Hedging Interest Rate Exposures under the Dodd-Frank Regime

Although the Dodd-Frank Wall Street Reform and Consumer Protection Act – commonly referred to as Dodd-Frank – was enacted in July 2010, its implementation is just now starting to become a pressing concern as these new regulations get phased in during 2013. While this act is far-reaching, affecting a host of organizations and regulatory entities, this article focuses only on the implications for users of interest rate swaps.

Conceptually, Dodd-Frank sought two primary benefits with respect to the derivatives marketplace: 1) to reduce the credit risk associated with trading of these instruments, and 2) to improve the transparency of derivatives pricing.

These outcomes have historically been achieved for futures contracts with the aid of a futures clearing house. Now, under Dodd-Frank, analogous trading and clearing house mechanisms have been mandated for a broader class of over-the-counter derivatives, including interest rate swaps.

Clearing houses of regulated exchanges serve as intermediaries between buyers and sellers, such that buyers and sellers look to the clearing house to satisfy the terms of the contract, rather than to their initial trading counterparties. In fact, in many instances, buyers and sellers may be anonymous to each other when a clearing mechanism is in place. Clearing a trade requires registering it with the clearing house. Subsequently, the clearing house collects losses from the losers and distributes those amounts as gains to the winners for each cleared trade. Both parties of the trade are also required to post collateral at the onset of the trade, which serves to guarantee that winners will, in fact, get paid, thereby obviating concerns about credit risk.

Given the transactions history maintained by the clearing house, as well as the requirement to have ongoing, reliable valuations, the clearing house is well-positioned to provide price transparency that might otherwise be lacking.

For enterprises that currently use interest rate swap contracts under an ISDA master agreement that stipulates bi-lateral collateral adjustments, the big change from Dodd-Frank is that cash will likely be the medium of the adjustment, rather than non-cash forms of collateral. Moreover, cash adjustments are most likely to be scheduled daily, as opposed to in response to valuation thresholds. Thus, Dodd-Frank will likely impose a contingent need for cash that is new. The difference between posting cash versus other forms of collateral may seem to be a relatively minor alteration for those with bi-lateral collateral agreements, but it is a huge change for entities that currently operate without such collateral adjustment clauses.

Case in Point. Consider the case of the interest rate hedger who uses swaps in the typical textbook fashion to transform variable-rate debt into synthetic fixed-rate debt. If interest rates fall, this swap takes on a liability value. Without any collateral adjustment requirement, assuming no further changes in interest rates, this hedger would expect to make swap settlement payments over the remaining life of the swap. In effect, the liability is a debt for our hedger, owed to the swap counterparty; and this debt is repaid over time, via the swap settlements. With a rise in interest rates, the swap would take on...
an asset value for the end-user; and, again, over time with no further changes in interest rates, this asset value will erode as the hedger receives swap settlements. In this instance, the dealer is the debtor.

In contrast to this practice, under Dodd-Frank, debt arising from a change in interest rates is normally called the day after this debt arises. This design imposes a significant liquidity consideration – referring to liquidity in the sense of requiring ready access to cash subsequent to entering into a swap in a way totally foreign to the way swaps have traditionally functioned. Unquestionably, this consideration will constrain either the horizon of swaps used or their notional amount, as a way for firms to assure that they will sidestep the prospect of a cash squeeze that might otherwise precipitate liquidation of the swap at a distressed price. Alternatively, end-users may try to arrange for, or expand, their use of revolver credit arrangements that permit the extension of credit whenever the cash adjustment requirements foster the need. Critically, with reliance on revolver credit, no reduction of credit risk occurs. Instead, the hedger simply substitutes an alternative lender (e.g., a traditional commercial bank) for the original lender (the swap dealer).

Beyond the credit risk considerations, Dodd-Frank will likely alter the way the swap fixed rates are determined. Pre-Dodd-Frank, the fixed rate that the dealer would quote to an end-user would be expected to reflect the credit quality of that end-user. Thus, two end-users with different credit risks would expect to be quoted different swap rates. The entity with the lower credit rating would expect to pay (receive) a higher (lower) fixed rate, and vice versa. Under Dodd-Frank, all comers should reasonably expect to face identical bid/ask spreads for cleared swaps, as the cash flow adjustment process under Dodd-Frank serves to eliminate credit risk for all counterparties.

While the move to Dodd-Frank might seem to offer the prospect of better pricing to end-users, that might be an erroneous judgment. Although the new regime might allow an end-user to pay a lower (or receiving a higher) fixed rate for a swap traded on a Dodd-Frank qualified exchange relative to the traditional bi-lateral trade, this comparison ignores the costs associated with the daily mark-to-market cash adjustments and maintenance of collateral. These costs are hard to quantify, in that they ultimately depend on the time path of future interest rate changes. We might be able to make some estimates as to the magnitudes of these costs over the long run, but those estimates will have a low probability of being realized for any specific swap transaction.

Critically, it appears that the requirement to trade and clear swaps using regulated entities may not apply to banks with assets of less than $10 billion, allowing large numbers of banking entities to continue their current trading practices. Claiming this exemption, however, still involves compliance with considerable administrative requirements. The possible election of this exception notwithstanding, it is conceivable - perhaps even likely - that a migration of trading to regulated exchanges may occur as the new norm. If so, this evolution could have profound effects on bank balance sheets. To the extent that swaps are cash settled, their balance sheet values will be constrained to amounts that equal the next day’s settlement amount to be paid or received. Thus, the carrying values for banks that trade and clear under the Dodd-Frank execution and clearing entities should be expected to be immaterial in all but the most extreme situations (i.e., when the entity holds a large swap position and a substantial rate change arises on the last day of the accounting period).

Conclusion. Currently, without daily cash flow adjustments, swaps’ values are transparently reported on the balance sheet. Under Dodd-Frank, while not on the balance sheet directly, the effect of swap positions will be reflected by some combination of the carrying values of cash or liquid assets and debt, meaning that many seemingly normal accounting ratios may now have to be reconsidered. It is not at all clear that the analyst community is ready for this change.

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