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HEDGE ACCOUNTING: A Q&A WITH DAN MORRILL AND RYAN HENLEY

As the FASB's hedge accounting standard continues its march to implementation – and with early adoption permitted – many companies may be wondering exactly how the changes will impact their operations. To get a better handle on life under the new rules, FMS checked in with **Dan Morrill** of Wolf & Company and **Ryan Henley** of Stifel for a quick summary of the changes to be aware of and the opportunities that may emerge for financial institutions.

Q: Which institutions would you expect to see the greatest impact from the hedge accounting changes?

A: While the accounting changes improved upon hedge relationships of several types, predominantly the rule changes allow for much greater flexibility in hedging fixed-rate instruments (converting fixed-rate assets or liabilities to floating), otherwise known as a fair value hedge. Given the current rate environment, institutions that would benefit most are those that have a risk to shrinking net interest margins in a continued rising rate environment as funding costs increase and fixed-rate asset yields remain constant.

Q: What are some of the new opportunities that have emerged as a result of these changes?

A: There are two primary strategies currently employed as a result of the changes. First, institutions are hedging assets that typically are offered in the market in a generic fixed-rate form. Fixed-rate loans or bonds of a longer maturity can now be converted to floating-rate asset classes by entering into an interest rate swap utilizing the new hedging rules. Secondly, institutions can create funding strategies paired with these same hedging alternatives to arrive at a cheaper funding profile for a given interest rate risk position.

Q: For those institutions that were hedging under the old rules, how significant will these changes be?

A: FASB's effort significantly simplifies the accounting results (in constructing, measuring and monitoring) of hedge relationships. For institutions with legacy hedge relationships, this would apply to both future hedging strategies they would employ, as well as the opportunity to amend existing hedging relationships upon adoption. It will simply lead to a cleaner hedging platform for the institution going forward.

Q: Which change in particular do you see as having the most impact on the operations of banks and credit unions?

A: The ability to now hedge fixed-rate assets (swap fixed-rate instruments to float) gives an institution a tremendous amount of flexibility in product offerings to its client base. If the institution's core market desires a longer-term fixed-rate product (in the consumer or commercial space), management can originate into this demand and then subsequently adjust the interest rate risk of the product without client involvement and in a clean accounting manner.

Q: Are there any effects of these changes that might be seen as a negative?

A: Generally speaking, most accounting changes carry with them a set of considerations or consequences that are not always favorable. Importantly, ASU 2017-12 was an attempt to rectify previous issues within hedge accounting. As a result, the rule really only improves upon the legacy framework. In our opinion, there are no negative consequences, as it affords greater flexibility than before.

Q: What should institutions be doing to prepare for these changes, or to make sure they're in the best possible position to take advantage of them?

A: It is important to note that a significant number of institutions are currently early adopting the standard to take advantage of these rules. Why is this so important? Because it is likely that a competitor will be employing the strategies mentioned above due to the added flexibility. There are considerations upon adoption that must be analyzed, such as whether the institution has any legacy hedge relationships. If so, should these relationships be amended upon adoption (leaning on the transition provisions of the rule), and does the institution have investment securities classified as held-to-maturity that are eligible to be transferred to available-for-sale as permitted by the standard? If so, does it make economic sense to do so for each eligible instrument? These are some of the questions to be asking now.

Disclaimer: The views and opinions expressed in this article are those of the authors and do not necessarily reflect the official policy or position of the Financial Managers Society.

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