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Boxed In

The government's push to standardize over-the-counter derivatives could severely disrupt corporate hedging programs.

Randy Myers, CFO Magazine
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Eager to prevent a repeat of last year's financial-market meltdown, in which the federal government was forced to bail out a number of big firms or risk a dominoes-like implosion of the credit-default-swaps market, the Treasury Department has drafted legislation that would impose tight new regulatory controls on the entire over-the-counter derivatives market. That market encompasses not just credit default swaps but all sorts of other derivatives contracts companies use to hedge commodity, interest-rate, and currency risks.

Corporations have largely applauded the Administration's efforts to bring more oversight and transparency to this market. But they have railed against Treasury's recommendation to "standardize" as many OTC transactions as possible and have them cleared on an exchange or through a central counterparty (CCP). Although that would both increase transparency and mitigate counterparty risk, it would also force companies to post collateral — cash or Treasuries — against their hedges based on a daily or twice-daily marking to market of their positions, thus tying up precious cash.

It's not just an issue for large companies. While OTC derivatives can be complex, many kinds of companies take advantage of them, even if only sporadically. According to the International Swaps and Derivatives Association, not only do more than 90% of the *Fortune* 500 use customized derivatives but so do half of midsize companies and thousands of small companies. "I would be shocked if I was talking to a treasurer for even a small $50 million company that didn't know about their availability," says Tim Murphy, foreign-currency risk manager for $25.3 billion manufacturer 3M. Before joining the company 8 years ago, Murphy spent nearly 12 years on the sell side of the derivatives market, at a bank.

Nash-Finch, a $4.7 billion wholesale grocery distributor, uses swaps to convert some of its floating-rate debt to a fixed rate, or to hedge its price exposure on the 3 million to 6 million gallons of diesel fuel its truck fleet burns through each year. It doesn't use derivatives for trading or other speculative purposes. Despite this small footprint — at the start of this year the company had two interest-rate swaps outstanding with a notional value of $52.5 million, and no diesel-fuel swaps — Nash-Finch may soon find be among the many companies whose modest hedging programs are less risky but more complicated and expensive.

That's because the push for centralized clearing would, among other things, jeopardize companies' ability to apply favorable hedge-accounting rules to their derivatives transactions. That accounting treatment is available under FAS 133 only when a derivative is "highly effective" in hedging the underlying risk, meaning that its value moves in a nearly perfect inverse relationship to the value of the underlying exposure.

Finance chiefs fear that standardized contracts might not offer that precision, and without hedge accounting, any fluctuations in the value of a company's derivatives positions would flow through to its income statement rather than its balance sheet, introducing an unwanted new source of volatility to the bottom line.

"If companies can't arrange the perfect hedge, they may be caught in a precarious position," says one treasurer. "It can cause pretty severe income-statement volatility, and that goes contrary to the purpose of hedging."

A Defining Matter

Whether the proposed legislation would actually cause the disruptions that Corporate America fears will depend to a large degree on how the government defines the term "standardized" in relation to derivatives contracts. The Obama Administration has proposed that the Commodity Futures Trading Commission and the Securities and Exchange Commission work up a definition. However, its draft legislation does say that any OTC derivative accepted for clearing by any regulated central clearinghouse would be presumed to be standardized. It wants to give regulators the teeth to enforce their definition, too, with the authority to prevent market participants from using "spurious customization" to avoid central clearing and exchange trading.

Treasury Deputy Secretary Neal Wolin insists the Administration isn't out to eliminate OTC derivatives. "What we've said is that we would like to have things move onto exchanges and be cleared through central counterparties," he says. "We think that has the advantage of better risk management and transparency. But we are not requiring all derivatives to be moved onto exchanges or cleared through CCPs. Companies would still have the capacity to trade in derivatives over the counter on a customized basis when they can't do it on an exchange in a way that allows them to manage risk appropriately."

Don Thompson, managing director and associate general counsel for JPMorgan Chase, one of the country's biggest derivatives dealers, isn't convinced that the proposed regulations would prove so benign. "When end users talk about customized derivatives, they're not necessarily talking about transactions that are very complex," he cautions. "Often, they're talking about a transaction that simply matches precisely the amounts and payment dates of underlying liabilities. So there's a good chance, for example, that a customized interest-rate swap that matches precisely the date of an underlying floating-rate bank loan will be deemed standardized. Thus end users may have to clear those, or not do them."

For some companies, the financial consequences of that would be meaningful but not onerous. 3M's Murphy says his company did a cursory analysis of what the proposed new regulations would have meant to it over the past two to three years and found that it would have required the posting of between $100 million and $200 million in collateral. "That's not a cost; that's the amount of money 3M would potentially have to have had sitting in a margin account against a pot of trades," he notes. "3M is certainly in a position where we have that kind of money, but it still represents an opportunity cost — a chunk of your balance sheet that's tied up."

For others, the impact could be significant. Southwestern Energy is a fast-growing, $2.3 billion (in revenues) gas and oil exploration and production company that saw its workforce grow to 1,400 employees from 250 in the four years ended December 2008. It typically hedges about 75% of its expected annual gas production, giving it the pricing certainty it craves in its budgeting activities.

Greg Kerley, the company's executive vice president and CFO, says that had Southwestern had to put up collateral on its derivatives portfolio on June 30, 2008, it would have had to post about $750 million — an amount that slightly exceeded the company's total debt at the time. By December 31, 2008, by contrast, its collateral requirement would have been approximately $120 million, thanks to a sharp decline in the price of natural gas over the preceding six months. "To post collateral for our natural-gas hedges over the past several years, we would have had to dramatically change our operations," Kerley says. "It would have greatly reduced our capital spending and the total number of employees we were able to add to our payroll."

Gauging the True Cost of Risk

Even if a company were doing derivatives transactions that did not qualify for clearing under the proposed regulations, it might still incur additional costs under the draft legislation, says Scott Hill, CFO of Intercontinental Exchange, an $813 million operator of regulated exchanges, trading platforms, and clearinghouses. The way the legislation is drafted, he explains, a dealer selling those derivatives contracts could face higher capital charges — in the form of higher reserving requirements — than it would currently.

"The commercial customer may not have a margin requirement," Hill says, "but I do believe the cost to put the hedge in place is likely to go up, because I can't imagine the bank or whoever is writing the other side of that trade is going to absorb their capital cost."

Wolin argues that all the talk about higher costs overlooks some of the savings that ought to accrue from having a more transparent marketplace that minimizes counterparty risk. "Right now, when pricing over-the-counter swaps, there is implicitly some charge for credit risk that one counterparty imposes on the other," he says. "If you have, in some circumstances, margin or capital requirements, the cost is more explicit. But it's not clear to me whether the direction is up or down. And we know from other capital markets that less transparency means higher prices."

The Obama Administration is expecting some version of its legislation to be introduced by Rep. Barney Frank (D–Mass.) in the House Financial Services Committee, and by Sen. Christopher Dodd (D–Conn.) in the Senate Committee on Banking, Housing, and Urban Affairs. Industry insiders are divided on how likely it is that any legislation will get passed this year.

Thompson is among the skeptics. "I think there's going to be a protracted battle," he says. "Whether anything gets done or not will depend in part on how health care goes. My best guess — and it's only that — is that this is likely to get lost among other things that are a higher priority or have more visibility or are of greater importance to the country. But it's not going away."

John Jay, a senior analyst with Aite Group, a consultancy serving the financial-services industry, suspects legislation could get passed this year, in part because the pain of last year's financial crisis is still so fresh. "I think we will get this," he says. "It's just a short time since the world almost ended."

Washington seems poised to exact a price from the business community in order to assure that the financial system avoids the risk of another meltdown. Companies can only wait and wonder how steep that price will be, and what exactly it will buy.

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Clearing the Way
A number of clearinghouses already deal with OTC derivatives.

Proposed legislation would require that all standardized over-the-counter derivative contracts be cleared on an exchange or through a central counterparty (CCP). While the drive to standardize contracts and push them into a clearing environment may be new, clearing OTC derivatives itself is not. A number of clearinghouses around the globe have been doing it for several years. Among them: LCH.Clearnet, which clears interest-rate swaps; Intercontinental Exchange and CME Group, which clear swaps based on natural gas, electricity, and crude oil; and Eurex and NYSE Liffe, which clear European equity derivatives.

Last March, ICE launched a new subsidiary, ICE US Trust, to begin clearing credit default swaps in the United States. It is structured as a CCP; dealers execute trades and then move them to the CCP, where the CCP creates new transactions interjecting itself as the counterparty to both buyer and seller. By early August, ICE US Trust had cleared credit default swaps with a notional value of more than $1.7 trillion. Intercontinental Exchange launched a European version of its CCP, ICE Clear Europe, in late July, which in its second week of operation cleared 699 transactions totaling $45.2 billion in credit default swaps. — *R.M.*