures as hedged items, or they can specify risks associated with specific benchmark interest rates: Risk-free, i.e., government, rates, fed funds, LIBOR, and LIBOR and OIS swap rates. Besides expanding this list to include SIFMA as a benchmark rate, FASB is also proposing allowing any contracted rate index to be an eligible hedged item, analogous to their approach to commodity hedging. This adjustment certainly makes sense, but it's likely to be relevant for only a small segment of the hedging community.

Finally, my candidate for the most substantive change being offered has to do with fair value hedges where interest rate swaps are used to convert from fixed cash flows to floating. Under this treatment, the total gain or loss of a swap is recorded in current income — both realized (i.e., settlements) and unrealized (i.e., the change in the swap's present value). Additionally, the

carrying value of the hedged item is adjusted to reflect the change in the value of the hedged item due to the hedge risk. What's more, this change, too, is reflected in current income.

When entities fail to qualify for the shortcut treatment, they are forced to calculate the required change in the carrying value of the hedged item using the *long haul method*. Under current rules, this method *requires* using different discount rates in connection with calculations for the swap versus the hedged item. The consequence of this requirement is that the *long haul method* will almost inevitably foster unintended ineffective earnings outcomes. This ineffectiveness, however, isn't real. It's simply an artifact of the accounting rules; rules that FASB appears ready to discard.

Under the new proposal, hedgers who use interest rate swaps to hedge the benchmark interest rate in fair value hedging situations will end up with an accounting result with zero ineffectiveness, i.e., the same outcome that would be realized under the shortcut treatment without explicitly declaring that treatment. The critical caveat is that the fixed interest rate on the debt being hedged must be greater than or equal to the swap's fixed rate as of the hedge's inception date. Otherwise, hedgers would be required to address the full fair value effects, rather than just benchmark rate effects, as the risk being hedged; and some ineffectiveness would likely still arise. This adjustment would be a major improvement, and it can't happen too soon!

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