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Theme 202
CURRENCY FUTURES

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The South Indian Bank Ltd., H.O. : 'S.I.B. House', Thrissur, Kerala

Theme No. 202 : CURRENCY FUTURES

A **currency future**, or **foreign exchange future**, is a futures contract to exchange one currency for another at a specified date in the future at a price, i.e. exchange rate that is fixed on the purchase date, through an exchange. Typically, one of the currencies is the US Dollar. Though contracts have physical delivery, investors can also close out the contract at any time prior to the contract's delivery date.

Currency futures were first created at the Chicago Mercantile Exchange (CME) in 1972, after the system of fixed exchange rates was abandoned along with the gold standard. Some commodity traders at the CME did not have access to the inter-bank exchange markets, and they established the International Monetary Market (IMM) and launched trading in currency futures. Today, the IMM is a division of CME. Currently the contracts are traded electronically. Globally, currency is the largest traded instrument. CME trades close to USD 32-40 trillion a year.

The Finance Minister, P. Chidambaram, on 29th August, 2008 launched trading in currency futures at the National Stock Exchange, Mumbai. Over 5,000 contracts were traded in the opening minutes. First trade took place at Rs.44.1500 to a dollar. Asia's oldest bourse, Bombay Stock Exchange (BSE) launched currency derivatives segment on 1 October, 2008, that would allow trading in the USD-Rupee futures platform. MCX Ltd (Multi Commodity Exchange) has already received in principle approval from SEBI for the launch of currency derivatives segment.

The pricing of a currency futures contract is determined by the prevailing spot rate and interest rates of the currency pairs. In ideal situations, interest rate differentials between the currency pairs are added to or substracted from the spot rates, depending on the premium or discount of the currencies, to get forward or future prices.

What is the need of currency futures?

In the absence of currency futures trading in India, companies were hedging their currency risk by entering into forward deals with banks where they agree to sell/buy the dollar at a future date and predefined exchange rate. As compared to currency futures, this method is less flexible, less liquid, and less transparent, therefore does not help companies fetch the maximum possible price. Despite these limitations, the dollar forward market in India has a daily turnover of around $3.5 billion.

How do currency futures help in hedging and in speculation?
Investors use futures contracts to hedge against foreign exchange risk. If an investor receives a cashflow denominated in a foreign currency on some future date, that investor can lock in the current exchange rate by entering into an offsetting currency futures position that expires on the date of the cashflow. Currency futures can also be used to speculate and attempt to profit from rising or falling exchange rates.

If a person in India wants $5,000 for travel overseas five months later and also wants to hedge his exposure, he can buy five dollar-rupee contracts (each contract equals $1,000) of five months expiry at say Rs 47.00, and this would amount to a notional value of Rs 2,35,000, but he needs to deposit a margin on that, say 3 per cent, amounting to Rs.7,050- Now at the end of five months if the dollar moved up to Rs 49, there would be a benefit of Rs 10,000 (5000 x 49-47), and if the dollar moved to Rs.45, a loss of Rs.10,000 (5000 x 47-45).

If at this time the person bought from his banker $5,000 that he requires for travel at the spot price of Rs 49, he would spend more, but there is the gain of Rs 10,000 from futures bringing down his costs. On the other hand, at the spot price of Rs 45- he pays less to his banker, but there is the loss of Rs. 10,000 from futures bringing up his costs. In the end his dollar cost amounts to the same, i.e.Rs.47.00, including the small opportunity cost on the margin he has deposited.

Can everyone trade in currency futures?
Anyone in India, except NRIs and FIIs, can trade on the currency futures. One has to send in an order to the NSE member exactly as with Nifty futures or any stock futures. However, the only restriction for the participants is that the position limit for a single client cannot exceed more than $5 million or 6% of the market-wide open interest (total buy or sell contracts outstanding), whichever is larger, and for trading members (excluding banks), the position cannot exceed $25 million or 15% of the market-wide open interest, whichever is higher. In short, non-FII and non-

NRI participants can take positions up to $5 million immediately, and this limit will grow when the open interest of the market exceeds $100 million.

So long as the market is restricted to only resident Indians, the rupee will continue to be traded in the offshore market in non-deliverable forwards. This market, mostly active in Singapore, is where overseas players such as portfolio investors or hedge funds trade in the rupee or avail arbitrage gains when the rupee trades at a huge premium or discount in comparison to the local spot market.

What about credit risk? What if the person who has lost money defaults?
As with all derivatives trading on NSE, the Clearing Corporation becomes the counterparty for the net settlement obligations of all clearing members. Hence, default of a clearing member does not adversely affect the counterparty. Trading in currency futures will call for the stakeholders to meet specific margin requirements. They will have to maintain a margin with the broker, to take care of any mark-to-market losses. In addition to this, the broker and the client will have to put in place stop-loss triggers and if needed, square off their open positions on the same day.

Can currency futures market in India cater to small and medium traders?
While the over-the counter market is characterized by the presence of bigger players because of the large ticket size of the transactions, exchange-traded currency futures will enable participation from wide range of stakeholders as the minimum contract size has been set at $1,000.

Can investors take advantage of currency futures as an asset class?
It may not be called an asset class because it is an instrument, which derives its value from an underlying currency, and that cannot be held for a long term, say five to seven years. It would be useful for traders, and not for real investors. Hence, it may not be as simple as an exposure to stock futures and options. It involves a deeper understanding of the conversion rate, while applying strategies, as it involves more than one currency. One has to pay margins and other costs, which range between 2% to 3%.

How is a currency future different from a forward market?
Exchange traded futures, as compared to forwards, serve the same economic purpose yet differ in fundamental ways. An individual entering into a forward contract agrees to transact at a forward price on a future date. On the maturity date, the obligation of the individual equals the forward price at which the

contract was executed. Except on the maturity date, no money changes hands.

In the case of an exchange traded futures contract, mark-to-market obligations are settled on a daily basis. Mark to market is the practice of revaluing securities and financial instruments using current market prices. Since the profits or losses in the futures market are collected / paid on a daily basis, the scope for building up of mark to market losses in the books of various participants gets limited.

What are the RBI/SEBI guidelines for currency futures trading in India?

Only 'persons resident in India' may purchase or sell currency futures. Presently, standardized currency futures shall have the following features:

a. Only USD-INR contracts are allowed to be traded.
b. The size of each contract shall be USD 1000.
c. The contracts shall be quoted and settled in Indian Rupees.
d. The maturity of the contracts shall not exceed 12 months.
e. The settlement price shall be the Reserve Bank's Reference Rate on the last trading day.

Commercial Banks are permitted to become trading and clearing members of the currency futures market of the recognized stock exchanges, on their own account and on behalf of their clients, subject to fulfilling the following minimum prudential requirements:

a) Minimum net worth of Rs. 500 crores.
b) Minimum CRAR of 10 per cent.
c) Net NPA should not exceed 3 per cent.
d) Made net profit for last 3 years.

According to the guidelines, trading members require a balance sheet net worth of Rs.1 crore while for the clearing member, it would be Rs.10 crores. The clearing member would also be subject to a liquid net worth requirement of Rs.50 lakhs.

Over the past two years, the Indian rupee has seen a rise and fall of more than 15% vis-à-vis the US dollar. Currency futures are now seen as an effective tool, especially for small and medium size exporters and firms, to hedge their foreign exchange risks. Once the new market segment gains momentum, contracts in other currencies too will be introduced, which would further help the market move away from the bilateral over-the-counter market.

GLOSSARY ON FUTURES CONTRACTS

Basis Difference between the current cash price of a commodity and futures price of the same commodity.

Cash Settlement A method of settling certain futures or options contracts whereby the market participants settle in cash (rather than delivery of the commodity).

Clearinghouse An agency or separate corporation of a futures exchange that is responsible for settling trading accounts, collecting and maintaining margin monies, regulating delivery and reporting trade data. The clearinghouse becomes the buyer to each seller and the seller to each buyer and assumes responsibility for protecting buyers and sellers from financial loss by assuring performance on each contract.

Forward Contract A contract which requires a seller to agree to deliver a specified cash commodity to a buyer sometime in the future. All terms of the contract are customized, in contrast to futures contracts whose terms are standardized. Forward contracts are not traded on exchanges.

Futures Contract A legally binding agreement to buy or sell a commodity or financial instrument at a later date. Futures contracts are standardized according to the quality, quantity and delivery time and location for each commodity. The only variable is price.

Hedging The practice of offsetting the price risk inherent in any cash market position by taking an equal but opposite position in the futures market.

Initial Margin The amount a futures market participant must deposit into a margin account at the time an order is placed to buy or sell a futures contract.

Maintenance Margin A set minimum margin (per outstanding futures contract) that a customer must maintain in his margin account to retain the futures position.

Mark-to-Market Debit or credit on a daily basis a margin account based on the closing rate of that day's trading session. In this way, buyers and sellers are protected against the possibility of contract default.

Open Interest The total number of futures or options contracts of a given commodity that have not yet been offset by an opposite futures or option transaction nor fulfilled by delivery of the commodity or option exercise. Each open transaction has a buyer and a seller, but for calculation of open interest, only one side of the contract is counted.

Tick The smallest allowable increment of price movement for a futures contract. Also referred to as Minimum Price Fluctuation.

Variation Margin Additional margin required to be deposited by a clearing member firm to the clearinghouse during periods of great market volatility or in the case of high-risk accounts.

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