A Comparative Study on Different Types of Contracts Operating in Derivatives Market in India

Ganesh B, Velmurugan V , Arun B K

Abstract--- *In financial terms, different methods of investments and depositing are termed as "instruments" and such of the instruments where there are specific rights and obligations are termed as "Contracts". A Derivative is an instrument whose value is derived from the value of underlying assets with respect to changes happening over a period of time. The assets that give rise to derivatives range from commodities to stocks. The term "derivative" refers to the likely movement of a commodity price or a share prices at a future date. Thus, derivatives depend on the investment made by the investors with respect to likely future price state. Over a period of time as the derivatives market progressed different types of participants emerged and to facilitate them different types of contracts were devised. The present study is based on the two research questions – "What are different types of contracts that are prevalent in Indian derivatives market? and "What are preferences for different types of contracts by different types of participants in Indian derivatives market". The study adopts both primary and secondary data collected from different and associated sources. The data so collected were analyzed by employing tabulation and comparison methods. The study, concludes that as the time progresses, the Indian derivatives market would see further differentiation among the different types of participants. Further, the study predicts that there will be further fine-tuning of the contracts in Indian derivatives market. Suggestions, Recommendations and Scope for future research were listed at the end of the research paper.*

Keywords--- *Derivatives, Derivatives Market, Contracts, Participants*

I. INTRODUCTION

In financial terms, different methods of investments and depositing are termed as "instruments" and such of the instruments where there are specific rights and obligations are termed as "Contracts". A Derivative is an instrument whose value is derived from the value of underlying assets with respect to changes happening over a period of time. The assets that give rise to derivatives range from commodities to stocks. The term "derivative" refers to the likely movement of a commodity price or a share prices at a future date. Thus, derivatives depend on the investment made by the investors with respect to likely future price state. Over a period of time as the derivatives market progressed different types of participants emerged and to facilitate them different types of contracts were devised (John and Basu, 2018).

The history of derivatives in Indian capital markets is longer than what is actually thought and believed. Derivatives trading was first started in the commodities market when the commodity futures exchange was setup in the Year 1875 in Mumbai under Bombay Cotton Traders Association dealing with cotton. But the actual Financial

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Derivatives contract started in India in the year 2000 after the Securities and Exchange Board of India (SEBI) granted the approval for the same. First the approval was given only to trade in the Index futures contracts, later the trading in Options contracts was approved at the index levels. In the year 2001 trading in individual shares began by the approval from SEBI. In India the trading and settlement in derivative contracts is done by following the rules and regulations prescribed by SEBI. At present the Indian Future and Options market has become a 72 lakh crores rupees markets in the turnover size (Fischer, 2017 and Prasanna Chandra, 2019).

Any business carries the risk of uncertainity,at every stage a manager has to come across the uncertainity. Hence it is important for the companies ,investors and traders to implement the risk management products to mitigate the risk. The underlying principle is these derivative instruments transfers the risk from risk averse individual to risk seeker individual for a predetermined price (Punithavathy, 2012 and Vohra and Bagri, 2017).

Futures and options contracts are available for trading in terms changes happening in foreign exchange, bank interest rates, stock indices, equity shares and commodities. The largest amount of derivative trading happens in the world with respect to government bonds of foreign countries, the stock market indices and currency exchange rates.

Critically analyzing the genesis of derivative markets in the world, Marlowe (2000) argues that the emergence of the derivative market products most notably forwards, futures and options can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. It is generally stated that regulation has an important and critical role to ensure the efficient and smooth functioning of the markets.

Analyzing the reasons for the emergence of derivatives market in India, Avadhani (2015) stated that a derivative as an innovative financial instrument, emerged to protect against the risks generated in the past, as the history of Indian financial markets has several instances of sufferings to the investors due to associated risk losing rather than gaining.

While searching for utilitarian value of derivatives Sahoo (2016) opines that derivative products initially emerged, as hedging (or protecting) devices against fluctuation in commodity prices and the commodity-linked derivatives remained the sole form of such products for many years.

Due to its attractiveness with respect to the probability of earning money in a short-time, derivatives have become increasingly popular and consequent opportunities for financial frauds. Against this background, Sahoo (2016) states that the legal framework for derivatives trading is a critical part of overall regulatory framework of derivative markets in order to obviate the frauds. The purpose of regulation is to encourage the efficiency and competition rather than impeding it.

The present research study focuses to study the various users of Derivatives Instruments and the concerned traders who are termed as “participants”.

II. RATIONALE OF THE STUDY

The present study was undertaken for following reasons:

• Trading in derivatives require adequate levels of self-reflection and self-analysis on the part of the traders in order to approach the real price of a commodity or a share. Against this backdrop, the researchers were interested to know more about the risk taken by the traders in the derivatives market and therefore the present study was undertaken.

• In present day business context, there are uncertainties due to rapid changes. Therefore, it is always better to mitigate the risk involved in equity shares market with the help of derivatives market. The present study was undertaken because of the relevance of the derivatives market.

• The researchers were curious to know the different types of contracts and different types of participants involved in the Indian derivatives market. The present study was undertaken because of this curiosity on the part of the researchers.

III. OBJECTIVES OF THE STUDY

The Research Questions for the study were "What are different types of contracts that are prevalent in Indian derivatives market? and "What are preferences for different types of contracts by different types of participants in Indian derivatives market". Based on these research questions, the following objectives were derived:

• To find out the different types of contracts which are widely used in Indian derivatives market.

• To get insights into different types of participants and their constituent differences in the Derivatives market.

• To find out the degree of preference by various types of participants with respect to different types of contracts.

• Based on the study, to identify the scope for future research.

IV. RESEARCH METHODOLOGY

The primary data for the study were collected from the purposefully selected six experts belonging to diverse backgrounds. Their diverse backgrounds helped to get the multiple perspectives that are associated with complex phenomenon of derivatives market A structured questionnaire and semi-structured interview schedules were employed to get insights from the responding experts. The responses so collected were collated and refined with three sets of iterations. The convergences in the responses of the six experts at the end of each iteration were recorded.

The context of the research questions were ascertained by secondary sources, both derivatives market specific and general. They included web-based literature, National Stock Exchange (NSE) bulletins, NSE newsletters, NSE circulars and NSE notice board displays. The research study was undertaken during the period of March to November, 2019. The trends thus noticed through critical observation were recorded for gaining further insights.

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The basic statistics were collated and presented in the form of tables aimed at arriving the differences associated with the entities.

V. RESULTS AND ANALYSIS

The results of the study were collated and presented in the form of four tables.

Table 1(A)

Differences between Futures and Forward

SI. No	Futures Contract	Forward Contract
1	Traded on a organized exchange	Over the counter
2	Standardized Contract	Customized contract
3	More Liquid	Less Liquid
4	Requires Margin payment	No margin Payment
5	Follows daily payment	Settlement happens at the end of the period
6	Less counter party risk	More counter party risk
7	More cost involved	Less cost involved

Source: Compiled by the researchers during the course of the study

Table 1 (A) highlights the differences between futures and forward. It may be noted that the futures contract is covered by a regulatory framework as there is the presence of mediation by the National Stock Exchange. Based on the analysis of Table 1(A), further hidden patterns were identified and summarized as in Table 1(B).

Table 1 (B)

Hidden Patterns of Futures and Forward

SI. No	Particulars	Futures Contract	Forward Contract
1	Mode of Operations	Maximum Three Months. Contract through exchange	Generally Three Months. Informal Contract between two or more parties
2	Extent of Application	Mainly Shares	Mainly Commodities
3	Rate of Growth of Popularity	2 to 3%	Data Not Available
4	Extent of Participation	All three viz., Hedger, Trader and Speculator	Predominantly Speculators
5	Likely Prospects	Likely to increase as	Government does not get taxes

		Government gets taxes	hence discouraged

Source: Compiled by the researchers during the course of the study

Table 2 (A) analyzes and differentiates between future contracts and options, where as, Table 3 (A) provides a self-explanatory picture about three types of participants of Indian derivatives market.

Analyzing the Table 2 (A) with respect to critical questions, further insights were obtained with respect to "Future Vs Options" and "Types of Participants in Indian Derivatives Market". It is interesting to know that knowledge regarding Options is yet to reach critical levels in Indian Derivatives Market. This fact also highlights the imitative mentality on the part of the participants of Indian Derivatives Market. Further, it is interesting to infer that the emotions of getting pleasure through uncertainties is enabling the development "tendency to earn quick money" and this has resulted in the evolution of participants in Indian Derivatives Market with "Speculators" coming first, "Traders" following the next. The "Hedgers" emerged as the last category. Table 2 (B) summarizes the analysis of Table 2 (A).

Table 2 (A)

Differences between Futures and Options

SI. No	Futures Contract	Options Contract
1	Obligation on both the parties	No obligation for the buyer
2	More risk for both the parties	Limited risk to the buyer
3	No premium amount is involved	Involves premium amount
4	Unlimited profit as well as Unlimited loss	For buyer loss is limited and profits are unlimited
5	Brokerage charges are less	Brokerage charges are high

Source: Compiled by the researchers during the course of the study

Table 2 (B)

Hidden Patterns of Futures and Options

SI. No	Particulars	Futures Contract	Options Contract
1	Rate of Growth of Popularity	2 to 3%	Very Low
2	Extent of Participation	All three viz., Hedger, Trader and Speculator	Predominantly Traders Little of Speculators
3	Likely Prospects	Likely to increase as Government gets taxes	May Grow in Future due to attractive features and tax revenue to the Government

Source: Compiled by the researchers during the course of the study

Table 3

Types of Participants in Indian Derivatives Market

SI. No	Particulars	Types of Participants		
		Trader	Hedger (Investor)	Speculators
1	Nature	Risk-Taker	Risk-Avoider	High Risk-Taker
2	Purpose	To make money in short-term	To avoid losses as much as possible	To make money in very short-term (intra-day)
3	Probability of Continuation	Medium probability of discontinuation	May continue in future	High probability of discontinuation
4	Returns Expected	Moderately High	Less Expectations	Very High
5	Reach of publicity	Moderately High	Low	High
6	Participation Extent	50%	40%	10%

Source: Compiled by the researchers during the course of the study

Table 4 provides a overview of the outcome of analysis in terms of preferences that are consistently exercised by the three main types of participants of Indian derivatives market with respect to three main types of contract that are operating in Indian derivatives market.

Table 4

Types of Participants and Their Preferences in Indian Derivatives Market

SI. No	Participants	Contracts With Preferences		
		Forward	Futures	Options
1	Trader	Least Preferred	Highly Preferred	Medium Preferred
2	Hedger (Investor)	Least Preferred	Highly Preferred	Medium Preferred
3	Speculator	Least Preferred	Highly Preferred	Medium Preferred

Source: Compiled by the researchers during the course of the study

Thus from results and their critical analysis it is clear that the classical definitions that define the three types of contract viz., forward, futures and options, as well as three types of participants of Indian derivatives market viz., trader, hedger and speculators are gradually manifesting in actual practices as ascertained during the course of the study.

VI. CONCLUSION, SUGGESTIONS AND RECOMMENDATIONS

The following are the Conclusion, Suggestion and Recommendations:

(i) Conclusion:

Based on the present study, the following points form the conclusion portion of the study. These conclusions are category-wise presented with respect to the perspectives of traders, and investors as well as in terms of future likely scenarios:

• It was found that it is better for traders to trade in the futures market when compared to forward market.

• Investors can safely enter the derivatives market by using the same as hedging tool to guard against losses which may happen in equity markets. Further, investors can leverage on the facility of paying 10-percent money only as advance instead of paying full amount.

• It Is expected that derivative markets is likely to gain popularity in future. In this process, the existing "contracts" would further be refined with more attractive instruments emerging from them. Further, based on this study, it is predicted that there will be further segmenting of the participants in the Indian derivatives market.

(ii) Suggestions:

Based on the study, the following suggestions were listed to improve the quality of

the present study:

• Similar study may be replicated with a larger sample.

• A separate study is needed to understand the mechanism involved in the impact of risks and returns associated with the derivatives market

(iii) Recommendations:

Based on the study, the following suggestions were listed:

• The derivative traders can utilize the futures market instead of forwards market due to the availability of regulations guarding against likely financial frauds.

• The authorities of the derivatives market need to periodically assess the extent of progress made in order to facilitate improvements. .

VII. SCOPE FOR FUTURE RESEARCH

Since derivative market is an emerging concept with a good employment potential further insights are needed. In this connection, the following were listed as the probable areas for further future research:

• A separate study needs to be undertaken for arriving at the "Options Pricing Strategies" that are more effective in Indian context.

• A study needs to be undertaken on designing and implementing the appropriate strategy to attract traders from tier two and three cities and towns as wells as villages to derivatives market in India in order to reap the full advantages offered by derivative instruments.

• A study needs to be undertaken with respect to "Options" propelled by the research question "Which strategy to be used in which situation?"

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