# Over The Counter (OTC) Derivative

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In news

Reserve Bank of India (RBI) released the draft Market-makers in OTC Derivatives Directions, 2020 for public comments.

What is OTC?

- OTC Derivatives are the contracts that are **traded directly between the buyer and seller without any intermediate exchange**. Stocks that trade through OTC are usually smaller companies that cannot meet the listing requirements of the exchange.
- An over the counter (OTC) derivative is a financial contract that is arranged between two counterparties but **with minimal intermediation or regulation.**
- OTC derivatives do not have standardized terms and they are **not listed on an asset exchange.**
- **As an example**, a forward and a futures contract both can represent the same underlying, but the former is OTC while the latter is exchange-traded.

How OTC Derivatives Works?

- Over the counter derivatives are instead private contracts that are negotiated between counterparties without going through an exchange or other type of formal intermediaries, although a broker may help arrange the trade. Therefore, over the counter derivatives could be negotiated and customized to suit the exact risk and return needed by each party. Although this type of derivative offers flexibility, it poses credit risk because there is no clearing corporation.
- **Examples of OTC derivatives** include forwards, swaps, and

exotic options, among others.

## Regulation of OTC Derivative

- **Till recently**, the OTC transactions in India were highly unregulated with respect to due diligence, governance, sharing of information, reporting to SEBI / RBI, Pricing and valuation.
- Reserve Bank of India **(RBI) released the draft Market-makers in OTC Derivatives** Directions Banks, market participants, and other interested people can **submit their feedback on the draft guidelines till January 15, 2021.**
- Under Section 45W of the **Reserve Bank of India Act, 1934** and under the provisions of **Foreign Exchange Management Act, 1999,** the RBI has recently issued the **"Draft Directions on OTC Derivatives"**

## Draft Directions on OTC Derivatives

- RBI provided definitions related to OTC in the draft directions.
- The Board of Directors (or equivalent forum) and senior management of the market-maker shall ensure effective risk management, appropriate organization structure, and establish policies for OTC derivative products.
- The policy for introducing new OTC derivative products should comprise the process for evaluation and approval of new products. Additionally, all the new products should be approved by the Board of Directors.
- Chief Compliance Officer (CCO) and the Chief Risk Officer (CRO) should also be involved in the approval of new products.
- Other directions include terms related to an internal audit, Internal control, Risk Management, Post-trade conduct, Pre-trade contract, preservation of records, etc.

## Derivative

- **Derivatives are the instruments** which include security derived from a debt instrument share, loan, risk instrument or contract for differences of any other form of security and a contract that derives its value from the price/index of prices of underlying securities.
- **Derivative** is a contract that derives its v**alue from the performance of an underlying entity.** This underlying entity can be an asset, index, or interest rate, and is often called the "underlying".
- **Financial derivatives** are effective financial instruments that are related to a specific financial indicator or commodity, and through which specific financial risks can be merchandised in financial markets in their own right.
- Transactions in financial derivatives should be treated as separate transactions instead of integral parts of the value of underlying transactions to which they may be associated.
- The **value of a financial derivative** derives from the price of an **underlying item, such as an asset or index**. Dissimilar to debt instruments, no principal amount is advanced to be repaid and no investment income accrues.
- Financial derivatives are used for various purposes such as risk management, hedging, arbitrage between markets, and speculation.

Common financial derivatives:

- **Options**: Options: An Option is a contract which gives the right, but not an obligation, to buy or sell the underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore is obliged to sell/buy the asset if the buyer exercises it on him.
  - Options are of two types – Calls and Puts options.

- ‘Calls’ give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date.
- ‘Puts’ give the buyer the right, but not the obligation to sell a given quantity of underlying asset at a given price on or before a given future date. Please note that options generally have lives of up to one year. The majority of options traded on exchanges have a maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-the-counter.
- **Forward Contracts:** In a Forward Contract, both the seller and the purchaser are indebted to trade a security or other asset at a definite date in the future. The price paid for the security or asset may be agreed upon at the time the contract is entered into or may be determined at delivery. Forward Contracts generally are traded OTC.
- **Futures:** Details follow in subsequent sections.
- **Stripped Mortgage-Backed Securities:** Stripped Mortgage-Backed Securities, abbreviated as SMBS, are Securities that reallocate the cash flows from the underlying generic MBS collateral into the principal and interest components of the Mortgage-Backed Securities to enhance their attractiveness to different groups of investors.
- **Structured Notes:** Structured Notes are debt tools where the principal and/or the interest rate is indexed to dissimilar indicators. For example, a bond whose interest rate is decided by interest rates or the price of a barrel of crude oil would be a Structured Note. Sometimes the two elements of a Structured Note are inversely related, so as the index goes up, the rate of payment (the “coupon rate”) goes down. This instrument is called an “Inverse Floater.” With leveraging, Structured Notes may change to a greater degree than the underlying index. Therefore, Structured Notes can be tremendously volatile derivative with high risk potential and a need for close monitoring.

- **Hedge Funds:** A hedge fund is a private partnership which aims to become wealthy investors. It can use policies to lessen risk. But it may also use leverage, which increases the level of risk and the potential rewards. Hedge funds can invest in almost anything anywhere. They can hold stocks, bonds, and government securities in all global markets. They may purchase currencies, derivatives, commodities, and tangible assets.