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NEED/IMPORTANCE OF THE STUDY
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HYPOTHESIS (ES)
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A TREND OF CURRENCY DERIVATIVES WITH SPECIAL REFERENCE TO HDFC BANK AND BOB

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ABSTRACT

Risk is as old as culture. Risk is unique because it cannot be eradicated; but managed. Globalization has headed to the interdependency of nations, thus, rising exposure to exchange rate instability. The instability of exchange rate give way to currency risk in all transactions in a foreign currency. The most important way to handle the currency risk is the use of currency derivatives. This paper explains currency derivatives as instruments to mitigate the currency risk. The paper has been divided into five parts. The first part deals with basic introduction of Currency derivatives. The second part reviews some literature on currency derivatives. The third part deals with growth of currency derivatives in Global as well as Domestic level. The fourth part deals with use of Currency Derivatives in HDFC bank and Bank of Baroda. The fifth part is analysis of data of the use of currency derivatives. The final part is the conclusions on it.

KEYWORDS

currency derivatives, currency forwards, currency futures, currency options.

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G11

INTRODUCTION

With the development of currency derivatives, a participant with a foreign exchange exposure can find simple method to get information over rates and future market prospects for the currencies traded. Advantage of trading in the currency futures segment are massive - from accessibility to price lucidity and standardization, which in the case of over-the-counter trade is entirely unlike. As far as ease is concerned, currency derivatives offer an online electronic trading platform as opposed to the interbank forex market. In terms of price transparency, an online trading real-time price access to all market participants, while in the OTC market one has to rely upon the rates offered by the bank. In India, currency derivatives have come out as a popular tool to hedge currency risks. But it is shocking to see that only 10 percent of volumes actually come from the hedgers. The reason why hedgers are currently weighing the currency market is that in India, the traditional propensity is to extract rates from the OTC markets and the quotes by the banks are considered as final. But a major drawback in case of over-the-counter trade is that different rates are offered to the bank clients depending upon on their affiliation with the bank and the volume of business that a client offers to the bank. The system of the OTC market is not clear and makes it difficult for small and medium enterprises along with retail investors to make an entry and have a successful trade. It is now a lot easier for a small and medium enterprise to venture in the foreign exchange market with clarity and transparency.

MEANING OF CURRENCY DERIVATIVES

Currency derivatives are complex financial instruments which are traded over – the – counter and this is a collective term used for futures, forwards and swaps. Currency derivatives are used for hedging. This hedging involves a future payment or receive in a foreign currency.

TYPES OF CURRENCY DERIVATIVES

Currency forwards: A currency forward is an agreement between two parties where both the parties agreed to buy/sell an underlying asset at a predetermined price in future. This involves future payment or receivable an unknown foreign exchange rate.
Currency futures: A futures contract is a standardized contract, traded on an exchange, to buy or sell a certain underlying asset or an instrument at a certain date in the future, at a specified price. When the underlying is an exchange rate, the contract is termed a "currency futures contract".
Currency options: A currency option is a contract giving the option purchaser (the buyer) the right, but not the obligation, to buy or sell a fixed amount of foreign exchange at a fixed price per unit for a specified time period.
Currency swaps: A currency swap is an agreement between two parties to exchange cash flows in two different currencies. The swap consists of interest rate differentials between currencies.

LITERATURE REVIEW

Nair (2004) viewed that in most of the countries, where currency futures have really flourished, the trading takes place on multiple commodity exchanges, rather than stock exchanges. Besides, since foreign operators – NRIs, FIIs etc. – are barred from contributing, the new exchange means the contract can be dealt only within India and that too, without involving any outflow of funds.
Guru (2009) pointed out that the global markets (mainly USA) become active only after Indian markets close at 5.00 pm and as a result there is an obvious fear about the risks connected with overnight fluctuations in the currency pair. Once the Indian markets close, the positions cannot be upturned by the traders till the next day. The tax treatment of the gains/losses in the futures currency market would this be treated as business income as in the case of equity derivatives also not make it clear by the regulator?
Nath and Lingareddy (2008) revealed that with increased depth of Indian currency trading, which has reached to a daily volume of around Rs. 2000-3000 crore, in spite of small contract size and low daily limits for individuals and trading partners. Within a year of its beginning, MCX-SX has achieved amazing growth in average daily turnover and open interest. The average daily turnover increased from Rs. 355.66 crore during the first month of operations to Rs. 16,980 crore for the month of February 2010.
Schulmeister (2005) defined the mutually reinforcing connections between exchange rate dynamics and technical trading strategies. The study was based on the presentation of 1024 moving average and momentum models in the single most active foreign exchange market, the DM/$ market between 1973 and 1999. An

out-of-sample test of the performance of all 1024 models between 2000 and 2004 (euro/US dollar) was also the part of the study. The main results showed that technical trading systems were quite profitable during the floating rate period. It was also found that technical models bring to bear an excess demand pressure on currency markets. When these models produced trading signals, approximately all signals were on the same side of the market, either buying or selling. When technical models preserve open positions they were either long or short. Initial exchange rate movements triggered a trend. This "Multiplier effect" was reflected by the close relationship between technical trading signals and Order flows. Author concluded that order flows were not only driven by (fundamental) news but also by Technical trading, which reinforces exchange rate trends to which it responds.

Mihaljek& Packer (2010) revealed derivatives markets in emerging market economies (EMEs) on a comprehensive basis. The study was based on the objectives to study about the construction and dynamics of EME's, the difference between the growth of EME's and mature markets, to study the factors that give details of differences in the growth of derivatives markets across countries and time. The study combined data from the Triennial Central Bank Survey of OTC derivatives market activity with those on derivatives traded on emerging market exchanges and data on exchange-traded derivatives, accumulated by commercial providers and published on a regular basis in the BIS Quarterly Review, provide detailed information on standardized derivative contracts listed and traded on emerging market exchanges. Data was analyzed through regression and coefficient of correlation. It was found that First, daily turnover in derivatives markets in EMEs was prolonged four times over the past decade, to over 6% of emerging market GDP. Second, derivatives in emerging markets were traded in almost equal proportions over the counter and on exchanges. Third, unlike in advanced economies, FX derivatives were still the most traded derivatives in EMEs (50% of total turnover), while interest rate derivatives stay underdeveloped. Fourth, the FX derivatives turnover in emerging markets was becoming increasingly global, with a growing share of transactions being done cross-border, and transactions in emerging market currencies increasingly taking place offshore. Fifth, the largest derivatives markets in EMEs were located in Korea, Brazil and the two Asian financial centers of Hong Kong SAR and Singapore. And sixth, trade, financial activity and per capita GDP were positively related to the growth of derivatives markets in EMEs.

Rajkumar& Rani (2012) explored the tendency and growth pattern of currency futures market in India. Secondary data was compiled from the SEBI annual reports and analysis was made using percentage method. It was revealed that the turnover of exchange traded currency derivatives increased day by day since its introduction and in 2010-2011, it was more than OTC currency derivatives market turnover. USDINR futures contracts were found to be the most actively traded contract among all the exchange traded currency derivatives instruments.

Pandey (2012) stated that currency futures are the immense necessity for the developing economies to raise international space and efficient currency risk management system for the economy. Currency derivative provides better supportive and forecasting of actual and implied volatility numbers. It also helps in the price discovery in long run and make treasury operations viable for Indian banks, multinationals exporters and importers. Majority of the trade in currency futures is contributed by high net worth individuals and medium size entities. A further research in currency futures could be conducted by academicians related to accounting & reporting of currency derivatives in Indian context.

Choudhary (2012) explained that foreign exchange markets are the largest on the basis of traded turnovers and thus had a significant instability. The journey of Indian futures has to face some challenges of myths of traders about the market and of liquidity. USD-INR pair is the mostly traded currency futures pair in India. While facing these challenges currencies were still best performers amongst all the classes, presently in India as there is no counterparty risk in currency futures trading. It was also suggested that FIIs and NRIs must be allowed in currency future trading and also the trading hours must be extended.

OBJECTIVES OF THE STUDY

1. To know the growth of Currency Derivatives in global as well as in Domestic market.
2. To compare the trend of Currency Derivatives in HDFC bank and Bank of Baroda.

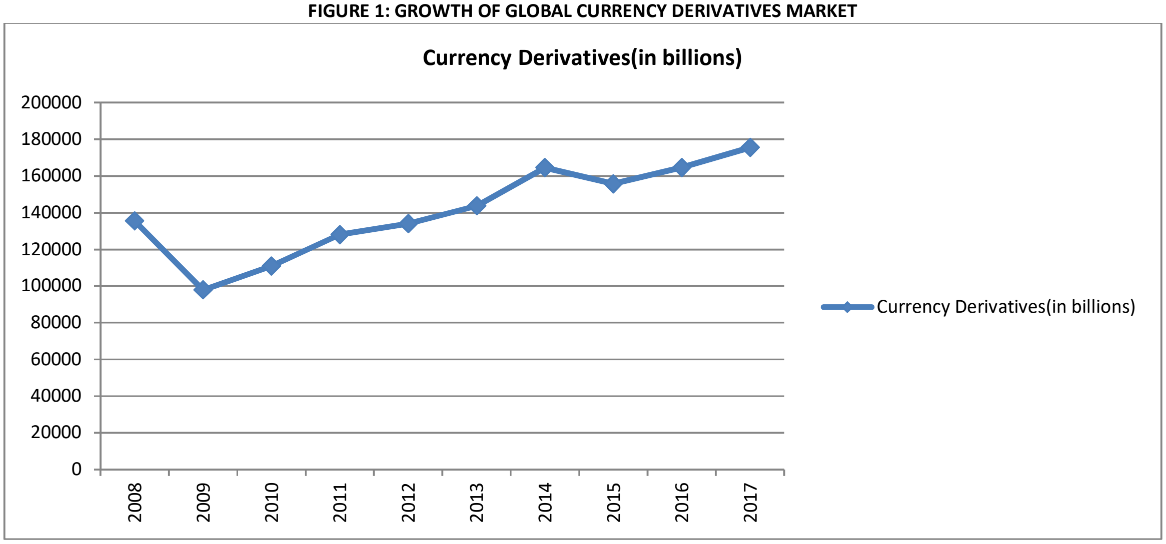
RESEARCH METHODOLOGY

The study is methodical in nature. In this paper attempts are done to find out the growth of Currency Derivatives in global as well as in Domestic market and trend of Currency Derivatives in HDFC bank and Bank of Baroda. The study is based on secondary data which has been collected from Indian Banking Association(IBA), Reserve Bank of India, Annual Reports of the banks and Capita-line Plus database. Data is collected for the financial year 2010-2017. Independent t-test has been used to assess the significance of results. SPSS 20 version was used for analysis.

ANALYSIS

DEVELOPMENT OF CURRENCY DERIVATIVES IN GLOBAL MARKET

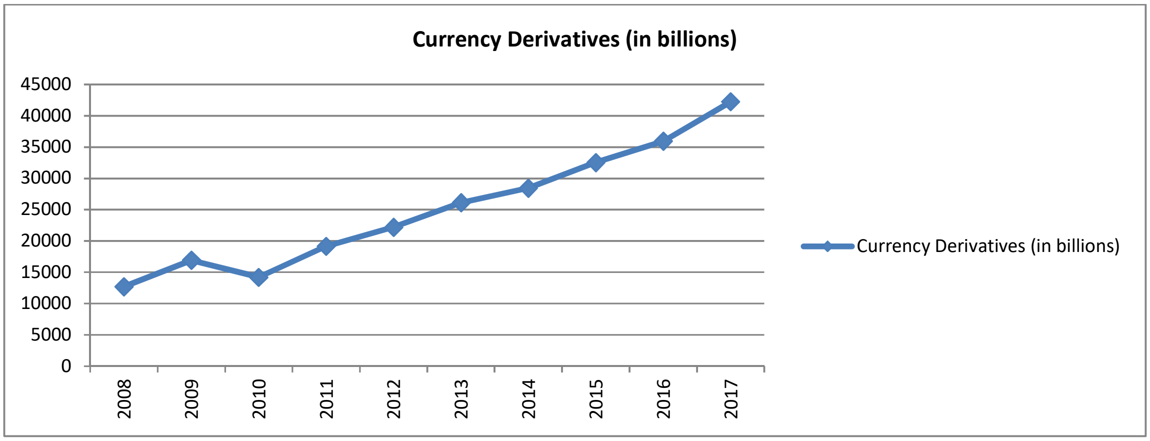
FIGURE 1: GROWTH OF GLOBAL CURRENCY DERIVATIVES MARKET



Source: Bank for International Settlement

The figure 1 shows the growth of Currency derivatives in global market. The figure shows Rs. 135453 billion in 2008 which decreased to Rs. 97913 billion in 2009. From the year 2010, the market of Currency Derivatives bounced back to its performance with Rs. 110921 billion and continued the hiked performance from 2011 till 2017 with the amount of Rs. 128047 billion in 2012, Rs. 1644572 billion in 2014 and Rs. 175546 billion in 2017.

FIGURE 2: GROWTH OF INDIAN CURRENCY DERIVATIVES MARKET



Source: Clearing Corporation of India Limited

The figure 2 reveals the growth of Currency Derivatives of in India. From the marginal performance of Rs 12727 billion in 2008 the hike continued till 2017 i.e. Rs. 16937 billion in 2009, Rs 22200 billion in 2012 and in the year 2017 the hike continued to be substantially a huge figure of Rs. 42226 billion.

TREND OF CURRENCY DERIVATIVES IN HDFC BANK AND BOB

The paper reviews the growth of Currency Derivatives in HDFC bank and BOB and also ascertains the factors which affect the use of Currency Derivatives. Study about the role of Currency Derivatives in risk management and its effect on the performance of the bank were analyzed. The study was also conducted on bank's foreign exchange rate risk management decision through Currency Derivatives.

VOLUME OF THE CURRENCY DERIVATIVES

The notional principal amount, defined as the amount of the assets used to analyze payments made on the Currency Derivatives instrument was taken into description to study the usage and pattern of Currency Derivatives. Tabular, graphical presentation and descriptive statistics method explains the use of Currency Derivatives over the period of study for both the banks. In order to study whether there exist any significant differences between the use of Currency Derivatives in HDFC bank and BOB, independent sample T-test was used.

FIGURE 3: VOLUME OF CURRENCY DERIVATIVES IN HDFC BANK AND BOB

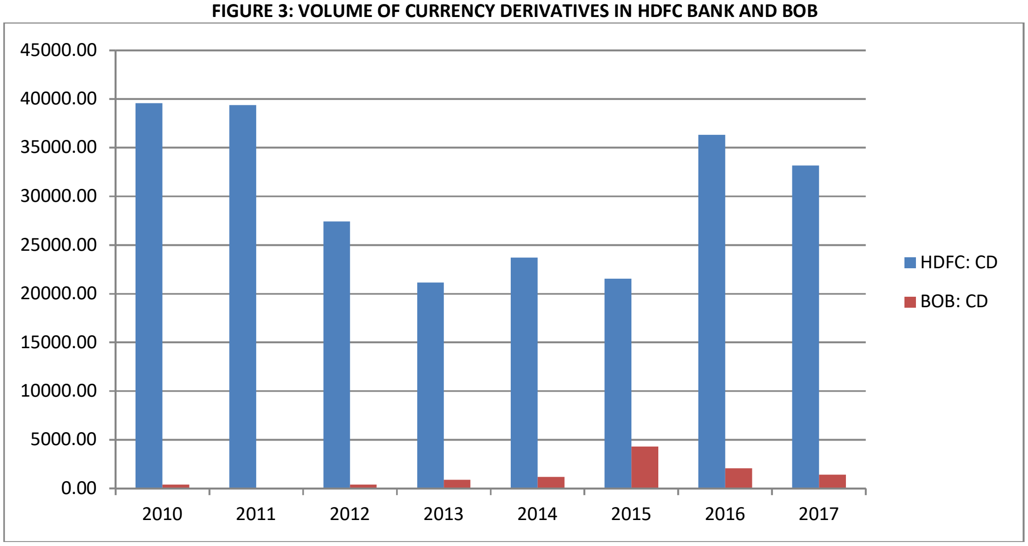


Figure 3 presents the volume and growth of Currency Derivatives of HDFC and BOB. In HDFC Bank, Currency Derivatives was amount to Rs 39559.63 Cr The hike was noticed in the year 2011 amounting to Rs. 39357.45 Cr. The up and down trend was shown from the year 2012 to 2015 i.e. Rs. 27405.51Cr, Rs. 21171.27 Cr., Rs. 23696.17 Cr and Rs. 21534.91Cr respectively. Again in 2016 and 2017the HDFC get bounced back in its performance i.e., Rs. 36309.52 Cr. and Rs33156.08 Cr. respectively.

In BOB, in the year 2010 the figure was Rs. 401.07 Cr. The year 2011 showed of about 93.14% decreased value in use of Currency Derivatives i.e. Rs. 53.32 Cr. From the year 2012 to 2017 the use of Currency Derivatives was found to be in growing movement of Rs. 422.78 Cr, Rs. 872.87 Cr, Rs. 1194.15 Cr. and Rs4304.80 Cr. Thereafter, there was a downward inclination established in the year 2016 and 2017 i.e. Rs. 2096.94 Cr. and Rs. 1393.94 Cr.

TABLE 1: DESCRIPTIVE STATISTICS FOR CURRENCY DERIVATIVES IN BOB AND HDFC BANKS

	HDFC	BOB
Mean	30273.82	1342.48
Std. Deviation	7784.54	1361.92
Coefficient of Variance	25.71	101.45
Skewness	.026	1.701
Kurtosis	-2.073	3.236

From the table 1, it is evident that average of the use of Currency Derivatives of HDFC is found to beRs.30273.82 Cr. which is more than Currency Derivatives mean value of BOB which is counted to be Rs. 1342.48 Cr. The Coefficient of Variance is observed to be higher in BOB as compared to HDFC which is counted to be 101.45 and 25.71 respectively. This clearly indicates that in BOB, the mean value is relatively lower but the use of Currency Derivatives is highly dispersed. As, the more scattered use was towards the right hand side of the mean, the asymmetric in the distribution of use of Currency Derivatives has found. It is depicted by positive skewness coefficients of.026 in HDFC and 1.701 in BOB. The data is positively skewed signifying that the average use of Currency Derivatives was lesser than the volume of Currency Derivatives for other years in HDFC Bank. In BOB also, the use of Currency Derivatives was positively skewed denotes that the average use was lesser than the most frequent volume of Currency Derivatives. The peakness of data in HDFC is below the normal as majority of years had shown lesser peakness in their use than normal curve as the data had platykurtic (k<3) nature of distribution pattern. The curve of BOB shows leptokurtic as the curve is more peaked than the normal curve.

The above descriptive statistics were additionally supported by a comparative analysis, where an effort was made to study if there exists any significant difference between the use of Currency Derivatives in HDFC bank and BOB. Independent sample t-test was used to clarify the usage and pattern of Currency Derivatives in HDFC bank and BOB. The hypothesis created were as follows:

Ho_1 : There is no significant difference between the use of Currency Derivatives in HDFC bank and BOB.

Ha_1 : There is significant difference between the use of Currency Derivatives in HDFC bank and BOB

TABLE 2: INDEPENDENT SAMPLE T-TEST FOR CURRENCY DERIVATIVES IN HDFC BANK AND BOB

	Levene's Test for Equality of Variances		t-test for Equality of Means		
	F	Sig.	T	df	Sig,(2-tailed)
Equal variances assumed	33.509	0.000	10.355	14	0.000
*5% level of significance					

Table 2 represents the independent sample t-test, the value of the two-tailed significance is less than 0.05, showing that there is a significant difference in HDFC bank and BOB about the use of Currency Derivatives. Equal variance though not assumed, t-test statistics was used for evaluating the null hypothesis of equality of means. The result from the analysis pointed out that there is a significant difference between HDFC bank and BOB on the use of Currency Derivatives. The test result gives the t value of 10.355 with 14 degree of freedom. The corresponding two tailed p value is.000, less than 0.05, therefore, the null hypothesis was rejected which means that the sample mean seems significantly different from the hypothesized value and the average of Currency Derivatives use in HDFC bank was not same as the average of Currency Derivatives use in BOB. At 0.01 significance level, also, the hypothesis was rejected as the p value is less than 0.01. This means that at 1% level of significance the average of the Currency Derivatives in two banks are not the same.

CONCLUSION

Financial system all over the world is going leading revolution. The recession that distinct the globe in 2008 accelerated the degree of currency and interest risk exposure to the firms and financial institutions. The firms and financial institutions that are more prone to interest rate and exchange rate instability needs special awareness of derivatives instruments in order to pick up from the owes of the global financial crisis. It should be noted that the post-recession period though being exposed to risk, has full opportunities that can be reaped using proper speculation strategies. Time calls for a change from defensive risk management strategies to offensive risk management strategies and go for risk mitigation through modern instruments like derivatives instruments.

SUGGESTIONS FOR THE STUDY

1. The study recommends that commercial banks should encourage the use currency derivatives because derivatives reduce the possibility of financial distress by lessening the inconsistency in firm value, thus reducing the expected costs of financial distress.
2. Based on the study, Banks should use these instruments sensibly so as to bring financial constancy in Indian economy. Because the risks involved in the banking industry cannot be seen in isolation, the management should follow an integrated approach while evaluating and managing these risks.
3. The bank should build a model of bank capital structure, and show that these patterns are consistent with optimal risk management under financial frictions.
4. The study demands that there is a need among the banks for proper determination of this foreign exchange exposure before they think of how much to hedge.
5. This study is helpful for the banks to evaluate their performance and to develop some other innovative techniques to measure and manage currency risk.

SUGGESTIONS FOR FURTHER STUDIES

1. This study is done at small level by selecting one sample banks from private sector and one sample banks from public sector, there is a opportunities in this research that it can be done at large level by selecting all the banks of private sectors and public sectors to get more specific results.
2. The research period of the study also can be expended to do further research.

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