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DERIVATIVES IN PRACTICE

SEMINAR, 21 NOVEMBER 1996

The seminar, which was held at the City Conference Centre, was chaired by Mr Ian Collier. In his introduction the chairman explained that, although this was not the first seminar on this subject, a lot had been happening recently. He summarised the history of the growth of the derivative market, starting in the 1980s, and the London International Financial Futures and Options Exchange, opening in 1982. Although new trading centres had opened in various European locations, London remains *the* centre with the development of the Over The Counter market. He believed that, after European Monetary Union, London would remain a strong derivatives centre. He also noted that there was still some hesitancy for United Kingdom institutions to use derivatives, and wondered whether this was due to general caution or to tax considerations.

The attendance of over 80 persons, with a strong life office representation, listened intently to Mr James Tuley talk, in the first session, on life offices' response to regulations and guidelines on derivatives. Although, as an employee of the Government Actuary's Department, Mr Tuley had been involved in the issue of the Department of Trade and Industry guidelines, he spoke from his own personal viewpoint. He gave a comprehensive overview of regulations and guidance, starting with the 3rd Life Directive which spawned the 1994 Regulations concerning admissibility and efficient portfolio management, the latter of which remains difficult to define precisely, but could imply being careful about gearing. There had followed amendments each year and the DTI's view expressed in prudential guidance notes. Other guidance from the Investment Management Regulatory Organisation and the Institute and the Faculty in GN1, GN8 and GN25 had appeared. Although derivatives continued to suffer from jargon and mystique, a DTI survey of Form 13A returns suggested that some insurers were making no use of them while others used them for asset allocation, currency management and to support products or obtain tax benefits. In total the survey identified equity exposure of £1.5bn and fixed-interest exposure of £2.7bn. A few offices admitted that they were using derivatives to hedge their solvency position, which was a subject of high DTI interest because of its lack of robustness. No insurer confessed to holding an inadmissible derivative at the end of 1995. The speaker saw the use of derivatives to hedge solvency as potentially expensive and ineffective. He was concerned that derivatives in linked funds should avoid counterparty risk by proper margining. He expected the quality of disclosure would have to improve so that the DTI could properly regulate products which were often complex. He also foresaw problems for returns from some Guaranteed Equity Bonds in poor markets. As to the control of derivative trading, he wondered whether the generally cautious approach by insurers would

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be shared by the more ambitious cultures of separate asset management subsidiaries.

Delegates were then given an interesting talk by Mr Stephen Fay, the author of *The Collapse of Barings*, who explained how he had come to write the book. His research had enabled him to cut through the jargon and understand what the traders were actually up to, and he thought it would be a good thing if some bosses in the City had a better understanding of what really went on on the trading floor, so that rogue traders like Leeson could be spotted sooner. He saw the Barings incident as a cautionary tale to a City that still operated very much on blind trust, and he expected that some similar incident will happen again somewhere. His analysis of what drives markets was PIG, i.e. panic, ignorance and greed, and his advice was never to believe what you are told. He saw the departure of the risk manager at Barings, leaving the business to be run by bankers who were not used to the derivative trading environment, as the key reason why the problems were allowed to occur.

Mr Trevor Robinson spoke on Risk Control. He saw this subject as being one that those responsible for companies had failed to understand. The guidance he outlined from the Futures and Options Association and the DTI implied a more detailed interest and control than boards of directors have traditionally exercised with regard to equity dealing. The sophistication of control mechanisms required was a function of the proposed activity level, but, although one cannot expect a director or manager to be able to stop a rogue trader from misbehaving cost effectively (as the trader knows the system better than the manager does), it is imperative for control systems to be capable of trapping the rogue quickly so that the potential loss is minimised. Dealing on next day settlement through a separate back office might go a long way to achieving that. Companies should beware of giving a junior clerk the responsibility of querying a more senior dealer's instructions, and suspect deals should always be referred up to a manager of equal or higher seniority to the dealer. The settlement staff must be able to understand the markets well enough to know if a deal makes sense or not. The speaker outlined various systems and measures that would assist control, but he emphasised that system designers and authorisers should always ask themselves: "How can this go wrong?". Groups of companies need to consider whether aggregate counterparty exposures are within limits agreed by the board. Some insurance offices have established independent risk management departments to supervise all aspects of investment control.

Ms Fiona Ferguson gave a brief address on how derivatives could be used to create retail products, to manage tax liabilities and the tax effect of different approaches. She also covered two topical issues concerning the uncertainties with regard to Guaranteed Income Bonds and Double Taxation Relief.

After lunch an entertaining and informative talk was given by Ms Lauren O'Hara, who is a broker at LIFFE, on 'A Day in the LIFFE of a Trader'. She explained how traders qualified for the various badges and coloured jackets which

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were the uniform adopted by LIFFE. The manner in which trading takes place was described, and some of the pressures of the job were conveyed. It seems that the new Automatic Pit Transaction system for options has proved to be a disappointment, and that hand signalling will continue for the time being. The speaker also described how this frenetic, and occasionally unruly, market is controlled by cameras, fines and suspensions.

Mr Jeff Pearson went over the derivative-backed Retail Products that have been, and are being, sold. It was in 1990 that a simple Guaranteed Equity Bond first appeared. This guaranteed the better of 100% money back or equity growth over a 5-year period. Since then the market had grown considerably, with new variations of guarantees of capital and/or interest. Falling deposit rates had put up the cost of guarantees leading to lower levels of guarantee or lower amounts of participation in any equity growth. Profits from growth bonds remained sensitive to the office's tax position and changes in the market, particularly between launch and sale. The current life, pension and unit trust products on the market were described. Mr Pearson felt that the market was here to stay, because purchasers were able to insure themselves against downsides they could not afford to risk (e.g. the loss of capital in the period near retirement) at the price of some performance, while others were happy to pick up the downside risks and profit from the extra performance in a rising market.

In the second session on Retail Products, Mr Paul Coleman looked inside current products, and showed how they were constructed. The matching of the guarantee usually boils down to a choice of stock plus put option to cover market falls, or, more flexibly, a deposit to pay the guaranteed minimum plus call option to provide some equity growth. The number of exotic products used in the latter approach was rising. Counterparty exposure needed to be managed, but this was usually possible through a suitable combination of instruments.

A useful day was rounded off with the speakers answering questions. The problems of keeping a matched position were shared. The recently announced examination on derivatives was seen to fill a void, although the value of passing it was yet to be proved. One delegate wondered if the PIA was expected to set any requirements on the management of risk.

At the end of an interesting day for all in attendance, the chairman thanked all those who had participated, and looked forward to future seminars on the subject.

J. M. Pearce

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