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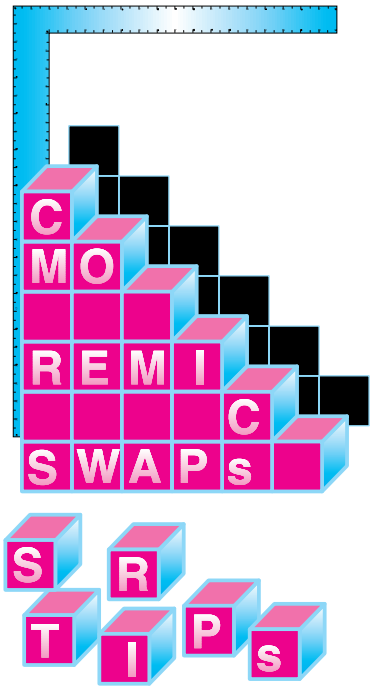

Derivatives

Powerful Tools in a Skilled Craftsperson's Hands

by Jeff Green and Jan Luytjes

DERIVATIVES TRANSACTIONS TAKE PLACE EVERY BUSINESS DAY WITH unremarkable regularity, despite a cloud of public suspicion that has dogged these financial instruments for nearly three years now.

Not only have **derivatives**[1] survived an onslaught of negative publicity blaming the **hedging** vehicle for huge investor losses, but the product is thriving in the hands of sophisticated investors able to wield the powerful tool to their advantage. Today, close to 3,000 U.S. companies make routine use of derivatives to alter risk positions or otherwise pursue investment strategies such as **speculation**, according to the trade publication, *Swaps Monitor*.

Furthermore, the value of derivatives activity worldwide, as measured by **notional** principal amount, is poised to hit, by Freddie Mac estimates, $44 trillion in 1996, a doubling of the nearly $18 trillion outstanding reported by the International Swaps and Derivatives Association for year-end 1995. As *Exhibit 1* illustrates, global derivatives volume has grown in each of the last seven years and, as of mid-year, was showing the fastest growth rate to date.

The growing popularity of derivatives results largely from several features valued by corporations and other investors. Derivatives can serve to hedge against risks either inherent in a firm's portfolio or in

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[1]See glossary on page 22 for definitions of words highlighted throughout the article.

Jeff Green is director of derivatives management at Freddie Mac. Jan Luytjes is director of quantitative analysis.

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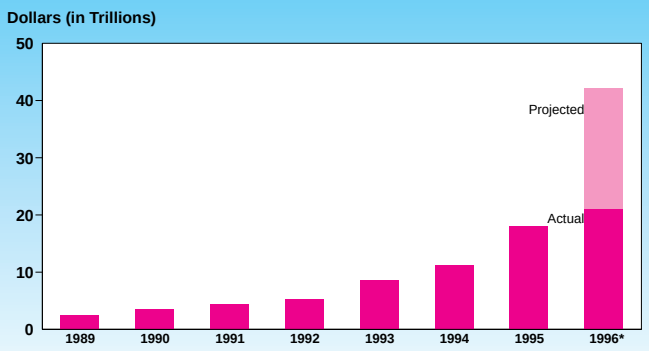
EXHIBIT 1: Derivatives Volume



Note: Derivatives volume reflects the notional principal of year-end contracts outstanding for interest-rate swaps, currency swaps, and interest-rate options.
*Data for 1996 reflects actual volume through June and projected volume for the year
Source: International Swaps and Derivatives Association

the nature of a business saddled with positions the company does not want to take but otherwise cannot escape, as is the case with the thrift and banking industries which often must fund long-term loans with short-term debt. Alternatively, derivatives offer a way to speculate for higher gains.

In addition, derivatives may at times reduce investor transaction expenses, thereby creating a low-cost way to hedge and manage exposure to interest-rate swings and other changing market conditions. For example, a small Missouri bank uses one type of derivative to swap a floating rate of interest for a guaranteed fixed rate. The banks pays a relatively bargain price of about $50 for a $1 million, three-month futures contract; a more traditional hedging device could easily cost $5,000 to $8,000.

Derivatives also provide a tool for managing cash flow more effectively and predictably, while sometimes providing the opportunity for higher yields. For those reasons, investors often are willing to pay more for derivatives—particularly for more elaborate varieties—than they would for simpler financial devices that do not meet their needs as efficiently.

Yet, despite the benefits of derivatives, a bombardment of bad press has left the general public with a perception that these tools are complex, sinister financial instruments that erode the assets and savings of investors, from municipalities such as Orange County and a small Texas college, to large, well-heeled corporations such as Proctor & Gamble Co.

According to this line of reasoning, derivatives pose unique and excessive risks capable of tricking the guileless and the adroit alike into suffering unjustifiably. Consequently, calls go out by industry observers from time to time to reform the design, sale or purchase of derivatives. The first officially proposed changes, aside from some legal rulings in individual derivatives loss cases, are now getting a serious airing. (See *Disclosure, Valuation Methods for Derivatives May Change,* page 21.)

Getting Down to Basics

Fundamentally, derivatives serve investors as a device for managing market risk, either to diminish it for greater safety or increase it for greater return.

In some ways, the misinformation surrounding derivatives is understandable, given that these are not straight-forward investment instruments. Rather, the returns and values of these financial contracts are obtained, hence derived, from the performance of an underlying asset. The underlying item can take the form of a mortgage security, stock, bond, commodity or pricing-mechanism index.

Most derivatives are formed around one or both of two fundamental building blocks, forwards and options contracts.

A forward-based derivatives contract creates an obligation to buy or sell an item at a specified price on a future date. As the underlying item's price fluctuates, the value of the future position may increase or decrease.

In contrast, an options contract imposes the right but not the obligation to buy or sell an item at a specified price on a particular date. If prices move

favorably, a rational holder will exercise the option for a gain. If prices move contrary to the investor's interest, then the holder, depending upon the situation, either takes a loss beyond the cost of the option or walks away with nothing to show for what proved to be a wrong-way guess at market direction.

Take, for example, a bank that funds long-term assets, such as mortgage originations held in portfolio yielding 7.5 percent, with short-term liabilities, such as customer deposits paying 5 percent. In doing so, the bank exposes itself to **interest-rate risk.** In other words, if rates do rise, the bank may end up paying 9 percent to borrow money to fund the assets yielding 7.5 percent, leading to losses for as long as short rates remain elevated. An interest-rate swap can reduce this imbalance by enabling the bank to receive a floating-rate stream of income while paying a fixed rate on the underlying deposits. If interest rates do indeed shoot up, then the higher return yielded when the variable-rate swap adjusts upward offsets the losses otherwise resulting from paying the higher rates on deposits.

Conversely, another bank could take the other side of the swap if it wants to speculate that interest rates will fall. That is, the second bank would receive a fixed rate and pay a floating rate. Hopefully, the bank possesses the equity capital cushion vital to bearing additional risk. If rates fall as expected, the bank would add to its earnings, but otherwise it may have to expend additional money to uphold its end of the deal.

The main benefit of a derivative lies in its ability to empower participants to alter their risk positions.

Forward contracts, like options and **interest-rate swaps**, are relatively simple types of derivatives. But to large investors or institutions doing business that requires frequent **rollover** transactions, these devices can prove cumbersome and expensive. To eliminate that deficiency, recently developed derivatives now combine, or "embed," a variety of futures, options or swaps into a single instrument. The need for successive, market-driven interest-rate swaps, for example, is reduced by means of **interest-rate ceilings** and **interest-rate floors.** The index applied to the embedded derivative produces roughly the same results achievable through multiple but more costly transactions.

Put another way, the profits or losses possible from such embedded formulas are the same as those attached to the more straightforward transactions they superseded. If an investor hedges a risk that does not occur or bets on a return that fails to materialize, then the investor loses money, just as if the holder had bought and sold the simplest underlying securities at the wrong time.

Consequently, the main benefit of a derivative lies in its ability to empower participants to alter their risk positions. That gives end users an efficient and inexpensive way to hedge and manage their exposure to shifting interest rates, commodity prices or currency exchange rates.

A precise definition of what constitutes a derivative is difficult given the customization inherent in matching the instrument to a particular financial exposure. By one accounting, there are more than 1,200 different kinds of financial devices either listed on exchanges or traded privately that meet the derivative definition.

Not surprisingly, then, derivatives are offered under a variety of names, including interest-rate swaps, **structured notes**, **interest-only (IO) strips, principal-only (PO) strips, inverse floaters, kitchen sink bonds, collateralized mortgage obligations** (CMOs) and **real estate mortgage investment conduits** (REMICs).

Even the common, fixed-rate mortgage qualifies as a type of derivative. A homeowner with a mortgage interest rate higher than prevailing market rates controls an embedded interest-rate option—the right to "call" or prepay the loan. The owner already has paid for this interest-rate-risk hedge as part of the loan's overall financing costs.

Nursing a Black Eye

Despite the myths surrounding derivatives, a closer examination reveals that the hedging tool, when managed effectively, poses no more risk than those presented by alternatives as pedestrian as 30-year Treasury bonds. Used in support of a carefully constructed and appropriate investment strategy, derivatives serve a valuable and necessary role in modern financial markets where interest-rate volatility has become a fact of life.

When all is said and done, the financial devastation blamed on these instruments has little to do with the "derivative" character of the instruments and far more to do with broad and largely inescapable economic trends at the time, including a rapid rise in interest rates, that were further exacerbated by old-fashioned, high-risk, leveraged financial strategies.

The tremendous pick-up in the usage of derivatives in the time since Orange County's woes first surfaced provides the best evidence in support of the proposition that derivatives themselves are essentially benign. Clearly, a more sophisticated business audience is undeterred by the sound and fury surrounding derivatives. Rather, the most skilled crafters of investment portfolios are focused on the market-tested abilities of the device. They are able to correctly construct a hedge that nets out their financial position regardless of whether the underlying item goes up or down. Moreover, they fully understand the risks taken when speculating with derivatives: modeling potential outcomes under the rapidly escalating interest-rate conditions of the early 1980s offers one way to comprehend the potential for losses. These investors also are aware of whether they possess sufficient equity to withstand major financial damage if necessary.

Derivatives serve a valuable and necessary role in modern financial markets where interest-rate volatility has become a fact of life.

The concept behind derivatives is nothing new. U.S. investors have dealt in commodities futures for well over a century while speculators have actively traded financial futures for more than 20 years.

While some highly visible and significant losses occurred in recent years due to derivatives use, it was the overall construction and execution of a particular investment strategy that landed the holders of derivatives in trouble rather than the specific instrument in most cases. A futures contract is one derivative that can lead to substantial losses on its own, however.

Derivatives first fell into common disrepute in the wake of losses blamed on the financial instrument in early 1994. Among the first to crash was the Granite Fund, a hedge fund run by Askin Capital Management, which, when the Federal Reserve unexpectedly raised interest rates, was heavily invested in a type of mortgage derivative, the REMIC, issued by Freddie Mac, Fannie Mae and others. The resulting drop in bond prices as well as a decline in demand for REMICs set off a chain of events that sharply depleted the value of Askin's funds.

By the end of 1994, not only did the municipality of Orange County careen into bankruptcy as the result of a $2 billion hit against the value of its portfolio, but more learned financial players also took a beating.

EXHIBIT 2: Building Leverage: The Borrow-Short, Lend-Long Strategy

A financial strategy loosely referred to as risk-controlled arbitrage is used essentially to expand the size of investments for a given capital-equity base. The example that follows illustrates how this is accomplished, how a balance sheet changes as a result and how such a strategy contributed to Orange County's financial losses.

Stage 1

	Assets	Liabilities	Equity
	$100 Bonds $4 Cash	$100 Loans	$4 (3.8% of assets)

Stage 2

	Assets	Liabilities	Equity
Pledge $100 in bonds as collateral for a $95 short-term loan of 30 days to 90 days and buy more bonds with loan proceeds. (Lenders usually require a 5-percent **haircut** as collateral insurance.)	$100 Bonds $4 Cash	$100 Loans	$4 (2.0% of assets)

Stage 3

	Assets	Liabilities	Equity
Repeat above step by pledging the new $95 in bonds as collateral for a $90.25 loan (minus a 5-percent haircut) and use proceeds to buy more bonds.	$285.25 Bonds $4 Cash	$285.25 Loans	$4 (1.4% of assets)

As the result of collateralized borrowing—investing in long-term assets funded with short-term loans—the investment in bonds in this example mushroomed by a factor of 2.85 (which is roughly the same leverage attained by Orange County when it grew its $7.5 billion investment fund to $20 billion through similar borrowing). The original equity of $4, which may have been sufficient to support the risk of the $100 in bonds, becomes very small relative to assets after leveraging and may not be sufficient to support the risk associated with $285 of bonds. In this instance, risk can grow while the ability to bear risk (equity capital) remains at the same level.

In the Orange County situation, it is important to assess the type of risk involved before drawing any conclusions about losses. In the county's case, the risk of payment default by bond issuers was nearly zero because most of the bonds involved obligations of the U.S. government and its agencies. Instead, the county took on interest-rate risk through collateralized borrowing. With this strategy, the values of assets and liabilities respond differently to changes in interest rates. In particular, the value of assets is more sensitive to rate changes than the value of liabilities. Consequently, if interest rates fall, assets appreciate more than liabilities, making the portfolio more valuable. If interest rates rise sharply, however, assets depreciate more than liabilities, leaving the portfolio far less valuable and possibly insolvent. Interest rates did just that throughout 1994, leaving Orange County with $2 billion in losses and bankrupt.

Proctor & Gamble, for example, lost $102 million in April 1994 when the speculative interest-rate swap it made based on U.S. interest rates and German marks went bad. Gibson Greetings, Inc. incurred a $23 million loss in May of that year through interest-rate swaps. Four months later, Paine Webber gave up $268 million when it made a wrong-way market guess using kitchen sink bonds.

Then there were the more heart-rending stories of non-profit groups like Odessa College, a small institution in East Texas, which was forced to raise tuition and borrow money to stay afloat after the sacrifice of $11 million in assets became necessary in September 1994 to settle speculative losses made with inverse floaters. Earlier in the spring, a Shoshone Indian tribe from Wind River, WY watched $3.7 million slip away thanks to market positions taken with inverse floaters and PO strips.

Whether resulting from naiveté or an abundance of bad luck, the investors involved in each unfortunate incident apparently had backed the proposition that interest rates would stay the same or drop. In September 1993, the one-year Treasury rate stood at a monthly average 3.3 percent. Twelve

months later, it had risen a whopping 2.43 percentage points to 5.76 percent. By December 1994, it had moved to 7.14 percent, a brutal 3.81 percentage-point upswing from 15 months earlier.

In Orange County, the wrong-way interest-rate bet brought the municipality to its financial knees. Yet, derivatives comprised less than 45 percent of Orange County's assets at the time. What's more, Robert Citron, the former Orange County treasurer who launched the municipality on its doomed trajectory, was hardly a financial innovator. Citron had merely adopted a long-standing tactic used within the financial community for years: borrow short, lend long and leverage your position.

This strategy of leveraging, loosely referred to as "risk-controlled arbitrage," became increasingly popular in the mid-1980s as more and more thrifts turned to short-term collateralized borrowing to finance long-term assets. It was essentially these very maneuvers that contributed substantially to the savings and loan crisis of the late 1980s. In purchasing hedges to control interest-rate risk, some institutions underhedged to gain more return. When short-term interest rates rose more than 3.5 percentage points over a two-year period, these institutions suffered heavy losses.

Relying on a similar leveraged strategy of collateralized borrowing, Orange County increased its investment fund from $7.5 billion to $20 billion (*Exhibit 2*). As a result, the county, like many savings and loans in previous years, left itself wide open to a number of perils, including:

When derivatives are used to ramp up the potential for profits through speculation, risks and potential losses are compounded.

Refunding risk: the possibility that borrowing costs could exceed asset yields.

Collateral risk: the prospect that lenders could demand more collateral from an investor if interest rates rise.

When derivatives are used to ramp up the potential for profits through speculation rather than to hedge risk from other investments, risks and potential losses are compounded. The downside of leveraging tactics is that risk can grow while the ability to bear risk remains the same.

Media coverage of Orange County's folly made considerable mention of the "inverse floaters" in the municipality's portfolio, but the articles included little or no explanation of how these financial instruments work or of their relative safety when used appropriately. To provide a better picture, *Exhibit 3* demonstrates how inverse floaters do work under one set of circumstances.

Keeping a Lid on Risk

Derivatives are not, and never will be, for everyone. They are innovative, highly targeted and specialized investment tools. With few exceptions, though, it is unlikely that it is the tool itself, but how that tool is used that matters.

The key to limiting any type of derivatives risk, just as it is with more commonplace investments, is to manage it effectively. The most important defense, then, is a good offense dedicated to sound risk-management principles and practices.

When market conditions deteriorate, then the value of an investor's position in any contract, financial instrument, asset, or portfolio will decrease accordingly. Effectively managing this type of situation, known as **market risk**, requires frequent re-valuation of the portfolio under prevailing market conditions. It also requires using a precise accounting measure of an investor's portfolio, such as **mark-to-market** discipline, identification and measurement of risk, establishing risk limits

EXHIBIT 3: A Primer on Inverse Floaters: It's Just Subtraction

To dispel some of the mystery surrounding derivatives, three inverse floaters, also known as structured notes, from Orange County's portfolio are described in detail here. Bond 1, just like a traditional bond, pays fixed interest for two six-month periods. After that, the interest rate floats in opposition to the 6-month **LIBOR** rate. The LIBOR is a short-term market interest rate. If the LIBOR rate increases, the bond coupon (which determines the interest payments received by the holder) decreases; if the LIBOR rate decreases, the bond coupon increases. Hence, the term "inverse floater": the bond's interest payments are not fixed but move inversely with another rate. The bond's coupon is determined by simply subtracting the LIBOR rate from the base interest rate. In the example below, the LIBOR rate fell to 5.88 percent in the fourth payment period; consequently the new interest rate is subtracted from the bond's 9.5 percent base interest rate, resulting in a coupon that climbs to 3.62 percent. These bonds are callable so that if the LIBOR rate falls significantly, the issuer could return the bond principal to the investor, prematurely ending the life of the bond. This, of course, limits the upside gain should rates fall, a risk for which the investor is compensated through a higher initial yield.

Bonds 2 and 3 are considered "stepped" inverse floaters. Unlike Bond 1, the base rate in these two cases increases or "steps up" one level and continues at that level until maturity. Like Bond 1, the interest payments are fixed for the first two six-month periods and subsequently move in opposition to the LIBOR rate unless the step change is sufficient to offset the LIBOR rate change. Again, calculating the bond's coupon is no more complicated than subtracting the LIBOR rate from the base interest rate. Bond 3's step schedule is more aggressive than Bond 2's, making it less vulnerable to rising interest rates. Like Bond 1, Bonds 2 and 3 are callable after the times indicated.

Payment Schedules for Inverse Floaters

	Bond 1	Bond 2	Bond 3
Issue Date	10/28/93	11/19/92	11/28/94
Maturity	5 years	5 years	5 years
Payments	10 semi-annual	10 semi-annual	10 semi-annual
Callable	1.5 years	3 years	1 year
Minimum Rate	0%	0%	0%
Maximum Rate	9.5%	11.0%	11.25%

Payment schedule	Base Rate	LIBOR Rate	Coupon	Payment schedule	Base Rate	LIBOR Rate	Coupon	Payment schedule	Base Rate	LIBOR Rate	Coupon
4/28/94	NA	NA	6.35%	5/19/93	NA	NA	6.63%	5/28/95	NA	NA	7.20%
10/28/94	NA	NA	6.35%	11/19/93	NA	NA	6.63%	11/28/95	NA	NA	7.20%
4/28/95	9.50%	6.38%	3.12%	5/19/94	10.35%	4.94%	5.41%	5/28/96	11.00%	5.59%	5.41%
10/28/95	9.50%	5.88%	3.62%	11/19/94	10.35%	6.31%	4.04%	11/28/96	11.00%	5.55%	5.45%
4/28/96	9.50%	5.55%	3.95%	5/19/95	10.35%	6.19%	4.16%	5/28/97	11.00%	Pending	Pending
10/28/96	9.50%	5.62%	3.88%	11/19/95	10.35%	5.75%	4.60%	11/28/97	11.00%	Pending	Pending
4/28/97	9.50%	Pending	Pending	5/19/96	11.00%	5.58%	5.42%	5/28/98	11.25%	Pending	Pending
10/28/97	9.50%	Pending	Pending	11/19/96	11.00%	5.55%	5.45%	11/28/98	11.25%	Pending	Pending
4/28/98	9.50%	Pending	Pending	5/19/97	11.00%	Pending	Pending	5/28/99	11.25%	Pending	Pending
10/28/98	9.50%	Pending	Pending	11/19/97	11.00%	Pending	Pending	11/28/99	11.25%	Pending	Pending

NA = Not applicable
= Callable period

and monitoring positions against these limits.

Similarly, limiting **credit risk** arising from a **counterparty** depends on extensively evaluating the creditworthiness of counterparties, setting risk limits to avoid excessive concentrations, regularly measuring exposures and tracking them in relation to risk limits.

Moreover, it is important to keep the risk posed by any individual financial instrument in context. The overall risk of a company's entire portfolio is a much more useful gauge of the firm's risk exposure for both the company itself and its shareholders,

Finally, media accounts

generally have failed to mention that derivatives are typically a zero-sum game: money lost by one investor is gained by another investor. Derivatives are not "black holes" where money disappears from the financial universe. Rather, the money, in the aggregate, is simply transferred. Furthermore, if the party incurring a loss does so within the context of a well-managed portfolio, then the event registers as no more than a cost of doing business as opposed to a crippling financial blow.

The Role of Regulation and Disclosure

Derivatives have stood the test of time, demonstrating that they are a valuable and necessary feature of a smoothly functioning capital market. In fact, the instrument has carved out a fundamental role in all modern currency and commodity markets and modern corporate finance.

Moreover, many of the derivative instruments that exist today have undergone regulatory scrutiny. The Securities and Exchange Commission (SEC) and the Office of Federal Housing Enterprise Oversight are among the watchdogs that currently oversee some or all aspects of derivatives activity.

A safe and efficient market generally does not result from arbitrarily limiting the instruments that can be sold into it or restricting which investors may deal in it. Such markets, however, do require clear, comprehensive information and full disclosure about the nature of a derivative and its potential risks at the time these instruments are sold. However, the SEC and other government agencies must continue to update and refine these regulations to respond to changing market conditions.

In an effort to refine accounting standards for derivatives in the wake of the highly publicized losses in recent years, regulators have issued a new wave of proposals intended to better ensure the efficient operation of these markets (see *Disclosure, Valuation Methods for Derivatives May Change* at right).

No Risk, No Reward

A derivatives deal, which is really nothing more than a paper transaction, does not make investment mistakes; people make mistakes.

Such financial missteps can and should be discouraged. Yet an absolute guarantee against financial error is impossible. A fundamental truth underlining any market enterprise applies equally to derivative investments: no risk, no gain. SMM

Disclosure, Valuation Methods for Derivatives May Change

The two rules-setting bodies for the accounting industry are proposing measures to clarify how a financial statement reports a company's use of derivatives and the firm's management of any resulting interest-rate risk. The proposals were formulated in response to the highly publicized losses incurred by several investors in recent years. If approved, the revisions would significantly alter the way companies account for and report their derivatives activities

The proposals from the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) signal a belief by both that the financial impact of derivatives should come across more explicitly and understandably to financial-statement readers.

The more complex derivatives contracts pose the greatest challenges to financial-statement readers. Changes in the underlying interest rates or market prices to which the contracts are linked are difficult to anticipate. Given that this results in volatile prices for derivatives, the two rule makers are seeking to change accounting practices to make derivatives, along with their net income results, more transparent to readers.

Under the present accounting rules, derivatives are used for either hedging or speculation.

Currently, hedging derivatives are rarely recorded on a firm's balance sheet. Rather, gains and losses resulting from a derivative are capitalized on the balance sheet but are not directly reported in earnings. These gains and losses are however, gradually recognized into income over the life of the hedged item. This deferral gives rise to the economics of the hedging strategy: the reduction of undesired gains and losses, thereby reducing the volatility of the income statement. Any subsequent changes in the value of a derivative likewise go unreported. Consequently, financial-statement readers are at a loss when trying to determine the effectiveness of the company's risk management procedures.

Speculative derivatives are recorded at market value with changes in the market value recognized in net income.

Derivative Designation	Purpose	Current Accounting	Proposed Accounting
Fair-value or fixed-rate hedge	Prevent undesired changes in value of fixed asset/liability.	Same as underlying item's. If one is recorded at cost, so is the other.	Derivative and hedged item recorded at fair value; derivative gain/loss impacts income immediately.
Cash-flow or variable interest-rate hedge	Prevent undesired changes in the amount of cash received/paid from pending transaction or scheduled variable-rate payment.	Same as above.	Derivative shown at market value; changes shown in equity until transaction occurs; net income gain/loss then recognized. No change in hedged item's treatment.
Speculation	Earn a profit predicting interest-rate price changes.	Derivative reported at market value with income changes taken in income. There is no hedged item.	No change in accounting treatment.

In June, FASB proposed a reporting requirement that would show all derivatives on the balance sheet at fair value. The proposal, entitled *Accounting for Derivative and Similar Financial Instruments and for Hedging Activity*, would separate derivatives activities into three categories and, depending on the designation of the derivative, would recognize the resulting gains or losses from market- value adjustments under net income or equity (see table above).

As is the current practice, the FASB proposal lays out certain criteria that a derivative must meet to qualify for hedge accounting. Namely, the derivative must reduce an identified interest-rate or price risk and must be linked to a specific asset or liability. If the derivative is considered a fair-value hedge then changes in the fair value of the derivative must substantially offset the changes in the fair value of the hedged item. For a cash-flow hedge, cash flows from the derivative must offset changes in the cash flows of the hedged item.

Although all of the implications of the proposal may be difficult to understand, certain impacts on hedge accounting are quite clear:

- The accounting results may not necessarily reflect the economics of the hedge because the deferral of gains or losses on derivatives would no longer be permitted.
- The volatility of a company's net income and equity will rise given the increase in the number of assets, liabilities and derivatives recorded at fair value.

FASB has issued an additional proposal, *Reporting Comprehensive Income*, requiring market-value adjustments previously reported in equity to be added to net income. This, in effect, establishes a new company performance measure, called comprehensive income, which will prove extremely volatile. Financial statements will display comprehensive income and net income with equal prominence and both will appear with their own per-share amounts.

Final rulings by FASB are expected in 1997. The proposal on comprehensive income would become effective prospectively for fiscal years beginning after Dec. 15, 1996. The accounting change for derivatives and hedging activity would begin with fiscal years starting after Dec. 15, 1997.

The SEC issued a proposed rule in December 1995 calling for disclosure of more information about a company's financial instruments, including derivatives. In particular, the proposal requires quantification of a company's susceptibility to market swings in interest rates, foreign exchange rates and commodity prices. The proposal also requires explanations as to how the company intends to manage its exposure to these market fluctuations.

Finally, the SEC proposal will require greater disclosure of a company's accounting policy for derivatives, thereby enabling financial statement readers to better understand how derivatives are reported. The SEC is expected to issue a final ruling in 1997.

—Eric Reiser, senior financial analyst