Pre-Emptive Strike by Derivatives Players

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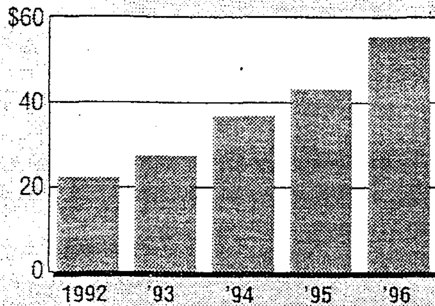
Call it the derivatives detour.

As accounting-rule makers forge ahead with controversial proposals on how companies must disclose their dealings in derivatives, an interesting thing is happening: Dealers and users of these often-complex financial instruments are seeking ways to bypass the possible new rules. At the same time, the rule makers have backed off certain proposals.

The Financial Accounting Standards Board's suggested changes, which would have the force of law for publicly traded U.S. companies if adopted later this year, already are "chilling" the demand for derivatives, dealers say. So the banks and financial institutions that market these products, while still campaigning against the proposals, are devising a new generation of products that wouldn't fall under the agency's scrutiny.

"Anything that's not incredibly plain and simple is just not getting done right now," as derivatives users brace for the F[illegible] ruling, says Kevin Connors, managing director at Lehman Brothers. "What really makes you nuts is when someone doesn't feel able to do something that's clearly the best economic solution to their problem, because of what might happen" as a result of new accounting rules.



The FASB's goal is to shed more light on how big corporations like Coca-Cola Co. and General Motors Corp. use derivatives, those financial contracts whose value is linked to, or derived from, that of an underlying asset such as a bond, stock or commodity. Companies typically use derivatives to offset, or "hedge," a variety of risks, such as exposure to interest-rate or currency movements, but also can employ them to make leveraged bets on the market direction of these and other financial instruments. The products themselves range from simple exchange-traded futures contracts on bonds, stocks or commodities to complex, customized structures sold by investment dealers to their clients.

The agency embarked four years ago on its quest to bring derivatives transactions onto corporate balance sheets so investors can better appreciate their nature, extent and potential impact. As derivatives usage has soared — there are some $55 trillion of contracts in existence today, up from about $43.2 trillion a year ago, according to estimates by industry newsletter Swaps Monitor — so has the demand for information. High-profile debacles linked to derivatives only a few years ago at companies such as Procter & Gamble Co. have added fuel to the disclosure debate. Even the Securities and Exchange Commission is pressing for quick action on new accounting rules.

Under current rules, most derivatives don't show up on balance sheets, since they don't have a "historical cost" — defined as the sum a dealer would be willing to pay to buy or sell a derivatives contract on the day it is entered into. While companies disclose a growing proportion of their

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derivatives dealings, in the absence of standardized rules, the information often is buried in notes to the financial statements. Now, the FASB is proposing that companies report the instruments as assets and liabilities at fair market value on the balance sheet. They also want users to report a profit or loss on some kinds of contracts in quarterly or annual financial statements.

The fair-market-value concept has drawn the most fire. For one thing, critics argue that some derivatives contracts have no readily available, standardized measure of market value. In addition, companies would have to report excess gains or losses from that hedge on the income statement, or pick instruments that match the maturity of the underlying position they are trying to shield.

"It's rare that you have a perfect hedge," says Paul Ogorzelec, executive vice president of Bank of America. Detractors say the FASB's proposal effectively would disallow companies from rolling over short-term derivatives hedges to cover longer-term exposures, a strategy commonly used to minimize credit risk. Collectively, these and other accounting changes would generate an unusual level of volatility in corporate earnings, critics believe. Bank of America, for one, says that if the proposed rules are adopted, the changes to the value of its derivatives hedges following a half-percentage-point move in the yield on the 10-year Treasury note would trigger a 10% swing in the bank's reported earnings.

The rule makers say they still want companies to report any changes in net worth caused by derivatives, possibly in a new line on the income statement dubbed "comprehensive income." But the proposal to many is "like basketball player Dennis Rodman's wedding where he married himself: confusing, misleading, and what's the point?," said William Roberts, senior vice president and controller of First Chicago NBD Corp.

Because of such complaints, however, the FASB has since backed off certain proposals. It now won't force companies to report "comprehensive income" per share, which would have competed with earnings-per-share measures. In addition, the FASB says it will let companies continue to report changes from the hedges of the fair value of their assets and liabilities by simply adding such amounts to the basis of those underlying assets. It previously had wanted companies to more broadly report in earnings certain gains and losses resulting from unhedged risks on their assets and liabilities.

Dealers and users of derivatives have united to protest the FASB's proposals—and find ways around them. First Chicago's Mr. Roberts says he already has seen dealers marketing derivatives contracts with provisions that would render the transactions null and void on the date that FASB implements the proposals. Then there are structured notes, which Mr. Roberts says are "getting dusted off." These are bond-like instruments that the FASB doesn't define as derivatives but that can be customized to offer similar kinds of protection from big interest-rate swings.

There also are more-complex strategies. The most common, and simple, derivatives transaction is an interest-rate swap, in which a company with fixed-rate debt uses a derivative to swap the fixed interest payments in return for a floating-rate obligation. Issuing debt into a trust, which then executes the swap, would allow a company to avoid the FASB rules, dealers say.

"We've seen only a couple of these so far, but they're clearly designed to be robust" should the new rules take effect, says Wilson Ervin, managing director of Credit Suisse Financial Products.

The FASB, watching the frequent pitches for these and other new products, warns it may crack down on such efforts to evade any new rules.

For now, at least, the accounting body is showing signs of flexibility. It tentatively agreed to allow users to delay reporting gains or losses from a hedge until a user can match it with the profit or loss on the underlying transaction. That would allow a manufacturer of breakfast cereals to delay reporting a gain or loss on a corn-futures contract until the company sells the cornflakes it produces, for instance. Dealers hope more concessions will follow.

"The best possible outcome is one that gives companies incentives to hedge properly," says Michael Rulle, managing director of Cibc Wood Gundy. "There's plenty of time to resolve these issues if there's the motivation."

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