Discussion on APAD 2019 Special Symposium

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Overview

- "How to activate long-term derivatives products in the new era of asset management" presented by Dr. Hyo Seob Lee analyzed global and domestic derivatives markets to show us why and how to activate long-term derivatives products.
  - According to his investigation, trading volume of exchange traded derivatives whose purpose is hedging has increased while speculative trading has declined. (He also mentioned arbitragers grow, but the evidence is relatively weak.)
  - And he also showed some statistics to verify more demand on long-term products.
  - He cited hedging demand on long-term bond markets, equity structured products, and insurances to explain the need for long-term derivatives products.
  - And he finalized presentation with suggestions to list more products, induce institutional investors, and innovate infrastructures.

Overview

- "Challenges for liquidity structure of the KOSPI200 options market" presented by Dr. Hankil Kang showed several statistics to explain the importance of long-term options and gave some suggestions to challenge.
  - He emphasized the importance of long-term options to follow recent trends of asset management, such as steady increase of market size of equity linked products, various strategies of equity traded products, and covering mark-to-market risk of variable insurance products under IFRS17.
  - He suggested to develop more related products, and offer more incentives to activate spontaneous market makers.

Why do the phenomena happen?

- According to my knowledge, markets of long-term exchange traded derivatives (let's say not nearest derivatives) are not that liquid for all over the world.
  - Year-end futures in commodity markets are by and large liquid to cover their annual positions or make arbitrage with calendar spread. (However, they are related to the depth of contango.)
  - Otherwise, it is not that liquid. Why? Isn't it necessary? Or is the OTC market more comfortable? Or can purpose of farther futures be fulfilled by composition of nearest futures?
  - I think we need to analyze first why farther futures are not liquid.
- However, market participants are sometimes thirsty for market liquidity for long-term derivatives.
  - Derivatives traders sometimes trade so called flex option to cover their long-term position, which is traded OTC and booked in exchange.

Composition with nearest contracts

- Over the context of the presentation, the word "long-term" is not clear.
  - Sometimes it means long-term matured derivatives while sometimes derivatives on long-term tenor underlying products.
  - I understood they intend both of them.
- However, maturities for 3, 5, 10y-Korea Treasury Bond futures are the first 2 consecutive month in the quarterly cycle. (Mar, Jun, Sep, Dec)
  - Most of traders fulfill their purpose by rollovering their futures position from near to far continuously.
  - Sometimes they can get additional profit by rollovers due to the undervalue of the futures as Dr. Lee mentioned. (Of course, that depends on their direction.)
  - Making short sell easier on underlying will help markets efficient to reduce the rollover risk.

Managing counterparty risk

- One of important benefits of exchange including CCP is reducing total counterparty risks of all market participants.
  - Even in the OTC market, many of counterparty requires "Break Clause" condition if the total maturity is longer than 10 years.
  - Longer contracts spend more credit, which means it could be a good opportunity to exchange.
- More accurate valuation for risk may give more chance to extend business of exchange.
  - In the OTC market, to reduce their counterparty risk and bilateral collateral, M2M style system is sometimes applied.
  - For example, FAP (Forward Amortizing Premium) let a buyer pay the differential between cash and M2M value instead of upfront premium.
  - More accurate model for initial margin such as VaR methods to offset risks among cross asset class might be big incentive to attract market participants to exchange.
  - For example, risks on IRS in CCP could be offset with risks on KTB futures in exchange.

Market balance

- Basically, a derivatives contract is matched by two parties who have economic benefit on opposite directions of the market.
  - One big problem in Korean option market is that almost all structured products are short-vega products, betting on lower volatility.
  - Most of big players in the option market hedge their positions by shorting options or dynamic delta hedging to reduce the volatility.
  - Institutional option traders say "There is no buyer in the market."
  - We remember that the Korean derivatives market significantly shrank and volatilities also shrank since the ELW market broke down.
  - Warrant (ELW) was one of the few long-vega products.
- Designing clever long-vega structured products to bet on higher volatility would help market liquid and rich.
  - Of course, the purpose to design that kinds of products should be making balance with present products.
  - Volatility bonds, or dispersion-like products could be one candidate to be developed.