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Research on Comprehensive Management Optimization of OTC Derivatives Business in Financial Institutions

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Abstract: OTC derivatives, as a foreign product, have experienced a development process from scratch, from existence to growth after entering the domestic capital market. With the development of mixed operation of domestic financial industry, the development speed of derivative products business has shown a trend of collapse in recent ten years. This paper will discuss how to improve the overall management and performance management of OTC derivatives business, promote the stable development of OTC derivatives business, improve the management ability and level of financial institutions' derivatives business, and help financial institutions achieve sustainable operation and stable development.

Keywords: OTC derivatives business; Features; Comprehensive management; Performance appraisal; Incentives and constraints

1. Introduction

In today's financial market, derivatives, with their unique characteristics and functions, have become an indispensable part of financial institutions. As an important category of financial instruments, derivatives not only increase the depth and breadth of the market, but also provide financial institutions with risk management, asset allocation and arbitrage opportunities. At the same time, the high complexity and potential risks of derivatives also bring unprecedented challenges to financial institutions, especially in highly leveraged and market-extreme situations. This dual nature requires financial institutions to invest significant resources, manpower, technology and expertise to effectively manage derivatives. The management of derivatives involves not only an understanding of the financial instrument itself, but also an in-depth understanding of the market environment, market trends, risk characteristics and regulatory requirements.

2. Suggestions on Optimizing the Management of OTC Derivatives Business

2.1 Overall management

2.1.1 Strategic and budgetary control

In the over-the-counter derivatives business, strategic and budgetary controls face unique challenges, primarily due to the non-standardised and highly customised nature of these products. For example, a financial institution may find that in order to meet a customer's hedging needs for a particular exposure, it needs to engage in a corresponding over-the-counter derivative business and develop a range of complex over-the-counter derivatives. This requires financial institutions to carefully consider how to allocate their own resources to support the development and management of these businesses and products in their strategic planning, and comprehensively consider factors such as customization of products, market trend demand and their own risk management capabilities and technological level, so as to better meet the market challenges, meet the needs of customers and ensure the long-term sustainability and profitability of the business.

2.1.2 Capital management and liquidity management

Financial institutions should conduct internal capital assessment regularly to ensure that they have sufficient capital to carry out derivatives business and their capital adequacy ratio can still meet regulatory requirements and internal standards after carrying out over-the-counter derivatives business. Financial institutions can use stress testing to predict capital requirements in extreme cases and diversify risk and capital use, diversify risk through diversified portfolios and hedging strategies, optimize capital use and reduce reliance on a single asset or market. At the same time, do a good job in its own liquidity management, including but not limited to: establish adequate liquidity buffer reserves, including cash, treasury bonds and other highly liquid assets, etc.

3. Specific Control Measures

3.1 Strictly evaluate the feasibility of new derivatives business before it is launched

Before the new derivative business is launched, financial institutions should fully consider and evaluate their own professional strength, risk tolerance and risk disposal capabilities, especially in extreme cases; The new derivative business must be subject to various risk assessments conducted in advance and comprehensively by an independent and professional risk management and legal compliance department, including but not limited to comprehensive analysis of compliance risk, legal risk, market risk, credit risk, liquidity risk and operational risk. In addition, the results of the risk assessment should be submitted to the management, who will judge whether the institution has the qualification and control capability to launch the new derivative business and decide whether to launch the new derivative business. New derivative businesses or new derivative products can only be launched to the market when management confirms that the risks are manageable and the institutions are fully prepared.

3.2 Evaluation in the Design Process of New Derivatives Products

When designing new derivative products, the legal and compliance department and the risk management department need to be involved in every stage of product design to ensure that all potential risks are identified and evaluated from initial design to final implementation, and to ensure that the new products comply with all relevant regulations and internal policies. Pricing models and market assumptions used in the OTC derivatives business should also be independently verified by the risk management team to ensure their reasonableness and accuracy, and the risk management team should stress test the new derivatives business to assess performance and risks under extreme market conditions. The results of the risk assessment should be reported to management in a timely manner to ensure that they make informed decisions based on a complete understanding of the risks.

3.3 Strengthen model and parameter management

In order to deal with the uncertainty of various parameters, financial institutions may consider using different volatility estimation methods, such as Monte Carlo simulation, to quantify the impact of the uncertainty; Sensitivity analysis and stress testing can be used to assess the risks under different interest rate and exchange rate scenarios and to develop appropriate hedging strategies; Or by using different models or considering more complex models. In addition, financial institutions should establish effective parameter evaluation, prediction and update mechanisms to ensure the effectiveness and adaptability of the model.

4. Business performance assessment, construction of incentive and restraint mechanisms and suggestions for improvement

4.1 Performance assessment and incentives and constraints on business departments

When designing performance indicators, financial institutions should organically combine the assessment of quantitative indicators with quality indicators, avoid over-reliance on a single indicator, guide business departments to not only pursue profit maximization, but also pay attention to the sustainable development of the business, taking into account both indicators that reflect the quantitative revenue of the business and indicators that reflect the quality of the business, and may try to introduce indicators such as risk-adjusted revenue and long-term investment ability assessment to conduct a comprehensive assessment of OTC derivatives business that takes into account both revenue and risk.

4.2 The business team's performance appraisal and incentive constraints

For the derivatives business team, financial institutions also need to establish a special assessment and incentive mechanism to better stimulate the vitality and motivation of the team and encourage collaboration between different teams. On the basis of the overall assessment indicators of business departments, more detailed indicators are set for different business teams, including quantitative indicators such as transaction performance, new product development, new customer acquisition, customer service, product promotion, business collaboration scale, as well as performance indicators such as risk management level, compliance degree, team collaboration degree, collaboration effect, contribution degree, completion of specified business training, compliance with operating procedures, participation in industry seminars, number of professional trainings, etc. These indicators can help the business team to consider all aspects of the business more comprehensively, improve the team’s overall business capabilities and market adaptability, and also promote business collaboration, knowledge sharing and team growth.

4.3 Performance assessment and incentives and constraints on the risk management department

When designing the assessment and incentive mechanism for risk management departments, financial institutions need to conduct comprehensive thinking and in-depth analysis. They should not only list the assessment indicators, but also consider how to better motivate the work enthusiasm, initiative and effectiveness of risk management departments through assessment methods, and guide them to give full play to the key role of independent risk supervision. The assessment should focus on the actual effect of risk prevention and control, which is the most important aspect. Quantitative indicators such as the number of occurrence of various risk events and the amount of losses caused can be set for assessment, so as to directly assess the actual work achievements of the department in controlling market risk, credit risk, operational risk, etc. If the number of certain types of risk events increases or the loss increases, the risk management department may be required to carry out cause analysis.

5. Summary and recommendations

To sum up, financial institutions should continuously optimize the overall management and performance management of the over-the-counter derivative business. Only by systematically implementing the overall management mechanism of the over-the-counter derivative business and continuously optimizing the performance assessment and incentive and restraint mechanisms of the over-the-counter derivative business can the over-the-counter derivative business continuously create value for financial institutions under the premise of controllable risks and truly realize the steady development of the business.

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