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Success of Derivatives - Issues & Challenges

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Presentation by

Ananth Narayan,
Regional Head, Financial Markets, South Asia
Standard Chartered Bank

Here for good

wholesalebanking.standardchartered.com

Agenda

- **Thoughts for this Saturday**
- **Hedging v/s Risk Management**
- **Market Opportunities/ Dislocations**
- **Principle based regulations**
- **Principle of two sides of a market**
- **Microstructure for Risk Management - Suggestions**

Thoughts for this Saturday...

- I would never die for my beliefs, because I might be wrong” – Bertrand Russell
- “Innovation is preparing for the next war, rather than the previous one”

Balanced with

- “Those who forget history, are condemned to repeat it” – George Santayana
- “Am starting with the man in the mirror” – Michael Jackson

Hedging v/s Risk Management

- Should we stop using the word “hedge” and start using the phrase “risk management”?
 - Importers/ FCY borrowers who “hedged” ...
 - ..and Exporters who did not .
 - Should we be encouraging only one side to “hedge”?
- Appreciating the CFO’s task
 - Regulatory versus economic versus accounting underlying exposure.
 - Crystallizing exposures versus competitive benchmarking. And who is the competition?
- Risk Management is view based.

Hedging v/s Risk Management

- Derivatives used to execute view.
- Stigma associated with derivatives.
- Avoid stereotypes of 'Weapons of Destruction'.
- Need for better governance within banks and clients.
- Need for principle based regulation, rather than trying to block every loophole.

Market Opportunities/ Dislocations

- Synthetic USD liability raising
- Knowledge of markets is advantageous

Principle based regulations rather than blocking loopholes

- Does the principle of payoff profile within fully “hedged” and fully “unhedged” – at all values of the underlying market – make sense?
- Should we move to a payoff based yardstick for Cost Reduction Structures (CRS), rather than a product based one?
- Given the case for risk management over “hedging”, should restrictions on CRS be eased?
- What can be duplicated in cash ...do via derivatives....

Principle of two sides of a market

- Does any healthy market need both buyers and sellers?
- Dilemma of wanting to encourage clients to buy insurance but disallowing selling of insurance by end users.
 - The case for covered calls & puts.
- The case for CDS.
 - Synthetic Corporate Bond.
 - Buy Government Bond+ Sell CDS on a corporate name

Microstructure for Risk Management - Suggestions

- Unintended consequences of regulation or lack thereof
 - Lack of MTM netting for entities under The Companies Act – the need for recognition.
 - CCR and Basel III CVA, in India context - the need for corporate exemption.
 - The implications of arguably unnecessary capital and its cost.

7year FCY to INR Cross Currency Swap

India	EU
Basel III RWA ~ 120% RWA of the underlying loan	Basel III RWA ~ 11% RWA of the underlying loan

- Higher hedging costs penalise risk management by users.
- Would banks prefer letting the ECB remain unhedged and prefer following provisions for unhedged foreign currency exposures?

Thank You