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Obstacles to the application of new financial mechanisms

Index

Introduction……………………………………………p.3

Primary dealers system…………………………..p.3

Margin trading………………………………………..p.5

Short selling…………………………………….…….p.7

Exchange traded funds…………………………….p.9

Financial derivatives………………………………..p.11

Obstacles…………………………………………………p.14

Introduction

During this time, the financial markets have evolved in conducive directions by developing a number of new financial mechanisms. This new and innovative financing instruments made it possible to harvest new sources of financing . As these innovative financing mechanisms have accessed new sources of funds for sector investments.

From this new mechanisms what have been introduced to the Egyptian market including the Primary Dealers System and margin trading . While other new mechanisms have been developed but still not applied in the Egyptian market such as the short selling, Exchange Traded Funds (ETFs) and the introduction of financial derivatives.

1) Primary Dealers System:

An innovated mechanism developed by EGX that has been adopted to finance the State's public budget deficit via the Primary Dealers system in the governmental bond-issuing market.

The Primary Dealers System emerge upon the following:

1. Acting as a link between bond issuers and investors in the market.
2. Maintaining a stock of governmental bonds, which allows trading.
3. To underwrite the initial offering of the government securities in the primary market.
4. To act as market makers in the secondary market.
5. To activate the bond market and enhance its liquidity.
6. Reduce the cost of borrowing for the government.

The Primary Dealers System is linked electronically to the primary dealers, custodians and Misr for Central Clearing, Depository and Registry (MCDR), to guarantee the availability of the bonds that are to be sold

Governmental bonds are zero-risk, as they are totally secured by the State. Accordingly, the interest on these bonds is the lowest.
The respective interest rates shall be determined according to mechanisms of supply and demand which, in turn, determine the bond yield.

Main Target:

Reducing the cost of the domestic public debt. The government's current approach is based upon re-scheduling the governmental debt and replacing the high-cost debt with low-cost debts. Accordingly, high-interest rate bonds have been replaced by other low-interest rate bonds. Bonds with an interest rate of 11 % have been amortized by 8 % bonds.

Therefore the Primary dealers in Egypt aims are:

- To enhance placement of government securities
- To ensure its liquidity in the secondary market
- To ensure reinforcement of Egyptian sovereign debt

List of primary dealers as at 30-Jun-2009:

- National bank of Egypt
- Banque misr
- Banque du caire
- Bank of Alexandria
- Commercial international bank
- Societe Generale bank
- Arab African bank
- Suez canal bank
- Export development bank
- Misr Iran development bank
- Credit Agricole
- Citibank
- Arab bank
- Barclays
- HSBC bank

CBE, in coordination with the Ministry of Finance, establishes the necessary rules and conditions for the operation of these banks in the governmental securities market to ensure the banks' capability of dealing efficiently with these bonds. The most important of these rules states that the capital should not be less than L.E. 500 Mn. and 200 Mn. for Egyptian banks and foreign banks' branches.

In case of dealing in governmental bonds via the open market, primary dealers shall notify the stock exchange of their purchases and sales of these government bonds . and the primary dealer do not have the right to obtain or pay any charges with respect to transactions taking place in the open market.

Dealing in treasury bills via the open market is prohibited. On the other hand, treasury bills shall be registered and traded at CBE. Moreover, the issuance of treasury bills shall be linked with the auction system at CBE which shall be re-structured to boost the pricing efficiency.

2)Margin Trading

Process whereby investors purchase securities with borrowed money and whereby securities themselves are used as collaterals.

Because borrowing money isn't without its costs You'll have to pay the interest on your loan. The interest charges are applied to your account unless you decide to make payments. Over time, your debt level increases as interest charges accrue against you. As debt increases, the interest charges increase, and so on . Therefore, buying on margin is mainly used for ***short-term investments***.

Margin trading allows you to buy more stock than you'd be able to buy and so to realize larger profits faster. Margin trading enables you to buy new securities, get overdraft protection, access credit, or short sell securities.

Margin account

To trade on margin, you need a margin account which make margin trading simple than using any other form of credit .

This account is different from a regular cash account in which you trade using the money in the account.

The margin account may be part of your standard account opening agreement or may be a completely separate agreement.

The **minimum margin** is the minimum account balance you must deposit The more you deposit, the more you will be able to borrow.

Once the account is opened you can borrow up to **50%** of the purchase price of a stock, you suddenly have access to more than that amount for your needs.

This portion of the purchase price that you deposit is known as the initial margin.

Margin call

when you sell the stock in a margin account, the proceeds go to your broker against the repayment of the loan until it is fully paid.

if your shares drop in price your broker may demand that you add to your margin account or sell stock to pay down your loan. When this happens, it's known as a margin call.

Example.

let's say that you have $10 000 to invest in 250 stocks. You trade on margin, and you can buy up to $20 000 in stocks, or 500 shares, since broker lends you $10 000 on the strength of the securities purchased with your own $10 000. If over the course of a month your securities rate is about $25 000, you gain 50% minus the interest on the $10 000 you borrowed to buy the stocks.

Risks

if your shares drop you might lose not only the amount borrowed, but you might need to liquidate some of the stocks purchased with your own money to pay off the debt. some of your existing securities may be sold even at a loss to pay your debts. Brokers may be able to sell your securities without consulting you. Since margin trading strategies can be risky most financial experts do not suggest that inexperienced investors try trading on the margin. You should only consider trading on margin if you are an experienced investor.

3) short selling

The investor's aim in the market is to make profit by buying stocks which are expected a rise in price in the future. but if the stock's price is expected a decline, the investor's best way is it to stay out of the market to avoid losses.

But in the case of **short selling the opposite happens** as the investor will sell the stocks that he doesn't own. His broker will lend it to him from broker's customers that wish to lend its securities or from customers of another broker or institutions or from custodian banks. The shares are sold and the proceeds are credited to the borrower account.

- Sooner or later, he must "close" the short by buying back the same number of shares and returning them to his broker with the market price. If the price drops, he can buy back the stock at the lower price and make a profit on the difference. If the price of the stock rises, he have to buy it back at the higher price, and he lose money.

- The idea of short selling **is used by hedge funds regularly** as hedge funds is used when the investor is not sure of the direction of movement of prices of securities so as to protect him from the low price of securities in the market. and is **generally, but not always, adopted by short-term investors**.

The parties in this process is the shareholder (lender), borrower, custodian and the brokerage firms.

The nature of the securities that is borrowed by the investor is to be*:*

1) Companies that sell goods or services that are not good or useless.
2) The companies that began to suffer from the presence of other competitors in its field.
3) Companies that suffer from a deficit in their financial position.
4) Companies that rely heavily on only one product.

Because you don't own the stock you're short selling (you borrowed and then sold it), you must pay the lender of the stock any dividends or rights declared during the course of the loan. If the stock splits during the course of your short, you'll owe twice the number of shares at half the price

Risks

1) When you short sell, your losses can be infinite. A short sale loses when the stock price rises and a stock is not limited in how high it can go.

2)When short selling, you open a margin account, and you may be imposed to the same risk of margin call as in the case of marginal trading.

3) when sellers rush to buy the stock to cover their positions. This rush creates a high demand for the stock quickly driving up the price even further. This phenomenon is known as a short squeeze.

The borrower has to return the securities in these cases :

1) It may be an initiative by the short seller, when the price of the securities in the market is low(less than the selling price when borrowing) and this will enable him to achieve his goal of earnings. So he will buy the same number of securities from the market with its market price and return the securities to the lender.

2) The lender may want to end the contract by notifying the broker who facilitates the lending process this is called (Recall Notice). in this case the borrower (Short Seller) has to restore what has been borrowed from securities.

And the Short Seller in this case has two options:

either buy what he borrowed from the securities from the market at the current price or to borrow the same number of securities from another lender and give them to the other lender. but it is difficult for the borrower to find another lender .

If the borrower can't re-stock the securities on the time for settlement, the lender buys the same number of securities using cash collateral retained in the borrower's account. And the borrower remains responsible for any additional expenses borne by the lender during the implementation of this acquisition.

4) <u>Exchange traded funds</u>

A security that tracks an index, a commodity or a basket of assets like an index fund, but trades like a stock on an exchange. ETFs experience price changes throughout the day as they are bought and sold.

Because it trades like a stock, an ETF does not have its net asset value (NAV) calculated every day like a mutual fund does.

By owning an ETF, you get the ability to sell short, buy on margin. When buying and selling ETFs, you have to pay the same commission to your broker that you'd pay on any regular order.

One of the most widely known ETFs is called the Spider (SPDR)

Advantages

1. **No Investment Minimums -** Several mutual funds have minimum investment requirements of $2,500, $3,000 or even $5,000. ETFs, on the other hand, can be purchased for as little as one share.

2. **Lower Cost Alternative -** The average mutual fund still has an internal cost well over 1%, whereas most ETF funds will have an internal expense ratio typically between 0.30-0.95%. Plus, ETFs do not charge (advertising fees) or sales charges, as do many mutual funds.

3. **More Trading Control -** Mutual funds are traded once per day at the closing NAV price. ETFs trade on an exchange all throughout the trading day, just like a stock. This allows you greater purchasing/selling price control and the ability to set protection features, such as stop-loss limits on your investments.

4. **Tax efficiency -** because an ETF portfolio does not experience very high turnover, they are generally tax efficient.

Disadvantages:

1) Limited upside - an ETF limits an investor to the return on the index less any fees. In the corporate bond market, an active investor may be able to take advantage of market inefficiencies to produce above-index returns.

2) Lack of transparency - although they regularly post their holdings, an investor may not know exactly what bonds an ETF holds at any given time. Investors with direct corporate bond holdings will have the advantage of tracking their holdings on a more consistent basis.

3) Lack of customization - an ETF investor is forced to hold all the bonds in the underlying ETF and cannot decide to overweight or underweight some bonds relative to the index.

5)Financial Derivative

A security whose price is dependent upon or derived from one or more underlying assets. The derivative itself is merely a contract between two or more parties. The subject of this contracts may be products, goods or real commodities or certain indicators such as exchange rate or interest rate or securities such as stocks, bonds or foreign currencies or even cash flow. Its value is determined by fluctuations in the underlying asset. Derivatives are generally used as an instrument to hedge risk.

-If the risk factor inherent in investment in general but it is very high in the investment in financial derivatives and the resulting high risk is due to UNCERTAINY of the prices as it depends primarily on future expectations and the extent to which these expectations can be achieved.

-There are many derivatives including forward contracts, options and swaps.

-Derivatives used by speculators and other financial means as a SOURCE OF REVENUE and also there is a greater opportunity to reduce the degree of risk through the hedge for protection from the effects of price fluctuations that typically arise either from the volatility of exchange rates or volatility of interest rates or the volatility of asset prices.

-The participants in the derivative market can be classified into two categories:

First category:
Are the end users ENDS USERS who enter these markets to achieve certain goals related to hedges and speculation.

Second Category:

Is the category of brokers or dealers (INTERMEDIARIES) who meet the needs of end-users of derivatives and these intermediaries reap revenues in the form of transaction fees.

A)Option

-In finance, an **option** is a derivative financial instrument that specifies a contract between two parties for a future transaction on an asset at a reference price.
A **call option** on a stock gives its holder the right to buy a fixed number of shares at a given price by some future date, while a **put option** gives its holder the right to sell a fixed number of shares on the same terms.

-The price of an option derives from the difference between the reference price and the value of the underlying asset plus a premium based on the time remaining until the expiration of the option. If the option is not exercised (When the holder of an option takes advantage of her right, he is said to exercise the option) by the expiration date, it becomes worthless.

-The reference price which is a key variable in a derivatives contract between two parties is the strike price or exercise price. The trade will be at the strike price, regardless of the market price of the underlying instrument at that time.

-When the underlying security's price is higher than the strike price a call option is more valuable.

-If the underlying security's price is less than the strike price, a put option is more valuable.

B)<u>Forward contracts</u>

- If your business simply sends and receives money internationally you need to consider how you will protect yourself against changes in foreign exchange rates and other foreign exchange risks. A small variation in the rate could cost your business thousands of pounds if not managed properly. So **<u>forward contract</u>** will protect you.

- Forward contract is a cash market transaction in which delivery of the commodity is deferred until after the contract has been made. Although the delivery is made in the future, the price is determined on the initial trade date. (price are set now, but delivery and payment will occur at a future date.)

A forward contract obligates one party to buy the underlying at a fixed price at a certain future date this party assumes a **<u>long position</u>** but the counterparty who is obligated to sell the underlying at that fixed price assumes a **short position**.

-It costs nothing to enter a forward contract as you don't have "marked to market" concept because you will not be asked to increase your marginal account even if the price of the commodity increase after the contract has been made.

C)<u>Swap</u>

A swap is a contract to exchange cash flow over a specific period.
two parties agree to exchange interest payments for a certain
period of time, based upon some agreed upon or "notional" amount.

The two most common types of financial swaps used by companies are currency swaps, and interest rates swap (may be either asset-driven or liability driven)

For example, company *A* has variable rate debt currently at 6% payable to *B*. A wants to ensure that their interest payments neither decrease or increase. Therefore, they enter into a "interest rate swap" for fixed interest payments from another financial institution, called *C* at 6%. If later the interest rate on the variable rate debt increases to 7%, *A* will pay *B* the 7% but will be reimbursed by *C* for the 1% difference. If the variable rate decreases to 5%, *A* will pay *B* 5% and an additional 1% to *C*. *A* is guaranteed to pay %6 and essentially betting that the interest rate rises. *C* is ensuring that *A* pays 6% and is betting that the interest rate falls.

obstacles:

The new financial mechanisms financial derivatives, ETFs and short selling has not been applied in the Egyptian market due to the following reasons:

Because speculators do not know:

- How securities markets work.
- Trading techniques and strategies.
- Market trends.
- The firm's business operations.

As speculators need only to make profit . and also due to the recent circumstances that hits the country economy after the January 25 revolution.

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