Derivatives: Risky Business or Effective Risk Management Tool?

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Overview

- What are derivatives?
- How are derivatives documented?
- Who uses derivatives?
- Why are derivatives used?
- Regulatory impact of the Dodd-Frank Act on derivative transactions.
What are Derivatives?

“Derivatives are financial weapons of mass destruction.”

– Warren Buffett, CEO of Berkshire Hathaway
What are Derivatives?

“Over and over again, financial experts and wonkish talking heads endeavor to explain these mysterious, ‘toxic’ financial instruments to us lay folk. Over and over, they ignobly fail, because we all know that no one understands credit default obligations and derivatives, except perhaps Mr. Buffett and the computers who created them.”

– Richard Dooling, American Novelist
What are Derivatives?

• Are derivatives tools used for speculation or can they be a legitimate risk management tool?
  – Derivatives can be used to speculate in the marketplace.
  – On the other hand, derivatives are one of many effective, legitimate business tools used to mitigate risk.
  – A house can be a hedge against rent increases or a speculative investment.
What are Derivatives?

• **Basic Definition:**
  
  – Financial transaction – no physical delivery involved
  
  – The value of the transaction is derived from the price or value of some other source
    
    • *E.g.*, an index price, a currency rate, a commodity price or an interest rate
  
  – Similar to a futures contract but traded between two individual companies, not through an exchange
What are Derivatives?

Physical Natural Gas Deal

Producer

Natural Gas

Market Price
$$$

Buyer

Fixed Price Payor

Floating Price Payor

Fixed Price

Natural Gas Index

Floating Price

(Producer)
What are Derivatives?

- **Commodity Price Swap: Characteristics**
  - No physical delivery occurs
  - Each party agrees to pay a floating or a fixed price with respect to a notional quantity of a commodity
  - No “Seller” or “Buyer” – either party may be obligated to pay under the swap depending on whether fixed is greater than floating or floating is greater than fixed.
  - No exchange or broker involved – an over-the-counter transaction (for now…we will come back to this).
What are Derivatives?

• **Commodity Price Swap: Example**
  – Fixed Price Payer ("A") pays fixed gas price of $7/MMBtu
  – Floating Price Payer ("B") pays floating gas index price per MMBtu

  ![Diagram]

  - If Index Price is $8: Party B pays Party A $1 per MMBtu.
  - If Index is $5: Party A pays Party B $2 per MMBtu.
How are Derivatives Documented?

• Master Agreement published by the International Swaps and Derivatives Association (“ISDA”)

• This ISDA provides:
  – Standardized termination rights
  – Rights to unwind transactions upon a default
  – Protections if a counterparty becomes less creditworthy
  – Multiple transactions under the same terms and conditions
  – Large body of supporting documentation
Why Are Derivatives Used?

- **Timing Flexibility**: Swap can be entered into after the underlying transaction is already in place.

- **Volume Flexibility**: Can lock in total volumes or amounts up front, or fix the prices for different portions of the total volumes or amounts over time.

- **Term**: A long-term fixed price contract creates risk as market prices shift. Instead, enter into swaps for shorter periods of time to lock in a fixed price.

- **Market Liquidity**: There may not be a market for a long-term fixed price deal, or many buyers or sellers at a particular delivery point, but the swap market is more liquid.
### Who Uses Derivatives?

<table>
<thead>
<tr>
<th>Banks</th>
<th>Municipalities</th>
<th>Large retailers</th>
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<tbody>
<tr>
<td>Private equity</td>
<td>Mineral producers</td>
<td>Commercial real estate owners</td>
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<tr>
<td>Pension funds</td>
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<td>Corporate borrowers</td>
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<td>Energy companies</td>
<td>Healthcare systems</td>
<td>Corporate debt issuers</td>
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Why Are Derivatives Used?

- **Interest Rate Swap** – Variable rate bonds
  
  “Swaps Cost Hospital System $69 Million”, *Ft. Worth Star-Telegram, December 24, 2010*

- Christus Health issued long-term variable rate bonds.

- To hedge such payments, Christus entered into 20 and 30 year interest rate swaps with Citibank and Merrill Lynch.
  
  - Christus pays a fixed rate of 3.38%
  
  - Citibank/ML pays a floating interest rate to cover Christus’ obligations to bondholders
  
  - Notional amount is $1.22 billion.
Why Are Derivatives Used?

- Bondholders
  - Bonds
  - Principal
  - $1.22 B

- Christus Health
  - 3.38% Fixed Rate
  - Variable Interest Rate

- Merrill Lynch & Citibank
  - Variable Interest Rate
Why Are Derivatives Used?

• “Swaps Cost Hospital System $69 Million”, *Ft. Worth Star-Telegram, December 24, 2010*

• What if Christus did not enter into any swaps?
  – A *decrease* in variable interest rates benefits Christus because they pay less to bondholders in interest expense.
  – An *increase* in variable interest rates means higher, unpredictable interest rate expenses payable to bondholders.

• No Swap = UNPREDICTABLE INTEREST RATE RISK
Why Are Derivatives Used?

• “Swaps Cost Hospital System $69 Million”, *Ft. Worth Star-Telegram, December 24, 2010*

• “Christus has had to pay as much as $1 million a month in additional interest costs, money that otherwise might have gone to its 30-plus healthcare facilities in Texas, six other states and Mexico.”

  – What if interest rates had skyrocketed instead and saved Christus millions of dollars in unforeseen expenses?

  – Would there have been an article about Christus’ substantial savings because of the swap’s protections?
Why Are Derivatives Used?

• “Swaps Cost Hospital System $69 Million”, *Ft. Worth Star-Telegram, December 24, 2010*

  – Impossible to know the total cost or benefit of a swap until it expires and you can compare it to the market.

  – But it should have no windfall or loss – it locks in a price to reduce risk, it is not a speculative position.

  • Similar to a fixed interest rate loan- the goal is not to profit off of interest rate swings, but to lock in cash flow and interest costs.
Why Are Derivatives Used?

- **Commodity Price Swap: Southwest Airlines**
  - Southwest Airlines’ use of derivatives to hedge jet fuel costs has been highly publicized as a cost saver for the company.
  
  - Since 1999, hedging has saved Southwest Airlines over $3.5 billion.
  
  - In 2008, Southwest hedged over 70% of its fuel supply at $51 per barrel when market prices sat at $140 per barrel.
Why Are Derivatives Used?

• **Commodity Price Swap: Southwest Airlines**
  
  – For Southwest Airlines, hedging was not a speculative position.

  • Technically, the swaps allowed SWA to lock in a price and have price certainty no matter which way the market moved.

  • SWA has been profitable in years when other airlines have not.

  • If Southwest was comfortable paying the locked-in price, was this the right business decision?
Impact of Dodd-Frank

• In the past, “over-the-counter” derivative transactions have not been regulated by the CFTC
  – “Over-the-counter”: Bilateral trades between two persons (i.e., not traded on an exchange like NYMEX).
  – In such case, certain exemptions applied under the Commodity Exchange Act.
    • So long as sophisticated counterparties and no fraud, little governmental regulation.

• The Dodd-Frank Act changes this dramatically.
Impact of Dodd-Frank

• Dodd-Frank applies to most swaps: (interest rate, currency, forex, commodity, etc.).
  – NOTE: Dodd-Frank does NOT apply to “forward contracts” where physical delivery is anticipated.
  • However, the CFTC has floated the idea that physical option contracts are swaps. This is a definitional stretch but would vastly expand CFTC authority.

• Dodd-Frank applies broadly to “Swap Dealers”:
  – Anyone who regularly enters into swaps with counterparties as an ordinary course of business for its own account.
Impact of Dodd-Frank

• **New Requirements:**
  – Registration and reporting requirements.
  – Mandatory clearing of swaps with a registered clearinghouse.
  – Position limits on how much a person can trade.
  – Capital and margin requirements imposed upon swap dealers and major swap participants.

• Rules remain unclear – CFTC and SEC working to finalize the rules before effective date in 2011.
Impact of Dodd-Frank

- Dodd-Lincoln Letter: Fewer than 300 entities will be affected.

- CFTC Chairman interviews: Almost every entity entering into swaps will be covered.
Impact of Dodd-Frank

• Costs for those deemed to be “Major Swap Participants” or “Swap Dealers” will be significant.

• Costs will include compliance, training, audit, systems, and employment of new mandated personnel.
Impact of Dodd-Frank

- Result – Industry uncertainty.
Key Points to Take Away

• Derivatives can help a variety of industries.

• Derivatives are documented under the ISDA.
  – Though ISDA may be presented as standard, it always can and should be negotiated.

• Major changes are coming to derivative transactions under the Dodd-Frank Act.
Questions?
Please give us a call

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