

# An overview of the JSE's Currency Derivatives Contracts

In response to the market's need for an on-exchange tool to hedge against currency risk, the JSE's launched currency futures in 2007. Trading in currency derivatives allows companies and individuals to successfully hedge against foreign exchange exposure as well as take a view on the movement of the underlying exchange rate.

Currency futures were launched as a retail investment product and were only available for individual investors. Then, in his 2008 budget speech, Trevor Manuel the previous Minister of Finance made a special dispensation that allowed all South African corporate entities to trade currency futures. Corporate entities, including limited or unlimited companies, private and public companies, close corporations, partnerships, trusts, hedge funds and banks are authorised to trade currency futures with no restrictions on the value traded. Corporate entities do not need to apply to Reserve Bank for approval to trade the currency futures nor do they have to report their trades. Pension funds are subject to their foreign portfolio allowances.

The JSE's currency derivatives products have experienced significant growth in over the past three years. Currency options were launched in 2008 and are complementary to the existing currency futures market. The introduction of currency options increased both trading volumes and liquidity in the local currency derivatives market.

The JSE currently offers the following currency futures and options contracts:

- ⊙ Dollar/Rand
- ⊙ Euro/Rand
- ⊙ Sterling/Rand
- ⊙ Australian Dollar/Rand
- ⊙ Japanese Yen/Rand
- ⊙ Canadian Dollar/Rand

## Currency Futures

A currency futures contract is a contract that allows market participants to trade the underlying exchange rate for a period of time in the future. Currency futures are agreements between two counterparties where one counterparty buys (longs) the underlying exchange rate and the other sells (shorts) the underlying exchange rate on a specified future date. The underlying instrument of a currency future contract is the rate of exchange between one unit of foreign currency and the South African Rand. Currency futures are contracts that allow participants to take a view on the movement of the exchange rate as well as hedge against currency risk. Currency futures will be used as a trading, speculating and hedging tool by all interested participants.

Here is a simple exchange of how an import business can use currency futures to hedge against foreign exchange risk. Say ABC Importers is a South African company that imports goods from the United States. The company is due to import goods from the states to the value of \$70 000 in three months time. In order to hedge against the risk of a depreciating rand, ABC Importers can purchase a currency future contract now, in doing

so, 'lock in' the current exchange rate of R7.6860. One contract is worth \$1000, so the company buys 70 contracts at \$70 000 or R538 020 at the stated exchange rate.

Fortunately, the contract does not require ABC Importers to deposit the full amount but rather a small percentage of the amount called an initial margin amount – in this case R21 700 (R310 x 70 contracts) as well as a brokerage fee negotiated with the company's broker. Three months later, when the company is due to pay the amount to the manufacturers in the states, the rate has moved to R7.9635, which will cost the company an extra R19 425 (R7.9635 - R7.6860 X \$70 000). Fortunately, the company has made a counteractive profit of R19 425 on the currency future contracts. The company can now sell the contracts and use the profit to offset the increased cost of the goods.

### Currency Options

Like currency futures, currency options allows investors and speculators to benefit from the movement of the Rand against other currencies, but differ in that they come with a 'built-in insurance policy' where the investor is able to resign a contract at any point in the contract term. In other words, currency options are contracts that grant the investor the right but not the obligation to buy or sell currency at a set rate at a set time. This means is that Currency Options allow the investor the choice not to exercise the contract if the exchange rate is not in his or her favour.

### Risk of trading Currency Derivatives

No investment or trading product can offer returns without the investor having to assume some risk. The main risk associated with currency futures trading is attributable to the effect that gearing or leverage has on a position. A geared transaction is simply 'the deposit of a smaller amount of cash, but being exposed to the full value of the transaction'. Investors deposit the 'initial margin amount' but are exposed to the full nominal value of the contracts traded. Gearing can cause significant profits or losses on a currency future position in a short period of time because of the effect of any movement in the underlying currency. The profits and losses on the underlying currency can be up to ten times more than on the future.



To find out more about the trading opportunities this market offers to both private and professional traders contact the JSE Currency Derivatives Team on 011 520 7000 or email [currencies@jse.co.za](mailto:currencies@jse.co.za)