

A Study on Derivative Market in India

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ABSTRACT

Since 1991, thanks to economic policy liberalization, the Indian economy has entered an era in which Indian businesses can no longer disregard global markets. Prior to the 1990s, the prices of a variety of commodities, metals, and other assets were carefully regulated. Others, which were not rolled, were primarily dependant on regulated input costs. As a result, there was no uncertainty and, as a result, no price fluctuations. However, in 1991, when the process of deregulation began, the prices of most items were deregulated. It has also resulted in the exchange being partially deregulated, easing trade restrictions, lowering interest rates, and making significant advancements in foreign institutional investors' access to the capital markets, as well as establishing market-based government securities pricing, among other things. Furthermore, portfolio and securities price volatility and instability were influenced by market-determined exchange rates and interest rates. As a result, hedging strategies employing a variety of derivatives were exposed to a variety of risks. The Indian capital market will be examined in this study, with a focus on derivatives.

Keywords-- Derivatives, Capital Market, Futures, Options

and organizations such as LIC, GIC, and others play a key role in the financial sector. During the previous decade, the globalization and liberalization wave has swept the globe, resulting in enormous growth in international trade and business. As a result, there has been a significant increase in global demand for international money and financial products. In this regard, changes in interest rates, exchange rates, and stock market prices on various financial markets have increased the financial risks to the corporate world. Unfavorable changes have taken place. Even the business world's survival was in peril. New financial instruments, sometimes known as financial derivatives, have been established in the financial markets to deal with such risks. The primary purpose of these instruments is to give price commitments for future dates in order to protect against future price variations and so reduce the severity of financial risks. Not only that, but they also provide profit opportunities for those ready to take more risks. To put it another way, these tools make it simpler to shift risk from those who wish to avoid it to those who are willing to accept it.

I. INTRODUCTION

Long-term loans with a maturity of more than a year should be sought out in the capital market. The capital markets are stock exchanges that provide funding by issuing shares or common stock in the primary market and allowing subsequent trading in the secondary market. Bond Markets, which provide finance through the primary market's issuance of bonds and subsequent secondary market trading, are also included in Capital Markets. The financial system of any country is a complex system that includes financial institutions such as banks, non-banking financial companies (NBFCs), regulators, and products, among other things. The Indian financial system can be classified into two categories: banking and allied services institutions and regulators, and financial market institutions and regulators. The banking sector includes the Reserve Bank of India, Public Sector Banks, Private Sector Banks, Cooperative Banks, and Foreign Banks. NBFCs

II. REVIEW OF LITERATURE

Ravichandran, (2008)¹ Investor preferences for various capital market investment strategies were explored, with a focus on derivatives. According to the survey, even for experts, investing in the markets is a significant challenge in the current environment. Derivatives are a valuable tool for minimizing the risk of stock market investing and attaining the best results. According to the paper, investors should be aware of the various hedging and speculation strategies that can be used to mitigate risk. Investors who understand the multiple uses of derivatives can reduce risk and increase profits.

Talati and Sanghvi (2010)² An attempt was made to determine investor awareness and perceptions of hedge funds as an investment channel, with a focus on Gujarat. It was observed that there was limited awareness of hedge funds in the study area. The investors were uninformed of the advantages of participating in hedge funds, as well as the fundamentals of how hedge funds operate. Gujarati

investors preferred to invest in government securities and nationalized bank fixed deposits because they knew their money would be safe, even if the profits were lower.

Tripathi (2014)³ The impact of derivative trading on investor perceptions was explored. Indian investors, according to the survey, prefer to invest in real estate and insurance because they are high-yielding and low-risk investments. It was determined that over 75% of investors are aware of derivatives, with 74% having made a derivatives investment. The most common users are those who invest 10% – 20% of their overall investment in derivatives, followed by those who invest 20% – 35% of their whole investment in derivatives. 76 percent of derivatives users have put their money into options that offer risk diversification and significant returns for a small investment. Men account for 72 percent of the derivative market, while women account for only 28 percent, according to the poll. He discovered that education, career, and gender have no impact on derivative investing behaviour during his investigation. Income, on the other hand, has been proven to have a significant impact in derivatives. According to him, investors employ these assets for a variety of purposes, such as risk management, profit improvement, speculation, and arbitrage.

III. OBJECTIVES OF THE STUDY

1. To look at the history of India's capital market.
2. The goal of this research is to assess the Indian derivatives market's performance.
3. To look into the elements that drive derivative market growth.

IV. RESEARCH METHODOLOGY

Always be sceptical of the information provided by sources, especially if the information was gathered for a specific purpose or to address a specific issue. Furthermore, many secondary sources do not clearly

describe issues such as the study's purpose, data collection, analysis, and interpretation, making it difficult for the researcher to assess their significance. To solve this challenge, I attempted to triangulate secondary data by utilizing a variety of sources.

Research Journals, Trade Magazines, Bank Annual Reports, and the Internet are used to obtain information for the problem. While researching, Evolution of Derivatives and Import and Factors, I focused on as much recent material as possible. I kept up with the latest developments in this subject by reading papers published in academic journals and trade magazines. I also used secondary data from online discussion forums. Furthermore, as opposed to agriculture or manufacturing, today's economic success of any country is heavily based on the service sector. The future economy's backbone is now services. India has previously set the path for revolution in the industrial and agricultural sectors, and it is now legalizing financial futures trading. India has the infrastructure and capability to trade a wide range of financial futures, such as stock market indices, Treasury bills, gilt-edged securities, foreign currencies, cost of living indexes, and stock market indexes, among others. India's financial derivatives market has enormous growth potential due to all of these factors.

V. EVOLUTION OF DERIVATIVE MARKET IN INDIA

India has gone from a controlled economy to a world where prices fluctuate on a daily basis. Risk management methods have gained popularity in India in recent years as a result of the liberalization process and the Reserve Bank of India's (RBI) efforts to build a currency forward market. Derivatives are a key component of the liberalization process for risk management. The NSE began the process of establishing a derivatives market in India after examining the market's needs. In India, derivatives trading began in July 1999.

Table 1: Represents the Evolution of Trading in India

Year	Description
14 th December 1995	The NSE requested authorization from the SEBI to trade index futures.
18 th November 1996	The L.C. Gupta Committee was established by SEBI to design a policy framework for index futures.
11 th May 1998	The report of the L.C. Gupta Committee was submitted.
7 th July 1999	The Reserve Bank of India (RBI) has approved the use of OTC forward rates.
24 th May 2000	For futures and options trading on an Indian index, SIMEX chose Nifty.
25 th May 2000	NSE and BSE were given permission by SEBI to trade index futures.
9 th June 2000	The trading of BSE sensx futures began on the BSE.
12 th June 2000	Nifty futures trading began on the NSE.
31 st August 2000	At SIMEX, futures and options on the Nifty was traded for the first time.
June 2001	At the NSE, you can trade equity index options.

July 2001	At the NSE, you can trade stock options.
NSE – 9 th November 2002	BSE offers single futures trading.
June 2003	Interest rate futures are traded on the NSE.
13 th September 2004	BSE offers weekly options.
1 st January 2008	BSE trades the Chhota (Mini) Sensex.
1 st January 2008	At the BSE, you can trade mini index futures and options.
NSE – 29 th August, 2008 Futures at NSE	Currency exchange trading started
BSE – 2 nd October, 2008 Futures at BSE	Currency exchange trading started

VI. CONCEPT OF DERIVATIVES

The term "derivative" refers to something that is derived from something else. The underlying asset may be a commodity or a financial asset, and its value is determined by a variety of factors. When it comes to financial derivatives, we can claim that they are extremely complex items that don't have any inherent worth. The value of derivatives goods is usually determined by changes in the value of other derivatives products, known as the Underlying, which can be anything from stock prices to interest rates to snowfall and commodity prices. The value of a derivative changes when the value of the underlying changes, therefore without the underlying, the derivative has no value. In the sense that they safeguard investors against various financial risks, derivatives are analogous to insurance products. Financial derivatives are described as "a security produced from a debt instrument, share, loan, whether secured or unsecured, risk instrument, contract for differences, or any other kind of security," according to the Securities Contract Regulation Act of 1996. "A contract whose value is determined by the prices, or an index of prices, of underlying securities." Derivative products first appeared on the market a few years ago, and they serve as a hedge against price fluctuations in various items. Although a variety of derivatives products have been available in the market for centuries, real derivatives trading did not begin until the 1970s. Financial contracts whose value is related to the value of an underlying asset are known as derivatives. They are sophisticated financial instruments used for a variety of purposes, including hedging and gaining access to new assets or markets. The majority of derivatives are traded over-the-counter (OTC) (OTC). Some transactions, like as options and futures, are, however, traded on specialist exchanges. The CME Group (Chicago Mercantile Exchange and Chicago Board of Trade), the Korea Exchange, and Eurex are the three largest derivatives exchanges.

Derivatives are a type of financial instrument that has been around for a long time. The first futures contracts, for example, may be traced back to Mesopotamia in the second millennium BC. However, until the 1970s, the

financial instrument was not frequently employed. The introduction of new valuation techniques propelled the derivatives market's rapid growth.

VII. PROS OF DERIVATIVES MARKET

Derivatives, unsurprisingly, have a big impact on modern finance because they give financial markets a lot of benefits:

1. The contracts are typically used for hedging risks because the value of the derivatives is tied to the value of the underlying asset. An investor, for example, might buy a derivative contract whose value moves in the opposite direction of the value of an asset he or she owns. Profits from the derivative contract may be used to cover losses in the underlying asset.
2. The price of the underlying asset is typically determined via derivatives. Futures spot prices, for example, can be used to approximate the price of a commodity.
3. Derivatives are thought to improve the efficiency of financial markets. One can imitate the payout of assets by using derivative contracts. To avoid arbitrage opportunities, the prices of the underlying asset and the corresponding derivative tend to be in equilibrium.
4. Derivatives can help businesses gain access to assets or markets that might otherwise be unavailable. Interest rate swaps allow a corporation to get a better interest rate than it could get from direct borrowing.

VIII. CONS OF DERIVATIVES MARKET

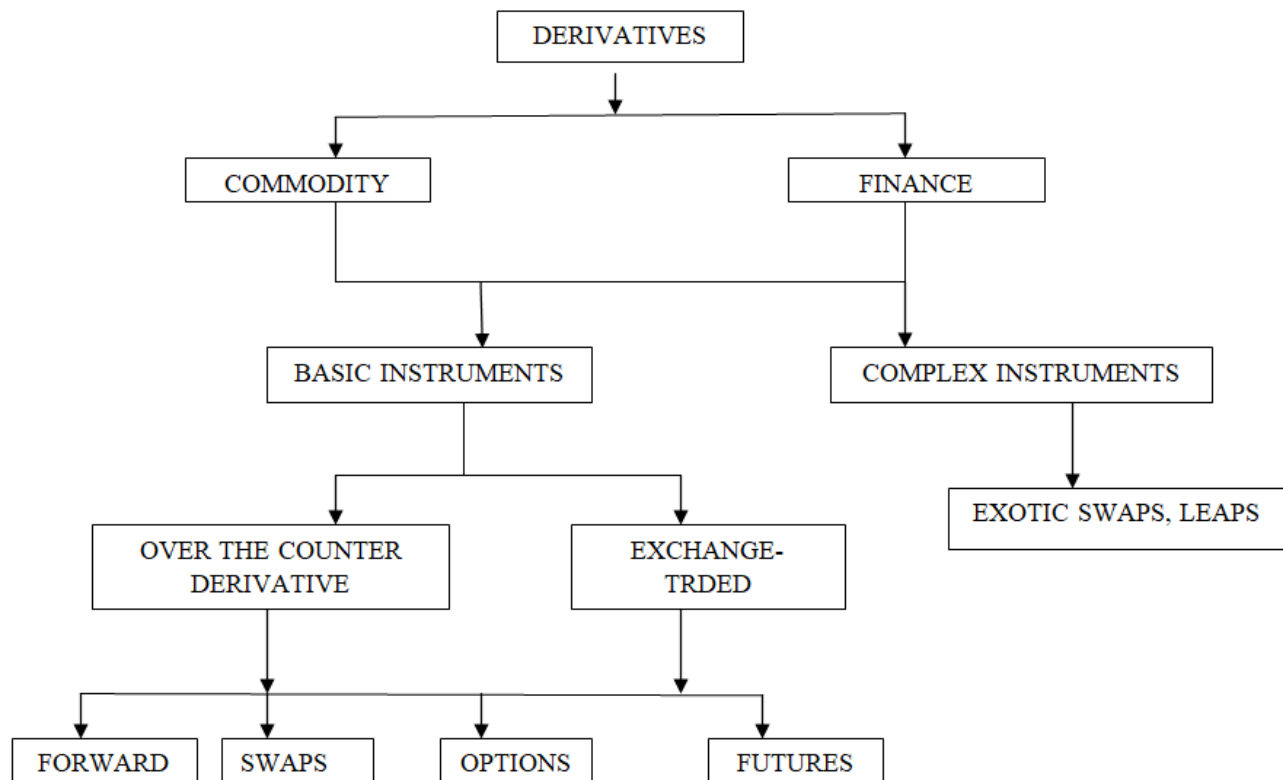
Despite the benefits that derivatives bring to the financial markets, they also have some substantial disadvantages. During the Global Financial Crisis of 2007-2008, the flaws had severe effects. Financial institutions and securities all around the world have collapsed due to the fast devaluation of mortgage-backed securities and credit-default swaps.

1. Derivatives' extreme volatility exposes them to potentially massive losses. The complex architecture of the contracts makes valuing them extremely difficult, if not impossible. As a result, they are exposed to a high level of risk.
2. Derivatives are often seen as speculative instruments. Unreasonable speculation can result in significant losses due to the inherently dangerous nature of derivatives and their unpredictable behaviour.
3. Although derivatives traded on exchanges often go through a thorough due diligence procedure, some over-the-counter contracts may not have a

due diligence baseline. As a result, there's a chance of a counter-party default.

IX. CLASSIFICATION OF DERIVATIVES

Cotton and pepper are examples of commodity derivatives, while financial derivatives include stocks, and foreign exchange is the most common sort of derivative in the world. Futures, swaps, forwards, puts, calls, swap options, and index-linked derivatives are the eight sub-categories of financial derivatives. Different types of derivatives are available to investors and traders, and they are detailed in depth below.



X. FORWARDS AND FUTURES

These are financial contracts that bind the contract's buyers to buy an asset at a pre-determined price on a pre-determined date in the future. The nature of both forwards and futures is roughly the same.

Forwards, on the other hand, are more flexible contracts because the parties can specify the underlying commodity, as well as the amount and transaction date. Futures, on the other hand, are standardized contracts exchanged on exchanges.

SWAPS

Swaps are derivative contracts that allow two parties to exchange cash flows. Swaps often entail the replacement of a fixed cash flow with a floating cash flow. Interest rate swaps, commodity swaps, and currency swaps are the most common types of swaps.

OPTIONS

The buyer of the contracts is given the option to buy or sell the underlying asset at a specified price, but not the responsibility to do so. The buyer can exercise the option on the maturity date (European options) or any date

before the maturity date, depending on the option type (American options).

XI. FINDINGS AND DISCUSSIONS

The economic policy liberalization since 1991, the Indian economy has entered an era in which Indian businesses can no longer ignore global markets. Prior to the 1990s, many commodities, metals, and other assets were subject to price controls. Others that were not implemented relied primarily on regulated input pricing. As a result, there was less uncertainty and hence less price fluctuation. However, after 1991, when the deregulation process began, most goods prices were deregulated. It has also resulted in partial deregulation of exchange rates, the abolition of trade regulations, interest rate reductions, significant reforms for foreign institutional investors' capital market access, and the implementation of market-based pricing of government assets, among other things. All of these measures have exacerbated price volatility in India for a variety of commodities and services, affecting both producers and consumers. Furthermore, portfolio and securities price volatility and instability were influenced by market-determined exchange rates and interest rates. As a result, hedging strategies employing a variety of derivatives were exposed to a variety of risks.

Futures trading provides a risk-reduction mechanism to farmers, producers, exporters, importers, investors, bankers, traders, and others, which is vital for any country. According to Alan Greenspan, Chairman of the US Federal Reserve Board, "the diversity of derivative products generated in recent years has increased economic efficiency."

These contracts have the economic function of reconfiguring previously integrated risks and transferring them to those who are most willing to assume and manage each risk component. The creation of futures markets in many countries has contributed significantly to the balance of payments in terms of invisible gains through fees and other costs paid by foreigners for using the markets.

XII. CONCLUSION

A derivative product, or simply 'derivative,' must be distinguished from the underlying cash asset. A cash asset is an asset that is purchased or sold in the cash market on traditional delivery conditions. As a result, the term "derivative" means "without intrinsic value." It denotes that its value is entirely derived from the value of the cash asset. The first important thing to remember about

derivatives is that they are forward or futures contracts, which are contracts for delivery and payment at a future date. They are typically used to facilitate the hedging of the price risk of a cash asset. In the market, they're known as 'Risk Management Tools.' Futures trading in commodities began in India in the 1950s, however there was a dramatic drop in futures trading in the 1960s. Exchanges were shut down one by one, owing to price increases in a variety of commodities tied to speculation on these exchanges.

As a result, the Central Government issued a notification outlawing derivatives trading in 1969. India's futures markets made a big resurgence in the late 1990s, compelling the Central Government to relax the ban on futures trading in October 1999. The Indian Pepper and Spice Trade Association was granted permission in 1996 to turn its Pepper Futures Exchange into an International Pepper Exchange, and the Civil Supplies Ministry agreed in principle to enable futures trading in Basmati rice. The importance of derivatives in India's capital market was proven in this study.

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