Zeti Akhtar Aziz: The nature of risks involved in dealing with OTC financial derivatives

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 4th Banking and Financial Law School Seminar, Kuala Lumpur, 19 February 2004.

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It is my great pleasure to be here at this 4th Banking and Financial Law School in light of developments in the global and domestic financial markets. We are in a period of great change. As the pace of globalisation intensifies the global environment has been marked by greater volatility and uncertainty. As a consequence we are often dealing with probabilities. The process of globalisation has resulted in international capital movements and developments in the global financial, and regulatory arena that have had significant implications on domestic financial institutions. There is therefore a need for a global perspective in effectively managing these risks. The universal application of ISDA Master Agreements is a demonstration of the need for globally oriented solutions. This morning my remarks will focus on the need to appreciate the nature of risks involved in dealing with OTC financial derivatives, both by the market and the regulators. I will also touch briefly on the opportunities emerging in terms of developing derivatives within Islamic banking and finance.

Financial institutions, as the linchpin for the process of financial intermediation, have a crucial role in facilitating the flow of capital to areas where it can be most productively used. The process of financial intermediation responds to changes in the environment with product and service innovations, and in this manner have continually re-shaped the international financial landscape. Derivatives are among the most innovative sub-sectors of the financial industry. Specifically, the ‘over-the-counter’ (OTC) products are not derivatives on organized markets, but rather individually customized, often highly complex with combinations of standard financial instruments packaged together to meet the specific needs of clients. Such contracts involve very little direct lending by banks to clients, and generate little net interest income to the banks. Derivatives generate substantial fee and commission income without the need to commit any of the institution’s capital. This therefore involves a different risk management approach as there is a shift away from continuous risk assessment and risk monitoring of funded investment projects that usually produce recurring flows of interest payments over time to the identification of riskless ‘trades’ that produce large, single payments, with much of the residual risks carried by purchasers of such packages. This process has possibly been accelerated by the introduction of risk-weighted capital requirements. Market players and regulators both have a role to play in balancing potential risk with potential returns in order to promote a vibrant financial system, without compromising the stability and integrity or agility of the system.

One of the Central Bank’s primary responsibilities is to maintain financial stability and confidence in the financial system and to ensure that the process of financial intermediation continues to function without disruptions. The financial and banking system provides vital financial services to the public. It is also a channel through which the central bank’s monetary policies are implemented. In the efforts to preserve financial stability, a careful balance is made in achieving the objectives of a sound and stable financial system with that which is efficient and effective in meeting the requirements of the economy. This is so that the system is innovative and competitive, while at the same time, the risks do not undermine the stability of the system.

In Malaysia, derivatives are generally used as hedging instruments and to a limited extent to enhance yield. Derivatives have allowed banking institutions to increase product innovation without losing their ability to manage the increased risks. With the advent of credit derivatives and Basel II proposals, derivatives have been more widely recognized as a risk mitigation technique which could also economise on capital adequacy requirements. In 2003, it is estimated that the notional value of total outstanding OTC derivatives, comprising interest rate and foreign exchange forwards, swaps and options, grew by more than two fold in Malaysia, to RM 171 billion over the last four years. It is important to note that statistics on OTC derivatives are difficult to capture, and that notional amounts are not an accurate reflection of the actual risk exposure to financial institutions. Between 1999 and 2003, it is estimated that the average annual growth in interest rate and foreign exchange OTC contracts collectively and in aggregate is about 40 percent. However, interest rate derivatives have experienced stronger growth given the sensitivity to interest rate changes and the need to manage exposure to fixed and floating rate financial assets.

In the international financial markets, the growth in OTC derivatives has been phenomenal in recent years. The statistics compiled by the Bank for International Settlements indicate that as of the end of June 2003 the total outstanding OTC derivatives in notional amounts was 169 trillion US dollars. This total figure includes 22 trillion US dollars of foreign exchange contracts, 121 trillion US dollars of interest rate contracts, principally swaps, 2.7 trillion US dollars of equity-linked contracts, almost 1 trillion US dollars of commodity contracts and 18 trillion US dollars classified as Others.

The fact that growth in financial derivatives has far surpassed the growth in the underlying real economies that generated the original transactions and risks for diversification is a matter of concern to regulators. It seems that speculators appear to have embraced derivatives as another form of investment for short-term capital gains. If financial derivatives take on a life of their own due to excessive speculative activity, the utility for risk diversification may prove illusory from a systemic point of view because the new risks introduced by derivatives may well overshadow the risks posed to the financial system by the underlying more risky financial assets.

On a preemptive note, in response to a series of derivative debacles that was sparked off by the Barings crisis in 1994, Bank Negara Malaysia has taken steps to enhance prudential regulations on the derivatives business of banking institutions. In 1996, the Guideline on Minimum Standards on Risk Management Practices for Derivatives was issued to provide a framework that outlines the minimum risk management standards for the derivatives business of banking institutions. It requires banks to ensure that risk management controls and procedures are in place before engaging in derivatives business. The guidelines also ensure that derivatives can be offered to customers for hedging purposes only. In May 2003, as a step towards a more liberalized financial market, banking institutions are allowed to embed derivatives into investment instruments to enhance yields. The investment has to be principal protected, and may be offered to high net worth or corporate clients and for a minimum transaction amount of one million Ringgit. As part of the prudential requirements, no leveraging is allowed on the structure. Gradual liberalization allows the banking industry and the regulator to work in a collaborative manner in developing an innovative yet stable financial system.

In the context of the significant growth in OTC derivatives, both in the domestic market as well as the global market, there is therefore an important need for prudential management in derivatives since speculation would itself introduce risks into OTC derivatives market and could deter the principal objectives of risk diversification and risk management.

Allow me now to share 3 points concerning risk management opportunities in the wake of developments emerging in the international financial landscape. The first point is that regional integration offers increased opportunities for OTC financial derivatives in managing financial risks. The second point is that the new Basle II Capital Accord must be studied carefully to ensure that the portfolio of derivative products is profitable and innovative while remaining in compliance with the risk-weighted capital requirements, and thus preserving the financial stability of the institution. The third point is that the growth of Islamic banking and finance offers substantial new opportunities with respect to designing OTC derivatives compliant with the Syariah principles and appropriate for commercial use. As bankers and legal practitioners involved in the OTC derivatives industry, I believe these points will be of relevance to you in providing quality services to your clients and in developing your organisation’s OTC business portfolio.

There are significant opportunities emerging in the Asian region. Regional integration has become more pronounced in recent years with the more rapid expansion of intra-regional trade in Asia. Intra-regional exports account for about one third of total exports of the region. Intra-regional trade with the ASEAN nations accounts for about 24% of the region’s total trade, exceeding ASEAN’s trade with the United States. Trade with China, India and Korea has increased significantly. Notably, since 1993, China’s role in the region has reversed from that of a net exporter to a net importer. East Asian exports to China have doubled during the past decade. There has also been a trend towards greater intra-Asian investment flows in the region. This includes higher investment of surplus funds into the region, in the form of foreign direct investments as well as portfolio capital flows.

These regional developments will lead to greater demand for OTC financial derivatives, which can be met by any of the major national, regional or global financial institutions operating in these markets. Malaysian banking institutions must be prepared to compete in this highly innovative and agile global industry by staying ahead on the learning curve for writing OTC derivatives that precisely match the risk management characteristics needed for effective hedging. At the same time, banking institutions must take into account the need for robust internal controls specifically in the area of credit, market, operational and legal risks to prevent the failure of any derivative contract.

My second point concerns the New Basle II Capital Accord. The International Swap Dealers Association, as the global trade association representing the leading participants of the OTC derivatives industry, has provided its views to ensure that the capital requirements of the New Capital Accord's will reflect the actual amount of risk that a bank is exposed to in a particular derivatives transaction. According to the recommendations put forth by the Basle Committee, capital requirements to support off-balance sheet derivatives are calculated by reference to the credit risk of the item adjusted for credit quality of the counter party. The approach essentially "marks to market" to determine the current replacement cost including the potential future exposures.

One particular development that should be observed is the growth of the use of credit derivatives. The 2001 Triennial Survey of Foreign Exchange and Derivatives Market Activity conducted by the BIS indicates a rapid expansion of the market for credit derivatives, with outstanding positions increasing from 108 billion US dollars in 1998 to 695 billion US dollars in 2001. The Centre for the Study of Financial Innovation has identified credit derivatives as a major risk area due to their rapid growth coupled with a lower understanding of the product. The implementation of Basle II's risk weighted approach to capital adequacy will have implications for banking institutions whose risk management systems have not assessed correctly the exposure due to off-balance sheet derivative items. As I have mentioned earlier, globalization and regional integration are introducing changes that will alter the nature of risks relevant to international trade, capital and the use of derivatives for risk management. Banks should be transparent and upfront in disclosing the risk and valuation approach of their derivative products such that the inherent risk of the product is adequately addressed. Let me also stress that the effectiveness of the risk adjusted capital requirements hinges not only on the capacity to perform sound risk assessments, but also on the legality of such derivatives transactions.

How banking practices and products reflect clearly and fairly the requirements of current and proposed prudential standards in their dealings with clients is a challenge, both for bankers and lawyers. The availability of a sufficient pool of legal experts in the Malaysian legal fraternity who are well versed with the detailed content and strategic intent of the prudential requirements will contribute immensely to the future development of the Malaysian derivatives industry, and as a consequence provide more opportunities for greater innovation in risk management within the Malaysian financial system.

Let me now turn to the final point I wish to make, which is about the opportunities within the rapidly growing Islamic banking and finance sector to develop derivatives that facilitate hedging of risks. The Islamic financial system, comprising the Islamic banking industry, the Islamic money and capital markets, and the Takaful market, is becoming an increasingly important component in the Malaysian financial system and in the global arena. Indeed, the Islamic capital market has registered very strong growth. In the debt market, the outstanding Islamic private debt securities as at the end of June 2003 was RM 68.2 billion, or 37% of total outstanding private debt securities. Malaysia has also made progress in developing offshore Islamic banking and financial products. The latest listing of the inaugural Sukuk by the Government of Qatar on the Labuan International Financial Exchange (LFX) on the 28th of January 2004 increased the market capitalisation of the exchange to USD 2.95 billion (RM 11.2 billion). The Bahrain-based International Islamic Financial Market (IIFM) has also endorsed the Sukuk in September 2003. The Labuan Financial Exchange has signed an MOU with IIFM to establish a framework for greater co-operation and to pave the way for both organizations to jointly develop an Islamic Capital Market with greater global reach. The importance to innovate and develop appropriate risk management tools is clear.

There are unique challenges to manage in developing derivative products for Islamic banking and finance because the end product must not only be Syariah compliant, in form and substance but also be globally attractive to all customers. While Islam encourages risk management in financial transactions, the tools or instruments used in such management must not have the prohibited elements of *riba* (interest or usury), *gharar* (uncertainty) and *maysir* (gambling). Certain basic Islamic financial products already exist that offer the benefits of hedging. The Bai' as-Salam contract, for instance, is essentially a forward contract where two parties agree to carry out a sale/purchase of an underlying asset at a pre-determined future date, but at a price negotiated and fully paid today. The *Istisna* contract is an example of a futures contract where a buyer contracts with a manufacturer to manufacture a product at a future date. A more interesting example is the *Istijrar* contract, introduced in Pakistan, which includes the characteristics of a put and call option, allowing the buyer to cap the purchase price, and the seller to set a floor for the selling price.

There is still considerable debate amongst Islamic scholars about the acceptability of the various forms of derivative products from the perspective of Islamic jurisprudence. Hence, there is a need for more investment in intellectual capital in the field of Islamic finance to promote innovation that integrates the appropriate Syariah principles within the Islamic financial instruments. Our efforts to keep abreast with such developments will facilitate more rapid development of Islamic financial instruments for the purpose of risk management, using derivatives.

It is evident that the derivatives business has global opportunities since risk in today's financial environment is a product of uncertainties prevailing in the global markets, whether financial or non-financial. The ISDA Master Agreements have been the universal means of bringing order and certainty to the complex and rapidly developing world of OTC derivatives. The culmination of the new 2002 ISDA Agreement, 10 years after its predecessor, comes in the wake of many financial crises. Legal documentation of derivative transactions has a role in mitigating risks for banks and businesses. The world has changed considerably in this recent 10 years - financial liberalization driven by rapid advances in information technology is altering the financial landscape at an unprecedented pace. The legal and regulatory infrastructure must keep pace. We must continuously learn, un-learn and re-learn. The acquisition and application of knowledge must be a deliberate strategy and activity in pursuing the path of excellence.

Apart from the developments in the nature of financial risk due to globalization and regional integration, the ramifications of the Basle II capital accord, and the potential for developments in Islamic derivative instruments, I am aware that there are many other highly technical matters that need to be appreciated and understood. I will leave this to the experts who have given their valuable time to share their knowledge with us today at this banking and law school event.

I wish you an engaging learning experience. This is also a rare opportunity to develop your networks, share your knowledge with your peers and reflect upon how this learning experience will make a difference in your professional career.