Derivatives as Investments

Category: Opinion 4 July 2018
Written by Dennis B. Funa

Derivatives are one of the three main classes of financial instruments or securities together with stocks (or equities) and debt (bonds and mortgages). However, it was only in 2015, through Circular Letter No. 2015-56 when it was recognized as an investment product for insurers by the Insurance Commission.

Derivatives is big business. In 2016, 25 billion dollars in derivative contracts were traded. 36% of these were traded in Asia, 34% were traded in North America, and 26% were traded in Europe. The derivative contracts were all worth US$ 570 trillion in 2016. In practical terms, derivatives can be useful for companies. The delivery of raw materials in the future at an agreed upon price may be secured by a futures contract.

A derivative is a contract that *derives* its value from something else or from the performance of underlying asset or assets. The underlying asset may either be a market index, interest rate, or other assets (commodities, stocks, bonds, and currencies). Commodities may be oil, gasoline, or gold. Currencies would often refer to the U.S. dollar. An illustration of interest as an underlying asset is the yield on the 10-year Treasury Notes. Hence, the value of the derivative is dependent on the fluctuations of the underlying asset.

There are different types of derivatives. Among these are the forwards, futures, options, swaps, and other variations. There are other forms as well such as the collateralized debt obligations (CDOs) and the credit default swaps (CDSs) which featured prominently during the 2007-2009 financial crises. CDOs are structured asset-backed security, which is a bit of a misnomer. These assets are usually credit card receivables, auto loans, manufactured-housing contracts, and home-equity loans. CDOs are composed of “bundled debts”, and premised on the promise that the debts or loans will be repaid. Similarly, mortgaged-backed securities (MBS) are securities based on mortgages.

Every type of derivative would have its own function or application. Hence, certain derivatives may be used as a risk management tool (or a hedge), while others may be for speculation.

Forwards is a contract between the parties where the payment is set at a specified time in the future and with a pre-determined price. It is only traded over-the-counter. Futures, which is a common type of derivative, is a contract to buy or sell an asset in the future at a price specified at the present. The futures contract is drafted by an exchange. Options is a contract where the owner is given the right, not the obligation, to either buy (call option) or sell (put option) an underlying asset. Swaps is a contract to exchange at a specified future date based on the value of the underlying asset. A swap may either be an interest rate swap or a currency swap. The Insurance Commission only allows forwards and swaps.

Derivatives may be traded in exchanges (or intermediaries) or over-the-counter (OTC). Exchange-traded derivatives (ETD) are derivative instruments traded through exchanges. One such exchange is the Chicago Mercantile Exchange (CME), which was formed after a merger between the Chicago Board of Trade and the New York Mercantile Exchange. OTC derivatives are traded privately, and directly between the parties, without intermediaries. Most derivatives (95%) are traded OTC and are therefore largely unregulated. This makes the Master Agreement prepared by ISDA very important.

****

Dennis B. Funa (dennisfuna@yahoo.com) is the current Insurance Commissioner. He was appointed by President Rodrigo R. Duterte as the new Insurance Commissioner in December 2016.