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A study on Emerging Trends and Development of Financial Equity Derivative Market in India.

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Abstract: - Derivative markets are found to positively contribute to economic development in the India short run and play a significant role in addressing the risk inborn in financial transactions. Derivative market has an important role to play in economic development of a country. The past decade has witnessed the multiple growths in the volume of international trade and business due to the wave of globalization and liberalization all over the world. As a result, the demand for the international money and financial instruments increased significantly at the global level. The new financial instruments have been developed in the financial markets, which are also popularly known as financial derivatives,. The basic purpose of these instruments is to provide commitments to prices for future dates for giving protection against adverse movements in future prices, in order to reduce the extent of financial risks. Today, the financial derivatives have become increasingly popular and most commonly used in the world of finance. This has grown with so phenomenal speed all over the world that now it is called as the derivatives revolution. Derivatives also help price discovery, and in efficient capital allocation in the economy, Given India's experience in informal derivatives trading, the exchange traded derivatives were quick to pick up substantial volumes. This paper attempts to emerging trends and Development of financial equity derivative market in India.

KEYWORDS: equity, derivatives, investment, risk, Development and finance.

INTRODUCTION

In India most of the investment avenues are termed to be risky by the investors. The major feature of investment as perceived by the investors is income stability, principal amount, liquidity, easy transferability and approval. there are a number of investment avenues available in India such as share, silver, real estate, gold, Life Insurance, Bank, postal savings, etc. Derivatives market in India began in 2000 when NSE and BSE commenced trading in equity derivatives. Since then India has become a huge and vibrant market for derivatives. Equity derivatives play a great role in price discovery. They help to enhance liquidity and also reduce transaction cost. Derivatives in share market gained importance as risk adverse investors wanted to protect themselves against uncertainties due to fluctuations in prices of assets. The investment may differ from provident fund, national saving certificate, chit funds, insurance schemes, company fixed deposits, government securities, bonds, equity, mutual fund schemes and derivatives. Derivatives derive their value from other existing asset classes such as equity, commodity, currency, etc. The participants in the derivatives market are Arbitrageurs, Hedgers and Speculators and there are 4 types of derivative instruments such as forward, futures, option and swap. The derivative market in India. It is widely believed in financial world that the most significant milestone in financial innovation is achieved with the issuance and trading of derivatives. Along with this positive element, the proponents of derivatives also admit that this term arouses more controversies and most people look at them with suspicion and few would believe that they do contribute to the society's welfare. But the matter of fact is that derivatives are a standard risk management tool that enables risk-sharing and facilitates the efficient allocation of capital to productive investment activities. In this study, we will try and examine the veracity of a few misconceptions that surround derivatives along with their economic benefits. Equity Derivatives in India have progressed a long way since then .This market has witnessed expanding list of eligible investors, increase in volumes, best risk management framework for exchange traded derivatives and innovation in market microstructure and design. The robustness should never be compromised for an increased sophistication and calibration of the markets. The benefits of Information Technology should be fully exploited to cover risk management.

OBJECTIVES

The main objectives of this study were

- To have an overview of derivative market in India
- To understands recent trends in derivative market.
- To study the factors that affects the choice of investors while selecting equity and derivatives.
- To find out new opportunities in equity derivative market in India.

PROBLEM STATEMENT

The significance of a study with respect to the emerging trends and Development of financial equity derivative market in India. The manner in which an investor perceive Investment Avenue and the factors that influence the perception levels of the investors are major problems relating to the investment decision making. These transfer risk from risk adverse investors to risk takers. Like its counterparts abroad, is increasingly gaining significance. Since the time derivatives were introduced in the year 2000, their popularity has grown manifold. It is therefore necessary to develop a set of new financial instruments known as derivatives in the Indian financial markets, to manage such risk. The objectives of these instruments is to provide commitments to prices for future dates for giving protection against adverse movements in future prices, in order to reduce the extent of financial risks.

METHODOLOGY OF STUDY

The present study has been undertaken with empirical analysis of status of financial derivatives in India with the use of secondary data. Data and information for the research study were collected and analyzed from secondary published sources like newspapers, web sited, books etc.

REVIEW OF LITERATURE

A study was conducted to ascertain the preference of investors and their requirement towards derivative investment that was based on convenience sampling (Bandivadekar & Ghosh, 2003). It was identified that the investors mostly preferred equity schemes while making investment into mutual funds. In addition to that a research study was also conducted to analyse the effect of a number of demographic factors on the attitude of investors towards equity and derivatives. The study revealed that out of 250 respondents, 71 respondents had positive attitude and 117 respondents had neutral attitude while 62 respondents had a negative attitude towards derivatives **(Sarangdevot & Rathore, 2014).** Study denoted that most of the investor was still confused about derivative and they could not form any attitude or behaviour towards the investment in derivatives. It was also observed that most of the respondents had lack of awareness about various aspects of derivatives **(Chawla, 2014).**

A research study conducted to identify and evaluate the factors that influence the perception of investors towards investment in the capital market in India on the basis of descriptive study **(Sahadevan, 2002).** It was identified that occupation is a factor that has the most significant impact on the investment pattern of the investors. This has impact on risk and uncertainty in future and option, cash market and size of investment in future and option. In addition to that age was another factor that had influential role on future and options and cash market **(Karthikeyan, 2014).** These are the two variables that were found to be very influencing for the behaviour of investors. Investors have huge scope for capital appreciation and current earnings in the emerging market.

To study the investment pattern and level of awareness of the investors a research study was conducted on a sample of 150 respondents. So that a pre test questionnaire was used **(Sah & Omkarnath, 2005).** It was identified that most of the investor were aware about the investment in equity and its benefits. It further identified that people belonging to the age group 19-55 years were the major individuals taking investment decisions for equity. Along with that the income group was 30,000-70,000 and above **(Kathuria & Singhania, 2010).** It is also identified that tax benefits and the diversification of portfolio for the major factors that attracted investors towards investment in equity.

The researchers have identified that derivative markets are more standardized and regulated and this is something that provides a controlled environment and it also relates with the fact that high risk results into higher Returns **(Kuemmerle, 1999).** The investors get motivated because they going to get higher returns by taking higher risk. But also results into earning more profit because of derivatives. This is also significant reason why commodity derivative 10 to play a crucial role in the price risks management of the communities **(Reddy & Sebastin, 2008).** There are different forms of derivatives that are forward, future, swaps and options that are widely used in India.

DERIVATIVES

Derivative is a financial instrument whose value is based on or value is derived from one or more underlying assets. The under lying asset may be a share, stock market index, a commodity, an interest rate or a currency. When the price of asset changes value of derivative will also change. It is a contract between two parties where one party agrees to buy or sell any asset at specified dates and rate Derivative is similar to insurance. Insurance protects against specific risk like fire, flood accident, whereas derivatives protects from market risks.

Derivatives are used by investors for the following purposes:

- To provide leverage (or gearing), such that a small movement in the underlying value can cause a large difference in the value of the derivative

- To speculate and make a profit if the value of the underlying asset moves the way they expect (e.g., moves in a given direction, stays in or out of a specified range, reaches a certain level)
- To hedge or mitigate risk in the underlying, by entering into a derivative contract whose value moves in the opposite direction to their underlying position and cancels part or all of it out
- To obtain exposure to the underlying where it is not possible to trade in the underlying (e.g., weather derivatives)
- To create option ability where the value of the derivative is linked to a specific condition or event (e.g. the underlying reaching a specific price level).

Concept of Derivatives

The term 'derivatives, refers to a broad class of financial instruments which mainly include options and futures. These instruments derive their value from the price and other related variables of the underlying asset. They do not have worth of their own and derive their value from the claim they give to their owners to own some other financial assets or security. A simple example of derivative is butter, which is derivative of milk. The price of butter depends upon price of milk, which in turn depends upon the demand and supply of milk. The general definition of derivatives means to derive something from something else. Some other meanings of word derivatives are: a derived function: the result of mathematical differentiation; the instantaneous change of one quantity relative to another; df(x)/dx, b derivative instrument: a financial instrument whose value is based on another security, (linguistics) a word that is derived from another word; "`electricity' is a derivative of 'electric'. The asset underlying a derivative may be commodity or a financial asset. Derivatives are those financial instruments that derive their value from the other assets. For example, the price of gold to be delivered after two months will depend, among so many things, on the present and expected price of this commodity.

Underlying Asset in a Derivatives Contract

As defined above, the value of a derivative instrument depends upon the underlying asset. The underlying asset may assume many forms:

- Commodities including grain, coffee beans, orange juice.
- Precious metals like gold and silver.
- Foreign exchange rates or currencies.

- Bonds of different types, including medium to long term negotiable debt securities issued by governments, companies, etc.
- Shares and share warrants of companies traded on recognized stock exchanges and Stock Index .
- Short term securities such as T-bills; and
- Over- the Counter (OTC) 2 money market products such as loans or deposits.

Participants in Derivatives Market

- **Hedgers:** They use derivatives markets to reduce or eliminate the risk associated with price of an asset. Majority of the participants in derivatives market belongs to this category.
- **Speculators:** They transact futures and options contracts to get extra leverage in betting on future movements in the price of an asset. They can increase both the potential gains and potential losses by usage of derivatives in a speculative venture.
- **Arbitrageurs:** Their behaviour is guided by the desire to take advantage of a discrepancy between prices of more or less the same assets or competing assets in different markets. If, for example, they see the futures price of an asset getting out of line with the cash price, they will take offsetting positions in the two markets to lock in a profit.

Development of derivative market in India

Derivative markets in India have been in existence in one form or the other for a long time. In the area of commodities, the Bombay Cotton Trade Association started future trading way back in 1875. This was the first organized futures market. Then Bombay Cotton Exchange Ltd. in 1893, Gujarat Vyapari Mandall in 1900, Calcutta Hesstan Exchange Ltd. in 1919 had started future market. After the country attained independence, derivative market came through a full circle from prohibition of all sorts of derivative trades to their recent reintroduction. In 1952, the government of India banned cash settlement and options trading, derivatives trading shifted to informal forwards markets. In recent years government policy has shifted in favour of an increased role at market based pricing and less suspicious derivatives trading. The first step towards introduction of financial derivatives trading in India was the promulgation at the securities laws (Amendment) ordinance 1995. It provided for withdrawal at prohibition on options in securities. The last decade, beginning the year 2000, saw lifting of ban of futures trading in many commodities. Around the same period, national electronic commodity exchanges were also set up. The more detail about evolution of derivatives are shown in table No.1 with the help of the chronology of the events. This table is presenting complete historical developments. In India, there are two major market namely National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) along with other Exchanges of India are the market for derivatives. Here we may discuss the performance of derivatives products in Indian market.

Growth of Indian derivatives market

The NSE and BSE are two major Indian markets have shown a remarkable growth both in terms of volumes and numbers of traded contracts. Introduction of derivatives trading in 2000, in Indian markets was the starting of equity derivative market which has registered on explosive growth and is expected to continue the same in the years to come. NSE alone accounts 99% of the derivatives trading in Indian markets. Introduction of derivatives has been well received by stock market players. Derivatives trading gained popularity after its introduction in very short time. If we compare the business growth of NSE and BSE in terms of number of contracts traded and volumes in all product. Due to compelling factor & features, the turnover of stock futures sub-segment surpassed the total turnover of the entire cash segment of NSE and BSE in coming years at their introduction itself. Stock futures contracts set an unprecedented record of daily turnover. The relative share of stock future at NSE and BSE has been observing a decline, both in terms of the number of contracts traded and stock futures turnover in total turnover. The world financial crisis of 2008 has proved to be a structural change in the growth path of the stock futures contract. Though the turnover has picked up since then but there is fall in the absolute number of contract traded. The relative shares are still declining. It was only after the outbreak of the global financial crisis that the continuous vise in the absolute number of SSFs contracts was reverted back. The temporary disenchantment of the investors from the single stock futures trading was only due to the ill effects of the futures trading misfired on account of global meltdown. Single stock futures have successfully strived to attain its previous level of contract traded but it is also getting a tough competition from index futures contracts in terms of number of contract traded. Meanwhile, index option has attained an infallible position in term of the number of contracts traded which requires another structural shock to dislocate from its current height. The above data represents the description of the two derivative product in terms of number of contract traded as well as turnover achieved in their respective sub-segments.

Risks involved in derivative trading

The primary risks associated with trading derivatives are market, counterparty, liquidity and interconnection risks. Derivatives are investment instruments that consist of a contract between parties whose value derive from and depend on the value of an underlying financial asset. Among the most common derivatives traded are futures, options, contracts for difference, or CFDs, and swaps.

Market Risk

Market risk refers to the general risk in any investment. Investors make decisions and take positions based on assumptions, technical analysis or other factors that lead them to certain conclusions about how an investment is likely to perform.

Counterparty Risk

Counterparty risk, or counterparty credit risk, arises if one of the parties involved in a derivatives trade, such as the buyer, seller or dealer, defaults on the contract. This risk is higher in over-the-counter, or OTC, markets, which are much less regulated than ordinary trading exchanges.

Liquidity Risk

Liquidity risk applies to investors who plan to close out a derivative trade prior to maturity. Such investors need to consider if it is difficult to close out the trade or if existing bid-ask spreads are so large as to represent a significant cost.

Interconnection Risk

Interconnection risk refers to how the interconnections between various derivative instruments and dealers might affect an investor's particular derivative trade.

Summary and Conclusion

Innovation of derivatives have redefined and revolutionized the landscape of financial industry across the world and derivatives have earned a well deserved and extremely significant place among all the financial products. Derivatives are risk management tool that help in effective management of risk by various stakeholders. Derivatives provide an opportunity to transfer risk, from the one who wish to avoid it; to one, who wish to accept it. India's experience with the launch of equity derivatives market has been extremely encouraging and successful. The derivatives turnover on the NSE has surpassed the equity market turnover. Significantly, its growth in the recent years has surpassed the growth of its counterpart globally. Financial derivatives have a significant place among all the financial instruments (products), due to innovation and revolutionized the landscape. Derivatives are instrument which helps the dealer to manage risk and earns profit. It helps to transfer risk from one to another. India is one of the most successful developing country in terms of a vibrate market for exchange-traded derivatives Launch of equity derivatives in Indian market has been extremely encouraging and successful. The growth of derivatives in the recent years has surpassed the growth of its counterpart globally. The equity derivatives market is playing a major role in shaping price discovery. Volatility in financial asset price, integration of financial market internationally, There is an increasing sense that financial derivative market has a vital role in risk management and economic growth .Financial derivatives have earned a significant place in all the financial instruments.

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