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INDIAN DERIVATIVE MARKET: EVOLUTION AND EMERGING CHALLENGES

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ABSTRACT

Derivative market is well known as risk averter market, in which investors invest their hard earned money without any fear. This market is well known for its logical mind under which individual investor or investment house can easily gain profits, but if they incurred any losses in present that is immediately adjusted with future derivatives to overcome the risk. Derivative market is a well known market these days because of commodities can easily be cashed in the future market, no matter the under laying asset is an agriculture product, metals or rupee value etc. Similarly, this paper includes the study regulatory framework regarding derivative market and its trading mechanism. This paper also highlights the challenges faced by derivative market in India and also considers the power of derivative in relation to economic development. It also attempts to analyze the impact of derivative on Indian market and role of derivatives in the emerging growth of Indian Stock Market.

Keywords: Derivatives, Stock Market, Exchange Rate, Rationality, Commodity, Volatility etc.

INTRODUCTION

The scenario of derivative market in India has reached to multi-trillion dollar level and with the passage of time it is increasing like anything. Its ability of transfer the risk with the advantage of locking in assets prices, derivatives are earning popularity among individual and corporate investors. With the introduction of economic reforms in 1991, maximum push has been made to increase the investors' confidence by generating the trading process more users' friendly. Current era is considered to be a Risk Management Era. Under which derivatives are framed as emerging tool of stock market .Derivatives are those instruments which are not having value of its own. The history of derivatives is related with the mechanism where the value of one underlying asset is derived from other asset. The underlying asset may be of any types from the above two i.e. Financial or non-financial. Derivatives are lying in the first place. These instruments are having power to redistribute the risk that an individual and corporate investor faces. Thus also add as an important component in the investor's portfolio. The unbalanced phase of equity markets over the years has resulted in efficient use of equity derivatives. The percentage of the exchange traded in equity futures and options have seen a significant growth. This unbeaten growth and development by the market participants has resulted in inflows of capital and also protect the investors from hedging. Derivatives are the financial instruments, which derive their value from some other financial instruments, called the underlying. It does not formulate any physical existence but comes out of a contract between two parties. It does not have any value of its own but is depends on the value of other physical assets which are called underlying assets. Therefore the base of all derivatives market is the underlying market, which could be spot market for gold, or it could be a pure number such as the level of the wholesale price index of a market price. With the help of derivative market the real and potential participants can exposure and speculate the movement of underlying variables and on the other hand find the opportunity where the arbitrage gain profit from mispricing of various products between different conditions lying in different markets.

Derivative market is consider as most profitable market these days because of its nature where commodities can easily be converted into cash in the future market, without assessing that the under laying asset is an metals, agriculture product or rupee value etc. There are broadly four types of derivative instruments such as Futures, Options and Forward & Swaps. Following the outline of emerging trading parties, derivatives are the much more polished means of trading now days. As considered they are taken as risk adjusted means of market, while considering the present conditions and future prospects. They allow the investor to think in a broad way taking aside his/her all fears and worries, which are well taken by its adjusted procedures. The derivative instruments generally includes Commodities, Precious metals, Foreign Exchange rates, Bonds, Shares and share warrants, Short term securities and Money market products.

The most important advantage of this market is that it allows highly leveraged position to an investor at low transaction cost and also helps the investor to get innovative and flexible payoffs (profits) by adjusting in different derivative Instruments.

REVIEW OF LITERATURE

It is bit difficult to define derivatives because the present financial scenario is too fast and globally the world is being ruled by a number of uncontrollable financial circumstances. So, the word ‘derivative’ is defined by various regulatory authorities and authors differently based according to the motive.

Securities Contract Regulation Act (SCRA) 1956

a) “a securities derived from a debt instrument ,share, loan whether secured or unsecured ,risk instrument or contract for difference or any other form of security;
b) “a contract which derives its value from the prices, or index of prices, of underlying securities”.

Cox (1976) asserts that the introduction of derivatives markets causes a stabilizing influence on the underlying market because of the speed at which information is incorporated into the prices as well as the amount of information reflected in expected prices. This event would be mainly because derivative markets attract an additional set of traders to the market and because these markets, which have lower transaction costs, transmit the new information to the spot market more quickly. It provides circumstances, which are more favorable to entering the financial markets, and therefore the distribution of the risk is improved.

Chatrath, Ramchander and Song, 1995

The critics of the derivative market called it as a market for speculators. Little cash is involved in this market which is the main reason of its risky nature. Thus, it is argued that the contributors of speculative traders in systems, which allow high degrees of leverage, lower the quality of information in the market. These uninformed traders could play a destabilizing role in cash markets.

Ayuso and Nuñez (1995) argue that the transference of the risk to the derivative markets could improve, to a substantial extent, the transactions of the spot market. This is because it is not necessary to include a risk premium in the spot market to compensate the fluctuations of the prices.

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Hentchell & Smith 1997 Discuss that Derivative product can reduce need on the part of firm and banks to hold idle precautionary balance to tide over unexpected adversities, thereby reducing the fraction of funds with these organization that remain unproductive.

Mr.Jitendra Pande, 2002 define that derivative trading in option reduce risk, as investors are aware of the maximum loss.

Deana Mehta, 2005 Proved that Share futures are most successful in India that anywhere else in the wo4ld because they are seen as a substitute for badla. The new system has to better than the old one and not to add risk in the market.

Jiménez (2008) used a large dataset from the credit register in Spain to show that bank borrowers are more likely to default if the loans are made when central bank interest rates are relatively low. They also showed that (i) the price of risk tends to be low when short- term interest rates are low and (ii) if the interest rate is low for a long time, the economy's "portfolio" of loans tends to be riskier.

RESEARCH METHODOLOGY

Research Methodology suggests the ways and methods for conducting research is an exploratory research. This present paper has been designed to measure the role of derivative market in the economic development of India. Similarly , it include the precise study of different conditions, which every stock exchange of India has to follow for working on the derivative market and it also clarify that how the derivative market is differs from the cash market. This study is based on the Secondary data which is gathered from different sources such as: Websites of BSE, NSE and SEBI, Internet, reference books, referred journals, and professional magazines. A conceptual analysis is used to explain the various relevant points as required to fulfill the objectives of the study

Objectives of the Study

The overall aim of this research is to gain an overall understanding of awareness, knowledge and application of derivatives such as a risk management tool among the Indian Stock Market.

However the main objectives of the study are:

1. To study the role and growth of derivative in India and its economic measures.
2. To analyze the constitution and trading framework of Derivative Market.
3. To analyze the Evolution and Challenges of Derivative Market in India.

ROLE AND GROWTH OF DERIVATIVE IN INDIAN STOCK MARKET

The concept of stock exchange was introduced in India in 1850 when four Gujarati and one Parsi stockbroker came together under banyan tree in front of Bombay Town Hall. As the member's increased the location was shifted to Dalal Street in the year 1874 and made an official organization known as 'The Native Share & Stock Brokers Association' in 1875. In 1956, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contract Regulation Act. The concept of Derivative market was also very old but it was officially introduced in 2000. This instrument brought a drastic impression on Indian market. In a time span of 10 years (app.) the derivative instruments are having its known place in trading market. The best quality of this instrument is its risk averter nature which helps the investors to settle down their losses and plan for their future hurdles. In this limited time period derivative market gained name, fame & reliability from the investors and other investment institutes in comparison to other instruments in stock market ,whether lies under primary or secondary market. In the case of hedgers it helped them to offset the value of their asset (commodity) in future market with concern to cash market.

We have tried to analyze the trend and growth rate of derivative market with the help of the data taken from National Stock Exchange and Bombay Stock Exchange. Data relating to the first two years of the table marked by star are excluding currency derivatives whereas the data thereafter are including currency derivative in Indian market. To analyze the stock exchange growth of derivative data of 2003 has been taken as a base. After analyzing the data of seven years i.e. 2003-04 to 2008-09 we can well conclude that there is a significant continuous upward growth in the derivative market. On the other hand the variation is not indicating the derivative growth in Bombay Stock Exchange. The total stock exchange throughout India is significant.

ECONOMIC CONTRIBUTION OF DERIVATIVE MARKET IN INDIA

As emerging growth of derivative market in India, it has been proved that the derivative market is also performing the various economic functions that are:

- Derivative market reflects the price perception of the market participants about the future This may lead to the discovery of current and future prices in the well organized market.
- Derivative market is a well organized market where the risk is well distributed among the investors that can easily appetite by them.
- Derivatives are derived from the underlying value of assets due to that quality more and more players are trading in high volume.
- Derivative has a tradition of influencing educated class with its clear and broad prospective. This all will help the economy to develop and create new employment opportunities, new business.

DERIVATIVE PLAYERS AND STRUCTURE IN INDIAN MARKET

Derivative refers to an assurance given against some property it may be in a part of asset, policy bound of insurance. So derivative is an assurance for some given value of a kind- a thing or a property. The feature of derivative market is to manage the risk by transitional efficiency and discovering the price

Players in Derivative Market

There are three players in derivative market:

Hedgers- They are the most relevant players in derivative market, which are in the market for adjusting their risk in relation to the value of their asset.

Speculators- They are probability players in the market and also consider as very short term players. Which are investing in the market on the basis of risk appetite and perdition of movement? They are having majority share in the market or existence of market depends on them.

Arbitrageurs- They are simultaneously dealing in two markets at one time for exploring opportunities from both the markets and adjusting risk if any.

TRADING MECHANISM

Trading system under National Stock Exchange for derivatives products are better known as NEAT-F&O (National Stock Exchange Future & Option Market) that is fully automated screen-based trading. There is great flexibility for the investors regarding placement of orders. There are various facilities available on the stock exchange terminal; such as immediate placement and cancellation of the orders, stop loss, limit creation and gathering information regarding the price prevailing in the market can easily be assessed during building an order. The trading in derivative market is as simple as trading in other stock market instruments. There are basically four entities required for derivative trading that are trading members, clearing members, professional clearing members and participants.

Trading members are registered under National Stock Exchange and assigned an ID (Identification) for their working. They can access on their own ID and also trade on behalf of their clients. On the other hand clearing members are working under the supervision of NSCCL (National Securities Clearing

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Corporation Limited). They are also consider as clearing members and can clear trade for themselves and others. Professional clearing members are basically professional institutions such as banks who work as custodies which clear and settle the trade for their members. In this derivative trading mechanism last root is participants who are like financial institutions. They can easily trade through multiple trading members but settlement is done under the roof of single clearing member.

EVOLUTION OF DERIVATIVE PRACTICE IN INDIA

The conceptually evolution in relation to derivatives was started long time ago when Bombay Cotton Trade Association Introduced future trading back in 1875. On the other hand Government of India banned cash settlement and options trading in 1952. Some year latter government took a favorable look regarding derivatives in June, 2000 with the approval of Security and Exchange Board of India with the ban on future trading in many commodities. The formal trading concept of derivative was started in May, 2001. National Stock Exchange and Bombay Stock Exchange are permitted to do the trading of derivatives by Securities and Exchange Board of India..

Bombay Stock Exchange

Bombay Stock Exchange also known as BSE was established in 1875. First stock exchange in India and oldest in Asia. Derivative trading was started on June 9, 2000 when it initially started trading as sub-tool of derivative called 'futures contract' for the first time. It is followed by another sub tool 'index option' on June 1, 2001. On September 13, 2004 BSE achieved a new milestone by launching worldwide 'weekly options', unparalleled product in the derivative market. In October 1, 2008 currency futures were introduced by BSE.

National Stock Exchange

National Stock Exchange popularly known as NSE was established in 1992.It is the third largest stock exchange in the world. On June 12, 2000 it started trading in 'Index future' as its first derivative product. On the other hand 'index option' was introduced on June 4, 2001. SEBI stipulated 233 future contracts securities. A landmark was achieved by NSE through introducing 'Mini Index Future & Options' with the one lakh as minimum contract size. On August 29, 2008 NSE Introduced in Indian Derivative market 'currency future contract' on US Dollar –Rupee.

CHALLENGES OF DERIVATIVE MARKET

Derivative market has shown a great potential in the last few years, but the real issues are yet not been resolved. Instruments traded under derivative market and its volume of trade is also increasing day by day, but the main objective .i.e. Setting up of different exchanges yet not achieved .On the other hand future prospects of derivative markets are not sound because of the unresolved issues and they are framed as big challenges in the way.

Cash vs Physical Settlement: The percentage of physical settlement under commodity derivatives is very less because of the Forward Contract Act, 1952. In this Act, cash settlement of outstanding contracts at maturity is disallowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To overcome this huddle participants settle their positions before maturity. This Act, needs to be adjusted which is a big challenge in front of derivative market.

Issue for market Stability and Development: Regulators and Supervisory bodies are having an eye on the counter derivative market due to its rapid growth. Some OTC (Over the Counter) derivatives are taken as stress relievers in the tough time of global crisis. But the big challenge is to overcome the assumption of the critics that this market is less transparent, weaker capital requirement and systematic risk.

The Warehousing and Standardization: Effective and Efficient warehousing system is necessary for smooth working of Commodity derivative market in the country. A well standardized labs and quality testing centers for the ultimate buyer who takes the physical delivery are in deficiency which is a big challenge in front of the derivative market.

Lack of Economics of Scale: Derivative market is still to achieve the stage of Economic of Scale. No matter there is number of commodity exchanges under which 80 commodities are traded, but in reality only few commodities are popular. Indian Government having the intention to integrate two markets .Which will reduce the effort and increase the competitive spirit and also increase the coordination among various regulating authorities such as Reserve Bank of India, Forward Market Commission, Securities and Exchange Board of India and the Department of Companies affairs of etc.

The Regulatory: Derivative market requires a setting up of a regulatory system like security market which is regulated by Security Exchange Board of India which is an independent body. On other side derivative is controlled by FMC (Forward Market Commission) which depends upon the funds of Department of Consumer Affairs for the development of this market a sole powered body is required. Both the regulatory authorities' i.e.SEBI and FMC are also required to work closely for better results

Competition of OTC derivatives with the Exchange traded derivatives: After financial crisis it is advisable to transform OTC derivatives into Exchange trade derivative. Advisors are having the view that this will increase the transparency, liquidity and on the other side clearing and settlement procedure is better. All the above advices are based on the assumption that the existing method of trading in OTC products is all based on telephone trading and there is no clearing system in place.

Strengthening the Centralized Clearing Parties: CCIL, which started functioning in 2002, is the only centralized clearing party for great processing and settlement services in India. It currently provides a guaranteed settlement facility for Government Security trading, Clearing of Collateralized Borrowing and Lending Obligation (CBLO), guaranteed settlement of foreign exchange trading and settlement of all Indian Revenue Service (IRS). Though the concentration of business relating to money, securities and forex market with the CCIL helps in pooling risk and reducing the overall transactions cost for the system, the Certified Financial Services Auditor's (CFSA) report opinion that the concentration of such a wide spectrum of activities leads to concentration of risk in one entity. Therefore, there is a need to strengthen more and more clearing parties.

New derivative products for Credit Risk Transfer (CRT): Credit risk transfer in broad since (including guarantees, loans syndication and securitization) has a long history. However there has been a sustained and rapid growth of new and innovative forms of CRT associated with credit derivatives. The most common credit derivatives are Credit Default Swaps (CDS) on single corporate entity and collaterized debt obligation. Once 2005, CRT activity became significant for two additional underlying asset classes-asset backed securities and leveraged loans. Internationally, banks and financial institutions are able to protect themselves from credit derivatives were not allowed in India until recently. The RBI has made an announcement in its second-quarter monetary policy2009-10 that it has considered it appropriate to proceed with caution on this issue. To start with 1st December, 2011, RBI has introduced guidelines for a basic, over-the-counter, single name CDS for corporate bonds for residents entities, subjects to safeguards.

CONCLUSION

It is bit difficult to analyze derivative and to control its ups and downs in limited form as the world scenario, is changing every moment. Precious metals like gold and silver, currencies like dollar and crude oil have become leader to indicate the financial instruments all over the world. So, derivatives which derive their value from the value from other assets are changing every moment. One rupee is being beaten every moment by dollar. The value of our currency is being degraded our capital assets are losing their market values. So derivatives are helping as a resisting tool for our economy to grow it in shocker assistance and to save it from the damages as growth rate of derivative is evident from the data. Derivative market is considered as most profitable market these days, which can redistribute the risk of investors. Derivative instruments are gaining popularity and having an extremely important place worldwide. The regulatory frame work as per Security Exchange Act is subject to certain conditions and the trading mechanism of derivatives at NSE in India is fully automated screen based trading. There are certain challenges which are faced by derivative, yet it contributes the maximum towards the economic growth of India. \The most important advantage of this market is that it allows the investor to follow highly leveraged position to an investor at low transaction cost and also helps the investor to get innovative and flexible payoffs by adjusting in different derivative instruments.

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