Taking Stock / *Menachem Feder*

Wanted: Legislation to unbind derivatives

Derivatives transactions have propelled companies world-wide to levels of efficiency and sophistication unimaginable only a few years ago. In Israel, the recent liberalization of currency controls and financial maturity of domestic companies have thrown open the doors to local participation in these transactions.

Almost. For an enthusiastic embrace of derivatives, derivatives market participants must have confidence in the full payment of obligations by counter parties that become insolvent. In Israel, many participants lack such confidence when it comes to privately negotiated initiatives. Legislation could provide the desired certainty.

Derivatives are financial products that allow organizations to isolate and transfer to willing others certain financial risks. These risks — of external market movements — are inherent in normal commercial operations and are beyond the control of any one entity. By using derivatives, organizations can withstand swings in commodity prices, interest rates, foreign exchange and the like.

What are they?

Derivatives are called derivatives because they derive from other products. Although an aura of mystery and hazard surrounds them, derivatives are not necessarily inscrutable nor intrinsically unmanageable. At root, nearly all off-exchange derivatives comprise only three types of financial product: forwards, options and swaps. From these basic blocks, financial institutions build a breathtaking array of products to address the specific needs of the financially exposed.

A forward is an obligation to buy or sell something at a certain price on a stipulated future date. An olive grower can agree to sell at a certain price at harvest, a kilogram of his currently half-grown crop, thus fixing his return before a market price for harvested olives is known. An olive oil producer, the likely party to make this type of deal with the olive grower, guarantees herself a price for olives that she will require many months from now.

An option confers a right to buy or sell something at a stipulated price in the future. Thus, upon paying a premium of NIS 3, the olive grower can buy the right to sell a kilogram of olives at NIS 30 in a month. If on the strike date, the market price is only NIS 20, the olive grower will exercise his option and earn the consequent profit of NIS 10, minus the NIS 3 spent on the premium. If, however the market price is NIS 40, the olive grower will let his option lapse and lose only the NIS 3 premium. Similarly, the olive oil producer can buy today the right to buy olives next month at a set price.

A swap is an exchange of cash flows. If the olive grower owes money to his lender at floating rate of interest, say LIBOR plus 1 percent, he can swap his obligations with another, for example a bank, that owes the same amount of money at a fixed rate of interest, say 9 percent. Post-swap, the bank will pay the olive grower the equivalent of the olive grower's payment obligations and the olive grower will pay the bank the equivalent of the bank's payment obligations — plus something more, say 1 percent, for the bank's fee.

The upshot is that the olive grower pays a strategically beneficial fixed rate (10 percent, in this case) and the bank pays LIBOR only, a good match for the LIBOR-plus loans that the bank originates. Swaps can also be used to exchange currency payments.

Why bother?

There are two primary motivations for engaging in derivative transactions. One is to hedge. For companies with financial market exposures, it is legitimate, even prudent, to guard against market movements. Indeed, companies that do not hedge may be at more risk than companies that do.

The other is to speculate. There is no shortage of entities willing to place their money on their view of future price or rate changes, despite no business-related exposure. Where hedging stops and speculation begins is not always clear, but speculation can increase transaction volume, which can drive costs down for all.

Optimally, derivatives require relatively little cash management. This is because of a concept called netting. With netting, parties offset multiple payments that are owed between them to a single "net" amount. Netting thus minimizes cash payment flows.

For a derivatives market participant to view its overall credit exposure on a net basis is critical. Typically, regulatory or internal controls limit the credit risks that a derivatives market participant may take, both overall and vis-a-vis specific counter parties. Netting frees supervised entities to transact pursuant to only a net, not cumulative, exposure. This allows a supervised entity to enter into more derivatives transactions and embrace higher "capital cost" transactions than it otherwise could.

Additionally, the provision of collateral is a common, but costly, aspect of derivatives transactions. If parties could collaterize on a net, rather than gross, basis, the costs of secured derivatives transactions would drop commensurately.

For a derivatives market participant to comfortably net, it must be able to set-off mutual obligations with its counter party if that counter party was to fail. Insolvency is the most likely reason for derivatives contract default and it is upon a counter party's insolvency that the law might absolve that counter party from paying, yet entitle it to be paid, in full.

Finance outpacing the legislature

Helpfully, Israeli law provides for insolvency set-off. Still, the lack of insolvency case law directly addressing derivatives undermines the confidence of several derivatives market participants in their rights to such set-off. This insecurity dampens the growth of derivatives transactions in Israel.

This is where legislature can help. Many countries with sophisticated economies already have recognized the importance of derivatives netting and over the last few years have legislated its availability in varying scopes. The Israeli economy is at the stage where it needs similar legislation.

It is not surprising that finance has outpaced law. Markets move fast and constantly innovate. Law-making, in justifiable contrast, is slow and deliberate. Nevertheless, the law must recognize fundamental developments or risk failing the citizenry, which deserves relevancy.

There is a growing demand for derivatives here. The legislature should foster the appropriate availability of these powerful tools of risk management.

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