Regulation of derivatives markets in developing markets finance essay

Finance

INTRODUCTION

By mentioning the historical year 1929, 1987, 1997, 1998, 2000, scholars and financial services practitioners know exactly what does it refer to. We also do not forget the days of 2008. The stock market went down dramatically, investment bank collapsed, credit markets froze, and hundreds billion dollar bailed out for major financial institutions around the world, and the worry about the financial regulatory system to confront the crisis too many times in history. The crisis was very complicated and derivatives were also blamed for making the market problem especially thought the complexity and innovation in derivatives (Dudley, 2012). Besides efficient risk management tool in the financial sector, derivatives can also involve risks such as default, price, and systemic risk. Law and regulation in the financial system of each country also keep changing and adjusting accordingly in respond to the problems and stabilized derivatives market. The International Monetary Fund (IMF) has supported and suggested the advantages of rule-base framework in regulate and supervise the market (Caruana, 2009). However, there is also concern about the rules-base regulation as not flexible in react the problem by pay more attention to the enforcement and administrative process too much. This essay will explore the regulation of rules-based approaches in derivatives in developing market. A rules-base regulation of derivatives in Thailand will be chose as a tool for discussion. To make it easier to understand, the essay has been divided into four major sections. The first part will briefly describe the background concept of derivatives and the creative, complexity as well as the risky it can be. After that a review on rule-based regulatory approach will

also mentioned with pros and cons of the rules. Section two will briefly describe the derivative market in Thailand and go deeper into derivatives regulation in Thailand by using Derivatives Act B. E. 2546 (SEC Thailand, 2003) to illustrate approached and practices. And then the essay will provide critical thinking on the Act follow by conclusion and recommendation for developing-derivatives market like in Cambodia, Laos or Myanmar.

OVERVIEW OF DERIVATIVES

Derivatives are supposed as one of the most complicated financial instrument to be understood by investors and regulators because they are developed by people with high knowledge and rare skills. The development of derivates has been in a very fast innovative way. Kolb (1996) defines financial derivative as a financial instrument derive their value on other financial assets or based upon another elementary financial instrument. For instance, an agreement between two people (future contract) to buy an asset with specific price at specific time in the future based on agreement between the two parties. To specify in real world context, suppose that a rice producer in Cambodia agree on a contract in April 2013 to exchange 1, 000 GBP for 1, 000 kilogram of rice to Tesco UK at the end of November 2013. In case there is unpredictable flood from Mekong River on farm land in Cambodia, the production of rice will drop which lead to the less supply in rice. Base on economic theory, when there is less supply, the price will go up. If the market price of rise rises to 1. 2 GBP per kilogram in the month prior to the maturity date of the agreement above, the value of this future contract of the Tesco increases because the Tesco can have 1, 000 kilogram of rice worth 1, 200 GBP for just 1, 000 GBP. Automatically, an increase in

the market price per kilogram of rice will make an increase in value of the futures contract of Tesco. In contrast, if the price of rice decreases, the value of future contract of Tesco will also decrease. A change in price of commodity leads to a change in value of future contract of a derivative product. In the real market, the establishments of derivatives instrument various in order to meet the financial need and commercial need from agriculture, to high tech product and services. To control risk, securities investors also need different type of financial instrument which lead to development constantly new types of derivatives. The common different categories of derivatives are future, options and swaps. The example of contract between the rice producer and Tesco above is a form of future. An option provides right to holder to sell or buy the asset by a certain date for a certain price. In buying and selling they use the term ‘ call option’ or ‘ put option’ respectively (Hull, 1997). It is commonly use in buying share or bond. For instance, before it expires date agreed the buyer can either choose to exercise or not exercise the options on bond hold. A swap is defined by Kolb as an agreement between two or more parties to exchange cash flows or assets over a period of time in the future. Within the swaps there are different types such as interest rate, currency, or commodity swaps. According to Schinasi (2000) derivates are traded in exchange-traded derivates and over-the-counter (OTC) market. As the name suggested, exchange-traded derivates are derivatives traded on exchange market, where OTC does not use the facilities of an exchange but the direct contract between buyers and sells. Producers and investor use derivates to manage risk (hedge) and to take risk (speculate). In other words, derivatives are use

for hedging and speculating. Many companies such as farm and mining industry use derivatives in order to transfer risk to speculators (Corrado, 2009). At the same time speculators dare to take those risks in exchange for possible profit in the future. Potential loss, of course, can also come together with profit. Besides using as a tool to reduce risk, derivative is supposed as one of the risky investment instrument. Complexity of the assets increases the possibility of failures for investors and other market participants. For investors, risk is not always bad, but it should never be ignored as well especially with the three common type of risk namely price risk, default risk and system risk. First, price risk refers to the potential for losses on derivatives because of the changes in the asset prices such as bonds, foreign currencies, and commodity prices (Kolb, R. W. and Overdahl, J. A., 2010, p. 85). When there is a change in price, investors tend to change rapidly. In a large degree of leverage for borrowing in futures and options, a small change in price mean a large amount of gain or loss. Second, default risk or credit risk is the risk that might occurs when any party in the contract cannot pay out on a derivatives contract at the obligated date (Ibid). Market players consider very much about this kind of risk when involve in the contract. A bank might invest too much in one derivative. When it is too much confident or too much money is invested in one derivative, then a potentially important loss can happen during an original derivative asset price change. Moreover, if insolvency in one or more of the investing banks happens, there will be defaults. Losses due to these defaults might lead to losses at other investing banks which could then also become insolvent. In other words, default in one type of derivatives contract can extend to other contracts and

markets which called domino effect like the case of the collapsed of Lehman Brothers (BBC News, 2008). Third, when the whole market collapse due to a great deal of defaults in the market will result in system risk. All derivatives in the market will be affected by this kind of risk in macro level. For instance, the systematic failure in insurance company in 2007 was a consequence of real estate bubble in 2006 in the US. Normally, not every default lead to systematic risk but it always have negatives correlated. What is more, some risks in one derivative might not be associated to other derivatives. For instance, a default on a rice producer future might not be related to an investment default on a bond. Additionally, investment in a portfolio could decrease the uncorrelated risks of derivatives by diversification (Juan, 2011).

RULES-BASED REGULATION

This part of the essay introduces rules-based approaches to derivatives regulation and also a brief review of advantages and disadvantages of this approach. Without detail study, it is not easy to identify which regulatory structure as rules-based regulation. However, one key indicator is on how the rules are applied, not too much depends on how the rules look like (Black, 2008). Black also distinguishes rule-based and principle-base regulation which uses principle rather than the feasible detail description of the rules and can perform in difference patterns. In implementation of the regulation, principles-based approach looks to principles first, and uses principles rather than detailed rules wherever feasible. It is not necessary to have the formal detail description of all elements in statutory drafting, but focus more on outcome with flexible practice (Ibid). The principle-based regulation will also discuss partly at the end of this essay. For lawmaker,

rules describes most or nearly all legal judgment to be regulated by predict in advance of actual cases with actors, decision makers, and enforcers to apply in each context. As a result, arbitrariness and decision-makers' bias can be reduced with expected equal treatment. Sullivan, as quoted in Shiffrin (2001, p. 1214), added that rules are can promote predictable result in legal conclusion by provide individuals with information about consequences. The same principle also applied in derivatives rules-base drafting. It is also interpret base on statute itself while principle based interpreted base on a common understanding between regulators and firms. Some derivatives regulation often combines the rule-based and principle-based law together because it is difficult to distinguish and isolate. For example, the UK Financial Services Authority (from April 2013 the FSA was separated into the Financial Conduct Authority, and Prudential Regulation Authority) is a leading institution in using the principles-based regulation approach, but its regulatory structure is an amalgam of rules and principles (Ford, 2010, p. 262).

ADVANTAGES AND DISADVANTAGES OF RULES-BASED REGULATION

There is a certain quality, such as flexibility and complexity in operating which makes this type of regulation have pros and cons. First of all, the rules based regulations have advantage in reducing the extent to which irrelevant and illegitimate factors might intentionally occurs in the decision-making because it is predictable by everyone with detail description in the legislation with reasonable and accountable manner (Shiffrin, 2001). Rules-based regulation is also promoted the consistency because the regulators do not

need to judge much on contextual factors but by following rules is enough. There is no double-standard inside the judgment process while it is not easy to have such standard in principles-based regulation. Moreover, rules-based regulation is also believed to provide more transparency by taking a great deal of discretion away from judges. Wallison (2007) supported that a rules-based regulation contributes to increase fair competition in the market soundness by increasing transparency and reducing barriers to market entry. To make it short, rule-based is more valuable than the contextuality and flexibility given by the principle-based regulation with clear and forceful regulatory process. However, rules-based regulation could also provide disadvantages as a result of limitation of the rules allowing practitioners to evade them by using other technique to avoid the coverage of law. Some giant companies have too many cleaver compliance experts who can find gaps in the law and cheat such as the case in the financial crisis in the United States in 2008 and the European sovereign debt crisis in 2010. For example, the Greece dept to Goldman Sachs had done nothing illegal, said senior executive Gerald Corrigan on Bloomberg, but lost transparency lead to the lost of investors confident and lost money (Gilbert, 2010). One more disadvantage is that the change of rule-based regulation is slower than the change in the market especially in derivatives. When the markets change, the existing rules might not be appropriate for responding to those revolutions in all cases.

DERIVATIVES RULE-BASED REGULATION IN THAILAND

The Stock Exchange of Thailand was launched in 1962 and then change to Bangkok Stock Exchange in 1963 but closed in early 1970s because of inactive participants from listed company and investor (SET, 2013). After the change of requirement in the capital requirement for company to be listed it began to develop. April 1975 the Securities Exchange of Thailand was re-opened with 14 listed companies, and renamed the Stock Exchange of Thailand on January 1, 1991. In May 2004, the Thailand Futures Exchange, a subsidiary of the Stock Exchange of Thailand, is a derivatives exchange was established as a result of the Derivatives Act of Thailand. The Thailand Future Exchange provides electronic trading platform for SET50 index, stock futures, stock options, and gold futures (TFEX, 2013). This market is supervised by the Securities and Exchange Commission. After describing the overview of derivatives and the nature of rules-based regulation, the following session will examine the Thailand derivatives act which takes a rule-based approach. The essay will use Derivatives Act B. E. 2546 of Thailand (SEC Thailand, 2003) as a principle to discus about the provision on insider trading, investor protection, and mandatory disclosure. The Derivatives Act was promulgated on 3rd July 2003 and came into force after approved by the King Bhumibol Adulyadej. It was amended once in 2008. The Act consists of nine chapters and 155 sections, describe a wide range of derivative operation from business operators to supervision and control by regulators. It defines derivative as a contract in which one party is obliged or entitled to demand that the other party deliver goods or make a payment as specified (Ibid, p. 3), and have characteristics similar to the definition defined

in the overview of derivatives above. From Chapter two to Chapter six the Act discuss by using rule-based text drafting be states in detail the requirement for licensing of operators, dealers, and derivatives investment advisors. It also mentions clearing the prohibited characteristic of individual working as operators such as being a person under receivership or a bankrupt, being an incompetent or quasi-incompetent person and having disreputable background et cetera (Ibid, p. 8). The requirement and condition of other actors such as clearing house, broker, and investment advisor also have similar characteristic in the Act. To show more about the rule-based characteristic of the Act, Chapter 4 about the Clearing House will be discussed. From Session 78 to Session 89 has a long list of obligation and supervision of the Clearing House, a network to provide clearing and settlement services, to protect customer assets. One requirement in the Session on customer protection is suggest the clearing house to separate its own asset from customer's when receiving order from members or members' customers. From paragraph to paragraph in this section mentions clearly measure for clearing house to provide fair and safe services in each derivative clearing transaction. All clearing service seems to follow requirement suggested by the Derivatives Act. Furthermore, section 99 about insider trading also express in the form of rule-based derivatives regulation. For example it describes in detail by not allow any person working in the related to the operation and regulation institution of derivatives to engage in derivatives transaction, or disclose information to another person because those information can lead to a change in prices or decision of investors to buy or to sell in derivates products. Within detail

description in the act, insider trading can be identified toward director, subcommittee members, representatives, and so on (Ibid, p. 29). Last but not least, the structure of implementation of the regulation in Thailand is centralized. The overall power is given to the Securities and Exchange Commission, through the Capital Market Supervisory Board, to supervise and monitor the derivatives business, according to Section 9 (Ibid). It is used the form of administrative communication between market practitioners and regulators with less cooperation. The Thailand Derivatives Act is a rule-based which focuses on the compliance process. The way to regulate is base on prescriptive rules by mentioning mainly about permitting and prohibiting the actions by market player. The next part will focus on the critical thinking of this approach in Thailand.

CRITICAL THINKING ON THAILAND DERIVATIVES ACT

As the world of financial markets expanding daily, the use derivatives in risk management is very popular. Derivatives authority working so hard to build regulations for building truths among markets participants especially focusing on controlling risk within the market itself as well as investor protection. The part of the essay comments critically on the approach of the Thailand Derivatives Act by focusing on regulatory orientation and allocation of regulatory responsibilities, and recommendation for an effectives approach in establishing such similar regulation in other developing-derivatives-market country. As described earlier, the Derivatives Act of Thailand is a prescriptive every conducting or action by related party in the markets with limitation. Like the prohibition of wrongful conduct in section 99

suggested some specific manner of insider trading of market participants. However, this can limit the capacity of market authority to identify wrongful case which generally complicated. Generally, it is always too late to find out the case because of the limitation of the law encourage the new way of cheating (William, 1995). The regulators mostly just trying so hard to follow the guideline in the regulation to prohibit activities instead of guarantee effective operation. The use of rule-based regulation mostly is not flexible. Regulatory orientation is also part of the weakness of rule-based regulation of Thailand. By using a process-oriented approach, detailed procedural requirements is a key tool for evaluation the outcome instead of verify compliance. For example, the requirement on settlement process in the clearing house to separate customer assets from the clearing house, would not assure the realization of a safe clearing system for market participants (Ford, 2010). The regulator might not be able to judge the clearing and settlement offered is fair or secure in accordance with the objective of the regulation. In developing a well organized regulatory systems required two main elements, collaboration and centralization. However, Thailand regulatory system adopts more centralized approach. There is less collaboration between the regulators and legislators as well as the self-regulatory organization. Facing complexity of derivatives market, the allocation of regulatory responsibility and having a free-open consultation meeting between the three parties above is vital for gaining specialized skills to develop effective law and regulation. In Thailand there is no special-self-regulatory institution to help monitor the conduct of dealers or advisors. The Securities and Exchange Commission of Thailand is responsible for mostly of

operations in this sector to ensure smooth transaction of the market. Actually there is complex reason behind on the choice of this rule-based regulatory approach mainly determines by history, specialization level and size of capitalization of the derivatives markets. Thailand Derivatives actually is a developing one with less experience and expertise. The derivative exchange, TFEX, born in 2004 with less trading volume and derivatives product is also the reason for Thailand to adobe the rule-based approached compared to other developed markets such as in the US or UK. A rules-based regulation might be good for Thailand context to establish an efficient infrastructure for market participants and a basic regulatory framework with limited capacity in such a short time. On the other hand, as the market keep expanding all the times and more products become available, so risk management approach and frameworks become much more important which required a flexible and responsive regulators. Base on the experience of other develop countries, there is a step by step change because rules-based approach may have been an effective and efficient way of encouraging the development of the necessary infrastructure to get a derivatives market started only. This part of the essay will discuss about the possibility to change in regulatory goals in Thailand to adobe a principles-based approach to regulation may now be suitable in respond to the expanding derivatives market. Risk effective risk management tool and innovation will also be promoted. In general, the derivatives market is operated better by principles-based regulation with timeless capacity development of regulators. One of the reasons why principle-based regulation is better because it help improve communication between

regulators and the companies, and facilitates better understanding between the two parties (Ford, 2010). This approach also preferable it can respond on time to the fast development of financial innovation and encourage competition worldwide. Ford (2010) continues that when problems occur, regulators also can take action on time. Thailand should start transforming their regulation to more principle-base approach in accordance with the development of its market.

CONCLUSION

This essay has examined the overview of derivatives markets identify the potential complexity and unexpected changes of derivatives markets. This market is very popular for those who try to avoid risk in the form of hedging and also those who have willing to take risk for profits thought speculation. The markets keep expanding every year thought the exchange market and the over-the-counter. Market operators, brokers, and investment advisors try to use good practices to secure and get truth from investors, who are looking for higher liquidity, profitable, and low risk. At the same time regulators also developing law and regulation suitable in respond to those fast development of the markets. Rules-based approaches in derivatives market have also analysis. It provides advantage of transparency and consistency but has the some disadvantages because of it nature is slow respond unexpected changes. Moreover, the characteristic of rule-based derivates regulation in Thailand has also considered. Thailand is developing-derivatives-market country using a rule-based regulation since the Thailand Future Exchange established in 2004. By using a detail description in Derivatives Act of Thailand, it is found that the use of rules-based approach may make the

market remain uncompetitive with limited capacity in respond to the potential risk in the market. The provision is mostly prescriptive and comprehensive rules. Even though there are quite a few principles, it commonly supplies discretionary command to the regulator and by and large does not give scope for straight industry contribution in the regulatory process or for firm-specific regulatory responses. Thailand may need a principle-based regulation soon because it is going to have competitive derivatives markets especially when there is a linkage of capital market in ASEAN and have cross border trading. In conclusion, rule-based approach is good for the first stage of derivatives market development especially in the developing markets with less expertise and specialization. However, it is much better to establish a stable market with low level risk and encourage product innovation by taking a principles-based approach or a hybrid of rule-based and principle-base regulation. I think the hybrid is the best choice for new-developing market like in Cambodia, Laos, or Myanmar.

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