March 4 (India Times). MUMBAI. Corporates are walking out of currency derivatives. In the past few weeks, more than 100 companies have cancelled their derivative contracts with banks to cut their losses. The fear of large derivative hits has suddenly deepened following the abnormal surge in currencies like the Swiss franc and yen against the dollar.

Amid a relentless dollar hammering in the international markets, these currencies have appreciated 3-4% against the greenback in the past one week — a swing big enough to wipe out much of what companies had earned from these deals.

Between June and September 2007, there were a flurry of deals as corporates entered into swap contracts to convert their liability into Swiss francs and yen.

(It looked irresistible: since interest rates on these currencies were significantly lower, converting local loans into these currencies was a quick way to cut cost, and improve profits.) The bet turned sour when the currencies began to rise. Today, many banks are advising their clients to exit these deals.

“It’s no longer wise to keep on punting. A large number of contracts are expiring between April and July. The loss could be bigger if you keep the positions open,” said a senior banker who has advised 50% of his clients to cancel the deals.

On expiry, a corporate has to pay the difference in the liability that has been swapped with the bank. As exchange rates have moved, chances are they will have to fork out much more than what they had thought when the contracts were signed.

In many cases corporates also did an option contract to protect the risk on such swaps. However, these call options were conditional risk protection products. For instance, a contract might say that as long as the Swiss franc (CHF) does not appreciate beyond 1.05 against the dollar (i.e., USD 1 = CHF 1.05), the corporate can buy Swiss franc at a rate of USD 1 = CHF 1.20.

If the exchange rate breaches 1.05 CHF/USD — say, touches 1.03 (which it did on Monday) — the corporate will no longer get Swiss franc at 1.20 CHF/USD; then, it will have to buy from the market which has turned more expensive. Even as late as September 2007, few thought the Swiss franc would touch 1.03 CHF/USD.

At any point in the life of the derivative contract (be it a swap or an option), bankers take note of the mark-to-market position that the corporate is faced with. Even if a contract expires in July, a corporate may be facing a mark-to-market loss of USD 2 million today. This means that in July it will have to pay the bank USD 2 million more than what it had calculated a year ago.

If the market miraculously improves (i.e., Swiss franc and yen fall sharply) in the next four months, the corporate will be out of the woods in July when it has to make the final payment to the bank. But today that looks unlikely. Given the bearish outlook on dollar, not many corporates are willing to hold on to their bets.

A mark-to-market loss hits corporates in another way. When a corporate is out of money (say, down by USD 2 million in the mark-to-market position), the bank often asks the corporate to furnish extra cash collateral. Since the corporate is sitting on a loss position, the bank becomes extra careful in protecting its own books.
This mostly is the case for small and mid-cap corporates. At times the bank’s derivatives sales team persuades the bank’s risk-management division to increase the credit limit to the corporate. But, this is unlikely to be accepted if liquidity is tight as is the case now.

If the bank is also a lender to the corporate, it quickly prunes the working capital limit. In other words, if a corporate is not big enough or look even a little shaky, banks do (may be, rightly so) what is required to protect its exposure.

But when things look grim and unlikely to change dramatically, the wisest thing may be to book losses and exit before it’s too late. Today, many corporates are doing just that.

**Questions**

1. Explain the speculation undertaken by the corporations described in the article. What kind of a distribution for $S_t$ (CHF/USD) they had in mind?
2. Explain the logic behind the senior banker who advised 50% of his clients to cancel the deals.
3. Explain the conditional call options used by many corporations. What kind of insurance did they provide? Why were they used instead of the traditional call options?
4. Explain how the mark-to-market works and how it affected the corporations described in the article.
5. Obviously, when one trader goes long, another goes short. Given the tone of the article, describing a bearish outlook for the dollar, why would anybody take the other side?