

**Presentation at
CAFRAL Conference on
Derivatives Markets**

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STRUCTURED PRODUCTS

1. Recently, RBI has liberalised the use of “structured financial and derivative products” by foreign branches/subsidiaries of Indian Banks.
2. This presentation summarises some personal views on the issue, in the light of
 - My analysis of structured products which led to large losses for many Indian companies; losses incurred by companies and banks in several other countries; etc.
 - Losses suffered by foreign branches of a couple of Indian PSBs in their holdings of

CLNs;

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- The financial crisis of 2008 which was the direct result of structured financial products, and the resultant tightening of capital charges.
- 3. The G20 decision to move derivatives trading to exchanges or at least through CCPs. Structured products can only be settled bilaterally.
- 4. Buffett once described them as “destructive creations”, as “weapons of mass destruction”.

CHANGES IN GLOBAL BANKING CULTURE

1. From relationship banking to transaction banking leading to “*The Death of Gentlemanly Capitalism*” and the birth of “*Greed Merchants*” (titles of books by Philip Augar, a long time City professional);
2. An “obscene bonus culture” in the words of the Chairman of Barclays Bank Remuneration Committee.
3. The way so many benchmark rates (LIBOR, forex rates, gold price) were manipulated; securities were mis-sold; money laundered.
4. The number of banks penalised by regulators for various malpractices.

STRUCTURED FINANCIAL AND DERIVATIVE PRODUCTS

1. Relatively short history.
2. Margins in vanilla transactions became unattractive;
3. Hence structured products: “proprietary”, “bespoke”; often attractively, if deceptively, named.
4. Combinations of swaps and vanilla/exotic options (bought and sold) so priced as to give early inflows.

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5. Are complex, structured products really necessary for any genuine hedging of market risks?
6. Derman Emanuel, a very famous quant : *“The salespeople liked tailoring and complexity because not only could you charge more for it, but it was also more difficult for a client to assess the value of its individual features. Complexity was also harder for competitors to copy.”*
7. To quote Satyajit Das, *“The complexity of modern derivatives has little to do with risk transfer...Traders invent complex variations to delay competition, prevent clients from unbundling products and generally reducing transparency”*.

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8. He argued in an article in the Financial Times (July 8th, 2009), that “*increasingly complex and opaque products are used to raise risk and leverage*”, that “*efficiency and transparency are not consistent with high product margins*”, and that “*knowledge asymmetry*” is taken advantage of by the seller of complex derivatives. (Satyajit Das, is a globally known expert on derivatives, and author of a standard 4 volume reference work titled “ Swaps and Financial Derivatives- Products, Pricing, Applications and Risk Management ”, and of “Traders, Guns & Money”.)

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9. Lord Adair Turner, then head of Financial Services Authority, U.K., in his Mansion House speech delivered on 22.9.2009 said that the top managements of banks *“need to ask searching questions about whether the complex structured products they sold to corporate and institutional customers, truly did deliver real hedging value or simply encouraged those institutions into speculative and risky exposures which they did not understand.”*

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10. *“The Financial Conduct Authority (FCA) announced sweeping changes in financial regulation, telling banks they can no longer blame customers when products go wrong ... The FCA’s main focus is on protecting consumers who have been ripped off in recent years by the selling of inappropriate products ... Banks will no longer be permitted to claim the “caveat emptor” or “buyer beware” defense when selling complex products to customers with little knowledge of finance” (Reuters, April 10, 2013).*

FCA has since asked banks to refund an estimated £ 2 bn to SMEs in respect of mis-sold derivatives.

11. Many other cases in Europe as well – Italy’s oldest bank, Portuguese PSEs; German SMEs, (the highest court in Germany ruled against DB asking it to unwind all such transactions at no cost to clients); etc

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12. Typical margins AFTER hedging cost and CVA: 4%+ of notional? (One example: the City of Milan entered into a structured IRS, notional € 1.7 bn, bank margin € 101 mn – 6%! Source: Bloomberg)
13. Since a part of the margin becomes the bonus of the structuring/marketing teams the temptation to take advantage of knowledge disparities is obvious: \$ 100 mn notional, \$ 4 mn bank margin, \$ 1 mn bonus?

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14. The average client in India is far less sophisticated than his European counterparts. A few years back even some PSBs “hedged” fixed rate coupons in tier 2 bonds, by undertaking coupon swaps in JPY floating rates – and suffered huge losses, when the yen appreciated!

STRUCTURED PRODUCTS AND INDIAN BANKS

1. Bank managements need to consider several issues before their branches/subsidiaries abroad use structured products.
 - Expertise in quantitative finance and models;
 - As end-users, there is little to gain;
 - Should they offer such products to customers;
 - The credit risks, margin practices and capital charges on non-cleared derivatives;
 - Hedge effectiveness and accounting issues (IAS39, AS30).