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When the standard advice fails to reflect Asian markets realities

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High-profile financial scandals, like the Barings or Daiwa cases, don't happen every day, but smaller-scale losses involving the use of both plain and sophisticated instruments are becoming more common in Asia due to a growing demand for new products to reduce risk.

Within this environment, Asian companies, banks and regulators have to be prepared to seek ways to reduce marketplace risks, because the standard recommendations for controlling new markets do not always reflect market realities in Asia.

The impact of global financial scandals has been felt in Asia. Of the two

at a Western financial institution's subsidiary in a major Asian financial center trading Asian financial instruments. The other involved a transplanted Asian trader employed by an Asian financial institution's subsidiary located in a leading Western financial center trading Western financial instruments.

Despite the Asian connection, these cases show why stereotyping of the securities industry scandals is so difficult. One involved the hard-core exchange-listed derivatives, while the other was primarily based on over-the-counter cash securities.

And the two cases dispelled the notion that the US Federal Reserve is a more effective regulator than its smaller counterparts like the Monetary Authority of Singapore.

And many derivatives proponents were relieved, because they can finally point to the Daiwa trading losses as a living proof that derivatives are not the only things that create chaos.

Put in a simpler way, all these facts [illegible]ely emphasize the universality of [illegible] greed and fear elements of human nature.

Given this, it is worthwhile to consider the main trends in this region and how regulators can best channel their efforts to adapt.

So far the story of new market development in Asia has been pretty one-sided with Western institutions leading the way. While this course continues, identifying potential problems in new markets is fairly straightforward.

Asian financial institutions and corporate treasuries have been victimized as end-users of the structured derivatives peddled to them by OTC derivatives purveyors dominated by a few Western banks.

It is easy to see why this is the trend. There are plenty of Procter & Gamble or Orange County equivalents – to give two examples of US derivatives users which claimed to be victims. But there are not many Bankers Trust or Merrill Lynch counterparts in Asia.

It would be quite inconceivable to think of a small savings-and-loan in the US buying a leveraged Thai Baht swap with a knock-out barrier wedding band from a major Thai bank, for example.

It is equally absurd to imagine that a finance director in a British corporation would have lost his job because, say, a

Scandals such as the Nick Leeson-Barings case highlight the need for Asian companies, banks and regulators to seek ways to reduce marketplace risks.

Malaysian banker talked him into buying ringgit-leveraged inverse floaters which resulted in big losses.

Likewise, in the majority of Asian countries, there are not many local derivatives dealers around trading (as in market-making, or making buy and sell quotations in the secondary market) in local currency derivatives or even major currency derivatives. Most of the so-called derivatives desks of local Asian financial institutions have been only

The demand in Asia for using derivatives as risk management tools has never been higher

end-users of some derivatives at best.

The fact that the market is so lopsided against Asian companies and financial institutions provides a different perspective on widely-accepted derivatives guidelines.

Standard recommendations relating to this topic were put forth by the Group of 30 – a worldwide group of industry leaders, bankers, central bankers and academics.

Those recommendations focus on the issues that concern derivatives dealers, end-users and regulators and are particularly important for the development of local markets.

But these suggestions do not cover the malpractice aspect of sales in the OTC-structured derivatives business. And they do not address the many structural problems in terms of developing a liquid local currency derivatives market.

In many markets, there is a lack of liquidity in underlying markets and a lack of bench mark yield curve. Also, the existence of some arcane local accounting practices and local regulatory requirements make the profit and loss calculations ambiguous, even on cash securities portfolio holdings.

Any changes in the current practices could mean a big swing in the profit and loss that banks in those markets report in their financial statements. Before a reasonable system is developed on the cash side, there is not much motivation in setting up a risk-warehousing derivatives-dealing operation.

Therefore the priorities for the Asian regulators and participants are not quite the same as those of their Western counterparts.

While many Western regulators are emphasizing preventive measures for a systemic meltdown scenario in each of the developed financial markets as well as the capital adequacy rules for their financial institutions, many Asian regulators are still busy coping with the mounting pressure to further open up their domestic markets to the new derivatives business and at the same time trying to maintain some control over them.

The idea of being able to control has prompted a few central banks in the region to set up bilateral repurchase agreements to defend each other's currency among themselves.

That way, they expect to exert a little control over the destiny of their own currencies.

As for the end-users, Asian regulators started to realize that the demand for using derivatives as risk management tools has never been higher due to the recent market volatility.

The old and conventional way of thinking by regulators, which involves ignoring the pent-up demand, will only further lure domestic corporations and other end-users into the offshore markets where anything goes.

This often occurs when relatively unsophisticated corporations fall flat on their faces as they become easy preys. After many bruises, black eyes and broken teeth, these domestic corporations would turn back to their regulators for some warm and cozy parental guidance and protection.

To many Asian regulators, adopting an attitude similar to parents' attitude toward their teenager daughters makes sense. Since they cannot stop their daughters from flirting, they would rather have them bring home boys and have them sit in the living room watching television together rather than outside where parents cannot keep an eye on their activities. At home they will be under supervision, of course!

Regulators adopting this approach have been quite proactive in directing local authorities to set up futures and options exchanges as a prelude to developing the local derivatives market.

Some countries have been encouraging major local banks to participate and to try to have the imported necessary know-how rooted in their financial markets.

Only through taking such a proactive approach will the derivatives industry be developed domestically under proper guidance and in a healthy and sound manner.

In such cases the G30 recommendations could serve as an ideal set of guidelines for the Asian derivatives end-users and prospective dealers as well as legislators, regulators and supervisors.

Realistically, however, additional guidelines regarding sales practice may still be required.

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