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Insurance Brief

Interpreting FASB's new Hedge Accounting standards

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The Financial Accounting Standards Board (FASB) has a project underway titled "Accounting for Financial Instruments—Hedge Accounting." A draft was originally released on Sept, 8, 2016, with comments due back by Nov. 22, 2016, however, no implementation date has been proposed.

What can be expected?

Overall these proposed changes would have limited to no impact on the majority of insurance companies. It will, however, have a favorable impact on insurance companies who have current programs where they are applying hedge accounting (which, in our analysis, would be an unusual approach.)

Important considerations for insurers:

Macro hedging: Using a hedge program to hedge risks in a portfolio of exposures (called "macro hedging") is still ineligible for hedge accounting treatment (except for certain, very limited, homogenous exposures). The International Accounting Standards Board (IASB) has a separate project underway to address macro hedging (called Accounting for Dynamic Risk Management), but have not reached any conclusions and have not had action since July 2015. Macro hedging for IFRS is therefore still governed by IAS 39, which is difficult to implement. Allowing macro hedging under US GAAP would be the most significant change for insurance clients.

Highly effective: To qualify for hedge accounting, hedges will continue to need to be quantitatively shown to be "highly effective" on implementation (or by the next quarter end), but there may not be a need for ongoing quantitative effectiveness testing if a qualitative assessment indicates there have been no material changes. This will be highly fact-dependent and most companies will need to perform some degree of qualitative testing to meet their own internal risk management requirements, so this will likely have limited impact on insurance companies who are managing a hedge accounting program.

Changes to "reference" interest rates: Current guidance only allows hedge accounting for certain limited interest rates (e.g., Treasury curve). The new proposal would allow non-reference rates to be used to hedge variable rate instruments, and would add the SIFMA Municipal Swap Rate as an additional reference rate for fixed-rate instruments (fixed-rate hedges will continue to be limited to reference rates).

What can be expected?

Overall, these changes will make the ongoing maintenance of hedging programs easier and less burdensome, and will reduce the impact if a program is determined to be not effective. However, hedge accounting will continue to be limited in its application and use of derivatives to manage duration risk will continue to be ineligible for hedge accounting. This means changes in derivatives market values will be mismatched relative to the hedged item – they will go through current income while for available for sale bonds the market value changes go through other comprehensive income (directly to equity).

It is worth noting that for US statutory accounting, there is a project underway by the NAIC to evaluate allowing macro hedging for variable annuity exposures (Special Accounting Treatment for Limited Derivatives, Issue 2016-03). Note this is specifically limited to variable annuity exposures, would be inconsistent with GAAP if implemented, and is designed to remove statutory accounting obstacles to the hedging of variable annuity policy exposures driven by capital markets exposures.

From the NAIC's exposure draft:
"The provisions within this issue paper are significantly different from what is currently allowed under SAP, U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS). The concept of allowing "effective hedge" accounting treatment for macro-hedges is currently not endorsed by any of the noted accounting standards. Provisions within this issue paper have been drafted with the intent to encourage risk-management transactions by insurers for limited, qualifying transactions in order to reduce non-economic surplus volatility and ensure appropriate financial statement presentation with sufficient transparency for regulator review."

Conclusion:

Overall, these changes will make the ongoing maintenance of hedging programs potentially easier and less burdensome, and will likely reduce the impact if a program is found to be not effective, but will not allow for new ways to hedge portfolio exposures.