Introductory Remarks of Mr. Yandraduth Googoolye, First Deputy Governor, Bank of Mauritius at the African Echoes, organised by Global Board of Trade, Mauritius as the Chairman of the Panel on The Emergence of a Well Regulated Platform to Trade African Currencies and Safeguard against Currency Fluctuations.

I am delighted to be participating in the African Echoes event this morning. The subject matter of this Panel's discussion is of considerable significance to both regulators and bankers. That also explains why this morning panel has me as Chair and also so many bankers in it.

We have been saying in various forums that the banks are in the business of taking risks. The maturity transformation that they undertake has inherent risks. The value of the assets they hold is subject to variations due to factors not within the control of the banks themselves. What we, at the central bank, tell banks is that their business involves taking risks, but however they should know what risks they are subject to and, having regard to their risk appetite, should put in place appropriate processes to measure, manage, control and mitigate them.

The banks are themselves only as sound as their constituents are. You cannot expect a bank to be sound if a large number of its clients are in poor financial shape or have balance sheets with huge un-hedged assets or liabilities. In a global economy where there is so much uncertainty and the more so in a small open economy like ours, the real sector operators are exposed to risks which could in turn impact banks. One of the major risks that the banks and the real sector operators can face in our situation is foreign exchange risk. Some currencies have high volatility which makes the need for foreign exchange risk management even more important in our context.

The factors that affect volatility of currencies can be broadly listed as follows:

- Flow of imports and exports between the countries
- Flow of capital between the countries
- Relative inflation rates
- Fluctuation limits, if any, on exchange rate imposed by the regulators of the countries
- Merchandise trade balance
- Rate of inflation in the country
- Flow of funds between the countries for the payment of stock and bond purchases

- Relative growth
- Short term and long term interest rate differentials
- Cost of borrowings
- Other short term events.

While controlling volatility may not be entirely in the hands of banks and the real sector operators, they can contain the adverse impact of the volatility by covering their risks. Derivatives are one of the most commonly used hedges against risks. If they are used with proper diligence and, if there is adequate control around the hedging process, then derivatives can help manage risks. As stated in one of the reports of the Emerging Markets' Committee of International Organisation of Security Commissions (IOSCO).

"Risk exists in all markets. This has caused the participants in many markets to look for ways to manage risk. One way of doing this is with derivatives. As awareness of the usefulness of derivatives as risk management tools has grown, so have markets for derivatives. Futures and options exchanges and over-the-counter derivative markets are integral parts of virtually all economies which have reached an advanced state of economic development. These markets will be important parts of many other economies as they move into more advanced stages of development".

One need not be surprised therefore that the world's largest financial market today is without doubt the derivatives market. The exchange traded derivatives market is also growing. I have some interesting numbers that I have managed to cull from the BIS website. Let me give some broad numbers so that we can appreciate what is happening in the global economy.

The aggregate outstanding financial futures and options (comprising those based on equity index, currency, and interest) at the end of June 2010 were of the order of USD 75.5 trillion as against USD 57.8 trillion at the end of December 2008. North America, Europe, and Asia and Pacific accounted for 98.4 percent and 97.0 percent respectively of these outstanding derivatives at end December 2008 and June 2010. Out of these total outstanding futures and options, currency futures and options aggregated USD 253.6 billion and USD 377.9 billion at the end of June 2008 and December 2010 respectively. The share of North America, Europe, and Asia and Pacific in these products was 47.0 percent in December 2008 and 59.3 percent in June 2010.

It shows that the countries other than those in North America, Europe and, Asia and Pacific are more active in the currency derivatives than in interest rate and equity based derivatives.

As you all know certain derivatives are offered over the counter (OTC) and those like options and futures are exchange traded products. By definition, there is greater transparency and lower counterparty risks in a well regulated exchange. If we look at the trend in some of the advanced economies there is a move to bring in greater control on the derivatives market by shifting as many products to the exchange traded segment from OTC as feasible. The havoc created by the credit default swap, which is an OTC product is well known. The recent Dodd- Frank Act in USA therefore envisages that OTC derivatives move to exchange-traded, standardized contracts with clearinghouses. While the Act does not require all OTC products to move to exchanges, it charges the Commodities Futures Trading Commission, and Securities and Exchange Commission to determine which should be subject to clearing based on a number of criteria.

Derivatives exchanges serve three important economic purposes: risk shifting, price discovery, and enhancing efficiency by providing a focal point where buyers and sellers can easily meet. None of these purposes can be properly served if prices on the exchanges do not accurately reflect the forces of supply and demand. Nor can they be served if buyers or sellers do not have confidence that prices do reflect these forces. That is, people will be unlikely to use the market if they do not believe in its integrity.

That brings us to the question of what we mean by a well regulated exchange and how they help control counterparty risks in particular. As per IOSCO, some of the more important requirements of a well regulated market would include –

- prescribing minimum capital standards for the operators,
- proper clearing facility which will include both trade clearing and trade settlement,
- margin requirements to eliminate risk of default by customers,
- provision for protection of customer funds, and
- above all an effective process for ensuring compliance and enforcement mechanisms to deal with violations.

Let me add a word of caution here. There are stark instances of banks facing huge losses on account of their derivatives desks. The blame for this does not lay on the derivatives themselves or the exchanges that provided these products. These incidents occurred largely because the banks themselves failed to put in place processes and procedures to ensure that the members of staff responsible for the derivatives activities are working in a well controlled environment. As a result, the rogue dealers were able to undertake deals which were more speculative in nature than for actual hedging.

To sum up therefore, banks and businesses face various risks. Currency fluctuations are one of the more significant markets risks they are subject to. Derivatives can help manage risks. Derivatives offered over well regulated exchange will provide liquidity, reduce counterparty risks and facilitate proper price discovery. At the same time those using derivatives for managing their risks should have well controlled environment surrounding the activity and processes to ensure that the controls are in fact working

16 October 2010