Talking point

Who are the end-users in the OTC derivatives market?

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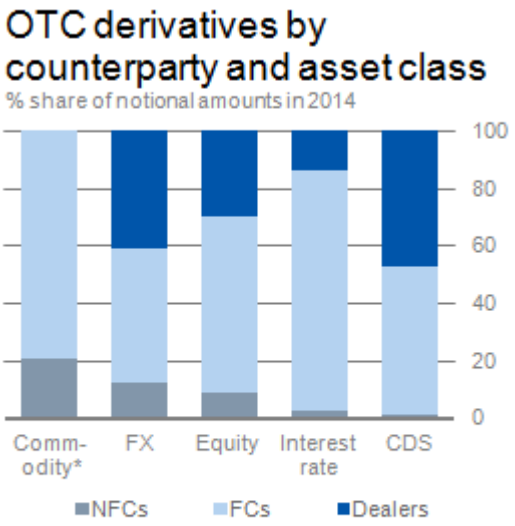
Available data suggests that OTC derivatives are primarily used to hedge business risks. The perception that the OTC derivatives market is an inter-dealer market looks exaggerated; by contrast, non-dealers are the investors in the majority of trades. Derivatives may thus help the efficient distribution of risk in financial markets.

Derivatives, in a nutshell, allow investors to manage their business risks efficiently and improve the price discovery of the underlying assets. They usually have bespoke features due to the varied needs of investors and are traded on over-the-counter (OTC) markets. Especially in recent years, financial markets have been subject to frequent episodes of intense volatility, so reducing market uncertainty via the use of derivatives has become even more crucial. This presumably has increased market participants' demand for derivatives. At the same time though, in the aftermath of the financial crisis, tighter regulation has driven up the cost of derivatives trading, thus putting pressure on the supply side of the market. Derivatives have also been criticised for being an inter-dealer market only and having a weak connection to the real economy. Hence, it is worth shedding some light on the trading objectives of derivatives market participants and their deals' relevance to the real economy.



* Limited data availability prevents the separate analysis of FCs and dealers

Sources: BIS, ESMA, Deutsche Bank Research

Figures from the Bank for International Settlements (BIS) provide interesting insights into the counterparties on the OTC landscape. More specifically, they distinguish between the trades of reporting dealers and (1) non-financial-counterparties (NFCs) i.e. mainly firms and governments, (2) other financial counterparties (FCs) including for instance central counterparties, pension funds, insurance companies, regional banks and hedge funds and (3) other dealers such as large investment banks. Starting with the derivatives market turnover, BIS figures show that around 65% of OTC trades involve a non-dealer; either an NFC or an FC (figures from 2013). A further breakdown with respect to outstanding notional amounts of different derivative classes demonstrates the heterogeneity in terms of counterparties. Here, non-dealers account for as much as 82% of the total market.

NFCs are parties to a relatively small proportion of all derivative contracts (by amounts outstanding). However, their shares of the various segments differ strongly. At 21%, it is the largest in commodity derivatives (as of 2014).* NFCs often use raw materials for their production or produce these materials themselves. The fact that NFC end-users aim to hedge their exposures to price changes in crude oil, natural gas, precious metals as well as agricultural commodities and even livestock largely explains their active role in the commodity derivatives segment. NFCs are relatively active in foreign exchange (FX) derivative trades as well and account for around 13% of the volumes outstanding in this segment. Indeed, being importers and exporters in increasingly interconnected international markets, NFCs are exposed to FX risk as never before, and they seek to hedge this risk via derivatives.

FCs account for the lion's share of interest rate derivatives (IRDs), with around 83% of these transactions being done between a dealer and a FC. Market participants use IRDs to hedge the future path of interest rates, which has become even more important with the extraordinary measures taken by central banks following the crisis. What is more, IRDs are important for insurance companies and pension funds that have to meet obligations from

their policies in the distant future and need to offset the risk from transactions involving fixed and floating rates. In the equity linked derivatives segment, FCs are fairly active as well: 62% of the total outstanding volume is between reporting dealers and FCs. Considering the episodes of heightened volatility in financial markets in recent years, it is not surprising to see FCs hedge against volatility risks using equity linked derivatives.

Inter-dealer trades have a higher share among credit default swaps (CDSs) and in the FX segment, where they account for 47% and 41% of the notional volume respectively. CDSs are one of those products that received a lot of criticism due to limited transparency regarding counterparty exposures and inadequate collateral posting practices before the crisis – as CDSs involve jump risk, collecting and updating sufficient initial and variation margins is particularly relevant in this segment. However, it is important to note that CDSs constitute only a small part of the OTC derivatives landscape, representing around 3% of the outstanding amounts. More importantly, dealers are market makers (liquidity providers) that themselves have to hedge imbalances in their trading books. This is indeed a part of their business model. Even though limited data availability prevents deeper analysis of market makers' trading motives, aggregate survey data does shed some light on the trading motives in OTC derivatives. Around 73% of all derivatives market participants cite "hedging" as their trade motive; 17% respond "arbitrage" and only 10% cite "speculation" as their trade motive.

All in all, the perception that the OTC derivatives market is an inter-dealer market looks exaggerated. The efficient redistribution of risk through hedging probably has a positive impact on the cost of capital for firms and their investment decisions.

* For the commodity derivatives segment, available data only differentiates between FCs (including dealers) and NFCs.

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