HANDLE WITH CARE

Treasurers should approach derivatives with caution, but not with loathing, says Sarah Boyce

Over the years, the public has increasingly associated derivatives with financial disaster. Regulators now want to impose greater control on them to try to avoid a repetition of the events of 2007/8. But is this 'fear' justified?

What are derivatives?

A derivative instrument can be defined as 'one whose value depends on the value of an underlying asset'; ie a share option is a derivative of the underlying share.

Derivatives are based on a very wide range of underlying assets, including commodities such as metals, wheat or energy and financial assets such as shares, bonds or foreign currencies. The one thing they have in common is that as the value of the underlying asset changes, so will the value of the derivative and there is no need to own the asset itself.

There are four main types of derivative product from which all others evolve:

- **FORWARDS AND FUTURES** – a contractual agreement between two parties with a known outcome. Forwards are bespoke, ie traded OTC, while futures are traded on an exchange in standard sizes and maturities.
- **SWAPS** – an OTC agreement to exchange payments on regular dates, where the payment legs are calculated on a different basis.
- **OPTIONS** – a contract that gives the buyer the right to buy or sell an underlying asset at some point in the future.

Who uses derivatives?

Derivatives are used to manage risk, to speculate on the price of assets and to arbitrage transactions. Hence, two distinct groups of users have evolved:

- **TRADERS** can be split into:
  - **Speculators** who 'bet' on price movements in an underlying asset by speculating on price movements in the relevant derivative. They take advantage of the leverage effect (where derivative contracts, which may be worth millions if the markets move in a particular direction, only cost a fraction of that to put in place). Derivatives can be much more flexible than the underlying asset and are generally settled in cash.
  - **Arbitrageurs** who are risk-averse, but will trade derivatives when they see market inefficiencies.
- **HEDGERS** (predominantly corporates) face risks associated with the price of the underlying asset (for example, the foreign currency) and they use derivatives to reduce or transfer this risk.

Market makers do not use derivatives as such, but create liquidity by quoting simultaneous bid and offer prices to the market, at which they are willing to buy or sell an asset.

Managing the risks

The risks associated with derivatives can be managed if you follow a few key steps:

- Define your risk policy.
  - Set clear policies and monitor them.
  - Take limits seriously – do not ignore limits because profits are being made (losses can easily follow).
  - Make sure a hedger doesn't become a speculator; be cautious about making the treasury department a profit centre.
  - Implement segregation of duties to mitigate the risk of fraud or error.
- Recognise that you can't always outguess the market, so don't even try.
- Diversify your risks – use a basket of solutions to any problem and remember that derivatives transform rather than eliminate risk.
- Carry out scenario analysis and stress testing to understand all possible outcomes (remember to always consider adverse movements whatever your bank or board might suggest).
- Make sure you understand the latest accounting rules and reporting regulations before entering into any transaction – the board will not thank you if you unwittingly reduce profits as a result of an accounting rule.
- Products can be complex and great care must be taken to ensure they are recorded and valued correctly.
- Do not ignore liquidity risk – particularly with the increasing introduction of margining and collateral calls. Margining exists so that any changes in value are settled on a day-by-day basis rather than at maturity, but can result in large cash flows.

Treat all structured products with caution (particularly overlaid derivatives). Financial products are sold to make a profit and the 'glitzier' products are likely to carry a higher margin for the seller. But do not exclude derivatives from your toolkit. If used in the right place at the right time, they make an extremely valuable tool.

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