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Simplifying Derivatives – Stabilizing the Foundation

It is interesting to note that, despite the prevalence and popularity of derivative instruments, most average investors remain unclear as to what these products are about. Currently, the mere mention of derivatives conjures thoughts of exotic products such as the over-complicated sub-prime mortgages and credit default swaps, which played a notorious role in the recent global financial crisis. Whilst this is true, it is not the whole picture. It is unfortunate that those specific structures created a negative stigma, which obscures the already limited understanding of derivatives and their usefulness. To illustrate, in 2003, world famous billionaire investor, Warren Buffett, labeled derivatives as "financial weapons of mass destruction", yet continued to use some of them himself. This underscores that derivatives, though potentially destructive, still have intrinsic value once regulated and used for the purpose that they were originally created.

Derivatives 101

Derivatives are financial instruments that obtain their value from an underlying asset (or group of assets) such as stocks, bonds, currencies or even commodities. Derivatives were, and still are, intended to enhance investors' ability to meet their investment objectives by 'hedging' against specific risks in anticipation of market contingencies. Hedging can be understood as a form of insurance that mitigates the impact of a negative event occurring. Classic derivative instruments utilized to hedge risk include: options, futures, and swaps. To get a clearer idea of how these instruments are beneficial to the investor they are illustrated simply as follows:

Options: An investor anticipating a fall in share price can purchase a *put option*, which would give him the right (but not obligation) to sell his shares at a pre-determined price by a specified date. If the share price falls he would have successfully hedged the risk of the shares losing value by locking in his share price. However, if the price appreciated he would have lost only the fee to purchase this option. Inversely, the option to buy in the future at a fixed price is a *call option.*

Futures: Airline X believes that oil prices are going to soar to mid-2008 levels by June 2010 and wants to hedge against the uncertainty of price fluctuations. Airline X therefore enters into a futures contract which allows the airline to purchase jet fuel at a fixed price at a date set in the future. Let's say Airline X entered into a futures contract based on an oil price of $70 per barrel for June 2010 and oil prices surpassed this level to reach $140, then Airline X would have successfully hedged the associated price risk and saved money by securing a lower price for the commodity. However, if oil prices did not reach $70, Airline X would still be obligated to pay at the price in the contract.

Swaps: Investor A has a variable-rate loan and wants to borrow more funds to expand his business. Investor A's lender anticipates that interest rates will rise and is concerned that Investor A will not be able to pay the loan. The lender will only lend to Investor A if the variable-rate loan is converted to a fixed-rate. Investor B has a fixed rate loan but wants a variable-rate loan as he believes interest rates are going to fall. These two investors can engage in a swap contract, which would allow Investor A's payments to go towards Investor B's loan and vice versa. The contract therefore gives them the flexibility to obtain the type of loan they really want based on their interest rate expectations.

The darker side of derivatives

It would be myopic to espouse only the usefulness of derivatives without balancing the picture to acknowledge the recent evolution of their less principle-driven side. These instruments have also been utilized to avoid taxes; take exposures not permitted in a particular charter (for example insurance firms taking mortgage risk through index amortizing swaps); speculate (for example traders using credit default swaps (CDS) to take short positions on corporate bonds); lever beyond permissible levels; and take 'off-balance sheet' risk (as this is not as easily monitored). Furthermore, derivative products have the potential to become extremely complex as they can be crafted in an almost limitless number of ways based on investors' needs. Challenges arise when they become over-complex as market participants are often unclear about the level of risk involved and are far less able to determine the instrument's fair value. This is best exemplified in the insurance giant, AIG's exposure to massive risks in CDS derivatives, which created such large counterparty risk that the entire financial system was at risk. To this end, merits of the US Treasury's proposed regulatory framework for over-the-counter (OTC) derivatives should be considered.

The case for regulation

The proposed regulatory framework is a four pronged approach which involves:

1. **Preventing activities in the derivatives markets from posing risks to the financial system.** This would entail the establishment of clearinghouse relationships to facilitate the mandatory clearing of standardized OTC derivatives through regulated clearinghouses. Additionally, large OTC derivative participants would also be regulated through the imposition of capital requirements and mandatory margin requirements. This will improve monitoring and reduce the risk of default.

2. **Promoting the efficiency and transparency of the derivatives markets.** This aspect of the approach entails recordkeeping and reporting requirements to make individualized transaction data available to regulators and aggregated transaction data available to the public. This will ensure that regulators and market players understand the web of counterparties to these instruments and the level of exposure to each other.

3. **Preventing market manipulation, fraud, and other market abuses.** The US Treasury proposes the amendment of federal securities laws to give the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) stronger oversight and full authority to police market players. This would ensure that authorities are no longer powerless to mount an effective policy response and therefore send strong signals to unscrupulous market players that there will be repercussions for market abuses.

4. **Redefining investor sophistication criteria.** Currently, high net worth investors are also considered 'sophisticated' and can participate in derivatives contracts without consideration being placed on the investor's experience or actual investment sophistication. This is due to the fact that such a person's net worth should be high enough to assume total loss of investment principal without damaging his/her overall net worth. As such, the US Treasury's intention is to impose additional disclosure requirements and a greater standard of care when engaging less sophisticated counterparties (in the true sense) in OTC derivatives transactions.

The future of derivatives

According to a report sourced from Reuters, the Bank for International Settlements (BIS) stated that there were US$683.7 trillion of derivatives contracts by mid-2008 and the International Swaps and Derivatives Association recorded US$450 trillion of OTC derivatives (exclusive of currency and commodity derivatives) as at the end of 2008. The BIS noted that once offsetting positions were taken into account, the total gross exposure in the financial system to OTC derivatives was US$20.3 trillion, a sum roughly 50% larger than US gross domestic product. This is a significantly large market and it is not the intention of the US government to eliminate the OTC market altogether. However, by initiating reforms for standardized derivative instruments that are exchange traded and backed by clearing houses, the government would effectively 'raise the bar' for non-standard, specialized OTC derivatives. Therefore, parties considering non-standardized derivatives would have to focus more on the value added, the quality of the product and riskiness involved, and the extent to which it legitimately fulfills their needs over the standardized product.

Although derivatives have been recently 'demonized' in the financial industry, the proposed reforms would help to 'exorcise' this view and preserve the inherent usefulness of derivatives as risk management tools. The reforms should accomplish this by creating confidence in the derivatives market through greater regulation; keeping unscrupulous derivatives structures in check through active policing; and ensuring greater attention is paid to transparency and disclosure of associated risks. There are still gaps in the framework as the US Treasury continues to flesh out the details, nonetheless, this initiative can be seen as a positive step toward financial industry regulation and the salvation of the derivatives markets.

FINANCIAL & ECONOMIC INDICATORS

As at 21 May, 2009

Exchange Rate/US$	Closing Value	Previous Week
Yen	94.41	95.80
Euro	1.39	1.36
Jamaica	89.04	88.99
Guyana	205.50	204.40

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	61.05	58.62
Natural Gas (US$/mmbtu)	3.76	4.08
Gold (US$/Troy Ounce)	953.80	926.50

Eurobond Indices (As at 21-May-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	0.32
JP Morgan EMBI+ (Basis points)	475
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	15.14

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0-0.25	0-0.25
Euro Zone	1.00	1.00
Japan	0.09	0.09
Brazil	10.25	10.25
Trinidad	8.00	8.00
Jamaica	17.00	17.00
Barbados	3.00	3.00

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.18	0.15
US 10-Yr Treasury	3.37	3.09
3-month UK Libor	1.30	1.37
Japan 90-day T-Bill	0.37	0.37
Brazil 90-day T-Bill	9.98	10.03
TT 90-day T-Bill	2.32	2.32
Jamaica 90-day T-Bill	19.82	19.82
Barbados 90-day T-Bill	3.91	3.92

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com