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CURRENCY FUTURES TRADING IN INDIA

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ABSTRACT

Currency futures are new forex risk management insturment. It is one of the better tool to hedge the foreign risk for the companies who have an exposure to foreign exchange either because of export or import. As these days Indian export as well as import are booming with huge volume so it is risky for the companies to keep an huge open positions, which can result into huge losses so forex futures is a better hedging tool where one can book the profit even before the receivables has arrived. While the process for introduction of contracts in other currencies such as rupee-euro, or rupee-yen may soon be available, the government wants the product basket to be akin to the OTC markets. Indian financial sector regulators are set to launch currency options shortly. Introduction of options will be good development as it will lead to diversification. Futures with non-dollar currencies can minimize the risk also. The extension of working hours will also helpful in increasing the volume of currency futures trading. All residents Indians are allowed to participate in currency futures, but this is expected to change once the local market has reached a maturity level than NRIs and FIIs will also participate in currency futures in India. It is feasible to shift trading to other currencies to exchange platform as volumes have grown apparently. Greater trade and financial flows from Euro Zone and Japan can make standardized contracts possible.

KEYWORDS

Currency, Management, Foreign Exchange, Import, Export, Forex.

INTRODUCATION

The global liberalization and integration of financial markets has created new investment opportunities, which in turn require the development of new instruments that are more efficient to deal with the increased risks. Institutional investors who are actively engaged in industrial and emerging markets need to hedge their risks from these internal as well as cross-border transactions. Agents in liberalized market economics who are exposed to volatile commodity price and interest rate changes require appropriate hedging products to deal with them and the economic expansion in emerging economics demands that corporations find better ways to manage financial and commodity risks.

The most desired instruments that allow market participants to manage risk in the modern securities trading are known as derivatives. The main logic behind the derivatives trading is that derivatives reduce the risk by providing an additional channel to invest with lower trading cost and it facilitates the investors to extend their settlement through the future contracts. It provides extra liquidity in the stock market. Derivative products like futures and options on Indian stock markets have become important instruments of price discovery, portfolio diversification and risk hedging in recent times. The global liberalization has brought inherent risk, and as result, corporate and institutional investors are looking towards derivatives for hedging the risk. Due to the increasing volume of global trade the volume of capital flows is on rise and many more banks are getting exposure to different currencies and growing derivatives in foreign trade. The derivatives are immensely used by various banks to bring variations in the funds to improve the health of their portfolios. Futures trading, a popular financial instrument is the most important tool of derivatives through which the trading is done in the capital market.

ROLE OF FINANCIAL DERIVATIVES

Derivatives may be traded for a variety of reasons. Derivatives enable a trader to hedge some pre-existing risk by taking positions in derivatives markets that offset potential losses in the underlying or spot market. In India, most derivatives be used for hedging purposes only. Another motive for derivatives trading is speculation (i.e. taking positions to profit from anticipated price movements). In practice, it may be difficult to distinguish whether a particular trade was for hedging or speculation, and active markets require the participation of both hedgers and speculators.

It is argued that derivatives encourage speculation, which destabilizes the spot market. The alleged destabilization takes the form of higher stock market volatility. The reason behind it is informational effect of the futures trading. Futures trading can alter the available information for two reasons: first, futures trading attract additional traders in the market; second, as transaction costs in the futures market are lower than those in the spot market, new information may be transmitted to the futures market more quickly. Thus, future markets provide an additional route by which information can be transmitted to the spot markets and therefore, increased spot market volatility may simply be a consequence of the more frequent arrival and more rapid processing of information.

The volatility on the Indian stock exchanges may be thought of as having two components. The volatility arising due to information based price changes and volatility arising due to noise trading/speculative trading, i.e., destabilizing volatility. As a concept, volatility is simple and intuitive.

Introduction of derivatives in the Indian capital market was initiated by the Government following, L C Gupta Committee Report on Derivatives in December 1997. The report suggested the introduction of stock index futures in the first place to be followed by other products once the market matures. Following are the recommendations and pursuing the integration policy, futures on benchmark indices (Sensex and Nifty 50) were introduced in June 2000. The policy was followed by introduction of index options on indices in June 2001, followed by options on individual stocks in July 2001. Stock futures were introduced on individual stocks in November, 2001 (Nath 2003).

By definition, derivatives are the future contracts whose value depends upon the underlying assets. When derivatives are introduced in the stock market, the underlying asset may be anything as component of stock market like, stock prices or market indices, interest rates, etc. Derivatives products are specilized contracts which signify in agreement or an option to buy or sell the underlying asset to extend up to the maturity time in the future at a prearranged price.

Only futures and options are used in this analysis, so these are introduced in brief:

OPTIONS

An Option is a contract which gives the right, but not an obligation, to buy or sell the underlying asset at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer or an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him.

FUTURES

A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Presently Index futures on S&P CNX NIFTY and CNX IT, Futures are available for trading at NSE. All the futures contracts are settled in cash.. A futures contract is a forward contract which trades on an exchange. Futures markets feature a series of innovations in how trading is organized. Futures contracts are exchange-traded derivatives. The exchanges clearing house acts as counterparty on all contracts, set margin requirement and crucially provides a mechanism for settlement. There are three types of persons who deal in futures- **Speculators, hedgers and arbitrator**.

OBJECTIVE

The present study is focused on the following objectives:
1) To offering insight into currency futures derivatives market in India.
2) To study the future prospects of currency futures trading in India.
3) To do a critical analysis of currency futures.
4) To study the various instrument, i.e. options, futures and swaps.

RESEARCH METHODOLOGY

The present study is based on Descriptive Research with the help of secondary data. The secondary data is published reports of NSE, RBI, MCX-SX and Newspaper. The area under study is BSE-Sensex, Reserve Bank of India (RBI) and S&P Nifty.

CURRENCY FUTURES

A currency future is a future contract to exchange one currency for another at specified date in the future at a price on which a specific currency can be purchase or sold at future date. When the underlying is an exchange rate, the contract is termed a “currency futures contract”. In other words, it is a contract to exchange one currency for another currency at a specified rate and at a specified time in the future. Therefore, the buyer and the seller lock themselves into an exchange rate for a specific value and exceed 12 months. Most of the contract has physical delivery, so for those held at the last day, actual payments are made in each currency.

PRICING

The pricing of a currency futures contract is completely determined by the prevailing spot rate and interest rates. Otherwise, investors would be able to arbitrage the difference between the futures and spot prices. The futures price is given by:
where:
F = futures price
S = spot price
rT = interest rate of the term currency
rB = interest rate of the base currency
T = tenor
Users of Currency Futures
Currency Future is a derivative instrument that can be used by hedgers, speculators, and arbitrageurs.
A Hedger uses the instrument to reduce risk by locking on to a future exchange rate and mitigate the risks due to adverse movements of the exchange rate. This can also reduce his profits. For example, Jenson is a investor in America. Who will receive £1,50,000 on January 1. The current exchange rate implied by the futures is $1.7/£. He can lock in this exchange rate by selling € 1,50,000 worth of future contract expiring on January 1. That why, he is guaranteed an exchange rate of $ 1.2/€ regardless of exchange rate fluctuations in the meantime.
A Speculator the instrument to take a risk by betting on a position based on his view on the future exchange rate between two currencies. In other words Currency futures can also be used to speculate and, by incurring a risk, attempt to profit from rising or falling exchange rates.
An Arbitrageur takes arbitrage as the strategy of taking advantage of difference in price of the same or similar product between two or more markets. That is, arbitrage is striking a combination of matching deals that capitalize upon the imbalance, the profit being the difference between the market prices. If the same or similar product is traded in say two different markets, any entity which has access to both the markets will be able to identify price differentials, if any. If in one of the markets the product is trading at higher price, then the entity shall buy the product in the cheaper market and sell in the costlier market and thus benefit from the price differential without any additional risk.

HISTORY

Currency futures are being increasingly used as hedging tool. Currency futures were first started in 1972 at the Chicago Mercantile Exchange (CME), less than a year after the system of fixed exchange rates was abandoned along with the gold standard. International Monetary Market (IMM). It was launched for trading in seven currency futures on May 16, 1972. Today the IMM is a division of CME.

CURRENCY FUTURES IN INDIA

Currency futures were launched only a year ago in 2008 with NSE starting trade towards end of August and Bombay Stock Exchange and the MCX-SX following closely in October. It has been observed that average turnover of these instrument in the NSE and MCX-SX in December was nine times higher than a year earlier. These exchanges are currently clocking an average daily turnover of Rs. 20,000 crore in currency products while it was just Rs. 2400 crore in January this year. The turnover in NSE and MCX-SX has increased tremendously but the turnover on BSE has been negligible in the second half of 2009 and the exchange has announced plans to shift its currency future platform to the new exchange. The participation of investors and traders has been increasing sharply due to volatility in dollars between Rs. 49 and Rs. 46 over the last few months. Reserve Bank of India has proposed for permitting the three recognized stock exchanges to trade currency futures.
Markets regulator SEBI has said that the exchange-traded currency futures market is more efficient than the over-the-counter (OTC) interbank. The bid-ask spread gives an indication of the cost and ease with which a contract can be traded, essentially a proxy for a market’s liquidity. In a recent research paper, Gurnain Kaur Pasricha, a senior analyst at bank of Canada said Brazil is the only country in the world, prior to India, where the currency futures market has become more liquid than the forward market.
“Once the exchange (traded market) becomes liquid, the network externality of market liquidity sucks in further order flow and preserves the domination of the exchange, even after these rules (helping the segment) are removed,” she concluded in the paper. The SEBI study also says the share of merchant (corporate) transactions in the OTC market has fallen from 63% in November 2008 to 30% in November 2008. This could mean that as a hedging tool, merchants are probably moving to the futures market, the memorandum said. U. Venkatraman, Executive Director, MCX Stock Exchange attributes this to banks offering the product to customers encouraging participation from exporters, importers and other small and medium enterprises.

The government is looking to deepen the currency futures market by allowing trading in more currencies including the Euro and Yen and on the exchanges, giving companies more options to hedge their exchange rate risks.
This will also help currency futures market move away from the opaque over-the-counter market (OTC) to more transparent and efficient exchange-traded platform. It would also bring down the cost of exchange rate hedging for companies.
Currently only Rupee-Dollar contracts are traded on the exchanges. Though, RBI has consented to introduction of INR-Euro contracts on exchanges, there is some resistance towards introducing Euro-Dollar and other such contracts, a move that would broaden the currency futures market in the country.
"The opinion in favour of exchange-traded products has strengthened after the financial crisis and it is viewed as more transparent and efficient." Moreover, exchange traded currency products has reduced the costs substantially.

CURRENCY FUTURES PROSPECTS

Currency futures are new forex risk management insturment. It is one of the better tool to hedge the foreign risk for the companies who have an exposure to foreign exchange either because of export or import. As these days Indian export as well as import are booming with huge volume so it is risky for the companies to keep an huge open positions, which can result into huge losses so forex futures is a better hedging tool where one can book the profit even before the receivables has arrived.
Prime Minister Manmohan Singh had in his speech at the India Economic Summit said: "We need to improve futures markets for better price discovery and regulation."
While the process for introduction of contracts in other currencies such as rupee-euro, or rupee-yen may soon be available, the government wants the product basket to be akin to the OTC markets.
Indian financial sector regulators are set to launch currency options shortly. Introduction of options will be good development as it will lead to diversification. Futures with non-dollar currencies can minimize the risk also. The extension of working hours will also helpful in increasing the volume of currency futures trading. All residents Indians are allowed to participate in currency futures, but this is expected to change once the local market has reached a maturity level than NRIs and FIIs will also participate in currency futures in India.
It is feasible to shift trading to other currencies to exchange platform as volumes have grown apparently. Greater trade and financial flows from Euro Zone and Japan can make standardized contracts possible.
A move is also a foot to clean up the regulation for all exchange trade derivative products by bringing them all under one regulator. Inter-ministerial consultations have already been initiated in this regard.

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