# *The Capital and Foreign Exchange Markets, Including Options and Forward Contracts* [1]

This symposium, in discussing various important topics in the field of financial operations, will not only concentrate on purely educational aspects, but also conduct target-oriented discussions stressing the need for banks and financial institutions to conduct their financial activities according to ethics and principles that discourage speculation. At the same time, we hope ways and means will be identified to protect the financial positions of these institutions from the various risks emanating from their activities.

It is not easy to be brief on issues concerning the capital market. Hence, I will concentrate briefly on the principal issues that banks and other financial institutions should take into consideration while dealing in money markets, apart from the technicalities involved in market transactions. I will also define the

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regulations and standards that should be observed in dealing with options and different forward contracts as special speculative practices.

To start with, I would like to define these markets and activities briefly. In a capital market, various forms of lending and borrowing take place, involving ordinary bonds and transferable bonds having various maturities. A money market usually refers to the market for short-term credit instruments such as treasury bills, commercial papers, bankers, acceptances, tradeable certificates of deposit, interbank deposits and other instruments which do not all enter the investments accounts.

The foreign exchange market is the international market where currencies are exchanged among countries, especially through financial institutions using various communication means. Foreign currency deals are done to meet obligations or to make profits out of changes in these currencies, exchange and interest rates.

Forward contracts involve buying and selling financial papers at fixed prices to be delivered at a future date. That is why contract prices reflect investors' expectations for interest rates or yields.

These contracted securities cannot be cancelled unless both parties consent. Options are another form of forward transactions, and they allow participants to sell or buy certain assets within a fixed period and at an agreed price. The sell or buy option costs an amount of money that would be lost if the option was not exercised.

The following aspects of trading in the money and exchange markets should be taken into consideration when looking into rules and standards for financial transactions:

1- All banking and financial practices should be performed in the light of the main objectives of these institutions and in accordance with the volume and nature of their financial resources, and as part of an efficient overall management of assets and liabilities. These institutions must take into consideration the risks involved with various activities and follow appropriate policies.

2- Priority should be given to realizing stable and fixed rates of return on the operations of these institutions in the financial markets. This requires concentration on sound financial investment through applying stringent standards of solvency, profitability and liquidity. This means balancing the risks in an optimal manner through quantitatively, qualitatively and geographically distributing the investments of these institutions to avoid risks associated with concentration in certain countries, currencies, and industries.

Moreover, any positions or exposures taken by these institutions regarding securities, commodities, and foreign exchange should be in the context of hedging operations. Also, financial institutions should avoid over-trading in securities and try to build optimal portfolios within a policy aimed at improving rates of return or augmenting the liquidity of these portfolios.

3- All speculative practices should be within prescribed limits, with consequence calculated in order to enable these institutions to cover their losses. Effective internal control is needed that takes administrative and accounting aspects into consideration, and is based upon written policies. Moreover, there is a need to make clear distinctions among activities, the setting of limits, asset maintenance procedures, and conservative accounting measures to calculate profits and losses. Reports should be submitted regularly to the higher management of these financial institutions.

4- Dealing in different financial instruments and in the exchange market is a very technical matter, and needs quail flied and well-selected professionals.

5- Greater capital mobility has been an important phenomenon in the past few years, and has made the international financial markets more integrated and more subject to external shocks. Therefore, banks and financial institutions should be aware of that when making their financial decisions, and they should especially enlarge their supervision and follow –up of international markets as part of continuous monitoring of monetary policy trends in major countries. As we all know, any changes in exchange rates and interest rates have a direct effect on the money market.

These suggested precautions are for general banking and financial institution practices, but clearly dealing with options and forward contracts needs special measures because of the purely speculative nature of these transactions.

While stressing the importance of integrated assimilation of all technical aspects concerning the different options and contracts, in order to reduce the risk of losses, here are some fundamental measures for such dealings:

1- Practices in this area should be within minimum limits, which oblige the management of banks and financial institutions to define their plans clearly and within permitted strategies for contracts and their relation with other activities of these institutions. Such strategies should show whether the aim of these deals is to cover specific operations or for speculative purposes, or both.

2- Positions taken in forward contracts should be part of an acceptable investment strategy for these banks and financial institutions, and should reflect their ability to settle their contractual obligations. Also, any exposure in these contracts should be related, within limits, to the cash positions of these institutions.

3- Banks and financial institutions should be sure of the solvency of their partners and of their ability to settle their contractual obligations. In addition, these contracts should be ratified according to the proper legal procedures required by such trading.

4- It is essential to keep detailed accounts of these transactions, showing their the size, nature, date of finalization, and maturity. This would facilitate auditing and monitoring operations by management. Such activity should also be subject to continued supervision through the issuance of mandatory periodic reports.

It must be emphasized that perceptions of limited possibilities available for achieving good returns in the Kuwaiti market should not dominate the investment attitude of some institutions, and push them to intensify foreign activity. These institutions should seriously seek domestic investment avenues, not only as a contribution to national development in Kuwait, but also with a view to long-term returns.