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Derivative Market in India: The Purposes and Issues.

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ABSTRACT - The introduction and trading of financial derivatives in financial world is considered as major milestone in financial innovation. The purposes of these financial instruments are to reduce the extent of financial risks by providing commitments to prices for future dates in order to protect the adverse condition in future price movements. And the main implication of this study is that, it involves huge risk however the extreme cautious risk-aversion and due diligence may reduce market volatility and increase the return. This paper tries to analyze the purposes and issues of derivative market which is based on secondary data and it vividly shows the acceptability of derivatives in molding financial structure of the world especially in India.

Key words: Derivatives, financial innovation, derivative market, financial risks, financial instruments.

I. INTRODUCTION

Derivative instruments are the financial instruments which enable to transfer unwanted risk to others who are more risk –tolerant participants in the derivative market. By speculating on the value of underlying assets in future, the derivative contracts can make profit and this is the main motive behind entering in to the derivative market. But they are the complex financial instruments generally used to hedge a position and to get access the additional assets or markets and it is a form of risk management where the investors use derivatives known as put options to protect their portfolios in the stock market. The best hedging instruments are futures and options because they can speculate the price movements and make high returns.

The present paper focuses on the concept of derivatives market, purposes and various issues. It helps to acquire fundamental knowledge about the importance of derivatives market in the present scenario and the contribution to the economic growth of the nation.

OBJECTIVES OF THE STUDY

- To obtain an overview about Indian derivatives market and its acceptability.
- To understand the purposes of Indian derivatives market.
- To identify the various issues faced by the derivatives market in India.

II. REVIEW OF THE LITERATUERE

Dr.Priyanka Sahora & Dr.S.K.S.Yadav, 2013 [1] examined the derivative market in India prospects and issues and concluded that an efficient derivative market has very important role in the price discovery process of underlying assets and capital allocation on basis of market forces of demand and supply. Although the range, diversity of contracts and instruments the equity derivative market facing various issues. They found, slow price discovery and lower risk bearing capacity of option writers take long time for risk hedging. And they suggest for integrate additional concerns in to the portfolio optimization process based on new methodologies for an optimal trade-off.

Dr.Mrs. Kamlesh Gakhar & Ms. Meetu, 2013 [2] discussed the evolution, trading mechanisms, various unresolved issues and future prospects of Indian derivatives market. And the study was found out some market issues of Indian banks' increased off balance sheet exposure, lack of economies of scale, requirement of independent regulator etc. Some of the issues can be resolved by the emergence of new and innovative derivatives products which help to meet the various needs of the investors moreover, the investors' confidence can be boosted; it leads the overall development of Indian Derivatives markets.

Ms.Shalini H.S. & Dr.Raveendra P.V., 2014 [3] discussed that in the recent years, due to innovations in financial engineering, incorporation of financial markets internationally, advanced risk management techniques, changes in asset prices etc. contribute the expansion of derivative segment considerably both in globally as well as in the Indian capital market.

K.Sarathkumar & Dr. SP. Dhandhayuthapani, 2016 [4] conducted research on 'analytical study on derivative market with reference to investors' attitude' and concluded that in India, the investors have awareness about the derivatives trading but their attitude towards derivatives

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market is changing frequently. In capital market, the introduction of the concept of behavioral finance is considered as an important tool to manage such risks.

Bhavya Mishra & Vibhor Jain, 2019 [5] concluded, credit risk and market risk are the two major risks influence the derivative investors and suggested it is the responsibility of SEBI and Government agencies to create awareness among derivative investors' through related seminars and training programs as a result the investors' knowledge can be enhanced about the various advantages and risks associated with derivatives instruments both in short and long run.

Devis J S Palathra & Yadukrishnan V, 2020 [6] this paper reveals even though the financial markets are dominated by humans, some of the big firms utilize artificial intelligence for complex derivatives in different manner – in terms of pricing , extracting information, valuations, risk reduction etc. And they conclude to keep the derivatives market and economy moving and growing, India should impose stringent measures in the form of proper regulation and control derivatives.

III. RESEARCH MEHODOLOGY

Secondary data are used for present study. It is based on exploratory research to get an overview or general idea about the Indian derivative markets with various purposes and issues. The paper will analyze the potential impact of derivative market in Indian context. It will give clear picture about different types of derivative instruments which are familiar with Indian derivative market and the history behind the introduction of derivatives in Bombay stock exchange and National stock exchange and also the information about different kind of derivatives instruments which are traded through these exchanges. Through this paper a new investor will get basic knowledge about the Indian derivatives market, its types and the various purposes and issues.

Data have been collected from various published sources of journals, research reports, news papers, periodicals, articles and related websites. And this analysis will draw certain findings, suggestions and concluding remarks to strengthening the derivatives market in India.

DERIVATIVES

A derivative is a financial security or a contract with a value, such value reliant upon or derived from the fluctuations in the price of underlying assets. Modern derivatives markets provide large numbers of options of underlying assets for derivatives are stocks, bonds, commodities, currencies, interest rates and market indices. Literally, we can buy a derivative on anything because, the derivatives are available for people those who are willing to predict the amount of rain or sunlight within a stipulated time and place.

TYPES OF DERIVATIVES INSTRUMENTS

Based on contract conditions and risk factor derivatives are classified in to forward contracts, future contracts, options contracts and swap contracts.

FORWARD CONTRACTS

These contracts are usually flexible where the parties can customize the underlying assets, quantity and the date of transaction. It is an agreement between two parties to buy or sell something which is based on predetermined price and time in future. As a customized contract, forwards are trading through over-the-counter; contracts are unregulated and not standardized.

FUTURE CONTRACTS

Future contract is also an agreement between parties based on an underling instrument at a predetermined price and time in future.

Since, the future contracts are standardized contracts they are trading through secondary markets or stock exchanges and the participants are required to be maintained margin money here all positions are market to market daily. Under future contracts, the clearing house act as counter party between the parties and it may eliminate the credit risk.

OPTIONS CONTRACTS

Option contract is a financial derivative contract and the underlying instruments determine its value here the underlying instrument includes stock, index, currency, commodity or some other security and also in this contract includes two parties the buyer or holder and the seller or writer. Option contract grants right to the investor or the buyer based on predetermined price and time to buy or sell an underlying instrument but not the obligation to buy or sell the underlying asset.

Call and put options are the two kinds of option contracts are used by the traders. Call option allows right to the buyer to buy the underlying instrument at the predetermined price but there is no obligation to the buyer as well as put option allows right to the buyer to sell the underlying instruments at a predetermined price and there is no obligation to buyer. All these option contracts are trading through exchanges.

SWAPS CONTRACTS

Swaps contracts allow the exchange of pre-agreed cash flows between two parties and these streams of cash flows are determined according to a predetermined nominal value.

Swaps are trading through over the counter and these are private agreements therefore, the risk of counter party default is very high. Counter parties include companies and financial organizations instead of individuals. Financial institutions engage in swap contract as the market makers of swap market. By matching counter

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parties the swap banks are the financial institutions facilitate the transactions in swap contracts.

EXCHANGE-TRADED VERSUS OVER-THE-COUNTER (OTC)

Derivatives trading through exchanges are known as exchange traded derivatives and certain standardized contract terms are the main feature of exchange traded derivatives. Since, the premiums or discounts are specified on the contract price ensuring the liquidity of derivatives and more useful for hedging. Derivatives contracts include options and futures are trading on specialized exchanges.

Most of the derivatives are traded through over-the-counter (OTC) or off-exchange. Here, trading take place between two companies or traders and also through an intermediary like a large bank. The derivatives such as swaps, forwards are trading privately over-the-counter they do not go through an exchange.

INDIAN DERIVATIVE MARKET

Modern financial market innovations largely based on the idea of derivatives and they were created out of the need of financial market. After independence, the government of India imposed ban on cash settlement and option trading which may lead the informal forward markets. And in the year 2000, the ban on future trading on commodities were uplifted, during this period national electronic commodity exchange was created.

In the era of Chicago Board of Trade (19th century), derivatives trading were mainly based on commodities only. But there is rapid expansion in the growth of derivatives and now we have derivatives for stocks, indices, commodities, real estate, etc. Derivatives helps to meet the needs of large number of individuals and the businesses as well and this is considered as the main reason for the expansion of derivatives market.

The Bombay Stock Exchange was established in 1875, before starting the derivatives trading, BSE was an electronic spot markets. As a 'future contracts' derivatives trading was started on June 9, 2000 in BSE for the first time followed by index options and stock options were introduced in 2001 and in 2002, BSE launched single stock futures and weekly options started in 2004. On October 1st 2008 BSE, launched the currency derivatives segment in dollar-rupee currency futures which facilitates efficient price discovery, better counter party credit risk management, increased transparency etc. To get available index and stock futures on BOLT terminal BSE re-launched the derivatives segment it enables the trader to trade in cash securities and future products through BOLT TWS/IML and option products trade though DTSS TWS/DIML.DTSS assist to take place settlement of futures and option trades and risk management.

The National Stock Exchange was established in 1992 and they commenced to trade derivatives on June 12, 2000 with the launch of index futures. Index options introduced on June 4, 2001 both were based on Nifty 50 index. Options and futures on individual securities were launched in 2001and now available on 156 securities stipulated by SEBI. Indices based futures and options contracts were also introduced by NSE and now available equity based derivatives on NIFTY50, NIFTY Bank and FINNIFTY.

Derivatives have greater significance among Indian traders and its counterparts abroad from the very introduction of derivatives trading in Indian market. Derivatives normally traded in stock exchanges comparing to cash segment the daily turnover of derivatives are much higher. The available derivatives trading platforms in India includes- National Stock Exchange and Bombay Stock Exchange for trading in stocks, for trading in commodities, Multi Commodity Exchange (MCX) and National Commodity and Derivatives Exchanges (NCDX) are available and trade in currency is possible thorough NSE-SX and MCX-SX and also the NSE platform is ready for trade in bonds. In India, futures and options or f&o segment is considered as the most common type of derivatives.

DERIVATIVES TRADING INSTRUMENTS IN INDIA

Mainly futures and options are the two types of derivatives trading through NSE platform. At NSE, all future contracts are settling through cash. Future contract is between two persons but there should be a clear corporation by default in each trade which always takes place opposite position against any order.

Similarly all options at NSE settling through cash, under option contract the buyer of option pays premium and the seller receives the premium and at the expiration date the buyer has the right to exercise his option hence, the seller is obliged to sell/buy the asset. But in general if we buy a call option, we receive the right but there is no obligation to buy the same at a predetermined price and quantity at the future date and in the case of put options we receive the right but not the obligation to sell the underlying asset at the predetermined price and quantity at the future date.

At NSE, both the indices and single stocks are available to trade on futures and options. NSE's various derivatives products include Nifty 50 future, CNX IT Index, Bank Nifty index, CNX Nifty junior index and Nifty Midcap 50 index, even though there is an option to trade in some individual stocks and options but the long dated option contracts on Nifty 50 generally used for trading. There are two types of options, American and European options where the options based on individual stocks are American options and the right can exercise at anytime during the expiration date whereas European options are index based here, option right can exercise on expiration date only.

REASONS FOR DERIVATIVES MARKET

Derivatives were created not only to safeguard interest of the investors but also to protect overall economy through

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global diversification also used to hedge the situation of inflation and deflation. In the last couple of decades, the derivative market has grown extensively in advanced and emerging economies. Thus, they do serve a wide variety of purposes based on the need of financial markets they are as:

To hedge

Derivatives are widely used as tools for hedging to protect the investor's anticipated position in the spot market. It is a mechanism to lessen the inherent price risk for reducing the volatility of a portfolio. Hedgers help to perform hedging. Through the hedging process the parties like individuals and companies who are ready to own a cash commodity and there is a chance to change the cost of commodity before buying in the cash market here, by purchasing or selling future contracts or option contracts of the same commodity the hedger can achieve protection against such price risk or price fluctuations in the financial instruments.

To speculate

For the existence of derivatives hedging has a legitimate purpose whereas speculation has not such any genuine or legitimate reason however, they have prominence in the derivative market because they are the participants providing liquidity in the market also helping others to analyzing the derivatives markets as well. Speculation is just opposite of hedging because in hedging the parties have genuine business interest in the underlying assets on the other hand the speculators are the traders entering in to the future or option contracts believe that they can make profit from the subsequent price movements or changes during times of market volatility. They have no specific interest in the underlying assets and do not protecting their portfolio they are only looking for higher gains in the shorter time.

Arbitrageurs

Arbitrage is a process where the traders or arbitrageurs simultaneously buying and selling financial instruments like stocks futures in different markets by exploiting market imperfections or price differentials for a risk-free profit. Arbitrageurs monitoring various markets it helps to identify inefficiencies among the markets therefore, the regulators can take corrective measures this leads the market efficiency.

Risk management

By the use of derivatives both government and non government organizations are able to break down their risks in to smaller elements and these elements are trading among the people who are willing to take risks. During the time highly flexible interest rate and volatile exchange rates derivatives facilitate to identify the desired and actual levels of risks through the hedging, speculation and arbitraging strategies and can control, manage, transfer such risk features of their portfolios. For example a trader can reduce his risk through buy a spot item and sell the futures contract or call option, in a spot market a fall in the spot price leads to a corresponding fall in the prices of future and option contracts at this time the traders can repurchase the contracts with less price which may result profit it enables to offset the loss on a spot item to a certain extent or partially and the speculation is more easy way to protect a position in the spot market.

Price discovery

Derivative helps to determine the actual price of a commodity and in derivative market the current and future prices of a commodity is affected by many factors like environment, world economy, world news, politics etc. The prices of futures and forwards contracts provide information about anticipated prices in future and also the option contract gives information about market volatility and price risks of underlying assets.

Improved liquidity

The introduction of derivative listing in stock exchanges increased the liquidity of stocks and it enables to convert assets in to cash and vice versa. The players of derivative market like the arbitrageurs and speculators are trading between cash and derivative markets provide more liquidity for the markets. The investors and traders are interested to invest in derivatives product if it is available in the market therefore, the stock market regulators give more consideration for derivatives along with other tools for enhancing the liquidity of the stocks.

Margin mechanism in exchange traded derivatives

Margin trading is a risk management strategy and it allows the derivative market to perform smoothly. Margin trading provides guarantee to the investors for their borrowed money which is invested in the market. Under margin mechanism the brokers maintain the margin account with exchanges hence; they can trade up to a specific level.

Efficiency in trading

The true price and economic value of underlying assets can be achieved through the arbitrage trading in derivative market because it brings price corrections and help to reach equilibrium trading in derivative market. The free trading of risk components in financial derivative markets increase the market efficiency and the traders are more attractive in financial derivative instruments than the underlying assets because of high liquidity and less transaction cost in the trading of financial derivatives than the trading cost of underlying assets in cash market.

Operational advantages

Derivatives market has more liquidity than spot market hence the transaction cost like commissions and other form of traders' costs are lower so, the derivatives market plays an important role to lower the overall transaction costs. Unlike the securities market derivatives market

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encourages short selling. It is an effective tool of selling short. Short selling is the situation where if we feel the prices of the stocks are declining then we can earn money by shorting. For short, first sell the stocks or futures later buy them. In derivatives option contracts are more fractional and less statutory costs also both futures and options are more liquid in the near future these short positions can be carried forward with premium it leads to lowering the risk of impact cost.

Encourage competition

Derivative market operators or players like hedgers, speculators, arbitrageurs, traders etc. prefer to take different kinds of risks or returns and such situation encourages competitive trading it also increases the trading volume in the market. Therefore, the growing trend of financial markets will be attracted by young investors, professionals and other experts who act as catalyst to the growth of economy.

Develop the complete market

The listing of derivative helps the incomplete market to develop towards a complete market and also increase opportunities for the investors. Complete market concept refers to a situation where equally considering all the investors and no scope for additional securities because their return patterns are covered by the already existing securities.

Circumventing regulations

Derivatives are helping to circumvent regulation in the market by de-risking the securities and make it legal to purchase. For example, because of the risk involved, pension funds are prohibited to invest but the de-risked mortgage backed securities created by the investment bankers with the support of Freddie Mac and Fannie Mae and such securities are risk free hence; the pension funds are legally useful to purchase them.

Other uses

Derivatives are helping to keep a stability influences on the spot prices therefore, the derivatives markets have smoothen the price fluctuations and integrate the price structure by removing gluts and shortages in the market. Also, it assists to the proper allocation of assets of investors, traders and other managers to achieve their investment goals.

IV. ISSUES OF DERIVATIVES MARKETS

Derivatives are considered as high risk instruments since; the value of derivatives determined by the underlying assets. Like other investment instruments the level of risk of these instruments are varying. Therefore, the investors should be taken at most care and knowledge about how to manage these risks involved in derivatives, a vigilant trader can only handle these highly leveraged investments effectively. The major issues of handling derivatives instruments include;

High volatility in the values of underlying things

Derivatives values are based on underlying assets and the prices of commodities, metals, stocks etc. are changing continuously also most of them are trading on open market hence, the risk is very high at which more chances of losing their values.

Contract life

The life of derivatives contracts is limited and one may have some chances of completely losing the values of derivatives within the stipulated time period.

Required expertise

High risks in the form of credit risk, market risk, operational and strategic risks involved in derivatives trading hence, to sustain in the market expert or professional knowledge very necessary.

Speculative features

Derivatives are extremely risky instruments and also have unpredictable behavior however they are considered as tools of speculation. Sometimes unreasonable speculation results huge losses.

Counter-party risk

In derivatives contracts, forward contracts are more exposed to counter party risk because these contracts are traded over-the-counter and there is not any thorough due diligence process hence, there are chances of arising counter-party default.

Systemic risk

In derivative markets relatively a small number of firms have more interest in certain securities and they may invest in those securities. If the failure of these firms can lead all system crashing because these firms have financial relationship with others hence, an adverse event in one organization brings cascading effect to the entire system because of the systemic risk involved in derivatives trading.

Issues in market stability and related developments

The size and growth of over-the counter market attracted the regulators and supervisory bodies however, OTC markets are less transparent, highly leveraged, not based through due diligence process contribute credit risk and counter-party risks.

Economic and political problems

Poor average per capita income, inadequate infrastructure facilities, primitive public services, political pressure and regulatory capture faced by the market operators or regulators may limit the market from developments.

Lack of training

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Unlike the cash market, the investors require proper training and certification to deal in derivatives markets.

Tax and legal bottlenecks:

Derivatives transactions are considered as speculative in nature hence, it discourages investors' participation in the market. It may lead to uncertainty in tax laws and rules.

Lack of economies of scale

There are number of regional and national commodity exchanges in India however the derivatives for commodities trade taking place through a few exchanges also the derivatives are available for some commodities only. The convergence of securities and commodities markets can bring the economies of scale and boost the growth of commodities derivatives market.

Warehousing and standardization

The commodity derivative market facing the issue of improper warehousing and standardization of commodities that is a sophisticated, cost effective and convenient warehousing system is essential for smooth functioning of commodities derivatives market in addition to that an independent quality testing centers should be implemented to certify the grade and quality of commodities.

V. FINDINGS

- The study reveals that the investors are able to get protection for their investment by the introduction of margin mechanisms for exchange traded derivatives.
- The main motives behind the use of derivatives instruments are risk management, price discovery and maintaining liquidity in the market.
- In India especially futures and option markets, investors are facing many problems such as price fluctuation, failure to access correct market information, current market situation, nation's economic policy and political situation etc.
- Derivative market mainly reliant upon speculative features along with hedging in order to maintain the market liquidity .But the speculators are the short time players with the intention of higher gains they do not protect their portfolios hence, the main problem confronted by the investors in derivative segment is high speculation.
- The investors those who have fundamental and technical knowledge about derivative trading can make reasonable return from the derivative segment.

SUGGESTIONS

- Based on various global, economic and local issues, derivative markets are highly volatile therefore, the investors should be taken sensible investment decision at the proper time it can be possible trough the investors' vigilance on government policies, market regulation and reforms.
- The regulatory bodies such as SEBI must be taken necessary steps to monitor and ensure guidelines to avoid market violations because most of the investors in India using derivatives as a tool for speculation rather than hedging their risk.
- Through various seminar and training programs educate the prospective and potential investors about the derivatives features, operations, return and risk factors involved, economic and market situations, etc.

VI. CONCLUSION

The present paper shows derivatives market has wide acceptability all over the world because its impact on the financial structure of whole world, global diversification, hedging against inflation and deflation along with protecting investors through diversifying the portfolio and hedging their risks. Derivatives extensive growth forms the backbone of financial structure of advanced economies and emerging markets. The improved liquidity of the underlying things, price discovery and efficiency in trading functions of derivatives contribute avenues for raising money, price corrections, equilibrium trading and increase the depth of markets.

The main purpose of financial derivatives market is to mitigate the risks involved but the derivatives instruments also used for speculative activities for more return by taking high risks. Therefore, the study finds investors looking for high return from speculation but this effort should be channelized to the hedging purposes also.

This paper reveals the high complexity of instruments and its difficulty in trading through stock exchanges. Therefore, to trade in future and option market segment adequate training is necessary for the investors in the form of various national seminars, mock trading terminals, stock brokers meet etc. Investors are mainly reliant upon the opinions of experts, professionals and stock brokers hence, these market participants should give correct information to them. The investors who have sufficient theoretical knowledge and practical experience about derivatives trading can trade and earn high returns from derivative markets.

The study identifies the implication of derivatives markets involve huge risks therefore; those who are trading in derivatives market require extreme caution and due diligence and the efficient use of derivatives instrument helps to control market volatility, reduce risk, increase the return also improves the financial health of global market.

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