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Topic of the Month: Hedge Accounting in Post Effectiveness Testing World

A proposed change to Financial Accounting Standards Board (FASB) statement 133 may allow those lenders employing hedge accounting to cease hedge effectiveness testing and value ALL closed, unallocated loans at market. If this change is implemented, volatility should decrease and accuracy increase in reported earnings.

The existing statement requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. An entity that elects to apply hedge accounting is required to establish at the inception of the hedge the method it will use for assessing the effectiveness of the hedging derivative and the measurement approach for determining the ineffective aspect of the hedge. Those methods must be consistent with the entity's approach to managing risk.

In the universe of mortgage banking for firms hedging their pipelines, statement 133 is a ruling by FASB that allows the firm to book gains on closed, unallocated loans where the hedge is proven effective. The statement applies to this portion of the pipeline because these loans are not considered derivatives by FASB. Prior to FASB 133 (and currently for those not employing hedge accounting), loans in this category received Lower of Cost or Market treatment, or LOCOM, which means no gains can be booked.

Currently, a typical month end FASB 133 summary shows entries for cash and unrealized gains/losses. Cash items include settled loans and current month pairoff gain/loss. Unrealized gain/loss items include gain/loss on pull-through weighted unclosed, unallocated loans, residual hedge, and receivables/payables on yet to settle pairoffs, all valued at market. These non-cash items also include closed, unallocated loans, though gains are only valued at market if hedged effectively. Losses are always valued at market and ineffectively hedged loans with gains are valued with a zero gain. Unrealized gains/losses are balance sheet items while their monthly changes flow to the income statement.

To date, in proving hedge effectiveness, many lenders choose a method where assets (loans) must be hedged by like liabilities (i.e. short MBS with similar durations). For those lenders, loans and hedges are deemed like by sharing the same duration characteristics and are placed in a bucket which houses a range of durations (for example, bucket 1 being durations from 0-1.99). Proving correlation between the closed, unallocated loans and the hedge resulting in R-Squared of 80% or above defines an effective hedge.

Many mortgage bankers anticipate a proposal currently making its way through FASB to simplify hedge accounting called the “fair value option” which would converge FASB standards with International Accounting Standards (IAS). The proposal would eliminate the requirement that firms demonstrate the effectiveness of the hedge in order to “avoid the time, effort and systems needed to document fair value hedging relationships and demonstrate their effectiveness”. FASB believes this will provide more relevant information than LOCOM treatment. With the proposal, firms could use the fair value option (value loans at market prices) at inception of the commitment and report changes in the fair value of the commitment in earnings. The importance of any changes lie in month, quarter and year end accounting entries, which can improve the financial snapshot of the firm as a result of the ability to book gains that are unavailable with LOCOM treatment.

What does this mean for Mortgage Bankers? With the proposal, gains may be booked on loans which are not effectively hedged, thereby further improving the financial snapshot of firms currently using hedge accounting. Gains may be booked on a wider scope of products for which hedge effectiveness is difficult to prove and therefore may not have been undertaken or were previously booked at LOCOM, such as ARMS. The proposal also opens the door for firms not currently testing the effectiveness of the hedge to use hedge accounting and therefore book gains on the closed, unallocated portion of their pipelines. The only requirement is that the fair value option be applied at inception of the commitment and applied throughout the life of the commitment (until the loan is allocated). Mortgage bankers should embrace this development as it not only reduces balance sheet and earnings volatility, but provides a more accurate view of the firm's assets and earnings potential. With the passage of this proposal there is no reason for firms to avoid hedge accounting. *-Virgil Caselli*