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Demystifying Dodd Frank's Impact on Corporate Hedging

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Overview

Section 1: Dodd Frank on Swaps and the End User

Section 2: How Companies Can prepare

Section 3: What Tools are Available?

Section 1: End User Overview

- Background
- Swap Definitions
- End User Exemption Background
- Establishing Status as an End User
- Captive Finance Subsidiaries and the End User Exception
- Inter-Affiliate Swaps and Exemption
- Reporting Responsibilities
- Business Conduct Rules
- Considerations – Cleared vs. Uncleared Swaps
- Trading Impact – Costs & Risks
- Potential Impact to Corporate Hedging Strategy

Background

- Section 723 of the Dodd-Frank Act states that it is unlawful for parties to engage in a swap unless they submit the swap for clearing to a derivatives clearing organization.
- The Dodd-Frank Act also establishes an exemption from this clearing requirement which is codified in Section 2H7 of the Commodities Exchange Act for swaps entered into by non-financial entities for the purpose of hedging or mitigating commercial risk.
- The act defines what a financial entity is and provides limited exceptions from that definition. It also directs the Commission to consider whether to exempt certain small financial institutions from the definition of financial entity. In doing so, small financial institutions would be permitted to use the end-user exception as well.
- Compliance period begins 180 days from July 11th, 2012 (Date Swap Definition was finalized)

Swap Definitions

Securities Based Swaps (principally regulated by the SEC):

Swaps based on single security or loan

Narrow based securities indices

Securities based on occurrence or non occurrence of events (CDS)

Non Securities Based Swaps (principally regulated by the CFTC):

Interest rate and currency swaps

Broad index based CDS

Commodity swaps including agricultural, metal, mineral, and energy

Options on commodity swaps with exemptions for physical settlement

FX Options and Non deliverable Forwards – pending determination by the Treasury Department

Derivatives Exempt Under Swap Definition:

FX Forwards and FX Swaps – pending determination by the Treasury Department

Forward sales of non-financial commodities or securities for physical delivery *

Exchange traded futures and options on exchange traded products

Commercial hedges of End Users

* The CFTC has published commentary that gives guidelines on the specific types of forwards that can be exempt

End User Exemption Background

- Acknowledges corporate users of swaps do not pose the same risk to the financial markets as large financial institutions.
- Regulators realize costs associated with clearing could create disincentive for End Users to hedge their commercial risk
- Will allow some users of swaps to be designated as end users of swaps for regulatory and reporting treatment.
- Exempt users will be subject to much less regulatory compliance action than non-exempt.
- There are clearly defined steps for the firm to take to establish end user status. It is largely an analysis of the type of firm and the type of trading activities the firm conducts.

Establishing Status as End User

Corporate users are covered under the exemption if they meet the additional following criteria:

- Not a “Financial Entity”: meaning banking institutions, pension plans and hedge funds. There are exceptions for banks, credit unions, savings associations, and foreign credit entities with less than \$10 billion in assets.
- Not a swap dealer or major swap participant as defined under Dodd Frank.
- Using swaps to “hedge or mitigate commercial risks” :
 - There are no dollar amounts or percentages applied to portfolios for this classification except for position limits, which will apply to end users. The determination of hedging activities is done on a swap by swap basis. Swaps that do not qualify will need to be cleared, which forces any non-hedge activity into standardized contracts. Proving exempt hedge status of a trade is the responsibility of the End User and can be accomplished by:
 1. Showing that the trade qualifies as a hedge under ASC 815 or GASB 53 standards; or clearly offsets financial risks the company faces as a result of its’ core business, including values of assets, products, inputs, inventories, etc.
 2. Demonstrating that the swap is not a speculative position. The swap should be relevant in terms of underlying asset, reference rate, tenor, etc. to the operations of the end user.
- End-user satisfies reporting obligations to CFTC including how it meets its financial obligations for non-cleared swaps. In practice, a swap dealer counterparty to the end user will be reporting to the Swaps Data Repository (SDR) the means that the End user has to support the swap. This would typically be the credit agreement between the end user and the dealer, collateral that might be posted, or other means that the End User has used to settle swaps trades.

Captive Finance Subsidiaries and the End User Exception

Dodd-Frank provides that captive finance companies are not Financial Entities if they satisfy the following requirements:

1. The primary business of the entity is providing financing;
2. Use derivatives for hedging commercial risks related to foreign currency (F/X) and interest rate exposures;
3. At least 90% of exposures arise from financing that facilitates the purchase or lease of products; and
4. At least 90% of such products are manufactured by the parent company or a parent's subsidiary.

Collectively items 3&4 are referred to as the “90/90 test”, and all 4 criteria must be demonstrated for the subsidiary to gain the benefits of exemption.

Inter-Affiliate Swaps and Exemption

Many firms use a central booking entity, using inter-affiliate risk transfers completed by back-to-back transactions. Dodd-Frank allows affiliates of an End-User (including captive finance subsidiaries) to rely on the End-User Exception when entering into the swap as agent on behalf of the End-User if an End-User could enter into the same swap and rely on the End-User Exception, unless the affiliate is a type of entity that is specifically not permitted to rely on this provision.

The CFTC declined to exempt swaps entered into by End-User hedging affiliates on a principal basis from the clearing requirement where the hedging affiliates are Financial Entities, even if the hedging affiliate is hedging or mitigating the commercial risk of the End-User. The CFTC states that the statute leaves no room for them to provide relief on this point. This position will disproportionately affect certain hedging structures.

Cases: The End-User Exception **applies** if the treasury function of an entire corporate group is undertaken by the parent or other corporate entity that engages in non-financial activity. However, **End-Users with a treasury affiliate that operates as a separate legal entity**, because the treasury affiliate would likely be a Financial Entity, **could not use the End-User Exception** if it acts as principal in conducting hedging. As a result, End-Users may need to restructure their business and risk management techniques, thereby potentially losing many benefits of their current centralized hedging operations.

Reporting Responsibility

Who is impacted?

- Where End Users trade with Swap Dealers, or other non End User counterparties, the counterparty will be responsible for regulatory reporting.
- End users will be required to provide regulatory reporting for swaps only under the following circumstances:
 1. For exempt swap counterparties where one participant is defined as a financial entity, that entity will be required to perform regulatory reporting.
 2. Where both parties are defined as End Users and either both or neither are defined as financial entities, the parties will have to agree at the outset of the swap which party will be responsible for reporting. Trading between End Users will likely be uncommon.

Reporting Responsibilities, cont.

Reporting requirements

- End users, where applicable, will have to keep all records of the swap transaction (initial contract, resets, payments, etc) for the life of the swap plus five years after termination, and will have to make this information available to regulators within 5 days of a request.
- End-User will likely have to provide representation regarding eligibility for End-User Exception to reporting counterparty
- Publicly traded companies electing End-User Exception must
 - Have board or appropriate committee approve End-User Exception election
 - Have board or appropriate committee maintain policies and procedures governing use of swaps subject to End-User Exception and review them at least annually or more often if triggering event occurs

Business Conduct Rules

The CFTC's external business conduct rules establish business conduct standards governing the conduct of Swap Dealers and MSPs when entering swaps with other market participants. These rules are a huge change for swap market participants. Counterparties have been on a "non-reliance" basis in which a market participant undertakes few, if any, specific duties with respect to a counterparty. **Swap Dealers and MSPs will be subject to strict and detailed business conduct standards in dealing with End-Users, obligating them to take the following actions:**

- Conduct due diligence on their counterparties to verify eligibility to trade (including eligible contract participant status)
- Refrain from engaging in abusive market practices;
- Provide disclosure of material information about the swap to their counterparties;
- Provide a daily mid-market mark for uncleared swaps;
- Inform their counterparties of their rights to clear a swap that is not required to be cleared; select the DCO through which a cleared swap is cleared; and request a scenario analysis and a daily mid-market mark for cleared swaps;
- Provide material information sufficient to allow the counterparty to assess the swap's material risks, characteristics, incentives and conflicts of interests;
- For swaps that are not made available for trading on a swap execution facility or DCO, upon request Swap Dealers must provide a scenario analysis that is developed in consultation with the counterparty;
- When recommending a swap to a counterparty, make a determination as to the suitability of the swap for the counterparty based on reasonable diligence concerning the counterparty.

Considerations– Cleared Vs. Uncleared Swaps

| End user Trades: | Cleared Contract | Non Cleared Contract |
|--------------------------------------|---|--|
| Swap terms: | Highly standardized terms. Classes of swaps to be traded will be suggested to DCOs by DCMs based on customer interest. DCOs decide which contracts will be eligible for clearing. | Custom |
| Maintenance Margin: | Calculated by DCM daily; end user will have to provide maintenance margin | Agreed upon by counterparties in the Credit Support Agreement (CSA) |
| Risk Consideration: | End user will have to accept basis risk from hedging and managing their exposure with standardized contracts | Customized contracts can be tailored that exactly match and offset end user's exposures and risks |
| Capital / Cost Considerations: | Swap Dealer will have lower regulatory capital requirements | Swap Dealer will have higher regulatory capital requirements |
| Swap Pricing: | Potentially tighter market/bid-ask spreads. Regulatory capital relief and standardization makes these swaps cheaper to trade for Dealers | Potentially wider market / bid-ask spreads. Regulatory capital requirements will make these swaps more expensive for Dealers to carry. |
| Regulatory Reporting Responsibility: | Falls on the Swap Dealer | Falls on the Swap Dealer unless the CP is another End User; then it is agreed upon at swap outset. |

Trading Impact – Costs & Risk

Swaps may become more expensive to trade under Dodd Frank – with different factors driving costs for cleared and uncleared swaps

Cleared Swaps

- Counterparties will be required to post margin adjustments similar to the futures market on a daily basis. This amount is determined by DCM calculations. The same margin rules apply for cleared contracts regardless of End User status.
- Only standardized contracts qualify to be cleared. Executing through the SEF model is likely to compress spreads as participants have more market information at any given moment. There will be fewer products but they will be much more liquid and the spread should be reduced compared to the OTC market.
- Counterparty risk shifts ultimately from counterparties up to CCPs. End Users of cleared products do not have to worry about counterparty risk.
- There is currently no established facility to unwind a centrally cleared swap. Until this changes, an End User may have to trade an offsetting, uncleared or cleared swap to close a swap position before maturity. The End user would have to manage the risk between the offsetting positions

Uncleared Swaps

- Margin rules for uncleared swaps are scheduled to be finalized on Sep 14, 2012. As proposed, CFTC rules would require that swaps dealers have margin requirements established in credit agreements with End Users for uncleared swaps. Margin in excess of a credit threshold would need to be collected by the Dealers. This margin is likely to be much higher than for cleared swaps.
- Swaps Dealers will have to carry significantly higher regulatory capital for uncleared swaps on their books. They will have to recoup this cost by charging a premium for uncleared swap trades. This will likely make uncleared swaps more expensive to execute from a spread standpoint. Dealers will need to determine how much 'rent' to charge for keeping capital committed to uncleared swaps.
- Uncleared swaps may become less liquid to execute as market interest and volume moves towards cleared products.
- Bilateral counterparty risk still exists.
- An End User can contact the counterparty and unwind the swap directly.

Potential Impact to Corporate Hedging Strategy

Will End Users trade cleared swaps and accept basis risk and unwind challenges in return for better pricing?

How will End Users quantify what are acceptable levels of basis risk to assume in a hedging strategy?

To what end will the industry develop new products or services to meet End Users needs?

When will End Users prefer to pay a premium for customized uncleared contracts?

Practical Considerations:

Other regulatory burdens remain. For companies using swaps to hedge commercial risks, the End-User Exception removes Dodd-Frank's clearing and execution requirements. Entering into only non-cleared swaps does not, however, allow end users to totally avoid the burdens imposed by Dodd-Frank and the related swap regulations. End users will have continuing reporting and record keeping obligations regarding their non-cleared swaps. Margin rules may require the exempt party to post margin on the non-cleared swaps, although the margin requirements may be similar to current collateralization practices in the swap markets.

Does the End-User Exception apply to existing hedging programs? End users intending to elect the End-User Exception should assess whether their status (*i.e.*, as a financial entity or a non-financial entity) and their hedging programs will allow them to claim the End-User Exception for the swaps into which they typically enter. If questions exist as to whether their swaps are hedging or mitigating commercial risks, those companies will also want to consider whether having their swaps subjected to the mandatory clearing and execution regime will impose an unacceptable burden on their hedging programs and whether and how they can adjust their hedging programs so they may take advantage of the End-User Exception.

Address reporting requirements with counterparties. Management of end users of swaps should understand the value of entering into swaps on a non-cleared basis and ensure that matters, such as the timely reporting of the End-User Exception election, are effectively addressed with their counterparties in connection with any new swaps to be entered after the initial date for compliance with the Clearing Requirement.

Practical Considerations, continued:

Remember that election is made on a swap-by-swap basis. Once the Clearing Requirement is in effect, management should keep in mind that the determination of the End-User Exception must be made on a swap-by-swap basis. While certain information, including whether the company's swaps for which the End-User Exception is elected are used to hedge or mitigate commercial risk, can be reported on an annual basis, management must still for each swap entered that (1) such swap is being used to hedge or mitigate commercial risk, (2) the company's most recent annual report was filed within the 365 days prior to such swap being entered and remains accurate and (3) when the company enters such swap, a report giving notice of the election of the End-User Exception for such swap and the identity of the electing counterparty is filed with an SDR or the CFTC, as applicable.

Clearing requirements applicable to existing swaps. End users should note that the Clearing Requirement is applicable to swaps which the CFTC has made subject to the Clearing Requirement and which swap was entered into either (1) before July 21, 2010 or (2) on or after July 21, 2010 and prior to the date on which the Clearing Requirement first applies to the class of swaps in which such swap falls. End users should consult with their counsel regarding the applicability of the Clearing Requirement to, and the reporting requirements for, their existing swaps.

Document decisions and elections. As part of the process for electing the End-User Exception as to swaps, end users should create and maintain complete and accurate relating to each election of the End-User Exception and of each report filed with an SDR or the CFTC. This includes reports filed by the other counterparty to the swap. The CFTC could audit an end user's practices regarding the End-User Exception, and end users should maintain the necessary documentation to allow them to respond effectively to any questions the CFTC's audit may raise.

Section 2: How Companies Can Prepare

- Internal Focus
 - Assessment
 - Planning
 - Training
- External Focus
- Be Prepared
- How to prepare
- Infrastructure
- Infrastructure Challenges
- Industry Advise
- Use your resources

Management must assess the following areas to ensure they will be prepared for the impending changes

- Internal factors
- External factors

Internal focus

- **How we currently do business** – Should we be considering any changes to the current way we do business e.g. alter the company structure, exit a line of business. Do we understand what the financial impact of margin and capital requirements will be to our business?
- **Staffing Assessment**– Do we have the right staff on hand to understand and handle the changes around Dodd Frank? Do we have the right finance and technology people on the team?
- **Technology** - Are my trading platforms sufficient to meet position limits requirements? Do our systems support the appropriate level of record keeping and reporting? Have all planned IT projects factored Dodd-Frank into the plans?

Internal focus

Process - What kind of changes might be needed in our existing processes that would help us manage the new requirements? Do we have a good enough understanding of the finalized rules to understand the risks and opportunities to our business?

Planning - Do we have a plan in place address these issues? Do I have my current resources focusing on the urgent activities? Do we have the right external legal counsel involved? Is senior management engaged? What is the impact of missing regulatory deadlines?

Internal focus

Training -Dodd-Frank will significantly affect the way institutions of all sizes conduct business

- Ensure the C-suite to the front line staff receive training
- Training should be compliance centric and focus on:
 - Why the changes are happening
 - Why the organization must respond
 - Which existing policies & procedures need to be enhanced
 - How the changes affect employees day-to-day responsibilities

External focus

Dealing with the derivative trader

- With increased regulations come increased paper work
- Engage the assistance of your derivative trading house
- The expert needs to interpret and assist with the onboarding process
- Keep the steps as simple as possible

The trading house should:

- Create a Single point of contact for communication & coordination
- Assist with legal document completion
- Ensure the broker and client have a good working knowledge of the product
- Simplify legal overview of Clearing documents and agreements
- Provide assistance with product implementation and trade testing

Be prepared

Companies should take action to ensure they are not left behind when the final regulations are passed and announced

How to prepare

- Companies should determine their regulatory classification
- Determine if you are a swap dealer or securities-based swap dealer
- Establish relationship with central clearing party best suited to trading products
- Conduct test trades to determine areas of concern

Trading Impact

- Discuss liquidity changes with management
- Discuss CCP collateral requirements with management
- Investigate the collateral strategies available to meet margins
- The trading infrastructure needs to be thoroughly investigated & tested

Infrastructure

- Implementing the upgrades is a stressful process for companies and their finance and IT staff
- Compliance with Dodd-Frank, to the satisfaction of regulators, is the responsibility of the company
- Companies must adequately test their systems to ensure compliance

Infrastructure challenges

- Combining data across multiple products and multiple systems is the challenge for those without a single database of record
- Dodd-Frank requires market participants to report their OTC derivatives trades to SDRs
- Common format is Excel spreadsheets
- Design systems to avoid duplicate trade reports

Industry advice

- Be flexible when setting up the centralized trade capture systems as future regulatory changes are likely
- Keep an eye and ear out for changes, deadlines and areas that affect your business
- Don't be caught off guard and behind the curve – it could end up costing you!

Utilize your resources

- Team up with your general counsel, corporate secretary, compliance officer, risk officer and others who share responsibility for compliance
- Seek advice from auditors, bankers and brokers
- The experts - Super Derivatives <https://www.superderivatives.com/>
- Association for Finance Professionals www.afponline.org

Section 3: How Companies Can Prepare

- Critical Questions
- Costs Of Compliance
 - Margin Requirements
 - Reporting
 - Liquidity
 - CCPs
 - Claiming Exemption
 - Counterparty Issues
- Conclusion

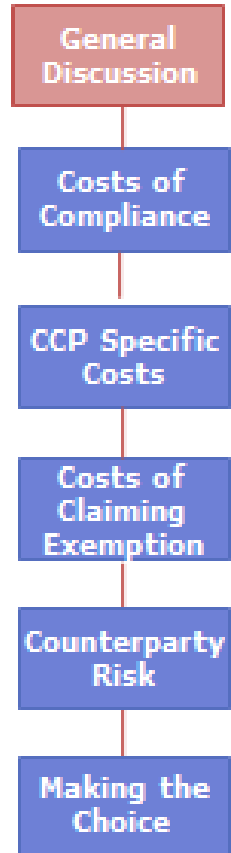
The Critical Questions then are:

What are the costs associated with the “end user exemption”?

Finally: What do we choose?

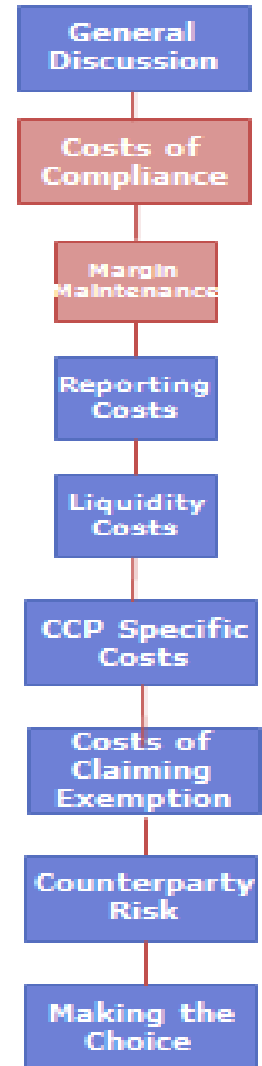
How do these costs impact Treasury?

What system(s) does a corporate need to have to comply with the regulations?



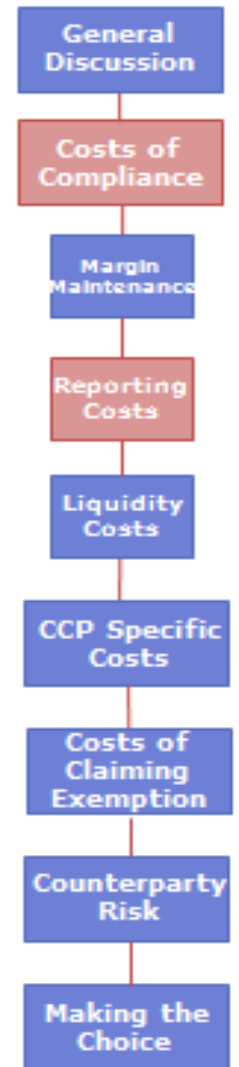
Costs of Compliance – Margin

- Exchange margin requirements will impose additional costs associated with:
 - Margin account management / cash flow management
 - Different financial instrument implications
- **Resolution: a compliance reporting tool that will provide analysis around:**
 - Expected margin costs incurred & cash impact
 - Optimize instrument mix the corporate uses



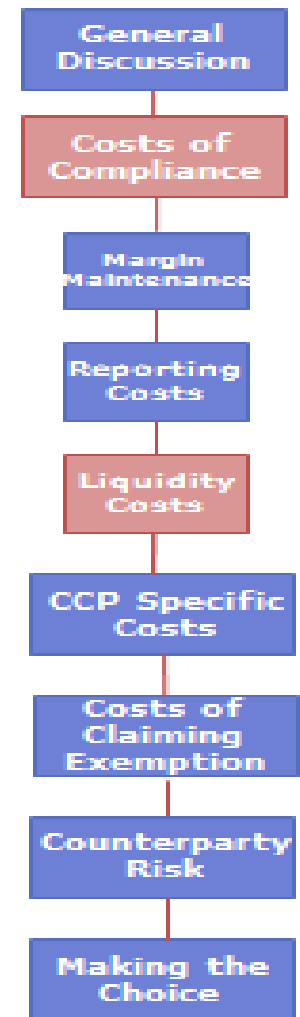
Costs of Compliance – Reporting Costs

- Additional costs will be reporting requirements in both scenarios:
 - Corporate chooses to clear its trades or
 - Claim the “end user exemption”
- **Resolution: a compliance reporting tool to provide:**
 - Full, complete and systematic records
 - Meeting 5 year historical reporting rule
 - 5 day turnaround rule



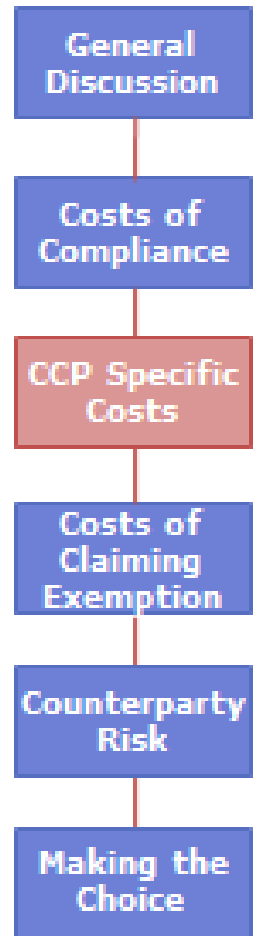
Costs of Compliance – Liquidity Costs

- Not clear how will the new regulations impact the liquidity on the market
- Potential for dual impact:
 - Basis risk from moving to CCP approach
 - Inability to hedge full exposure
 - Widened spreads by market makers in OTC market
 - Potentially cause increase the costs of hedging
- **Resolution: a transaction cost analysis tool to understand:**
 - **Basis Risk vs. Customization**
 - **Liquidity issues**



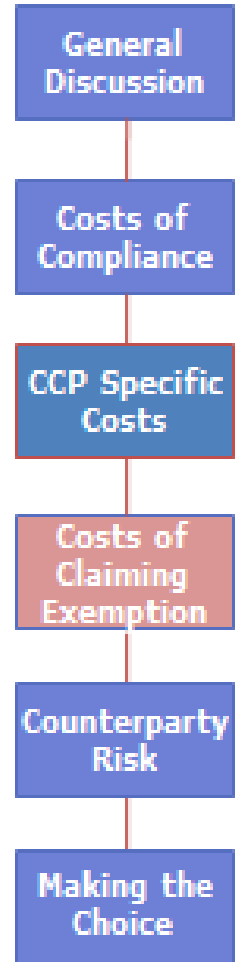
CCP Specific Costs

- CCPs will have a different margin policy and varying fee structure
 - Result in some CCPs having a better “fit” to different corporate clients
- **Resolution: an integrated tool that will analyze the following for each CCP:**
 - Fees structure
 - Instrument coverage / Asset Class coverage



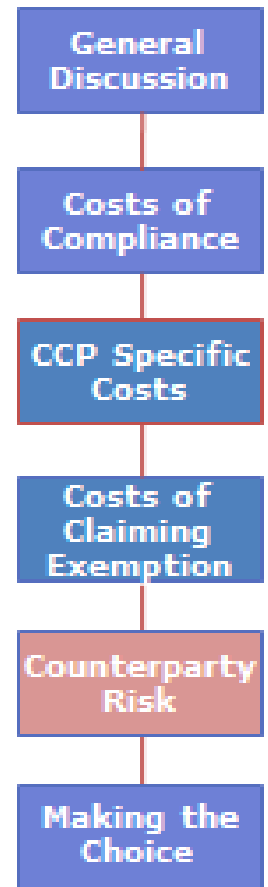
Costs of Claiming Exemption

- Legal and professional services costs associated with proving end-user criteria
- **Resolution: a systematic tool that will analyze these requirements by helping:**
 - **Satisfy legal reporting requirement:**
 - Financial Entity Status
 - Hedge of commercial risk
 - Meeting financial obligations



Costs of Claiming Exemption – Counterparty Risk

- Firms claiming exemption face counterparty risk; while firms clearing with CCPs will have this risk eliminated
- Corporations claiming exemption will need to estimate the credit risk involved and monitor it
 - Credit lines
 - Credit exposure
 - CVA charges (credit valuation adjustment)
- **Resolution: a tool that will monitor counterparty credit risk in order to minimize exposure and credit-related costs**



Conclusions

- There are both direct and indirect costs of complying with Dodd-Frank for corporations
- Incurring extra costs of Dodd-Frank while keeping their treasury strategy status quo vs. avoiding Dodd-Frank costs and changing treasury strategy
- Look at technology alternatives that will potentially allow corporations to minimize costs of Dodd-Frank implications while maximizing current treasury strategy results

