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A Study on Derivatives Markets in India

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ABSTRACT:

Most commodities and capital markets are characterised by risk. Risk management is more important than ever before in today's extremely confusing corporate environment. The advent of the derivatives market is a smart financial engineering effort that gives an effective and less expensive solution to the problem of risk that is embedded in the price volatility of the underlying asset. The growth and progress of the derivatives market in India is a relatively new phenomenon. Since its start in June 2000, the derivatives market has grown exponentially in terms of both volume and quantity of traded contracts. Financial derivatives are financial products or instruments whose prices are determined by the prices of their underlying assets.

To control such risk, it is therefore critical to build a set of new financial instruments called as derivatives in the Indian financial markets. The primary goal of these instruments is to provide price commitments for future dates in order to provide protection against adverse price fluctuations in order to limit the number of financial risks. Financial derivatives are growing popular and widely employed in the world of finance today. This has spread so quickly over the world that it is now known as the derivatives revolution. The emergence and growth of the derivatives market in India is a relatively new phenomenon.

Keywords: Derivative, Futures, Options, Spot Price, Future Price.

OBJECTIVES:

1. To study the evolution of the Indian capital market.
2. To evaluate the performance of the Indian derivative market.
3. To study the elements that contribute to the growth of derivative markets.

NEED OF THE STUDY:

1.It helps the investors to construct a diversified portfolio.

2.This study suggests investors about investment in futures, options, and swaps.

3.It is used to know the risk management in derivatives.

INTRODUCTION:

The derivatives market is the financial market for derivatives, which are financial instruments derived from other types of assets such as futures contracts or options. The market is separated into two sections: exchange-traded derivatives and over-the-counter derivatives.

These contracts can be used to trade a wide range of assets and each has its own set of risks. The prices of derivatives are determined by fluctuations in the underlying asset. These financial instruments are commonly used to gain access to certain markets and may be exchanged to reduce risk. Derivatives can be used to mitigate risk (hedging) or to assume risk in the intention of making a profit (speculation). Derivatives have the potential to shift risk (and thus earnings) from risk-averse to risk-seeking investors.

Types of Derivatives:

- **Futures**: A contract to purchase or sell a defined amount of a commodity or financial instrument at a certain price at a future date. The investor will profit if the price of the commodity or financial instrument rises between the contract date and the future date; otherwise, the investor will lose money. The market for such contracts is also referred to by the word.
- **Forwards:** A forward contract, also known as just forward, is a commercial agreement to buy or sell an asset at a given price on a future date. The forward contract is a sort of derivative since it refers to the underlying asset that will be delivered on the specified date.
- **Swaps:** It is one of the most effective diversification and trading tools used by both investors and traders. It can be broadly separated into two groups based on its structure: contingent claims, often known as options, and forward claims, which include exchange-traded futures, swaps, or forward contracts. Swap derivatives are effectively utilised to exchange obligations from these groups. These are agreements between two parties to exchange a series of cash flows over a set period of time.
- **Options:** Because options are a type of derivative, their value is determined by the underlying instrument's value. A stock, an index, a currency, a commodity, or any other security could be used as the underlying instrument.

Features of Derivatives

- A financial derivative's value is generated from another asset.
- Derivatives are utilised to shift risk from risk-averse investors to risk-taking investors.
- Financial derivatives provide promises to future prices or rates or provide protection against adverse price or exchange rate changes, reducing the size of financial risk.

MAJOR PLAYERS IN THE FINANCIAL DERIVATIVES TRADING

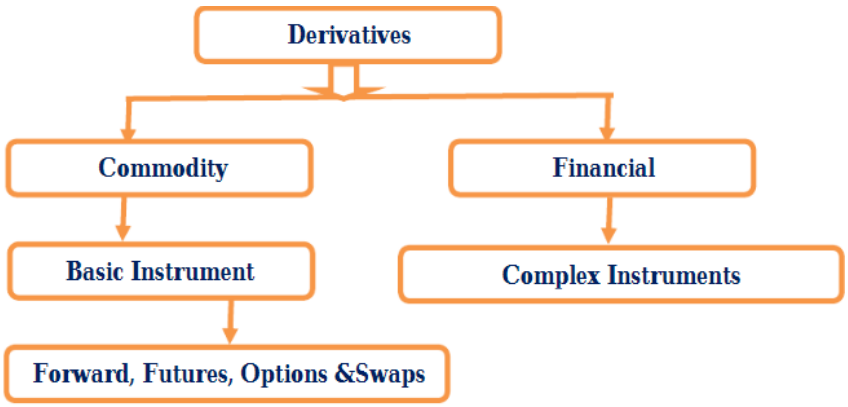
Financial derivatives trading is dominated by three key players:

1. **Hedgers** are traders who utilise derivatives to mitigate the risk they incur from anticipated market variable fluctuations and to avoid exposure to adverse price movements of an asset. This category includes the vast majority of players in the derivative market.

2. **Speculators** are traders who buy/sell assets with the intention of reselling/buying them profitable at a later date. They desire to take risks. They employ derivatives to speculate on the future direction of an asset's price and take a position in order to benefit quickly. By using derivatives in a risky business, they can enhance both possible gains and potential losses.

3. **Arbitrageurs** are traders who buy and sell the same (or separate but related) assets at the same time in order to profit from exaggerated price differentials. They try to make money by locking in a risk-free trade by transacting in two or more markets at the same time. They attempt to profit risklessly from differences between futures and spot prices, as well as between multiple futures prices.

Categorisation:



REVIEW OF LITERATURE:

James Morgan (Journalist) nicely captured the ambiguous role of derivatives in an article of Financial Times "a derivative is like a razor. You can use it to shave yourself…. or you can use it to commit suicide".

Chatrath, Ramchander and Song, 1995 The critics of the derivative market called it as a market for speculators. Little cash is involved in this market which is the main reason of its risky nature. Thus, it is argued that the contributors of speculative traders in systems, which allow high degrees of leverage, lower the quality of information in the market. These uninformed traders could play a destabilizing role in cash markets.

Hentchell & Smith 1997 Discuss that Derivative product can reduce need on the part of firm and banks to hold idle precautionary balance to tide over unexpected adversities, thereby reducing the fraction of funds with these organization that remain unproductive.

Greenspan (1997) "By far the most significant event in finance during the past decades has been the extraordinary development and expansion of financial derivatives…"

Sahoo (1997) opines "Derivatives products initially emerged, as hedging devices against fluctuation in commodity prices and the commodity-linked derivatives remained the sole form of such products for many years.

Hathaway (1998) stated that, while there is a perceived similarity of regulatory objective, there is no single preferred model for regulation of derivative markets.

RESEARCH METHODOLOGY

It is always vital to be sceptical of the information offered in sources, especially when the material was acquired to address a different issue. Furthermore, many secondary sources do not clearly define problems such as the objective of a study, how data was collected, analysed, and evaluated, making it difficult for the researcher to evaluate their relevance. To solve this issue, I attempted to triangulate secondary data by utilising multiple independent sources.

The problem's details have been gathered from research journals, trade magazines, bank annual reports, and the Internet. I concentrated on as recent material as possible when reviewing "Evolution of derivatives and important factors!" I used a number of papers published in academic publications and trade periodicals to stay up to date on the newest advancements in this field. We also used secondary data from Internet-based discussion communities.

FACTORS INFLUENCING GROWTH OF DERIVATIVE MARKETS

Price volatility, market globalisation, technology advancements, and breakthroughs in financial theories are all factors contributing to derivatives' spectacular rise.

Price volatility: A price is the amount of money paid to acquire or use something valuable. The valuable objects could be commodities, local currency, or international currency. When we talk about commodities, practically everyone understands the concept of pricing. The purchase of food grain, oil, petrol, metal, and so on has a cost. The interest rate is the cost of using a unit of another person's money. An exchange rate is the price paid in one's own currency for one unit of another currency.

Globalisation of markets: Formerly, managers had to deal with home economic concerns; what happened elsewhere in the world was largely immaterial. Globalisation has increased the scale of markets while also increasing competitiveness. It has benefited consumers who cannot afford items of greater quality at reduced prices. It has also exposed modern businesses to considerable risks, leading to reduced profit margins in many circumstances. In the Indian context, the 1997 South East Asian currency crisis harmed our products' competitiveness versus decreased currencies.

Technological Advances: The rise of derivative instruments has been fueled by technical advances. Advances in this area include the development of high-speed computers, network systems, and improved data entry methods. Telecommunications improvements are closely tied to advances in computer technology.

Improvements in communications enable for real-time global conferencing and data transmission through satellite.

FINDINGS

Since 1991, as a result of economic policy liberalisation, the Indian economy has entered an era in which Indian firms cannot ignore global markets. Prior to the 1990s, numerous commodities, metals, and other assets had price controls. Others, which were not regulated, were mostly reliant on regulated input pricing. As a result, there was little uncertainty, and thus no price fluctuation. However, since the beginning of the deregulation movement in 1991, most commodity prices have been deregulated. It has also resulted in the partial deregulation of exchange rates, the removal of trade regulations, the reduction of interest rates, important reforms for foreign institutional investors' capital market access, the introduction of market-based pricing of government assets, and so on.

CONCLUSION

A derivative product, often known as a 'derivative,' must be separated from the underlying cash asset. A cash asset is one that is acquired or sold in the cash market on standard delivery conditions. As a result, the term 'derivative' implies that it has no independent worth. It indicates that its worth is totally 'generated' from the cash asset's value.

The important issue is that derivatives are forward or futures contracts, which means they are contracts for delivery. The fundamental idea is that derivatives are forward or futures contracts, which are contracts for delivery and payment at a future date specified. They primarily serve to facilitate the hedging of the cash asset's price risk. They are known as 'Risk Management Tools' in the market.

Commodity futures trading in India began in the 1950s; however, the 1960s saw a significant fall in futures trading. Market following market was typically closed because price increases in various commodities were linked to speculation on these marketplaces. As a result, the Central Government prohibited derivatives trading through a notification issue in 1969. In the late 1990s, there was a wide scale resurrection of futures markets in India28, thus the Central Government lifted the restriction on futures trading in October 1999.

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