

# Bank Asset/Liability Management



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## Hedging Pre-payable Financial Instruments

In August 2017, the Financial Accounting Standards Board (FASB) Issued Accounting Standards Update No. 2017-12 that amended the guidance on accounting for derivatives and hedging transactions. While not mandated to be effective until fiscal years starting December 15, 2018, the new rules can be early-adopted any time. The amendment purportedly reflects FASB's effort to allow reporting entities to better reflect the economics of their risk management activities. It also largely simplifies derivatives accounting procedures and liberalizes some of the more restrictive prerequisites for applying hedge accounting. This article addresses one such risk management activity, *hedges of pre-payable financial instruments*, where the amended guidance will likely offer some measure of relief to large numbers of banking institutions.

Prior to issuing this new amended guidance, whenever entities wanted to hedge a risk pertaining to a portfolio of items, each element of that portfolio had to be specifically identified, and all items in the portfolio had to satisfy a high degree of homogeneity. With such a portfolio defined, if and when any of those elements were to fall out of the portfolio, say due to prepayment or default, that designated hedge would no longer be correctly documented, and hedge accounting under the original documentation would have to terminate, requiring the initiation of a new schedule of amortization. Going forward, the entity could only continue hedge accounting if new documentation were prepared, where a newly-revised portfolio composition was specified.

The amended guidance takes a different position. It authorizes a *last-of-layer* approach that allows entities to hedge some notional amount of an initially designated portfolio, as long as the entity can justify its expectation that this stated balance will remain out of the originally defined portfolio elements, subsequent to any prepayments that might arise along the way. With this expectation satisfied, hedge accounting under the

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initial documentation can proceed without interruption through the life of the hedge.

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This guidance has a corollary that imposes an adjustment to the way fair value hedging works. In other fair value hedge situations, two steps are required: 1) derivative gains or losses are posted to earnings, and 2) the balance sheet carrying value of the hedged item is adjusted to reflect the value change of the hedged item due to the risk being hedged. In the situation pertaining to hedges of a portfolio of pre-payable financial instruments, however, because we can't know which of the originally defined portfolio items will serve as the specific units being hedged until the hedge terminates, this second step has to be modified. Rather than adjusting carrying values of any specific portfolio item(s), per se, we post an aggregated carrying value adjustment as a generalized *basis adjustment*. This basis adjustment would be reflected on the same line item as the designated portfolio items on the entities balance sheet, but it wouldn't be individually allocated to the components, as would be the case in the more typical fair value hedge.

Over the course of the hedge, one of two things could happen: either 1) the hedge would be maintained until its natural end when the derivative expires, or 2) the hedge would terminate early. In the first case, if properly calculated, the accumulated basis adjustments would sum to zero. Put another way, all such basis adjustments self-cancel when hedges are held to term. These basis adjustments are artificial in the sense that the gains or losses on the portfolio will ultimately reflect only the gains or losses on the portfolio components, as they would be calculated independent of any associated hedging activity. Basis adjustment effects are thus transitory in nature.

In the second case, where the accumulated basis adjustments sum to some non-zero amount as of the date of the early termination, a new process would have to be initiated to force a reversal of these earnings. The new guidance requires that when the hedge is terminated early, an allocation of the aggregate basis adjustment amount posted to date would have to be made *to each of the portfolio items still remaining from the original designation*. A consequence

of this requirement is that new accretion schedules for each of these portfolio elements would also be required.

Perhaps an unappreciated, and attractive, aspect of the new guidance relates to the definition of *payable*. While the terms of the pre-payable option may differ, sometimes requiring prepayment at a particular value (e.g., the outstanding balance or par) and at other times requiring prepayment at a market price, *everything* is pre-payable. What's more, if the guidance is interpreted in this way, the last-of-layer approach may apply much more broadly than many observers might realize.

As much of an improvement the last of layer approach is, it doesn't quite mitigate all of the roadblocks to hedge accounting. Perhaps the first hurdle has to do with FASB's restrictions relating to the composition of the portfolio that serves as the hedged item. Specifically, FASB requires an extraordinary degree of homogeneity of the components, or otherwise, hedge accounting is proscribed.

More likely than not, the impact of this guidance is that hedgers will construct their portfolios with elements that have extremely close maturity dates, i.e., not more than one month apart. Otherwise, as time passes and maturities decrease, the interest rate sensitivities of the components of the portfolio would almost assuredly get out of line. But even applying this constraint won't necessarily offer a safe haven. In all likelihood, besides operating with a very narrow maturity window, the credit quality of the debtors and (possibly) the geographic concentrations of the portfolio items would also have to be *very* similar. These considerations would likely result in the need to segment portfolios not only with like maturities, but also with like coupon rates.

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It's possible that the FASB actually meant to over-ride this guidance with the last-of-layer approach; but we can only come to that conclusion by inference. In the preface to ASC No. 11-2017 FASB expressly sought to improve *"the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements."* Additionally, in that same preface, it also states that an entity should be able to measure the

change in fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception, *rather than on the full contractual coupon cash flows as required by current GAAP.*

This passage may reasonably be interpreted to allow for the use of the same discount factors when calculating the change in the carrying value of the hedged item as are used in valuing the derivative. This simple and practical expedient would seem to be entirely consistent with FASB's stated orientation. Moreover, with this perspective, the sensitivity to benchmark rate changes would be identical for, say, a triple-A rated bond and a junk bond, such that, assuming the objective were to offset benchmark rate changes, both instruments could be included in the same portfolio.

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One argument in favor of this approach is that, as long as the issuers of the financial instrument(s) being hedged don't default, the effects of changes in the benchmark rate in fair value hedges are purely temporary. Ultimately, the interim carrying value adjustments wash, and the gains or losses on those portfolio items will end up being the difference between the item's starting and ending prices, plus any coupon settlements. Given that, should the choice of the discount rate really be the transitory nature of these value changes. Why then should anyone be particularly concerned about the specific rate uses in making these calculations? Requiring different discount factors for the two sides of the fair value hedging relationship unnecessarily, and arbitrarily, complicates the accounting process and misrepresents the underlying economics of the hedge.

The second impediment to applying the last-of-layer approach is that the hedging entity still needs to pass an effectiveness test.

Before getting to that, a brief digression is in order: When we use swaps with the economic objective of transforming fixed cash flows to floating cash flows, we first forecast the volume of financial instruments, i.e., outstanding balances, for which hedging is intended, period by period, e.g., month by month or quarter by quarter. Then, given this projection, the hedging derivative would be structured such that its notional amount would be set to match these projected outstanding balances. In performing this analysis, most hedgers would take a conservative posture,

striving to ensure that the notional balance on the swap won't exceed the corresponding outstanding balance in any period during the intended hedge horizon. Other than imposing this amortization schedule, the swap would be the typical fixed-versus-floating design, with no other bells and whistles. Such a swap would serve as an economically perfect hedge that converts the fixed cash flows on the loans to variable cash flows for the portion of loans being hedged, irrespective of the fact that the hedged item is composed of instruments having an embedded prepayment option, while the swap does not.

The FASB appears to fully appreciate the way this hedge would work, as reflected by 815-20-25-118A, which states that in *"a fair value hedge of interest rate risk designated under the last-of-layer method, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk."* This provision reflects a realization that the prepayment option, which definitely has a bearing on the instruments price, has no bearing on the way the hedge should be structured. The consequence of this provision is that the carrying value basis adjustment should be determined *as if the component portfolio items were not pre-payable.*

So far, so good; but while this position would seem to offer the green light to applying the shortcut treatment in last-of-layer hedges, shortcut is specifically proscribed in these situations. (See BC125 in ASU No. 2017-12.) That means that in last-of-layer fair value hedges, an alternative hedge effectiveness test, other than appealing to the shortcut conditions, would be necessarily.

Unfortunately, in this author's view, quantitative tests for these kinds of hedges are problematic. Consider the simple case when the fixed-rate hedged item is issued at par and redeemed at par, and a derivative is also entered into with the same start and end dates. Over the life of the hedge, the change in the fair value of the hedged item would be zero, but the derivative would generate a set of cash flows that would sum to some non-zero amount. Thus, in the long run, i.e., over the expected term of the hedge, the derivative doesn't offset the change in the fair value of this hedged item, nor should this outcome be expected!

It seems that the only way entities can assert that the derivative will offset the change in the fair value of the hedged item is if they ignore realized hedge gains or losses, i.e., the settlements, and focus only on the unrealized results, i.e., the derivative's change in value; but derivative settlements are a component of derivative performance, and there's nothing in the accounting guidance that justifies excluding these settlements from the assessment of hedge effectiveness. We find ourselves with a problem: An effectiveness

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testing methodology that ignores settlements and relies exclusively on fair value changes should be recognized as being deficient, but at this point, this methodology is ubiquitous and well-entrenched in practice.

The shortcut treatment is the antidote for this predicament as it essentially over-rides any consideration of offset as long as the qualifying conditions are satisfied, as they would likely be whenever the economic objective is to swap from fixed to floating. In virtually all such cases, the appropriate hedge structure corresponds to the shortcut's requirements. Why the shortcut is explicitly proscribed for last of layer hedge effectiveness testing is perplexing. However, given this explicit determination, hedgers with last-of-layer exposures will need to meet the effectiveness assessment requirement by some other method. Given that swaps results, realized and unrealized, can't realistically or reasonably be expected to offset the fair value changes of fixed rate instruments over the hedge's horizon, however, asserting that they do so and thus qualifying for hedge accounting inevitably involves a wink and a nod.

There seems to be three ways that entities address this problem. First, as noted above, they could apply tests that ignore cashflows, despite this test's previously stated shortcomings. Second, the entity could recognize that while the derivative can't be expected offset changes in fair value of the hedged item over the entire term of the hedge, perhaps offsets might be sufficiently close *in the short run*, i.e. period by period. If the cash flows represent a small fraction of the change in the hedged item's fair value, this test should work; but sometime or other, short-run offsets might prove to be ineffective. And finally, independent of the explicit text of the accounting standard, auditors may simply come to more permissive attitude. They may simply accept the proposition that swapping from fixed to floating is a legitimate hedge objective, and thus with FASB's stated objective of having the accounting reflect the risk management activities undertaken, the barrier to hedge accounting for this strategy should be eliminated. In this case, the effectiveness test would ignore any consideration of *offset* and simply default to the qualitative statement that the entity has entered into the hypothetical derivative that achieves the desired swapping objective.

Sorry to say, but FASB has issued refinements to it hedge accounting rules where the general orientation of harmonizing the economics of hedging still seem to be out of reach in connection with several, important hedging strategies. Specifically, without liberalizing the rules relating to the composition of *hedgeable* portfolios, that last-of-layer portfolios still requires the portfolio of financial instruments being hedged to have homogeneous credit qualities, effectively complicating what would otherwise be a simple hedging exercise. FASB also seems committed to requiring that, under the long-haul accounting method, i.e., where shortcut is not authorized, discount rates used for valuing the change in the carrying value of the hedged item are required to be different from those used in valuing the derivative. And if distinct discount rates are required for the hedged item and the hedging derivative, how do you set those discount rates when the hedged item is composed of anything other than a single

financial instrument? This is a critical question that the guidance simple fails to address.

Perhaps the most far-reaching shortcoming of the revised guidance is its unchanged posture relating to the hedge objective of swapping from fixed cash flows to floating. Under current guidance reporting entities that don't qualify for the shortcut treatment are asked to articulate a hedge effectiveness testing methodology that proves the unprovable, that the derivative's gain or loss will offset the change in the fair value of the hedged item. Never has; never will. Swapping from fixed-to-floating cash flows is about as plain vanilla a hedging strategy as it can get; and it deserves a carve-out where qualitative effectiveness testing should be all that is required. Expanding the allowance for applying the shortcut treatment would have gone a long way toward solving this problem. FASB's reluctance to go that route is apparent, but it begs re-thinking.

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