Baboo R Gujadhur: The value of derivatives markets to Mauritius

Speech by Mr Baboo R Gujadhur, First Deputy Governor of the Bank of Mauritius, on the occasion of the Workshop on Derivatives by the Financial Markets Association of Mauritius, Port Louis, 22 March 2006.

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President & Members of the Association

Distinguished Guests

I am pleased to be with you this morning on the occasion of the opening of the Workshop on Derivatives. I must in the same breath congratulate the Financial Markets Association of Mauritius for the initiative taken to bring up a Workshop on derivatives for the benefit of its members in Mauritius. I have also the pleasure to welcome Peter Skerritt in our midst who I understand will share with you his expert knowledge of the derivatives market over the coming days.

As most of you should be knowing, the derivative market is a market for measuring and estimating the volatility of price movements and permitting investors to determine the price they are willing to pay to reduce the amount of volatility which they face. Although derivatives have become prominent on market places in the recent past, they have actually existed in various forms over thousands of years. The difference today is that they are more extensively employed on the global markets in modern times with the basic underlying principle of using another level of instruments to protect against primary risk.

At end December 2003, the global OTC derivatives market accounted for outstanding trades amounting to US$197 trillion. As at end June 2005, the figure climbed up to US$ 270 trillion. Daily turnover is US$2.4 trillion on this market as regards foreign exchange and interest rate related products only.

Other than banks, exchanges and financial institutions, funds, hedge funds and asset managers are also actively engaged on derivative markets, which goes to explain the phenomenal rate at which these markets have been growing. In Mauritius, a few banks started of late to offer a few derivative products, including currency options, but we have remained essentially outside of this massive global market growth over a long number of years.

There may be several reasons why derivative trading has been eluding us for such a long time. One of them could be our relative distance from the mainstream markets where these products, are actively traded, notably in Europe, America and Asia. There is also not much active risk management based on derivative products in the countries of our region. South Africa could be an exception in this respect. Derivative trading requires the build-up of reliable exchange platforms based on a pool of available skills targeting diverse products. I am informed that our bank treasurers are not wanting in those skills but then they do not have the demand on which to exercise their talents on the markets.

Further, it is a precondition for the sound and sustained development of an active derivative market that the underlying markets should be deep and liquid. For some reason, active interbank trading of forex has been absent from our markets. This situation is likely to persist if individual banks continue to hoard their holdings of foreign exchange to themselves without engaging in interbank trading with them. This lack of engagement has been observed to be the case whether the balance of payments is in good or less good shape.

Individual banks could, however, consider the added scope that would be created to develop a derivative market over here if they were willing to relinquish a strong attachment to short term profit maximization from spot only and a few sparse forward forex dealings. The liquidity factor imparted by departure from the established pattern could then increase the depth of the market with time. I would say that it is never too late to go for an earnest sharing of forex resources among players to be able to deliver the necessary wider scope to the local forex market. Obviously, players will develop more confidence in each other if there was continuous two -way traffic with individual banks coming to the market as both buyers and sellers of foreign exchange from time to time.

Geography should not be seen as an impeding factor today, given the vast advances made by technology interconnecting the markets. The cost of communications is also a matter that can be addressed if it is an obstacle in the way of market development. So, the real issue remains that of substance. Markets are formed on the basis of demand and supply : sometimes, there is a chicken-and-egg puzzle when deciding which of these two should come first in order to create market activity of a reasonable scale. My answer to this would be that in undeveloped market conditions, development can be triggered if there is a driving initiative. Hence, since banks and other operators are potential suppliers of derivative products to the market, they are in a position to trigger latent demand by innovating and bringing the products at the doorstep of clients. By so doing, they may add to the market yet another layer of activity that has been absent for quite some time. In this manner, futures trading can become a reality in Mauritius and take concrete shape gradually. We would thus be positioning ourselves a notch or two higher on global financial markets and bringing to ourselves a share of the total incomes generated by the 270 trillion dollar global derivatives market.

In addition to the scope that may thus be given to our financial market by fetching international derivative trades to our shores, we will be gradually building up, among business operators, core skills that accompany the development of the derivatives market in general. This is the context in which this Workshop and others that will follow it assume a relevance of their own in defining a more diversified future profile of our financial market. I can then look forward to a strong spirit of innovation in developing financial market instruments in this context. This process will no doubt be reinforced by continuous training and the experience gained by our operators through actual operation on the markets.

Having encouraged you thus to engage in derivative trading to give greater scope to financial business undertaken from Mauritius, we can consider the positive spinoffs this will result in as we progress in this area in the future. Let us stop and take a look at the challenges of persevering in this line of action. It is generally acknowledged that derivative markets have a positive fallout on underlying markets in so far as they help to redistribute risk and increase market efficiency and liquidity. Derivatives have become an indispensable part of a modern financial system and will so remain so long as uncertainties will have to be provided for. In the context of new capital standards being introduced currently for banks, credit derivatives are seen as risk mitigating factors against portfolio risk to the extent they serve to lower capital charges of banks. Healthy financial sector development is thus supported by this activity if only by increasing the scope for risk management. The resulting control over volatility in portfolios of financial institutions has, in turn, the effect of improving the risk appetite of market participants for a higher volume of business.

In one of Shakespeare's plays, it was said that "Security is mortals' chiefest enemy" The size and speed with which derivative markets have grown in the recent past to overcome uncertainties have also given rise to certain apprehensions surrounding derivatives themselves. Given also the totally liberalized markets of today, allegations have been made that derivatives would, in fact, be adding to market volatility. This has not been tested and proved. It is therefore not advisable to press down the growth and development of derivative markets and thus risk stifling their development due to such fears. As a regulator, the Bank of Mauritius will no doubt oversee the workings of this market to ensure that risks are properly controlled, that banks have adequate capital to support the risks taken and that there is adequate transparency regarding the size and nature of the derivates market as it unfolds in the future.

I am personally hopeful that operators will put in place adequate systems for measuring, managing and controlling on-going risks being taken on board. Most people would have learnt the necessary lessons from the collapse of Barings. But other types of risks associated with derivative trading can crop up and it would be necessary to put in place an adequate number of safeguards against unexpected market movements to ensure prudent and sound management of the banking environment. Derivatives are seen in this context as a vital tool for risk management provided they are carefully handled and there is sufficient capital to support unexpected losses.

I am confident that the additional dimension that can be given to our financial sector activity by embarking on the derivatives market will enhance the market environment and increase the job satisfaction of our qualified treasurers by putting into their hands a wider range of tools to work with. I am sure that the Workshop will help to reinforce your confidence in your ability to deliver on the products, given the extensive experience of your main presenter at the Workshop.

May I wish you successful deliberations so that all of you come out better equipped by the end of this Workshop.

Thank you