

NEW FINANCIAL DERIVATIVES ON ROMANIAN MARKET - CONTRACTS FOR DIFFERENCE

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1. Between innovation and caution on financial derivatives market in Romania

Investors' motivation on derivatives market is a profit gain under the law of "buy cheap and sell expensive" no matter the order in which the two operations succeed. From the standpoint of the capitalist society, the pursuit of profit for a company is a normal and desired action. Participants on derivatives market are divided in three categories, as follows: hedgers, those who want to be protected against certain risks, speculators, those who follow a profit through risk taking and arbitrators, those who follow a profit from speculation of the differences between markets.

Two important aspects have characterized the global financial markets in the years preceding the current crisis. The first one was the excess of liquidity, financial derivatives markets' participants had more money to invest. This has determined a decrease of the attention on how the investments should be made. The second issue was the deregulation of banking activity¹. As a result, the main holders of market liquidity, namely commercial banks, were free to invest on the risky financial market. At first, commercial banks justify this with the need to cover certain risks, such as currency risk and the interest rate risk, it was only a matter of time until they find a possible new El Dorado of the profits. The major problem, which was forgot, by the commercial bank was the principle of

prudence. Another important aspect was the combination of two factors, namely excess liquidity and deregulation. This combination of two factors has created a need which appeared in the form of financial innovation. The desire to obtain higher profits made the new derivatives to mix profits with the lack of clear specifications for the use of financial products.

During bubble excess liquidity from the period before the commencement of the 2008 crisis, the Romanian market of financial derivatives was preserved because of their own limitations. Thus, the number of participants on the Sibiu Exchange was low and liquidity was also below and this may have caused a frenzy of easy profits. Financial derivatives market in Romania was caught by the crisis in a developing stage. Another important aspect is that Romania has virtually no over-the-counter market and this is very important because the most dynamic and innovative global markets are over-the-counter. Innovation without limits was favored by the lack of control from the over the counter markets. In order to trade a new product, the Sibiu Exchange has to receive prior approval by the regulatory authority in Romania, namely the National Securities Commission. This additional barrier has protected a developing market from the participants' ability to trade more in normal operating conditions. It is necessary to note that the futures market in Romania is more developed than the options market, this situation contrasts with what is happening worldwide. At the global level

¹ Marin Oprețescu, ș.a. – Monedă, Credit, Bănci, Editura Sitech, Craiova, 2009, p. 308.

options are much more used than futures contracts because of their increased risk management opportunities. Hence we can conclude that if the two traditional types of financial derivatives still have problems of acceptance and knowledge than the development in terms of diversification and sophistication of products traded in this market should be done with caution and temper.

2. Contracts for difference

Following the efforts to increase the use of financial derivatives, the Sibiu Exchange introduced for trading in August 2009 contracts for difference - CFD. The introduction of these new derivatives is a new step in their diversification program of the offer and going further with the wish to have at Sibiu a spot market. The legal framework which regulates financial derivatives is former by the regulations 1 and 3 of the Romanian Clearing House and regulation 4 of SIBEX.

Contracts for difference (CFD) between buyers and sellers are formal contracts where they agree to settle the difference between the value of an asset at the beginning and at the clearing agreement². The underlying asset for these contracts can be: stock, index, goods, government bonds and currencies.

The moment of their birth is 1990, when Brian Keelan and John Wood from the London Stock Exchange created CFD, because these contracts were not charged by British authorities. Since 2000 the trading of these contracts has seen an explosive growth not only due to lack of taxation but especially as they allow the purchase on margin and there is a high flexibility for participants. The main point for CFD is based on the fact that the transaction does not transfer ownership rights but speculates on a

variation of the underlying asset price. Unlike the spot market, where as a participant you must first buy and then sell, on the CFD market you can sell (you can open a long position) if you forecast a drop for price. In the classical style, the speculation could be done only when the price rises. This opportunity to speculate when the price grows or drops, is a consequence of how is settle the profit and loss as a difference between entry price and the exit one. For investors who want short-term profit there is virtually no difference between a stock and a contract for differences for the underlying stock. Owning an investment in CFD gives the owner the opportunity to obtain the same gross profit like the spot market, but with a much smaller investment, and it also allows the investor to obtain dividends due to price changes for the stocks with dividends which are marked permanently. Major difference between an investment in shares and one in CFD is that in the latter case you don't have the opportunity to participate in the management of that company, fact which does not bother a speculator.

In Sibiu are currently traded contracts for differences for 5 underlying assets for the most liquid shares on the Bucharest Stock Exchange. These 5 contracts are the following: Romanian Development Bank, SIF1 Banat Crisana SIF4 Wallachia, Transylvania Bank, SSIF Broker SA. The board of Sibiu Exchange doesn't want to trade CFD for SIF5 Oltenia because the futures contracts for SIF5 are among the most traded derivatives in Sibiu and the emergence of a similar product could change the old contract market, under the circumstances of a shortage in liquid products on the Romanian market of financial derivatives.

For example, for any individual who wish to invest in stocks, it is much more advantageous to invest in CFD for the following arguments:

- Transactions on margin - with a minimum amount an investor could

² Gabriela Anghelache – Piața de capital în context european, Ed. Economică, București, 2009, pag. 239.

participate to actions on spot market. Margin may have a ratio between 1:2 and 1:200, this level in extreme cases of high liquid and very deep markets. Transactions on margin, allows a much better performance if the market movements are anticipated but with high risks if an unfavorable trend appears. If the margin is very high, for example could be 1:200 on FOREX, the potential profit could be very high, and it may also imply a potential loss. Experienced brokers on FOREX recommended the maximum margin at a level of 1:100. For Romania, where the market hasn't reached full maturity, the margin use by the SIBEX Clearing House is 180 lei / contract. The margin is required by the clearing house but the broker could claim the customer a bigger margin if the investor is considered involved in risky transactions. The additional margin requested by the broker will remain in his account, only the sum of 180 lei goes to the Clearing House. The purchased contracts are considered a collateral deposit for the situation when the investor can not pay under margin call;

- The lifetime of a contract - there was no deadline for this type of contract. The purchase of such a contract allows the investors to keep the position open for the whole period of the underlying asset. This aspect creates a strong connection with the underlying asset from the spot market. At the beginning and at the end of the day the price, of the underlying assets and CFD contracts, is the same. This situation allows a better marking every day at a real price and a better control of a potential profit or loss. From this point of view, every day transactions are engaged from zero, without the need for an output and input on a new contract. For the international practice, maintaining a contract overnight is charged with an interest related to a reference rate, plus one or two percentage points - this cost is called daily interest financing. This cost is paid by the person who holds a long position.

The cost of these operations is not meaningful for a night but for a very long period of time it becomes significant. In some situations we can talk about reducing the profitability of investment. Costs for rolling the contract, to keep it overnight, is calculated including holidays. For the moment, SIBEX board decided to charge the open positions for overnight rolling at a level of 7,5% per year;

- Lower costs of transaction - paying a flat fee may be trading a CFD contract regardless of its value. Transaction costs on Sibex are approximately 2 lei for a contract. These costs may vary depending on the broker. The commission structure includes the following fixed costs: SIBEX 0.3 lei/contract, Romanian Clearing House 0.2 lei/contract and the National Securities Committee 0.1 lei/contract. Besides the amount of 0.6 lei/contract³ the broker is free to add a variable amount depending on the customer and its turnover;

- Selling in absence - because of financial derivatives markets mechanisms, we can sell a contract without holding it in advance. Therefore it is possible to enter the market with a short sale position without holding previously the traded product. This is possible because trading contracts for differences points only on price differences and not the price of underlying asset;

- Liquidity - the use of margin accounts and the fact that we can sell in absence determine a pattern for more liquidity than the one created on the spot market. Since speculators are the most numerous participants on market, the above mentioned two advantages are paramount in deciding to invest in a traditional market or derivatives;

- Profit sharing – owning a CFD offers the opportunity to get dividends if the underlying asset has received such a

³ www.sibex.ro

facility. The amount comes from the change rate of the stock. So, owning a long position could determine a profit according to the sum of money associated for dividends paid to shareholders. The amount for the dividends' payment is taken from the account that has a short position in the market. This payment is justified by the fact that any influence of the price for the underlying asset sends a similar change in the contracts for difference market. In reality, a change of the stock price may have a delay until its influence covers the derivatives market. However it is important to note that somebody can get indirect participation for profits without entering the respective shareholding structure.

Payment required for a CFD, means to transfer the margin in broker's account, before launching the trading order. Money should be paid in advance, as from the opening position the order can be executed any time and depending on the rate variation may appear possible financial flows. Trade fees are automatically charged at the time of transaction. To cover the possible adverse variations, the customers should transfer in the account the necessary money to initiate the transaction.

On the Romanian Capital market it is very important to mention a specific problem. An investment in CFD can turn from a profitable operation into a failure, one due to lack of liquidity in the market. Forming the prices can be heavily influenced by a powerful volatility and the lack of liquidity. As a consequence, a participant may find unable to protect himself from an unfavorable trend, even if he uses a stop loss order, because the investors are not willing to participate in a possible transaction to close in the position.

Another disadvantage that might arise in the CFD trading, is the leverage effect. If the contract is on the expected trend, the leverage brings far better returns than any investment. The

English brokers said that in a year they obtain for an investment, 2000% yields. But this potential profit hides a sad truth for many investors; according to British analysts, about 95% of the individual participants on derivatives markets record heavy losses⁴. This happens because the participants on these markets don't have the necessary theoretical and practical trainings to deal with margin. If the leverage maximizes profits, the same leverage maximizes the loss in case of an unfavorable trend. Keeping an unfavorable position for a long time can lead to a loss far greater than the initial margin. It can also allow the investors to initiate a far greater number of transactions than the classic system, in which acquiring a financial product was conditioned by its full payment. This aspect combined with marking the market in real time, can generate the over-trading phenomenon. In this case, the risks of appearing a non coherent analysis for the investment, increases a lot.

The volume of contracts for difference is very low for now, because few investors are aware of their appearance on the Romanian market and they seem reluctant to invest, because they may not shut down the position at an affordable price. So, dozens of contracts for difference were made and the investors opened about 100 positions. As these financial products will be promoted in Sibiu stock exchange and also as economic conditions will become better, speculators will access these derivatives with more courage and the transaction volume will increase.

While futures contracts are used primarily by professional investors, contracts for difference are popular with small investors. This makes the size of a futures contract greater than one per CFD. As the number of individual investors is low in Romania, I estimate

⁴ www.contracts-for-difference.com

that the use of contracts for difference will need the support of the Sibiu Exchange until the trading will reach an acceptable level. If the market hasn't sufficient liquidity and it isn't sufficiently deep, the financial innovation cannot generate development. SIBEX should be focused in the next period on attracting more investors. As the stock exchanges in Romania have not been sufficiently attractive, many individuals and legal persons from Romania have decided to invest in a foreign stock exchange market. A solution in my view would be the reviewing the position of SIBEX and BVB leaders regarding one market for traditional assets and derivatives. In my opinion, a separate development of the two institutions is a wrong long term decision, because the size of the two cannot compete with exchanges from the neighboring countries. The technological progress and the free movement of capital in the European Union give the investors the possibility to choose the most attractive stock exchange market without any boundaries from the national interests.

3. Conclusions

Trading CFD in Romania through SIBEX represents a great advantage from the point of view of removing the counterparty risk. In the European Union countries the explosion of CFD market was due to over the counter markets. Trading through a regulated market brings the advantage of a process of approval by the National Securities Committee. Until the current crisis, the process of approval for new products was considered dull and limited. The crisis has shown that a regulated system may allow a trading of derivatives in terms of relative safety. Regulated market cannot cover all risks for the investors, but gives them a chance to know much better the traded products and to take the risks consciously. Innovation is apparently limited but the

probability to turn the market into a lottery is much lower.

If a stock market investor fears of a price decrease, he can use a contract for differences to cover the risk. For this, he will initiate a short position on a contract for differences on the same stock. In this way he covers the risk of decreasing the trading rate but with the price of no profit. If the stock quotation grows, the contract for differences will record a loss, equivalent with the stock profit.

From the practical point of view, the market of contracts for differences is a zero-sum game. This situation is specific for futures transactions. The profits made by some of the participants are always found in an identical value to those who loose. If the total market doesn't have a profit or loss, for participants each profit hides the loss of one of the investors.

Contracts for difference are a good option for short-term investment. The possibility to trade very cheap, relatively simple mechanism of trading and permanent marking to market make the CFD perfect tools for short-term speculators. For long periods of time the CFD investments are not so profitable because of the leverage effect that requires a permanent surveillance of the investment and because of the costs it should be remembered daily the financing interest rate for long positions. For a long-term, risk management can emphasize safer investments such as stocks or for the individuals in contributions to private pension funds.

Finally it should be pointed out the fact that the investments in CFD aren't suitable for any investor. Depending on the risks that the investor wants to assume and the knowledge he acquired so far, the decision to invest in CFD can be taken. The permanent increase of the derivatives number has the role to enable a large number of participants to find the right product for everybody. If the purpose of trading

derivatives is speculation, the investor should not forget that the leverage is so spectacular when generates profits and so painful when produces losses. If a potential investor on financial derivatives

market does not take into account the possibility of losing, it is better for him to participate on a traditional market where the price, paid to initiate a transaction, limits the risks and profits.

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