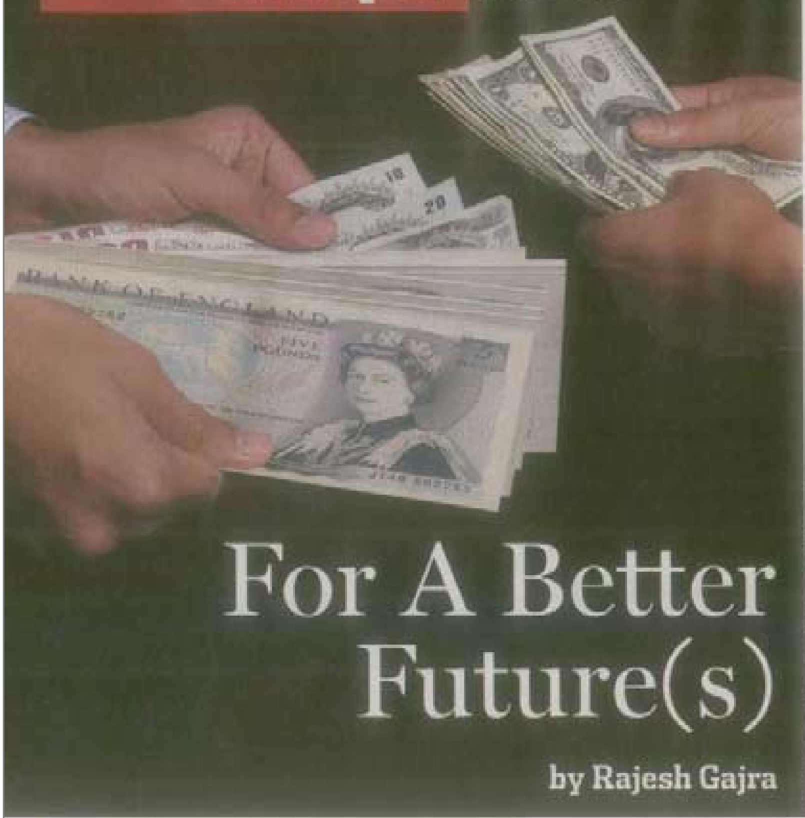
Date : 29-Dec-2008 Edition : National Page No.: 90 Page Name: n.a. Size: 456.29 sq. cm

Sector: Banking and Finance Circulation: 125009 AVE: Rs.515604.38 Frequency: Weekly

Businessworld



For A Better Future(s)

by Rajesh Gajra

Currency futures market will need a push from brokers

EXCHANGE-TRADED CURRENCY FUTURES MARKET is four months old. Trading in this market started off on a promising note (see 'Steady But Slow'). But it is facing tough challenges and has many bridges to cross before volumes become comparable to those at the 15-year-old over-the-counter (OTC) currency forward market.

Currently, the exchange-traded currency futures market sees volumes that are just 4-8 per cent of those in the OTC forward market. The OTC market is a private market, where information vendors such as Reuters collate currency forward prices from banks and primary dealers to show to subscribers. But the trades get executed directly between the buyer and the seller through telephone, email or fax.

"The main challenge is the lack of domain knowledge in currencies," says Arindam Chanda, vice-president for products and marketing at Kotak Securities. And so, the brokerage company is busy organising seminars, conducting trade demonstrations and making Web-cast events for its clients.

The bear phase in equities is adding to the woes. "Because their core market, that is, equities, is not performing well, brokers' foray into currency futures is taking a backseat," says Rekha Shah, CEO of Analyze n Control (AnC), a consulting firm in financial services space.

"Currency futures market is also facing our traditional lethargy for everything new," says the head of treasury at a public sector bank, which is one of the largest dealers in OTC currency forwards and now a member on the currency futures segment on the National Stock Exchange (NSE).

Yet, in quite some numbers among the 1,000-odd exchange-traded currency futures brokers on the NSE, the Bombay Stock Exchange and Multi Commodity Exchange, there has been a concerted action to understand the paradigm shift they would have to make for their exchange-traded currency futures offerings. The competition among the three exchanges is also providing the necessary push.

This is the first time that banks have been permitted to have direct membership in exchange-traded derivative space. In equities and commodities derivatives, they can enter only through their subsidiaries.

"Brokers must realise that they cannot sell exchange-traded currency futures like a pure trading product to their existing clients. They are competing with banks, which are far ahead in the knowledge curve in currencies," says Shah of AnC.

Targeting SMEs

AnC and the Association of NSE Members of India had organised a workshop on currency futures in October. Speakers at the workshop highlighted the advantages of exchange-traded currency futures for small and medium-sized enterprises (SMEs), which export, import or both. In the exchange-traded currency futures market, traders have access to price and liquidity information, can trade small-sized lots, (minimum trading lot of $1,000 compared to $250,000 in case of OTC). Also, daily marked-to-market margins help reduce risk. Moreover, to trade on the currency futures market, one does not need prior exposure to the forex market unlike in the case of OTC market where

REALITY CHECK: The currency futures market allows more clarity and competition than the OTC market

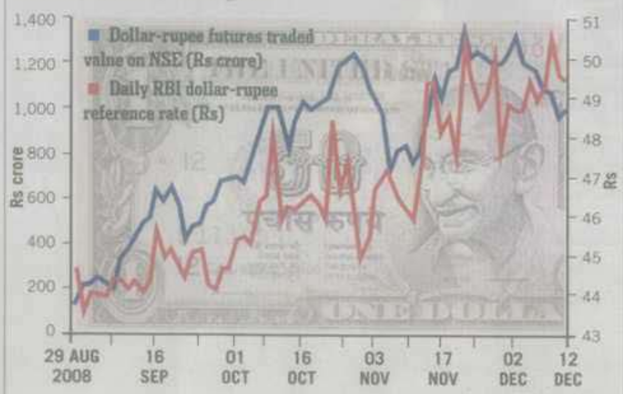
Date : 29-Dec-2008 Edition : National Page No.: 92 Page Name: n.a. Size: 445.57 sq. cm

Sector: Banking and Finance Circulation: 125009 AVE: Rs.503489.27 Frequency: Weekly

Businessworld

STEADY BUT SLOW

Bearish equity markets put a drag on exchange-traded currency futures' volume growth



Source: NSE, BW research

Reserve Bank of India (RBI) mandates it.

SMEs and other players with forex exposure, in the past two years, have had a taste of how volatile the international forex markets can be. From January 2007 to November 2007, unhedged exporters were badgered by the rise in rupee exchange rate (vis-à-vis the dollar) from Rs 44.21 to Rs 39.31. Suddenly, from April to November this year the rupee began depreciating against the dollar. It fell from Rs 39.96 to Rs 50.12. SMEs are the worst hit as OTC currency forward desks of banks and primary dealers are not keen to serve them as they cannot bear the high commissions charged. "Big companies can bully the banks, but 60 per cent of importing or exporting companies are SMEs, who get jammed by high card rates of banks," said Sandeep Diddi, executive director for fixed income at Morgan Stanley India.

But still, SMEs have not yet taken to currency futures in a big way. Partly because they do not understand the market well. These enterprises have many misconceptions. For instance, SMEs consider cash-squared currency futures contracts costly. "Most exporters here go for deliverable OTC currency forwards, whereas in exchanges the currency futures contracts have to be settled in cash and not delivery," says K. Ilango, joint managing director of Coimbatore-based RSM Autokast, a medium-sized auto components' manufacturer and exporter. An NSE official, however, says delivery-based settlement in OTC forwards is not cheaper than cash-based settlement in currency futures contracts.

The knowledge sharing by brokers may dispel doubts and bring more clarity. Coimbatore Capital Chairman and NSE currency futures member D. Balasundaram says, "We conducted seminars at Coimbatore and Tirupur, giving out brochures and information on hedging using currency futures. We are also installing view-only NSE currency futures trading terminals in our SME clients' offices."

Some of these new clients, particularly exporters, are already active in exchange-traded currency futures. "Our new clients on our NSE's currency futures offering exporters and importers mainly from Tamil Nadu and Andhra Pradesh. And about 300 trader-clients are entering trades every day," says C.J. George, managing director of Geojit Financial. But many of these clients are professional equity traders who are attracted by the volatility in dollar futures.

Besides SMEs, brokers can target companies which are neither exporters nor importers, but are still exposed to fluctuations in international currencies. As Diddi of Morgan Stanley points out, "A lot of domestic-sales companies are exposed to prices of commodities such as metals and oil where local prices are influenced by the dollar or euro rates of these commodities internationally." Also, individuals who can invest or spend the rupee equivalent of $200,000 in international assets, products or services will need to hedge themselves in a volatile currency market.

Regulatory Snags

A few regulatory restrictions need to be removed to add depth to the currency futures market. To begin with, the futures contracts should not be limited to dollar-rupee hedging only. Exporters and importers, who need futures contracts the most for hedging, are increasingly exposed to non-dollar currencies such as euro, yen, renminbi and pound. "Many exporters have 60-90 per cent of their billing in euros," says Balasundaram.

Restriction on participation of foreign institutional investors (FIIs) and non-resident Indians (NRIs) is another hindrance. Even primary dealers are not allowed to become members of exchange-traded currency futures. "A good way to make a market succeed is to put all kindling (in case of exchange-traded currency futures permission for FIIs, options, rupee-euro, etc.) into the fire right at the outset," says Ajay Shah, a senior fellow at the Indian Institute of Finance.

It is, however, not too late. RBI and Securities and Exchange Board of India — need to do their bit to help exchange-traded currency futures survive in hard times, and compete with the OTC currency forward market.

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