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A STUDY ON FINANCIAL DERIVATIVES AND ITS EFFECT ON INDIAN CAPITAL MARKET

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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. The market turn-over has grown from Rs.2365 crore in 2000-2001 to Rs. 11010482.20 crore in 2008-2009. 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.

KEYWORDS

derivatives, futures, options, forwards, swaps, trading, financial market, risk, hedgers, arbitrageurs, speculators, turnover.

INTRODUCTION

Risk is a characteristic feature of all commodity and capital markets. Over time, variations in the prices of agricultural and non-agricultural commodities occur as a result of interaction of demand and supply forces. The last two decades have witnessed a many-fold increase in the volume of international trade and business due to the ever growing wave of globalization and liberalization sweeping across the world. As a result, financial markets have experienced rapid variations in interest and exchange rates, stock market prices thus exposing the corporate world to a state of growing financial risk. Increased financial risk causes losses to an otherwise profitable organization. This underlines the importance of risk management to hedge against uncertainty. Derivatives provide an effective solution to the problem of risk caused by uncertainty and volatility in underlying asset. Derivatives are risk management tools that help an organization to effectively transfer risk. Derivatives are instruments which have no independent value. Their value depends upon the underlying asset. The underlying asset may be financial or non-financial. The present study attempts to discuss the genesis of derivatives trading by tracing its historical development, types of traded derivatives products, regulation and policy developments, trend and growth, future prospects and challenges of derivative market in India. The study is organised into four sections. Section I deals with the concept, definition, features and types of financial derivatives. Section II has been devoted to a discussion of the growth of derivatives market, and regulation and policy development. Section III discusses status of global derivatives market vis-a-vis Indian derivatives market. The last section specifies summary and concluding remarks.

CONCEPT OF DERIVATIVES

The term 'derivatives, refers to a broad class of financial instruments which mainly include options and futures. These instruments derive their value from the price and other related variables of the underlying asset. They do not have worth of their own and derive their value from the claim they give to their owners to own some other financial assets or security. A simple example of derivative is butter, which is derivative of milk. The price of butter depends upon price of milk, which in turn depends upon the demand and supply of milk. The general definition of derivatives means to derive something from something else. Some other meanings of word derivatives are: a derived function: the result of mathematical differentiation; the instantaneous change of one quantity relative to another; df(x)/dx, b derivative instrument: a financial instrument whose value is based on another security, (linguistics) a word that is derived from another word; "`electricity' is a derivative of 'electric'. The asset underlying a derivative may be commodity or a financial asset. Derivatives are those financial instruments that derive their value from the other assets. For example, the price of gold to be delivered after two months will depend, among so many things, on the present and expected price of this commodity.

DEFINITION OF FINANCIAL DERIVATIVES

Section 2(ac) of Securities Contract Regulation Act (SCRA) 1956 defines Derivative as: a) "a security derived from a debt instrument, share, loan whether secured or unsecured, risk instrument or contract for differences or any other form of security; b) "a contract which derives its value from the prices, or index of prices, of underlying securities".

PARTICIPANTS IN DERIVATIVES MARKET

1. Hedgers: They use derivatives markets to reduce or eliminate the risk associated with price of an asset. Majority of the participants in derivatives market belongs to this category**.**

2. Speculators: They transact futures and options contracts to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and potential losses by usage of derivatives in a speculative venture.

3. Arbitrageurs: Their behaviour is guided by the desire to take advantage of a discrepancy between prices of more or less the same assets or competing assets in different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

OBJECTIVES

1. To assess the growth and development of financial derivatives in the Indian Capital Market.
2. To develop and understanding about the concept and role of financial derivatives in India.
3. To assess the financial derivatives in India
4. To examine the performance of financial derivatives in the Indian Capital Market.

TYPES OF DERIVATIVES

Derivatives can be classified into four types:

FORWARD CONTRACTS

A forward contract is an agreement between two parties – a buyer and a seller to purchase or sell something at a later date at a price agreed upon today. Forward contracts, sometimes called forward commitments , are very common in everyone life. Any type of contractual agreement that calls for the future purchase of a good or service at a price agreed upon today and without the right of cancellation is a forward contract.

FUTURE CONTRACTS

A futures contract is an agreement between two parties – a buyer and a seller – to buy or sell something at a future date. The contact trades on a futures exchange and is subject to a daily settlement procedure. Future contracts evolved out of forward contracts and possess many of the same characteristics. Unlike forward contracts, futures contracts trade on organized exchanges, called future markets. Future contacts also differ from forward contacts in that they are subject to a daily settlement procedure. In the daily settlement, investors who incur losses pay them every day to investors who make profits.

OPTIONS CONTRACTS

Options are of two types – calls and puts. Calls give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date. Puts give the buyer the right, but not the obligation to sell a given quantity of the underlying asset at a given price on or before a given date.

SWAPS

Swaps are private agreements between two parties to exchange cash flows in the future according to a prearranged formula. They can be regarded as portfolios of forward contracts. The two commonly used swaps are interest rate swaps and currency swaps.

APPLICATIONS OF FINANCIAL DERIVATIVES

Some of the applications of financial derivatives can be enumerated as follows:

1. MANAGEMENT OF RISK

This is most important function of derivatives. Risk management is not about the elimination of risk rather it is about the management of risk. Financial derivatives provide a powerful tool for limiting risks that individuals and organizations face in the ordinary conduct of their businesses. It requires a thorough understanding of the basic principles that regulate the pricing of financial derivatives. Effective use of derivatives can save cost, and it can increase returns for the organizations.

2. EFFICIENCY IN TRADING

Financial derivatives allow for free trading of risk components and that leads to improving market efficiency. Traders can use a position in one or more financial derivatives as a substitute for a position in the underlying instruments. In many instances, traders find financial derivatives to be a more attractive instrument than the underlying security. This is mainly because of the greater amount of liquidity in the market offered by derivatives as well as the lower transaction costs associated with trading a financial derivative as compared to the costs of trading the underlying instrument in cash market.

3. SPECULATION

This is not the only use, and probably not the most important use, of financial derivatives. Financial derivatives are considered to be risky. If not used properly, these can leads to financial destruction in an organization like what happened in Barings Plc. However, these instruments act as a powerful instrument for knowledgeable traders to expose themselves to calculated and well understood risks in search of a reward, that is, profit.

4. PRICE DISCOVER

Another important application of derivatives is the price discovery which means revealing information about future cash market prices through the futures market. Derivatives markets provide a mechanism by which diverse and scattered opinions of future are collected into one readily discernible number which provides a consensus of knowledgeable thinking.

TABLE 1: DERIVATIVES TURNOVER (Turnover in ₹ Cr.)

Year	Total Contracts	Total Turnover	Avg. Daily Turnover	Trading Days
2015-2016	7,57,09,981	31,44,419.47	35,732.04	88
2014-2015	50,54,78,869	2,03,62,741.42	83,797.29	243
2013-2014	30,19,42,441	92,19,434.32	36,730.81	251
2012-2013	26,24,40,691	71,63,576.66	28,654.31	250
2011-2012	3,22,22,825	8,08,475.99	3,246.89	249
2010-2011	5,623	154.33	0.61	255
2009-2010	9,028	234.06	0.96	244
2008-2009	4,96,502	11,774.83	48.46	243
2007-2008	74,53,371	2,42,308.41	965.37	251
2006-2007	17,81,220	59,006.62	236.97	249
2005-2006	203	8.78	0.03	251
2004-2005	5,31,719	16,112.32	63.69	253
2003-2004	1,43,224	5,021.81	19.77	254

CONCLUSION

Innovation of derivatives have redefined and revolutionized the landscape of financial industry across the world and derivatives have earned a well deserved and extremely significant place among all the financial products. Derivatives are risk management tool that help in effective management of risk by various stakeholders. Derivatives provide an opportunity to transfer risk, from the one who wish to avoid it; to one, who wish to accept it. India's experience with the launch of equity derivatives market has been extremely encouraging and successful. The derivatives turnover on the NSE has surpassed the equity market turnover. Significantly, its growth in the recent years has surpassed the growth of its counterpart globally

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