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Corresponding Solutions to the Problems in China's Derivatives Market

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Abstract: With the increasing uncertainty of the interest rate, exchange rate, inflation rate, and other factors in the financial market, financial institutions need all kinds of financial instruments in order to avoid financial risks, and in this situation, financial derivatives were born. With the progress of society and economic development, the financial derivatives market continues to expand in China. However, opportunities always coexist with crises, and there are still some problems in China's derivatives market. This paper studies the problems existing in China's derivatives market and puts forward corresponding solutions. It is found that problems such as an ineffective mechanism for supervision, insufficient innovation, immature investors, single market tools, and ineffective market functions still exist in China's financial derivatives market. To address these issues, China should improve the legal system, enhance transaction transparency, strengthen supervision and management, enrich the types of financial derivatives, cultivate qualified institutional investors, and reduce restrictions on overseas business.

Keywords: financial derivatives, financial markets, financial instruments, investors

1. Introduction

Derivative securities are a concept corresponding to basic financial products, and their prices depend on the price (or value) of basic financial products. Derivative securities mainly include options, futures, forward contracts, swaps and interest rates, exchange rates, various price indices, etc. From a micro perspective, the functions of financial derivatives mainly include risk avoidance, price discovery, hedging, and financial innovation ability improvement. From a macro perspective, financial derivatives play a great role in optimizing resource allocation, reducing the country's overall financial risk, absorbing social idle capital, effectively increasing market liquidity, and improving transaction efficiency [1].

In recent years, China's economy has shifted from high-speed growth to high-quality development. With the continuous opening of the financial market and the rapid development of the Internet economy, this is both an opportunity and a challenge for the derivatives trading market. Therefore, financial enterprises need to further analyze the current situation of the financial derivatives trading market, effectively solve the problems faced in the current development, and better promote the healthy development of the financial market. Since the 1980s, some financial derivatives have often been used to avoid market risks because of their leverage effect [2]. With the

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continuous development of the global economy, the position of financial derivatives in the international financial market has gradually become prominent. However, financial derivatives are a double-edged sword. On one hand, they bring profits to financial institutions and effectively realize risk prevention and avoidance. On the other, the exchange carries great risks because of financial derivatives' characteristics of uncertainty and high risk, and there is a potential for a huge financial crisis [3].

This paper first explains the current situation of China's financial derivatives market in recent years. Then, it summarizes the problems in the risk management of China's financial derivatives market. Finally, corresponding solutions are proposed, so as to shed light on the risk factors and development strategies of China's financial derivatives market.

2. Current Problems of China's Derivatives Market

2.1. A Lack of an Effective Mechanism for Supervision

Since the 1990s, financial derivatives have begun to develop in the Chinese market, and commodity futures, treasury bond futures, etc. have begun to enter people's lives. Changing from the initial wait-and-see attitude, people have gradually started to purchase financial derivatives, and this has brought more opportunities to the development of China's financial industry. However, the development period of financial derivatives in China is relatively short, the financial derivatives market is relatively immature, and the supervision and management of financial derivatives are relatively insufficient. As a result, individuals or enterprises with bad ideas begin to carry out fraudulent activities under the banner of financial derivatives, leading to a distortion in people's objective understanding of financial derivatives. An effective supervision and management mechanism can prevent the occurrence of various problems. However, the lack of relevant national management systems will cause problems of poor market stability, which is not conducive to the stable development of the social and financial industry [4]. At the same time, in the context of the current information age, access to information resources in the financial market is extremely important for consumers, but at present, consumers cannot enjoy information resources equivalent to some institutions, which has caused damage to their interests to a certain extent.

2.2. Insufficient Innovation of Financial Derivatives

The development of China's financial derivatives market is lagging behind, and it is plagued by financial innovation. From an international perspective, financial derivatives are the main trading varieties in the exchange derivatives market. Except for stock index futures, other mainstream products have not yet been launched, and the financial derivatives traded on the market are absent. At the same time, a lack of financial innovation is the consensus of China's academia and industry. Such an economy with a serious lack of financial innovation hinders the development of China's financial derivatives market. The historical event that plagued the development of China's financial derivatives most was the subprime crisis in the United States. The subprime mortgage crisis has caused people to "talk about financial innovation" and have a high degree of doubt and resistance to complex financial instruments, pricing models of derivatives, high leverage, and capital speculation. The lag in the development of local financial derivatives and the exogenous impact of financial innovation plague China's capital market at the same time [1]. Nowadays, the refinement of domestic commodity futures types is not in place, the futures corresponding to the key futures varieties have not yet been launched, the hedging and other functions of the futures market cannot involve all commodity market fields, and the company's demand for price prediction and diversification of market risks for a larger number of products cannot be basically guaranteed.

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2.3. Immature Investors in the Market

Although China's financial derivatives market has cultivated a number of institutional investors, China's investors are still immature. There is a large gap between immature Chinese institutional investors and mature foreign qualified institutional investors in terms of corporate governance structure, internal control mechanism, research and analysis ability, and investment level of financial derivatives. The immaturity of investors cannot be completely attributed to the enterprise itself. It also reflects the insufficient development of China's over-the-counter financial derivatives market. The insufficient development of the domestic market makes Chinese enterprises lack a stage and space for exercise and growth, while the lack of trading varieties further forces Chinese enterprises to go to the international market for trading [5]. There is another situation where investors ignore this information that can be easily obtained on mobile phones or other Internet channels, and they have less risk management of investment products after buying. Due to the enthusiastic recommendation of bank staff, investors are tempted by potential high returns and subconsciously rely on institutions and other reasons, showing that they make buying decisions without sufficient information [6].

2.4. Relatively Single Market Tools and Ineffective Market Functions

For domestic entities, their risk control comes from procurement, production, sales, and many other aspects. Therefore, domestic entities should select applicable tools and control the risks arising from vertical and horizontal business lines. However, it is difficult for a single domestic financial derivatives market instrument to meet the comprehensive control requirements of a company and it is hard for a single futures type to effectively hedge various nonlinear risks. At the same time, China's on-exchange financial derivatives market only recognizes the participation of domestic investors, and the over-the-counter derivatives market only allows the participation of some domestic financial organizations. In addition, the price of most financial derivatives does not have enough impact on the pricing of international financial derivatives, and it has little impact on the markets of some countries and regions, which largely limits the internationalization level of the domestic financial derivatives market and China's pricing power in international trade, making it hard for China to obtain the right to speak which completely match its own economic strength [7]. As for foreign financial derivatives markets, developed countries in Europe and the United States concentrate most of the world's exchange financial derivatives transactions, and more than 80% of the world's transactions are distributed in North America and Europe. This concentration trend has become more obvious in recent years. Europe's market share increased from 29% in 2000 to 42% in 2006. Moreover, Europe and the United States still continue the pattern of competition and mutual promotion: the United States takes the lead in the derivatives market with CME; Europe with EUREX and EURONET as the right arm to compete for the hegemonic position. According to their own development needs and historical background, they have formed a derivatives development path suitable for their own development, which is an important reason why Europe and the United States have been undefeated in the financial derivatives market for a long time [8].

3. Corresponding Solutions to Existing Problems

The future development of China's financial derivatives market can be reformed and innovated by building a sound financial derivatives market supervision and management system and ensuring the transparency of financial transactions. There is a need to find a solution to the problem of the underdevelopment of China's over-the-counter financial derivatives market, including the lack of trading varieties.

3.1. Standardized Construction of the Legal System

In order to promote the smooth operation of the financial derivatives market and promote safer transactions, China must establish and improve the legal system and enhance the transparency of financial derivatives transactions [9]. All relevant institutions or departments in China should strengthen supervision and management, cooperate and coordinate with each other, and better play the role of supervision. Regulatory departments should clearly confirm their own responsibilities and strengthen the supervision and management of financial markets [10]. Moreover, the accounting processing and information disclosure of financial derivatives should be strengthened to make the financial market more open and transparent. Effective financial derivatives accounting processing and information disclosure can enhance the transparency of financial derivatives transactions and help investors better understand the value and risks of financial derivatives [2]. The existing supervision mechanism of China's financial market needs to be changed to fundamentally safeguard the fairness and justice of the over-the-counter financial market, so as to effectively protect the interests of consumers.

3.2. Introduction of a Variety of Financial Derivatives

No matter in which field, it is necessary to first clarify the role of innovation. Innovation is the driving force for development. Only by continuously strengthening financial innovation in the financial field can we enrich the types of financial derivatives and realize better development of the financial derivatives market [11]. Based on this, China's financial market should continue to deepen reform to create more financial derivatives and form a set of scientific and reasonable financial market operation rules. With the gradual improvement of China's stock index futures, China's financial industry can gradually launch China's treasury bond futures, international interest rate futures, and other high-quality financial derivatives, give full play to the respective advantages of financial derivatives, and continue to vigorously innovate the development of China's financial derivatives market according to the actual needs of economic development so that China's financial derivatives market develops faster and better [2]. Obviously, the development of the domestic financial derivatives market is backward, and at present, the most critical factor restricting the progress of the derivatives market is the lack of types. The introduction of a variety of derivatives in the future is an important guarantee for the development of the domestic market economy.

3.3. Cultivation of Qualified Institutional Investors

In response to the problem of immature investors, the following approaches can be used to improve this situation. First of all, cultivate and develop qualified institutional investors to improve the investor structure and improve the internal control mechanism and risk management system for financial derivatives transactions. In addition, it is also necessary to strengthen investor education and learn from advanced foreign theories and experience to improve the investment and operation level of investors' financial derivatives. At the same time, it is important to vigorously improve the corporate governance structure of various investors and guide them to establish and improve the internal control mechanism and risk management system of financial derivatives. In view of the problem of insufficient enrichment, it is necessary to enrich the types of market institutional investors to avoid the homogenization of market participants and introduce more investors with diversified and differentiated needs to encourage corporate customers to participate in domestic over-the-counter financial derivatives transactions [11]. From the perspective of market access, the incident warned all investors in the financial derivatives business of commercial banks to learn to fear the market, professionalism, and risk and strengthen the learning of financial professional knowledge, especially to have full understanding and vigilance of financial risks. In terms of the

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investment in financial derivatives, because it is leveraged trading, investors should fully identify risks in the face of the temptation of high returns and take measures to prevent and control risks and transfer risks before the risk occurs, which requires much higher trading levels for investors compared to the investment in bank wealth management products. Moreover, because the derivatives market conditions change rapidly, it is better for investors to keep an eye on the market during the trading process. When investing in products that go beyond the boundaries of one's knowledge, it is likely to result in a loss [6].

3.4. A Reduction of Restrictions on Overseas Futures Business

A more appropriate type of option must be chosen to protect futures and match risk more precisely. Meanwhile, the real economy has diversified and personalized risk control needs, and these needs also need to be supported by the over-the-counter derivatives market. For example, the number of over-the-counter swap contracts for iron ore on the Singapore Exchange reached 15 million tons in August 2012 alone, with a position of nearly 10 million tons, and the proportion of Asian steel mills and traders accounted for only 13%, which shows that China's on-market standardized market is difficult to meet the risk control requirements [7]. Besides, it is necessary to reduce restrictions on overseas futures business, actively encourage those more innovative and competitive futures enterprises, and provide high-quality services for Chinese enterprises to go global. In addition, gradually liberalizing domestic varieties and allowing foreign investors to participate in China's futures trading to establish China's authority in global pricing is also a key measure.

4. Conclusion

This article analyzes the current situation of the financial derivatives market and summarizes the problems faced by China's financial derivatives market, including imperfect standardized construction of the market rules, immature investors, insufficient innovation, single market tools, and ineffective market functions. As a new and important investment method and a product that acts as a leverage to hedge risks, financial derivatives play an essential role. Therefore, it is necessary to build a sound financial derivatives market supervision and management system and ensure the transparency of financial transactions. This includes improving the level of investors and encouraging more investors to enter the financial derivatives market. In the context of the continuous development of economic globalization, China must improve and perfect the financial derivatives market mechanism to better promote the development of the financial derivatives market.

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