

VI SEMESTER B. COM

FINANCIAL DERIVATIVES

MODULE 1 - INTRODUCTION TO FINANCIAL DERIVATIVES

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DERIVATIVES

Derivatives are financial instruments or contracts which derive their values from the prices, or index of prices of some other assets .

The other assets are known as underlying securities. The underlying assets may be interest rate, foreign exchange, commodity, share or any security.

Derivatives are the instruments for hedging risk, used for eliminating the risk involved in buying, holding and selling assets whose price fluctuate.

These are contracts written between two parties for easily marketable assets.

HISTORY AND EVOLUTION OF DERIVATIVES

The forward trading was in existence during 12th century in England and France. Forward trading in rice was started in 17th century in Japan, in 1730, this market got official recognition and became the first futures market in the sense that it was registered on organized exchange with the standardized trading norms.

The butter and eggs dealers of Chicago Produce Exchange joined hands in 1898 to form the Chicago Mercantile Exchange for futures trading. The exchange provided a futures market for many commodities including pork bellies (1961), live cattle (1964), live hogs (1966), and feeder cattle (1971). The International Monetary Market was formed as a division of the Chicago Mercantile Exchange in 1972 for futures trading in foreign currencies and in 1982, it introduced a futures contract on the S&P 500 Stock Index.

During 1980's, markets developed for options in foreign exchange, options on stock indices, and options on futures contracts. The Philadelphia Stock Exchange is the premier exchange for trading foreign exchange options.

The modern futures contracts first came into existence with the establishment of the Chicago Board of Trade (CBOT) in the year 1848. In 1865, the CBOT framed the general rules for such trading.

In the early 1970s, it is witnessed that the financial markets were highly in- stable, as a result, so many financial derivatives have been emerged as the means to manage the different types of risks and also for taking advantage of it. Hence, the first financial futures market was the International Monetary Market, established in 1972 by the Chicago Mercantile Exchange which was followed by the London International Financial Futures Exchange in 1982.

The Forwards Contracts (Regulation) Act, 1952, regulates the forward/futures contracts in commodities all over India. As per this the Forward Markets Commission(FMC) continues to have jurisdiction over commodity forward/futures contracts. When derivatives trading in securities was introduced in 2001, the term 'security' in the Securities Contracts(Regulation)Act,1956(SCRA),was amended to include derivative contracts in securities. Consequently, regulation of derivatives came under the preview of Securities Exchange Board of India (SEBI).

CLASSIFICATION OF DERIVATIVES

I On the basis of nature of contract

- Forwards
- Futures
- Options
- Swaps

II On the basis of underlying assets

- Commodity Derivatives
- Financial Derivatives

III On the basis of trading mechanism

- Over the Counter Derivatives
- Exchange Traded Derivatives

Financial derivatives

Financial contract which derives its value from stocks, bonds, interest rates or currencies are known as a financial derivative or common derivative. The seller of the contract does not have to own the underlying asset.

Features

- It is a contract
- No independent value
- Derives value from underlying asset
- Specified Obligation
- Instruments for hedging risk
- Minimal initial investment
- Direct or exchange traded
- Related to notional amount
- Delivery of underlying asset not involved
- Secondary market instruments
- Exposure to risk
- Off balance sheet item

TYPES OF FINANCIAL DERIVATIVES

- Currency Derivatives
 - Interest Rate Derivatives
 - Equity Derivatives
 - Stock Indices Derivatives
 - Credit Derivatives
- Warrants
 - LEAPS
 - Baskets
 - Convertibles

USES OF DERIVATIVES

1. **Risk management**
2. **Prediction of future prices**
3. **Enhance liquidity**
4. **Assist investors**
5. **Income generation**
6. **Integration of price structure**
7. **Reduce transaction cost**
8. **Catalyze growth of financial markets**
9. **Brings perfection in market**
10. **Financial engineering**

ECONOMIC FUNCTIONS OF DERIVATIVE CONTRACTS

- 1. Risk management functions**
- 2. Price discovery function:-**
3. Liquidity function
- 4. Efficiency function**
- 5. Portfolio management function**
- 6. Economic development function**

LIMITATIONS OF DERIVATIVES

1. **High Volatility**
2. **Increased regulatory burden**
3. **Enhancement of risk**
4. **Speculative and gambling motives**
5. **Instability of the financial system**
6. **Limited contract life**

RISK INVOLVED WITH DERIVATIVES

1. **Counter party risk**
2. **Systematic risk**
3. **Basis risk**
4. **Agency risk**
5. **Liquidity risk**
6. **Operation risk**
7. **Inter connection risk**