# Evolution and Significance of Currency Futures in the Indian Financial Market

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**Abstract:**

Currency futures play a pivotal role in the financial market, enabling participants to hedge against currency risk, engage in speculation, and capitalize on arbitrage opportunities. Introduced in the Chicago Mercantile Exchange in 1972, currency futures were first traded in India on the National Stock Exchange (NSE) in 2008, followed by the Bombay Stock Exchange (BSE) and Multi Commodity Exchange (MCX). This paper provides a comprehensive overview of the currency futures market in India, explaining the various types of derivatives, their regulatory framework, contract specifications, and market participants. The paper further highlights the advantages and limitations of currency futures in comparison to over-the-counter (OTC) forwards. The findings indicate that the introduction of currency futures in India has enhanced market efficiency, provided risk management tools to corporate entities, and increased transparency in forex trading. However, the standardization of contracts poses challenges for firms with specific hedging requirements. Overall, this study contributes to a deeper understanding of the role of currency futures in financial risk management in India.

**Keywords:** OTC, Forward, Future, Forex, Derivatives, Efficiency**.**

## Introduction:

Derivative is a product whose value is derived from the value of one or more basic variables, called bases (underlying asset, index, or reference rate), in a contractual manner. The underlying asset can be equity, foreign exchange, commodity or any other asset. For example, wheat farmers may wish to sell their harvest at a future date to eliminate the risk of a change in prices by that date. Such a transaction is an example of a derivative. The price of this derivative is driven by the spot price of wheat which is the "underlying".

In the Indian context the Securities Contracts (Regulation) Act, 1956(SC(R)A) defines "derivative" to include-

1. A security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security.

2. A contract which derives its value from the prices, or index of prices, of underlying securities.

Derivatives are securities under the SC(R)A and hence the trading of derivatives is governed by the regulatory framework under the SC(R)A.

Derivative contracts have several variants. The most common variants are forwards, futures, options and swaps. We take a brief look at various derivatives contracts that have come to be used.

**Forwards**: A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

**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. Futures contracts are special types of forward contracts in the sense that they are standardized exchange traded contracts.

**Options:** Options are of two types - calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

**Warrants:** Options generally have lives of upto one year, the majority of options traded on options exchanges having a maximum maturity of nine months. Longer-dated options are called warrants and are generally traded over-the-counter.

**LEAPS:** The acronym LEAPS means Long-Term Equity Anticipation Securities. These are options having a maturity of upto three years. Baskets: Basket options are options on portfolios of underlying assets. The underlying asset is usually a moving average of a basket of assets. Equity index options are a form of basket options.

**Swaps:** Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are:

I. Interest rate swaps:
II. Currency swaps

**Swaptions**: Swaptions are options to buy or sell a swap that will become operative at the expiry of the options. Thus a swaption is an option on a forward swap. Rather than have calls and puts, the swaptions market has receiver swaptions and payer swaptions. A receiver swaption is an option to receive fixed and pay floating. A payer swaption is an option to pay fixed and receive floating.

**Currency futures**

Currency Future is first introduced in Chicago Mercantile Exchange (CME) in 1972. National Stock Exchange was the first stock exchange in India, permitted by the SEBI, to set up a separate currency derivative segment with trading starting on 28 August 2008 in NSE. Similarly BSE and MCX also started trading the currency futures from 7$^{th}$ October 2008 respectively. The major objective of using this derivative is hedging the currency

risk. The currency futures market in India had passed a journey of almost four years and many changes have been employed over the period recently SEBI permitted Option trading in Indian markets.

A futures contract is a standardized contract, traded on an exchange, to buy or sell a certain underlying asset or an instrument at a certain date in the future, at a specified price. When the underlying asset is a commodity, e.g. Oil or Wheat, the contract is termed a "commodity futures contract". 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 date and a specified rate in the future. Therefore, the buyer and the seller lock themselves into an exchange rate for a specific value or delivery date. Both parties of the futures contract must fulfill their obligations on the settlement date.

Currency futures can be cash settled or settled by delivering the respective obligation of the seller and buyer. All settlements however, unlike in the case of OTC markets, go through the exchange. Currency futures are a linear product, and calculating profits or losses on Currency Futures will be similar to calculating profits or losses on Index futures. In determining profits and losses in futures trading, it is essential to know both the contract size (the number of currency units being traded) and also what is the tick value. A tick is the minimum trading increment or price differential at which traders are able to enter bids and offers. Tick values differ for different currency pairs and different underlyings.

Futures markets were designed to solve the problems that exist in forward markets. 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. But unlike forward contracts, the futures contracts are standardized and exchange traded. To facilitate liquidity in the futures contracts, the exchange specifies certain standard features of the contract. A futures contract is standardized contract with standard underlying instrument, a standard quantity and quality of the underlying instrument that can be delivered, (or which can be used for reference purposes in settlement) and a standard timing of such settlement. A futures contract may be offset prior to maturity by entering into an equal and opposite transaction.

**Exchanges offer currency futures trading in India**

National Stock Exchange (NSE)

Multi Commodity Exchange (MCX)

United Stock Exchange (USE)

**Currency pairs available for currency future trading in India**

USD/INR (US Dollar/Indian Rupee) - Futures and Options

GBP/INR (Britain Pound/ Indian Rupee) - Futures

EUR/INR (European Euro/ Indian Rupee) - Futures

JPY/INR (Japanese Yen/ Indian Rupee) - Futures

**Contract specification snapshot**

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|---|---|
| **Trading** | **Monday To Friday** |
| **Trading Hours** | **9:00 AM to 5:00 PM** |
| **Price Quotation** | **In INR** |
| **Tenor of Contract** | **Maximum of 12 Months** |
| **Available Contracts** | **Monthly** |
| **Settlement Mechanism** | **In INR** |
| **Settlement Reference** | **Rate RBI Reference Rate** |
| **Last Trading Date** | **Two working days prior to Final Settlement Date** |
| **Final Settlement Date** | **Last working day of month, except Saturday** |
| **Settlement Daily** | **settlement : T + 1**<br>**Final settlement : T + 2** |

**Uses of Currency Futures**

- Hedging:
- Speculation: Bullish, buy futures
- Speculation: Bearish, sell futures
- Arbitrage

**Advantages and limitations of Currency Futures**

**Advantages of Currency Futures:**

- Transparency and efficient price discovery. The market brings together divergent categories of buyers and sellers.
- Elimination of Counterparty credit risk.

- Access to all types of market participants. (Currently, in the Forex OTC markets one side of the transaction has to compulsorily be an Authorized Dealer).
- Standardized products.
- Transparent trading platform.

**Limitations of Currency Futures:**

- The benefit of standardization which often leads to improving liquidity in futures, works against this product when a client needs to hedge a specific amount to a date for which there is no standard contract
- While margining and daily settlement is a prudent risk management policy, some clients may prefer to not incur this cost in favor of OTC forwards, where collateral is usually not demanded.

**Conclusion:**

This paper is an attempt to make aware of currency futures to general public, and small and medium and big corporations. Various corporate can now hedge currency risk in stock exchange by using various kinds of currency derivative contract. In India Currency future is one of the important hedging tools to mitigate the risk from the 2008. Earlier to hedge currency risk corporate have to depend on bank and most of the hedge contracts were forward contracts. So in this paper we tried to explain various aspects which relating to currency future and its markets in Indian context.

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