

Airpockets Ahead



Companies that crash-landed their exotic derivatives three years ago are now playing it safe. But as turbulence builds up in the rupee market, the grounded approach may no longer be enough.

JOHN SAMUEL RAJA D , SRIRAM SRINIVASAN , NANDITA DATTA , SUDIPTO DEY

Exotic Losses

- Total principal amount (notional) outstanding were estimated at Rs 71.71 lakh crore (\$1.65 trillion) as on March 2007.
- It increased sharply to Rs 117 lakh crore (\$ 2.45 trillion) in fiscal 2008
- Total mark-to-market (MTM) gains for 22 banks from the above derivative contracts is Rs 31,719 crore as on December 2008. These gains were MTM losses in the books of banks customers
- However, the unrealised dues for banks is only Rs 756 crore.

He's taught Wal-Mart a thing or two about supply management. Chartered accountant-turned-entrepreneur S Susindran doesn't just export home furnishings from his office in Karur, Tamil Nadu. He also helps the world's biggest retailer determine which products sell faster, how to stack them in the stores and how much stock to hold.

But even a canny businessman like Susindran was caught unawares by the havoc the global slowdown of 2008-09 left in its wake. While the drying up of orders wasn't unexpected, the impact of currency fluctuations was bewildering and brutal. "There was a double impact," says Susindran. "Sales dropped because of the recession and the rupee moved in the opposite direction to what we had anticipated." Three years ago, Susindran's company, Sabare International, had followed financial consultants' advice and hedged at the prevailing

rate of Rs 40 to a dollar. But the rupee went on to lose value at a record pace (it had fallen to Rs 50.52 to a dollar by November 20, 2008).

To make matters worse, Sabare had also subscribed to complex hedging products (see: *Hedging Demystified*), now known as 'exotic' derivative products, since they promised not just protection of export earnings but also profits. Instead, in addition to a Rs 50 crore drop in sales, the Rs 300-crore company lost Rs 12 crore because of subscribing to these products. It is now fighting a bitter court battle against the bank for alleged "mis-selling". (Sabare's sales dropped to Rs 250 crore because of the recession.) It isn't much comfort to Susindran that Sabare wasn't alone in succumbing to the lure of exotic options. Now, three years after the exchange rate-driven loss that wiped out his profits for the year, Sabare stays far away from complex derivative products. A lesson learnt at a very high price.

Why did Indian exporters rush, lemming-like, over the cliff of financial instruments? Forex consultants blame the inexperience in dealing with "two-way" movements of the rupee against major currencies like the dollar or the euro. Until 2006, exporters played safe as it was a one-way bet for them: the rupee depreciated against the dollar. "The biggest learning we've had from the 2007-08 forex crisis was that the market doesn't always move in one direction. It can swing both ways and very rapidly," says V Balakrishnan, Senior Vice-President and CFO of Infosys Technologies, which earns \$1 billion every quarter from clients abroad.

Most exporters just weren't prepared for currency volatility—and its impact on their earnings. So, they sought solutions wherever they could—in this case, from exotic derivatives. "Exporters then thought they could beat the market, but they learnt their lessons," says Jamal Mecklai, a leading forex expert and CEO of Mecklai Financial.

They overlooked one crucial aspect of currency movements—the exchange rate between India and the US is not determined by just what is happening in these two countries, but also by other global events. Last month, for instance, when the euro was rapidly losing value on the threat of sovereign debt defaults by some Eurozone members, investors across the world dumped the euro and flocked to the dollar. The greenback strengthened, not just against the euro, but also the rupee. These events are now becoming increasingly difficult to predict, making the exchange rate volatile once again. And increasingly, the value of the rupee is being determined by so-called "hot money"—short-term capital flows.

Hot Money

Between 2005 and 2008, Indian GDP grew at over 9% a year, which acted like a magnet on short-term capital inflows into the country as foreign investors rushed to participate in the growth story. From just under \$7 billion in 1990-91, when India's forex crisis was at its peak, capital flows increased steadily to \$45 billion in 2006-07. The next year, that figure ballooned to \$107 billion, and the rupee appreciated 9% against the dollar.



By the following year, though, the global financial crisis took its toll and net capital inflow dried up to \$7 billion—not enough even to bridge the trade deficit. The result: the rupee's value plummeted, depreciating nearly 22% in 2007-08. "A strong or a weak currency is a reflection of a number of factors and we don't have choices. It depends on how other economies look at us (India)", says India's Chief Statistician, Pronab Sen, explaining that factors that lead to the rise or fall of the rupee cannot be controlled easily.

The Reserve Bank of India (RBI) Governor holds similar views. Speaking recently at a conference on 'The International Monetary System', jointly organised by the Swiss National Bank and the IMF in Zurich on May 11, D Subbarao touched upon a proposal to tax capital inflows. He added that "learning to dam the flows so that the benefits of capital flows exceed their costs remains an intellectual and policy challenge for emerging market economies".

Uninformed Choices

Paradoxically, every improvement in the Indian economy—and the consequent strengthening of the rupee—is a body blow for exporters. When the rupee appreciates, exports from India become more expensive, and buyers look for alternative sources. In a knee-jerk reaction to the see-sawing rupee three years ago, many exporters opted for complex hedging products. Now they're fighting legal battles against their banks, claiming they were cheated since the finer details of their contracts weren't explained to them.

Among them is Tirupur-based textile garment exporter Raja Shanmugam. His firm, Warsaw International, bought a complex currency derivative product with a leading private bank three years back. "We were not regular customers of the bank. They (the bank) were selling products door-to-door and we believed the sales pitch," he says. It was only when the rupee depreciated sharply against major currencies that Shanmugam came to know the implications of buying those products. "The maximum gain I could have got from the contract is \$8,000, whereas my loss is a bottomless pit," he rues. Warsaw International now faces a loss of Rs 3.28 crore on a contract valued at \$2 million (about Rs 9 crore).

Now, he has formed a forum with 40 other exporters who, like him, have lost money by buying the so-called exotic products. Their group is called the Forex Derivative Consumers' Forum (FDCF)—its members have collectively lost between Rs 300 crore and Rs 400 crore, and all have filed cases against the banks that hawked the products to them.

The FDCF represents just a fraction of the losses because of currency derivative products. According to an RBI submission in the Orissa High Court, the mark-to-market (MTM) losses for customers who bought these derivative products stood at Rs 31,719 crore in December 2008. (MTM is an accounting principle where the value of these contracts is marked at current exchange rates.)

According to the RBI, 22 banks that sold complex derivative products had incurred a loss of Rs 756 crore as of December 2008 (more recent data is not available). Numerous cases are still pending in many courts, but the main one is in the Supreme Court, where the Fixed Income Money Market and Derivatives Association of India (FIMMDA) has filed a petition against the orders of the Orissa High Court, which has ordered a probe by the Central Bureau of Investigation (CBI) into these transactions. The apex court has stayed the CBI investigation and a final judgement is awaited.

The main contention of the companies that bought the complex hedging products is that they were "mis-sold" by banks—they were not made aware of the huge risks involved. Banks, on the other hand, contend these firms earned profits when their bets went off well, but since the going got tough, they have been trying to wriggle out of honouring their commitments.

Lessons Learnt

Three years since the last crisis, are Indian companies better prepared to handle currency volatility? To find out, *Outlook Business* spoke with over 20 companies across seven sectors: information technology, textiles and garments, oil refineries, commodities, automobiles, gems and jewellery, and pharma. *12 Ways To Manage A Swinging Rupee* highlights their different strategies. But there's one striking commonality between them: none of the firms, except one, subscribes to "exotic" or complex hedging products. And, tellingly, "even the banks themselves are not offering these derivative products", points out Shanmugam.

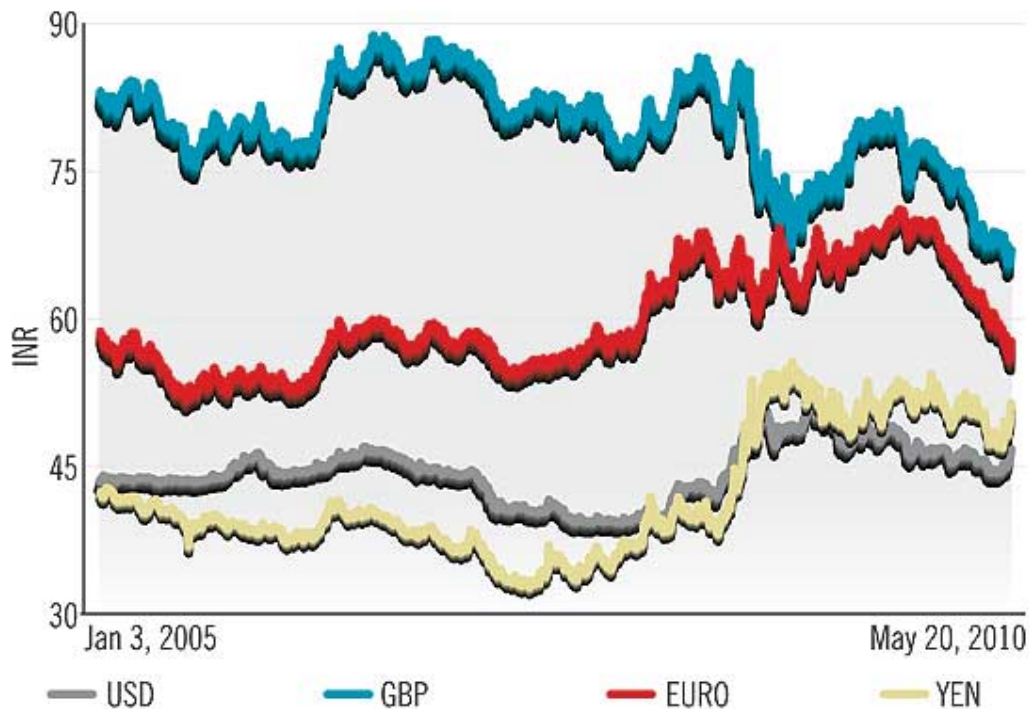
Meanwhile, Mecklai points out, "Demand for simple derivative products (like plain vanilla options) has seen a huge increase." The evidence is the trading numbers in the currency futures



market. From less than Rs 800 crore per day in October 2008, the average value of trading in currencies has now crossed Rs 35,000 crore. Out of this, nearly 80% is rupee-dollar contracts, says Primit Bhrambhatt, Chief Executive of Alpari India, which provides online foreign exchange trading services.

Companies are also no longer looking to make profits from hedging their export earnings, but are using it purely as a risk-management tool. "It is not a place to make profits," adds Bhrambhatt, referring to hedging activity. Indian firms seem to have learnt their lesson from their previous experience.

March Of The Currencies



Now What?

Even as exporters seek new ways to tackle currency volatility, policymakers continue their hands-off approach to the exchange rate. According to Shankar Acharya, honorary professor at the Indian Council for Research on International Economic Relations (ICRIER), the RBI was actively intervening in the foreign currency market by buying and selling dollars and other currencies until spring of 2007. After that, the central bank has adopted a non-interventionist approach, leading to the exchange rate being determined by short-term capital flows, he adds. As a result, the RBI's Real Effective Exchange Rate (REER), a measure of the rupee's value against a basket of six currencies, appreciated to 116.17 on April 16, 2010, compared to 98.58 last April.

Acharya, the former chief economic adviser to the government of India, advocates active RBI intervention in the market to prevent rupee appreciation and maintain a REER reading of 105. "In the Indian context, preventing rupee appreciation is the best form of support for small and medium exporters," he says, pointing out that most of their competitors are in China and Bangladesh, where the foreign exchange rates are fixed. Another solution proposed by some economists is to impose a tax on short-term capital flows. But Chief Statistician Sen opposes such knee-jerk reactions to contain capital flows. "We need to think through the situation and wait for some clarity to emerge from the current situation (the threat of sovereign defaults in some parts of Europe)," he adds. Ashima Goyal, a professor of economics at the Indira Gandhi Institute for Development Research, also feels there is no need for intervention now by the RBI. However, "in the long run, the RBI should intervene because of the large current account deficit. The rupee has to be competitive against other currencies."

Where will the rupee be six months from now? There are near equal views for a strong and weak domestic currency—and everybody agrees that regardless of where the rupee ends up over the next half-year, it's in for a roller-coaster ride. "Moving forward, we feel the rupee is unlikely to move in any one direction—it will swing both ways. My prediction is that we are in for a very volatile forex movement," says Balakrishnan of Infosys. One reason for this volatility, according to forex expert PV Raghunathan, is the herd mentality exhibited in the rupee-dollar market. "People are either close to zero hedging or 100% hedging. When the rupee fell to 44 to a dollar, everyone covered for the next five years. And when the rupee went to 50 and beyond, all the importers started hedging for the next three years. This sort of market positioning exaggerates the movement," he says.

Besides, the rupee movement will also be guided by global factors. For instance, the strengthening of the dollar against the euro—which has lost 30% of its value in the past one year—will also impact the rupee value. Similarly, high oil prices (over \$80 a barrel) will disrupt the trade balance and lead to rupee depreciation. "Global factors could lead to rupee depreciation in the short run, but the trend is towards rupee appreciation," explains former chief economic advisor Acharya. Short-term capital flows, which influence the rupee value to a large extent, could be impacted if the US decides to increase interest rates. If that happens, investments will be diverted from emerging economies back to the US, leading to a fall in the value of the rupee.

The current interest-rate structure favours investments in India. "Many institutional investors are pumping money into India and that increases dollar supply," says Ashok Leyland CFO K Sridharan. He expects the rupee to strengthen substantially over the next six months to one year.

Umang Vohra, CFO of Dr Reddy's Laboratories, also believes the rupee will have an appreciating bias. Apart from a strong domestic economy that is attracting money into the country, says Vohra, "we think the renminbi will have to appreciate in time and that will create an appreciating side for the rupee. What's happening in Europe or elsewhere in the world may lead to periodic upticks. But we believe the Rs 44-47 range will hold for quite some time."

The dark horse in the rupee race is capital account convertibility (allowing resident Indians to freely invest money abroad without any restrictions). "If that happens, there will be a steep swing in favour of the rupee," says Sridharan. That's a far-off possibility, though, and Susindran is thankful for that small mercy, at least.

—By John Samuel Raja D, Sriram Srinivasan and Nandita Datta With inputs from Sudipto Dey

<http://business.outlookindia.com/article.aspx?265937>