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FINANCIAL DERIVATIVES MARKET IN INDIA

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ABSTRACT

Risk is a characteristic feature of most commodity and capital markets. Variations In the prices of agricultural and non-agricultural commodities are induced, over time, by Demand-supply dynamics. The last two decades have witnessed many-fold increase in the Volume of international trade and business due to the wave of globalization and Liberalization sweeping across the world. This has led to rapid and unpredictable variations In financial assets prices, interest rates and exchange rates, and subsequently, to exposing The corporate world to an unwieldy financial risk. In the present highly uncertain business Scenario, the importance of risk management is much greater than ever before. The Emergence of derivatives market is an ingenious feat of financial engineering that provides An effective and less costly solution to the problem of risk that is embedded in the price Unpredictability of the underlying asset. In India, the emergence and growth of derivatives Market is relatively a recent phenomenon. Since its inception in June 2000, derivatives Market has exhibited exponential growth both in terms of volume and number of traded Contracts. Within a short span of eight years, derivatives trading in India has surpassed cash segment in terms of turnover and number of traded contracts. The present study encompasses in its scope an analysis of historical roots of derivative trading, types of derivative products, regulation and policy developments, trend and growth, future prospects and challenges of derivative market in India. Some space is devoted also to a brief discussion of the status of global derivatives markets vis-a–vis the Indian derivatives market.

MEANING AND DEFINITION

The derivative itself is a contract between two or more parties based upon the asset or assets. Its value is determined by fluctuations in the underlying asset. The most common underlying assets include stocks, bonds, commodities, currencies, interest rates and market indexes.

Definition: A derivative is a complicated financial contract that gets (derives) its value from an underlying asset. The buyer and seller agree on how much the asset price will change over a specific period.

The underlying asset can be a commodity, such as oil, gasoline or gold. Many derivatives are based on stocks or bonds. Others use currencies, especially the U.S. dollar, as their underlying asset. Still others use interest rates, such as the yield on the 10-year Treasury note, as their base. These assets can be, but do not have to be, owned by either party to the agreement. This makes derivatives much easier to trade than the asset itself. Most derivatives require that the agreement is fulfilled. That's accomplished by either by an exchange of the asset, a cash payment, or another agreement that offsets the value of the first.

ECONOMIC FUNCTION OF THE DERIVATIVE MARKET

Some of the salient economic functions of the derivative market include:

1. Prices in a structured derivative market not only replicate the discernment of the market participants about the future but also lead the prices of underlying to the professed future level. On the expiration of the derivative contract, the prices of derivatives congregate with the prices of the underlying. Therefore, derivatives are essential tools to determine both current and future prices.
2. The derivatives market reallocates risk from the people who prefer risk aversion to the people who have an appetite for risk.
3. The intrinsic nature of derivatives market associates them to the underlying spot market. Due to derivatives there is a considerable increase in trade volumes of the underlying spot market. The dominant factor behind such an escalation is increased participation by additional players who would not have otherwise participated due to absence of any procedure to transfer risk.
4. As supervision, reconnaissance of the activities of various participants becomes tremendously difficult in assorted markets; the establishment of an organized form of market becomes all the more imperative. Therefore, in the presence of an organized derivatives market, speculation can be controlled, resulting in a more meticulous environment.
5. Third parties can use publicly available derivative prices as educated predictions of uncertain future outcomes, for example, the likelihood that a corporation will default on its debts.

In a nutshell, there is a substantial increase in savings and investment in the long run due to augmented activities by derivative market participant.

The derivative market performs a number of economic functions. First, prices in an organized derivatives market reflect the perception of market participants about the future and lead the prices of underlying to the perceived future level. The prices of derivatives converge with the prices of the underlying at the expiration of derivative contract. Thus derivatives help in discovery of future as well as current prices. Second, the derivatives market helps to transfer risks from those who have them but may not like them to those who have appetite for them.

Third, derivatives, due to their inherent nature, are linked to the underlying cash markets. With the introduction of derivatives, the underlying market witnesses higher trading volumes because of participation by more players who would not otherwise participate for lack of an arrangement to transfer risk. Fourth, speculative trades shift to a more controlled environment of derivatives market.

In the absence of an organized derivatives market, speculators trade in the underlying cash markets. Margining, monitoring and surveillance of the activities of various participants become extremely difficult in these kind of mixed markets. Fifth, an important incidental benefit that flows from derivatives trading is that it acts as a catalyst for new entrepreneurial activity.

The derivatives have a history of attracting many bright, creative, well-educated people with an entrepreneurial attitude. They often energize others to create new businesses, new products and new employment opportunities, the benefit of which are immense. Sixth, derivatives markets help increase savings and investment in the long run. Transfer of risk enables market participants to expand their volume of activity. Derivatives thus promote economic development to the extent the later depends on the rate of savings and investment

DERIVATIVES IN INDIA

In India, all attempts are being made to introduce derivative instruments in the capital market. The National Stock Exchange has been planning to introduce index-based futures. A stiff net worth criteria of Rs.7 to 10 corers cover is proposed for members who wish to enroll for such trading. But, it has not yet received the necessary permission from the securities and Exchange Board of India. In the forex market, there are brighter chances of introducing derivatives on a large scale. Infect, the necessary groundwork for the introduction of derivatives in forex market was prepared by a high-level expert committee appointed by the RBI. It was headed by Mr. O.P. Sod Hani. Committee's report was already submitted to the Government in 1995. As it is, a few derivative products such as interest rate swaps, coupon swaps, currency swaps and fixed rate agreements are available on a limited scale. It is easier to introduce derivatives in forex market because most of these products are OTC products (Over-the-counter) and they are highly flexible. These are always between two parties and one among them is always a financial intermediary.

However, there should be proper legislations for the effective implementation of derivative contracts. The utility of derivatives through Hedging can be derived, only when, there is transparency with honest dealings. The players in the derivative market should have a sound financial base for dealing in derivative transactions. What is more important for the success of derivatives is the prescription of proper capital adequacy norms, training of financial intermediaries and the provision of well-established indices? Brokers must also be trained in the intricacies of the derivative-transactions.

Now, derivatives have been introduced in the Indian Market in the form of index options and index futures. Index options and index futures are basically derivate tools based on stock index. They are really the risk management tools. Since derivate are permitted legally, one can use them to insulate his equity portfolio against the vagaries of the market.

Every investor in the financial area is affected by index fluctuations. Hence, risk management using index derivatives is of far more importance than risk management using individual security options. Moreover, Portfolio risk is dominated by the market risk, regardless of the composition of the portfolio. Hence, investors would be more interested in using index-based derivative products rather than security based derivative products.

There are no derivatives based on interest rates in India today. However, Indian users of hedging services are allowed to buy derivatives involving other currencies on foreign markets. India has a strong dollar- rupee forward market with contracts being traded for one to six month expiration. Daily trading volume on this forward market is around $500 million a day. Hence, derivatives available in India in foreign exchange area are also highly beneficial to the users.

Risk is a characteristic feature of most commodity and capital markets. Variations In the prices of agricultural and non-agricultural commodities are induced, over time, by Demand-supply dynamics. The last two decades have witnessed many-fold increase in the Volume of international trade and business due to the wave of globalization and Liberalization sweeping across the world. This has led to rapid and unpredictable variations In financial assets prices, interest rates and exchange rates, and subsequently, to exposing The corporate world to an unwieldy financial risk. In the present highly uncertain business Scenario, the importance of risk management is much greater than ever before. The Emergence of derivatives market is an ingenious feat of financial engineering that provides an effective and less costly solution to the problem of risk that is embedded in the price Unpredictability of the underlying asset. In India, the emergence and growth of derivatives Market is relatively a recent phenomenon. Since its inception in June 2000, derivatives Market has exhibited exponential growth both in terms of volume and number of traded Contracts. Within a short span of eight years, derivatives trading in India has surpassed cash segment in terms of turnover and number of traded contracts. The present study encompasses in its scope an analysis of historical roots of derivative trading, types of derivative products, regulation and policy developments, trend and growth, future prospects and challenges of derivative market in India. Some space is devoted also to a brief discussion of the status of global derivatives markets vis-a–vis the Indian derivatives market.

CONCLUSION

The chapter provides an overview of derivatives markets, products and participants. Derivatives are invented in response to some fundamental changes in the global financial System. They, if properly handled, should help improve the resilience of the system and bring Economic benefits to the users. In this context, they are expected to grow further with financial globalization. However, past credit events exposed many weaknesses in the Organization of derivatives trading. The aim is to minimize the risks associated with such Trades while enjoying the benefits they bring to the financial system. An important challenge Is to design new rules and regulations to mitigate the risks and to promote transparency by Improving the quality and quantity of statistics on derivatives markets.

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