

The non-deliverable forward (NDF) market

October 18, 2022

In news– The Reserve Bank of India, seeking to arrest the rupee's slide, is asking local banks to not build additional positions in the non-deliverable forward market, a move that could lead to offshore volatility spilling into local markets, bankers.

What is non-deliverable forward market?

- An NDF is a short-term, **cash-settled forwards contract that investors use to trade in currencies in an offshore market.**
- The two involved parties create a settlement between the contracted NDF rate and the leading spot price when both parties agree on a notional amount.
- NDFs in the non-deliverable forward market are always settled in cash and are non-deliverable, meaning the trader can not take the delivery of the currencies.
- The largest NDF markets are in the Chinese yuan, Indian rupee, South Korean won, New Taiwan dollar, and Brazilian real.
- Much like a Forward Contract, a NDF lets one lock in an exchange rate for a period of time.
- However, instead of delivering the currency at the end of the contract, the difference between the NDF rate and the fixing rate is settled in cash between the two parties.
- **A NDF is usually executed offshore, meaning outside the home market of the illiquid or untraded currency.**

How does a Non-deliverable Forward market work in India?

- The non-deliverable forwards market **works with the exchange of cash flows between the two parties based on**

the NDF price and the prevailing spot price. In the transaction, one party agrees to settle the contract by paying the other party the difference resulting from the exchange.

- These contracts are OTC (over-the-counter) and are usually settled in the offshore currency market.
- For example, if a currency is restricted to be traded outside the country, it becomes impossible to settle trade with someone who is outside the country.
- In this case, the parties use NDFs within the non-deliverable forward market that converts all the profits and losses to a freely traded currency in both countries.

What are Forward Contracts?

- A forward contract, also known as forwards, is a private agreement between two parties to purchase or sell the underlying asset at a predetermined time at a specific price.
- Any forward contract is subject to both market risk and credit risk.