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CURRENCY FUTURES: AN INNOVATION IN CAPITAL MARKET

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ABSTRACT

Over time, the foreign exchange market in India achieved some sophistication and vibrancy. However, the volatility in exchange rates remained an issue. With global trade and business increasing exponentially, Indian companies had to find ways of hedging currency risk. The only instruments available were forward, swap and option contracts but all were customized and OTC. However, when the sub-prime crisis hit the US, Europe and other major economies of the world, the exchange rates went away. Indian companies were unable to realize the full value of their business dealing abroad. Worse still, the forward contracts they had entered into for hedging their currency risks themselves turned into risks. To cover the risk involved in currency exchange, the RBI and SEBI jointly formed a committee which recommended starting currency future trading in India, consequently NSE started in dealing currency futures from August, 2008.

KEY WORDS

Over the Counter, Chicago Board of Trade, U.S Dollar, Indian Rupee, Future Currency, Security and Exchange Board of India, Reserve Bank of India

INTRODUCTION

Each country has its own currency through which both national and international transactions are performed. All the international business transactions involve exchange of one currency for another. The currency units of one country are exchanged with the currency of another country. The price of one currency in terms of another currency is known as Exchange-rate. The foreign exchange market of a country provides the mechanism of exchanging different currencies with one another and thus, facilitating transfer of purchasing power from one currency to another. With the multiple growth of international trade and finance all over the world, trading in foreign currency has grown tremendously over the past several decades. Since the exchange rates are continuously changing, so the firms are exposed to the risk of exchange rate movements.

A Currency Future Contract provides a simultaneous right and obligation to buy and sell a particular currency at a specified future date, at a specified price and a standard quantity. The foreign currency futures were started for the first time in the year **1972** at the **International Money Market – a division of Chicago Mercantile Exchange of Chicago.** The major currencies which at this exchange launched were British Pound, Canadian Dollar, Deutsche Marks, French Franc, Japanese Yen, Swiss Franc and Australian Dollars. Currency Future contract are similar to other future contracts like that of commodities, interest rates and metals etc. In the other words, in currency future market, the different currencies are sold and purchased at the specified future date, at predetermined price and at a specified quantity on a particular recognized exchange.

REVIEW OF LITERATURE

So far researchers have carried out a little work on the prospectus and problems of currency future in India, but the suggestions based on the material published so far are mentioned hereunder:

V D M V Lakshmi (2008) have quoted the decision taken by RBI to allow exchange traded currency future in India as a gift to traders and investors as well since it is a standardize and transparent instrument to hedge their exposure to the currency risk. He also described how the currency future can be used by market participant to cover the risk due to fluctuation in exchange rates in currency market besides the legal framework and sanction approval procedure from authorized agencies.

Nirvikar Singh (2008) stated that off-shore non-deliverable forward markets have existed in India and Reserve Bank of India also oversees domestic currency forward trading but exchange traded currency future were simply banned. However, in June 2007, trading of rupee future started on Dubai Gold and Commodities Exchange prompting the RBI to set up a Committee to look into this possibility for India. The paper described that during 2007 rupee future trading on DGEX and despite the fact that it was not controlled by the RBI, so there were no restriction on trading and participation beyond those that would be normal for an exchange and it clearly seemed that the new market was being used for short-term hedging, probably by parties engaged in international trade. He concluded with stated the RBI role should be of macroeconomic management not microeconomic details if India is serious about financial sector development.

S. B. Kamashetty (2008) threw a light on trading mechanism of currency future with the average daily traded volume in the global forex market and in India as well. He also mentioned the guidelines for the currency future trading with its flip slide and shortcomings. The author also suggested to grant the permission in dealing with three-four major currencies besides USD, in which India has strong underlying traded.

Krishnan Sitaraman and Satish Prabhu (2010) descried the currency future with mitigating exchange Rate risk with illustrative support. They have also showed the progress, operational aspect and new developments of currency future in India. The paper also suggested introducing the currency option in the market.

Padmalatha Suresh (2010) has admitted that currency future helped the undernourished Indian financial markets in a big way and described how exchange traded futures are the answer to preventing systematic risks in the future. He also thanked to the RBI decision to extend the currency futures market to include three more currency pairs as earlier stated financial advisors were saying and appears that currency options, as natural extension at the currency future market, are also on the anvil. He also reviewed the performance of currency futures in December, 2009 since the inception of trading, and presents some interesting insights i.e. both OTC markets (INR and other currencies) and currency futures (only INR/USD) traded on NSE and MCX showed a remarkable increase in the turnover of derivatives as a percentage of OTC forward turnover. The paper also quoted some reasons for inefficient and illiquid market in India such as inadequacy of financial firms, Regulators and structured barriers, Frictions caused by taxes and suggested that currency futures are not an end in themselves but more positive actions from the regulators and government are expected to nourish the market without being overprotective.

OBJECTIVES OF THE STUDY

No study can be undertaken without specified objectives. Same is true with this paper which is focused on the following objectives:

- To examine the need of Currency Future Derivative in India
- To analyze the importance of Currency Derivatives market in India
- To present the problems of Currency Future pattern in India
- To study the impediment for the development of Currency Future Trading in India

- To suggest the measure for the development of Currency Future Trading in India

NEED OF CURRENCY FUTURE

Foreign currency is needed to import the goods & services as well as for investment in foreign countries. Conversely, we receive foreign currency from export of goods and services and through foreign investment. After collapsing the Bretton Wood Agreement during 1971, the prices of a currency at foreign exchange rate is determined by demand-supply phenomenon. An investor or trader needed foreign currency to explore their business but depreciation or appreciation in rupee against foreign currency may arise risk. Moreover, interest risk and credit risk also raise the problems in foreign trade. Earlier, businessman usually tried to cover this risk by entering a forward contract to sell/buy a foreign currency (dollor) at a future date on predetermined rate of exchange. But these contracts were customized in nature and assumed to be risky due to non- transparency and non availability of clearing houses. So, there was a great need to remove all these problems, consequently RBI and SEBI had taken an initiative to start foreign currency future in India during 2008 to make these contracts standardize.

CURRENCY FUTURE: A HEDGING TOOL

During last two year Indian rupees has depreciated many times leads to high volatility, made the foreign business more risky. To cover this risk, a businessman may undertake a future contract from specified exchanges. Under this contract an investor or businessmen have to buy required currency futures contracts and "locks in" a price for the purchase of foreign currency i.e. Dollar, Pound, Yen or Euro and there by hedge (cover) the risk that may arise due to fluctuations in exchange rates. As there are clearing houses, which guarantee the performance of the contracts, there is no question of counter party risk. More over, both buyer and seller have to deposit margin money with the concerned exchange that makes transparency in dealing as well. Therefore, a trader can avoid exchange fluctuations risk by using currency futures.

CURRENCY FUTURE IN INDIA

In India the Forex future currency trade can be carried out through recognized stock markets – **Bombay Stock Exchange, National Stock Exchange** and **Multi Commodity Exchange. National Stock Exchange** has started Forex future currency trading from August 29, 2008. NSE is the first exchange in India to have obtained an in principle approval from Security and Exchange Board of India to set up currency derivatives segment. BSE is the third exchange in India to have obtained an in principle approval from Security and Exchange Board of India after NSE and MCX. In brief the history of

Trading in Currency Future contracts in India can be traced back to the year 2008 when various stock exchanges started trading in currency futures on the following dates:

- **National Stock Exchange** starts its trading in August 29, 2008
- **Bombay Stock Exchange** starts its trading in October 1, 2008
- **Multi Commodity Exchange** starts its trading in October 7, 2008

(MCX got the approval from SEBI before BSE but it could start trading in Currency future after BSE) This shows that trading in currency futures in India is not very old rather it is at the stage of infancy.

PATTERN OF CURRENCY FUTURE TRADING IN INDIA

NSE is the first exchange in India which get the first permission in trading of currency future after BSE and MCX get the permission.

NSE: All the trades done at NSE are cleared settled and risk managed by National Security Clearing Corporation. NSCCL is set up as a separate and independent entity. Below is currency future at NSE:

Date	Instruments	Underlying	Expiry Date	MTM settlement price
20-02-09	FUTCUR	USDINR	25-02-09	497875000
20-02-09	FUTCUR	USDINR	27-03-09	498825000
20-02-09	FUTCUR	USDINR	28-04-09	499700000
20-02-09	FUTCUR	USDINR	27-05-09	500725000
20-02-09	FUTCUR	USDINR	26-06-09	500400000
20-02-09	FUTCUR	USDINR	29-07-09	503000000
20-02-09	FUTCUR	USDINR	27-08-09	504000000
20-02-09	FUTCUR	USDINR	28-09-09	502525000
20-02-09	FUTCUR	USDINR	28-10-09	503300000
20-02-09	FUTCUR	USDINR	26-11-09	503950000
20-02-09	FUTCUR	USDINR	29-12-09	504700000
20-02-09	FUTCUR	USDINR	27-01-2010	505350000

BSE: BSE is the third exchange in India to have received the regulatory permission to launch exchange traded currency future. **BSE CDX (C**urrency Derivatives exchange) would soon commence trading in INR currency future. The timing of BSE **CDX** is Monday to Friday between 9.00 A.M to 5.00 P.M.

MCX: MCX said in an invitation that it will launch exchange-traded rupee futures on Oct. 6. The currency futures trading will be through MCX Stock Exchange, the new company that MCX has recently floated. Presently all future contracts on MCX-SX are cash settled. There will be no physical contracts. All trade on MCX-SX takes place on its nationwide electronic trading platform that can be accessed from dedicated terminals at locations of the members of the exchange. All participants on the MCX-SX trading platform have to participate only through trading members of the Exchange. Participants have to open a trading account and deposit stipulated cash/collaterals with the trading member. MCX-SX stands in as the counterparty for each transaction; so participants need not worry about default. In the event of a default, MCX-SX will step in and fulfills the obligations of the defaulting party, and then proceed to recover dues and penalties from them. Those who entered either by buying (long) or selling (short) a futures contract can close their contract obligations through squaring-off their positions at any time during the life of that contract by taking opposite position in the same contract. A long (buy) position holder has to short (sell) the contract to square off his/her position or vice versa. The participants will be relieved of their contract obligations to the extent they square off their positions. All contracts that remain open at expiry are settled in Indian rupees in cash at the reference rate specified by RBI.

PROBLEMS OF CURRENCY FUTURE IN INDIA

The main problems of Currency Future in India are as below:

1. **No permission to FIIs and NRIs in Currency Future Trading:** At present the foreign institutional investors and non-resident Indians are not allowed to take part in this trading. As result of non-presence of these entities, the volume in Currency Future market is very thin.
2. **Compulsory to follow the guidelines those are provide by RBI and SEBI such as:**
   - The maximum size of the contract is $ 1,000 and tick size is 0.25 paise
   - The contract shall be quoted and settled in Indian rupee and no underlying assets is required to trade in this instrument
   - The trading period will range from one month to 12 months
3. **Security Transaction Tax will be levied:** The problem of currency future trading in India is that the exchanges are not levying any exchange transaction fees. Therefore the brokers are required to pay only brokerage charges which is 0.05 percent on carry forward traders and 0.025 percent on inter-day traders.
4. **Eligibility for Banks to becomes a Clearing and/or a trading member:** If banks can fulfill the following eligibility conditions only than they can become the trading member otherwise not:
   - The bank should have minimum net worth of 500 crores
   - Capital Adequacy ratio of 10 percent
   - NPA should be less than 3 percent
   - They must have a profit record of 3 years
5. **Standardization:** It is not possible to obtain perfect hedge in terms of amount and timing as comparison of over the counter market.
6. **Others:**
   - The exchanges are required to establish a separate segment within exchange for trading in currency future and should have at least 50 members
   - Membership of the currency future should be separated from the membership of other segment of the exchange.

FUTURE OF CURRENCY FUTURE

Currency Future in most of the country is way below the over the counter market of the currency which is supposed to be the biggest market in the world. It has been anticipated that the future market in currency will be helpful for the retail, small & medium enterprise, who has generally less exposure compared to the industry, which generally hedge there position by taking position forward at the OTC market. Although according to some of the experts the most important policy issue in the present situation is to start an INR cash settlement future and option market, where citizens and firms can do their own currency trading and thus obtain private solution to their own risk management problem. Other broker view as a speculation medium because the liquidity in this market seems to be very less compared to the OTC market. Investors could bet on the future of dollar and take his position according to their expectations following the near months. A large number of exchanges, banks, dealers, exchange broker and speculators are all getting ready to join it. But also get ready for some fun and games. In fact India is getting into the game at right time. World over exchanges traded currency derivatives are slowly eating into the traditional foreign exchange trading platform, especially the spot and OTC market.

RECENT DEVELOPMENT

In June, 2007, Dubai Gold and commodities Exchange (DGCX) introduced the first exchange traded Indian rupee currency futures contract which awakened the RBI to consider the possibilities at the same in India. Consequently, on Feb 28 2008 a standing technical committee have been formed by RBI and SEBI to lay down the framework for the launch of exchange traded currency futures ultimately on Aug 29 2008 the NSE have been granted permission to introduce currency future till Jan, 2010 the contracts based on USD/INR were permitted only but on Jan, 19 2010 the RBI and SEBI allowed the Euro, Pound and Yen with rupee for trading contract. From an average daily turnover of Rs 200 Crore during its initial months of trade, the currency derivatives segment of both the NSE and MCX are now generating an average daily turnover of Rs 14000 Crores and Rs 14700 Crore respectively. Moreover, the RBI –SEBI standing Technical Committee an exchange traded currency future in India is deliberating on the various parameters for introducing currency option trading in currency future is expected to come within next two months.

SUGGESTIONS

The following prerequisites are certain to give a big boost to currency future trading in India such as:

- The market should be efficient with widespread awareness amongst various market players.
- It is most important that the contract size should be kept at such a level that it facilitates price discovery as well as trading, particularly for retail segment of market.
- While attracting liquidity through product innovation is a feature of the competitive market in the initial phase, a standardized product across various exchanges would invite greater participation and add to the liquidity of currency future markets.
- If FIIs have to be allowed in currency future trading, there should than be a cap on their open interest position in currency future. The positive aspects of the entry of these securities will be that they will bring in huge volumes and liquidity into the market.
- The contract should be settled on the last working day of the following month and settlement price should be the RBI reference rate on the last trading day. The exchange rate should be determined by the market forces, there should be a substantial intervention by the RBI.

- There can be two types of members in this trading such as- Hedger and Speculators. The responsibility of fixing of margin for these categories may be left to the exchange.
- Having a dedicated exchange for currency future may be preferred approach since it would ensure a clean regulatory and supervisory structure.

CONCLUSION

The origin of currency futures can be traced back to 1851 when the CBOT introduced standardized forward contracts. The main advantages of currency future over its closest substitute product viz. forward which is traded OTC lie in price transparency, elimination of counter party credit risk and wider reach through easy accessibility. The futures are also disadvantageous when these are compared with OTC market such as, inability to obtain a perfect hedge, margin requirement that derive up the cost. The high volatility in the value of Indian rupee could have forced the government to introduce the currency future. The introduction of this new instrument is a first step towards creating a full fledged foreign exchange derivatives market in India and would take the country closer to full capital account convertibility. As of now currency futures are permitted in Euro, Yen and Pound in addition to USD, the Indian currency future market will shape a new paradigm. Moreover, option trading in currency future is expected in near months. The participants should remember that it is not an investment avenue like stocks. So that investors should invest for hedging against their foreign investment.

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