Why a Good Derivatives Policy Could Protect Your Job

By Ann Galligan Kelley, CPA

Warren Buffett describes derivatives as "instruments of mass destruction."

With this warning from Buffett, don't be lulled into complacency by the recently approved 2,315-page Dodd-Frank Wall Street Reform and Consumer Protection Act. This legislation strives to increase the transparency in the pricing and trading of derivatives. CFOs and controllers, however, should still ensure that their organization has a comprehensive, up-to-date derivatives policy to not only protect the organization from derivative risks, but also the CFOs and controllers from criticism for not adequately informing management of the unforeseen risks.

Even if your organization doesn't use derivatives currently, it's your responsibility as a financial manager to know the risks and advantages of having a comprehensive derivatives policy in place. Your organization will then be prepared when the next Wall Street investment banker proposes the next exotic product to senior management using derivatives.

Why Are Organizations Using Derivatives?

Companies use derivatives in a number of ways. For the most part, they can be beneficial when used correctly. The next time you fly Southwest Airlines, the fuel for that jet may have been hedged using futures contracts, a type of derivative. Hence, when you bought your ticket six months in advance, Southwest wasn't at risk if fuel prices spiked upward. Derivatives can also help a farmer

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who wants to lock in a price for his crop while it's still in the field and not risk taking a lower price when the crop goes to market.

Many companies are now using derivatives to convert variable rate debt to fixed rate debt to lock in the existing low interest rates. Companies are also using interest rate caps to limit exposure to potential interest rate volatility. Interest rate swaps have been around for years and are actually quite prevalent in the governmental and nonprofit world. According to the Bank for International Settlements' June 2010 report, "The total notional value of interest rate derivatives including swaps reached nearly $450 trillion as of June 30, 2010." Although management should be aware of all facts, entities often enter into these long-term risky contracts without fully understanding the potential risks and implications. That's why it's important that policies and procedures be in place before even considering derivatives.

The most common types of interest rate derivatives include interest rate swaps, interest rate caps, basis swaps, and rate locks. Let's take a look at each type.

1. Interest rate swaps synthetically convert variable rate debt to fixed rate and vice versa. For example, if a university can efficiently issue variable rate debt but would prefer not to be exposed to potential future interest rate increases, the university could enter into an interest rate swap with another group, called a counterparty, to effectively convert its variable rate debt to "synthetic" fixed rate debt.

2. Interest rate caps can limit exposure to interest rate volatility. For example, an organization with variable rate debt may be willing to tolerate interest rate increases up to a certain level or believe that interest rates will remain low. But the organization may want to limit its interest rate risk by purchasing an interest rate cap, which ensures that the organization won't pay an interest rate exceeding the rate prescribed in the cap.

3. Basis swaps manage or change the "basis" on which variable interest rates are calculated. These are more commonly associated with revenue bonds where an organization's income may depend on a particular interest rate index, yet the debt the organization has issued is based on a different index. For example, if revenues are based on the prime interest rate but the interest expense that must be paid is a function of London Interbank Offered Rate (LIBOR), and the traditional correlations between these two indices digress, a basis swap will protect the entity from market dislocations. Companies use LIBOR to determine the price of many financial derivatives, including interest rate swaps. This is the average short-term deposit rate that banks participating in the London money market exchange offer each other.

4. Rate locks are based on interest rate swaps and used to hedge, or "lock in," an interest rate for an upcoming bond issue. These are really nothing more than institutional versions of an interest rate lock fee that someone might pay to lock in an interest rate when applying for a home mortgage.

The Risks

Would you want to have to go to senior management to tell them that you had to pay millions of dollars to terminate an existing derivatives contract? That's exactly what Harvard University financial managers had to do. They fell for Wall Street's oblique financial vehicles, and in 2009 Harvard paid $497.6 million to investment banks to terminate an interest rate swap on $1.1 billion of debt—an effective penalty or interest rate of nearly 50%. In addition, Harvard agreed to pay $425 million to offset an additional $764 million in swaps over a period of 30-40 years. Harvard University wasn't alone in suffering this fate. Many colleges, hospitals, and corporations have suffered a similar fate when they terminated their swaps, though likely on a smaller scale. Investment bankers can present a swap as a terrific solution, but swaps can be difficult and expensive to terminate.

It also pays to read the fine print. If you don't, you might have to tell senior management that you have to place cash and investments in a restricted trust. Many derivatives contracts have a clause that an entity might have to actually post collateral by transferring some of its liquid assets into a restricted trust to protect the provider of the derivative! Such a requirement can arise for a variety of reasons, including interest rate fluctuations or if the credit standing of the organization declines. These clauses protect the other party in the derivatives contract, so it can be a startling surprise for your entity if this were to occur. In today's economy, this isn't unusual.

CFOs and controllers don't have to be derivatives experts, but they do have to know the risks. The four most common risks—two of which I already mentioned—are:

1. Counterparty/credit risk: The entity on the other side of the transaction is unable to fulfill its obligation.

2. Basis risk: The interest rate that an entity is trying to hedge doesn't track exactly with the derivative, so the

entity may not get the full benefit that it's anticipating.

3. Termination risk: Under certain circumstances, the counterparty may be able to terminate the swap when you need it most. It's important to understand the termination conditions and how the termination costs will be calculated.

4. Credit downgrades: There are consequences of a credit downgrade or default of either party.

These four risks illustrate the need for a derivatives policy, the primary component of which would require hiring a qualified derivatives advisor. You can find a qualified derivatives advisor by issuing a request for proposal (RFP) asking for professional qualifications, experience, and a list of their prior and current clients. When hiring an advisor, don't seek the opinion of their underwriter or banker—they aren't independent parties.

Elements of a Policy

A basic derivatives policy should address several situations:

1. To avoid potential conflicts of interest, the policy should specify that the organization's banker or underwriter should *not* also be the financial advisor on the derivatives transaction. Unbelievably, there are some derivatives policies that specifically state that the derivative provider must be the underwriter. Obviously, the underwriter must have had significant influence in the drafting!

2. The derivatives policy should specify how the company will acquire the derivative, including options such as negotiated bids, competitive bids, or a combination of the two. Many see the current pricing of derivatives as a bit of a proverbial black box (not easily understood). A new development that should assist in this process will result from Section 721-774 of the Dodd-Frank Act, which gives the Commodity Futures Trading Commission (CFTC) or the Securities & Exchange Commission (SEC) authority to determine which swaps must be cleared through a registered clearinghouse. Ideally, as a consequence, this will result in more transparent pricing of derivatives and facilitate the monitoring of systemic risk.

3. Termination terms include the circumstances under which either party can terminate the derivative and how to calculate the termination payment. There should be a stipulation that an independent third party calculates the termination cost.

4. If either or both parties have unsatisfactory credit ratings, there may be a need for marketable securities to be posted as collateral with a third party to help ensure the performance of the swap contract terms. To minimize credit risk, the parties to the contract should have to post collateral with a third party. This clause should also address potential subsequent downgrades in credit ratings. Is the posting of collateral something that the organization is financially capable of doing? Furthermore, how might this impact operations?

5. When performing due diligence, the organization should research whether a swap provider is currently or has formerly been involved in swap-related litigation.

6. Prior to entering into the swap, the organization should attempt to determine if the risks associated with this transaction will adversely affect its ability to issue additional debt or its credit rating.

7. The policy should state that derivatives can only be used for risk management (hedging) purposes and not, for example, speculating on interest rate movements.

8. Entering into a derivatives transaction is a material contractual obligation that the governing board of directors or a finance subcommittee should vote on. Unless management is experienced in the derivatives area, the company should hire a qualified and independent financial advisor to evaluate the financial and legal aspects of the derivative proposals.

9. The independent financial advisor should provide a written report thoroughly informing the governing body of the risks associated with issuing derivatives and then, if possible, quantify the organization's financial exposure based on these potential risks.

Constantly Evolving

While the Dodd-Frank financial reform legislation creates a division within the Federal Reserve designed to protect consumers, it isn't a substitute for individual and organizational prudence and due diligence. The Dodd-Frank Act increases the transparency of complex financial products, including the oversight of swaps and other derivatives, for example, but many changes in this law won't be fully enacted until 2015.

Entering into these contracts should never be done lightly. A sound derivatives policy should be in place to protect an organization, and it should be updated periodically to keep pace with new and increasingly complex, constantly evolving financial instruments. **SF**

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