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The ins and outs of Over-the-Counter Swaps

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By Fran Howard

Mary Ecklund, market analyst with Downes-O'Neill/FCStone, provides a quick lesson in over-the-counter swaps in the following eDairy/*Weekly Insider* Q&A.

eDairy: What are over-the-counter swaps, also known as OTC swaps?

Eckund: Over-the-counter swaps are off-exchange traded financial contracts. Their values depend on the values of an "underlying instrument," typically a futures price or some other transparent series, to act as a reference price. They typically cash settle without any physical delivery.

eDairy: What are the advantages of using OTC swaps, and what products can be traded?

Ecklund: Any commodity can be traded as an OTC swap even if it is not an exchange-traded commodity. The advantages of OTC swaps include customization and flexibility. Each OTC swap can be customized and tailored to the needs and risk appetite of the customer. They offer more flexibility than trading in futures. Volumes, or the quantity of product traded, can be larger or smaller than a futures contract offered for the same commodity. Expiration dates, pricing, and settlement are also advantages. Settlements can be an average of a price series instead of one price on a certain day. They are more flexible and can often be negotiated between one seller and one buyer.

eDairy: Who would use these vehicles and would they be considered a hedge?

Ecklund: Yes they are considered a hedge. Any qualified customer whose hedging needs are not met by the futures markets and who is looking for customized hedging tools would be a good candidate for an OTC swap. However, just like with futures or options trading, OTC swap participants must meet certain financial requirements.

eDairy: Could you give an example of who in the dairy industry might be a candidate for an OTC swap?

Ecklund: A good example of a prime candidate for an OTC swap in dairy would be a cheese manufacturer who does not price its product off of the Class III market. This cheese maker might utilize a cheese swap that prices the cheese off the CME spot cheese market to obtain a higher correlation between what the company pays for milk and the price at which it can sell its cheese.

eDairy: Can other dairy products be traded as OTC swaps?

Ecklund: Yes, any dairy product or dairy ingredient, such as nonfat dry milk, butter, buttermilk, or WPC 34 could be traded over the counter as long as there is a transparent pricing series to help value the product. And, of course, there would need to be a willing seller and a willing buyer for the product.