Corporate Hedging, Contract Rights, and Basis Risk
Discussion at ABFER 2024

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Overview

Focus: the termination rights in derivative contracts

- Counterparties have rights to terminate contracts

The paper offers theory and ideas about exercising these rights.

- It reports interesting economics

Questions

- What is the nature of the exercise boundary
- The incentives to exercise and their economic effects
- Empirical evidence on exercise of termination rights

Main Idea

Basic intuition

- The counterparty exercises to avoid getting drawn into distress and the resultant renegotiations and protocols
- But this is when the firm does not want exercise

Feedback effects

- Firms may be more likely to face distress
- Ex-ante, firms may even hedge less than they should

Empirical Results

Firms in SIC 1220 (coal), 1311 (O&G), 4512 (airlies)

Default events from UCLA database + restatements, downgrades, proxies

Result

- Hedging ↓ upon default events, indicating terminations and no re-hedges
- In SIC 1311, unwinds are not seen in supply agreements
- Lehman v. Metavante 2009 (NY) - raises costs to *not* terminating
  - We see more terminations, especially with NY jurisdictions

Overall…

Paper makes its points directly and clearly.

The basic point is that in derivatives, contractual details matter. They

- Impact default boundary and potentially increase defaults
- Can reduce benefits of hedging
- Can explain why there is less derivatives usage than one expects

What to do, if anything, is a highly subjective matter. I don't have many suggestions and mine may be grist for future papers.

Thoughts on Framework

Model extensions are interesting

- Lender holds derivatives — problems worsen
- Multiple holders of derivatives — inefficient equilibria

I wonder if there is an opportunity to do counterfactual inferencing.

- How many companies have these structures?
- How do counterparties behave in these structures?
- What would be the gains under alternative — better — configuration?

Thoughts on Framework

I was wondering about other counterfactual exercises

- What if companies using supplier contracts used derivatives instead? What is the loss?
- What about vice versa? Is there evidence that firms are managing risks sensibly?

Are there accounting issues?

- Hedge accounting versus mark to market comes to mind.

Thoughts on Framework

Deadweight losses

- Are they significant?
- If they are significant, should we see renegotiations or reconfiguring contracts to avoid hitting termination boundaries?
- If we don't — and I'm not sure about it — why not?

If one were to design derivatives contracts ground up, what would they look like?

Empirics

Basic structure of empirical analysis is to consider terminations versus a host of variables including distress, profitability, bankruptcy costs, fair value, and other variables.

Analysis is conditional on hedging in the first place.

- I was wondering if there is an extensive margin effect on whether derivatives are used or not?
- This may be viewed as a selection issue

Empirics

What is the feedback effect of derivatives settlement rules on

- ex-ante use of derivatives,
- the amount of usage

Ballpark aggregate estimates might be useful

Firm-level estimates of alternate policies and value might be even better

Concluding

A well-focused paper that makes its points effectively

Perhaps broaden scope a little — but it is self-contained as is.