How Can We Mitigate Derivatives Misselling?

Muadh Alhusaini

03 March 2022

Most Saudi banks offer various financial derivatives that help companies and beneficiaries manage their financial risks. Yet some companies suffer negative repercussions from misselling, suboptimal practices, exposure to significant losses, and late discovery of inaccurate decision-making, bringing transactions nearer a speculative trade than a hedging one.

As the famous proverb says, "An ounce of prevention is worth a pound of cure." And in this article, I hand out a few ounces to help us prevent these repercussions.

Regulation Around Derivatives

Most of these derivatives locally are linked to two main asset classes: interest rates and foreign exchange. Such transactions fall under the regularity umbrella of the Saudi Central Bank "SAMA", which supervises the banking sector and imposes policies and procedures banks must follow when dealing with derivatives.

These transactions occur locally and directly between companies or individuals on one hand and banks on the other. They happen via Over-The-Counter (OTC) transactions and are not Exchange-Traded through a clearinghouse with greater transparency and credit protection. SAMA handles all aspects over the financial derivatives in its scope of OTC transactions (such as interest rates and foreign exchange) and the settlement of banking disputes.

Ensuring Appropriateness and Suitability

A financial derivatives sale between the bank and the company cannot occur until after fulfilling the governing agreements. Moreover, it includes providing the bank's required credit limits (where applicable) to the company. This implies the bank's prior knowledge of the client’s hedging needs and a complete understanding of its financial position.

For example, suppose the total debt is one billion Saudi riyals. This company aims to enter into an Interest Rate Swap (IRS) hedging product with over one billion. Unless clear justification exists, this means the hedge exceeds the need (over-hedging). Therefore, all bank stakeholders (from the corporate banking relationship manager to those in the treasury department) must document this product’s suitability.

Some argue that gaining a complete picture of the derivative exposures of one company with all the banks is impossible. Yet mitigating risks in this aspect is straightforward. A practical step is investigating the financial statements and their disclosures. Additionally, documenting the client's declarations about other hedging activities entered into with other banks is a viable solution to counter such exposure blurriness.

Derivatives Accounting

The importance of hedging varies from one company to another according to risk tolerance. It accounts for economic angles, but also the accounting impact. Yet many companies are not fully aware of the accounting impact that financial derivatives introduce. They typically realize it when issuing financial statements and after implementing hedging.

Problematically, we find some companies try hard to insulate the financial statements from any fluctuations caused by recording the impact of hedging. This makes the accounting matter more important than the economic benefit obtained from hedging. Therefore, banks should prioritize asking companies about this before selling them financial derivatives.

It is not the bank's duty to provide an accounting perspective of derivatives impact. Still, accounting standards require companies to reflect financial derivative transactions in their financial statements. As part of the sale due diligence process, I think banks should document such aspects in the bank's suitability and appropriateness form.

Risk Disclosure and Demonstration

Risk disclosure and demonstration is the top priority. Financial derivatives range in complexity from vanilla to highly complex structured products. We all know that the bank does not (and should not) act in advising capacity when selling these products, as its role involves selling the product and showing how it works. However, given the potentially enormous consequences of financial derivatives, there must be a clear framework for explaining risks to the client.

For example, demonstrations must go beyond merely presenting pay-off scenarios if market prices change. It should also indicate what the product's fair value (Mark to Market) could be. By doing so, the product's effectiveness and suitability will be understood and documented better ahead of the trade. For example, some products are structured so that their benefits are capped, but their losses expose the company to an open-ended risk.

> **Risk demonstrations must go beyond merely presenting pay-off scenarios if market prices change. It should also indicate what the product's fair value (Mark to Market) could be**

Banks need not provide companies with comprehensive analysis and scenarios for all products. But I advise they exercise due diligence when selling a structured and complex financial derivative. As a result, the company knows the risks of fluctuations on the fair value and other critical and related elements. If the product is classified as a vanilla instrument, then enhanced due diligence may be unnecessary because understanding the product is easy. When the company's debt suffers because of high interest rates, for example, the vanilla hedging product compensates for the losses and vice versa almost symmetrically.

Governing Bank Profits

There is no ceiling or regulatory framework banks should follow for the profitability of selling financial derivatives to corporate and retail clients. But to avoid disputes down the line, the bank must create an internal procedure that activates if the expected profit from the financial derivatives transaction exceeds a certain threshold.

Document the rationale for this profitability and have the concerned department or responsible managers approve the process. Doing so will limit individual staff from taking advantage of the clients' unawareness of the derivative pricing details. Going this extra mile helps avoid incidents where the price significantly exceeds what the prevailing market prices reflect during the derivative trade execution.

Derivatives Restructuring

Not every derivatives restructuring is effective. The objectives of restructuring differ drastically from one company to another. The aim may be to postpone the losses incurred by the company from closing a suboptimal product that failed to suit its initial needs. Or there might be an economic or commercial reason for desirable restructuring.

For example, a simple interest rate hedging product may be restructured because the underlying hedged debt has had its repayment schedule changed, meaning it no longer matches the hedging product schedule. Here, restructuring and adjusting would make the product compatible again with the debt, so it becomes an effective hedge as before.

With all this, I believe SAMA must impose clear rules and a framework on banks for restructuring financial derivatives (especially the structured trades). Specifically, these rules may include imposing a minimum level of approval from the client side for the restructuring.

> **I believe SAMA must impose clear rules and a framework on banks for restructuring financial derivatives (especially the structured trades)**

According to the company's established governance, such consent could come from the executive committee or the board of directors (adding one more level beyond the authorized person inside the company who closed the original derivative trade). Likewise, the bank follows the same approach to create another path of approvals on restructuring, with all relevant stakeholders documenting the justification. This protects both the bank and the company, ensuring restructuring is required and consistent with the company's objectives and risk management.

The Bottom Line

Some of the prevention steps in this article are complex. But I believe if even some are implemented, they will contribute to the whole process of informed decision-making by clients and companies and enhance the levels of governance within banks. There might also be a decent reduction of disputes and issues related to dealing with financial derivatives in the medium and long term.

For more information, please contact Muadh Alhusaini, Partner at Ehata Financial, Muadh.alhusaini@ehata.com.sa. You can also read the article from the website here.

ABOUT EHATA FINANCIAL

Ehata Financial is a specialist financial risk management advisory firm, licensed and regulated by the Capital Market Authority (license No. 17183-20). We are independent practitioners with expertise covering interest rate, foreign exchange, commodities, and derivatives. We leverage on our technical capabilities and market know-how to ensure that our clients get the excellence of the advice and the satisfaction that comes with it.

DISCLAIMER

Ehata Financial Company is authorized and regulated by the Capital Market Authority (license no. 17183-20). Ehata Financial Company may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Rd, Avenue Building, 5th Floor, P.O. BOX 241106, Riyadh 11322. The information contained in this article was prepared by Ehata Financial Company. Though the information herein is believed to be reliable, Ehata Financial Company makes no representation as to its accuracy or completeness. You should not rely solely on this communication when making a decision whether or not to enter into a derivatives transaction. If you are not an experienced user of derivatives, if you are not capable of making independent trading decisions and you do not understand the terms and risks related to derivatives transactions, you should refrain from entering into such transactions. You should consult your own legal, tax and accounting advisers with respect to any proposed derivatives transaction. Under no circumstances shall we or any of our associates or any of our associates' respective directors, officers, employees or agents, be liable for indirect or consequential losses including any failure to realize any profit, advantage or opportunity relating to the transaction or otherwise. The information contained in this article should not be reproduced in any form without the express consent of Ehata Financial Company. The information contained in this article from the sender shall not be considered as advice or solicitation to buy or sell any securities.