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First Things First: Establishing an Infrastructure for Using Derivatives

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According to the International Swaps and Derivatives Association, the over-the-counter (OTC) derivatives market has experienced dramatic growth¹ (Exhibit 1). Even with the recent, and some would posit temporary, slowdown due to FAS 133, derivatives are now a part of the standard financial toolbox for many organizations.² That makes sense since derivatives frequently provide a low-cost means of hedging or altering cash flows.

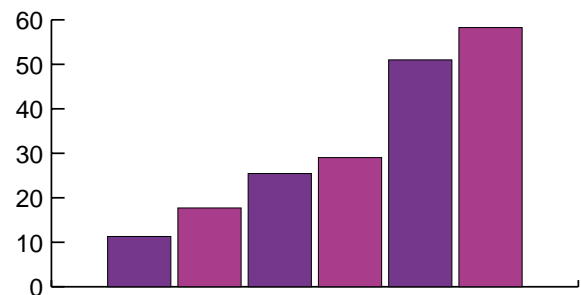
While there is much to know about derivatives, a quick check of booksellers' Web sites suggests that valuation and trading techniques are popular subjects. Relatively few books exist that focus exclusively on derivatives-related controls. Perhaps the subject is thought of as the purview of compliance officers alone.

Nothing could be farther from the truth. Building an effective and sustainable infrastructure — one that addresses education, trading limits, risk measurement, reporting and oversight — is an essential preliminary. Derivative policies and procedures affect company profitability and should be everyone's business. Even with the formation of various industry groups to study system weaknesses, there is no substitute for the homework each individual corporation must complete before trading derivatives.^{3,4}

Education

Financial literacy is a cornerstone of any plan. Arguably, the emphasis on education should start at the top and move its way down the organization. It should be very clear to everyone why derivatives are being used in lieu of alternatives, including the option of doing nothing. A good training program should cover derivative products and market characteristics, but needs to go well beyond the basics. The economic and accounting impact of derivative instrument use, by product type, should

Exhibit 1: OTC Derivatives Market Size
(Trillions of Dollars)



Source: International Swaps and Derivatives Association, Inc.
www.isda.org/statistics/recent.html

constitute a big part of educational materials made available to employees.

To illustrate, consider a company that issues short-term commercial paper but fears that rates will rise. Entering into a fixed-floating interest rate swap as the fixed rate payor provides one way to hedge. Buying an OTC cap is a second approach and exchange-traded products offer yet another way to hedge. Choosing the right product will depend on understanding how the risk/return trade-off, cash flow pattern and accounting realities vary for each alternative. A cursory knowledge leaves the manager ill equipped to address shareholder concerns when asked to defend the selected course of action.

Process Design

Once economic exposures have been identified, the board needs to approve what derivative products can be traded, clearly documenting how and when each instrument will be used. Setting limits by product and trader, and establishing a

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Derivatives, continued

transaction process from trade request to completion is a logical next step. At the same time, someone needs to lead the effort to develop a system — or modify an existing one — that will capture identified risks, measure them and generate user-friendly reports for senior management. Effective design and implementation necessarily reaches across multiple company functions such as legal, treasury, systems, accounting and operations.

The initiative to put good controls in place is not always straightforward, especially if a company's compensation plan encourages risk-taking and emphasizes short-term performance. Additionally, many risks are correlated with each other, making it difficult to disentangle one type from another. The decision to treat derivative instrument risks as part of a portfolio or as standalone transactions materially affects risk quantification, but is itself affected by internal and external constraints. For example, hedge effectiveness under FAS 133 is difficult to achieve for a portfolio of dissimilar hedges. Alternatively, information may not flow easily from one corporate division to another, so it would be hard to identify a portfolio of hedges. Exhibit 2 lists a few of the many questions that must be answered as part of a company's derivatives-related policies and procedures.

Oversight

It makes no sense for traders to oversee their own work, nor does it make sense for people to think of oversight as a dead-end career. This is easier said than done when the compliance function is viewed regularly as a drag on earnings. It only takes one rogue trader to topple a company, jeopardizing

shareholders' wealth and employees' jobs. Protecting against mishap has to be rewarded.

Importantly, oversight is ongoing. Any process that fails to capture contemporaneous changes does no one any good. Running sensitivity analyses helps, but it is not enough. Someone has to be in charge of looking forward. This person or team of professionals should forecast how expected changes in regulatory, operational and financial conditions are likely to impact the company's derivatives-related profit and loss statement (P&L).

A chief risk officer (CRO) will do this and much more. Furthermore, a CRO formalizes the risk management

Exhibit 2: Common Sense Questions About Derivatives

1. Has the board established a clear and consistent risk management policy, including risk limits?
2. Do key controls exist to ensure that only authorized transactions take place and that unauthorized activity is quickly detected and acted upon?
3. Do the characteristics of derivatives used match the company's objectives?
4. Are authorized personnel appropriately trained and qualified to trade?
5. Is the necessary information available and disseminated to the right people?

Source: AICPA's Common Sense Questions About Derivatives, www.cpaspan.com/questions.htm

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function, making it very clear that self-discipline is solemn business.

Summary

There is evidence that the risk management function is being taken more seriously by corporate America, but much more work must be done. For starters, a company can ease shareholder anxiety by making its derivatives-related policies and activities transparent and clearly understood, beyond what is currently required.⁵ In the best of worlds, disciplined companies not only will protect their bottom line, but also be rewarded for the carefulness that guides their use of derivatives.

Second, senior management can help by making risk management an integrated part of training and career development. A third step is to encourage proper risk-taking by tying compensation to compliance with internal procedures.

These are just a few of the many things to consider. Of course, no progress can be made without first identifying the need to establish controls and move forward from there. ●

Disclaimer: The information provided by this article should not be construed as financial or legal advice. The reader should consult with his or her own advisors.

Endnotes

- 1 The OTC market is still large, at an estimated notional amount of \$95.2 trillion. However, growth in OTC derivatives "slowed in the second half of 2000 to a rate equal to that of exchange-traded derivatives" as reported by the Bank for International Settlements, due possibly to the rising number of bank mergers. (See <http://www.futuresmag.com>, July 2001, page 12.)
- 2 "Derivatives Use Slows Due to Burden of Complying with FAS 133, Says AFP Survey." *AFP Pulse*, Volume 21, Number 6, June 2001, page 8.
- 3 "Superintendent McCaul's Remarks Presented at Derivatives Symposium, Fordham Law School." March 7, 2001. The full text of this speech can be found at <http://www.banking.state.ny.us/sp010307.htm>.
- 4 "Remarks by Governor Laurence H. Meyer Before the Derivatives Risk Management Symposium, Institute on Law and Financial Services, Fordham University School of Law." February 25, 2000. The full text of this speech can be found at <http://www.federalreserve.gov/boarddocs/speeches/2000/20000225.htm>.
- 5 The quality and amount of disclosure, beyond mandatory requirements, will vary across companies. The role derivative usage plays in differentiating a company from its competitors will influence how much voluntary information a company reports.