Invited Editorial

Regulating the chaotic (exotic) derivative products: Disciplining the unruly

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ABSTRACT Through this research work, the author intends to highlight that the policies governing OTC derivatives shall also consider developing the infrastructure to ensure that the market participants are complying with the norms and are acting responsibly. The author has discussed various institutional arrangements that prevail to govern the financial markets vis-à-vis the arrangements followed by financial markets in India. The author further analyses the regulations governing Indian derivative markets and how the ignorance of undisciplined market participants resulted in huge financial losses. The author concluded that the market participants have to be disciplined while dealing with derivative instruments, in order to explore the real economic benefit of hedging the underlying risk.

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Blaming derivatives for financial losses is akin to blaming cars for drunken driving fatalities. Christopher Culp¹

India is a growing anecdote, and Over-the-Counter Derivatives (OTC derivatives) – although in infancy – have a share in the effective functioning of the Indian financial system. Considering the economic significance of OTC derivatives in terms of the flexibility offered, customised risk transfer and reallocation

functions, price discovery processes, infusing liquidity and so on,² they have become essential hedging tools, promoting efficiency in the financial system. Nevertheless, pursuant to the inherent characteristics of OTC derivatives such as counterparty risk, lack of transparency, opaque market, non-availability of post-trading infrastructure, information asymmetries, volatility and so on,³ OTC derivatives are blamed for global crisis and huge financial losses. However, no one realises that these risks were

voluntarily manufactured in the name of innovation,⁴ creating leverages through highly complex derivative models clubbed with unjustifiable confidence that only ignorance can support. As Goethe puts it, 'There is nothing more frightening than ignorance in action'.⁵ To avoid this ignorance in action, the commentators draw an important distinction 'between ineffective supervision of individual market participants and changes to, or regulation of, market structure itself'.⁶

On the basis of this distinction, the author argues that it is the indiscipline and ignorance of 'market participants', along with the lack of extant policy guidelines to regulate OTC derivatives, which caused the downfall of OTC derivative markets. Therefore, in the current scenario, although it is inevitable to have effective institutional arrangements in place to define financial infrastructure, product design and scope of innovation in OTC derivative markets,⁷ the policies shall also consider the infrastructure to ensure that the market participants are complying with the norms and are acting responsibly.

At the outset, the author discusses various institutional arrangements to regulate the financial markets and how the market participants are undisciplined because of insufficient monitoring infrastructure. Subsequently, the author briefly discusses the institutional arrangement prevailing in India.

INSTITUTIONAL ARRANGEMENTS: A THEORETICAL OVERVIEW

The economic rationale to regulate, monitor and supervise the financial markets with optimal financial regulations is well established globally.⁸

However, a sustainable structure of agencies with allocated responsibilities has to be devised based on the ultimate criterion to achieve effectiveness and efficiency in regulations.⁹ The financial markets may be regulated broadly under three categories of regulatory arrangements: institutional (that is, regulating financial institutions irrespective of the line of business), functional (that is, regulation based on the activity), or objective based (that is, regulating through specialist regulators, based on demarcated responsibility to achieve regulatory objectives).¹⁰

To promote effectiveness and efficiency in the financial markets and maintain overall systemic stability with accountability, it is necessary to adopt an appropriate institutional framework based on the market characteristics in various jurisdictions, failing which the social costs of market failures are very high.

Concomitantly, it is argued that the mere adoption of appropriate institutional arrangements and implementation of an efficient policy framework to regulate and supervise complex financial markets does not guarantee safeguard against systemic failure of markets. Llewellyn observed that, 'Public policy arrangements should never eliminate the incentive for consumers of financial services to exercise due care'.¹¹ However, practically speaking, it is perceived by market players that the regulated entities are systematically organised institutions under the governance of regulatory agencies, and therefore these institutions cannot fail and/or are insulated from insolvency. This myth was negated by the recent failure of Satyam Computer Services Limited¹² (an Indian listed entity), which occurred because of sheer lack of information. Professor Joseph Mason notes, 'The key

problem facing markets today is information. ... Information problems ... are the root of most financial crisis known to history'.¹³ Further, Dr Y.V. Reddy (former Governor, Reserve Bank of India) highlights the regulators' constraint that 'the regulators cannot evaluate on an ongoing basis whether the internal controls of an institution are in order or whether the external regulations imposed by the regulators are complied by the participating institutions'.¹⁴ This lack of information in the modern financial markets contributes to the opacity and rapidity with which the counterparty exposures are capable of changing.¹⁵ The opaque and rapid market increases volatility, which in turn creates arbitrage opportunities, resulting in exploitation of markets by the market participants.

Therefore, it becomes essential to install appropriate infrastructure for better transparency in the financial system, instill more effective interaction among the financial regulators and have better coordination while regulating the financial markets. The author proposes that without unifying the multiple regulatory institutions and their respective functioning structures, a 'unified information network' may be developed that will contain the requisite information about market participants and institutions dealing in such markets, which shall be available for inter se sharing among the regulatory agencies. This information network will equip the regulators to monitor the information of a particular segment and have an overall industry view to facilitate introduction of suitable policies in the respective segment. The consolidated information database will also help in identifying the relevant areas that are required to be regulated and enable better governance of the key industry players for a healthy financial

system. Such a network of information may also be utilised as a forum for promoting best practices in the opaque financial market.¹⁶

INDIAN INSTITUTIONAL ARRANGEMENT: OBJECTIVE BASED

In India, the financial regulations have evolved as an instrument of planned development.¹⁷ Owing to historical reasons, the interaction among multiple financial regulators, such as the Reserve Bank of India (*RBI*),¹⁸ Securities Exchange Board of India (*SEBI*),¹⁹ Insurance Regulatory and Development Authority (*IRDA*)²⁰ and such other authorities, takes precedence over arm's length relationship while monitoring their respective sectors in India.

It is globally argued that boundaries between regulators no longer reflected the economic reality of the industry.²¹ However, in India, the approach of market regulators has grown in line with the joint-family approach,¹⁷ where the 'Karta'²² (that is, central government) is the supervisory agency to regulators. In addition, the Indian regulatory structure is undergoing a change with the introduction of 'Financial Stability and Development Council', an apex regulatory authority established to maintain financial stability in the Indian financial system.²³

In any case, for a better overview of the economic reality in a particular industry, a 'unified information network' (as suggested above) may be a boon for Indian regulators, enabling them to implement efficient policies in their respective domains.

With this construction of the regulatory structure in India, the author shall now discuss the governance of OTC derivative markets in

India, as they serve important, productive and necessary economic purpose.²⁴

REGULATING THE OTC DERIVATIVES IN INDIA

In India, the governance of derivative transactions falls within the domain of the SEBI and RBI. The derivative contracts were legally recognised in India for the first time in 1999, subject to the condition that such contracts shall be compulsorily traded on the recognised stock exchange and settled on the clearing houses in accordance with the rules and bye-laws of stock exchange.²⁵ It is pertinent to note that the SEBI regulates stock exchanges,²⁶ whereas the RBI regulates the 'clearing and settlement systems' through clearing houses.²⁷

After giving legal sanction to exchange-traded derivatives, a doubt was raised on the legality of OTC derivatives, which were permitted under RBI guidelines.²⁸ These guidelines were time and again amended, until the enactment of the Reserve Bank of India (Amendment) Act, 2006,²⁹ wherein the legal validity was accorded to OTC derivative instruments prescribed by the RBI. Thus, the RBI was legislatively empowered to lay down suitable policies governing OTC derivatives.

Thereafter, OTC derivatives in India evolved in the regulated space where the RBI prescribed types of derivative instruments permitted under the Indian financial system to curb detrimental speculation in financial markets. The RBI prescribed that one of the parties to derivative contract should be an RBI-regulated entity such as banks, primary dealers, financial institutions and so on. Further, the RBI prescribed that users of such instruments shall transact in derivative

markets essentially to hedge their underlying exposures and not for speculative purposes.

Speculative contracts are economic ills that introduce a high level of uncertainty, leading to reduced return, systemic risk and price manipulation.³⁰ Such speculative contracts are generally wagering contracts that are *per se* illegal. Although every wagering contract is speculative in nature, every speculative contract need not necessarily be a wager.³¹ It has been judicially settled by Indian courts that parties engaging in derivatives should not only be interested in the end result, but also in the activity performed to cause the end result, thus avoiding treatment of derivative contracts as wagering contracts being illegal.³¹ Therefore, if the derivative contracts are to be enforced in the court of law, it has to be demonstrated before the court that the parties were not only interested in the end result, but also in the activity undertaken to achieve the end result.

As derivative contracts may still be speculative in nature, but not a wager, it becomes difficult to distinguish and prove in court whether the contract is speculative or for hedging the underlying economic risk. The definition of hedging and speculation is subjective; therefore, the RBI does not prescribe the parameters to evaluate whether the products offered were for hedging risks or were speculative exotic products to book large fictitious profits. However, Lynn Stout proposes that when the notional value of a derivatives market is more than four times larger than the market for the underlying, it is a mathematical certainty that most derivatives trading is speculation, not hedging.³²

The author shall now deliberate upon the circumstances that led to the fall of OTC derivative markets in India and how the

ignorance of undisciplined market participants resulted in financial distress.

FALL OF THE UNDISCIPLINED TITANS: FAILURE OF THE OTC MARKET

The parties to the OTC derivative contract, which are RBI-regulated entities, are supposed to act in good faith while offering OTC derivative products to corporations, thereby ensuring that the products are for hedging purposes only. However, in recent years, the pressure mounted by senior management or contemporary market makers – either directly or indirectly – on the treasury operations of such entities to earn profits compelled the treasurers to use derivatives more for speculation than to hedge the underlying risks. A treasurer's job is to borrow at optimum cost and lend in best profitable manner. Nevertheless, modern treasurers have turned treasury departments into profit centres by offering exotic derivative products to corporations. In addition, the appetite of corporations to take risks is not genuine. In fact, it is the result of their greed to earn profits, particularly when corporations are not able to earn desired returns from their usual business. The corporations booked huge profits by cherry picking the contracts, but in unfavourable circumstances they started pleading ignorance about the product when they incurred huge losses. The menace of using OTC derivatives for speculative purposes was well seen during the recent financial crises. The corporations that were too big to fail turned into corporations that could not be saved.

The corporations in India incurred voluminous losses during the financial crisis. They moved courts pleading ignorance and

malice on the part of banks for offering such exotic derivative products. In many cases, corporations filed suits for declaring derivative contracts as illegal, even before crystallisation of their liability under such contracts. Indian banks had no option but to unwind trades. Banks had entered into 'back-to-back' contracts with other counterparty banks, under which the banks had to pay the counterparty banks and recover from the corporations that became subject to years of litigation.³³ In the midst of all this commotion, the regulator (RBI) was silent with respect to the interpretation and clarification on policy prescribed. The regulator adopted the strategy, 'if you can't say anything nice, don't say anything at all'.³⁴ In the exacerbated anxiety and panic due to OTC derivative products, market participants suffered huge losses. In many cases, settlements were arrived at between corporations and banks to avoid cumbersome non-yielding litigation. These circumstances exhibit the need to develop infrastructure for disciplining market participants in OTC derivative markets.

CONCLUSION

The OTC derivative instruments can be used for hedging, for speculation and for arbitrage. If used appropriately by market participants with the help of well-defined policies, procedures and risk management tools, derivatives will surely cater to the concerns for which it has been coined and instituted. Unfortunately, the ability to use OTC derivatives for speculation along with the greed of market participants to earn huge profits has undermined the very purpose of OTC derivatives for hedging underlying risks.³⁵

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- 18 RBI is the central bank of India and broadly manages general superintendence of the Bank's affairs, formulates monetary policy, manages foreign exchange, performs merchant banking functions for central and state governments and so on, <http://www.rbi.org.in/scripts/AboutusDisplay.aspx>.
- 19 SEBI regulates the securities market of India and broadly protects the interests of investors in securities and promotes the development of various market participants. Available at <http://www.sebi.gov.in/Index.jsp?contentDisp=AboutSEBI>.
- 20 IRDA regulates, promotes and ensures orderly growth of the insurance business and re-insurance business in India. Available at http://www.irda.gov.in/ADMINCMS/cms/NormalData_Layout.aspx?page=PageNo101&mid=1.2.
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