point of view

OTC Derivatives:
Should all customized derivatives be standardized?*

Most agree reform is needed. But how much reform is unclear.

Highlights

Reform efforts are underway to increase oversight of OTC derivatives.

OTC derivatives enable businesses to custom-tailor a contract to offset nearly any financial risk exposure.

More than 90% of Fortune 500 companies use customized OTC derivatives every day, as do half of midsized firms and thousands of smaller US companies.

The market may provide an alternate means of increasing OTC derivative transparency and reducing potential systemic risk.

Why should the right balance be struck when it comes to regulating OTC derivatives?

Some OTC derivatives have been criticized for contributing to the financial crisis. But new proposals may affect how all derivatives are traded and designed.

Most financial derivatives have been safely and prudently used over the years by thousands of companies seeking to manage specific risks.

OTC derivatives are privately negotiated because they are often highly customized. They enable businesses to offset nearly any financial risk exposure, including foreign exchange, interest rate, and commodity price risks.

Proposals to standardize terms for all OTC derivatives could inadvertently limit the ability of companies to fully manage their risks.

OTC derivatives reduce risk and contribute to a resilient economy

More than 90% of Fortune 500 companies safely and prudently use customized OTC derivatives today, according to the International Swaps & Derivatives Association, as do half of midsized firms and thousands of smaller US companies to manage specific financial risks.

An attempt to address systemic risk

Some over the counter (OTC) derivatives are believed to have contributed to the financial crisis. New proposals for increased oversight of all derivatives may result in standardizing the terms and conditions associated with derivatives traded in the OTC market.

OTC derivatives typically are highly customizable contracts privately negotiated between two parties. These contracts are used to facilitate the efficient management of various financial risk exposures by a wide variety of companies.

To date, some of these products have been exempt from regulation. The Commodity Futures Modernization Act of 2000 explicitly exempted OTC derivatives from Commodity Futures Trading Commission and SEC oversight.

The Obama Administration proposes that "all standardized" OTC derivatives be cleared through regulated central counterparties, with regulators imposing robust collateral requirements and other risk controls. The Senate's proposed Derivatives Trading Integrity Act (S. 272), would disallow all derivative contracts from being traded over the counter.

Some OTC derivatives have caused problems in the past. Moreover, credit default swaps have been criticized for playing a role in the recent crisis. But, overall, the vast majority of financial derivatives have been safely and prudently used over the years by thousands of companies seeking to manage specific risks. Any reform effort, therefore, should consider the role played by these transactions and how they are used today.

Derivatives: A valuable tool for consumers, farmers, and businesses

Derivatives have benefited consumers, farmers, and non-financial companies alike for more than 150 years, and have contributed to the development of the United States from an agrarian nation to a global economic superpower.

The 1848 formation of the Chicago Board of Trade serves as an early example of how derivatives markets work. Due to the seasonality of grain, Chicago spot prices rose and fell drastically. A group of grain traders eventually created the "to-arrive" contract. It permitted farmers to lock in the price and deliver grain later. These contracts eventually were standardized, serving to stabilize food prices and mitigate the boom-bust farming cycle.

Over the years, the use of OTC derivatives grew in line with the expansion of global trade and capital flows. These derivatives eventually enabled businesses to custom-tailor a contract to offset nearly any risk exposure, including foreign exchange, interest rate, and commodity price risks.

An essential component of corporate risk management

More than 90% of Fortune 500 companies safely and prudently use customized OTC derivatives today, according to the International Swaps & Derivatives Association, as do half of midsized firms and thousands of smaller US companies to manage specific financial risks.

An energy producer, for example, may use an energy derivative to manage the risk of changes in gas or electricity prices. A beer producer may hedge its grain costs. Or a US food company doing business worldwide may hedge its international revenues or expenses using foreign exchange (FX) derivatives.

OTC derivatives help companies to reduce risk and contribute to a more efficient economy. These benefits convinced past legislators to allow these innovative financial products to operate relatively freely. Derivatives that can be standardized tend to end up traded on exchanges or through clearinghouses. Unique derivatives are traded in the OTC space.

Overregulation of OTC derivatives may hinder corporate risk management

The objectives proposed by the Obama Administration may be obtained without mandating the specific steps required to achieve them.

We agree with the Obama Administration's broad proposal to oversee OTC derivatives more closely and to monitor their trading activity.

However, we would caution against proposals that require all OTC transactions to be processed through exchanges or clearinghouses. Limiting the flexibility of these markets may lead to reduced or inadequate corporate risk management, or the movement of these transactions to friendlier, offshore jurisdictions.

Added costs and risks for businesses and consumers

While derivatives are often portrayed as being somewhat nefarious, the role they play in providing efficiency to the capital markets is significant.

US businesses operating overseas will typically sell their products locally and get paid in local currency. To protect these payments against currency fluctuations, a company may enter into a foreign currency contract.

S.272 would limit a company's ability to mitigate its specific foreign currency risk exposures by forcing it to use a one-size-fits-all FX swap instead of one tailored to expected cash flows. The same would hold true for interest rate risk or price risk for commodities or other raw materials.

Reduced corporate liquidity

Currently the amount of collateral needed for a derivative transaction, the circumstances in which it should be posted, and the form of such collateral are negotiated between counterparties. A contract also can be tailored to include less liquid collateral that a user may have as part of its ongoing business operations.

To achieve greater transparency, current proposals would require conducting OTC transactions on exchanges or through clearinghouses. Yet these entities typically require posting a substantial amount of cash collateral or other highly liquid instruments in amounts in excess of the fair value amount of the derivative contract. As such, these proposals would reduce corporate liquidity, thereby lowering return to shareholders and driving up the cost of capital--all at a time when credit is tight and earnings are under severe stress.

These added inefficiencies may be passed on to consumers as higher costs. Over the longer term, however, competitive pressures may force OTC transactions to move offshore. This could result in less transparency, rather than more, and negatively impact the US's leading role in financial innovation.

Set policy rather than methodology

We believe the objectives proposed by the Obama Administration may be obtained without mandating the specific steps required to achieve them.

For example, a June 2, 2009 letter from the major derivatives players to global regulators proposed achieving the same goals as the G20, the European Commission, and the Obama plan but with less need for direct regulator supervision.

The alternative approach, as proposed in the letter, includes implementing data repositories for non-cleared OTC derivatives to ensure appropriate transparency and disclosure; assisting global supervisors with oversight and surveillance activities; and clearing for standardized derivative products.

Today's complex financial markets are global and irreversibly interlinked. The government, therefore, should strike a balance between guarding against systemic risk and allowing companies to prudently manage their business risks. Eliminating OTC derivatives may unintentionally interfere in this process, adding new inefficiency to the global financial system.

Systemic risk oversight should also allow for market innovation

Q&A

Q: Are you suggesting the derivatives market remain unregulated?

A: No. We believe the derivatives market should receive the same oversight as other sectors of the capital markets. In addition, the recent compromise between the SEC and CFTC in which credit default swaps and other derivatives related to securities would fall under SEC supervision seems reasonable. Oversight of derivatives tied to interest rates, commodities, currencies, energy, etc., would fall under CFTC purview.

For OTC derivatives, the CFTC ideally would set broad oversight parameters and then work with industry groups and market participants to establish practices that meet the goals established by Congress.

Q: Why shouldn't cash collateral be required as a function of the OTC derivatives market, rather than less liquid assets?

A: For exchange traded contracts, each counterparty is required to post margin collateral (normally cash) at inception. This amount is adjusted daily in response to daily fluctuations in the value of the derivatives. In private, or OTC contracts, with non-financial counterparties, collateral can be in the form or amount agreed upon by the parties, such as a line of credit, with no daily movements of collateral. Many non-financial companies are simply not equipped to monitor and move potentially sizable cash balances for each of their derivative positions. Adding these capabilities would require incurring substantial new operational, system, and liquidity costs at many companies.

Q: You say the capital markets can address its deficiencies. What have they done to address credit default swaps, the OTC derivative most closely associated with the credit crisis?

A: Intercontinental Exchange Trust, a leading operator of regulated global futures exchanges, clearinghouses and OTC markets, recently surpassed $1 trillion in cleared CDS since operations began in March. These results indicate the market has begun to address its deficiencies while also providing the transparency and clearing function sought by regulators and legislators. Further, increased oversight of financial institutions and other entities issuing credit derivatives should address the key concerns that have been raised.

Q: How would standardizing OTC derivatives affect hedge accounting?

A: The impact of current legislative proposals could preclude companies from achieving the synchronized price movements between instruments necessary for economically effective hedges. This is because movements in the value of a standardized derivative may not fully or closely offset the change in value of the item to be hedged. This mismatch, or ineffectiveness, can be substantial and cause earnings unpredictability. It can result in immediate cash losses to a company as well increase its cost of capital over the long term.

Contact information

To have a deeper discussion about how this legislation might affect your business, please contact:

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