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STUDY ON GROWTH AND DEVELOPMENT OF DERIVATIVES AND ITS MARKET IN INDIA

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Abstract

Risk is a characteristic feature of all commodity and capital markets. Prices of all commodities – be they agricultural like wheat, cotton, rice, coffee or tea, or non- agricultural kike silver, gold etc. – are subject to fluctuation over time in keeping with prevailing demand and supply conditions. Producers or possessors of these commodities obviously cannot be sure of the prices that their produce or possession may fetch when they have to sell them, in the same way as the buyers and the processors ate not sure what they would have to pay for their buy. Similarly, prices of shares and debentures or bonds and other securities are also subject to continuous changes. Those who are charged with the responsibility of managing money, their own or of others are therefore constantly exposed to the threat of risk. In the same way, the foreign exchange rates are also subject to continuous change. Thus an importer of certain piece of machinery is not sure of the amount he would have to pay in rupee terms when the payment becomes due.

***Keyword**: Derivatives, Overview and Applicability*

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INTRODUCTION

The term "Derivative" indicates that it has no independent value, i.e. its value is entirely "derived" from the value of the underlying asset. The underlying asset can be securities, commodities, bullion, currency, live stock or anything else. In other words, Derivative means a forward, future, option or any other hybrid contract of pro determined fixed duration, linked for the purpose of contract fulfillment to the value of a specified real of financial asset of to an index of securities. Derivatives have become very important in the field finance. They are very important financial instruments for risk management as they allow risks to be separated and traded. Derivatives are used to shift risk and act as a form of insurance. This shift of risk means that each party involved in the contract should be able to identify all the risks involved before the contract is agreed. It is also important to remember that derivatives are derived from an underlying asset. This means that risks in trading derivatives may change depending on what happens to the underlying asset.

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A derivative is a product whose value is derived from the value of an underlying asset, index or reference rate. The underlying asset can be equity, forex, commodity or any other asset. For example, if the settlement price of a derivative is based on the stock price of a stock for e.g. Infosys, which frequently changes on a daily basis, then the derivative risks are also changing on a daily basis. This means that derivative risks and positions must be monitored constantly.

BRIEF HISTORY

The history of derivatives is quite colorful and surprisingly a lot longer than most people think. To start we need to go back to the Bible. In Genesis Chapter 29, believed to be about the year 1700 B.C., Jacob purchased an option costing him seven years of labor that granted him the right to marry Laban's daughter Rachel. His prospective father-in-law, however, reneged, perhaps making this not only the first derivative but the first default on a derivative. Laban required Jacob to marry his older daughter Leah. Jacob married Leah, but because he preferred Rachel, he purchased another option, requiring seven more years of labor, and finally married Rachel, bigamy being allowed in those days. Jacob ended up with two wives, twelve sons, who became the patriarchs of the twelve tribes of Israel, and a lot of domestic friction, which is not surprising. Some argue that Jacob really had forward contracts, which obligated him to the marriages but that does not matter. Jacob did derivatives, one way or the other. Around 580 B.C., Thales the Milesian purchased options on olive presses and made a fortune off of a bumper crop in olives. So derivatives were around before the time of Christ.

GLOBAL OVERVIEW

The global market for derivatives has grown substantially in the recent past. The Foreign Exchange and Derivatives Market Activity survey conducted by Bank for International Settlements (BIS) points to this increased activity. The total estimated notional amount of outstanding OTC contracts increasing to $111 trillion at end− December 2001 from $94trillion at end− June 2000. This growth in the derivatives segment is even more substantial when viewed in the light of declining activity in the spot foreign exchange markets. The turnover in traditional foreign exchange markets declined substantially between 1998 and2001. In April 2001, average daily turnover was $1,200 billion, compared to $1,490 billion in April 1998, a 14% decline when volumes are measured at constant exchange rates. Whereas the global daily turnover during the same period in foreign exchange and interest rate derivative contracts, including what are considered to be "traditional" foreign exchange derivative instruments, increased by an estimated 10% to $1.4 trillion.

NEED FOR A DERIVATIVES MARKET

The derivatives market performs a number of economic functions:

- They help in transferring risk from risk averse people to risk oriented people.
- They help in the discovery of future as well as current prices.
- They catalyze entrepreneurial activity.
- They increase the volume traded in markets because of participation of risk-averse people in greater numbers.
- They increase savings and investment in the long run.

FACTORS DRIVING THE GROWTH OF FINANCIAL DERIVATIVES

- Increased volatility in asset process in financial markets,
- Increased integration of national financial markets with the international markets,
- Marked improvement in communication facilities and sharp decline in their costs,
- Development of more sophisticated risk management tools, providing economic agents a wider choice of risk management strategies, and
- Innovations in the derivatives markets, which optimally combine the risks and returns over a large number of financial assets leading to higher returns, reduced risk as well as transactions costs as compared to individual financial assets.
- A derivative is a financial instrument whose value depends on the value of other, more basic underlying variables.

The main instruments under the derivative are:

- Forward contract
- Future contract
- Options
- Swaps

DEVELOPMENT OF DERIVATIVES MARKET IN INDIA

The securities Contract Regulation Act (SCRA) was amended in December 1999 to include derivatives within the ambit of 'securities' and the regulatory framework were developed for governing derivatives trading. The act also made it clear that derivatives shall be legal and valid only if such contracts are traded on a recognized stock exchange, thus precluding OTC derivatives. The government also rescinded in March 2000, the three-decade old notification, which prohibited forward trading in securities. Trading and settlement in derivative contracts is done in accordance with the rules, byelaws, and regulations of the respective exchanges and their clearing house/corporation duly approved by SEBI and notified in the official

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gazette. Foreign Institutional Investors (FIIS) are permitted to trade in all Exchange traded derivative products.

INSTRUMENTS AVAILABLE IN INDIA

The National stock Exchange (NSC) has the following derivative products:

Products	Index Futures	Index Options	Future on Individual securities	Options on Individual Securities
Underlying Instrument	S&P CNX Nifty	S&P CNX Nifty	30 Securities stipulated by SEBI	30 Securities stipulated by SEBI
Type		European		American
Trading cycle	Maximum of 3-month trading cycle. At any point in time, there will be 3 contracts available: 1)Near month, 2)Mid month & 3)Far month duration	Same as index futures	Same as index futures	Same as index futures
Expiry Day	Last Thursday of the expiry month	Same as index futures	Same as index futures	Same as index futures
Contract Size	Permitted lot size is 200 & multiples there of	Same as index futures	As stipulated by NSC(not less than Rs.2 Lacs)	As stipulated by NSC(not less than Rs.2 Lacs)

TRADERS IN DERIVATIVES MARKET

Hedgers: Hedgers are the traders who wish to eliminate the risk (of price change) to which they are already exposed. They may take a long position on, or short sell, a commodity and would, therefore, stand to lose should the prices move in the adverse direction. The trader can sell futures (or forward) contracts with a matching price, to hedge. Thus, if the wheat prices do fall, the trader would lose money on the inventory of wheat but will profit from the futures contract, which would balance the loss.

Speculators: If hedgers are the people who wish to avoid the price risk, speculators are those who are willing to take such risk. These are the people who take position in the market and assume risks to profit from fluctuations in prices. In fact, the speculators consume information, make forecasts about the prices and put their money in these forecasts. Depending on their perceptions, they may take long or short positions on futures and/or options, or may hold spread positions (simultaneous long and short positions on the same derivatives).

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Arbitrageurs: Arbitrageurs thrive on market imperfections. An arbitrageur profits by trading a given commodity, or other item, that sells for different prices in different markets. An arbitrageur is basically risk averse. He enters into those contracts were he can earn riskless profits. When markets are imperfect, buying in one market and simultaneously selling in other market gives riskless profit. Arbitrageurs are always in the look-out for such imperfections.

REGULATIONS RELATED TO DERIVATIVES:

Securities Contracts(Regulation) Act, 1956

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 A contract which derives its value from the prices, or index of prices, of underlying securities. Section 18A provides that notwithstanding anything contained in any other law for the time being in force, contracts in derivative shall be legal and valid if such contracts are:

- Traded on a recognized stock exchange
- Settled on the clearing house of the recognized stock exchange, in accordance with the rules and bye–laws of such stock exchanges.

Regulation for derivatives trading

1. Any Exchange fulfilling the eligibility criteria as prescribed in the L C Gupta committee report may apply to SEBI for grant of recognition under Section 4 of the SC(R)A, 1956 to start trading derivatives. The derivatives exchange/segment should have a separate governing council and representation of trading/clearing members shall be limited to maximum of 40% of the total members of the governing council. The exchange shall regulate the sales practices o its members and will obtain prior approval of SEBI before start of trading in any derivative contract.

2. The Exchange shall have minimum 50 members.

3. The members of an existing segment of the exchange will not automatically become the members of derivative segment. The members of the derivative segment need to fulfill the eligibility conditions as laid down by the LC Gupta committee.

4. The clearing and settlement of derivatives trades shall be through a SEBI approved clearing corporation/house. Clearing corporations/houses complying with the eligibility conditions as laid down by the committee have to apply to SEBI for grant of approval.

RESEARCH METHODOLOGY

OBJECTIVES OF THE STUDY:

- To study the derivatives market in India
- To study how derivatives market has evolved in India in the last few years.
- To understand how derivatives market work, how contract is executed, how settlement of a contract takes place, what are the different factor which had contributed to the success of derivatives in India.

SCOPE OF THE STUDY:

Derivatives since its introduction have gained a lot of importance from the all segment of the society. Since the very beginning of it, players started finding out relationship between the Cash Market and the Derivatives Market. So in this project we had tried to understand the derivatives market in India along with that what's happening around the world over in the same market.

SELECTION OF SECURITIES:

To study the relationship of derivatives and cash market we have selected one index i.e. "NIFTY" and four individual securities on which derivatives trading is allowed. Selection of the security for the study is purely based on the following grounds:

- Liquidity
- Contract traded in a particular day
- Continuation of security in F & O Segment
- Turnover over of a particular security in derivatives as a % of total derivatives turnover.

DERIVATIVES IN EMERGING MARKETS

As we watch these efforts going into the creation of India's exchange--traded derivatives industry, comparisons with international experiences are inevitably useful. We know that in all OECD countries, derivatives are a crucial and vibrant part of the financial system. In addition, one interesting question has been ``what has the experience of other emerging markets been like"?

Consider the 23 significant exchanges in 16 emerging markets:

- Brazil (BM & F)
- China (SSE, SME, SHME, SCCFE)
- Guatemala (BDP)
- Hungary (BCE & BSE)
- Korea (KSE)

- Malaysia (KLOFFE, KLCE)
- Philippines (MIFE)
- Portugal (PSE)
- Russia (MICEX & MCE)
- Slovak Republic (Bratislava)
- Slovenia (Ljubljana)
- South Africa (SAFEX)
- Argentina (MERFOX)
- Spain (Meff Renta)
- Singapore (SIMEX)
- Hong Kong (HKFE, SEHK)

CONCLUSION

The Derivatives market is developing in India. It has great future as several measures are being taken to develop the market. The market is dominated by few large players. Generally, individual investors are not having enough knowledge for derivatives market. There is unawareness regarding derivatives in case of individual. **India** is one of the most successful developing countries in terms of a vibrant market for **derivatives**. This episode reiterates the strengths of the modern development of **India**'s securities markets, which are based on nationwide market access, anonymous electronic trading, and a predominantly retail market.

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