# NISM VIII

## CHAPTER 1: BASICS OF DERIVATIVES

### LEARNING OBJECTIVES

- Meaning of derivatives and types of derivatives products
- History of derivatives market
- Significance of derivative markets
- Risks in derivatives trading

## 1.1 BASICS OF DERIVATIVES

Derivatives are contracts whose worth comes from the **'underlying'.**

Here are some examples of what the underlying can be:

- Metals like gold, silver, and copper.
- Energy sources like oil, coal, and natural gas.
- Farm products like wheat, sugar, and cotton.
- Financial items like stocks, bonds, and money from different countries.

So, the value of the derivative changes based on these underlying things. If the price of gold goes up, the value of a derivative based on gold also changes.

# 1.2 DERIVATIVES MARKET AND HISTORY

| Year | Event | Description |
|---|---|---|
| 1996 | Gupta Committee Formation | SEBI sets up a committee to draft a **regulatory framework** for derivatives. |
| 1998 | Gupta Committee Report | Recommends derivatives be classified as '**securities**' to bring them under the same regulatory framework as other securities.. |
| 1998 | Varma Committee Report | Focus on **risk containment measures**, it details operational requirements (margin, deposits, potion monitoring etc) for derivatives trading. |
| 1999 | Amendment of SCRA (Securities Contract Regulation Act) | Derivatives included under securities regulation. |
| 2000 | Repeal of Forward Trading Ban | Legal barriers to derivatives trading (threedecade-old notification, which prohibited forward trading in securities.) removed. |
| 2000 | Start of Exchange Traded Derivatives | SEBI **enables BSE and NSE** to offer index futures. |
| 2001 | Expansion in Derivatives Trading | Introduction of index options and options/futures on individual stocks. |
| 2013 | MSEI Trading Derivatives | MSEI begins offering derivative products, further expanding market options. |

## Factors influencing the growth of derivative market globally

### Increased Volatility

- Financial markets have become more unpredictable.
- Derivatives are useful for protecting money (hedging) and for making bets on these price changes (speculative trades).

### Risk management

- Derivatives offer quick ways to **protect investments** against big surprises and rapid changes in the market.

### Technology & connectivity

- Advances in technology have made **trading cheaper and easier**,
- Attracting more people from all over the world to participate in derivatives markets.

# 1.3 INDIAN DERIVATIVES MARKET

### Forwards

- **Private agreements** between two parties to buy or sell an asset at a specified price on a future date.
- Not traded on exchanges these are **over-the-counter (OTC)** deals, meaning they are traded directly between parties without public exchange.

### Futures

- Similar to forwards but are **traded on an exchange**, making them standardized in terms of contract size, expiration, and other terms
- Require a margin deposit to honor the transaction or maintain a position in a futures contract.

## Options

- Contracts that give you the **right to buy or sell something** at a set price within a specific time frame, but you don't have to use them if you don't want to.
- Offer more **flexibility** than futures or forwards because buyer is not obligated to complete the transaction.

## Swaps

- You have an apple every day, and your friend has a banana.
- You decide to swap your snacks because you like bananas and your friend likes apples.
- So, you agree to trade your snacks every day. – That is a swap
- offer more flexibility than futures or forwards because buyer is not obligated to complete the transaction

# 1.4 MARKET PARTICIPANTS

## Hedgers

- Hedgers are individuals or companies that use derivatives to **protect themselves against potential losses** due to price fluctuations in the underlying assets.
- An airline might use fuel derivatives to hedge against rising jet fuel prices.

## Traders/speculators

- They engage in the market to **profit from fluctuations** in the price of derivatives.
- Derivatives provide them,
  - leverage
  - lower costs of transaction &
  - faster execution over buying/selling the asset.

## Abitrageurs

- Arbitrageurs **exploit price differences** for the same asset in different markets.
- Primary goal is to make profits with minimal/zero risk, achieve this by executing trades at high speeds, reacting instantly to market opportunities.

# 1.5 TYPES OF DERIVATIVES MARKET

Mainly 2 types - **OTC (over the counter)** & **Organised (exchange traded)**

| Aspect | OTC Derivatives | Exchange-Traded Derivatives |
| --- | --- | --- |
| Participants | Banks, hedge funds, corporations, high-net-worth individuals | General public and various financial entities |
| Trading Venue | No specific location; done via brokers & dealers | Organized exchanges |
| Regulation | Less regulated & tranparent; private transactions | Highly regulated; transactions are public |
| Contract Customization | Tailor-made to fit specific needs | Standardized contracts |
| Risk Management | Each party manages its own risk; no centralized oversight | Centralized risk management through clearing houses |
| Position Limits | No centralized limits; managed internally by participants | Position and leverage limits enforced by exchanges |
| Contract Enforcement | Relies on bilateral agreements/ trust; no central guarantee | Guaranteed by clearning corporations |

# 1.6 SIGNIFICANCE OF DERIVATIVE MARKET

## Price Discovery

- Derivatives help everyone understand the probable **fair value of assets**
- By showing what the market thinks these assets will be worth in the future.

## Risk Management

- Derivatives provide a way for those who don't like risk to manage or eliminate them
- While offering opportunities for others who seek risk with the potential for profits.

## Market Stability

- By regulating and overseeing the trading of derivatives, the **market maintains order and integrity,**
- Helping to prevent crises and maintain confidence in the financial system.

# 1.7 VARIOUS RISKS IN DERIVATIVES MARKET

## Counterparty Risk

- The risk that the other party in a derivatives contract will not fulfill their obligations.

## Price Risk

- The risk of losing money due to **unfavorable movements** in the price of the underlying asset.

## Liquidity Risk

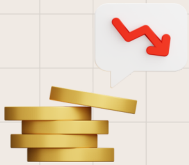
- The risk of not being able to quickly exit a position without significant losses.

## Legal or Regulatory Risk

- The risk that a change in laws or regulations will impact the value or enforceability of a derivatives contract.

## Operational Risk

- Risks arising from operational failures such as **fraud, errors in trading, or inadequate documentation.**



“A market participant should therefore **carefully consider** whether such trading is suitable for him/her **based on these parameters”**