Lessons from the Australian experience

Alan Cameron
Derivatives - tools for transferring risk*

• First used mainly to manage price risks for commodities
• Now available on an extensive range of risks, from interest rates to electricity prices
• Tremendous innovation, wide variety of contract designs
• Truly a global market - the largest in the world (?)
  – * Boyle and Boyle, Derivatives - the tools that changed finance
Derivatives - tools for transferring risk

But - not well understood

- “concocted in unstoppable variation by rocket scientists who rattle on about terms like delta, gamma, rho, theta and vega, they make a total hash of existing accounting rules and even laws”
  - Carol Loomis, *Fortune* magazine, 1994, quoted in *Boyle*

- “too complicated to explain, too important to ignore”
  - 60 Minutes, also quoted in *Boyle*
Derivatives - tools for transferring risk

The Benefits

• better risk sharing across the economy
• provide investors with more flexibility to tailor their portfolios to suit their wants
• prices reveal useful information about future events that can lead to better decisions
  
  – Boyle, op. cit.
Derivatives - tools for transferring risk

The Downside

• easy to take on large amounts of risk
• that can lead to large losses
  – The disasters, like Orange County, Metallgesellschaft, Barings
    • Boyle, op. cit.
  – None in Australia
An Early Perspective*

- 6th century B.C. - Greece - forward trading
- Middle Ages - European trade fairs - forward delivery
- 17th century M. E. - Japan - futures contracts like those of today
- 19th century - Chicago, USA - futures markets based on commodities
- 20th century - the switch to financial futures
  - *Carew, Fast Forward, the history of the SFE
The Australian Perspective

- 1960 - Sydney Futures Exchange was opened
- 1974 - One millionth contract traded
- 1986 - *Futures Industry Act commenced*
- 1989 - Introduced electronic night-time trading via SYCOM
- 1992 - SFE buys New Zealand Futures and Options Exchange
- 1999 - SFE closed the trading floor
The Australian Perspective continued

- 2000 - SFE demutualises and lists on Exempt market
- 2000 - SFE buys Austraclear
- 2001 - SFE changes name to SFE Corporation
- 2001 - ADX starts, and stops
- 2002 - ASX Futures commences trading
- 2002 - Financial Services Reform Act commences, unifying legislation for securities and futures
- 2002 - SFE Corporation Limited lists on the Australian Stock Exchange
SFE Firsts

• First Financial Futures Contract outside the US (1979)
• First Cash Settled Futures Contract (1980)
• First Stock Index Futures Contract outside the US (1983)
• First Bond Futures Contract outside the US (1984)
SFE Firsts continued

- First exchange to gain CFTC approval (1988)
- First overnight electronic trading (1989)
- One of the first to announce trading floor closure (1997)
- One of the first to demutualise (2000)
- First stand alone Futures Exchange to list (2002)
SFE Corporation Limited - Today

SFE Corporation Limited

SFE Clearing Corporation Pty Ltd
Austraclear Limited
Sydney Futures Exchange Limited
New Zealand Futures and Options Exchange Limited
SFE Products and Services

**Trading**
- Interest Rates (SFE and NZFOE)
  - 3 yr Bond Futures and Options
  - 10yr Bond Futures and Options
  - Bank Bills
- Equities
  - SPI 200 Index Futures and Options
  - Individual Share Futures
- Currency
  - Australian Dollar Futures
- Commodities
  - Electricity, Grains and Wool

**Clearing**
- Central Counterparty Clearing
- Exchange Traded Products
- OTC products
  - Bond Repo Clear
  - CGS, Semi-Government
- Delivery vs Payment
- OTC products
  - Commonwealth Gov Bonds
  - Semi-government Bonds
  - Discount securities
The Role of SFE in Australian Financial Markets
Distribution of SFE Products and Services

- Chicago
- London
- Hong Kong
- Japan
- New Zealand
SFE - Highlights of 2001

- A record 36.9 million futures and options contracts were traded at SFE, up 15% from previous year
- 3 Year Bond Futures set a new record of 15.7m, up 15%
- Net profit after tax was $21.4m, an increase of $16.9m
- ROE: 14.5%  ROI: 61%
- Opened new communication hub in Chicago
- Bond and Repo Clearing was introduced, the first example of CCP Clearing for OTC products in Asia
- Commonwealth Government Securities were moved from Reserve Bank to SFE.
SFE Exchange and Product Ranking

The 10th largest Financial Futures Exchange in the world
2. EUREX     7. NYME
3. CME       8. BM&F
4. CBOT      9. CBOE
5. LIFFE     10. SFE

The 2nd largest Financial Futures Exchange in Asia
1. Korea Stock Exchange
2. SFE Corporation Limited
SFE Exchange and Product Ranking - continued

- The 7th and 11th most actively traded Bond futures contracts in the world
  1. EUREX Bund  
  2. EUREX Bobl  
  3. EUREX Schatz  
  4. CBOT T-Bond  
  5. CBOT 10yr Note  
  6. CBOT 5yr Note  
  7. SFE 3yr Bond  
  8. KOFFEX Bond  
  9. TSE JGB  
  10. LIFFE Gilt  
  11. SFE 10yr Bond  
  12. CBOT 2yr Note

- The 5th most actively traded short-term interest rate future - SFE Bank Bill

- The 6th most actively traded Asian Equity index Futures Contract
SFE - Looking Forward

Continued Growth through:

• Client Acquisition via electronic distribution
  – US and Europe

• Product expansion for both trading and clearing
  – One Session Options, Swap Futures
  – Third Party and Remote Clearing

• Cost reductions
  – via Infrastructure partnerships with other exchanges and technology partners
  – via continued improvements in internal efficiencies
Regulatory issues

- SFE, and ASX, front line regulators of brokers
  - self regulation less appropriate since demutualisation
- Australian Securities and Investments Commission (ASIC) the statutory regulator of all financial markets, products and services
  - licenses all intermediaries
  - memoranda of understanding with each exchange re referrals, surveillance protocols and so on
- central bank responsible for systemic supervision of clearing and settlement system
The Nomura case..

- a complex arbitrage play - an attempt to selling a matching portfolio of a $600 million basket of stocks, and the largest parcel of futures put together by anyone in the history of the SFE.

- The futures contracts represented a gamble that the "All Ords" would fall - Nomura's massive share-selling activity would make this a certainty. For every percentage point it fell, Nomura would make several million dollars on its futures contracts sales.

- To ensure buyers for the shares, Nomura set up "bid baskets" with several brokers, offering to buy its own shares for up to 20 per cent below market price. In two cases, it did wind up buying its own shares, a practice outlawed by most stock exchanges and by Nomura's own rules.
The Nomura case.. continued

But for several reasons, including Nomura's own failure to understand the way the index worked, and its brokers refusing to dump the shares at bargain-basement prices, Nomura was left holding $150 million worth of its shares, and the index fell "only" 26 points, or about 1 per cent, in the last half-hour of trading.

- Both SFE and ASX referred the trading to the regulator
- Nomura and its officers not in Australia
- Civil proceedings - defended by Nomura, alleging market manipulation - successful; injunctions and declarations
- Disciplinary proceedings in London and Hong Kong
The future

- Will ASX and SFE merge?
  - Competition law rejection in 1999
  - since then, HK, and Singapore
  - SFE still willing, ASX reluctant
- Will ASX become a serious competitor for SFE?
  - ask someone else!
- Will technology kill all exchanges?
  - The Economist, Jan 29, 1999