An Unfinished Mission: Making Wall Street Work for Us

AMERICANS FOR FINANCIAL REFORM and THE ROOSEVELT INSTITUTE

Toward an Understanding of the Use of Derivatives by End Users

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Basic Swap Configuration

Inception Price of 100 Barrels of Oil in June @ Cushing

June Price of 100 Barrels of Oil in June @ Cushing
Swap as Hedge

Payments at Close of Swap Contract

Party A

Purchase Price

$120/Barrel

$120/Barrel

Party B

$100/Barrel

$120/Barrel

Oil Seller
Credit Exposure on Swap

Swap Lost on Potential Default

$10,000 @ $100/Barrel

Party A

Actual June Price

Party B

Potential Replacement Swap

$10,100 @ $101/Barrel

Party A

Actual June Price

Party X

A has extended $1/barrel of Credit to B.
## COMPARISON OF SWAP AND RESERVE FUND

<table>
<thead>
<tr>
<th>Initial Cost</th>
<th>Reserve vs. Adverse Price Move</th>
<th>Swap Synthetically Fixing Price @ Today’s Forward Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Capital to Fund Reserve</td>
<td>Cost of Capital on Amounts Applied to Losses from Adverse Price Move</td>
<td>Charge for Potential Credit Exposure and Fee to Bank</td>
</tr>
<tr>
<td>Ongoing Potential Cost</td>
<td>Inadequate Sizing of Reserve</td>
<td>Cost of Funds for Required Margin Collateral</td>
</tr>
<tr>
<td>Risk</td>
<td></td>
<td>Counterparty Non-Performance, Cash Liquidity, Operational Inflexibility</td>
</tr>
<tr>
<td>Upside From Advantageous Price Move</td>
<td>Retained</td>
<td>Lost</td>
</tr>
</tbody>
</table>
Valuation/Risk Issues

- Obscure Pricing, especially of Credit Extension
- Catastrophic Margin Call Risk
- Valuation of foregone Upside
- Inter-relationship with Operations
If the operating company shuts down the production line, it remains obligated on the swap. This would cause a loss if the price at maturity falls below the fixed payment.
Operational Relationship

Party A

Fixed Payment: Forward Price at Inception
$100

Floating Payment: Fuel Price @ Swap Maturity

Fuel Price Exposure

Line Shuts Down; Party A Reverses Swap

Loss to Party A: $100 - $90, or $10.
Hidden Reasons Businesses and Governments Use Swaps

- Mis-perception/Obscuring of Risks and Costs
- Credit Rating Agencies
- Tax Consequences of Reserves
- Accounting Rules regarding Credit Exposures
- Safe decision for Executives
- Share Value Compensation Rules
- “Shadow” Debt