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## **Developments in FX products (derivatives) during the last 25 years**

by Hubert de Vauplane

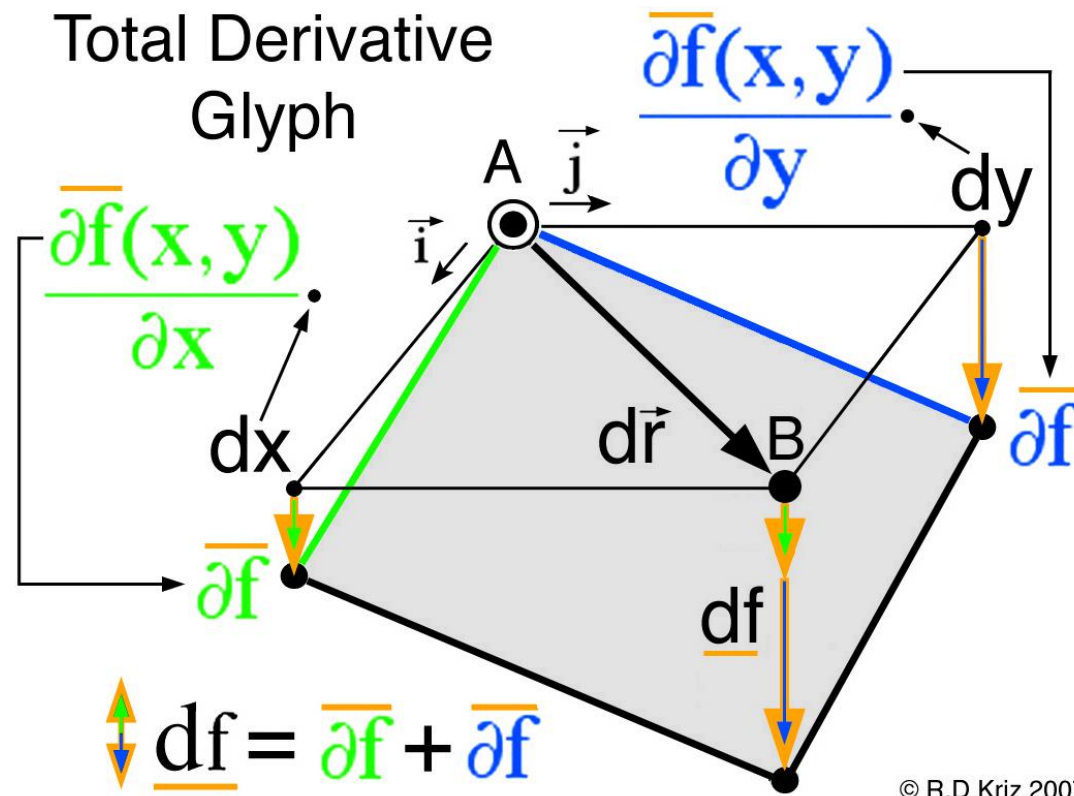
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# Evolution of derivatives market in volume (BIS)

- More complexity
- More variety (futures, options, forwards, swaps)
- More questions about regulation

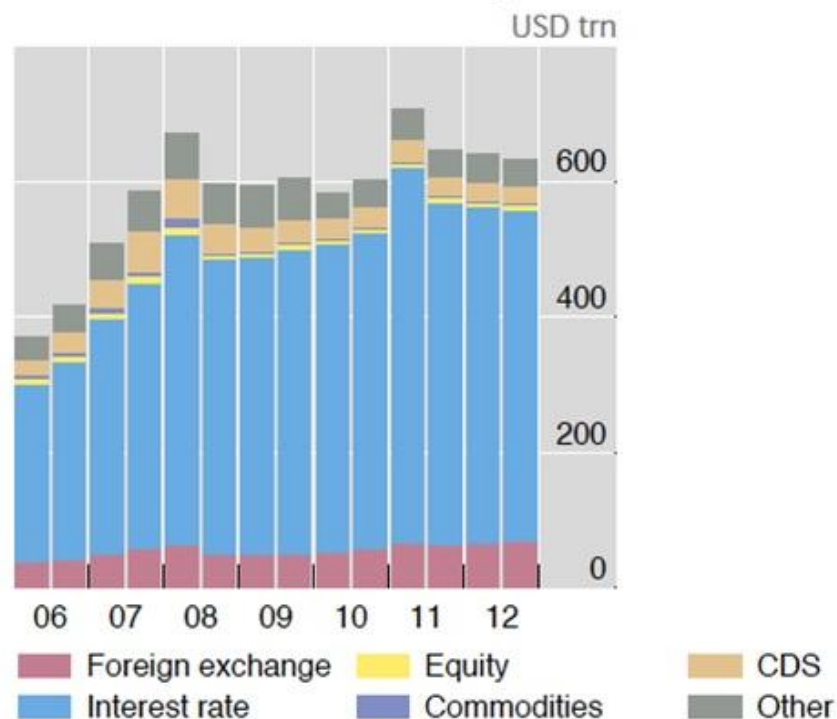


# Evolution of derivatives market in volume (BIS)

## Global OTC derivatives

By data type and market risk category

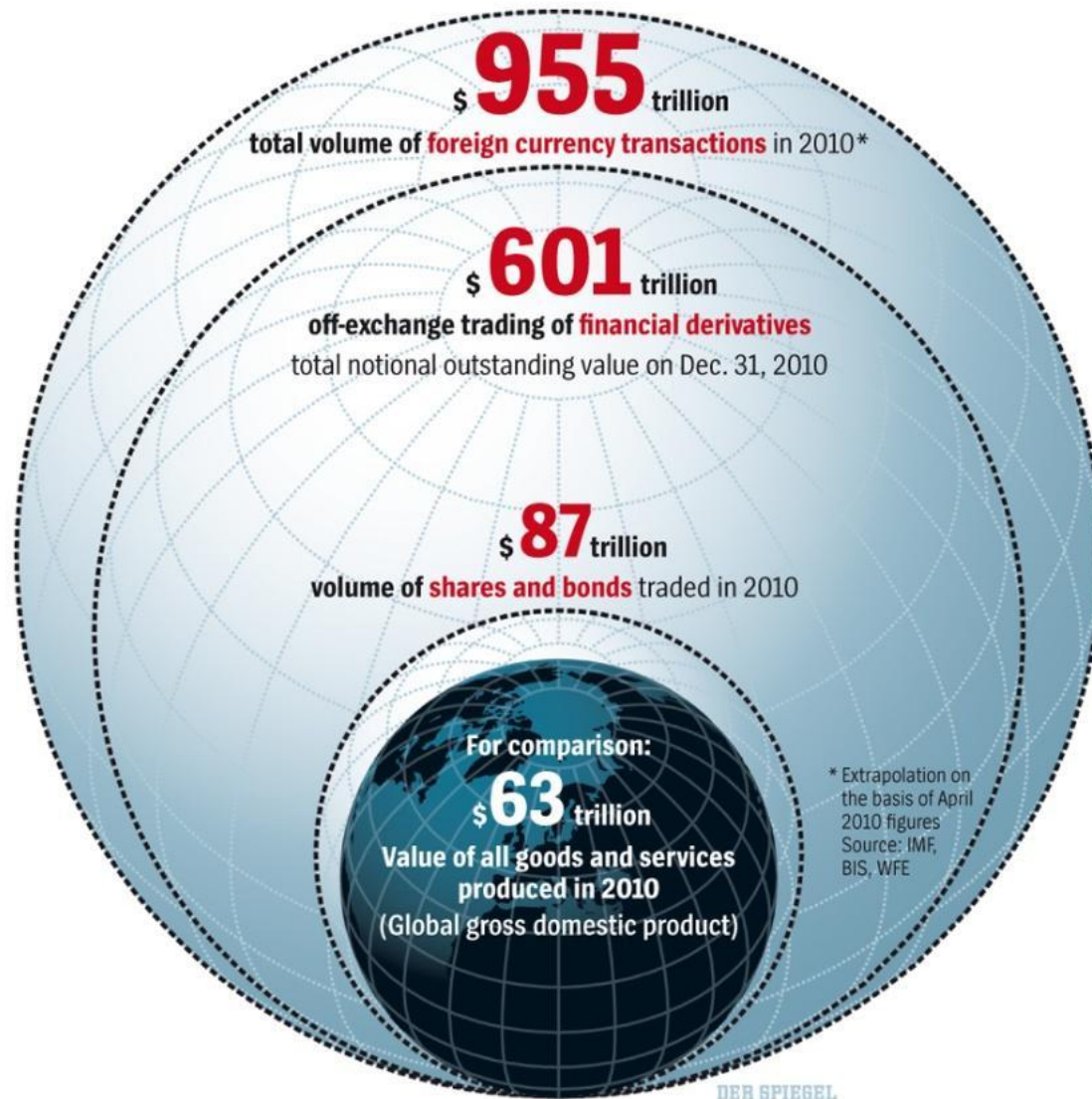
Notional amounts outstanding



“OTC derivatives notional amounts outstanding totalled \$633 trillion at end-December 2012, down from \$639 trillion at end-June 2012. Exchange rate movements masked a somewhat larger underlying decline because the depreciation of the US dollar against the euro and Swiss franc between end-June and end-December 2012 increased the dollar value of contracts denominated in those currencies. Over the same period, the appreciation of the US dollar against the yen tended to lower the dollar value of yen-denominated contracts.”

Source: BIS OTC derivatives statistics.



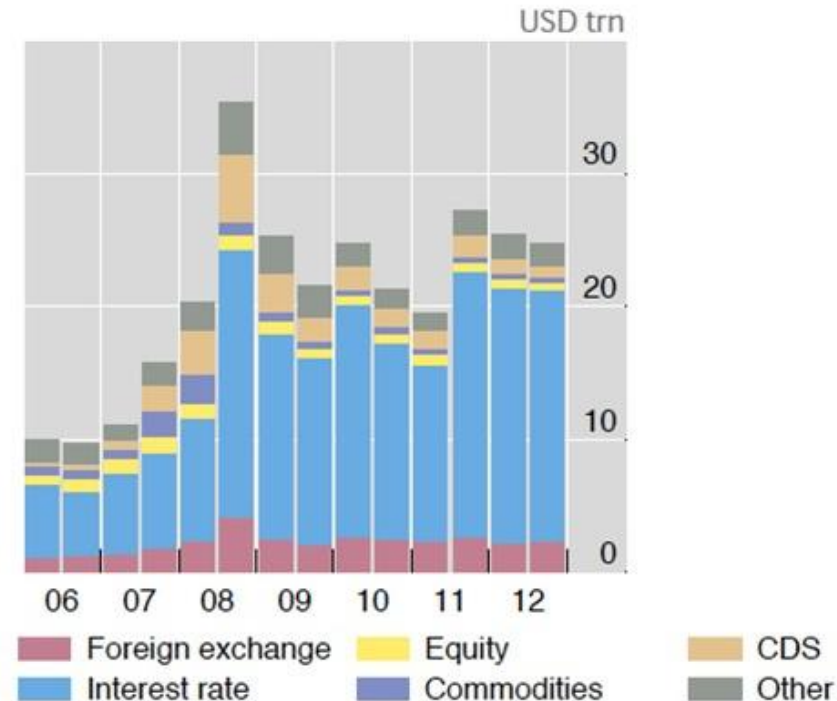


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By data type and market risk category

### Gross market values



“The gross market value of all contracts, ie the cost of replacing the contracts at current market prices, equalled \$24.7 trillion at end-2012.”

Source: BIS OTC derivatives statistics.

# Evolution of derivatives market in volume (BIS)

## Global OTC derivatives

### By data type and market risk category

#### Gross credit exposure

Percentage of gross market values



“Gross credit exposure, which deducts from the gross market values the amounts that reflect legally enforceable bilateral netting agreements, equalled \$3.6 trillion. This was equivalent to 14.7% of market values, about the same percentage as at end-June 2012.”

Source: BIS OTC derivatives statistics.



# Three generations of financial products

## ■ First generation:

- Derivatives (options/futures/swaps) on forex/ interest rates/ commodities

## ■ Second generation

### (1) - extension of underlying eligible assets:

- Climate
- Energy
- Inflation, etc.

### (2) - new instruments

- « Swaptions »
- Barrier options
- ETF / Warrants (...)

## ■ Third generation - extension of covered risks:

- Credit risk (CDS/ CLO/ CLS,...)

## Financial WMDs

**\$15**  
**TRILLION**  
U.S. Money Supply



**\$50**  
**TRILLION**  
World GDP



**\$100**  
**TRILLION**  
Total value of the  
world's stock and  
bond markets



Source: U.S. Global Research

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# **Weapons of Mass Destruction or « Zoo with no zookeepers » (Alan S. Blinder): Reasons for criticisms**

- The derivatives market is the largest financial market worldwide
  - For example: The US\$650 trillion in notional amount outstanding in OTC derivatives market is more than ten times annual global GDP (Bank of England, Financial Stability paper, Oct 2012)
- Financial products were first created for experts, but then “democratized”
- The risk is thus transferred to the larger public, but it is not understood
- Derivatives can either create, shift or neutralize the risk
- Criticisms:
  - Lack of transparency
  - No limit on creation of products (no adequate regulation)
  - Asymmetrical interrelation with real economy

$f(x) = \textit{position}$

$f'(x) = \textit{velocity}$

$f''(x) = \textit{acceleration}$

$f'''(x) = \textit{jerk}$

$f''''(x) = \textit{jounce}$

# An overview of losses and scandals related to derivatives

Question: what is the relation of derivatives to financial problems?

- Excessive faith in free markets
- Financialisation of the economy
- Mathematisation of finance
- Marketization of credit risk

Since these products are not widely understood (except perhaps by those who created them), it is difficult to value them.









## Some scandals and losses

- 1993 : Metallgesellschaft, 2.28 bn USD of losses in Oil Futures (Heinz Schimmelbusch)
- 1994 : Orange County default, Leverage bond investments losses of 2.38 bn of USD (Robert Citron)
- 1995 : Barings Bank, 1.78 bn USD of losses in Nikkei Futures (Nick Leeson)
- 1998 : Long Term Capital Management default, 5.85 bn USD losses of Interest Rate and Equity Derivatives (John Meriwether)
- 2008: Morgan Stanley, CDS, 8.67 bn USD of real loss (Howie Hubler)
- 2008 : Société Générale, European Index Futures, 6.95 bn USD of losses (Jerome Kerviel)
- 2008: Aracruz, FX Options, 2.43 bn USD of real loss (Isac Zagury and Rafael Sotero)
- 2008: CITIC Pacific, Foreign Exchange Trading, 1.82 bn USD of real loss (Frances Yung)
- 2008: Deutsche Bank, Derivatives, 1.74 bn USD of real loss (Boaz Weinstein)
- 2008: Group Caisse d'Epargne, Derivatives, 1.06 bn USD of real loss (Boris Picano-Nacci)
- 2008: Sadia, FX and Credit Options, 1.05 of real loss (Adriano Ferreira, Alvaro Ballejo)
- 2008: MF Global, Wheat Futures, 0.13 bn USD of real loss (Evan Dooley)
- 2008: Morgan Stanley, credit-index options, 0.12 bn USD of real loss (Mat Piper)
- 2010: HQ Bank, equity derivatives, 0.143 bn USD of real loss (Fredrik Crafoord, Mikael Konig, Patrik Enblad)
- 2011: UBS, 1.83 bn USD in Equities ETF and Delta losses
- 2012: JP Morgan Stanley, Credit default swaps, 5.8 bn USD






# Reminder of commitments of G20 and current state of affairs

- Pittsburgh (2009): find an answer to the developing financial crisis
  - Implement Basel II by the end of 2011
  - “Swim out” of sea of loss (FSB compensation structure)
  - Attempt to render derivatives contracts standardized, reported and cleared through central counterparties.
- Toronto (2010):
  - Continue to progress in the process of financial repair by building a more resilient and regulated financial system.
- Cannes (2011):
  - Concentration on “too big to fail” financial institutions
  - Protection of taxpayers from bailing-out and bearing the costs of resolution of financial institutions
  - Protection of financial services consumers
  - Oversee of shadow banking
- Los Cabos (2012):
  - Creation of central bank funding for banks for long-term investment projects and to attenuate maturity mismatch
  - Ensure a fair relationship between the financial institutions and consumers
  - Completion of the implementation of three pillars of Basel II and the implementation of Basel III.

# The question of prohibition or limitation of derivatives (Volcker, Liikanen...): bad or good « cure-all »?

|   |   |   |    |   |   |
|---|--|--|---|--|--|
| <b>Prohibition<br/>Ring-fencing</b>                                   | Prohibition of certain risky financial activities  | Ring-fencing   | Ring-fencing  | Ring-fencing   | Ring-fencing   |
| <b>Prohibited/<br/>Ring-fenced<br/>financial activities</b>           | <ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ Investment or sponsorship of hedge funds / private equity funds</li> <li>✓ Specific transactions with hedge funds or private equity funds managed by the bank</li> </ul> | <ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ <b>Market making</b>, all assets or derivative positions incurred in market-making</li> <li>✓ Private equity</li> <li>✓ Hedge funds related activities, including prime brokerage</li> </ul>   | <ul style="list-style-type: none"> <li>✓ Proprietary trading</li> <li>✓ Unsecured transactions with hedge funds</li> </ul>  | In the UK, the ring-fence would surround the protected (rather than the excluded) activities, e.g. retail deposits, payments and core investment services. Some retail derivatives may also be ring-fenced.  | <ul style="list-style-type: none"> <li>✓ Transactions for own account</li> <li>✓ Credit and guarantee business with private equity and hedge funds (including funds of hedge funds)</li> <li>✓ Dealing on own account (defined in the relevant EU Directive 236/2012)</li> </ul>   |
| <b>Permitted<br/>activities<br/>conducted by the<br/>deposit bank</b> | <ul style="list-style-type: none"> <li>• <b>Market-making</b></li> <li>• Underwriting</li> </ul>   | <ul style="list-style-type: none"> <li>• Lending to companies</li> <li>• Trade finance</li> <li>• Consumer lending</li> <li>• Mortgage lending</li> <li>• Retail payment services</li> <li>• Interbank lending</li> <li>• Participation in loan syndications</li> <li>• Plain vanilla securitization for funding purposes</li> <li>• Securities underwriting</li> <li>• Private wealth hand asset management</li> <li>• Exposures to regulated money market funds (UCITS)</li> </ul> | <ul style="list-style-type: none"> <li>• Client service,</li> <li>• Clearing,</li> <li>• Hedging,</li> <li>• <b>Market-making</b>,</li> <li>• ALM management,</li> <li>• Investment operations</li> </ul> | In the UK, it is the excluded activities which would be pushed out of the retail bank, e.g. wholesale and investment banking activities such as dealing in investments as principal, transacting with financial institutions and <u>carrying on business outside the EEA</u> , with exceptions to allow ring-fenced banks to manage their own risks prudently. | <p>All other activities, including market making activities (defined in EU Directive 236/2012)</p> <p>However, the BaFin can issue a prohibition order and order the cessation of market making activities or other transactions comparable to market making by their risk involved or transfer of positions to a financial trading institution, if the position value does not exceed the defined thresholds (see below material scope), if the solvency seems jeopardized.</p> |

# The question of prohibition or limitation of derivatives (Volcker, Liikanen...): bad or good « cure-all »?

|                          |   |   |    |    |    |
|--------------------------|--|--|---|---|---|
| <b>Territorial scope</b> | <p>All banks having a US agency or entity + all its affiliates, subsidiaries in the world</p> <p>Exception: activities executed solely outside the US (restrictive interpretation)</p> | <p>Consolidated level and level of subsidiaries.</p>   | <p>Consolidated level and level of subsidiaries.</p>  | <p>UK incorporated banks and other entities carrying on "core activities" from an entity incorporated in the UK. For incoming firms, a general pressure to subsidiary only – no direct application.</p> | <p>Banks incorporated in Germany. According to present state of discussion only 19 « big » German banks will be affected.</p>   |
| <b>Material scope</b>    | <p>No thresholds for the application of the VR .</p> <p>Some thresholds apply for quantitative metrics</p>   | <p>The ring-fencing would apply to:</p> <ul style="list-style-type: none"> <li>• Risky activities exceeding 15-25% of the bank's total assets or EUR100bn</li> <li>• Significant volume with respect to financial stability</li> </ul> | <p>Thresholds to be determined ("décret en Conseil d'Etat")</p>   | <p>Deposits from HNWIs (i.e. who have, on average over the previous year, held free and investible assets worth GBP 250,000 or more) and financial institution SMEs need not be ring-fenced.</p>        | <p>Prohibition to apply if positions</p> <ul style="list-style-type: none"> <li>- exceed €100 bn. on the balance sheet date of the preceeding year, or</li> <li>- balance sheet total is not below € 90 bn.in the last three financial years and positions exceed 20 per cent of the institution's balance sheet total of the preceeding financial year.</li> </ul> |
| <b>Timing</b>            | <p>➢Entered into force on 21st July 2012</p> <p>➢Expected final implementing rule Q3 2013</p>  | <p>European Commission proposal expected Q3 2013</p>   | <p>➢To be voted by Summer 2012</p> <p>➢ Identification of transferred activities by July 2014 – effective transfer by July 2015</p> | <p>Bill currently being negotiated in Parliament; ring-fencing to be implemented in full by 2019.</p>   | <p>Governmental draft of 4 March 2013 will soon be introduced in parliament. Deadlines:</p> <ul style="list-style-type: none"> <li>- for establishment of financial trading institutions: 1 July 2014;</li> <li>- for general application of regulations (including prohibition rules) 1 July 2015</li> </ul>   |

# Crystal ball overview of the market for the next ten years

## Some observable phenomena

- The next global goal of regulators will be to “simplify” the market but instead the market will only become more and more complex. *“Plus ça change, plus c’est la même chose”*.
- It was suggested to hold all the participants jointly and severally liable to the public when the market goes wrong. But that would only kill and not heal the market. (view attributed to Joseph Stiglitz)
- Resurrection of the Bretton Woods agreement, Bretton Woods II, by going back to the global gold standard as a reference point of market expectations about inflation, deflation and future currencies (view attributed to Robert Zoellick).
- Implementation of legal limits of use or unfavorable regulation as such TTTF. If not, the Derivatives market will continue to grow, maybe to more than US \$ 2.5 quadrillion
- But, the most global challenge in the next 25 years is the re-localisation of the financial market from US / Europe to Asia:
  - According to Robert Fogel (Nobel Prize) China's share of global GDP in 2040 will be 40 % compared to the United States (14 %) and the European Union (5 %).

**Thank you for your attention!**  
**Questions?**

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