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The role of financial derivatives in enhancing the banking institutions under the rising of prices of US dollar

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Abstract

The value of financial derivatives contracts is determined by the value of a certain asset or commodities money market instrument. To maximize the return on his investment portfolio or to cover risks, an experienced investor would typically use derivatives. Options, forward, and future contracts are the most frequent derivatives. It is often regarded as the most divisive and complex financial issue. At the macro level, it is impossible to count the good and negative effects it has on economic activity. It is also one of the financial instruments that arose from financial philosophy and is utilized in stock exchanges.

Introduction

The study focuses on financial derivatives that are legal and economic in nature. Futures contracts, which are not intended for delivery but rather to resolve price disparities, are seen as a gamble that is not recognized by law. These transactions are analogous to gambling in terms of economics since they do not provide value. Rather, they are merely transactions in which one side profits in exchange for the loss of the other. The prospect of establishing an organized market for trading derivatives as new financial instruments to control risks in the banking system and financial investment has surfaced following the repeal of the restriction on dealing with financial derivatives in the new banking legislation. This tries to spread and lessen the financial risks faced by dealers while also taking use of the benefits provided by these technologies.

Research problem:

Financial derivatives create many risks because they are based on the expectations of the seller and buyer. Thus, the lack of clear knowledge of derivatives may put many investors in banking institutions at risk.

Research importance:

The significance of the study arises from understanding the legal risks associated with losses stemming from a legal or regulatory act that undermines the contract legality in the bank.

Research objectives:

The research aims at:

1. Studying commonly used financial derivatives and understanding the obstacles that prevent their application in banks.

2. Identifying the risks they cause and put forward some proposals for optimal employment in banks.

Research Methodology:

The analytical descriptive approach is adopted within the current study, through the theoretical definition of financial derivatives, in addition to the risks faced by banks and the possibility of hedging against them using financial derivatives.

Concept of Derivatives

In order to understand the concept of financial derivatives, this topic is divided into two parts: The definition and importance of financial derivatives. This part will be divided into two

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sections: the first deals with the definition of financial derivatives, while the second section deals with the importance of financial derivatives.

First. The definition of financial derivatives

It's one of the consequences of financial engineering, which entails the creation and development of new financial instruments as well as the improvement of current ones (Abu Zaid, 2014 and Radwan, 2005). They are contracts and agreements whose value can be stemmed from actual assets like commodities and precious metals, financial assets like stocks and bonds, or cash flow indicators like interest rates and price exchange. As a result, they are subcontracts arising from or derived from fundamental contracts and financial instruments relating to off-balance sheet items (Attia, 2003).

It is a type of financial contract that derives its value from the value of another asset called the basic or related asset, such as stocks, bonds or commodities. Among the most prominent forms are future contracts, future contracts, swap contracts, options contracts, and others (Abbadi, 2008). They are financial contracts related to off-balance sheet items and their value is determined by the value of one or more of the underlying assets or influences associated with them. This has been defined by the Bank for International Settlements as “contracts whose value depends on the prices of the financial assets subject of the contract, but do not require the investment of a financial asset in these assets, and as a contract between two parties to exchange payments on the basis of prices or returns, then” (Radwan, 2005). They were defined as contracts that are determined at a future date that does not need early investments, but rather requires a small initial amount compared to the value of the contracts. The value can be derived from the value of the underlying asset, which is why it is called derivative (Hammad, 2003). Financial derivatives may be described as contracts with a future settlement date that do not need early investments, but do need a small initial amount in comparison to the contract's value. The value of the underlying asset is used to calculate its value, either at a profit or at a loss, which is why it is referred to as a derivative.

Second: The importance of financial derivatives

It is considered one of the investment tools that have been produced in the light of scientific and technological development and what has resulted in the need for liquidity and raising efficiency to reduce risk. This made these tools a way to hedge against fluctuations, especially since they do not generate cash flows except in a small way. This is what prompts some to use it as a speculative tool (Al-Quraishi, n.d). Financial derivatives are of great importance to the investor, as financial transactions gain greater flexibility through (Nasaar, 2006):

1- Hedging: It is a good tool to hedge against the main risks that investors are exposed to, which usually include the risks of:

- A - fluctuations in foreign exchange rates.
- B - fluctuations in the prices of securities.
- C - fluctuations in interest rates.
- d- The fluctuation of commodity prices.

This is done by transferring these risks to another party, without the need for a prior purchase of the underlying asset.

2- A means for predicting the predictable price in the current stock exchange: contracts provide dealers with information about what the price of the asset will be where the contract was concluded in the current stock exchange on the time of delivery.

3- Providing an investment opportunity for speculators: The speculator enters into financial derivative contracts with the aim of making profit, by taking advantage of the advantage of margin trading.

4- Facilitating and activating dealing on the assets related to the contract: Financial derivatives exchanges are known for their low transaction costs, which make it hard for current stock exchanges to compete. As the stock market gets more efficient, this decline has an effect on its liquidity. This increases the likelihood of finishing the page at a price that is near to fair.

5- Struggling to restrict the stock exchange's perfection: The stock exchange's perfection is accomplished when it offers dealers with financial asset costs that are in line with their aims and desires, whether in terms of return or risk. Despite the fact that perfection in the preceding image is difficult to accomplish, financial derivative contracts have become a viable option for generating contract and

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security formations sold on today's stock exchange. As a result, the investor obtains unique levels of return and risk that no investment sold on the present stock exchange can match.

The second: Types of financial derivatives

The most widely traded types in the financial markets and the most famous are as follows:

First: Execution Forward contracts

These contracts that whereby the seller has to deliver to the buyer the commodity subject of the contract at a later period at an decided price at the time of execution, are called the execution price. However, in such contracts, it may be agreed to pay the value of the contract upon signing, or a part is paid and the rest is deferred until the date of delivery. The two parties agree on the quantity, method and method of paying the contract, which shows the personal nature of this type of contract. The two parties specify the terms of the contract to suit them. It indicates that there is no secondary market for this type of contract and when the contract is concluded; it cannot be canceled, which entails the risk of non-delivery. (Al-Ba'aly, 1999) Neither party can cancel it, as this entails the risk of not being able to deliver and the risk of a change in the speed of the commodity in the future. This is in addition to the fact that these contracts are rarely used by speculators, as they have no purpose in the commodity, but rather what concerns them is to seize the opportunities of temporary price changes to sell or buy in order to achieve profits (www.badlah.com/page-778.html).

It is also defined as "a contract concluded between two parties, a seller and a buyer, to deal in an asset on the basis of a price determined upon contracting, provided that delivery is at a later date" (Abbadi, 2006). On the other hand, the forward contract is defined as "an agreement between the two parties according to which each of them guarantees the application of a specified interest rate in the future to his borrowing or investing a certain amount of money" (Al-Hindi, 2003). Examples of future contracts are: export and import contracts, borrowing contracts for the purchase of real estate....etc. A forward contract means an agreement between two contracting parties to sell an asset at a specified price and a specified delivery date. As though a merchant promised to sell him 10 tons of wheat on a specified day for a price of 50.000 dirhams to be paid on the same day of delivery, for instance. Those contracts are called derivatives, which means that it is permitted since the sale is the buyer or seller's responsibility under this contract. Whether the sale is to another contractual party or to a third party, the financial derivation takes place as described above. These agreements are not made in a controlled private market. It differs from so-called futures contracts because of this.

Second: future contracts

It is "an agreement to buy or sell a commodity or financial instruments to be delivered in the future, unlike a specially negotiated forward contract that includes objective terms. The future contract is a standardized agreement in which only the price and settlement month change" (Hammada, 2007). It is a typical binding contractual obligation to either sell or buy a specific asset, at a specific price, and on a specific date in the future. It differs from a future contract in that it is available for trading on the stock exchange (Siham, 2014). Others defined it as a reciprocal legal obligation among two parties that forces one of them to deliver or receive from the other via a third party (the intermediary) a specific quantity of a specific asset or commodity in a specific place and time and at a specific price (Mattar, 2003). On the other hand, it is defined as future sales contracts that take place in organized markets, namely the financial markets. In the view that they too are generally subject to particular provisions imposed by the regulated market, they are normal contracts. This market ensures its execution, and one of the benefits of these future contracts is that it eliminates the challenge of locating contractual parties willing to execute forward sales in the commodities under consideration. The assurance of the governing market also ensures that it will be performed. The market, not the two contracting parties, determines the price of commodities or financial instruments exchanged in them. (Abu Zaid, 1999). Future contracts are characterized by several characteristics, including (Kacumula, 2003):

- In future contracts, there are two parties, one accepts the location of the buyer or recipient, and the other accepts the location of the seller or deliverer. Thus, what one party gains in these contracts, the other party loses.

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- The two parties to the transaction often do not know each other. Thus, the two parties do not enter directly with each other in dealing, but through the clearing house that acts as a buyer or a seller without competing with any of the buyers or sellers. It then works on balancing accounts, paying profits, collecting payments, achieving stability, bypassing direct exchanges between dealers, and ensuring the efficient completion of contracts.
- Futures contracts are standardized in terms of shape, size and amount, and their original owner can easily modify or cancel them before the time of delivery. In a particular study, it was found that less than (2%) of these contracts last until the time of delivery without modification or cancellation.
- Trading in derivatives requires depositing an initial margin with the clearing house as a guarantee that the parties will fulfill their obligations. Margin is determined by market conditions and investor behavior.
- Determining the area in which the price fluctuates, and to achieve this, deposit holders are prevented from using futures for speculative purposes.
- "Because these contracts are dealt with through the official market, they are negotiable and thus free the contracting parties from their obligations to deliver or receive the contracted item" (Radwan, 2005).

Third: Options Contracts (Options)

Linguistically, the word “Kiyarat” choices” is the plural of the word “Kiyaar” choice”. It is a name derived from “choice”, which means choosing and seeking the best of the two things, and the best of the two things, i.e. admitted to him the choice (Al-Razi, 1981). In the contemporary financial and economic literature, the option fits with what the language dealt with, as it is defined as a special contractual agreement that gives the holder the right to buy and sell assets at a fixed price at any time and before the given date (Abbadi, 2008). Option contracts are among the most important derivatives of financial assets that are traded in the option markets, which may be independent markets, or part of the existing market. Option contracts were spread with the aim of protecting the investor against the risk of price change. An option contract is defined as a contract that gives its holder the right to choose, but not the obligation, to buy or sell a specific financial asset during a certain period. Since the purchaser of this option has the right to implement it or not, he pays the one who gave him this right, who is the editor of the choice, a non-refundable reward called the price of the option or the premium paid upon contracting and is not considered part of the value of the contract (Boissonnade, 1997).

Options of contracts represented in forward buying/selling shares, were first traded on a regulated stock exchange in 1973. Since then, there has been a significant growth in the forward buying/selling options markets. These options are now traded on several exchanges around the world. Large amounts of buy/sell options are traded in the over-the-counter markets by banks and other financial institutions including stocks, stock indices, currencies, debt instruments, commodities, and futures contracts. There are two basic types of buy/sell forward options. The forward purchase option gives its holder the right to buy the underlying asset on a specific date and for a specific price. As for the forward selling option, it gives its holder the right to sell the underlying asset at a specific date and for a specific price. The price in the contract is known as the exercise price. As for the date or date in the contract, it is known as the date of expiry of the contract, its validity, the date, or the due date (Hammad, 2001). Through the previous definitions, we see that an option contract is an agreement among parties that grants the option holder the right to sell or buy the underlying asset, in return for the payment of a non-refundable reward. Moreover, it is not part of the deal.

Fourth: Exchange contracts

It is defined as a series of post-implementation contracts, where the swap contract is settled on a periodic period that may be (monthly, quarterly, semi-annual...etc) (Hamaad, 2001). A swap contract is binding on both parties to the contract unlike option contracts. The receipts or payments (profits or losses) are not settled daily as in the case of future contracts. In addition, the swap contract is not settled once, as is the case in subsequent contracts (Shamout and Kanjo, 2008). The swap contract is characterized by the following (Al-Hindy, 2011).

- The swap contract is binding on both parties to the contract, unlike what is known in options contracts.

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- Receipts or payments are not settled daily, as is the case in future contracts.
- It is not settled once, as is the case in subsequent contracts.
- This type of contract is the most common type of derivative contract (Salih, 2002).

The process of currency exchange links the direct purchase of a currency and its sale at the same time forward, or vice versa. In other words, this process includes the release of two simultaneous contracts; one is a buy, while the other is a sale. The value of both contracts is much the same, but their maturity dates are varied. They are divided by a time period. (Kurneau, 1997).

There are several types of swap contracts, but there are two basic types of swaps, which are dealt with daily through most market makers, namely: interest rate swaps and currency swaps.

The concept of banking institutions

In this section, we will explain the concept of a banking institution and its risks:

Definition and importance of banking institutions

This part will be divided into two sections: the first deals with the definition of banking institutions, and the second section deals with the importance of banking institutions.

First: Defining banking institutions

Banking institutions, technically speaking, are financial institutions that receive cash deposits, open accounts for various transactions, and create credits for the benefit of their customers under various forms, such as lending, opening credits, letters of credit, paying commercial bonds, participating in financial operations belonging to companies and groups, receiving deposits of bonds from their customers and providing them with special services. (Kurneau, 1997, 1517). The word bank indicates the place of exchange, and the bank is called a bank, and the bank is a public or private company in which money and deposits are placed. It is collected by banks and known as "the bank." It appears from this definition that the bank is the place in which banking operations take place (Jibran, 1994. 10). The French legislator defined him in Article (1) of the French Banking Law issued on January 24, 1984 AD, "He is a legal person who practices banking operations as usual" (Shawariby, 2007. 33). At the same time, we find that the Law of the Central Bank, the Banking System and the Egyptian Monetary No. (88/ 2003) is did not mention of the definition of the bank. Jurisprudence defines the bank as a financial institution that takes the form of a joint stock company, whether it is a public or private person or a joint capital authorized by law or the Central Bank to practice banking operations such as receiving deposits, granting credit, exchanging money and providing banking services (Shawariby, 2007). As for the Algerian law, the bank may be defined as "an economic institution that owns a commercial legal personality that deals with others on the basis of commercial rules that are subject to the principle of organization and harmony in its dealings with its external environment, that are free from all restrictions, and that are free to finance projects. It requires that the bank be registered on a list Banks and by means of a credit issued in the Official Gazette" in accordance with Algerian Law No. 10/90 (see: Act 90/10). As for the Iraqi legislator, the bank was defined as a person holding a license or legislation under this law to conduct banking business, including a government company established in accordance with the Governmental Companies Law No. 22 of 1997, as amended (4) (See: The Iraqi Legislation Base, Article (1) of the Iraqi Banking Law No. 94 on 7/6/2004).

Second: the importance of banking institutions.

1- Providing a coverage service against the risks of price changes: by transferring those risks to another party, without the need for a prior purchase of the underlying asset. Certainly, coverage is the most important function of derivatives markets, which is the reason for the existence of those markets.

2- A method for determining the current market's predicted price. It informs dealers what the price of the asset under which the contract was made will be in the current market on the date of delivery, so it's an effective instrument for figuring out what the price should be on the time of delivery. The price of the asset in the present market varies in light of derivative contract prices, indicating the factors that

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demonstrate the overall trend of dealers' expectations.

3- Creating a valuable potential to forecast cash flows: As long as the seller understands that the proceeds of selling the asset will be based on the contract price, the two parties to the contract may appropriately anticipate their future flows. The buyer also realizes that his buying price is dependent on the contract price.

4- Providing investment potential to the speculators: the speculator tries to achieve profits via his expectations concerning prices. However, his quest for profit by becoming a party to the contract provides a social service, even if he does not intend it, because he is the party to whom the risks that the other parties do not desire. These are the parties that actually own the asset (the selling party) or want to own it in the future (the buying party) for a real need for it.

5- Supporting and enacting transactions on the contract's assets: Dealing in derivatives markets is characterized by extremely low transaction costs, which are hard to match in today's markets. A future contract for $1 million has a transaction cost of no more than $100, which is an average cost of 0.01 percent of the contract value. Transaction cost has an impact on market liquidity. These make the market more efficient, giving a better chance of closing the deal at a price close to the fair price. Dealing with contracts also contributes to activating the market for the contracted asset, by increasing the volume of trading on it. This is because the amount that the investor pays when contracting represents only a small percentage of the transaction value, and is much less than the initial margin that the buyer is obligated to deposit with the broker in the event of a marginal purchase of the asset from the current market.

6- Implementing investment strategies quickly: Derivative contracts have another advantage, which is the speed of implementation of investment strategies, due to their flexibility and great liquidity. (Al-Hindi, 2003. 19-20)

The risks of banking financial derivatives under the rise in the price of the US dollar.

This section will be separated into two sections: the first will include standard risks, and the second will cover unique risks. Iraqi economy is experiencing a fiscal and monetary policy crisis, which is affecting every aspect of the country's economic and social life. Because Iraq has a fixed exchange rate system, this is greatly exaggerated. It also supports the external product rather than the local one. As a result, the dollar's exchange rate versus the Iraqi dinar increased. The dollar exchange rates recorded an increase in the markets of Baghdad and the Kurdistan region, where the Central Kifah and Al-Harithiya Stock Exchanges in Baghdad recorded (125,200) dollars. It also increased in money exchange shops in the local markets in Baghdad, where the selling price amounted to (125,500) Iraqi dinars for (100) US dollars. Economists analyzed this rise owing to the overlay of a set of expectations of the financial crisis in Iraq. They are triggered by the decline in oil prices, the effect of the Covid-19 and the curfew, which caused the suspension of currency sale outlets in the Central Bank. The cessation of commercial activities at the local level was reflected on the rise in the exchange rate of the dollar. The decline of the Iraqi currency, in addition to the speculation of currency traders, was accompanied by multiple rumors about the Central Bank's efforts to classify banks and exchange offices (www.alfalluga.tv). The factors affecting the currency exchange rate can be highlighted:

1. Changes in the value of exports and imports: There is a direct relationship between the value of the currency and the demand for exports.
2. Inflation rates: Assuming the stability of other factors, local inflation causes a decrease in the value of the currency. For instance, once the value of a currency rises by (10%) at a period when the general level of prices in other states is stable. Domestic inflation in the country will push consumers to increase their demand for foreign goods and, consequently, for foreign currencies.
3. Change in domestic interest rates: Increases in real interest rates will attract foreign capital, causing the currency's value to appreciate in the foreign exchange market.
4. Change in foreign interest rates: it will motivate investors in the short term to exchange their currency for the currencies of those countries in order to acquire gains in the foreign market.
5. Government interventions: They occur when the central bank tries to adjust the currency exchange when it is not appropriate with its financial and economic policy.

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6. Political and military factors: They are usually linked to economic and financial news and bulletins or through official statements (Al-Hasani, 1999. 158-159).
7. Gross domestic product: where the rise positively affects the exchange rate.

First. The traditional risks

These are risks that financial derivatives share with other contracts and other financial instruments and these risks include the following:

Market risk:

Which can be expressed in the risk of price movement in the opposite direction of hedging, and these risks relate mainly to unanticipated fluctuations in the prices of derivative contracts (Al-Tantawi, 2008. 36).

2- Credit risk:

It arises when customers stop fulfilling their obligations to the bank at the specified times which affects the financial position of the bank that is regulated by the derivative contract. These losses are the costs through which a new contract replaces the previous contract (Hobner, 2003. 13).

3- Operational and administrative risks:

They are related to the individuals' mistakes working in the field of derivatives, the failure of managers, the inefficiency of administrative and control systems, as well as the weak follow-up to the actions of those responsible for managing and dealing with derivatives. The increased complexity of these tools makes it difficult to manage them correctly and may achieve large losses as a result of mismanagement.

4- Settlement risk:

Few of the financial transactions related to derivatives instruments are settled instantaneously, or on the same day of execution. In the American financial markets, for example, the settlement period extends to several days, which leads to one of the contracting parties being exposed to a loss due to the possibility of changing prices quickly during that period or in the same day of implementation.

5- Legal risks:

The Iraqi legislator defined legal risks as “the potential losses resulting from fines, penalties and punishments applied to the bank in the event of its failure in its contractual and legal obligations, or as a result of its application of the provisions of the contract in violation of the provisions of the contract, or because these provisions do not reflect the contractual rights and obligations of the bank or the counterparty in a clear and proper manner.” (The Iraqi Bank, 2004).

It arises from the illegality of some contracts, and as a result of changes that occur in the legal environment governing derivatives. In addition, the ambiguity of some legal aspects and the difficulty of judicial implementation when any disputes occur lead to the difficulty of implementing contracts (Shahata, 2017. 120). It also arises from poor documentation in contracts, the counterparty's failure to have the necessary powers to contract, the unclear legal status of some transactions, and the inability to judicially implement in the event of default or bankruptcy. Changes in the legal environment lead to some risks, or the literature of countervailing changes in thelaws of taxation, or the existence of laws prohibiting enterprises from investing in particular kinds of instruments (Ezzit, 2002. 47). It relates to losses attributable to a legal or regulatory act that invalidates the contract or thwarts the end-user or its counterparty from conducting in accordance with the terms of the contract or relevant arrangements of liquidation.

Second. The special risks

It may be found in other financial instruments, but it has more impact on the derivative financial instruments, which are as follows: (Alexandria Bank, 2003) (Hammad, 2001)

Liaison risk:

It is the most common type of risk specific to the derivative financial instrument and results from the change in the value of the derivative financial instrument at a rate not equal to the rate of change in the financial asset being protected. This risk increases when an asset is hedged with a derivative financial instrument that is different

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in type or trading market than the asset being hedged. (Mohsin, 2009)

3- Liquidity risk: arising from the bank's inability to meet its needs or obligations towards others, which negatively affects its profit. The most important reasons behind these risks are (Al-Laith et al, 2015):

- Weak liquidity planning in the bank, which leads to an inconsistency between assets and liabilities in terms of maturity dates.
- Poor distribution of assets over uses, which makes it difficult to monetize them when needed.
- Sudden transformation of some contingent liabilities into actual ones.
- Factors of recession and hard crises in the markets.

4- **Pricing risks**: the pricing of derivative contracts requires great experience and advanced mathematical models, especially in pricing derivatives linked to bonds. An efficient mathematical model for pricing an error-free derivative contract has not yet been found.

5- **Financial rise risks**: the profits or losses associated with dealing in these instruments fluctuate to a greater degree than the volatility of their revenues, which leads to the realization of large losses when there is a slight change in their revenues or costs.

6- **Substitution risk**: It has nothing to do with one of the parties failing to meet their commitments throughout the settlement period, but rather to its inability to fulfill this obligation at all. This is the matter with which the other party is forced to enter into a new contract in order to be able to fulfill its commitments towards others while bearing great losses, which is the difference among the contract price and the market price of the contracted papers (Radwan, 2005).

Conclusion

Through what was covered in the research, we reached the following conclusions and recommendations:

First: The results

1. Financial derivatives are financial contracts whose value derives from the value of the underlying asset, including forward, future, swap and option contracts.
2. Dealing with options contracts in the stock exchange protects the investor from heavy losses, and from its negative aspects it does not achieve the principle of contractual balance.
3. Banking institutions are still unable to attract individual deposits and increase the number of customers.
4. The relatively unstable political situation in Iraq and the surrounding region has created a great demand for the dollar, which has led to a recent rise in the currency exchange rate.

Second: Recommendations

The research results in a set of recommendations that must be taken into account, which we believe, in our estimation, are necessary to determine the dimensions of the contracts, represented by the following:

1. Allow foreign banks to operate in Iraq in line with the investment law and motivate Iraqi banks to devise mechanisms to improve their performance and create an atmosphere of competition.
2. Activating the private banks to employ their superior liquidity in providing credit and increasing their contribution to the development of economic sectors and private projects suffering from a low volume of capital formation.
3. Seeking to reorganize the financial derivatives markets and limit the deals concluded in the unregulated markets due to their lack of transparency and lack of oversight.
4. Raising efficiency in local financial institutions by increasing competition and improving the quality of banking service.
5. Forming, urgently, committee to study the fluctuation of the Iraqi dinar exchange rate against the rise of the dollar and to provide appropriate solutions to ward off damage to the national economy.

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