Funds Hotline

September 26, 2009

SEBI DRAWS FIIS "INTEREST": PERMITS TRADING IN INTEREST RATE FUTURES

Introduction

Aligning with the changing market dynamics and keeping an eye with the main objective of protecting the interests of the investors, Securities and Exchange Board of India ("**SEBI**") has *vide* its Circular No. SEBI/DNPD/Cir-46/2009[1] ("**2009 Circular**") dated August 28, 2009 introduced trading in exchange traded Interest Rate Futures ("**IRFs**").

Interest Rate Futures

IRFs are standardized derivative contracts that have been introduced for trading in the Indian market. It is similar to any other derivative product except for the underlying security. The underlying security here is not a stock or basket of securities but instead it's a 10 year notional coupon bearing Government of India security ("**G-Secs**"). National Stock Exchange (NSE) initiated and launched the trading in IRFs on August 31, 2009; accordingly the launch by the Bombay Stock Exchange (BSE) should follow soon.

Characteristics of the standardized IRFs:

Following are the characteristics of the standardized IRFs, including the product design, margins and position limits that have been introduced / clarified by SEBI and which should be complied with all the recognised stock exchanges:

- For the G-Secs to operationalise, SEBI has prescribed the Deliverable Grade Securities ("**DGS**"). All the exchanges shall select their own basket of securities from the list of eligible DGS prescribed by SEBI.
- The maturity period for the DGS should be within 7.5 years to 15 years from the first day of the delivery month with a minimum total outstanding stock of INR 100,000,000,000 (app. USD 2 billion).
- The contract size is to be INR 200,000 (app. USD 4,000) with a maximum maturity period of 12 months.
- The contract cycle would consist of four fixed quarterly contracts for entire year, expiring in March, June, September and December.
- The contract would be settled by physical delivery of DGS using the electronic book entry system of the existing depositories (NSDL and CDSL) and public debt office of the Reserve Bank of India.
- The rate of the coupon of such G-Secs would be 7%.
- SEBI has laid down the method of determining the daily settlement price for the G-Secs.

Trading by Foreign Institutional Investors ("FIIs")

Pursuant to the 2009 Circular, all the FIIs registered with SEBI have been allowed to trade in the IRFs. However, investments by FIIs in IRFs will be considered as debt investments and will be subject to the overall limits prescribed for debt investments. SEBI had *vide* Circular No. IMD/FII & C/ 29 /2007[2] dated June 6, 2008 raised the total investment limit by all the FIIs in G-Secs to USD 5 billion on a 'first come first served' basis.

In the 2009 Circular, SEBI has prescribed the following two conditions:

- the total gross long (bought) position in cash and IRFs markets taken together should not exceed the individual permissible limit for investment in G-Secs; and
- the total gross short (sold) position, for the purpose of hedging only, should not exceed their long position in the government securities and in IRFs, at any point in time.

Implications

The introduction of Interest Rate Futures in India was in itself a step towards the integration of the Indian markets with the rest of the world. Being a great initiative it paved the way for many more innovative options in trading. Some of our observations are as follows:

- As the underlying security in IRFs is not a stock but interest rates instead, it may be used as a good tool for the purposes of hedging specially for those who hold G-Secs in large number;
- The process of calculation of the daily closing price of IRFs for mark to market settlement is transparent being the last half an hour weighted average price of the futures contract;
- By opening the doors to FIIs to trade in the IRFs, besides retail investors, fund houses, banks, etc., it is a step towards opening of the market to greater heights and bigger indexes.

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1 Circular No. SEBI/DNPD/Cir-46/2009

2 Circular No. IMD/FII & C/ 29 /2007

- Divaspati Singh & Sambhav Ranka

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