1999

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The Impact of Statement of Financial Accounting Standards 133 on the Banking Industry*

I. INTRODUCTION

On June 16, 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 133. This long awaited statement contains major changes to the accounting rules for trillions of dollars worth of derivative transactions. The accounting requirements contained in this standard will have a tremendous effect on the banking industry because financial institutions are generally the largest users and providers of derivatives and because of the unique accounting problems that result from managing the various risks inherent in the banking business. This note examines the impact this standard will have on financial institutions and analyzes the legislation that it has prompted. Part II of this note contains a brief explanation of derivatives and their use by financial institutions. Part III outlines the basic accounting rules contained in SFAS 133. Part IV analyzes the impact these rules may have on financial institutions and addresses some of the concerns that the banking industry has over this standard. The final section details the legislative responses to the issuance of SFAS 133 and analyzes whether these measures are appropriate. The conclusions of this

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1. The FASB is an entirely private-sector accounting body that was established in 1973 based on a proposal by the Wheat committee. As such, the FASB has no inherent authority, but rather derives its power from the SEC's recognition of its standards as generally accepted accounting principles for purposes of financial disclosure. See Martin Mayer, FASB on Trial, INSTITUTIONAL INVESTOR, Nov. 1997, at 79, 81.


3. See id.

analysis are twofold. The first is that SFAS 133 represents a significant improvement over the current accounting rules for derivatives even though in some ways it may negatively impact financial institutions. The second is that the legislation proposed in response to the issuance of this standard does not appropriately address the banking industry's specific criticisms of SFAS 133 or its general criticisms of the process for setting accounting standards and therefore should not be adopted.

II. OVERVIEW OF DERIVATIVES

Part of the mystery surrounding derivatives is that there is not one simple definition that explains exactly what a derivative financial instrument is. For example, the accounting firm KPMG Peat Marwick LLP defines a derivative as, "[a] generic term often used to categorize a wide variety of financial instruments whose value 'depends on' or is 'derived from' the value of an underlying asset, reference rate or index." Although this definition identifies what makes a financial instrument a derivative, namely that its value is based on the value of something else, it does little to facilitate a truly functional understanding of what derivatives are and how they operate. Unfortunately, the definition contained in SFAS 133 is even less helpful in explaining the practicalities of derivatives to a reader who has little or no previous exposure to them.

Briefly defining and analyzing the specific derivatives most commonly used by financial institutions may facilitate a general

6. Id. at 1.
7. See id.
8. SFAS 133 defines a derivative as a financial instrument or other contract with all three of the following characteristics: a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required. b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors. c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 133 ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES 3 (June 1998) [hereinafter SFAS 133].
understanding of the concept of derivatives better than attempting to broadly define them. These instruments may be broken down into three general categories: forward-based contracts, options, and interest rate swaps.9

A. Forward-Based Contracts

A forward-based contract is an agreement to buy or sell a financial instrument or commodity on a specified date at an agreed price.10 These contracts may be further broken down into two groups: forwards and futures.11 In terms of the substantive agreement, a future is very similar to a forward.12 The main differences between the two are: (1) futures have standard dates for either net settlement or delivery of the underlying asset whereas settlement dates for forwards are privately negotiated, (2) futures are traded in standardized units whereas forwards may be written for any amount, and (3) futures are traded on an organized exchange whereas forwards are over-the-counter products.13 The exchange coordinates the processing and settlement of futures and requires each party to post an initial margin deposit of cash or securities.14 Additional variation margin is posted on a daily basis in an amount equal to the difference between the initial contract price and the daily closing price of the contract in order to limit the counterparty credit risk of futures.15 A currency future is an example of a typical future.16 This contract requires delivery of a specified quantity of a foreign currency on a future date at a fixed exchange rate.17 The value of the currency future then changes on a daily basis as foreign exchange rates fluctuate.18

9. See generally KPMG Peat Marwick LLP, supra note 5.
11. See KPMG Peat Marwick LLP, supra note 5, at 2.
12. See id. at 3.
14. See KPMG Peat Marwick LLP, supra note 5, at 3.
15. See id.
16. See id. at 4.
17. See id.
18. See id.
B. Options

The second general category of derivative financial instruments is options. An option is a contract that gives the holder the right, but not the obligation, to buy or sell an underlying at a fixed price (the strike price) on or before a specified date (the exercise period). An option that provides the buyer the right to buy an underlying is known as a call and allows the holder to benefit when the price of the underlying rises above the strike price. Similarly, an option that provides the buyer the right to sell an underlying is known as a put and allows the holder to benefit when the price of the underlying falls below the strike price. In exchange for the right to exercise the option, the holder pays a premium to the party who sells (writes) the option. The writer of the option then has the obligation to buy or sell the underlying at the strike price if the option is exercised. The most common example of an option is a stock option, which gives the holder the right to buy or sell a fixed number of shares of stock at the specified strike price on or before a fixed date in the future.

C. Interest Rate Swaps

The final general category of derivatives commonly used by financial institutions consists of interest rate swaps. An interest rate swap is an agreement between two parties to exchange interest rate payments that are based on a specified notional amount for a given period of time. Normally the interest rate payments over the life of the swap are equal in value when the parties initially enter into the

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19. An underlying is the variable or instrument on which the option contract is based. Examples of underlyings include, but are not limited to, equity securities, indexes and commodities. See THE CHASE MANHATTAN BANK, N.A. AND RISK MAGAZINE, supra note 13, at 54.


21. See KPMG PEAT MARWICK LLP, supra note 5, at 6.

22. See id.

23. See id.


25. See KPMG PEAT MARWICK LLP, supra note 5, at 7.

26. See id. at 4. See generally PAREKH, supra note 20; WINSTONE, supra note 10.
agreement. The parties settle the net obligation under the agreement on a periodic basis as specified in the contract. There are several types of interest rate swaps that are routinely utilized by financial institutions. The most common is a plain vanilla swap, where one party agrees to pay a fixed rate of interest on a fixed notional amount to the other counterparty in exchange for a variable rate of interest on the same notional amount. The most common variable rate used for plain vanilla swaps is the London Inter Bank Offer Rate (LIBOR) because it is a truly international market rate. However, other rates such as the prime rate or the rate on U.S. treasury obligations may be used. A basis swap is a contract where the parties agree to exchange interest payments based on two different variable rates. For example, one party may agree to make payments based on LIBOR in exchange for payments based on the rate on 30 year U.S. treasury bonds. Finally, an index-amortizing swap is essentially a plain vanilla swap with an embedded option.

D. Use of Derivatives

In order to understand fully the impact SFAS 133 will have on the use of and accounting for derivatives, it is helpful to examine how derivatives are frequently used. There are three main uses of derivatives today: speculation and arbitrage, reduction of funding costs, and risk management. For the most part, only dealers and

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27. See KPMG PEAT MARWICK LLP, supra note 5, at 4. For example, assume that a party wants to pay a fixed rate of interest on a given notional and receive a variable rate based on LIBOR for one year. If the current market rate for a fixed rate obligation of parties with similar credit risks is 8% and LIBOR is currently 6%, the party may agree to pay an 8% fixed rate in exchange for interest payments equal to LIBOR plus 200 basis points.

28. See id.

29. See id.

30. See id.

31. See id.

32. See id. at 5.

33. See THE CHASE MANHATTAN BANK, N.A. AND RISK MAGAZINE, supra note 13, at 36. The embedded option portion of an index amortizing swap is the feature whereby the notional amount of the swap amortizes based on changes in interest rates. See id. For example, the notional may amortize as interest rates fall, thus the fixed-rate receiver has essentially granted an option to the fixed-rate payer because the fixed-rate payer has the "option" to make and receive interest payments based on a lower notional when interest rates fall. See id.
traders use derivatives for speculation or arbitrage, however financial institutions may choose to use derivatives to speculate on the direction of various markets. When an institution uses derivatives for speculation, it is normally attempting to predict which way interest rates, commodity prices, equity prices or foreign exchange rates will move. On the other hand, arbitrage involves using derivatives to take two offsetting positions in order to take advantage of inefficient pricing in the market.

Derivatives are also often used to reduce funding costs. It has been estimated that over half of all new financings utilize derivatives. The most common use for derivative financial instruments in structured financings involves a borrower issuing either fixed or floating rate debt and then simultaneously entering into an interest rate swap. In this manner, a company can convert its fixed rate debt into a variable rate obligation, or convert a variable rate obligation into a fixed rate obligation. By utilizing derivatives in these transactions, it is possible to take advantage of differences in interest rates for different borrowers, usually due to differences in credit risk, and/or possible cross border tax differences that could not be achieved by just directly issuing debt.

Finally, the most common use for derivatives is to manage (hedge) risk. Financial institutions may use derivatives to manage several different types of risk. First, derivatives, usually options, may be used to protect against securities price risk. Derivatives may also

34. See KPMG Peat Marwick LLP, supra note 5, at 19.
35. See id.
36. See id. For example, if gold futures for delivery in one month are selling for $300 per ounce in New York and $301 in London, a trader may take a long position on New York futures and an offsetting short position in London futures in order to take advantage of the $1 spread.
37. See id. at 18.
38. See id.
39. See id.
40. See id.
41. See id.
42. See id. at 13.
43. See id. at 14. For example, if X purchases 100 shares of Y Company for $150 per share, X can limit his possible loss on the stock by purchasing a put option which allows him to sell his 100 shares at some fixed strike price (e.g., $125 per share). In this example, X’s possible loss is limited to $25 per share plus the premium paid for the option because if the market price for Y Company shares falls below $125, X will exercise his option and sell his 100 shares for $125 per share.
be used to manage interest rate risk\textsuperscript{44} or to reduce a firm's exposure to fluctuations in foreign exchange rates or changes in the prices of commodities.\textsuperscript{45} Financial institutions also use derivatives to manage risks other than market risk, such as credit, operational, and/or liquidity risk.\textsuperscript{46}

III. ACCOUNTING FOR DERIVATIVES UNDER SFAS 133

Although SFAS 133 is a rather long and detailed statement – FASB Chairman Edmund Jenkins called it “250 pages of scintillating reading”\textsuperscript{47} – most of the basic concepts are fairly straightforward. The actual accounting for derivatives under SFAS 133 can be broken down into two general parts: initial recognition of derivatives and subsequent changes in fair value. For initial recognition, SFAS 133 requires all derivatives to be recognized as either assets or liabilities on the balance sheet.\textsuperscript{48} Recognition as an asset or liability will depend on the rights or obligations under the specific contracts.\textsuperscript{49} The value to be recognized on the balance sheet is the fair value of the financial instrument as determined by using the guidance provided in SFAS 107, “Disclosures About Fair Value of Financial Instruments.”\textsuperscript{50} Recognition of all derivatives on the balance sheet at fair value represents a significant change from current accounting practices, which do not require certain derivatives such as interest rate swaps to be recognized on the balance sheet at all.\textsuperscript{51}

The accounting for subsequent changes in the fair values of derivatives recorded on the balance sheet will depend on the use of each financial instrument. First, an entity must determine if the

\textsuperscript{44} Examples include modifying the maturities of interest-bearing assets or liabilities, such as when a firm uses T-bill futures to shorten the maturity of its current T-bill holdings, and hedging anticipated transactions, such as when a mortgage company uses forwards to reduce the interest rate risk associated with its commitment to fund mortgage loans in the future. See id. at 15.

\textsuperscript{45} See id. at 15-16.

\textsuperscript{46} See id. at 14.

\textsuperscript{47} Burkholder, supra note 2, at 1006.

\textsuperscript{48} See SFAS 133, supra note 8, at 9.

\textsuperscript{49} See id.

\textsuperscript{50} Id.

derivative will be designated as a hedging instrument. If a derivative is not designated as a hedging instrument, then the change in fair value will be recognized in earnings as a gain or loss in the period when the change in value occurred. Financial institutions will use this method for derivatives that are used for speculation and/or arbitrage.

If the derivative is designated as a hedging instrument, there are three ways to account for a change in fair value depending on the specific classification of the hedge. First, a derivative used as a hedging instrument may be classified as a fair value hedge. In a fair value hedge, a derivative financial instrument is used to reduce exposure to changes in the fair value of either a recognized asset or liability. Subsequent changes in fair value of these hedges are recognized as gains or losses in earnings in the period the market value changed. The offsetting gains or losses on the recognized asset or liability being hedged are also recognized in earnings in this period. The effect of this treatment is to recognize in earnings the net gain or loss resulting from the ineffectiveness of the hedge in offsetting changes in fair value of the hedged item.

The second hedge classification is a cash flow hedge. For a derivative to be designated a cash flow hedge, it must be hedging a firm's exposure to variable cash flows from a forecasted transaction. Subsequent changes in fair value resulting from the effective portion of the hedge are initially recognized in other comprehensive income. Other comprehensive income is not a component of earnings, so the gains or losses resulting from changes in fair value of these instruments will initially only impact equity. However, these gains or losses are subsequently reclassed into earnings in the period when

52. See SFAS 133, supra note 8, at 9.
53. See id. at 10.
54. See id.
55. See id.
56. See id. at 11.
57. See id.
58. See id.
60. See SFAS 133, supra note 8, at 10.
61. See id. at 18.
62. See id. at 10.
63. See Stevens, supra note 59, at 33.
the forecasted transaction being hedged affects earnings.\textsuperscript{64} Gains or losses from any portion of the hedge deemed ineffective are reported in earnings immediately.\textsuperscript{65}

The final classification is a foreign currency hedge of a net investment in a foreign operation.\textsuperscript{66} If a derivative financial instrument is hedging this type of exposure, then any gain or loss resulting from a change in the fair value of the derivative is recognized as a component of other comprehensive income as part of the cumulative foreign currency translation adjustment.\textsuperscript{67}

The requirements for the initial adoption of SFAS 133 are fairly straightforward as well. SFAS 133 is effective for all quarters of all fiscal years beginning after June 15, 1999, though it may be adopted early as of the beginning of any fiscal quarter after issuance of the Standard.\textsuperscript{68} Upon adoption of the Standard, all hedging relationships should be designated and appropriately documented.\textsuperscript{69} SFAS 133 also requires companies to define the parameters of a "highly effective" hedging strategy in order for derivatives designated as hedges to qualify for hedge accounting.\textsuperscript{70} Thereafter, firms must assess the effectiveness of their hedging strategies on at least a quarterly basis.\textsuperscript{71} Any derivative financial instruments initially designated as hedges that subsequently fall outside these parameters will no longer qualify for hedge accounting, meaning that changes in fair value will have to be recognized in earnings in the period of change.\textsuperscript{72} Although the FASB has not provided official guidance on how to measure the effectiveness of a hedging strategy, it has indicated that the SEC would consider items to be "highly correlated" if the change in value of the hedge is within plus or minus 20\% of the offsetting change in value of the hedged item.\textsuperscript{73} In adopting a highly

\textsuperscript{64} See SFAS 133, \textit{supra} note 8, at 10.
\textsuperscript{65} See id.
\textsuperscript{66} See id.
\textsuperscript{67} See id. at 11.
\textsuperscript{68} See id. at 29.
\textsuperscript{69} See id. at 10.
\textsuperscript{70} See id. at 11.
\textsuperscript{71} See id. at 12.
\textsuperscript{72} See id. at 16.
effective hedge strategy, it is also permissible to hedge against a group of assets that are fairly consistent or homogeneous.  

IV. IMPACT OF SFAS 133 ON THE BANKING INDUSTRY

SFAS 133 will likely have the greatest impact on the banking industry as it generally includes the largest users and providers of derivatives and because of the unique accounting problems that result from managing the various risks inherent in the banking business. Furthermore, based on the extensive lobbying efforts in Congress, it appears that the banking industry is adamantly opposed to the implementation of SFAS 133. The dissatisfaction with the new accounting standard seems to revolve around four main objections: (1) the use of fair value on the balance sheet, (2) the probable increase in volatility in the financial statements, (3) the significant costs of implementation, and (4) the suspected decline of prudent risk management.

A. Use of Fair Value

The first main objection that the banking industry has to SFAS 133 is the general requirement that derivatives be recorded at fair value on the balance sheet. This requirement is really the foundation of the entire standard, because if derivatives are not recorded at fair value, then the issues arising from the accounting for subsequent changes in fair value are irrelevant. While the banking industry

74. See SFAS 133, supra note 8, at 13.

75. See Derivatives Hearings, supra note 4, at 400 (prepared statement of William J. Roberts).

76. This note focuses on the impact that SFAS 133 will have on financial reporting for the banking industry. However, SFAS 133 will also impact regulatory reporting, the computation of net capital requirements, and other regulatory requirements of financial institutions. See generally Agency Information Collection Activities: Proposed Collection; Comment Request, 63 Fed. Reg. 71,470 (proposed Dec. 28, 1998); Proposed Agency Information Collection Activities; Comment Request, 63 Fed. Reg. 52,794 (proposed Oct. 1, 1998); Interim Regulatory Reporting and Capital Guidance on FAS 133, “Accounting for Derivative Instruments and Hedging Activities” Fed. Banking L. Rep. (CCH) ¶ 62-159 (Dec. 29, 1998).

77. See Butner & Brezovec, supra note 51.

78. See Derivatives Hearings, supra note 4, at 400 (prepared statement of William J. Roberts).
admits that the use of fair values may be appropriate in some situations, it opposes fair value accounting for derivatives because financial institutions are not managed using fair values. Instead, management evaluates the net cash flows resulting from the derivative and the item being hedged over the life of the transaction. Therefore, providing fair value information to users of financial statements does not provide them with information that accurately reflects the underlying circumstances of the business, nor does it provide a useful comparison of business trends.

Several other arguments exist against using fair values on the balance sheet. First, the use of a “hybrid” value for the assets and liabilities being hedged is problematic because there is no objective way to compute the values, and thus the comparability of financial statements between firms will be reduced. This comparability problem will be exacerbated by the fact that values of instruments for which there is no ready market will be heavily laden with assumptions that are likely to vary from one firm to the next. Finally, there is great concern that SFAS 133 is a piecemeal approach to the use of fair values. The FASB has recently begun a study of the use of fair values for all financial instruments, and the banking industry believes that SFAS 133 should be delayed until the results of this study are complete. Federal Reserve Chairman Alan Greenspan has argued that “fair value accounting for all financial instruments could inappropriately increase the reported volatility of earnings and equity

79. See id.
80. See id.
82. The “hybrid” value is the result of the asset or liability being adjusted for changes in fair value related to the risk being hedged. For example, if an interest rate swap is used to hedge the interest rate risk associated with a variable rate loan, the loan will be reported on the balance sheet at cost (generally the amount funded) as adjusted for the change in fair value of the loan due just to changes in interest rates. Thus, changes in the fair value of the loan due to other factors, such as a change in credit risk, would not affect the value on the balance sheet. See id. (prepared statement by Susan M. Philips).
83. See id. at 289 (prepared statement by Susan M. Philips).
84. See id. at 329 (prepared statement of David S. Berry).
85. See Derivatives Hearings, supra note 4, at 401 (prepared statement of William J. Roberts).
86. See id. (prepared statement of William J. Roberts).
measurements” and “reduce the reliability of financial statement values” if conservative and fairly specific standards for estimation of the fair values of financial instruments are not adopted. These repercussions could put banks at a serious disadvantage in the capital markets as almost all of their assets and liabilities would be recorded at fair value while few of non-financial institutions’ assets and liabilities would be recorded at fair value. The result may be an increase in the relative investor uncertainty regarding the financial position of banks.

B. Increased Volatility

The second general objection of the banking industry centers on a suspected increase in volatility of the reported earnings and equity of financial institutions resulting from the accounting for subsequent changes in fair value of the derivatives. Three basic examples help illustrate their position. The first example involves the use of forwards to hedge the mortgage-banking pipeline. When a mortgage bank commits to fund a loan at a fixed interest rate, it exposes itself to interest rate risk during the time period between this commitment and the sale of the loan. In order to hedge this expected transaction (the sale of the loan), mortgage bankers use forwards. Under SFAS 133, a forward used to hedge this exposure may be designated as a cash flow hedge of a forecasted transaction. Thus, the changes in fair value of the forward will be reported in equity, with no offset for changes in value of the commitment to fund the loan. This is because the commitment is still a forecasted transaction and thus has not been recorded in the financial statements. Thus, the accounting for these hedging transactions under SFAS 133 will increase volatility

87. Id. (prepared statement of William J. Roberts).
88. See id. (prepared statement of William J. Roberts).
89. See id. (prepared statement of William J. Roberts).
90. See Butner & Brezovec, supra note 51.
91. See id.
92. See id.
93. See id.
94. See id.
95. See id.
in the equity of mortgage banks.\textsuperscript{96}

The second example of a transaction that results in increased volatility is any hedge transaction that is ineffective.\textsuperscript{97} Under SFAS 133, changes in the fair value of derivatives that are not perfectly offset by changes in fair value of the item being hedged are reported in earnings.\textsuperscript{98} For example, if the fair value of a mortgage bank's commitment to fund a loan increases by $100 and the value of a forward used to hedge this commitment decreases by $110, the firm must report a loss of $10 in earnings in the current period. Under current practice, however, the firm would not report any loss in earnings as long as correlation between the two was established.\textsuperscript{99} Thus, the accounting treatment required under SFAS 133 would increase volatility in earnings.\textsuperscript{100}

The final example, which is the use of derivatives in a macro hedging strategy, also results in volatility in earnings.\textsuperscript{101} SFAS 133 does not permit the use of hedge accounting for hedges of diverse groups of assets or liabilities, such as the net interest rate risk position of both loans and deposits of a bank.\textsuperscript{102} Thus, the changes in fair values of derivatives used in a macro hedging strategy must be reported in earnings in the period of change, with no offset from the change in values of the hedged items as these items are generally recorded at historical cost, and not fair value, on the balance sheet. This result is particularly problematic, given that the Federal Reserve increasingly is encouraging banks to use macro hedging strategies to manage the aggregate risks of banking while de-emphasizing the use of derivatives to hedge specific transactions.\textsuperscript{103}

\textsuperscript{96} See id.
\textsuperscript{97} See id.
\textsuperscript{98} See id.
\textsuperscript{99} See id. Correlation was generally established as long as the change in fair value of the derivative was within plus or minus 20\% of the change in fair value of the item being hedged.
\textsuperscript{100} See id.
\textsuperscript{101} See Derivatives Hearings, supra note 4, at 402-403 (prepared statement of William J. Roberts).
\textsuperscript{102} See id. at 402 (prepared statement of William J. Roberts).
\textsuperscript{103} See FASB Hearing, supra note 81, at 285 (prepared statement by Susan M. Phillips).
C. Costs of Implementation

Financial institutions have also argued that the implementation of SFAS 133 will have significant costs, and that these costs are not justified based on the relatively few benefits to users of financial statements. The largest costs associated with implementation will be systems related.\(^{104}\) Since most banks do not manage derivatives based on fair values, they do not currently have systems capable of generating the accounting entries associated with SFAS 133.\(^{105}\) The emphasis placed by SFAS 133 on hedging specific transactions rather than entire portfolios will compound the cost of implementation because new risk management systems will also be needed since the current systems are designed for macro hedging.\(^{106}\) Additional systems complications that will increase the cost of implementation include the need to simultaneously address Year 2000 computer problems, a lack of knowledgeable programmers and the lack of software that has addressed the new standard.\(^{107}\)

The other significant costs associated with implementation of SFAS 133 relate to accounting measurement challenges.\(^{108}\) The measurement of fair value for derivative financial instruments will require significant effort for many financial institutions, especially for financial instruments for which there is no ready market.\(^{109}\) For these instruments, the fair value will have to be estimated using a discounted cash flow analysis, and may include management assumptions that are difficult to automate.\(^{110}\) An even more sophisticated pricing model will be required to estimate the "hybrid" value for hedged items as this value represents the historical cost as adjusted for changes in fair value due solely to the risk being hedged.\(^{111}\) Finally, the quarterly

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104. See Derivatives Hearings, supra note 4, at 399-400 (prepared statement of William J. Roberts).
105. See id. at 400 (prepared statement of William J. Roberts).
106. See id. (prepared statement of William J. Roberts).
108. See Butner & Brezovec, supra note 51.
109. See id.
110. See id.
111. See id.
evaluation of the effectiveness of every hedge transaction will require significant new resources.\textsuperscript{112}

\textbf{D. Decline of Risk Management}

The final, and most significant, objection of the banking industry to the adoption of SFAS 133 is that it may discourage the use of prudent risk management. The basic premise of this argument is that if a risk management strategy does not qualify for hedge accounting under the standard, then financial institutions will be much less likely to utilize it because of the aforementioned volatility concerns.\textsuperscript{113} For example, deposits with no contractual maturity and securities designated by management as held-to-maturity may not be designated as hedged items under SFAS 133.\textsuperscript{114} Thus, if management chooses to use derivatives to hedge these items, the change in fair value of the derivative must be reported in earnings in the current period with no offset for the corresponding change in fair value of the deposits or securities as these instruments are recorded at historical cost. Since this will increase the volatility of earnings, management may choose not to follow a prudent risk management strategy by leaving the interest rate risk associated with these instruments unhedged.

The adoption of SFAS 133 might also result in financial institutions decreasing their use of certain derivatives.\textsuperscript{115} For example, the use of basis swaps may decline, as SFAS 133 requires that both sides of the swap be designated against some asset or liability in order to qualify for hedge accounting.\textsuperscript{116} Similarly, the use of index amortizing swaps may decline as uncertainty over the embedded option feature of the swap and whether it will qualify for hedge

\textsuperscript{112} See id.
\textsuperscript{113} See generally id.
\textsuperscript{114} See id.
\textsuperscript{116} See id. This means that rate index of one leg of the swap (for example LIBOR) will have to match the rate index of the asset being hedged and the rate index of the other leg (for example the 30-year U.S. Treasury Bond rate) match the rate index of the liability being hedged. See Katherine M. Reynolds, Regulation: FASB Tweaks its New Rule, But Declines Fed Suggestions, BOND BUYER, Nov. 17, 1997, at 34, available in LEXIS, Bankng Library, CURNWS File.
accounting will make financial institutions wary of these derivatives.\footnote{117}{See Certain Derivatives to Lose Luster, supra note 115.}

In order to avoid the volatility associated with the use of derivatives, financial institutions may be forced to use cash instruments, which are not subject to SFAS 133, to hedge the risks inherent in the banking industry.\footnote{118}{See Derivatives Hearings, supra note 4, at 402 (prepared statement of William J. Roberts).} This would result in increased cost because cash instruments cannot be tailored to offset the particular risks of a specific portfolio of financial instruments, and therefore are often more expensive to use.\footnote{119}{See id. (prepared statement of William J. Roberts).} Furthermore, cash instruments introduce more credit risk because they are more capital intensive.\footnote{120}{See id. (prepared statement of William J. Roberts).} The increased cost of these hedging transactions will most likely be passed on to the public in the form of lower rates on deposits or higher rates on loans.\footnote{121}{See id. at 400 (prepared statement of William J. Roberts).}

The costs associated with implementation of SFAS 133 may also affect the risk management strategies of financial institutions.\footnote{122}{See id. (prepared statement of William J. Roberts).} Institutions that choose to hedge their risks with derivatives will incur the significant systems costs associated with implementation of the standard, while those that maintain unhedged positions will not.\footnote{123}{See id. at 400 (prepared statement of William J. Roberts).} This provides an incentive for management not to use derivatives as part of a prudent risk management strategy.\footnote{124}{See id. (prepared statement of William J. Roberts).} Furthermore, because banks are already facing a scarcity of resources to devote to resolving year 2000 systems issues, management may decide to avoid the systems complications associated with implementation of SFAS 133 by not utilizing derivatives to manage risk.\footnote{125}{See id. (prepared statement of William J. Roberts).} Finally, smaller institutions may find the cost of these systems issues prohibitive, and thus may choose not to use derivatives as hedging instruments.\footnote{126}{See id. (prepared statement of William J. Roberts).}

A final drawback to the implementation of SFAS 133 is that financial institutions may be forced to alter certain consumer products because of their inability to qualify for hedge accounting if derivatives
are used to hedge the risks associated with these products. There are two main examples of such products. First, mortgage bankers no longer may offer consumers the option of locking in a fixed interest rate any time after the loan application is accepted but before the loan is closed. This option is beneficial to consumers as they can benefit from the fixed rate-lock if rates increase; however, it exposes the institution to interest rate risk. In order to hedge this exposure, mortgage bankers currently use forwards. However, this option may be eliminated as the accounting for these derivatives under SFAS 133 increases the volatility of the institution’s equity. A second result may be the reintroduction of prepayment penalties. By offering borrowers the ability to prepay loans without penalty, lenders are exposing themselves to the risk of falling interest rates. Currently, most mortgage bankers hedge this exposure with derivatives. However, if they determine that the use of these derivatives will result in significant volatility in the financial statements under SFAS 133, they may cease to use derivatives and instead reintroduce prepayment penalties to manage this risk.

V. RESPONSES TO THE BANKING INDUSTRY’S CONCERNS

Although the banking industry has raised some valid concerns regarding the impact SFAS 133 will have on its members, a careful examination of the statement will demonstrate that, despite these concerns, the new standard will significantly improve the accounting for derivatives. Specifically, the new standard appropriately recognizes the fair value of derivatives on the balance sheet, represents a fair compromise with respect to the accounting for subsequent changes in the fair values of these financial instruments, and will not

127. See FASB Hearing, supra note 81, at 315 (prepared statement of John T. Thornton).
128. See id. (prepared statement of John T. Thornton).
129. See id. (prepared statement of John T. Thornton).
130. See id. (prepared statement of John T. Thornton).
131. See id. (prepared statement of John T. Thornton).
132. See id. at 316 (prepared statement of John T. Thornton).
133. See id. (prepared statement of John T. Thornton).
134. See id. (prepared statement of John T. Thornton).
135. See id. (prepared statement of John T. Thornton).
necessarily lead to investor uncertainty over volatility or the decline of prudent risk management strategies.

The most fundamental concept of SFAS 133 is that derivatives should be recorded on the balance sheet at fair value. All of the other complexities of the standard, which generally relate to the accounting for subsequent changes in fair value of these instruments, necessarily flow from this basic concept. The current accounting for derivatives does not require many derivatives to be recorded on the balance sheet. This practice is neither an oversight of the accounting profession, nor the result of a previous decision that derivatives should not be recorded on the balance sheet. Rather, it is the result of the basic accounting model that requires assets and liabilities to be recorded at historical cost. Under this basic model, derivatives are not recorded on the balance sheet because they often involve no up front cash payment, and not because they have inconsequential economic effects. The current practice is simply an improper accounting method because derivatives represent either a contractual obligation to make a net payment or payments in the future, which is clearly a liability, or they represent the contractual right to receive a net payment or payments in the future, which is clearly an asset. Since derivatives often have little or no historical cost, the true economic effects of these instruments are not reflected in the financial statements under the historical cost method of accounting. Thus, the only way to record these assets or liabilities is to use the fair value of the instrument.

The alternative to fair value, namely the continued use of historical cost with simple disclosure of fair value, is problematic.

136. See id. at 293 (prepared statement of Professor Mary E. Barth).
137. See id. (prepared statement of Professor Mary E. Barth).
138. See id. at 294 (prepared statement of Professor Mary E. Barth).
139. See id. (prepared statement of Professor Mary E. Barth).
140. See id. (prepared statement of Professor Mary E. Barth). This conclusion follows directly from the definition of a derivative contained in SFAS 133, which lists the attribute that derivatives require “no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors” as one of the three principle characteristics of a derivative financial instrument.
141. See Derivatives Hearings, supra note 4, at 360 (prepared testimony of Edmund L. Jenkins).
142. See FASB Hearing, supra note 81, at 294 (prepared statement of Professor Mary E. Barth).
According to the FASB's Concepts Standards, disclosure is not an adequate substitute for recognition of an asset or liability because disclosures about derivatives are located in the notes to the financial statements, where information is harder to find and understand and may seem less important. The lack of recognition of derivatives on the balance sheet has led to unpredictable losses. For example, in 1994 Proctor and Gamble surprised its investors with the announcement that it had lost tens of millions of dollars on unrecognized derivative financial instruments. In that same year, the Treasurer of Orange County, California announced the county had lost $1.7 billion on its unrecognized derivatives. Under SFAS 133, these instruments would have been recognized on the balance sheet, thereby giving investors the information necessary to assess the possibility of such losses.

Given that recording derivatives at fair value on the balance sheet is the appropriate way to account for these instruments, the methodology adopted by SFAS 133 for recording subsequent changes in the fair values of these instruments is a fair compromise between the FASB and the banking industry. There are two simple alternatives to SFAS 133 accounting for these changes. The first is to recognize decreases in the fair value of derivatives (losses) as assets and increases (gains) as liabilities. Since losses do not provide a firm with any present or future benefit and gains do represent present or future obligations, this alternative is clearly improper. The second alternative is to record all gains or losses on derivatives in earnings in the period of change. While this method is proper from an accounting standpoint, the banking industry vehemently opposes this simple requirement because they fear it would significantly increase

143. See id. (prepared statement of Professor Mary E. Barth).
144. See Derivatives Hearings, supra note 4, at 360 (prepared testimony of Edmund L. Jenkins).
147. See generally FASB Hearing, supra note 81 (prepared statement of Professor Mary E. Barth).
148. See id. at 296 (prepared statement of Professor Mary E. Barth).
149. See Derivatives Hearings, supra note 4, at 361 (prepared testimony of Edmund L. Jenkins).
the volatility of the income statement and does not properly reflect the
hedging strategies of financial institutions.\footnote{150}{See generally id. (prepared statement of William J. Roberts).}

By adopting the aforementioned standards relating to hedge
accounting, SFAS 133 represents a compromise that significantly
reduces the volatility problem in two ways. First, gains or losses on
derivatives classified as fair value hedges may be offset in earnings by
gains or losses recorded in the current period on the items being
hedged.\footnote{151}{See FASB Hearing, supra note 81, at 295 (prepared statement of Professor Mary E. Barth).}
This solution results from SFAS 133's allowance of the
historical cost of hedged items to be adjusted for changes in the fair
value of the item due to the risk being hedged.\footnote{152}{See id. (prepared statement of Professor Mary E. Barth).}
Thus, the only income volatility that will result from transactions accounted for this
way will be due to the ineffectiveness of the hedge.\footnote{153}{See id. (prepared statement of Professor Mary E. Barth).}
Management
will thus be more accountable for its hedging strategies and will insure
proper recording of that portion of derivatives that represents
speculation as opposed to risk management.\footnote{154}{See id. (prepared statement of Professor Mary E. Barth).}

The second way SFAS 133 addresses the concerns relating to
volatility in earnings is by allowing gains or losses from derivatives
used in certain hedging strategies to be recorded in equity in the period
of change and then later reclassed to earnings in the period when the
gains or losses on the items being hedged are recorded in earnings.\footnote{155}{See Derivatives Hearings, supra note 4, at 361 (prepared testimony of Edmund L. Jenkins).}
For example, the use of forwards to hedge the mortgage-banking
pipeline will undoubtedly increase equity volatility. However, this is a
result of the unique accounting problems posed by hedging anticipated
transactions.\footnote{156}{See id. (prepared testimony of Edmund L. Jenkins).}
Since the hedged transaction (i.e., the closing and
subsequent sale of the loan) is only expected to occur, it is not
appropriate to record its economic effects in the financial
statements.\footnote{157}{See id. (prepared testimony of Edmund L. Jenkins).}
Therefore, the gains or losses from this expected
transaction are not available to offset the gains or losses from the
derivative. This volatility is an appropriate accounting result,
however, because financial statements reflect a firm's existing assets and liabilities at a given point in time and do not include the results of expected transactions that may or may not actually occur.\footnote{158}

Finally, evidence suggests that the concerns over volatility and the reduction of risk management are unwarranted. John Brennan, President of the Vanguard Group, indicated in his testimony before Congress that "the standard will not create volatility in the earnings of derivatives users."\footnote{159} According to Brennan, the volatility is already there, and it is just difficult for investors to quantify the impact of derivatives under current accounting methods.\footnote{160} Thus, if financial institutions do not recognize the fair value of their derivatives on their balance sheets, they may face a higher cost of capital as investors will be less willing to accept the risk associated with their debt or equity securities.\footnote{161} Furthermore, although the standard may reduce speculation, it will not discourage companies from using derivatives to manage risk as it is economics, not accounting, that dictates the use of derivatives.\footnote{162} This testimony is significant because it is the product of experience rather than mere speculation as investment companies are already planning to market all derivatives positions held by their mutual funds according to special accounting rules that apply to these institutions.\footnote{163}

V. LEGISLATIVE RESPONSES TO SFAS 133

In response to the heavy criticism of SFAS 133, especially the objections of financial institutions to the new Standard, two bills were introduced in Congress which sought to limit the impact of SFAS 133. The first bill, S. 1560,\footnote{164} stated that any accounting standards issued by the FASB after November 13, 1997 that related to accounting for derivatives should not be regarded as generally accepted accounting

\footnotesize{\begin{itemize}
  \item \footnote{158} See id. (prepared testimony of Edmund L. Jenkins).
  \item \footnote{159} FASB Hearing, supra note 81, at 326 (prepared statement of John J. Brennan).
  \item \footnote{160} See id. (prepared statement of John J. Brennan).
  \item \footnote{161} See id. at 327 (prepared statement of John J. Brennan).
  \item \footnote{162} See id. (prepared statement of John J. Brennan).
  \item \footnote{163} See id. at 328 (prepared statement of John J. Brennan).
  \item \footnote{164} S. 1560 was sponsored by Senator Lauch Faircloth from North Carolina and was introduced on November 13, 1997. See S. 1560, 105th Cong. (1997), available in LEXIS, Genfed Library, BLTEXT File; <http://www.access.gpo.gov/sudocs/aces/aaces002. html>.
\end{itemize}}
principles for depository institutions for purposes of complying with federal banking law. However, this legislation is no longer a threat to the full implementation of SFAS 133 as the bill’s sponsor failed in his bid for re-election in the November 1998 elections.

Section 3 of the second bill, H.R. 3165, amends section 19 of the Securities Exchange Act of 1934 in several ways. First, it requires the SEC to formally approve all accounting principles proposed by the FASB. The process for approval begins with the FASB filing with the SEC any proposed accounting principles. The SEC then must give interested persons a reasonable opportunity to submit opinions on the proposed standard. Finally, the Commission must either approve the proposed standard or institute proceedings within 35 days of the publication of notice of the filing of the proposal in order to determine if the proposed standard should be rejected. H.R. 3165 also sets forth the grounds on which the SEC should approve a proposed standard. Specifically, the Commission should approve a proposed accounting principle if it is “consistent with the public interest and the protection of investors.” Furthermore, it should consider “whether the principle will promote efficiency, competition, and capital formation.” H.R. 3165 also provides that the SEC should consult with all federal banking agencies that regulate an entity that will be affected by a proposed standard when determining whether to approve or reject the proposal. Finally, H.R. 3165 makes judicial review of accounting standards available by stating that a proposed standard that is approved by the SEC is to be

165. See id.
167. See id.
168. See id.
169. See id.
170. See id.
171. See id. The 35 day time limit may be extended to up to 90 days after the notice is published if the SEC finds a longer period appropriate and publishes its reasons for extending the approval period. See id.
172. See id.
173. Id.
174. Id.
175. See id.
considered a rule of the Commission.176

As might be expected, H.R. 3165 and S. 1560 sparked heavy debate over the future of SFAS 133 and, more generally, the role of the FASB. Proponents of the two bills focused their support on two main areas. First, under H.R. 3165, companies will be able to seek judicial review of the process whereby proposed accounting standards are adopted.177 This would eliminate the need for aggrieved persons to seek legislative help from Congress every time they disagree with the substance of proposed accounting standards.178 Furthermore, Representative Baker has argued that the power to seek judicial review will not result in a litigation explosion as “few regulated parties will want to take their regulator to court unless they harbor serious concerns.”179

The second main argument in support of the proposed legislation is that it will increase the accountability of the private sector bodies that propose new accounting standards, specifically the FASB, without necessarily increasing the SEC’s authority.180 Currently, the SEC regards the standards set by the FASB as generally accepted accounting principles for financial reporting purposes.181 Thus the SEC has implicitly approved the FASB’s standards. Under H.R. 3165, the role of the FASB in proposing new standards would be preserved.182 The only change would be that the SEC would have to explicitly approve the new standard after considering whether it is in the public interest.183 Bill Leiter, chief accounting expert at Bane One Corp., has argued that the SEC should have to formally approve accounting standards proposed by the FASB because the FASB went through its formal process for adopting SFAS 133 but did not really react to any of the comments made by those who disagree with the new standard.184 By requiring SEC approval, Leiter believes the

176. See id.
179. Id.
180. See Salfi, supra note 177, at 55.
181. See Mayer, supra note 1, at 79.
182. See Salfi, supra note 177, at 55.
183. See id.
184. See Bill Subjects FASB to Judicial Process, supra note 178.
FASB would pay more attention to comments in the future. The requirement of explicit SEC approval would also make the review process for accounting standards similar to other self-regulatory institutions like the National Association of Securities Dealers, thereby creating similar rights to judicial review.

Although there has been some support for passing legislation that alters the impact of SFAS 133, critics of the proposed legislation have pointed out serious flaws that call into question the wisdom of adopting H.R. 3165 or proposing future legislation in this area. First, Edmund Jenkins, Chairman of the FASB, noted that companies already have the right to challenge proposed accounting standards in court, thereby making H.R. 3165 moot. Currently, if a firm feels that the FASB has been "arbitrary and capricious" in its process of adopting an accounting standard, it can request the chief accountant of the SEC to exempt it from the standard. If this request is denied, then the firm can appeal to the commissioners. If the commissioners also decline, then the firm can seek help from the judicial process. By expanding the scope of judicial review beyond this standard, H.R. 3165 could be placing a huge financial burden on the FASB in the form of legal costs incurred while defending its accounting standards.

The second general criticism of the proposed legislation is that the FASB's current process for adopting accounting standards provides firms adequate due process. The current process affords interested parties the opportunity to comment on proposed standards in writing as well as attend open meetings to voice any potential concerns. In fact, before SFAS 133 was formally adopted, the FASB held 140 public meetings over a span of six years. The composition of the

185. See id.
186. See id.
189. See id.
190. See id.
191. See id.
192. See Jenkins, supra note 187, at 4.
193. See Loewenberg, supra note 146, at 4.
FASB also helps ensure that proposed accounting standards reflect the opinions of professionals in a wide variety of fields. Only three of the seven Board members are from accounting firms, with only two of those members coming from large firms. The rest of the Board is comprised of members from the investing and financial statement-preparing communities as well as the academic world. The FASB also seeks input from a wide range of interested parties before proposing new standards.

The third general criticism centers on the negative effects of politicizing the process of setting accounting standards. First, allowing a governmental body to approve accounting standards may lead to a general lowering of standards as political pressure from interested parties, namely those being forced to comply with the standards, will influence the process. The consequences of lower accounting standards include higher capital costs, as investors will be faced with uncertainty over untrustworthy financial statements. There is already evidence that political pressure may have influenced the introduction of H.R. 3165 as Representative Baker, the bill’s sponsor, received money from 18 banking political action committees in 1997. Empirical evidence suggests that allowing a governmental agency to set accounting standards can lead to disastrous results. During the 1980’s, the Federal Home Loan Bank Board (FHLBB) allowed S&L’s to ignore generally accepted accounting principles, as adopted by the FASB, and defer the losses realized on the sale of loans over a twenty-year period. This allowance meant that a deferred loss was recorded on the balance sheet as an asset of the institution. The result was approximately $150 billion in losses from S&L’s that

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194. See Mayer, supra note 1, at 82.
195. See id.
196. See id. at 83. These parties include: the American Institute of Certified Public Accountants standards committee, similar committees from the individual states’ CPA associations, the standards committee at the American Accounting Association, financial analysts, the various self-regulating organizations of the securities business (such as the NASD), accounting firms, corporations, and the various banking regulators. See id.
197. See Ketz & Miller, supra note 188.
198. See id.
199. See id.
200. See id.
201. See id.
the FHLBB had certified were solvent.\textsuperscript{202} Other concerns with allowing a governmental agency to certify accounting standards include possible jurisdictional disputes among regulators and the need for new competencies within various governmental agencies.\textsuperscript{203}

The final, and perhaps most compelling, criticism of the proposed legislation is that it threatens the current effort to introduce international accounting standards. The need for a set of generally recognized international accounting standards is clear, as the lack of such standards seriously limits the formation of world capital markets.\textsuperscript{204} Many companies operate in an international marketplace, and as such may require access to capital from world markets, as they no longer have the ability to raise sufficient capital domestically to facilitate their desired growth rate.\textsuperscript{205} Furthermore, firms may want to widen their shareholder base by listing their shares on international exchanges, thereby emphasizing their commitment to countries in which they operate as well as making it easier to use stock rather than cash to finance acquisitions abroad.\textsuperscript{206}

Without the ability to report their accounts in one set of generally recognized accounting standards, companies that desire access to world capital markets may find the costs of conversion to various other standards prohibitive. For example, the SEC currently does not recognize any accounting standards other than U.S. GAAP for cross-border filings in the U.S.\textsuperscript{207} Thus, foreign companies that wish to be listed on the New York Stock Exchange (NYSE) must comply with U.S. GAAP.\textsuperscript{208} The conversion from other standards to GAAP may result in huge disparities in the financial position of foreign companies. For example, when Daimler-Benz was listed on the NYSE in October 1993, its first half profits of DM 168 million under German standards became a loss of DM 949 million when its

\textsuperscript{202} See Mayer, supra note 1, at 79.
\textsuperscript{204} See generally Stewart Hamilton, Accountants Gather Round Different Standards, FIN. TIMES, Mar. 20, 1998, at 12.
\textsuperscript{205} See id.
\textsuperscript{206} See id.
\textsuperscript{207} See Salfi, supra note 177, at 55.
\textsuperscript{208} See Hamilton, supra note 204, at 12.
accounts were converted to GAAP. A similar disparity occurred when the German conglomerate Hoechst was listed in 1994 as its profits of DM 1.7 billion under German standards became a loss of DM 57 million when the accounts were brought in compliance with GAAP. Thus, in order to have access to the NYSE, both companies incurred not only the cost of converting their accounts, such as systems changes and fees paid to auditors, but also a presumably higher cost of capital as investors were faced with uncertainty caused by the disparities in financial position of the two companies as reported under the different accounting standards.

An international effort is currently underway to adopt one set of accounting standards, and H.R. 3165 seriously threatens this effort. The International Accounting Standards Committee (IASC) is currently working on a set of standards to be presented to the International Organization of Securities Commissions (IOSC). The IASC is made up of the accountants’ societies of 86 countries and generally has the support of the European Union, as evidenced by recent legislation in Germany that allows companies to use standards set by the IASC for domestic reporting purposes. Generally speaking, the IASC has adopted the main principles of SFAS 133, therefore making it entirely possible that the FASB’s standards for accounting for derivatives could become the de facto standard for the world. If H.R. 3165 is passed, the result could well be two sets of standards in the U.S. alone: the FASB’s rules for private companies and the SEC's standards for public companies. The resulting disparities in accounting standards in the U.S. would obviously threaten the IASC’s effort since its standards would not be generally accepted in the U.S. and therefore would not guarantee foreign companies access to U.S. capital markets.

209. See id.
210. See id.
211. See generally id.
212. See Cheney, supra note 145.
213. See Mayer, supra note 1, at 89.
214. See Hamilton, supra note 204, at 12.
215. See Cheney, supra note 145.
217. See generally id.
VI. CONCLUSION

The general purpose of this note was to analyze both the impact that SFAS 133 will have on financial institutions and the legislation proposed as a result of the FASB issuing this standard. The first conclusion of this analysis is that any negative impact SFAS 133 will have on financial institutions is significantly outweighed by the benefits of improved accounting for derivative transactions. The second is that the pending legislative response that attempts to limit the applicability of this standard and to change the current process for adopting accounting standards is inappropriate because of its failure to address the banking industry’s specific criticisms of SFAS 133 and its failure to propose a more effective process for setting accounting standards.

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218. *See supra* notes 47-163 and accompanying text.
219. *See supra* notes 164-217 and accompanying text.