IGIDR roundtable on *Currency risk management using derivatives markets*

Venue: Taj Lands End, Bombay

4 July 2012

The last five years have been marked with extreme financial markets volatility, both internationally and domestically. The latest sector where volatility of prices has been felt keenly is the currency market. Here, the value of the INR has reached unprecedented levels, higher than have been seen, and unanticipated, given the relatively controlled exchange rates previously in place. These large changes in the exchange rate had the potential to damage the corporate sector balance sheet through two paths: higher costs of external borrowings, and more importantly, through higher cost of inputs to production. The latter is either through explicitly higher costs of imported goods and services, or implicitly, through price-parity between the international and domestic markets.

Unlike past episodes of high currency volatility, the sheer size of volumes on the currency markets are much larger now. There is also exposure in multiple currencies with the wider global reach that Indian firms enjoy today. The size and the complexity is such that there is little scope for the central bank to manage currency volatility, as it has been able to do in the past. Thus, there is a double-whammy of increased currency volatility: because of higher integration of the Indian economy with global markets and a lower control by the central bank on currency fluctuations. This leaves the onus of currency risk management on the firms and individuals themselves.

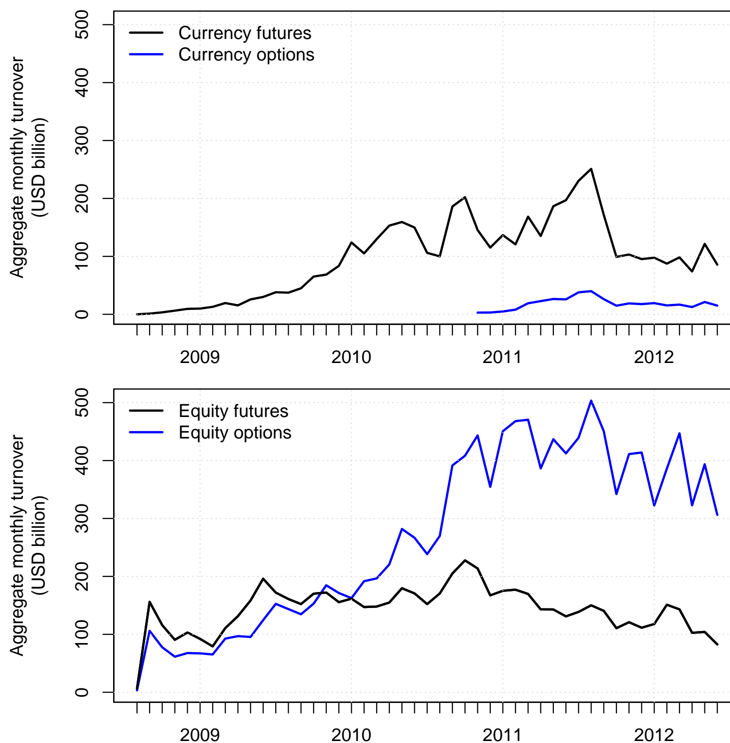
Until August 2008, the sole financial contracts that were available to hedge currency risk were the *outright forwards/options* and the *foreign exchange*

swaps (FX swaps) available on the over-the-counter (OTC) markets with banks as counterparties. These markets suffered from the well-known problems of low immediacy of price and trades information, and counterparty risk.

The introduction of exchange traded USD-INR foreign exchange (FX) futures in 2008 was a step towards providing another financial contract to hedge against adverse currency movements. These markets were developed on the well-understood market structure of electronic limit order book markets with novation by clearing corporations, and delivered all the similar superior outcomes of higher transparency of prices and trades, as well as available liquidity, that is so familiar in the equity markets in India today.

Figure 1 Monthly turnover on currency and equity derivatives

The first graph shows the combined monthly turnover on currency derivatives traded on the MCX-SX, NSE and USE. The second graph shows the monthly turnover on equity derivatives traded on the NSE.



Source: NSE, MCX-SX, USE

The markets were later extended to include three other currency pairs in early 2010 (GBP-INR, EUR-INR, JPY-INR), and later, options on the USD-INR. Though the OTC markets continued to be larger in terms of total traded volumes, exchange-traded derivatives have seen a spectacular growth in volumes since their inception (Figure 1). The combined average daily turnover for all exchange-traded currency futures was USD 6 billion during the quarter of Apr-Jun 2012. The liquidity of these markets, where the average bid-ask spread is less than or equal to half a paisa, is typically higher than that of the traditional OTC markets.[1] These are all indicators that Indian firms and individuals are beginning to actively use these contracts to manage currency exposure.

Access by a wide variety of participants has been key to the success of these markets. The wider the reach of the markets and the more heterogenous the set of participants, the more efficient are the markets in terms of better price discovery and deeper liquidity. However, access to these markets is through different financial intermediaries, who in turn, are strongly influenced through guidelines and regulatory mandates of their regulators. For instance, recent measures by the RBI could adversely affect the quality of the exchange traded markets, because such regulatory limits will act as a deterrant for intermediaries to offer access of these contracts to end customer.

The aim of this roundtable is to bring together the economic stakeholders – the end-user firms, regulators, financial intermediaries – on a common platform, and to provide a perspective on the following issues:

- What are the key sources of currency exposure for Indian firms?

  How can these be managed using the market instruments of FX futures and options efficiently?

- Some examples for firms which have used exchange-traded FX futures and options to successfully implement corporate hedging strategies.

- How policy interventions can affect the effective use of these financial contracts to hedge currency risk?

[1] *Source:* SEBI

Agenda for the roundtable[2]

10:00 – 10:10	Introductions **Susan Thomas**, *IGIDR Finance Research Group*
10:10 – 10:40	Currency risk: Measurement and management **Nidhi Aggarwal**, *IGIDR Finance Research Group*
10:45 – 11:05	CCP clearing in OTC forex derivatives market in India **Siddhartha Roy**, *CCIL*
11:10 – 11:30	Hedging using exchange traded futures: the GSFC experience **D V Pathakjee**, *GSFC Ltd.*
11:35 – 11:55	Foreign exchange risk management tools **Vipul Chandra**, *Citigroup*
12:00 – 13:00	Panel and Floor discussion **Ravi Narain**, *National Stock Exchange of India* (TBC) **Ajay Shah**, *National Institute of Public Finance Policy* **K. N. Vaidyanathan**, *Mahindra & Mahindra*
13:00 – 14:00	Lunch

[2]TBC: To be confirmed