DERIVATIVES MARKET

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DERIVATIVES MARKET

□A derivative can be defined as a financial instrument whose value depends on (or derives from) the values of other, more basic, underlying variables.

DERIVATIVES CONTRACTS.

➤ Forward contract.
➤ Future contract.
➤ Options contract.
➤ SWAPS.
➤ Warrants.
➤ Leaps.
➤ Swaptions.

FORWARD CONTRACT.

Features.
- Not Standardized.
- Counter party risk.
- Trading (OTC).
- Liquidity(LESS).
- Decentralized.
- Settlement.

FUTURE TERMINOLOGY

➢Spot price

➢Future price

➢Tenure

➢Expiry date

❑MARK TO MARKET (M TO M)

Forward Vs. Future Contracts.

Forward	Futures
Private contract between two parties.(OTC)	Traded on an exchange.
Not standardized.	Standardized contract.
One specified delivery date.	Range of delivery dates.
Settled at end of contract.	Settled daily (MtoM).
Delivery or final cash settlement usually takes place.	Contract is usually close out prior to maturity.
Some credit risk.	No credit risk.

People who use Derivatives

❑Speculators.

❑Hedgers.

❑Arbitrageurs.

❑ <u>What are options?</u>

➤ Futures are derivative instruments where one can take a position for an asset to be delivered at a future date. But there is also an obligation as the seller has to make delivery and buyer has to take delivery.

➤ In option, as the name indicates, gives one party the option to take or make delivery. But this option is given to only one party in the transaction while the other party has an obligation to take or make delivery.

➤ The asset can be a stock, bond, index, currency or a commodity.

➤ But since the other party has an obligation and a risk associated with making good the obligation, he receives a payment for that. This payment is called as premium.

➤ Eg. **RAILWAY TICKET.**

OPTION TERMINOLOGY

- Index options.
- Stock options.
- Buyer of an option.
- Writer / seller of an option.
- Option price/premium.
- Expiration date.
- Strike price.
- American options.
- European options.
- In-the-money option.
- At-the-money option.
- Out-of-the-money option.
- Intrinsic value of an option.
- Time value of an option.
- Exercise and Assignment.
- Covered option.
- Naked option.