

How SJM saved Tirupur from Forex derivative losses

“Double one-touch options” are not from the latest Madonna album. “Option legs” need not necessarily be associated with Mallika Sherawat. “Tokyo Cut” is not the latest cricketing shot invented by Kevin Peterson. “Knock In and Knock” out are not terms associated with boxing.

In fact, all these terms are from the arcane world of finance, notably Forex derivatives. Possibly, they could well be Greek and Latin to many readers even in downtown Mumbai, the Mecca of high end finance in India. But that is not so in distant Tirupur, a small town in interior Tamil Nadu. And the price Tirupur has paid to understand these terms and crucially their debilitating impact – an estimated Rs 400 crores as on date.

Tirupur – an introduction

But before I proceed to explain the devastation caused by Forex derivatives in Tirupur a brief introduction about Tirupur itself would be in order. Tirupur is an extraordinary success story. And like all success stories about India, it has been held back as a secret by the establishment, media, intelligentsia and of course academicians from our own people. After all, aren't we a nation of sceptics?

It is for these very reasons and despite its remarkable success, no B-school or management institute has undertaken an in-depth analysis of the success of Tirupur. Why, in fact many educational institutions in the neighbouring Coimbatore did not know about its success. And one of the primary contributors for the success of Tirupur has been the existence, functioning and domination of castes – yes castes – which urban Indian loves to hate, abuse and ridicule.

When the World Bank conducted its study a few years back about Tirupur it came to a conclusion that this remarkable growth of Tirupur was due to the coordinated efforts of the *Gounder* community, many of whom were not even matriculates. It is often commented that the Bumble bee as per the established laws of Physics should never fly. Yet it flies. And the only possible explanation for this is that the Bumble bee does not understand the laws of Physics! For, should it understand Physics it too could be burdened by the laws of Physics and explanations of physicists, never even attempt to fly.

Likewise the lack of education in Tirupur was a blessing in disguise for it turned employees, for want of clerical opportunities, into employers. And such employers, because of caste and community affiliations turned their factories, not only to produce goods but also into an open air university which would in turn endlessly produce entrepreneurs. This in brief is the remarkable story of Tirupur.

Consider this -

It is in this connection that the World Bank commented “Since 1985 Tirupur has become a hotbed of economic activity in the production of knitted garments. By the 1990s, with high growth rates of exports, Tirupur was a world leader in the knitted garments industry. The success of this industry is striking. This is particularly so as the production of knitted garments is capital-intensive, and the state banking monopoly had been ineffective at targeting capital funds to efficient entrepreneurs, especially at the levels necessary to sustain Tirupur's high growth rates.”

So what was behind this story of unprecedented growth and development of Tirupur? How was the capital, skill and technology available to people, who were as already pointed out, mere matriculates and in many cases much less. It is here that the World Bank analysis becomes crucial. Pointing out to the emerging frontiers of economies that are able to develop, regulate and sustain themselves, the World Bank suggests that the rise of Tirupur was because of its ability to manage its affairs by itself, raise capital from within and inspire others within the community to become entrepreneurs.

It is here that Dr Sharad Chari's meticulous research titled *Fraternal Capital: peasant-workers, self-made men and globalisation in provincial India* (Stanford University Press), tracing the rise of most entrepreneurs of Tirupur who belong to one community — *Goundars* — becomes instructive. Further, what is interesting is that he points out that only two-thirds of the entrepreneurs in Tirupur are matriculates or less, with only a third having been to college, and none — yes none — professionally qualified. This paradigm — lack of education on one hand and continued entrepreneurial spirit on the other — is central to his study of how castes and community in India are able to arrange themselves on their own, without any help from the government.

Likewise the World Bank's conclusion was stunning and much as it was forthright. It concluded that "The needed capital was raised within the Gounder community, a caste relegated to the land-based activities, relying on community and family network. Those with capital in the Gounder community transfer it to the others in the community through long-established informal credit institutions and rotating savings and credit associations. These networks were viewed as more reliable in transmitting information and enforcing contracts than the banking and legal systems that offered weak protection of creditor rights"

It was a product of liberalisation too

Tirupur was a product of its own discipline as much as it was a product of the liberalisation process. It may be noted that the rise of Tirupur coincided with the new economic policies adopted by the Indian government in the early 1990's. Crucially as the Rupee was steeply devalued, Tirupur acquired global competitiveness. It was its first brush with the global markets which in turn had a positive snowballing effect. Thanks to a liberalised regime, Tirupur quickly acquired newer technologies, adopted modern management techniques and of course leaner manufacturing practices. In effect, it was a classical case in convergence of the best practices in the Far East and the West.

Remember all this was achieved by people who were not schooled in high-end management institutes. Rather, they began to employ the products of these very institutes, Chartered Accountants, engineers and other professionals!

All this meant that the exports from Tirupur grew from Rs 15 crores in 1985 to close to Rs 12,000 crores in 2007! The un-stated yet official policy of the RBI to keep the Rupee weak to facilitate exports since the 90's helped Tirupur to grow from being a small dusty town into a bustling export centre of India. Put pithily, the continuous depreciation of the Rupee Vis-à-vis the USD since the early 90's till mid-2001 in more ways than one propelled the rise of Tirupur.

As the Rupee depreciated to almost 49 in early 2001, exporters of Tirupur virtually took out the exchange rate movements, importantly the Rupee appreciation out of their calculus. But linearity rarely works in life, much less in economics. Nevertheless, when the Rupee began appreciating since mid 2001 till early 2007 against the US Dollar, it was

so minimal and gradual that the exporters were even then able to adjust to this new phenomenon without recourse to any financial or Forex experts.

Paradoxically, what was the propelling force behind the rise of Tirupur, quickly turned into its Achilles heel. When the Rupee began to appreciate rapidly vis-à-vis the USD in the second quarter of 2007, [from a level of Rs 44 in January 2007 it reached a peak of almost Rs 39 per USD in January 2008] the exporters of Tirupur faced a huge crisis. This loss was twofold – on one hand it was erosion of profits resulting in gargantuan losses. More importantly, it was erosion of competitiveness for which the exporters off Tirupur which lead to significant loss of opportunities and markets in the first place.

Thus, the exporting community of Tirupur which was a beneficiary of the continuous depreciation of the Rupee was completely unprepared for this and was perplexed at the sudden turn of events. Surprised, stunned and stumped the exporters of Tirupur were scouting for antidotes to this financial Tsunami that hit them virtually from nowhere. This is where the story gets murkier.

Derivatives a weapon of mass destruction?

Before I proceed to deal with the banks, their role and the manner in which they have lured these exporters into exotic (or is it erotic) derivative contracts, its debilitating impact on the economy of Tirupur and various questions of law and violation of the RBI guidelines that it raises, an introduction the world of derivatives itself would be in order. Most economists begin by explaining as to how a farmer who has a wheat crop expected to be harvested in say April enters into a contract with a baker in February or in March to deliver a fixed quantum for a pre-determined price. It is further argued by proponents of such outlandish ideas that it is a win-win situation to both the farmer and the baker even when the prices of wheat rise or falls! Do not get fooled by such simplistic arguments, naïve illustrations and crude assumptions. The fact of the matter is that no farmer- repeat no farmer – ever sells his wheat in the futures markets. And even if he does no baker does buy it there.

Where is the question of selling in futures markets when normal banking channels is out of bounds for three-fourths of our farmers? As per the Economic Survey published by the Government of India, most of our farmers are even unaware of the Minimum Support Prices (MSPs). Yet they are supposed to sell their products in the futures markets! Most of these proponents of the futures markets in commodities do not even understand that many of the farmers are illiterates. And those who are literate do not have computers. And those who have computers do not have electricity to operate. Yet the standard assumption is that forward markets help farmers in “discovering prices” for their produce.

In short, whether these markets help our farmers or not, these are gambling indulged by finance professionals, couched in jargons, aided by technology and sanctified through an elaborate process of law. No wonder less than 2% of the trades in any of these derivative markets are settled through otherwise then by actual delivery. Yet the standard explanation has been than a bit of speculation helps in ensuring liquidity of the markets. Is it a case of ninety-eight percent wagging two percent or is it the other way around? Either way, one fails to understand the underlying logic that drives the purpose of these institutions and instruments especially in a country like India.

Whatever be it, it would be surprising to note that Warren Buffet calls derivatives as Weapons of Mass financial Destruction (WMD). Noted Chartered Accountant and eminent columnist, Gurusurthy, calls derivatives as Intercontinental Ballistic Missiles (ICBMs) after the recent spate of credit derivatives originating from the US hitting financial institutions across the Atlantic in Europe.

And this is not without reason. It is in this connection readers may recall that the Black-Scholes Model for determining the value of options was published in the eighties. The net consequence was that many financial institutions involved with derivatives were employing mathematicians and physicists to design ever more sophisticated financial instruments! And when economics marries physics with mathematics acting as the priest, the results have often been a disaster.

What is further interesting to note here is that Merton and Scholes, were awarded the Nobel Prize in economics in 1997 for developing a formula for the valuation of stock options. And within a year after Merton and Scholes received the Nobel Prize for their 'pioneering work,' their firm, Long Term Capital Management (LTCM), faced the dubious distinction of going belly up, merely because they could not handle derivatives. Surely, it was far easier to devise a model and be awarded a Noble Prize rather than handle the same in real life. In fact, their firm had to be rescued at a cost of USD 3.5 billion by the US government as it was feared that its collapse could have had a disastrous effect on financial institutions around the world.

The lessons from the fall of LTCM cannot be dismissed by any intelligent person or nation. Crucially, if Noble laureates have failed in handling these instruments, what can be expected of lesser mortals? Importantly, no one can master them, not even their inventors. It may be noted that Enron -- till then hailed as an aggressive user of many of these exotic products -- had made extensive use of energy and credit derivatives. Subsequently, it suffered huge losses and became one of the largest American firms to go bankrupt in history after systematically attempting to conceal huge losses. But in this entire melee, what has been forgotten is the fundamental characteristic of these contracts. What is trading in index numbers if not a wager? Instead of the derby it is now taking a bet on the movement of numbers? Is it not speculation *per se* packaged in sophisticated language, exotic terms and backed by legislation, regulators and sanctified by the government?

Banks promising to play Santa turn into villain

The weatherman who predicts the weather is no different from the parrot astrologer who predicts your future who is no different from the financial experts who claims to have the necessary expertise to predict the gyrations of currencies in the Forex market. And a confused exporter community in Tirupur, benumbed already by the huge losses on account of the Rupee appreciation, lent itself to become a sacrificial lamb to the banks which professed to have the necessary expertise to deal with the extant situation. It is not all. Bankers have even warranted to their clients, i.e. exporters in Tirupur that they would not only prevent future Forex losses but in some cases have assured these clients that they could even recoup past losses.

Like drug peddlers encouraging users of drug by providing easy and cheap drugs to students, some of these banks have lured exporters to enter into what is popularly called 'exotic derivative contracts.'

As I understand from Tirupur, the bait was first to 'allow' these exporters to make easy money in the first few transactions entered by the banks with the corporates. Invariably exporters bet on small amounts and tasted success. Exporters, emboldened by such initial success, were further encouraged by banks to take bigger bets. And when their bets went awry, exporters were stuck with massive losses. This is the crux of the issue. What is interesting to note here is that these transactions were not only undertaken by the foreign and private sector banks, but also by various nationalised banks, who were known for their prudence. But remember Gresham's law – when the bad circulates with the good, the bad drives out the good.

In the process experts opine that these banks have violated many of the well-intentioned guidelines issued by the RBI on these matters. In the process the business community of Tirupur have charged the bankers of mis-selling these products to them. The issue now hinges on the suitability of these contracts to the exporters. After all, why should an exporter who normally bills his exports in USD, take a position in Japanese Yen or the British Pound. It is not all. According to some of the exporters who have been at the receiving end of these transactions:

- Bankers have advised exporters to buy diverse kinds of Forex derivative products ranging from forward contracts which included intra-day speculation on currency movements to complex products which it is difficult for even the best financial minds to fathom. These contracts, as they are not backed with appropriate underlying, violate the RBI policy on the extant issue.
- When the exporters expressed their inability to understand these complex financial products, these banks took upon the role of financial advisors and repeatedly assured the exporters that they were experts in the field having sufficient experience in handling these products. These bankers even suggested that the exporters could try out sample deals on the basis of their advice and thus convinced the exporters to enter into these transactions. Invariably these transactions resulted in profits to the exporters.
- The banks had thus positioned themselves in a fiduciary capacity vis-à-vis these exporters purporting to offer risk management and cost reduction services. The exporters, after having sampled the profits from these deals began trusting the bankers to the hilt. Naturally, they lapped up every subsequent suggestion of the bankers without understanding the product being offered. It would be pertinent to note that after gaining the confidence of the exporters, these banks had pushed through products which were grossly inappropriate and unsuitable. In fact, these products exposed the exporters to unlimited risks instead of mitigating risks as they were originally intended in the first place. It may be noted that these assurances of bankers were built on past history of currency movements and no one could ever warrant on their movement.
- In fact, most of these financial products were marketed not by regular bankers but by bankers who had nothing to do with the regular businesses of these exporters
- Being a strange and unfamiliar deal, the onus of necessarily and repeatedly explaining the complexities of the contract as well as its suitability would certainly rest squarely on the bank and to ensure that the client has understood the essence as well as the associated risks in the deal before taking his acceptance as a valid one.
- Further, the banks acted as an advisor, in a fiduciary capacity as well as a party to the transaction and as a beneficiary under it, thereby violating the commonly accepted banking and professional ethics.

- Most of the exporters from Tirupur are Small and Medium enterprises [SMEs]. The policy on who could sell derivatives to SMEs was well captured by Ms Shyamala Gopinath, Dy Governor Reserve Bank, at the Euromoney Inaugural India Derivatives Summit, 2007, Mumbai on 24th October 2007 when she stated “In order to ensure that SMEs understand the risks of these products, only banks with whom they have credit relationship are allowed to offer such facilities. These facilities should also have some relationship with the turnover of the entity.” The bankers who sold the derivatives to the exporters of Tirupur totally acted contrary to this declared policy and sold derivatives to exporters who were not their clients at all. More, the turn over on derivatives exceeded the export turnover of the many exporters by several times.
- Further the Dy Governor added “The critical importance of ‘suitability’ and ‘appropriateness’ policies within banks for derivative products being offered to customers (users) have been underlined.” The banks also violated this crucial prerequisite.

Given these scenario, the exporters of Tirupur had collectivised themselves as FOREX Derivative Consumers’ Forum [FDCF] under the guidance of Swadeshi Jagran Manch and approached the RBI.

The FDCF demanded that the RBI immediately set up a high power committee to investigate the entire class of derivative contracts that were entered into by Banks with various Indian exporters across the country in complete violation of the RBI circulars and submitted a petition with the following prayer:

- To instruct the bankers to arrive at an amicable solution so as to save the industry
- To instruct banks not to debit the resultant loss in the regular account of a customer but to keep it in a separate account pending the outcome of such investigation by the high power committee
- To instruct the bankers not to classify the account as NPA consequent to non payment of derivative losses debited to the exporters’ account
- To request the RBI and keep the proposed draft Guidelines on Off-balance sheet items of banks in abeyance because it is too premature and the real gravity of the problem is not yet fully known. If one account is classified as NPA, then all the accounts of that exporter will automatically become NPA thereby causing major disturbance to the running businesses resulting in closure and possible loss of employment to thousands of employees.

The essence of this Memorandum submitted by FDCF on July 4th 2008 is that RBI should constitute a Committee to receive all relevant material from the exporters and to secure the materials from the respective banks both disclosed and undisclosed and to suggest / devise ways and means to solve the dead lock in such a manner that the industrial activity in Tiruppur is not brought to a grinding halt on account of the derivative losses.

Exporters of Tirupur are not the sole victims of Derivatives. It is reliably learnt that many export centres in the country too has been devastated by such financial instruments. And in every case it has virtually followed the Tirupur pattern.

Subsequently as RBI, perhaps given the magnitude of the issue and also the fact that many corporates had gone to the courts on the same issue was in fact dithering. Subsequently, when the then Governor, Mr. Reddy, demitted office in September 2008, things again came to a standstill.

This was when the exporters of Tirupur approached the SJM for further guidance. Understanding the official apathy and anticipating the lackadaisical approach of the government and RBI on this matter, the SJM immediately moved the Parliamentary Committee on Finance under the chairman ship of Shri Ananth Kumar Ji. The Hon'ble committee was gracious enough to provide early hearing on the matter.

The entire matter was represented in the Committee by a team from SJM lead by Shri S Gurumurthy in October 2008. The entire presentation was marked by numerous clarifications by the Hon'ble members of the committee. This meeting was attended also by the representatives of RBI as well as Finance Ministry. The SJM was able to impress on the Hon'ble members on the illegality of the contract and how and why these contracts could not be enforced in any court of law.

Further, explaining the moral dimensions of the entire contract, the SJM team provided the necessary arguments even for the RBI to come out with a circular in late October 2008 virtually acceding to the prayers of the Tirupur exporters. At this point in time, this circular of RBI virtually provides a stay to banks from collecting the necessary losses from all exporters, especially SMEs.

In effect, the SJM's stand is comprehensively vindicated in its approach in repeatedly warning the nation that the sophisticated global financial architecture is not suitable to a country like India. Yet, successive government, notably the UPA government have chosen to ignore the well-intended advice of the SJM at their own peril.