Non Deliverable Forwards

NDF (Non Deliverable Forwards) as the name suggests is an OTC (Over the Counter) derivative market for currencies. The NDF market is an off shore market where trading for a currency pair takes place outside the country of origin. Trading for the USD/INR pair takes place in Singapore, which is the hub for NDF markets. NDF market does not require physical delivery of the currency and is more like a futures market that is traded on the stock exchange.

The NDF market has been in existence for well over a decade. The fact that the market is unregulated and is highly institutionalized with players comprising of global banks and hedge funds makes the market difficult to follow and understand by non institutional market participant. Hence a FAQ on NDF will help you to get to know the NDF market better.

NDF – How is it traded?

The NDF market is an OTC market. Trading on NDFs takes place through telephones and private electronic media channels. Traders quote bid-ask spreads on currency pairs such as the USD/INR, USD/CNY, USD/THB, USD/IDR, USD/PHP, USD/KRW and USD/MYR and hedge funds, banks and FII’s hit the quotes to buy or sell a currency pair.

Example of a NDF quote

A trader quoting on a 1 month USD/INR NDF will quote Rs 58.90/ Rs 59.10 for a USD 5 million notional against a spot price of Rs 58.50. A hedge fund wanting to go long the pair i.e. shorting the INR, will buy the pair at Rs 59.10.

The hedge fund is long the USD/INR pair at Rs 59.10 for a notional amount of USD 5 million.

Are there any margin payments involved in the transaction?

Margin payments depend on the counterparty risk limits the trader has with the hedge fund. Trades between two banks would not usually involve margin payments but again this depends on the banks involved. Small banks with weak credit ratings might have to pay margins on the trade.

Price Movements on the NDF

The hedge fund is long the USD/INR pair for USD 5 million notional at Rs 59.10. The INR depreciates against the USD in the next one week and the quote for one month NDF by the trader for USD 5 million notional is now Rs 59.30/Rs 59.50.

The hedge fund believes that it is the right time to take profits and goes and sells the pair at Rs 59.30. The hedge fund has effectively made a profit of USD 16,863 on the trade in a week and receives the profit from the trader. ((59.30-59.10)*50000000)/59.30.
Cash settlement

NDF trades are cash settled with only the difference between buy-sell rate being exchanged between counterparties.

Limits on transactions

The NDF market is not regulated and a country’s currency controls (if any) are not applicable. The market is self-regulated and primarily works on counterparty risk limits.

How does the NDF market affect a domestic market?

The NDF market affects a domestic market largely on sentiment. For example if USD/INR one month forwards rise in the NDF market, it will affect both the spot and the forward market in India as there will be worries on FIIs pulling money out of the country. Equities and bonds too will see weak sentiments on FII pull out worries.

The reason why rising NDF markets suggest FII pull out is that hedge funds and FII’s selling the INR indicates risk aversion leading to selling in all other asset classes.

Arjun Parthasarathy is dedicating his experience of over twenty years in financial markets to guide investors to the path of informed decision making on their investments. The more informed the investor, the more money the investor will make is the guiding principle of Arjun. The fact that he has worked across markets including equities, interest rates, credits and currencies and across market platforms of fund management, proprietary trading and research, gives Arjun the extra edge that is required to guide investors to make the right investments in the globalized nature of markets.