similar, but the holder is not compelled to purchase or sell, and will only do so if it is to his or her financial advantage. The purpose of a derivative is to allow for the separation and exchange of risks with respect to the price of an underlying asset. This "unbundling" of risks allows for the transfer of certain risks to agents more capable and/or willing to bear and manage them. As well as risk management, derivatives can be used for speculative purposes, whereby the holder is exposed purposely to certain risks based solely on the possibility of generating profits from underlying price movements.

Derivatives are traded in two ways -- on organized exchanges or on so-called over-the-counter (OTC) markets. Organized exchanges such as the Chicago Mercantile Exchange offer standardized contracts, set margin requirements and act as clearinghouses to guarantee contract performance. The organized exchange is itself the counterparty in each transaction, and is subject to government regulation. The OTC market is an informal market consisting of dealers, or market makers (mainly commercial and investment banks) that trade electronically. One advantage of OTC contracts is that they can be tailored to suit specific requirements, i.e., contracts need not be standardized. Dealers manage their derivatives portfolios by hedging against risks that they are exposed to in providing OTC contracts, either by matching up counterparties wishing to offset different risks or by using exchange-traded derivatives.[2]

Derivatives markets, including those in Canada, are dominated by a relatively small number of large commercial banks, investment banks and securities dealers.[3] This reflects the preference of derivatives users to deal mainly with institutions with the highest credit ratings, as well as the complexity of derivatives and the expertise (normally found in only the largest institutions) required to service the market effectively.

In 1993, the notional principal outstanding for exchange-traded derivatives was close to U.S.$7.84 trillion.[4] In 1992, the latest complete year for which data are

---

[2] See P. A. Abken, "Over-the-Counter Financial Derivatives: Risky Business?", in *Economic Review*, Vol 79. No. 2, Federal Reserve Bank of Atlanta, Atlanta GA, March/April 1994, p. 4.

[3] See S.M. O'Connor, *The Development of Financial Derivatives Markets: The Canadian Experience*, Bank of Canada Technical Report No. 62, Ottawa, June 1993, pp. 28-9; and B. Quinn, *Derivatives - A Central Banker's View,* in Quarterly Bulletin, Bank of England, London U.K., August 1994, p. 278.

[4] See Bank for International Settlements, *64th Annual Report*, Basle Switzerland, June 1994, p. 112. The notional outstanding amount of derivatives is not an accurate portrayal of credit risk. The credit risk of a derivative contract is the cost of replacing the contract if the counterparty defaults.