

Recent Trends in Indian Capital Market - Currency Futures

*Ravi Akula

**M. Anuradha Reddy

CURRENCY FUTURES: WHAT THEY ARE REALLY?

Risk is the inherent component involved in all the financial activities. Everybody tries to reduce the risk as to the extent of possible. With a view to enable entities to manage volatility in the currency market, RBI on April 20, 2007 issued comprehensive guidelines on the usage of foreign currency forwards, swaps and options in the OTC market. At the same time, RBI also set up an Internal Working Group to explore the advantages of introducing currency futures.

The report of the Internal Working Group of RBI submitted in April 2008, recommended the introduction of exchange traded currency futures. Earlier, there were some instruments like forward contracts which were not traded through the stock exchanges. To overcome that problem, futures and options had also been introduced in our capital market. They have not provided the hedging facility with regard to foreign currencies. Now it is the time for innovative instruments which facilitates the players with attractive benefits. The currency futures are the contracts to buy or sell one currency with another currency at a specified price and date in the future. In simple terms "*Currency futures are contracts to buy or sell one currency (only dollar-rupee as of now) against another at a specified price and date in the future*". The National Stock Exchange has already started currency futures trading from August 29. The Bombay Stock and the Multi-Commodity Exchange are yet to get clearance from SEBI to start operations. In a nutshell, Currency futures are standardized foreign exchange contracts traded on a recognized stock exchange to buy or sell one currency against another on a specified future date, at a price specified on the purchase or sale date.

Any financial product innovation or introduction has a lot of fanfare attached to it. Even the recently-introduced currency futures had similar pre-launch blitz attached to it, and heavy marketing by all the exchanges which have received in-principal approvals from SEBI, for its launch. The introduction of the currency futures is a significant event in the Indian financial history. The Indian capital market is emerging as an attractive destination for all the investors across the globe. After 1991, particularly in the era of new industrial policy, the Foreign Institutional Investors were allowed into Indian capital market. The risk management tools like forwards, futures, options and swaps are already available. The currency futures will provide opportunities to hedge the foreign currency exposure. Mainly transactions related to foreign trade will be eased. Due to the dynamics of globalization, dramatic fluctuations are taking place in the foreign exchange markets. Currency exchange values are moving ups and downs. Currency futures can be used as the risk management instruments.

OBJECTIVES OF THE STUDY

The main objective of the study is to familiarize with the concept of currency futures.

The other objectives are:

- To understand the contract specifications with respect to currency futures.
- To examine the daily turnover in the currency futures segment in NSE.
- To list out the problems in the currency futures segment.
- To suggest some of the measures to overcome the problems in the area of currency futures segment.

DATA SOURCES

The data has been collected from various secondary sources like newspapers, magazines, research journals, RBI reports, SEBI Bulletin and stock exchange publications. Discussions were held with some of the retail investors to know their response with regard to currency futures.

LITERATURE REVIEW

Edwards (1988) tried to examine the fact that that stock index futures trading has destabilized the spot market in the long run. Using variance ratio F tests from June 1973 to May 1987, Edwards concluded that the introduction of futures trading has not induced a change in the volatility in the long run. He observes that there is some evidence of futures induced short run volatility, particularly on futures contract expiration days, but this volatility does not appear to carry over to longer periods of time.

Harris (1989) examined volatility after introduction of index futures by comparing daily return volatilities during the pre-futures (1975-82) and post-futures (1982-87) period between S&P 500 and a non S&P 500 group of stock controlling for differences in firm attributes. He found that increased volatility was a common phenomenon in different markets and index futures by themselves might not be a cause. Chan and Karolyi (1991) estimated the intraday relationship between returns and returns' volatility in the stock index and stock index futures. Their study covered both S&P500 and Major Market Index

*Assistant Professor of Commerce, Mahatma Gandhi University, Nalgonda. Andhra Pradesh-508001. Email: arreddy888@yahoo.co.in

** Faculty of Commerce and Business Management, Mahatma Gandhi University, Nalgonda, Andhra Pradesh

(MMI) futures. Bivariate GARCH models were used to estimate volatility. Their results indicated a strong inter-market dependence in volatility of spot and futures returns.

Hendrik Bessembinder and Paul J Seguin (1992) examined whether greater futures trading activity, volume and open interest are associated with greater equity volatility. They also documented the heterogeneous effects on volatility of the expected and unexpected components of each trading series. They used the S&P 500 index prices from January 1978 to September 1989 breaking them into expected and unexpected components using an ARIMA (0, 1, and 1) model. They found evidence that active futures markets are associated with decreased rather than increased volatility and a positive relationship between equity volatility, contemporaneous trading volumes in the spot equity and equity futures market. They documented a positive relationship on spot volatility with unexpected futures trading volumes with a negative relationship with open interest.

Gary Robinson (1993) analyzed the daily stock price volatility on the London Stock Exchange for the period 1980-93 to measure the effect of futures on cash market volatility and concluded that index futures contracts were found to have reduced volatility significantly by around 17%.

Michael D. McKenzie, Timothy J. Brailsford and Arobert W. Faff (2000) examined the impact of trading in individual share futures contracts on the systematic risk and volatility of the underlying shares. The study evidenced a general reduction in systematic risk on individual stocks and decline in unconditional volatility while the evidence concerning the impact on conditional volatility was mixed.

Premalatha Shenbagaraman (2003) examined the impact of introduction of NSE Nifty index futures on Nifty index. Using an event study over the period from October 1995 to December 2002, she tested for changes in the volatility before and after the introduction. Using GARCH techniques to model the time series, she concluded that futures trading have not led to a change in the volatility of the underlying stock index but the structure of volatility seemed to have changed in post-futures period.

Mukherjee and Mishra (2006) used intraday data from April to September 2004 to investigate the lead-lag relationship between Nifty spot index and Nifty futures. They found that there was a strong bi-directional relationship among returns in the futures and the spot markets. The spot market was found to play a comparatively stronger leading role in disseminating information available to the market and therefore is said to be more efficient. The results relating to the informational effect on the lead-lag relationship exhibit that though the leading role of the futures market wouldn't strengthen even for major market-wide information releases, the role of the futures market in the matter of price discovery tends to weaken and sometimes disappear after the release of major firm specific announcements.

A. CONTRACT SPECIFICATIONS

The currency futures are traded in accordance with certain specifications. There are certain norms like size (lot), margin limits and position limits etc...

National Stock Exchange of India Limited is the forerunner in currency futures trading. The currency futures contract specifications are as follows:

Table:1 Currency Futures contract specifications

Symbol	USDINR		
Market Type	N		
Instrument Type	FUTCUR		
Unit of trading	1 – 1 unit denotes 1000 USD		
Underlying	The exchange rate in Indian Rupees for US Dollars		
Tick size	Rs.0.25 paise or INR 0.0025		
Trading hours	Monday to Friday (9:00 a.m. to 5:00 p.m.)		
Contract trading cycle	12 month trading cycle.		
Last trading day	Two working days prior to the last business day of the expiry month at 12 noon.		
Final settlement day	Last working day (excluding Saturdays) of the expiry month. The last working day will be the same as that for Interbank Settlements in Mumbai.		
Quantity Freeze	10,000 or greater		
Base price	Theoretical price on the 1 st day of the contract. On all other days, DSP of the contract		
Price operating range	Tenure upto 6 months +/- 3 % of base price	Tenure greater than 6 months +/- 5% of base price	
Position limits	Clients higher of 6% of total open interest or USD 5 million	Trading Members higher of 15% of the total open interest or USD 25 million	Banks higher of 15% of the total open interest or USD 100 million
Minimum initial margin	1.75% on day 1, 1% thereafter		

Extreme loss margin Calendar spreads	1% of MTM value of open position. Rs. 250/- per contract for all months of spread
Settlement	Daily settlement : T + 1 Final settlement : T + 2
Mode of settlement	Cash settled in Indian Rupees
Daily settlement price(DSP)	Calculated on the basis of the last half an hour weighted average price.
Final settlement price(FSP)	RBI reference rate

(Source: NSE website)

From the above table, we can understand the practicalities of currency futures. The symbol of currency futures in USDINR means the contract of US Dollar and Indian Rupees. One contract unit stands for 1000 US Dollars. As we know already that the currency futures are derivative products in which there should be some underlying here the exchange rate will be the underlying on which the values will be settled. The trading hours are between 9.00 am and 5.00 pm. Price operating ranges are as follows: Tenure upto 6 months it is +/- 3% of base price. for tenure greater than 6 months; the price operating ranges are +/-5% of base price. The position limits are mentioned in the contract specifications as follows: for clients it is higher of 6% of total open interest or USD 5 million; for trading members, the position limits are higher of 15% of the total open interest or USD 25 million and for Banks, the position limits are higher by 15% of the total open interest or USD 100 million. The settlement periods are as follows: daily settlement T+1 and the final settlement are T+2. The mode of settlement is in Indian Rupees on cash basis.

B. DAILY TURNOVER

With currency futures set to be launched in India, we are set for a dynamic shift in currency trading and hedging. This initiative would enhance the overall efficiency of the currency market via transparency in pricing, increasing investor categories and growing the number of market participants, enhancing opportunities and eliminating counter-party risk. The first trade on the Exchange was by East India Securities Ltd. Amongst the Bank participants, HDFC Bank carried out the first trade. The largest trade was by Standard Chartered Bank constituting 15000 contracts. Banks contributed 40% of the total gross volume. 12 serial month contracts were available for trading i.e., September 2008 to August 2009. The most active contract was September 2008 expiry with around 43000 contracts being traded. The near month contract traded at a premium of 0.40% to the spot price. Trading took place from across major centres of the country.

The following table depicts the details of trading volumes of Currency future in NSE from 29th August, 2008 onwards.

Table: 2 Daily Turnover

Trade Date	Total Contracts	Total Value (Rs. lakhs)	RBI Reference Rate
29-Aug-2008	65798	29,104.57	43.7900
01-Sep-2008	24344	10,774.40	44.2100
02-Sep-2008	42123	18,718.28	44.2600
04-Sep-2008	40171	17,862.89	44.4500
05-Sep-2008	37668	16,820.96	44.3700
08-Sep-2008	54077	24,056.12	44.2600
09-Sep-2008	54313	24,406.48	44.8900
10-Sep-2008	44036	19,897.84	45.1200
11-Sep-2008	51556	23,534.72	45.4400
15-Sep-2008	50386	23,205.67	45.9400
16-Sep-2008	97642	45,688.17	46.6300
17-Sep-2008	72667	33,800.93	46.3400
18-Sep-2008	81003	37,811.43	46.7100
19-Sep-2008	66512	30,757.68	46.3200
22-Sep-2008	57046	25,940.14	45.4000
23-Sep-2008	79429	36,322.08	45.7200
24-Sep-2008	82266	37,762.10	45.8300
25-Sep-2008	48268	22,318.67	46.2500
26-Sep-2008	43232	20,068.22	46.4300

(Source: NSE Website)

The above table depicts the details of trading volumes in the currency futures segment of NSE. Trading on the first day (i.e. 29th August 2008) -total number of contracts are 65,798 with the volume of Rs. 29,104.57 lakhs. On 16th September, 2008 the highest amount was traded in volume Rs. 45,688.17 lakhs. The lowest trading volume took place on 1st September, 2008 with Rs. 10,774.40 lakhs. The average daily turnover for the first 19 trading days is Rs. 26255.33 lakhs.

The currency futures in India have started with high expectations, already NSE has started and other Stock Exchanges are yet to start trading. In order to encourage active participation in the Currency Derivatives segment, the NSE has decided that no transaction charges will be levied on the trades done in this segment on the exchange from August 29 till September 30. However, every trading member participating in currency derivatives during the above period shall be required to make a lump-sum contribution of Rs. 500 towards an Investor Protection Fund.

C. SOME ISSUES OF CURRENCY FUTURES:

Following are the some issues connected with trading of currency futures

i). Currency Futures With US Dollar Only

Presently, only US dollar-Indian rupee contracts would be allowed. The contract size will be of 1,000 US dollars and the tick size (minimum price fluctuation) will be 0.25 paise. Other currency futures such as Euro, Pound etc... maybe added in the future.

ii). Low Margins

Having more than one exchange offering, currency futures will keep the margins down, which is critical since the intra-day movements in USD/INR are not much more than 0.4 percent, which doesn't leave much room for day traders to go in and out, unless costs are very, very low. The scope for speculation is very limited in the currency futures segment. While it may not provide a bonanza for brokers, let the game begin!

iii). Settlement by cash only

Such as the contract is cash settled which makes it of limited value for hedging. Cash settlement will impact the volume negatively.

iv). Limited (few) players only

Till now NSE is not permitting FIIs and NRIs. These players are not (yet) permitted to access this instrument, and, given that, in general, currency futures are trading (rather than hedging) instruments; this may constrain the development of liquidity. Liquidity will be improved when there are large numbers of participants in the market.

D. SUGGESTIONS

Keeping in view the problems associated with trading of currency futures, the following suggestions are offered.

i). Proper Regulation

It is the prime duty of the regulators (SEBI, RBI etc...) to protect the interests of the investors. Proper regulatory practices are imperative to boost the confidence of the investors. Regulators should formulate the rules, byelaws, regulations in such a way that should attract all sorts of the investors. E&Y national director (financial services), Hiresh Wadhvani says, "Proper regulatory oversight is imperative as otherwise smaller firms with little or not enough knowledge of currency derivatives market could burn their fingers". (We have in recent memory the episode of not only small firms but also even bigger companies like L&T being hit by exotic derivative contracts that banks sold to them).

ii). Permit NRIs and FIIs

To increase the liquidity and trading volume, the NRIs as well as FIIs should be allowed to participate in the currency futures trading. It increases the trading volumes and in the same time, liquidity also increases. FIIs are dominant players in other segments like Equities and Wholesale Debt segment. Here in currency futures segment also, they can participate actively, if they are permitted.

iii). Awareness creation

Awareness creation will boost the participation of investors. The regulatory bodies have to create awareness about the currency futures. To attract large number of participants, the regulators should conduct campaign programmes, workshops, seminars and awareness drives.

iv). Expansion of products

Now initially, NSE launched only single currency futures (i.e. USDINR) it also required to start other currency futures instruments like Pound, Euro etc..., Multiple currency futures will facilitate a large number of participants to hedge their exposure.

CONCLUSION

The success of the currency futures segment highly depends on the regulatory mechanism because it is an innovative derivative instrument. Globalization is the order of the day and we cannot stop foreign investments in the long term. We should prepare ourselves to face the conditions. Mainly the regulators have to observe the things carefully and they have to take necessary steps and actions accordingly. The prime object should be to protect the interest of the investors. No doubt that the currency futures will be successful instruments in Indian capital market, if proper mechanism exists for regulating the activities of currency futures.

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