

Research Notes

2009 ISDA Derivatives Usage Survey

- New survey shows that 94 percent of the world's largest corporations report using derivatives to manage business and macroeconomic risks
- Foreign exchange and interest rate derivatives are the most widely used instruments among large global corporations
- Reported derivatives usage was uniformly high among companies based in developed economies

ISDA published the results of its first survey of derivatives usage by the world's major companies in 2003. The 2003 ISDA Derivatives Usage Survey found that 92 percent of the world's 500 largest companies, a broad-ranging sample covering industries that included banking, mining, manufacturing, aerospace, wholesalers of office and electronic equipment, and retail, used derivative instruments to manage and hedge their business and financial risks.

ISDA recently updated this survey for companies in the Fortune Global 500. The results show that the use of derivatives by businesses continues to grow. According to the most recent results, just over 94 percent of the sample—471 out of 500 companies—report using derivatives.

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OTC Derivatives in Russia

As Russian financial institutions, corporations, and investors become more integrated into the international financial system, the need for risk management tools has encouraged growth of domestic derivatives markets, both on exchange and over-the-counter. The course of development has not been smooth, however, and ISDA is actively involved in reform efforts in three areas, namely, legal enforceability, close-out netting, and treatment of collateral. The following note discusses the obstacles to the development of OTC derivatives in Russia.

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Survey Background

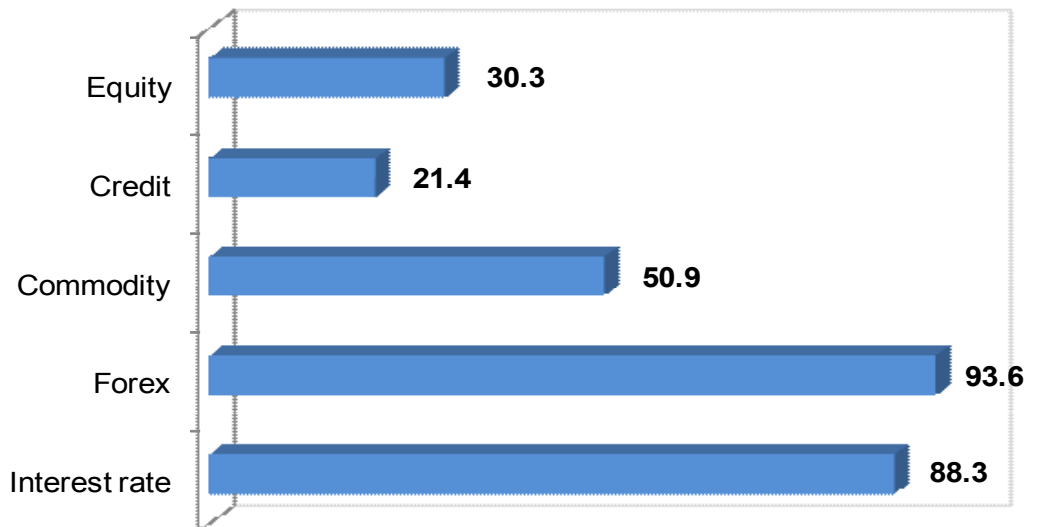
The survey¹ was conducted in March and April of 2009 using information reported in the most recent available annual reports of the 2008 Fortune Global 500 and, in some cases, by contacting the companies directly. Most financial reports did not differentiate between usage of OTC and exchange traded derivatives.

Of the 500 companies included in the Fortune Global 500, eight did not report sufficient information to make a determination. These companies were classified as not using derivatives.

Usage by risk type

Chart 1 shows use of derivatives by type of risk covered; the numbers are percent of companies in the sample using derivatives. Not surprisingly considering the global scale of the companies surveyed, the largest number of companies (441) report using foreign exchange derivatives, followed by interest rate derivatives (416), commodity derivatives (240), equity derivatives (143), and credit derivatives (101).

Chart 1.
Types of risk managed
using derivatives (%)



Cross-industry comparisons

Companies in all industries report using derivatives to manage risks. Chart 2 (following page) shows that the use of derivatives by financial services companies is almost universal (98 percent), followed by basic materials companies (97 percent), technology companies (95 percent), and health care, industrial goods, and utilities (92 percent each). Services companies report the lowest usage rates (88 percent).

¹The complete survey results are posted at http://www.isda.org/statistics/stat_nav.html

Chart 2.
Derivatives usage
across industries (%)

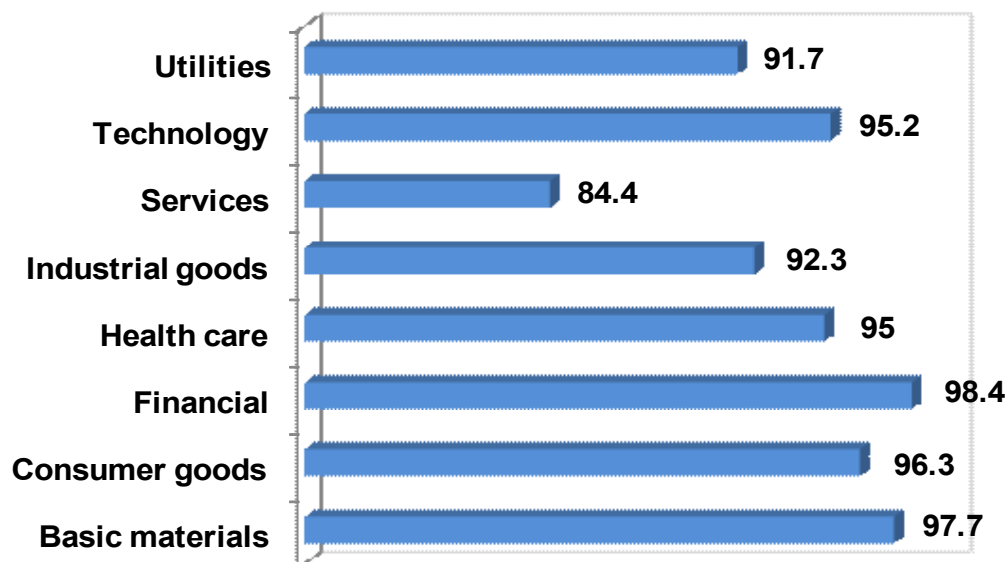


Table 1 breaks out by industry the types of risks managed using derivatives. As expected, financial services companies tend to be the most intensive users of all types of derivative instruments, although utilities and basic materials companies are more likely than financial services companies to use commodity derivatives. With few exceptions, the use of interest rate and foreign exchange derivatives is widespread among companies in all industries.

Table 1.
Derivatives usage by
industry category

Sector	Interest rate	Forex	Commodity	Credit	Equity
Basic materials	60	74	68	0	5
Consumer goods	46	53	26	1	6
Financial	116	117	75	93	97
Health care	17	14	1	1	5
Industrial goods	34	34	9	1	9
Services	66	69	31	1	8
Technology	55	59	10	4	11
Utilities	22	21	20	0	2
Total	416	441	240	101	143

Financial companies are the heaviest users of credit and equities by a wide margin. This is not surprising since the credit risk and equity price risk are more important in the financial sector.

Table 2 illustrates the point further by breaking out financial companies into three

groups, banks (including securities firms), insurers, and diversified financial firms such as Fannie Mae, Freddie Mac, and GE Capital. In Table 2, banks are active in all derivatives, insurers in all but commodities, and diversified financial firms mainly in interest rate and currency derivatives.

Nonfinancial firms, by contrast, are less involved in equity and credit derivatives.

Table 2.
Derivatives usage by financial and non-financial firms

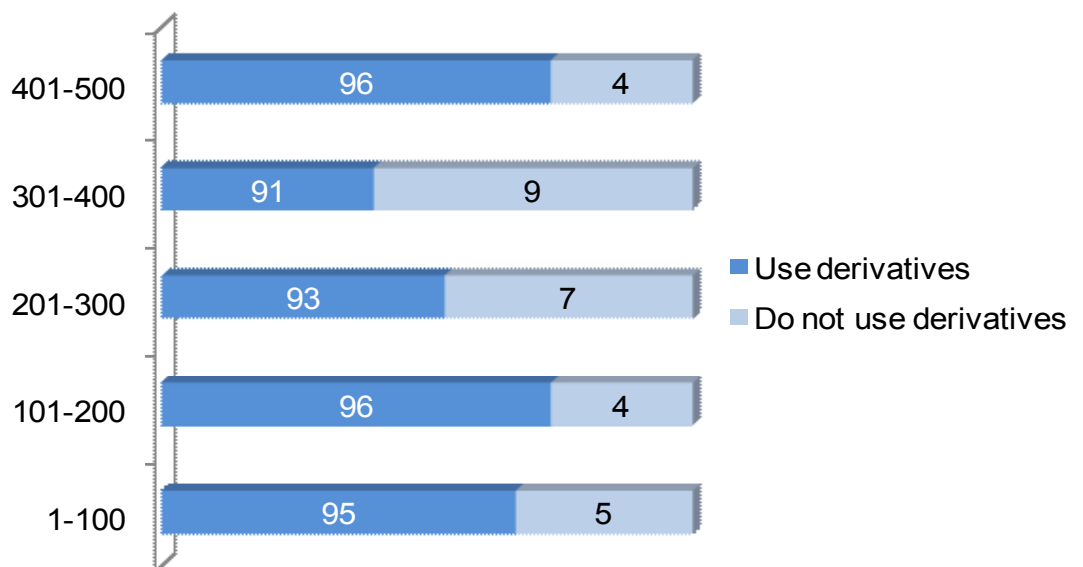
	No. of firms	Use derivatives	percent				
			Interest rate	Currency	Commodity	Credit	Equity
Banks	71	100	99	100	87	86	86
Insurers	45	96	87	89	24	64	76
Diversified fin'l	7	100	100	86	29	43	29
Non-financial	377	93	80	86	44	2	12
Total	500	94	83	88	48	20	29

Overall, the results show that nonfinancial companies typically use derivatives to manage risks inherent to their industry—the use of commodity derivatives by utilities and companies in basic materials, for example—or to manage financial risks stemming from changes by macroeconomic conditions, as evidenced by the widespread use of interest rate and currency derivatives.

Derivatives use and company size

One might expect derivatives usage to be relatively higher among the largest companies in the sample, but Chart 3 shows that derivatives usage is almost uniformly distributed across companies of all sizes: derivatives use throughout the 500 firm sample is as high as for the 100 largest firms.

Chart 3.
Derivatives usage by Fortune Global 500 firm size

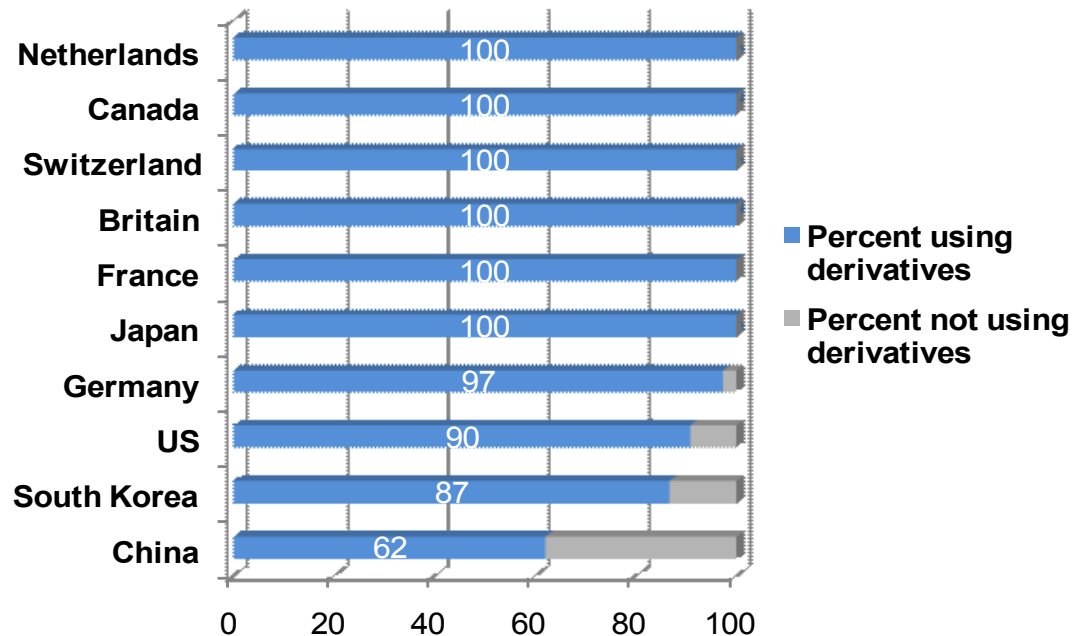


Cross-country and regional comparisons

Although the use of derivatives is common to companies worldwide, the survey results suggest that there are regional differences. All the reporting companies based in the Netherlands, Canada, Switzerland, Great Britain, France, and Japan use derivatives (Chart 4). Among the rest of the ten countries with the largest number of companies in the Fortune Global 500, 97 percent of German companies, and 92 percent of US-based companies report using derivatives. Within the ten largest user countries, derivatives use is lower among South Korean (87 percent) and Chinese (62 percent) companies. Finally, large companies in emerging market jurisdictions report high rates of derivatives use. For example, of the six Indian firms and five each Russian, Brazilian, and Mexican firms in the sample, all report using derivatives.

Concluding comment

Chart 4.
Top 10 countries
for companies
using derivatives
(%)



Derivatives use is almost universal across borders and across industries. Despite occasional controversies, the use of derivatives for risk management is now so commonplace among financial institutions and corporations as to be considered routine.

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Over-the-Counter Derivatives In Russia

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Available data suggest significant growth of both exchange-traded derivatives and over-the-counter (OTC) derivatives in Russia. Turnover of exchange-traded derivatives has risen 168 percent per year on average since 2000 (ZEW 2007). Similarly, average daily turnover of OTC derivatives, 89 percent of which were linked to foreign exchange, grew from USD 7.9 billion in 2004 to USD 19.5 billion in 2007 (NFEA 2008).

Although trading in currency derivatives has grown, trading in non-currency instruments such as interest rate, equity, and commodity derivatives has been relatively slow to develop. Currency controls, a complicated registration scheme for foreign companies, and low transparency of local firms have all conspired to reduce liquidity in domestic markets and to push derivatives activity offshore. Offshore volume is five to seven times onshore volume (NFEA, 2008).

As with many other developing countries, however, legal uncertainty over the enforceability of derivatives contracts is the primary obstacle to further development of domestic derivatives markets in Russia. Appropriate legislation would aid the development of Russian derivatives markets, thereby benefitting the economy by facilitating hedging and risk management by both banks and corporates.

ISDA has been involved in the development of Russian legislation governing derivatives trading since 2001. During this time, ISDA has discussed with Russian policymakers several legal issues hampering the development of the Russian derivatives market:

- the need for clarity regarding the legal enforceability of derivatives transactions;
- explicit recognition of close-out netting in Russian insolvency law; and
- the need for legislation to improve the efficiency of collateral transactions and to clarify the treatment of collateral in the event of the insolvency of a counterparty.

This paper discusses recent progress in these three areas as well as other factors affecting the development of OTC derivatives in Russia.

Legal enforceability of derivatives transactions

Like most jurisdictions, Russia has anti-gambling laws designed to restrict and to regulate activities such as gaming and lotteries. In the absence of legislation that explicitly recognizes the right of sophisticated parties to enter into risk-shifting contracts for purposes of risk management, courts in developing economies sometimes interpret anti-gambling statutes as prohibiting derivatives trading. Such rulings create the risk that derivatives contracts may be deemed unenforceable. To provide legal certainty regarding enforceability of derivatives contracts, most jurisdictions have enacted legislation exempting derivative contracts from the provisions of anti-gambling statutes¹.

¹Gooch and Klein (2002), pp. 71-2.

A similar situation exists in Russia. In late 2006, the Russian Duma approved an amendment to Article 1062 of the Civil Code of the Russian Federation designed to exempt financial and commodity derivatives from the anti-gambling provisions of the Code. But this exemption includes several qualifications, the most notable of which is the limitation of the exemption to transactions in which at least one counterparty is a licensed or regulated bank, broker, or other financial institution. As written, the amendment is unclear as to whether a foreign financial institution dealing with a Russian client can rely on this exemption for comfort that a contract with a Russian counterparty will be legally enforceable. Even though the Civil Code states that Russian laws apply equally to Russian and foreign entities, Russian courts might not recognize foreign licenses in practice. The resulting uncertainty has discouraged foreign dealers from participating in the Russian market. Moreover, the scope of transactions covered by the amendment does not appear to be broad enough to cover the full range of derivative transactions in which market participants might wish to engage (ISDA 2006).

Uncertainty over market regulation has led to further uncertainty over the legal status of derivatives. The Federal Financial Markets Service (FFMS), established in March 2004 by a presidential decree, assumed supervisory and regulatory functions involving financial markets. This decree divided the regulatory responsibilities of the FFMS and other regulators such as the Central Bank of Russia. The FFMS acts to promote development of financial markets, including derivatives markets. But many market participants have concerns regarding overlapping and possibly contradictory regulatory scope of the different agencies.

Close-out Netting Legislation

Close-out netting provisions are at the center of derivatives trading. If netting in insolvency is not enforceable in a jurisdiction, a liquidator might pursue payment on transactions with positive value while disclaiming those with negative value. The primary concern with such “cherry-picking” is that inability to terminate and net the transactions increases the risk of a chain of interrelated defaults, that is, systemic risk. Legislation that recognizes contractual netting arrangements such as the ISDA Master Agreement addresses the issue of cherry-picking by allowing for the enforceability of close-out netting².

Current Russian insolvency law is undergoing important changes toward explicit recognition of close-out netting. The first step is the introduction of standardized documentation for OTC derivatives transactions. In June 2009, three Russian financial associations (Association of Russian Banks, National Foreign Exchange Association, and the National Association of Securities Market Participants) published standard documentation for domestic transactions in Russia. The architecture of the documentation is based on international practice, primarily the ISDA Master Agreement, as well as the

²Close-out netting applies to the occurrence of any or all of the following: the termination, liquidation and/or acceleration of any payment/delivery obligations. When invoked, close-out netting facilitates the calculation of a close-out (market/liquidation/replacement) value; the conversion of calculated values into a single currency; and the determination of the net balance of the values

peculiarities of the Russian legal system and market practice. The full effectiveness of any domestic documentation will ultimately depend on further improvements to the Russian legal framework, especially on bankruptcy and the recognition of close-out netting.

The second step is recognition of close-out netting in Russian insolvency law. Draft legislation on close-out netting has been introduced recently.³ The draft amendments are intended to increase legal certainty going forward for the use of master agreements and the enforceability of netting in case of bankruptcy. The draft bill attempts to ensure that obligations are calculated as the aggregated sum of all money liabilities (net obligation) under the same Master Agreement and that specific rules against cherry-picking are in place.

Although the current proposal is a notable step forward it still contains significant limitations. One is that corporations are still excluded from the list of counterparties eligible for netting; only banks and professional market participants qualify. The other is that eligibility for netting is restricted to a limited number of underlying assets.

Collateral Arrangements

There is currently no legal certainty that collateral agreements are enforceable without registration or other formal certification. Recent changes to the law on security interest and pledge have resulted in certain clarifications, including assumption of title, restrictions on enforcement. Further improvements are needed, however, including the express recognition of title transfer collateral arrangements.

ISDA has suggested two amendments to the current legislation. The first is to make collateral available without having first to petition the bankruptcy court in case of insolvency. The second is to extend close-out netting rules for collateral practices according to methodology common to international standard contracts and as proposed by the ISDA Model Netting Act (ISDA 2007).

Another related factor impeding the development of Russia's financial markets involves the lack of clarity about the status of a central securities depository (CSD). A CSD makes it easier and less risky to handle securities as collateral by eliminating the necessity for physical relocation of securities. Further, a CSD guarantees the fulfillment of obligations by means of handling the securities with certain market value that serve as the guarantee in case of bankruptcy. All major markets have CSDs, but legal clarity on the status of a CSD has not yet been attained in Russia. The FFMS recognizes the importance of a CSD for the stability and further development of financial markets, and it supports the passage of a special law that will determine the status of the CSD as well as principles of its establishment and operation (FFMS 2006).

³ The most recent amendments were submitted to the Lower House in June 09 and, if approved, could be adopted by year's end.

Conclusion

Despite considerable growth in the past years, the full potential of the derivatives market in Russia has yet to unfold. The primary reason is lack of an adequate legal framework. Recent amendments to the Russian Civil Code providing more legal certainty for derivatives transactions are steps in the right direction. Russian law, however, still does not set out a clear position on full legal rights for derivatives trades or enforceability of critical provisions of the ISDA Master Agreement, particularly those that relate to close-out netting and collateral. Such legal uncertainty means that market participants cannot take advantage of netting benefits when calculating their exposures and consequently face high capital charges.

Similar patterns could be observed during the early years of derivatives activity in the United States when currency and interest rate swaps started to grow rapidly. The peak of legal concerns came in 1990, when a U.S. federal court found that some commodity derivatives were illegal commodity futures, which led to uncertainty about the enforcement of other OTC derivatives.⁴ Such legal uncertainty led to reluctance to enter into some contracts as well as to the potential for shifts of swap activity offshore. Similarly, today's Russian derivatives market remains underdeveloped, limited onshore to activities with futures and currency forwards and with far more activity occurring offshore. Even simple transactions are difficult to structure because securities market regulation, and especially derivatives regulation, are complex, incomplete, and controversial. At present, the only part of the market covered by comprehensive legislation is futures and options on equities and equity indices (FFMS, 2006). In contrast, an efficient legal framework for currency, interest rate, and commodity derivatives remains to be developed.

Increased legal certainty as to the treatment of enforceability, netting, and collateral will bring substantial benefits to parties wishing to engage in cross-border as well as domestic transactions. Opportunities to reduce credit risk in Russia will allow market participants to increase their transactions with Russian counterparties. The result will be increased integration of Russia into the international financial system.

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⁵ Gooch and Klein (2002), p. 77.

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ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 830 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Since its inception, ISDA has pioneered efforts to identify and reduce the sources of risk in the derivatives and risk management business. Among its most notable accomplishments are: developing the ISDA Master Agreement; publishing a wide range of related documentation materials and instruments covering a variety of transaction types; producing legal opinions on the enforceability of netting and collateral arrangements (available only to ISDA members); securing recognition of the risk-reducing effects of netting in determining capital requirements; promoting sound risk management practices, and advancing the understanding and treatment of derivatives and risk management from public policy and regulatory capital perspectives.

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