MADE TO MEASURE

OTC PRODUCTS OFFER TREASURERS A BESPOKE APPROACH TO THEIR HEDGING STRATEGIES, SAYS DANIEL MARCUS

There is a wide and flexible range of over-the-counter (OTC) products that complement treasurers' hedging strategies and the global risk profiles of their companies. Products traded on an exchange are standardised, comprising of standard coupons, premiums and expiration dates. But OTC products have bespoke terms that are agreed and negotiated between the counterparties, and are more likely to meet a participant's requirements. Market forces determine these product terms, while trading platforms, such as Trad-X, provide guidance on market prices, along with data vendors and repositories.

OTC markets are used in three fundamental ways:

Funding

OTC products can be specifically designed to aid funding strategies that meet the requirements of both the issuing and investing firms. Issuing equity or debt to the market drives capital finance growth in the 'real economy'.

Hedging

Treasurers can hedge to balance out their market positions, thereby reducing their company's exposure to risk and protecting its assets. This trading activity also leads to systemic risk reduction in the market and the wider economy.

Speculation

This is an informed bet on the movement of a particular product (which may or may not be part of a hedging or funding strategy). It can also take the form of arbitrage investment, whereby financial institutions look to make high-volume, small-profit opportunities from trading around the product bid/offer price. Speculation can result in significant gains, but also large losses, thereby resulting in wider systemic risk.

Without speculation, however, firms that are looking to raise funds or hedge their risk positions may struggle to find counterparties willing to trade with them – particularly in less liquid/more bespoke products. In these circumstances, liquidity diminishes and price/size discovery becomes a challenge. As a result, market risk can be inaccurately priced and structured, increasing systemic risk.

As these different types of trading strategy are symbiotic in nature, legislators and regulators must take care not to damage liquidity and risk-reducing activities by curtailing a particular strategy. In these circumstances, the biggest loser would be the 'real economy' itself.

Daniel Marcus is managing director strategy and business development at Tradition, provider of Trad-X, a hybrid trading platform for OTC derivatives and other financial instruments. Email him at trad-x@tradition.com

Trad-X LIQUIDITY AT A TOUCH