Everything About Currency Derivatives
Basic Facts
Encompasses the basic facts about the Currency Derivative Segment like currency and futures market size, cross currency rates, interest rates etc.

Who can invest in Currency Derivatives?
Shares the overall understanding of the market segments and talks about the target audience.

Investing in Currency Derivatives
Gives the operational details like documents required while opening the account, margin required, currency derivatives contract details, settlement etc.
Basic Facts

Currency Market Size

- By RBI published numbers, turnover of forex market in India is between USD 40 bn to USD 60 bn. Indian currency market is one of the fastest growing currency markets in the world. Till now, INR was not a widely traded currency. After the liberalization process, the scenario has started changing and volumes in INR has picked up drastically. FII inflows and development of currency markets like Singapore are some of the contributing factors for the same.

Currency Future Market

- NSE introduced currency future segment on 29th August, 2008. BSE and MCX – SX joined the wagon on 1st and 7th October, 2008 respectively. Combined turnover on all three exchanges have touched Rs. 2000 crore a day from the time of the inception. The same has got very encouraging reception even from corporate which are finding the segment as much better way for price discovery than the OTC market. Liquidity and easy access is the key to the growth of the same.

Forward Market Facts

- Unlike futures market, forward market is an OTC market and is dominated by banks in India. The same is accessed by corporate with foreign currency exposure either through debt, receivables, payables or business transactions. Unlike a future price which reflects the expected rate at the time of expiry of the contract, forward takes into account the interest rate differential between two currencies involved. The forward rate is arrived by discounting the spot price with interest rate differential between two currencies.

Cross Currency Rates

- Unlike some other free float currencies, INR is pegged to USD. In simpler words, the exchange rate between INR and a third currency is derived using the exchange rate between INR and USD. This is a big drawback and the reason why INR is not a globally significant currency today. From a long time, Indian government has been talking about free convertibility of INR, but the same is still at the concept stage.

Interest Rates

- Prevailing interest rates in any economy is one of the major factors to determine the exchange rates between two currencies. E.g., for a long time Japan was following zero interest rate regime which encouraged Yen carry trade. In simpler terms, as interest rates in Japan were almost zero, one can take loan from Japan in Yen terms, can convert the same in USD and then deploy them towards higher yield instruments and benefit from the same. Today interest rates are perceived to be one of the most effective tools for all central bank in their monetary policies.
Spot Market USD – INR

- Unlike future and forward markets, spot markets refer to instant delivery of the currency. When one walks into a bank is buying or selling a particular currency, he is unknowingly participating in spot market. In India, there are lots of restrictions for spot market participation, e.g., one need to have exposure in the currency or one need to require the currency (e.g., travelling abroad). Most of the times, for a retail participant, the merchant or the bank will quote the rate with premium added on both sides (buy and sell). The premium will be based on multiple criteria including liquidity in market, amount of currency required etc.

Current Account Convertibility

- INR is currently convertible on current account. In simpler terms, currently Indian residents are allowed to make or receive trade related payments in foreign currency. E.g., they are allowed to receive USD for the services they have rendered or goods they have sold to an American company. Investments and borrowings in foreign exchange terms are still not allowed or regulated by the government and RBI.

Capital Account Convertibility

- Unlike current account convertibility, capital account convertibility refers to complete freedom to exchange local financial assets to foreign financial assets and vice versa. There will be no restrictions in movement of assets from one currency to other currency. E.g., one is allowed to raise funds from European banks in EURO term, convert in USD and use the money and then payback the loan using EURO again by converting USD in EURO. Indian policy makers have been promising the same from a long time but there is no visible progress towards the same.

Weak Currency

- If a currency is weak, one has to pay more units of the same currency to purchase another currency. E.g., when USD weakens against EURO, more USD will be required to purchase same number of EURO. This situation is favorable for exporters or service providers. Under such situation, products or services will become cheaper from the country with weaker currency. Some of the countries who are dependant on exports keep their currency weaker using central bank or policy interventions. E.g., China keeps its currency Yuan or Renminbi weak to enable itself to drive cheaper exports.

Strong Currency

- If a currency is strong, one has to pay lesser units of the same currency to purchase another currency. E.g., when INR strengthens against USD, lesser INR will be required to purchase same number of USD. This situation is favorable for importers. Under this situation, it will be cheaper for the country to buy services or products from the other country. Countries that are having more reliance on imports will prefer a strong currency. Strong currency will make exports from the country costlier. USA is a net importer of goods and services hence it is better for them to have a strong USD against the currencies of the countries that they are importing goods or services from.
Who can invest in Currency Derivatives?

Exporters

- Exporters do have exposure in foreign currency as they have receivables in foreign currency against their services or goods. They generally hedge their currency fluctuation risk with banks. But the process is not transparent and especially for smaller exporters the rates from the banks are not competitive. Exchange traded currency futures will provide them much effective tool to hedge their currency risk.

Importers

- Importers have to pay the service or goods provider in foreign exchange. Any adverse movement in currency can affect their business negatively. Hence there is a need for hedging their currency risk. Exchange traded currency futures can provide them with simple and more transparent way to hedge their currency risk.

SME

- Some of the SME businesses have currency risk either due to their exposure in FCCBs or foreign currency loans. In the current markets, bank rate most of the SME business as a risky proposition for financing. This raises a unique challenge for them where they are unable to get favorable quotes from banks. Access to exchange traded currency futures provide them access to cover their foreign exchange exposure without relying on banks and their structures. They themselves can manage their risk on their own books.

Traders

- Exchange traded currency derivatives has opened up a new avenue for traders. From the beginning of the segment, there is enough liquidity for traders to get benefited from the currency exchange rate movement. With decent contract size of USD 1000, it is easy to access too.

Industries where payment can be taken in foreign exchange

- Most of the hotels publish their room tariff both in INR and USD. Non Indian residents are allowed to pay their tariff in foreign currencies. These receivables are generally converted in INR and hence there is a need of hedging the currency fluctuation risk. As the amount may not be significant for a bank to quote a favorable rate, exchange traded currency derivatives will be ultimate tool for them to freeze their exchange rates.

Professionals receiving remuneration or stock options in foreign currency

- With global companies expanding in India, lots of Indian nationals receive their remuneration in foreign currency. A typical example for this would be an IT guy on deputation in USA. They can freeze the favorable exchange rate between USD – INR by taking position in futures market.
Similarly, many foreign listed companies give their employees stock options where stocks are traded globally. They also carry exchange rate risk. Such retail clients don’t have access to currency market through bank also due to regulations so the only avenue to hedge their currency risk is exchange traded futures.

Commodity Traders

- Commodity prices are never independent of the currency fluctuations. Till now there was not even a single avenue where commodity traders were able to hedge the inbuilt currency risk in their portfolio. Currency derivatives will allow them to isolate currency risk from their portfolios.

Individuals having global portfolios

- No Indian national is allowed to participate in currency market, but they are allowed to invest money abroad to a specified limit. This makes them vulnerable to currency fluctuation risk. Exchange traded currency derivatives are the first time when they can isolate them from such fluctuations. At the same time, this is a new investment avenue (currency market) for them.

Individuals who travel globally

- Global travel requires payments in different currencies. An unfavorable movement in exchange rate can ruin a perfectly planned vacation. And imagine what if it happens quite frequently which is possible in current market due to volatility. Simply taking positions in exchange traded currency futures will remove that uncertainty from the vacation. So, anyone who travels globally either in personal capacity or on business purpose frequently can utilize the instrument to his benefit.

Education abroad

- As per one of the surveys Indian students are among largest student community in USA. Along with studies there will be lots of other payments which are made in foreign currency. If the payment due date collides with major weakening of INR, the cost of education can be treacherously high. Instead the risk can be mitigated through the USD – INR exchange traded futures.
Investing in Currency Derivatives

Account Opening

- To invest in Currency Derivatives you need to open a Trading and Demat account. If you have a trading account you can apply for Currency Derivative segment and start investing through the same account as you invest in Mutual Funds.

Margin

- Margin charged by Kotak Securities in the segment is 5% of the contract value. Currently only cash margin is accepted. Going forward we may accept equity as the margin in this segment.

Documents – Individual

- Proof of Identity
- Proof of Address

Documents – Non Individual

- Last 2 year balance sheet copy
- Copy of latest shareholding pattern and list of all having more than 5% in share holding
- Copy of MoA
- Copy of board resolution approving participation in the segment
- Photographs of Partners / Whole time directors, individual promoters holding 5% or more, either directly or indirectly, in the shareholding of the company and of persons authorized to deal in securities.

Contract Details

- Size of the contract is USD 1000 and underlying is the rate of exchange between 1 USD and INR. The reference rate will be that of RBI published on daily basis. Currently only USD – INR futures are available. Going forward, exchanges may introduce other contracts.

Traded Contracts

- At any given point of time there will be 12 near month contracts traded on the exchange with underlying of USD – INR. E.g., in November 2008, there were monthly contracts till October 2009 available on the exchange.
Contract Expiry / Settlement

- Contract expiry will be on the last business day of the month and contract fixing will be two days prior to contract expiry. The settlement will happen on expiry date. The settlement will be done in INR on relevant RBI reference rate.

Limits

- Trading member limits are set by exchange at 15% of the total OI or USD 25 million whichever is higher.
- Client wide limits are set by exchange at 6% of the total OI or USD 5 million whichever is higher.

Market Timings and reference rate

- Markets timings are from 9 am to 5 pm from Monday to Friday excluding exchange declared holidays. RBI published exchange rate between 1 USD to INR will be taken as the reference rate.