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Theme 215
INTEREST RATE FUTURES

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SIB STUDENTS' ECONOMIC FORUM

OCTOBER 2009

Theme No. 215 : INTEREST RATE FUTURES (IRFs)

Interest rate risk is one of the most basic common risks faced by market participants today. The volatility in interest rates has increased in the liberalized competitive environment. Interest rate futures help in hedging exposure due to interest rate risks. Changes in interest rates will affect value of interest-bearing assets, such as bonds, securities or loans. Interest rate futures will help in offsetting losses by holding such positions, by generating corresponding gains in futures position. In case of losses from futures position, there will be offsetting gains from the holding portfolios, thus futures acting as hedge to interest rate uncertainty.

An IRF is a derivative contract traded on the stock exchanges. It is an agreement to buy or sell an interest bearing underlying instrument at a future date and at a specified price. Investors are allowed to take a bet on the future movement of interest rates by buying or selling IRF.

As per RBI directions on the subject, an IRF is a standardized interest rate derivative contract traded on a recognized stock exchange to buy or sell a notional security or any other interest bearing instrument or an index of such instruments or interest rates at a specified future date, at a price determined at the time of the contract.

Interest rate futures were introduced at the National Stock Exchange (NSE) in 2003, but they did not succeed. The long term IRFs were re-launched on August 31, 2009 at NSE as the 'Notional 10 Years Government of India Securities Futures.'

Features of the Standardized Interest Rate Futures Contracts:

i. The contract shall be on 10-year notional coupon bearing Government of India security.
ii. The notional coupon shall be 7% per annum with semi-annual compounding.

iii. The contract shall be settled by physical delivery of deliverable grade securities using the electronic book entry system of the existing Depositories, namely, National Securities Depositories Ltd. and Central Depository Services (India) Ltd. and Public Debt Office of the Reserve Bank.
iv. Interest Rate Futures contracts on instruments shall be traded on the Currency Derivative Segment of a recognized Stock Exchange. Individuals or firms can buy or sell interest rate futures by placing orders with the trading members of the exchange.

Thus the IRF contract is on a notional security and not actual security because a security conforming to this description may not exit. The seller will fulfill his obligation by delivering one of the deliverable grade securities approved by the exchange. The security exchanged will be an existing security. It may carry a coupon higher or lower than the 7 percent required under the futures contract. Suitable adjustments in final payment made by the buyer will ensure that he actually gets the coupon rate of 7 percent compounded half yearly.

Duration of IRFs

The futures contract will have a maximum expiration cycle of 12 months. Quarterly contracts are available, expiring by the months of March, June, September and December. Thus there will be December 2009 futures, March 2010 futures and so on. A futures contract expires seven working days prior to the last business day of the expiring month. The expiry month is also known as delivery month since delivery of security for outstanding contracts are expected during this period.

Delivery under the IRFs

The obligation of the seller under the futures is to deliver one of the deliverable grade securities. The list of deliverable grade securities is specified by the exchange separately for futures of each quarter. The criteria applied for including a security in the list is that (i) the Indian government security should mature after at least 8 years, but not later than 12 years from the first day of the delivery month, and (ii) its minimum outstanding stock should be Rs. 10,000 crore.

The seller can deliver the securities on any day during the delivery month.

The seller should convey to the exchange his intention to deliver securities at least 2 business days prior to the actual delivery date.

Size of contract, Price Quotation, Settlement Price

The size of one futures (lot size) is a security whose face value is Rs. 2 lacs. There will be 2000 such units for a specified futures. Thus a buyer who wants to acquire securities of the face value of Rs.20 lacs needs to order 10 futures.

The quotation is similar to the quoted price of government of India securities. The price is quoted for the security having a face value of Rs. 100. The tick size – minimum price variation - is Rs. 0.0025, a quarter paise, and quotations can be changed in multiples of a quarter paise.

Invoice price is the actual amount that the buyer should pay to the seller on receipt of securities delivered under futures contract. Each deliverable security has been assigned a conversion factor to make the yield on the delivered security equal to 7 percent compounded half yearly as on the first day of the delivery month.

Margin and Marking to Market

The futures contract is marked to market daily on the basis of the closing price on the previous day. The change in the value of the contract due to marking to market is adjusted in the margin account of the clients – both buyer and seller. Initial margin levy is based on 99 percent value at risk over one day horizon. The minimum initial margin is 2.33 percent on the first day of trading and 1.6 percent thereafter. Extreme loss margin is in addition to initial margin and is required to be maintained at 0.3 percent of the value of the futures. Delivery margins are levied once the positions are intended for delivery.

Use of Interest Rate Futures

Interest rate futures can be used for hedging, speculation and for arbitraging as well. Hedgers use interest rate futures to reduce losses arising from interest rate volatility. If one has net long (bought) position in interest sensitive assets and liabilities, his spot position will be adversely affected by an interest rate increase. If interest rate increase is anticipated, one should sell interest rate futures. If the interest rate subsequently rises, futures prices will fall. He can offset the position on futures by buying

futures at a cheaper price, resulting in profit in the futures market. This will partially or fully compensate for the loss in the spot position.

A decline in interest rates will affect the person who is short (sold) in interest sensitive assets and liabilities. Fall in interest rate will cause the future price to rise. One who is oversold in assets/securities can buy futures and sell when interest rates come down and futures prices increase. By buying low and selling high, the hedger makes a profit in the futures market. Speculators and traders take a view on interest rates and enter into positions in the futures market to earn profit. If it is viewed that interest rates are going to decline, a long (bought) position can be taken, expecting price of futures to go up. If it is viewed that rates are likely to increase, a 'short' (sold) position can be taken, expecting prices to come down.

Arbitrageurs take into account the price difference between the futures price and the underlying price. Arbitraging may also be done when mis-pricing is observed between futures of different maturities.

Just like portfolio values can be hedged through IRFs, investors and borrowers can make use of IRFs for protecting interest income and interest cost out of their investments and on loans holding till maturity. An investor in long term floating rate bonds will incur the risk of lower returns in case of a fall in interest rates. He can hedge against that risk by taking a long position in interest rate futures – i.e. buying futures. When interest rates actually decline, the bond prices will increase, thereby futures price will also increase, and actual decline in interest income will be offset by gain from the sale of futures at higher prices. A borrower can hedge against increasing interest cost by selling futures. When interest rates actually increase, he can buy back futures at lower prices thereby the gains will offset higher interest cost.

Interest rate futures have added one more instrument of hedge to the bankers and corporate treasurers. Corporate treasurers can use the instrument for hedging as well as trading. Banks can use them to manage their investment portfolio and also offer them as a risk management product to their customers.

Interest Rate Futures - Product Design

Product Design Parameters	**Remarks**
Underlying	10 year Notional Coupon-bearing GoI security
Coupon	Notional coupon 7% with semi annual compounding
Trading Hours and Days	9.00 a.m. to 5.00 p.m.; Monday to Friday
Size of contract	Rs. 2,00,000
Quotation	Similar to the quoted price of the GoI Security
Tenure of the Contract	Maximum maturity : 12 months
Contract Cycle	Four fixed quarterly contracts - expiring in March, June, September and December
Daily Settlement Price	Closing price of the 10 year National Coupon bearing GOI security futures contract on the trading day
	Closing Price = Weighted Average price of futures for last half an hour/ the theoretical price to be determined by the exchanges
Settlement Mechanism	Settled by physical delivery of deliverable grade securities
	Delivery of deliverable grade securities from the first business day of delivery month till the last business day of delivery month
Deliverable grade securities	Goi securities maturing after at least 8 years but not more than 15 years from the first day of delivery month with a minimum total outstanding stock of 10,000 core.
Conversion Factor	Conversion Factor for deliverable grade security equal to the price of deliverable security on the first day of delivery month, to yield 7% with semiannual compounding.
Last Trading Day and Delivery Day	Seventh business day proceeding the last business day of the delivery month; and last business day of the delivery month

Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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