A Global Derivatives Framework for Banks to Centrally Manage and Hedge Market Risks in the Financial System

Anurag Singh Chauhan[1]

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[1] Author is a 2010 batch MBA graduate from *Narsee Monjee Institute of Management Studies, India* and can be reached at contact_anurag@yahoo.co.in or anurag.s.chauhan@gmail.com.

Abstract

The bank's customers *viz.* non-bank company often get into various kinds of derivative transactions with a bank or some other non-bank company in order to cover or hedge against the unwanted exposure to volatility in interest rates, currency rates or some other underlying rate. A non-bank company defaults when the situation goes unfavorable enough for it to have no other alternative; this cascades the impact to many other non-bank companies and banks. I take forward the opinion that **non-bank company defaults are more likely than those by a bank in a derivative contract**.

This risk in the risk management approach using derivatives can be reduced through the **derivatives framework proposed in this paper**. The main objective is to reduce the direct exposure of non-bank companies to the derivative contracts. Instead, offer them such customized (hedged) products that meet the same objectives under the terms and covenants of the underlying borrowing or lending contract. This will not only ensure non-bank company to have an implicit risk hedging in the (hedged) transaction itself, but will also help them to avoid any direct obligation or exposure to the risky derivative instruments.

Now, the question is who will then get into the derivative transactions? The answer is **the banks**; they need (and have) to hedge their own exposure by getting into derivative contracts with other banks that are exposed toward the opposite exposures of the same type of underlying assets. The overall effect apparently remains similar to what exists in the current framework. However, there are significant advantages under the proposed framework that describe how the banks can play a central role to the risk management (hedging) of market risks in the financial system.