Intermediation services by financial institutions in derivatives markets

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Goals

- What comprises intermediation services?
- The risks posed by intermediation to financial firms.

Intermediation services

- There are several places where the financial institution can play a useful role without taking on risk:
  1. **Information:** what is available? What are the alternative mechanisms? What is the legal and regulatory requirements?
  2. **Order processing:**
     Best efforts order execution: best price, immediacy.
  3. **Post-execution processing**:
     Clearing: management of margins, financing / liquidity provision.
     Settlement: management of payments, delivery, managing penalties and client default risk
     Records
  4. **Position** / **portfolio management**: Information about the position.
- In each of these cases, there is a fee that the financial institution will charge.

  With robust systems, there is little to no risk in these activities.

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Intermediation in the context of the financial problem

- Where does intermediation step into each of the following cases?
  - Example: A rubber plantation owner fears a drop in rubber prices, when it is time to sell his rubber sheets.
  - Example: Gujarat State Fertiliser Corporation wants to fix the USD price at which to purchase oil for the next year.
  - Example: Canara Bank wants to protect at least 70 percent of the value of its PSL loan portfolio lent to wheat farmers against a drought.
  - Example: Govt. of India wanting to buy wheat from Australia, each month, for six months after April for a price fixed in the budget announcement, if the price in the market rises beyond a fixed level.

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Areas of concern

- Providing liquidity / financing to customers.
  This requires building and managing credit history of customers, and building a margin system in paralle with that in place at the clearing corporation.
- Managing client dispute resolution and defaults at settlement for commodity derivatives.
  The risk of this is lower when handling orders on exchange traded contracts. For those that slip through, the risk of these can be monitored and managed using margins for those clients that intend to take delivery.
- These also become business opportunities.
  For example, facilitating transportation of goods across warehouses can be a service that can earn an extra fee.

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Issues with advisory

Advisory services

- Advisory services was typically bundled with intermediation in the traditional financial intermediation for derivatives products.

  Your broker or bank would be trusted to guide you as to the choice of the products and exposures that were best suited for you.
- Over the last couple of decades, there has been an increasing awareness of the distinction between advisory and intermediation.
- Given the various, well-advertised episodes of mis-selling at banks and insurance companies across the world, there is now an increased regulatory focus on advice as a focus area of financial sector regulation.
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Regulatory strategies for financial advice

- Entry regulation: compulsory registration for advisory firms and agents, with strict criteria.
- Prudential regulation: there are different capital requirements put in place for firms that provide a combination of advice and custodianship of positions.
- Governance: special requirements about the governance and management of advisory firms.
- Disclosure: strict guidelines on how the adviser interacts with customers. However, this does not take into account different behavioural aspects of the customers.
- Conduct: Regulations imposing a standard of conduct on intermediaries, to protect against imbalance between the firm and the customer.

  This includes rules of suitability, best execution, and rules to manage conflicts of interest.
- Insurance: One mechanism to protect the customer is to put in place insurance schemes that protect the customer from the adviser.

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Consequences

- All regulations impose a cost on the service provider, in return for benefits to the customer.
- Similarly, the response of the adviser or the financial services firm is likely to be biased towards offering these services only for those customers who can afford to pay for it.

Thank you

Questions?