

The advantages and disadvantages of exchange traded derivatives. assignment

[Business](#)



“ The International Swaps & Derivatives Assn. recently estimated the worldwide market at \$ 105 trillion. The Office of the Comptroller of the Currency (OCC) says U. S. commercial banks held \$ 56 trillion of derivatives at the end of 2002”, and by comparison the GDP of the US was estimated to 10. 4 trillion the same year. The world’s largest financial market today is therefore without doubt the derivative market. Derivatives have come into existence because nearly every business has its risks.

Derivatives are used to protect against key-business risks which are beyond our control, such as movements in the markets of commodities and foreign exchange . Those who use derivatives as a way of managing risk are called hedgers. Martin Taylor, former Group Chief Executive of Barclays, compare risk with energy; “ Risk is neither created, nor destroyed, merely passed around. ” This is where the speculators play an important role in the derivatives market. The speculators have no interest in the underlying itself, but for the possibility of a reward they are willing to accept a certain level of risk.

Without the speculators the derivatives markets would not function. The third group of players in this market is the arbitragers. These people look for mis-pricing and market mistakes, this give them a risk-free profit, a situation that gets the mistakes to disappear before becoming too large. After a number of huge derivative losses in the mid-nineties, a lot of criticism was pointing at the derivative trading. For example, Orange County lost \$1 billion in SWAPS contracts and went bankrupt, Barings Bank shut down business after a ? 880 million loss caused by futures trading in Singapore.

In this essay, I will look at both the upsides and downsides from the use of derivative instruments, mainly focusing on exchange traded derivatives. Different user groups such as private investors, companies, banks and traders, will be taken into account. In addition, I will discuss whether there is a need for further restriction of the derivatives market or not. According to several financial institutions, derivatives are not as risky as many fear. When the right derivative instrument is used prudently by qualified people, they can lead to benefits.

On the other hand, derivatives are extremely powerful financial instruments, charged with a high degree of leverage, and carries a substantial level of risk. Small movements in the underlying instrument can result in very large swings in the products price, ending with great gains or losses. Institutions can reduce funding costs by, for example, purchasing debt in the market where they have comparative advantage, and entering into either a currency- or an interest rate swap to receive the required debt type. Derivatives can, as mentioned earlier, also be used to hedge exposures.

For example by entering in to a forward- or a future contract, foreign exchange risk can be reduced or almost eliminated. An investor worried about losses on portfolio investments in stocks or bonds can use derivatives to define the downside. Hedging a portfolio can be done by buying/selling options on an index, in the case of UK, the FT-SE share index. One can also hedge by simply buying a put option for one particular share. The Index futures and options are commonly used by equity funds; it is especially useful when market volatility is high or in a bear market.

This is a form of insurance, for which the investor has to pay a premium.

There are several strategies investors can undertake when making use of options, depending on the view of the future movements in the market and their attitude to risk. Strategies in an option market are for example Protective puts; buy put options on the underlying you owe to cover for short-term fall in price. Covered calls; write a call at the underlying you own to increase potential profits if the market does not move and at the same time be protected against a fall in the underlying. Derivatives have potential on several counts beyond risk management.

Because of the leverage involved, there are staggering profit opportunities.

The derivatives market makes it possible to make money, whether the market is in bear or in bull. If an investor believes the market will rise, he can either buy call options, write a put option or buy a futures contract and vice versa if the market is believed to fall. The futures market gives investors and traders the ability to take a short position in the underlying, which is selling something you do not have. It is important to be aware that huge losses may occur if the market moves in the opposite direction.

Derivatives may as well offer tax advantages over otherwise comparable financial strategies; it may reduce transaction costs and enhance liquidity.

Derivatives create a more efficient market. In the stock-market for example, when not moving very much, investors are sometimes better off selling their shares and move their funds in to the money market. Derivatives enable them to make a profit regardless of the market is at status quo, rises or falls, and moving their funds is less attractive. By buying or selling exchange-

traded derivatives the investor is exposed to less risk than those who trade Over-The-Counter.

The risk of default by a counterparty is transferred to the exchange, in return for deposits called margins from buyers and sellers. A lot of the derivatives scandals, such as Orange County and Metallgesellschaft were a result of Over-The-Counter trading. The Exchange offers greater liquidity, but investors are not able to construct a perfect hedge, which they can by trading for example forwards Over-The-Counter. OTC derivatives are customised contracts between two parties, while exchange traded derivatives are standardised. This liquidity of the market creates low transaction costs; in addition, investors can maintain their anonymity.

This attracts investors to use the derivatives market to get hold of relatively large proportion of the underlying, making use of for example synthetic shares. A synthetic share is you write a call and buy a put at the underlying, both with the same strike and exercise date. This yield will match the yield of the underlying. The gearing effect of the options is also attracting investors. That is, the percentage yield on an option is a lot higher than the yield of a share. One can with a lot less capital, get a return similar to what buying the underlying would have yielded. For example, suppose the current price of MSFT is \$100 (and we are in March). For some reason, you expect the price to appreciate to \$120 by September. You therefore buy a "Microsoft \$100 September call". This gives you the right to buy MSFT at \$100 at the expiration. Suppose this costs you \$3 per option, (this is called the premium). In September, let us assume that the price reached \$120, you are

said to be in the money. You now exercise your option at \$100 selling instantly at \$120 making a \$17 profit per option. Notice that you have made \$17 on a \$3 investment (i. e. 67% gain) while the stock only appreciated by 20%! This effect is called leverage if you are American or gearing if you are British. " The margin system of the futures allows investors a geared exposure to equity or interest rate risk. At the same time, the gearing effect of the margining system also means that investors can quite easily lose their entire investment. This is unlikely when investing directly in shares or bonds. It is the gearing effect that attracts a lot of speculators; they see an opportunity to make enormous profits even when there are small changes in the market.

I have earlier pointed out the important role of the speculators, but they can also contribute to large financial scandals. " The 7th largest company in the US and the world's largest energy trader made extensive use of energy and credit derivatives but became the biggest firm to go bankrupt in American history after systematically attempting to conceal huge losses. " Some regulators worry that derivatives make it easier for banks to leverage themselves because the down-payment is smaller than the amount it puts at risk. There are plenty of other ways in which banks can take huge bets on markets.

As for worries about the complexity of derivatives, many of the disasters that are criticised mostly involved relatively simple contracts. The cause is by many, argued to be greed or mismanagement. In fact, swaps, options and other derivatives actually help to reduce the chance of a systematic crisis to

occur by providing a cheap and efficient way of shifting risk from those who want it to those who do. Banks are often criticised for putting too much money at risk when investing in derivatives, an argument often used for a more regulated market. When a bank makes a loan, it runs a big credit risk.

If the borrower defaults, it can lose all its money. It is different with derivatives, the size of a contract, its notional value, is a reference point of calculating how much is actually owed. For example, a currency swap may have a notional value of \$ 20 million, but the cost of replacing if one party defaults is only the movement in the foreign exchange rate since the contract was drawn up. This is often a small fraction of the notional value. Another factor causing concern for many regulators is the biggest banks domination of their industry's derivatives business.

A more fragmented market would not necessarily lessen the risk of systematic crisis; it may as well increase it by bringing in many inexperienced players. One must bear in mind that the large investment companies have invested heavily in risk management systems and have good credit ratings. The proponents of derivatives regulations have not demonstrated that market failure has occurred in the derivatives market, even though, people have lost money, it does not qualify as a market failure. This is one argument often used against further regulation.

Further on, instead of reducing risks, more regulations would impose new regulatory costs and risks on market participants. Many derivatives contracts are very specific and customised products. In contrast, regulations are mostly general and vague. Regulators are often people who know very little

about the complex derivative instruments, which can frighten market participants. A worst case scenario can be that the derivatives business is driven out of their existing markets and into less regulated shores. This will reduce the competition and liquidity of the domestic markets and the costs of risk management will therefore increase.

The main reason for regulating the financial market is to protect those involved. Disclosure of essential risk information by an investment bank advising organisations or individuals is one such regulation. To help discovering a crisis at an early stage it is important that information between different exchanges and/or investors is exchanged. “ Last year, Warren Buffett, America’s most famous investor, launched a new tirade against derivatives, calling them “ financial weapons of mass destruction. ” He was joined by Bill Gross, the manager of PIMCO, a multi-billion-dollar bond fund.

They and other critics charge that derivatives contracts contain dormant losses that will come to haunt their owners, typically insurance companies and banks. The critics also claim that derivatives enable corporate treasurers to gamble with shareholders’ money” I believe that the use of financial derivatives should be encouraged, and that it is a very useful financial tool for all market participants, but if you don’t have the personnel, systems and technology in place to adequately understand, measure and control the risks, then my advice is don’t use them t all. I also believe that the development of regulated clearing systems should be encouraged. Clearing systems can employ a variety of risk management tools, such as mutualizing risk and offsetting multiple obligations. Consequently, clearing systems help

reduce systemic risk by lowering the possibility that the failure of a single market participant could disproportionately disrupt or impact the overall market. Bibliography Books: David Cobham (1992), *Markets & Dealers*

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