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Derivatives demand picking up in S-E Asia

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THE demand for derivatives is picking up in South-East Asia. Banks which are starting to venture into the derivatives market have strong interest to learn about the latest developments in derivative instruments such as options and swaps.

The increasing demand for derivative products is in line with the growth in the export-oriented manufacturing sector, which resulted from the high economic growth in the region, said Chase Manhattan Asia Ltd managing director (structured derivatives) Ralph Yiehmin Liu.

Derivatives are so named because their value is derived from, or linked to, movement in interest rates, foreign exchange rates, commodity and equity prices.

The term was once used primarily to describe futures and options traded on financial exchanges, but it has expanded to cover a wide range of custom-designed and privately negotiated over-the-counter contracts, which can include swaps, forwards and options.

"The growth of financial products' sophistication should match the growth in the manufacturing sector. Because of the strong economic growth in Malaysia, for example, a lot of corporations have major exposure in foreign currencies due to their export growth to various countries.

"Active capital market players who borrow in foreign currencies and portfolio fund managers who invest overseas will also incur

some sort of currency exposure.

"Derivatives are primarily used for hedging purposes in risk management. Without the hedging instruments, those corporations and other market players who are exposed to currency fluctuations will be at a disadvantaged position compared to companies in other countries which make use of the instruments," he said in a recent interview with Business Times on Pulau Langkawi.

Liu, who is based in Hong Kong, was the main speaker of a Foreign Exchange Options and Derivatives Seminar organised by The Chase Manhattan Bank, N.A. in Langkawi. The seminar, held from August 1-3, was attended by dealers of most of the major local banks.

According to Liu, every company is exposed to three types of risks — transactional risk, translational risk and economic exposures risk.

"Transactional risk is a typical cash flow risk exposure. An example is a company which has income in Deutschmark (DM) and liability in yen. If DM depreciates against yen in the future and the company does not hedge, it has to sell DM at lower level or at loss. Forward hedging can be used to counter that type of exposure.

"An example of a translational risk is when a multinational corporation invests in a third country. A more advanced exotic option can be used to hedge for this type of exposure.

"The economic exposure is the least understood risk, which is more important



□ LIU ... 'demand up'

than the other two. An example is when a Malaysian manufacturing company uses parts imported from Japan, while its major competitor uses parts imported from the UK. The Malaysian company needs to have access to all types of risk management instruments to ensure that it does not have to sell its product at higher price if the yen appreciates," he said.

Although the primary purpose of derivatives is for hedging or to reduce risk, their usage can also result in speculative activities.

"In order to have a market, it is unavoidable for some people to take advantage of the derivative products as speculative trading instruments. This is where the regulators should focus on.

"As far as hedging is concerned, there should be less restrictions so as not to stifle the market growth. Hedging will help Malaysian companies reduce their risks in order to compete on equal basis with companies in the more developed countries," noted Liu, who had served with Morgan Stanley as an investment advisor in equi-

ties and fixed-income securities.

In the US, where derivative products are extensively used, several major corporations have suffered losses, burned by trading in derivative products that were originally devised as a way to limit exposure to such potential risks as rising interest rates or declining foreign exchange rates.

When asked to comment on this, Liu said: "Derivatives are very powerful instruments which need to be used intelligently. If used correctly, it can be very useful to reduce risks.

"However, if the derivatives are used incorrectly, they can create a lot of trouble. From time to time, you may have people who get into some sort of 'accident' by using these powerful instruments. To avoid such cases, adequate education and training is very important for the users."

The seminar in Langkawi is part of Chase Manhattan Asia Ltd's periodical effort to promote the usage and understanding of foreign exchange options and derivatives among the financial institutions, including central banks, in Asian countries.

"Some of the banks in the region may not have the infrastructure for the derivatives market. By training and educating the relevant staff, the banks will be able to offer the more advanced derivative products to their customers," he said.

The annual turnover of the derivatives market worldwide is between US\$10 trillion (US\$1 = RM2.58) and US\$12 trillion. The market is growing every year.