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SHOULD INDIAN MSMEs USE FINANCIAL DERIVATIVES?

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ABSTRACT

During the period of year 2007-08, when rupee was appreciating against US dollar and was even expected to touch Rs 35 against a dollar, many MSME (Micro Small and Medium Enterprises) exporters (and others) entered into forex derivative contracts with banks to hedge against the currency fluctuations, which ultimately turn out to be sour and in the process, SME (small and medium enterprises) lost thousands of crores in the process and many cases were filed in Indian courts in this regard. The situation is turn out to be similar at present also, albeit in different manner this time, where very volatile rupee fluctuation against dollar is unnerving the importers and exporters alike. This paper discusses about the background of previous fall out of derivative uses and related issues by MSMEs and proposes the measures to minimize the risk associated with derivative products uses by MSMEs.

KEYWORDS

MSME, SME, Financial Derivatives, Rupee Fluctuation.

INTRODUCTION

Rupee has breached the barrier of 64 against the dollar on August 20, 2013 and in near future expected to breach the psychological barrier of Rs. 70 against the dollar, paving the way for widespread panic and sense of gloom in the market, being reflected by the recent tanking of Indian Bourses.

Fluctuation of rupee against the dollar has been perhaps most dramatic among its peers in currency markets in recent years, which during the year 2007-08 was being anticipated to touch the value of Rs. 35 against a dollar (touching Rs. 39.15 per $ on Jan 12, 2008) while currently moving towards Rs. 70 against dollar in steadfast manner (as it seems now).

While the situation in 2007-08 created panic among the exporters and forced them to hedge against the dollar, under the influence of some public and private banks, ultimately getting their fingers burned in forex derivatives contracts, of which MSME exporters were worst hit, resulting in the losses running over thousands of crores, which severely affected exporting MSME clusters like Tirupur (Tamilnadu) and Ludhiyana (Panjab), urging Reserve Bank of India, courts and government to step in.

The situation is more or less similar at present in 2013 on this front, albeit in a different manner; while in 2007-08, the sufferers were the exporters and beneficiaries were the importers, the situation has turned quite upside down. Though the volatility is disturbing both.

In a rare ray of hope, this situation may propel Indian economy towards being export oriented in somewhat similar manner as to how it was achieved by Japan, South Korea, many South East Asian nations and China in the past, as even the most daring finance minister would not have dared to devaluate the rupee to such extent and manner, provided there is a clear political will to do it, which is perhaps the greatest deficit India is facing currently.

This situation is and will be hammering on burgeoning import and importers will be forced to mitigate their currency risk with the help of forex derivatives.

As it is famously said, 'history repeats itself twice, first as a tragedy and then as a farce', which might very well turn out the case if proper precautions are not administered specifically in the case of small importers .

This paper discusses the use of derivative products by Indian MSMEs in the past and proposes the measures to prevent the life threatening (of business) use of derivative products.

THE BACKGROUND

In year 2008-09, according to the Federation of Indian Exporters Organization (FIEO), based on the rough estimates, the SME sector alone has estimated to have lost over 20 billion rupees. According to A. Sakthivel, President of FIEO, banks, especially foreign banks, had wrongly sold derivative products to SMEs by exploiting the SME sector and violated the stipulated norms and procedures of the Reserve Bank of India.

The exporters were not informed about the full implications of derivatives and most had entered into contracts in good faith. Their losses had forced some SMEs to close down, while a few others were on the verge of closure.

FIEO had urged to the Finance Ministry urged to check the exploitation of the SMEs sector by the banks and financial institutions.

Exporters had lost heftily through derivative products offered by financial institutions at a time when they had hedged their risks in the wake of the appreciation of the rupee.

Cases were launched against the banks, among these most notable one was Rajshree Sugar and Chemicals Ltd. Vs. Axis Bank Ltd. In a ruling that set the precedent for at least a dozen cases between companies that bought complex derivative products and banks that sold them, the Madras high court on Oct. 14, 2008 ruled in favor of Axis Bank Ltd.

The high court held that the derivative contract is not a wagering contract, meaning it was not illegal and the bank is entitled to recover the money from the party. This ruling clearly throws out the claim of innocence on the part of the firms and expect them to be prepared to bear the consequences of their actions in derivative contracts.

In an advertisement on the April 28, 2008, by Apex Chamber of Commerce & Industry (Punjab) in a leading national business daily seeking intervention of the finance minister and the Reserve Bank Governor in order to 'save SME/business from currency derivatives.' The advertisement alleged that some private sector banks created special currency derivative products which were then sold to the firms to hedge against the currency fluctuations.

Exporters in various parts of the country be it in Panjab or in Tamilnadu devastated by these contracts and the original estimate of the loss on derivatives -- Rs. 20,000 crore (Rs 200 billion) -for India as a whole during the period, does not seem to be too conservative.

According a report published by Tahelka on March 19, 2012 this whole issue characterizes the features of a scam which could turn out to be a bigger scam than 2G in which nineteen banks who violated the RBI and FEMA guidelines to sell forex derivatives to exporters in year 2000, caused a monstrous loss of Rs. 25 lakh crores.

This incomprehensive background gives the gist of potential threat arising due to the unmindful use of financial derivatives which increases manifolds in the case of SMEs due to their financial size and intellectual competence.

SO, ARE DERIVATIVE PRODUCTS SO DANGEROUS?

In one of his famous addresses, legendry investor Mr. Warren Buffet compares derivative products with weapons of mass destruction, which indeed proved to be true when the world financial structure bend to its knees due to USA's mortgage loan crisis, ripples of which were felt throughout the world, a direct result of reckless and greedy use of derivative products in unbridled speculation as against of risk mitigation, which is what the basic purpose of derivative products intended for.

On the other side, use and proliferation of derivative products cannot be separated from the international financial net. According to the estimates forex derivative contracts to the tune of $3 trillion were traded in India as on December 2007 whereas the total foreign exposure of India was not more than $500 billion annually. Companies across sectors entered into derivative agreements with nationalized and private banks to safeguard their foreign exchange risks.

So, it is quite clear from the above statements that derivatives are indeed one of the potent in the hand of a hedger which well turn out to be dangerous if not handled with care. In this way it could be very well compared with the fire which is used to cook food, but if handled improperly can harm its user to the extreme.

SO, WHAT THESE DERIVATIVE PRODUCTS ARE

In simple terms, derivatives (in finance) are financial products which derive their value from some other underline assets. These instruments derive their value from the price and other related variables of the underlying asset. They do not have worth of their own and derive their value from the claim they give to their owners to own some other financial assets or security. One of the simplest example of derivative product is Sensex, which derive its value from underlying 30 scripts.

The asset underlying a derivative may be commodity or a financial asset. Derivatives are those financial instruments that derive their value from the other assets. For example, the price of any commodity to be delivered after two months will depend, among so many things, on the present and expected price of this commodity.

According to IAS 39, "a derivative is a financial instrument : (i) whose value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates , a credit rating or credit index, or similar variable; (ii) that requires no initial net investment or little initial net investment relative to other types of contracts that have a similar response to changes in market conditions; and (iii) that is settled at a future date.

According to section 45U of RBI Amendment Act 2006, "Derivative means an instrument, to be settled at a future date whose value is derive from changes in interest rate, foreign exchange rate, credit rating or credit index,, price of securities(also called 'underlying'), or a combination of more than one of them and includes interest rate swaps, forward rate agreements, foreign currency swaps, foreign currency rupee swaps, foreign currency options, foreign currency rupee options or such other instruments as may be specified by the bank from time to time."

NEED FOR SMEs TO BE MORE CAUTIOUS WHILE DEALING IN THE DERIVATIVE PRODUCTS

While throughout the world, derivative products are extensively being used and despite several hiccups in the past due to their reckless use, these products are here to stay as an important tool for hedging, speculation, price discovery and market efficiency.

It is empirically provable as to what extent reckless use of these products, clubbed with human greed, could trouble not just the individual investors and business firms but to the national economy itself considering the case of USA's mortgage crisis and European sovereign default crisis in the past, its very nature requires to be more cautious if being used by small players in the market. Here are three main factors why SMEs needs to exercise greater restrains in their use as compared to their bigger counterparts-

1. ***Economic Size:*** Size does matters in the finance. Finance or money being the prominent resource to allow the firm for its perpetual functioning, is almost always act as a bottleneck for SMEs where studies after studies have marked it as perhaps biggest hurdle in the growth of these firms, where SMEs find themselves struggling more to acquire money from the market than the bigger firms, where banks and government itself open purse for the bigger firms. Consider how USA bailed out its multinationals during the crisis, case of Kingfisher Airlines in India and the ratio of bad loans across sectors, which is much lower in the case of SMEs in India.

This small economic size (medium enterprises are defined in the case of manufacturing and service sector is up to Rs. 5 crore and 2 crore respectively in total capital investment) makes them very vulnerable to even small tremors on financial front, while bigger firms having more resources at their disposal are capable to swim over any minor financial stress easily.

2. ***Availability of Intellectual Capital:*** This point is also directly related with the first one. Bigger firms having more financial muscles, have greater access to the financially trained manpower and specialized departments to handle their financial decisions, while in majority of SME firms, like all other decisions, quality of financial decisions also solely depend on the competence of entrepreneur's itself and in the case of complex decisions like the purchase of forex derivatives, they rely heavily on their banks, unable to comprehend and judge the nitty-gritties of various issues involved in underline decision and ones decision is taken, they are bound to bear its consequences.
3. ***Need for Financial Derivatives:*** While the simple plain vanilla products like options and forward contracts are widely used widely used without even bothering about the complex jargons associated with them, complex forex derivatives are mainly needed to hedge the currency risks of importers and exporters. If the underlying contract is big enough, fluctuations in currency market may heavily dent the bottom line of the firm.

SMEs by using their traditionally tested methods like taking orders only in rupee terms, might not be bothered about the fluctuations, though this rout is not feasible always as in the case of bigger orders given the international trade is heavily dependent on US dollar.

What is intended here is that majority of SME exporters might not feel to use these products at all, had they not opted for aggressive export expansion until and unless someone make them realize to use these products, like their banks.

PRECAUTIONS NEEDS TO BE TAKEN

As SMEs have already burned their fingers with derivatives in the past and thus ought to be more cautious in the dealing with these, there are several precautions which needs to be exercised by these firms to prevent getting embroiled in the menace again.

1. Take orders only in rupee terms: This option is suitable only for the SMEs entering into exports with limited amount of exports order which successfully shields them from any negative fluctuation in currency market.
2. If you don't understand-don't touch: Follow the traditional wisdom-not to play with unknown water. It may very well turn out to be risky.
3. If you have not thought about it, probably you don't need it.
4. Take the help of an independent qualified consultant-Do not solely and blindly dependent on the advice and persuasion of your bank.
5. Enhance own competence –know what you are doing: It calls about regularly updating oneself about the happenings in financial world within one's own country and beyond as demanded by the cut throat completion.
6. Decide the issue in group manner: This may overcome the many structural limitations like size and intellectual capital, if the issues are properly discussed in the professional bodies of SME exporters themselves.

CONCLUSION

It is quite ironic that the derivative products, which were primarily devised as a potent risk mitigation tool have turn out to be a risk in themselves. Despite this contradiction, the lure of these products and uncertainty in the market might compel the firms to use these products and decision to use these products need a careful consideration. Prevention is always better than the cure, so the decision of using them needs to be sufficed by the risk bearing capacity of the entrepreneur which is different and unique for every individual and perhaps the best suggestion about the risk bearing capacity could be-take only that amount of risk which doesn't affect one's leisure sleep.

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