

Recent Losses in Currency And Interest Rate Derivatives



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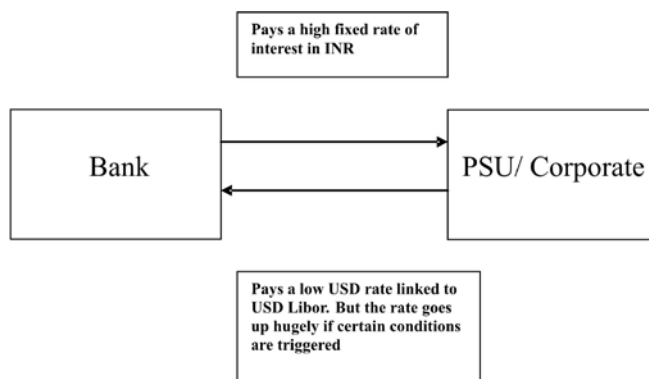
Background:

Currency and interest rate derivatives got introduced to India in 1996. The Reserve Bank of India came up with guidelines for the first time. Since then the derivatives markets have grown at a brisk pace, to say the least.

Over the last two months, the Indian newspapers have been carrying reports of large losses incurred by Indian corporates on account of risky transaction in currency and interest rate derivatives executed by them. Some of the losses have been booked while others remain in the respective books of the corporates as Mark To Market (MTM) losses. The term 'MTM' denotes that losses are yet to be crystallized and the final quantum of loss may be higher or lower than the MTM figure. The market estimates of the overall losses vary between US\$ 2 Billion to \$ 4 Billion.

What is going on? How did a crisis of this magnitude take place? Who is to blame? Is it all speculation? Have the markets been terribly volatile? Has the RBI been taking corrective action in a timely manner? What could have been done to avoid this? What are the important learnings?

It is important to get into a bit of recent history to get the perspective right. The first murmurs of trouble brewing in India's backyard were heard in 2006-07. A very large PSU had entered into a derivative contract with a highly reputed U.K. based bank. This was seamlessly packaged with an underlying bond issue and the ostensible purpose of doing the derivative was to reduce the rate of interest on the bond.



So far so good. Except that the PSU that did the transaction perhaps thought that it was a one way ticket towards saving a great deal of money. Did they understand that the derivative contract was an exotic one? Did they have the internal resources/personnel to understand the risks embedded in the transaction? Was an attempt made to quantify the risks? Did the company's prior background in dealing with derivatives or other such instruments that are traded in the markets

indicate any degree of readiness or familiarity to take on the transaction under question? I am afraid that the answers to these questions are all in the negative.

What about the Bank? Did they think that the PSU client chosen for the transaction was an appropriate one? Would they attempt selling a similar transaction to One of India's top 20 corporates that have laid down risk management policies and more importantly have the right resources to handle them?

When the MTM loss came to their knowledge, the PSU lodged a complaint with the RBI claiming that they never understood what they were getting into. They added that the bank never explained all the risks embedded in the transaction and had therefore sold them a structured transaction that was highly inappropriate for a corporate of this kind. The RBI after due deliberation sought feedback from a large cross section of the markets. Upon receiving feedback and weighing their pros and cons, the RBI made it mandatory that every transaction must hereafter have a brief explanatory note on all the risks embedded in the transaction.

The banks took a while to recoup their marketing efforts. Their task was not necessarily made any more difficult than in the past since all they needed to do was to indulge in "perception management". They needed to be perceived by the regulators that the risks were incorporated in the 'term sheet' of a transaction.

Current state:

It is estimated that between August 2006 and October 2007, corporate India got into long term derivative contracts, many of which were leveraged, ostensibly to hedge their currency and interest rate risks. The reality was a little different and somewhat scary. Before getting into that let us state some facts from the perspective of the markets, banks and corporates. It is important to clarify at this stage that while talking of "corporates", we are excluding the top 20 private sector corporates, others with sound risk management policies that they diligently follow and companies whose treasuries are run by market professionals.

The market perspective:

- The dividing line between hedging and speculation is very thin.
- The large global MNCs and an increasing number of the truly large Indian clients are fairly sophisticated in their approach to risk management, are usually conservative and choose simple instruments for hedging.
- It is not surprising therefore that they usually do not lose BIG money.
- Asian clients and now increasingly so Indian clients are

a hot favourite of large global and investment banks. The reasons are not far to see.

- While corporates are running huge MTM losses, banks never lose money unless a client defaults, i.e. the bank's position on the client trade is fully hedged. To illustrate, a bank may make a profit of INR 25 crore on a long term derivative contract whereas its counterpart client, if the view goes wrong, lose INR 50 crore.

The Bank's Perspective:

- They are merely doing their job. Their job is to sell and make more money.
- They keep their internal compliance teams happy about being on the right side of laid down regulations in the countries they operate in.
- Globally, derivatives make a huge amount of money for large banks
- Banks are not advisors but act as mere counterparties. Corporates in India have a grossly erroneous perception that banks act as their advisors

The Corporate Perspective

- Many of the corporates that are running large MTM losses have very little understanding of derivatives or markets
- While they have sound management practices in operations, sales and other key functional areas, key resources are lacking for managing the treasury portfolio. Most do not have the in house expertise of demarcating between a risky and low risk trade.
- Some get lucky with low profits in relatively risky trades which embolden them to look at bigger transactions.
- Small profits are readily booked but MTM losses are often wished away and not attended to till matters blow up.
- Market volatility is often underestimated.
- While they are aware of their shortcomings, are often reluctant to seek professional help meaningfully.

Summing up

India is still a nascent and emerging market from the perspective of local corporates and Institutions as far as their knowledge and awareness of markets and derivatives is concerned. They are pitted against large global commercial and investment banks, whose profit motive is substantial and their technical knowledge derived from learning of more advanced markets is of a very high order. This makes it a battle of unequal partners.

In the recent run up to the losses, a few companies have run up gigantic MTM loss numbers. It is not clear what quantum of such losses have been booked. There have been

rumours that banks may arrange for credit lines to help their clients overcome this trying phase. Among sectors that have got hit, just to name a few are, infrastructure, auto components, software, diamond, textiles. The main driver of transactions has been "greed" and not "fear".

In some family run companies, the CEO, takes key decisions often because he perceives that as the leader he will take the most appropriate decision. Some patterns come to light. There is very little understanding of certain basics, some elementary "dos" and "don'ts" that a company must follow. Professional external advice is sought and paid for but decisions are largely taken by the companies themselves often disregarding advice.

An important point to understand is that a "hedging transaction" as compared to a "speculative transaction" will never result in such losses.

How much are the markets to blame? There is an old saying in the market that the "*market may not be as smart as you, but the market is always right*". The CFO of a textiles company pointed out to me recently that not one bank from the dozen odd banks whose research he reads regularly, had forecasted that the EURUSD would touch 1.5950. Just goes to show how predictable markets can be and the suave banker at the other end knows as little as the client does about the future. Yes the sub prime crisis has aided the US dollar's plunge but then what logic is there for a USD exporter to dabble in an exotic transaction comprising of six currencies none of which he understands.

Does the bank not have the client's interest at heart? Of course they do. Clients are never forced into trades and it is the bank's job to make money. If every other sphere of

business is looking at India as a key market, it is not a surprise that Indian corporates are targeted.

Impact:

In the short term, activity in the derivatives segment will certainly slow down. Some companies will stop derivatives completely. The larger ones will work towards finding out what they could have done differently. Some of the corporates that are taking the banks to court may settle out of court.

In every crisis, there is usually an opportunity. Having said that, corporates that have not been hurt in the recent crisis are likely to be apprehensive of entering into derivatives at this stage.

In the medium term, business will pick up. Corporates will begin to dabble with derivatives. The ones that wish to become serious players must go about identifying and acquiring the right resources. The corporates that have large MTM losses must learn from the experience of those who have sound risk management policies and have great internal resources to take balanced decisions on matters relating to markets.

Will such events occur again? They will, almost certainly. Since public memory is usually short and greed and indiscipline rule large in financial markets.

Outsourcing of treasury activity could catch on. For that to happen, corporate India needs to come out of the mindset of "pennywise, pound foolish" since meaningful advice is never inexpensive.

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