Derivatives as weapons of mass destruction: An Indian perspective

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Introduction

Derivatives have famously been described as 'weapons of mass destruction'[1]. T he use of certain derivative products in India from around 2007–2009 has certainly led to financial destruction of several export companies who entered into these complex agreements, as well as arguably damaging the reputation of Indian banking sector. This article seeks to set out the background to what has happened so far with regard to these transactions, noting the recent change in approach of the banks, controversial elements of the contracts, before considering the legal principles and arguments involved in the case that was put before the Madras High Court in *Rajshree Sugars and Chemicals Limited*[2], before drawing some conclusions.

Background and context

During 2007 – 2009, many SMEs (largely export companies) suffered huge losses from currency derivatives. During this time, a number of banks aggressively marketed certain derivative products as an alternative profit making mechanism available to these SMEs. It has been argued[3] that in reality, the majority of these companies did not have enough expertise to fully understand the contracts that they were entering into, and ultimately these contracts exposed them to a risk of huge financial loss. Within a few months of entering into these contracts, the risk of loss became reality.

The common allegations brought by these companies against the banks are likely to be based on the belief that (a) banks did not adequately explain the products and their underlying risks to their (less sophisticated) counterparties; (b) banks did not check whether the products were suitable for the counterparties' needs, or stated another way, they did not advise on less risky

[1] By Warren Buffett.
[2] 2008 Indlaw MAD 4314
[3] Oomen A Ninan, The Hindu: "Mis-selling of derivative products: RBI acts", 2nd May, 2011; IMF Working Paper "Exotic Derivatives Losses in Emerging Markets: Questions of Suitability, Concerns for Stability" July 2009; Development Research Group, Reserve Bank of India: "Monetary Policy, Forex Markets and Feedback under Uncertainty in an Open Economy", 3rd September, 2009.

products that would more suitable than those sold; (c) banks did not check on whether the counterparties' businesses had the capacity to incur the extreme losses (as a result of complex ratcheting/gearing elements of the products) – i.e. would they be able to absorb the losses or could this potentially cause severe damage to the enterprise (e.g. lead to insolvency).

The common factor and underlying thread of all these discussions is "suitability". The Reserve Bank of India's "Comprehensive Guidelines on Derivatives"[4] cover "Suitability and Appropriateness Policy". These guidelines specifically state -"Market-makers should undertake derivative transactions, particularly with users with a sense of responsibility and circumspection that would avoid, among other things, mis-selling." It is also stated that products should only be sold to those users who understand the nature of the risks inherent in these transactions. Furthermore, the products offered must be "consistent with users' [i.e. counterparties to the banks] business, financial operations, skill & sophistication, internal policies as well as risk appetite."[5]

The RBI guidelines further state that when selling derivative products, a market-maker (i.e. financial institutions selling these products) should document, how various aspects of the product work (e.g. pricing and the generic components of the product). Amongst the information that may be shared with the user, the RBI includes "sensitivity analysis identifying the various market parameters that affect the product" and, "scenario analysis encompassing both the possible upside as well as the downsides."[6] Perhaps even more importantly at paragraph 8.3 (g) of the document, the RBI state that the market-maker must:

> "Ensure the terms of the contract are properly documented, disclosing the inherent risks in the proposed transaction to the customer in the form of a Risk Disclosure Statement which should include a detailed scenario analysis (both positive and negative) and payouts **in quantitative terms** under different combination of underlying market variables such as interest rates and currency rates, etc, assumptions made for the scenario analysis and obtaining a written acknowledgement from the counterparty for having read and understood the Risk Disclosure Statement."

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[4] DBOD.No.BP.BC.86/21.04.157/2006-07 dated April 2007.
[5] Ibid. at p.8.
[6] *Ibid.* at p.9.

It is yet to be seen whether the required due diligence[7] regarding "suitability" was carried out by the Indian banks. Suitability has been described by the FSA[8] as a matter of both "willingness" and "ability". However, looking at the matter entirely objectively, one has to suggest that no business would be *willing* or enter into these 'hedging'[9] contracts if they understood that any potential gain would be limited, yet the loss would be enhanced due to the very nature of the product being sold.[10] Furthermore, it is clear to see that these businesses were not *able* to absorb these losses, or to enter into speculative transactions.

Rajshree Sugars[11]: An analysis

There is very limited case law covering this aspect of derivatives from an Indian perspective. In this section of the article, the authors seek to analyse the first case on this aspect of derivatives in India, covering the type of agreement in the case, the arguments put forward by the plaintiff company and the reasoning behind the court's rejections.

Facts:In pursuance of the ISDA Master Agreement dated 14-5-2004, at least 10 deals were struck between the plaintiff company and UTI Bank (which later became AXIS Bank Ltd.). Admittedly, 9 out of those 10 deals have already matured without any dispute on either side. But the plaintiff company went to the court with regard to the 10th deal. The structure of the deal was as follows:

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[7] Conducting this due diligence would be in the banks' interest to protect against counterparty credit risk, market risk and litigation risk, and ultimately its own operational risk (through reducing moral hazard) as well as systemic risk.

[8] FSA Guidance consultation: "Assessing suitability: Establishing the risk a customer is willing and able o take and making a suitable investment selection", January 2011.

[9] After all, derivatives contracts can only be entered into in India for hedging purposes. The RBI's "Comprehensive Guidelines on Derivatives" sets out at page 2 that "Users can undertake derivative transactions to hedge – specifically reduce or extinguish an existing identified risk on an ongoing basis during the life of the derivative transaction – or for transformation of risk exposure, as specifically permitted by RBI. Users can also undertake hedging of a homogeneous group of assets & liabilities, provided the assets & liabilities are individually permitted to be hedged."

[10] N.b. on the matter of suitabilityin the UK, the FSA recently published a report ("Assessing Suitability: Establishing the risk a customer is willing and able to take and making a suitable investment selection"). This report was made on the basis of an audit carried out between March 2008 and September 2010, which found that more than half of those transactions judged to be "unsuitable" were due to the fact that the products sold were unable to meet the risk a customer was willing and able to make. The findings of the audit led to substantial fines on the adviser firms.

[11]2008 Indlaw MAD 4314

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(i) The plaintiff would receive USD 100,000 on 23.6.2008 if spot never trades at 1.2385 from trade date namely, 22.6.2007 till fixing date 1 namely, 19.6.2008.

(ii) During the reference period from 22.6.2007 to 19.6.2008, if USD-CHF never touches 1.1250 and 1.2385 and if it ever touches 1.2385, there is no exchange of principal, but if it ever touches 1.1250 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300.

During the reference period from 22.6.2007 to 15.6.2009, if USD-CHF never touches 1.1200 and 1.2385 or if it ever touches 1.2385, there is no exchange of principal, but if it ever touches 1.1200 and never touches 1.2385, the plaintiff should buy USD 20 million against paying CHF at 1.3300.

(iii) If the USD-CHF touches the level of 1.2385 ever during the period starting from 22.6.2007 to 15.6.2009, then the entire structure gets knocked out with no subsequent liability and the plaintiff would receive USD 100,000 on the spot date of touch. However if spot touches 1.2325, then the plaintiff would receive instant payment of USD 100,000, though the structure will not get knocked out.

In terms of the above deal, entered into on 22-6-2007, the defendant paid USD 100,000 to the plaintiff on 27-6-2007. The plaintiff received the said amount. However, after 6 months, the plaintiff sent a letter dated 12.12.2007 claiming that the entire structure as per the contract dated 22.6.2007 got knocked out with no liability to either of the parties. But, by a reply dated 7.1.2008, the bank challenged the claim and contended that the contract was still alive and that the bank was prepared to work out suitable risk mitigation structures. Not satisfied with the stand taken by the bank, the plaintiff filed a suit where they argued that the contract in question was a wagering contract, void ab initio, illegal, violative of RBI Guidelines and opposed to public policy (at para 53).

Was this a wagering contract?

The plaintiff challenged the contract as being void as a wagering contract.

It is submitted in this article that the court came to the right conclusion that this was not a wagering contract; however the reasoning was arguably flawed. Firstly, with regard to one of the criteria for a wagering contract (that one party is to win and one is to lose upon the determination of event and that both parties must stand either to win or lose), although the bank stood to lose perhaps USD 100,000 on the occurrence of certain events, ultimately they only stood to gain, or for nothing to happen. This is particularly the case if we consider that the USD 100,000 payments to be payment of premium (this issue is considered below), as the money would essentially be sunk costs in order to enter into the deal. Similarly, it appears that the plaintiff could only receive the (relatively) small payments, or lose a substantial amount. Thus, it appears arguable that the contract would not be a wager on this basis. A further contentious issue with the Court's discussion on wagering is the statement that:

> "… derivatives transactions ceased to be purely speculative deals, long time ago. The pricing of the deals, follows a scientific pattern on the basis of Financial Mathematics. Just as Actuaries scientifically determine the value of risks and the premium payable, Financial Mathematicians (or Portfolio Managers) evaluate the price of these derivatives. Hence they cannot be termed as wagers."[12]

Surely this cannot be a true analysis of derivative transactions. Just because mechanisms are used to value risks, and data is entered into computer programmes which produce mathematical models of likely outcomes, speculative elements is not removed. Perhaps parties may be able to make a more informed guess as to what is to happen, but ultimately, these products cannot always accurately predict the future and potential macro-economic events that affect price-volatility of products. Therefore, it is submitted that on this basis, the Court's reasoning was flawed.

Was the deal a product of misrepresentation?

The plaintiff also argued that the bank misrepresented that "USD would never reach the stipulated level of exchange rate against CHF." The Court held that even if such a representation had been made, this would still not amount to a misrepresentation. The reasoning for this was that this representation was on a matter neither party had any control over, and that both parties

[12] At para 81

knew that they had no control over.[13] Of course, mere sales talk, puff or matters upon which reliance is not placed in order to enter a contract will not succeed in claims for misrepresentation. However, should there be recourse if there a chance that actually these statements were relied upon and as a result the contract was entered into?

As Professor Alastair Hudson has discussed[14], in consideration of *Bankers Trust,*"Mance J was… critical of BT because the seller's marketing material tended to emphasise the likelihood of gain rather than the risks of the loss, and further the material might have given a misleading impression of the effect of the product. Mance J found expressly that such a transaction would have founded liability for the tort of misrepresentation in respect of an ***inexperienced counterparty***[15]." Mance J emphasised that assessment of the potential liability of a bank in this context had be a matter of relativity. The extent of a seller's liability will always depend on the buyer's knowledge and expertise in the context of transaction. Hudson has argued (inferring from Mance J's judgment) that a counterparty that is demonstrably incapable of ascertaining the risks involved, or a counterparty that has not been proactive in pursuing these particular structures and that relies more on the advice given to it by the seller, would appear to have better grounds for a claim based on misrepresentation.

Therefore, it is at least arguable that the Madras High Court was not circumspect while dismissing the claim for misrepresentation without even considering the fact that the bank was obviously experienced in these matters, and that a counterparty would rely on information imparted to them.

Was the deal unlawful and opposed to public policy?

The plaintiff argued that the deal was illegal on the following grounds[16]:

(1) the receivables and payables were not denominated in swiss franc and hence a forex option in USD/CHF was wholly unauthorised and not permitted;

[13] At para 78
[14] The Law on Financial Derivatives, 4th Edition at 7-08
[15] emphasis added
[16] As set out in para 101.

(2) the deal was not with reference to any particular underlying exposure and hence it was violative of the Master Circulars (issued by the RBI);

(3) the defendant bank had an obligation under the Master Circulars to see that there is a risk management policy in place in the plaintiff company and that they failed to ensure this; and

(4) the payment of USD 100,000 by the bank to the plaintiff amounted to the payment of a premium, which is prohibited by the Regulation and the Master Circulars.

With regard to the first ground the plaintiff put forward, this was rejected by the court on the basis that the RBI has issued circulars[17], which expressly permit customers to hedge their receivables and payables against a third currency instead of Indian rupee, subject to 2 conditions; (1) that such third currency should be a permitted currency and (2) that it should be actively traded in the market. The court held that swiss francs satisfy both conditions, and thus the plaintiff's first ground was unsustainable.

Furthermore, the Judge relied on Paragraph A.1x of Schedule 1 of the Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 in his judgment. He stated that this paragraph made it clear that even the currency of hedge and tenor were left to the choice of the customer and hedging need not necessarily be in terms of US dollars versus Indian currency. According to the Judge, if a customer feels that the Indian currency is highly volatile and unstable as against US dollar, he is entitled to opt for a more stable currency, so that his risks are minimised. But when a contra situation arises, he would stand to lose, but the same would be part of the game. Therefore, it is futile to contend that the transaction is prohibited by law, on account of a third currency (swiss franc) being used for hedging.

With regard to the plaintiff's second ground that there was no underlying exposure to the deal, the High Court held that this argument could not be accepted. The Foreign Exchange Management (Foreign Exchange Derivative Contracts) Regulations, 2000 [(at paragraph A.1(a) and (b)] as well as the RBI's Master Circular No.06/2006-07 state that a bank has to (through

[17] Master Circulars AD (MA Series) 21 & 26 dated 23rd December, 1994

verification of documentary evidence) be satisfied as to the genuineness of the underlying exposure.

The Judge held[18] that due to the fact that the plaintiff made a declaration that it entered into the agreement solely for the purpose of hedging its foreign currency balance sheet exposure, this was in turn sufficient for the bank to enter into the deal. The statement was binding on the plaintiff, and in view of the provisions of the RBI Master Circulars and regulations, the bank had complied with its requirements in order to check that there was an underlying exposure "on the basis of a declaration of exposure[19]" by the plaintiff. The Judge further held that it was only on the basis of "showing their foreign currency receivables and payables that the plaintiff entered in to the ISDA Master Agreement. Therefore, they cannot now contend that this particular deal alone had no underlying exposure."

Prima facie, this is the case. However, the authors submit that the Judge did not consider that if one looks objectively at the contract at hand, there does not seem to be a clear risk that the plaintiff is hedging against. Upon certain contingencies occurring, the plaintiff would only receive USD 100,000; this is contrary to typical option contracts. There is no point (where the plaintiff's exposure would become too high) at which the plaintiff could exercise its option and hedge against its exposure[20].

In the context of third ground the Court held that the plaintiffs could not argue that the transaction was violative of the RBI's Master Circulars on the basis of the fact that the authorised dealers (the bank) were obliged to ensure that the Board of Directors of the plaintiff had drawn up a risk management policy, laying down clear guidelines for concluding the transactions and institutionalised the arrangements for a periodical review of operations and annual audit of transactions to verify compliance with the Regulations. According to the plaintiff, no risk management policy was in place in the company and the bank simply went ahead with the transaction on the basis of a declaration made by the company's CFO.

[18]At para 108.
[19]See paragraphs 106 and 107.
[20]Cf the bank.

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The Court held that the CFO was an authorised signatory of the plaintiff and the company could not raise objection about the non-existence of a risk management policy having remained silent earlier. Furthermore, it is unfair for the plaintiff- a listed company to argue that the bank failed to ensure the existence of a risk policy, when it also had to comply with mandatory requirements due to its being listed with regard to publishing quarterly details of its exposures.

The authors feel that it is at least arguable that the fact that these types of relationships are often built on an element of reliance of one party (corporates) upon the other (banks) to provide the right products for them (taking into account their ability or lack-thereof to manage certain risks). If one further takes into account the fact that guidance from the RBI states that it is a requirement of the bank to ***ensure*** that these parties have clear risk management policies in place, (arguably requiring pro-active due diligence, not just reliance on statements) a duty of care on the bank to carry out more thorough checks may be established.

This duty of care could arguably have been breached if only ensuring that the requisite documents were signed without for example checking that the counterparty understoodthe need for a risk management policy required. A breach of this duty could arguably be considered a negligent act (if this led to the ultimate loss), or at the very least could be a factor that would be considered in an argument for negligence, undue influence or other such claims brought before a court against the bank.

Given the fact that for example, the RBI itself has recognised that some banks clearly have breached their duties in failing to conduct thorough due diligence on these matters; in front of a more sympathetic court, if it is found that the banks did fail to carry out these practices, would it be possible to find such a contract void?

In the case of *BOI Finance Ltd v Custodian and Ors*[21]the argument was put before the Supreme Court that breach of RBI directions or instructions by the bank are unlikely to lead to a contract being void, where the transaction is not otherwise invalid. This would particularly be the case where a penalty was provided as a deterrent in order to prevent non-compliance. However, one should note that it was discussed in this case that no general rule can be laid down in these

[21] 1997(4)ALLMR(SC)450

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matters[22] and that one needs to look at the object of the statute on a case by case basis. One has to look at matters of public policy and the rationale behind legislation/guidance given by Government bodies. In the case of *BOI Finance* the Act at hand, is "to a large extent directed towards aiding the Government in executing its fiscal policy rather than regulating the relationship between banker and customer *per se*"[23]. This was an important factor in the Court not finding the contract void as such, on the basis of not following the RBI guidance. However, the cases that are being discussed in this article can surely be distinguished, in that guidance provided by the RBI on matters of suitability, and a requirement to ensure that counterparties have clear and adequate risk management policies in place, must surely be meant for the purposes of regulating the relationship of the bank and its counterparty. The compliance with these regulations, arguably go to the heart of the contract; but for these elements, a party may not have the ability to enter into these contracts.

With regard to ground (4) the plaintiff argued that the payment of USD 100,000 by the bank to the plaintiff amounted to the payment of a premium for writing of option which was not allowed under RBI Guidelines.

The Court held that this was a contract, in which the plaintiff was not the seller of the option; rather it intimated that this was a "zero cost option" where there was no financial outlay for the customer in the form of a premium[24]. The plaintiff's argument that the potential receipt of payments amounted to receipt of premium was dismissed.

At paragraph 79 of the *Rajshree Sugars* judgment, one can see that the plaintiff argued that the payment of USD 100,000 by the bank to the plaintiff, in pursuance of the contract, was a premium paid by the bank. The Court countered this by stating that "In an insurance cover, the insured pays premium to the insurer and not vice versa. Therefore, according to the plaintiff, the payment of the amount by the bank made it an unlawful deal."[25] Further, at paragraph 63, the Judge states that "[t]hus the plaitiff stands to gain at times, while the Bank stands to gain at other

[22] *Ibid.* at 31.
[23] *Ibid.* at para 32.
[24] At para 115.
[25] At para 79

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times. The gain of the plaintiff is intended to off-set the loss that they may incur in their foreign currency receivables or payables."

It is submitted that the Court was again misguided in its analysis. It appears here that the payment was indeed a premium, but unlike more vanilla contracts, it was paid upon the occurrence of specific contingencies. The bank was the party that appears to have been hedging against the risk that USD-CHF would touch 1.1250 (but that it would never touch 1.2385), as this was the party that would get a big pay out on the occurrence of the event. It seems as though in the case of the plaintiff company however, no risk was being hedged, but rather it was taking a huge risk that it would have to pay out USD 20m against paying CHF at 1.3300. When one considers which party takes on the burden of risk in an option, it is always the writer (the seller), and the buyer is the party that pays a premium (and whose loss is limited to that premium), whilst in return having risk mitigated, it appears that the court's analysis was wrong. In this scenario the insured party that the Court speaks of was surely the bank, and the payments of USD would surely be payments of premium.

It is quite clear that the court in this matter saw this transaction as a deal conducted at arm's length between two sophisticated parties. However, it is felt here that the judgment was not correct on the basis of two factors. First, the Madras High Court appears to have not understood fully the contract between the two parties, and clearly thought that the plaintiffs were trying to get out of a bad bargain, without dealing with the consequences. Secondly, if one looks at the greater context (i.e. that the RBI itself has recognised that the banks were acting contrary to their regulations and thus penalised them; that regulators and bodies of importance e.g. RBI, IMF have recognised that banks mis-sold products without fully taking account of their suitability, and the lack of risk management procedures within counterparties; that there appears to be a shift in momentum with regard to the fact that banks are now more willing to settle out of court with counterparties), it is at least arguable that if this issue was to come before a court today, the plaintiff's claim should be considered more thoroughly rather than wholly dismissed.

Conclusion

It is clear that the tide is beginning to turn with regard to how these derivative contracts that were marketed and sold around 2007–2009 are being treated. The regulators are finally waking up to the fact that these transactions do not appear to be straightforward contracts to be used as hedging tools, perhaps as a result of litigation, enhanced press coverage on this matter, and the fact that this has been a global issue that will not go away until it is dealt with. It will be interesting to see what happens as a result of the penalties that have been imposed on the 19 banks found to be at fault; whether counterparties will take the incentive to use this as a sign to battle in court rather than to settle out of court with the banks (which until now has been the trend). Furthermore, one has to keep the fingers crossed whether the courts will wake up to the fact that there clearly has been an endemic, systemic problem with regard to these banks (mis)selling these products and that this needs to be addressed.

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