DERIVATIVES MARKET DEMAND & NECESSARY STEPS

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Derivatives constitute an important segment of the stock market, especially in developed economies. An instrument for transferring risks, derivatives represent an inevitable development of the stock market in a country. In Vietnam where the stock market is still in its infant stage, derivatives are getting more and more attention from market participants. The paper presents some initial observations by HoSE authority about market demand for a derivative exchange, an analysis of advantages and disadvantages needed for selecting an appropriate model, and a roadmap suggested by Oliver Fratzscher for the building of an effective derivative exchange

Keywords: Derivatives, Vietnam's stock market, HoSE, demand, investors, advantages, disadvantages

It is said that derivatives nowadays gradually penetrate into Vietnamese securities market. In recent conferences and seminars, some securities companies have shown their concern about these products. Derivatives also become more and more popular with investors through information about developed stock exchanges in the world. Derivatives have been mentioned in Securities Law 2006 with the concepts of Futures and Options. As for HCMC Stock Exchange (HOSE), its research on derivatives had been started since 2007 and then was submitted to the Ministry of Finance and States Securities Commission of Vietnam (SSC) in 2009. In 2010, SSC also build a research team specialized in derivatives and held conferences to get opinions about starting derivatives transactions in Vietnam.

Derivatives are considered as a kind of commodity of finance market; so they also follow rules

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of commodity economy. A product must come from the demand of a market to assure its existence. Therefore, it can be exclaimed that the prerequisite condition to set up a derivative market is its demand, specifically the demand by investors. In this article, we mention some remarks on demand by stock exchange for a centrally-organized derivative market, as well as analyzing its disadvantages and advantages in order to suggest several necessary steps to be done by authorities to set up a sustainable derivative market needed by investors.

1. The existence of the demand for a derivatives market

In order to suggest the most possible judicious opinion, this demand has been considered from different angles: from the happenings of Vietnamese stock exchange over the past years themselves, from the management agency and from investing community. Among those, the demand of investing community is considered the most carefully. It can be said that all others point of view are for satisfying the demand of exchanging derivatives by investors.

a. Demand from the development of the market:

Vietnamese stock exchange has passed its beginning period and is gradually growing up together with the development of national economy. After more than 10 years of operation, the stock exchange has started to set up a channel to mobilize and distribute important medium- and long-term capital sources, attracting the attention of numerable local and foreign investors. However, over the past period, together with unpredictable happenings of global stock exchange, Vietnamese one also could not avoid continuous fluctuations and had to face the risk of sharp decrease (shown by a 80% fall of VN Index from 1,170.67 on March 12, 2007 to 235.5 points on Feb. 24, 2009 – source: HOSE), which created a wave of anxiety and losing trust in the market among investors. The reason is that they themselves directly suffer severe damage caused by the instability of this market, leading to a "non-stop" decrease in the value of securities portfolios. Therefore, they really need tools which can help them manage risks and preserve the value of their portfolios. When combining with derivative exchanges, investors can gain profit of different levels. It means investors can set an expected profit level under changes in the original securities market. Therefore, derivatives are evaluated as one of fairly effective methods to gain the above objective.

With present products, investors just have one choice: either joining the market and accepting its risks, or leaving the market and ignoring its risks. It seems that the only risk management tool of investors is prompt buying and selling according to changes in the market, which is usually called a type of "surfing investment." This leads to short-term trading but not encouraging long-term investment, whereas this is a very important factor in developing a stable stock market. With derivatives, investors can separate risks from their basic portfolio and manage them through exchanges in derivative market, so that they can keep their mind more on their long-term investment strategy.

b. The result of market research:

Demand for derivative transaction is confirmed by the result of market research done by specialists of HOSE. Among the total number of 366 participants in 25 stock exchanges of securities companies investigated in April 2008, there are more than 71% working in financial fields such as securities, banking and more than 75% getting basic knowledge about derivatives. The result of this market research shows that 67% of surveyed participants agree that it is necessary to introduce derivatives and more than 67.7% of them say that they first think of derivative as a tool of risk prevention and 92.8% are willing to join in the derivative market if it is opened (whereas just 26.2% of them think of bonds). These specific numbers partly prove the demand for derivatives and a derivative market in Vietnam has become urgent in present circumstance so that Vietnamese investors can enjoy practical benefits from this kind of tools.

c. Real exchanges:

It is not only a matter of demand. Derivative products have been exchanged unofficially in several securities companies. Vietnamese securities companies are always pioneers in opening new services in order to satisfy investors' demand;

thereby enhancing their competitiveness and expanding their market shares. Realizing benefits from derivative as a popular investment tool in other nations, some securities companies have introduced option – a class of derivative instrument. Some companies can earn billions of dongs per month from option agreements. These agreements are usually supplied to organizations - big customers. Over the past time, many securities companies also intended to trade in stock index futures that have characteristics similar to derivatives with individual investors as their target market. This shows the demand for derivatives of both individual and institutional investors is not only showed through research results but in reality as well.

d. The demand for management and supervision:

The history of foreign stock exchanges shows that OTC market for derivatives will emerge in an unruly manner when the stock exchanges have developed to a certain level. And then, due to the high risk level and poor liquidity of OTC market, organized markets will be set up to overcome those weaknesses. This is the popular process in developed stock markets in North America and Europe. However, the reality has showed that financial crises coming from derivatives are almost relevant to products exchanged in OTC markets. One of reasons of the recent American financial crisis comes from structured credit-linked securities of OTC market and collateralized/asset-backed securities. Stock index futures and stocks traded in stock exchanges are not factors causing this crisis (according to *Global derivatives market – An introduction* of German Stock Exchange).

Therefore, newcomers such as South Korea and India have policies to open concentrated derivative markets right after appearing a demand instead of letting the uncontrolled development of OTC market. Initial success of these nations has proved this right orientation. Therefore, it has become a popular tendency for derivative markets in emerging economies. North American and European markets themselves are also making efforts to standardize OTC markets for derivatives and allow them to be traded in concentrated stock exchanges and closely managed by legal system.

In Vietnam, learning experience of other countries, right from the beginning period when a demand for and trade in derivatives made their appearance, it is necessary to have a tight management and supervision through a mechanism for organizing and running a concentrated market for derivatives, thereby avoiding an uncontrollable development of the OTC market.

2. Advantages and disadvantages

As a rather young stock exchange in comparison with hundred-year-old international ones, Vietnamese stock market will have to face many difficulties in developing a derivative market. However, in the position of a newcomer, Vietnam also enjoys certain advantages. This has been proved by practical lessons from several Asian derivative markets – developing fast and stably, and avoiding mistakes due to learning from age-old markets of North America and Europe themselves. Last but not least, policy adopted by authorities is a very important factor in developing such a market.

a. Disadvantages:

- In Vietnamese legal system, there are no clear and detailed regulations on this kind of product, which may cause some legal obstacles when opening this market.

- Vietnamese stock exchange has not entered its stable period; foreign investors have not put much trust in it because it even suffered severe decreases occasionally; so introduction, knowledge popularization, training investors about new kinds of securities may not attract investors' attention and participation.

- In knowledge popularization, the most difficulty for individual investors is that they lack information about derivatives while they themselves must be clear about the characteristics and risks of derivative instruments. According to assessments of the research team, knowledge popularization for individual investors will take time, which may cause obstacles for the market in setting-up period as well as sustainable development in the future.

- Number of professional and institutional investors is still small whereas this is one of necessary factors for the operation and development of a derivative market. In option trade, in reality, sellers are investment banks and institutional investors that are familiar with risk management and have diversified portfolios, whereas buyers are usually individual investors. Therefore, a small number of institutional investors will lead to a low liquidity of options.

- There is not a real derivatives market while interest rate offered by the market for foreign exchange derivatives is not attractive enough. In other countries, the concept of derivatives has become familiar to investors because it has been exchanged from a very long time in commodity market.

- Risk management has not existed and developed in securities investment and business administration. Risk management in organizations and companies has not been appreciated.

b. Advantages:

- Policies of the government on development of a diversified capital market in terms of types and stable development in the future have been adopted.

- Derivative is a new concept in Vietnamese market but has become more and more popular. Some securities companies have built a research team for this specific kind of securities. This is a great advantage when opening a derivative market.

- Margin and forward trading is being researched and expected to be carried out in the coming time. And margin trading is possibly considered as an important fundamental step that helps investors avoid confusion when approaching derivatives in stock exchanges where margin requirement is obligatory. Whereas, forward trading is much similar to futures contract – a main derivative product of stock exchange.

- Gold and foreign currencies option agreements have gradually been developed in banks. This helps investors get familiar with derivatives as well as exchanging methods.

- After joining WTO, policies of the government have become opener. Foreign direct and indirect investments have considerably increased. Even though Vietnamese stock market is still young and affected by fluctuations of international market, it is always evaluated to be a prospective market for investment and be attractive towards foreign investors.

- The instability of fundamental stock exchanges is also an advantage for the development of a derivative market because it shall prompt investors to find risk management tools for their investment such as derivatives.

- HOSE and HNX have signed MOU contracts with many stock exchanges in the world, which help staffs of these two stock exchanges acquire and learn managerial and organizational experience from other countries.

3. Necessary steps

How to build up a healthy, stable and effective derivative market is a big issue for developing countries in the development of national finance market. Therefore, this issue has been considerably studied by professors and specialists in the field. Based on analysis of above advantages and disadvantages, we find that the research of Oliver Fratzscher (a WB specialist) is relatively appropriate to the development condition of Vietnam. We extract here the research result of the mentioned specialist on necessary steps to build up a stable derivative market (based on the model of building up a stock exchange before developing an OTC market) as follow (from Oliver Fratzscher (2006), *Emerging Derivative Markets in Asia*, World Bank):

(1) First, there should be an efficient, liquid, and integrated cash market that is broadly market determined rather than driven by administered prices. Segmented markets and access restrictions can lead to less liquid and less efficient markets. In addition, modern IT, trading platforms, and internet trading often enhance liquidity.

(2) A derivatives law needs to be enacted that protects netting arrangements in bankruptcies and enables effective enforcement.

(3) Prior to trading of derivatives, both long and short positions should be allowed in the underlying cash market. For bond markets, repurchase agreements need to be established, which requires the development of securities lending, and often is combined with margin trading. Short

positions may be limited to hedge net long positions, but they are critical to develop liquidity and avoid the primary motivation for derivatives as substitutes for short cash positions.

(4) Market participants that intend to deal in derivatives should be licensed and trained.

They should be required to follow best practice governance and accounting standards and to hold sufficient capital for their respective risk positions. Also, intermediaries must be accountable to deal only with fit and proper clients who understand characteristics and risks of derivatives.

(5) Tax regulations should provide a level playing field for all cash and derivatives trading.

If any one market segment is exempted from taxes, it may initially help market development, but will not be sustainable if that market becomes a substitute for tax arbitrage reasons. Typically, capital gains taxes are considered more efficient and less distortionary than transaction taxes.

(6) The major institutional setup of a derivatives exchange will ideally be implemented through a single demutualized exchange. Typically, index futures are among the first products before options on individual assets are introduced. Safety cushions of the exchange must include appropriate capital and a sound margining system.

(7) Clearing and settlement of derivatives products should be executed through a single counterparty (CCP) with multilateral multi-product close-out netting arrangements. Typically the exchange or its subsidiary will provide these services, which may also cover OTC trading as it will further strengthen the prevalent OTC design of bilateral ISDA master agreements.

(8) Local accounting standards should be upgraded to IFRS, including mark-to-market principles as required under IAS39. Full disclosure of all derivative positions should be required.

(9) Subsequently, more tailored or innovative OTC derivative products may be designed, such as credit default swaps. Typically, intermediaries are banks which should receive specific regulatory clearance and should support their risk positions with adequate capital. Counterparty credit risk management requires special emphasis, which is typically facilitated through ISDA master-agreements, the use of counterparty credit ratings, and the posting of collateral.

(10) Finally, the investor base may be further broadened, for example by attracting a larger share of foreign institutional investors or by opening up new ETD markets for retail investors. This can be facilitated by strategic partnerships among exchanges, modern trading platforms, and reduced transaction costs, as well as by innovative products that meet new hedging needs.

4. Conclusion

Derivative exchanges promise a new developing period of Vietnamese stock market. In a recent seminar, stock exchange authority has mentioned several next steps in building up a derivative market. Together with developing a basic stock market, a research team for derivative market setting-up project has been created by SSC to finish researches on legal issues, central counterparty, and development of financial intermediaries, etc. The first planned product is oriented is stock index future. This is considered a positive action towards market demand of the stock market authority. It can be said that, together with challenges, this is a big chance to create a turning point for the national stock market. As a result, it requires very careful preparations to take this opportunity from not only authority but market participants as well■

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