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Sustainable Architecture for Finance in Europe (<https://safe-frankfurt.de/>)

SAFE Finance Blog

“Investors Should be able to Decide for Themselves”

05/10/2017

Christian Schlag takes a critical stance towards the ban of Contracts for Difference (CFDs) by the Federal Financial Supervisory Authority



On Monday, 8 May, the Federal Financial Supervisory Authority (BaFin) banned the sale of Contracts for Difference (CFDs) to private investors. According to BaFin, private investors are not able to correctly assess the financial risk associated with these leveraged products. Christian Schlag (<https://safe-frankfurt.de/research/researchers/researchers-details/showauthor/91-schlag.html>), Director of the research area "Financial Markets" at SAFE, is skeptical whether this is the right way to go. “In my view, it is, in

general, problematic to ban financial instruments that are not outright fraudulent. And, in my opinion, this is not the case with CFDs. The characteristics of these products are well known and described in sufficient detail. Therefore, it should be left to each individual investor whether he or she wants to invest in such a

product or not.”

A CFD is a contract that is based on some other financial asset, such as a stock or bond. The buyer bets on a certain movement of this base product. Example: An investor buys a CFD on a stock which is currently worth 100 euros. If its value increases to 110 euros, the investor is paid out the difference: 10 euros. However, the investor does not need to buy the stock for 100 euros but only to deposit a margin which is usually a very small percentage of the current asset value, say 1%, which would correspond to 1 euro in our example. This implies that CFDs allow for extremely attractive profits with little initial capital if the base product develops according to the investor’s expectations.

In contrast, if the base product does not develop as hoped, an investment in CFDs can become very expensive. “If prices move against the position of the buyer, the CFD provider will call upon him to deposit additional margin to cover the potential losses,” Schlag explains. This obligation to deposit additional margin can result in substantial losses for the investor when the market moves against his or her expectations. However, it is possible to limit losses – similar to other market transactions – by means of a stop loss order. “If I define a stop loss limit at 99 euros in the example contract, I can only lose capital up to this limit. This is why a CFD is only really dangerous when you do not employ such protective tools – either due to hubris or to ignorance.”


The Professor of Derivatives and Financial Engineering admits that the obligation to deposit additional margin may not be clear at first sight for laymen because it is not known from other financial products like stocks, bonds or mutual fund shares. “Usually, you pay a price for a product, and the worst case is that you lose this investment completely – but not more.” When investing in CFDs, losses can accrue (in theory) infinitely. As a consequence, private investors in particular are obliged to inform themselves diligently, and to resist the temptation to speculate with these instruments due to the small initial investment, Schlag says. “Nevertheless, I would not ban these products but rely on private investors to collect sufficient information in their own interest.”

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