International Journal of Research
Available at https://edupediapublications.org/journals
e-ISSN: 2348-6848
p-ISSN: 2348-795X
Volume 05 Issue 07
March 2018

"A Snapshot of Derivatives Instrument in Indian Securities Market"

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ABSTRACT:

Derivatives are innovative financial instruments designed to suit an investor's appetite for risk. These financial tools help to effectively transfer risk from those who wish to avoid it to those who wish to accept it. In India, the derivatives market has recorded an impressive CAGR of 34 per cent, in terms of annual turnover, in the last five years. India is one of the most successful developing countries in terms of a vibrant market for exchange-traded Derivatives. This reiterates the strength of modern developments in India's securities markets.

INTRODUCTION:

The emergence and growth of the market for derivative instruments can be traced to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. Derivatives are meant to facilitate the hedging of price risks of inventory holdings or a financial/commercial transaction over a certain period. By locking in asset prices, derivative products minimize the impact of fluctuations in asset prices on the profitability and cash flow situation of risk-averse investors, India is one of the most successful developing countries in terms of a vibrant market for exchange-traded derivatives. This reiterates the strength of modern developments in India's securities markets, which are based on nationwide market access, anonymous electronic trading and a predominant retail market. There is an increasing sense that the equity derivatives market plays a major role in shaping price discovery.

CONCEPT OF DERIVATIVES:

Derivatives are financial contracts, which derive their value off a spot price time series, which is called 'the underlying'. The underlying asset can be equity, index, commodity or any other asset. Some common examples of derivatives are forwards, futures, options and swaps.

OBJECTIVES OF THE STUDY:

- To View the snapshot of derivatives in Indian stock market.
- To study on the Products and applications of financial derivatives.

GROWTH OF DERIVATIVES IN INDIA – A SNAPSHOT:

Derivatives trading in India started in the year 2000 with the commencement of BSE Sensex futures at BSE and Nifty futures at NSE. Trading in equity index options and stock options was also started the following year at NSE. As the derivatives business grew in India, the markets have started offering currency and interest rate derivatives as well. The market has come a long way since its inception in 2000, and has recorded an impressive CAGR of 34 per cent (in terms of annual turnover) in the last five years. Increased derivative trading can be attributed to

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discrete periods of range bound behaviour and phases of high volatility in Indian markets. The speculative nature of Indian investors and a drive to hedge investments among money managers has also contributed to the business growth in this segment. Of late, currency options and futures have also start gaining traction slowly. The product composition in derivatives has also witnessed major changes since its inception.

Derivative products:

There are four main types of derivative contracts: forwards, futures, options and swaps.

Forwards and futures contracts:

A forwards and futures contract is an agreement to buy or sell a specified quantity of an asset at a specified price with delivery at a specified date in the future. But there are important differences in the ways these contracts are transacted. First, participants trading futures can realize gains and losses on a daily basis, while forwards transaction requires cash settlement at delivery. Second, futures contracts are standardized, while forwards are customized to meet the special needs of the two parties involved (counterparties).Third, unlike futures contracts, which are settled through an established clearing house, forwards are settled between the counterparties. Fourth, because of being exchange-traded, futures are regulated, whereas forwards, which are mostly over-the-counter (OTC) contracts, are loosely regulated.

Options contracts:

Options contracts can be either standardized or customized. There are two types of options: 'call' and 'put' options. Call options contracts give the purchaser the right to *buy* a specified quantity of a commodity or financial asset at a particular price (the exercise price) on or before a certain future date (the expiration date). Similarly, put options contracts give the buyer the right to *sell* a specified quantity of an asset at a particular price on or before a certain future date. These definitions are based on the so-called American-style options. And for European style options, the contract can only be exercised on the expiration date. In an options transaction, the purchaser pays the seller—the writer of the options—an amount for the right to buy or sell. This amount is known as the option premium. In the event that options are not exercised at expiration, the purchaser simply loses the premium paid. If the options are exercised, however, the option writer will be liable for covering the costs of any changes in the value of the underlying that benefit the purchasers.

Swaps:

Swaps are agreements between two counterparties to exchange a series of cash payments for a stated period of time. The periodic payments can be charged on fixed or floating interest rates, depending on contract terms. The calculation of these payments is based on an agreed-upon amount, called the notional principal amount or, simply, the notional.

CLASSIFICATION OF DERIVATIVES:

Derivatives are broadly classified into two types. They are Commodity derivatives and financial derivatives. In case of commodity derivative, Underlying assets are Wheat, Gold, Silver etc.. and in case financial

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derivatives are underlying assets are stocks , currencies, bonds and risk bearing securities.

Forward Contracts:

Forward Contract is a cash market transaction in which delivery of the instrument is differed until the contracts has been made, although the delivery is made in future. The price is determined on the initial trade date. The contract terms like delivery price and quantity are mutually agreed upon by the parties to the contract; Forward contracts are traded over the counter and are not dealt with on exchange.

Futures Contract:

Futures is a standardized forward contract to buy (long) or sell (short) of the underlying assets at a specific future date at a specified price through a specified exchange. Exchange sets the standardized terms in term of quality, quantity, price quotation, date and delivery place of a commodity. Future contracts being traded on organized exchanges impart liquidity to the transaction. The clearing house is the counter party to both sides of transaction.

Options Contract:

Option Contract as the name suggest is in sense as an optional contract. The option is the right but not the obligation to buy or sell something at a stated price and a stated date. Option contract are of two types and they are call option and put option."Call Option" gives one the right to buy whereas "put Option" gives one the right to sell a pacified asset at a set pric on or before a specified date trough exchanges.

Swaps Contract:

A Swap can be defined as a barter exchange. It is a contract whereby the parties agree to exchange underlying assets to each of them. The two commonly used swaps are Interest rate swaps and Currency Swaps. Interest rate swaps which enable swapping only the interest related cash flows between the parties in same currency whereas the currency swaps entail both principal and interest swapping of different currencies between the parties.

PARTICIPANTS IN DERIVATIVES MARKET:

Hedgers:

They use derivative instruments so as to reduce risk. Most of the Participants are hedgers only in Indian Stock market by trading in derivatives of financial instruments.

Speculators:

They will transact with futures and options contract to get extra leverage through betting on future movements in the price of underlying asset.

Arbitrageurs:

Arbitrageurs are desired to take a benefit of discrepancy between price of more or less on the same assets or competing assets in different markets.

SUMMARY AND CONCLUSION:

Innovation of derivatives have redefined and revolutionized the landscape of financial sector across the world. The world financial markets have

undergone qualitative changes in the last three decades due to the phenomenal growth of derivatives. Hence there is an increasing sense that the derivatives market is playing a major role in shaping growth of Indian Stock Market.

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