Good news from the FASB
Hedging strategies have just gotten easier.

By Jim Reber and Tommy Warren

Expanded playing field
The accounting standard that still is essentially the controlling document for reporting interest rate hedging is ASC 815, which is nearing its 20th birthday. That document limits the use of hedge accounting on prepayable fixed-rate assets. In turn, that took large portions of a typical community bank’s balance sheet out of the discussion for interest-rate hedging. Mortgage loans, mortgage-backed securities (MBS) and consumer loans, in particular, were not eligible for hedge accounting. These comprise nearly a third of community bank assets.

The new standard allows for the desired hedge accounting treatment of these classes. In addition, hedge accounting can now be achieved when hedging only certain portions of the life of a financial asset or financial liabilities. This “partial-term hedging” allows for an interest rate swap to be in play for, say, three years through five of a five-year term. Now there is also the opportunity to hedge a community bank’s rate risk on a pool of prepayable assets using an approach known as “last-of-layer.” This allows users to hedge a percentage of a closed pool of prepayable assets. Combined with partial-term hedging, this new framework makes it much easier for banks to efficiently manage interest-rate risk. These improvements should benefit the industry by allowing for customized hedging strategies specific to each community bank’s balance sheet and unique risk profile.

Objectives more easily attained
From a financial reporting standpoint, the appeal of using interest rate swaps has been, and continues to be, predicated on the user being able to achieve “hedge effectiveness” in the strategy. The recent amendments of losing hedge accounting (and the resulting negative consequences) have been substantially reduced.

Improvements to the rules were made to better marry the beneficial economics of hedging using interest-rate swaps with the accounting rules. FASB’s changes now make it possible for virtually any institution to make use of interest rate products to improve their operating results and compete with much larger institutions.

Ready for use
The timeline for these new rules is for public companies to adopt them for fiscal years ending after Dec. 15, 2018, and for private companies to adopt them for fiscal years ending after Dec. 15, 2019. However, early adoption is available, and we expect many community banks to take advantage of this. Included in the timeline is the one-time option to reclassify bonds from Held-to-Maturity (HTM) to Available-for-Sale (AFS). That alone will spur many community banks to act sooner rather than later.

In summary, the amended standard should enable a much larger segment of the industry to avail itself of a very effective toolbox. The much-expanded set of assets that can achieve the desired accounting treatment, and the increased ability to create customized solutions to a particular community bank’s risk profile, will help many an institution remain viable and competitive.

W e don’t often get to write a headline like the one above, so we thought we should take advantage of the opportunity. Especially since (1) it’s absolutely true, and (2) it potentially affects thousands of community banks. It has been well documented (by your regulators, among others) that more community banks have been shoring up their income statements and balance sheets through the use of interest rate products than ever before.

The Financial Accounting Standards Board (FASB) recently issued an Accounting Standards Update (2017-07; FASB) that will greatly simplify the use of hedge accounting. We believe this will enable your industry to be more competitive, more profitable and more insulated against rate risk. This month’s column will highlight these changes to help you to assess the benefits of these strategies.

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23% Percentage of FDIC-insured banks between $100 million and $1 billion in assets that were using interest-rate swaps as of June 30, 2017.

ICBA Securities’ exclusive broker, Vining Sparks, and its special-purpose subsidiary, Vining Sparks Interest Rate Products, have produced a one-hour webinar that explains the new accounting standards in more detail. To view the event, visit vinsparks.com.

The 2018 webinar series “Community Banking Matters” is being scheduled. There will be eight topics covered, each of which will address a different aspect of the balance sheet. We will again offer CPE credit for each date. Be on the lookout for information on the series in Independent Banker and in your email inbox.