

Jyoti Nivas College Autonomous
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Presents

DERIVATIVES IN INDIAN SCENARIO

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The Roles and Importance of Derivatives in Indian Scenario

1.1 Derivatives

These are contracts which usually derive their value from some underlying asset. A derivative does not have any physical existence but emerges out of a contract between two parties. It does not have any value of its own, but its value, in turn, depends on the value of other physical assets which are called the underlying assets. These underlying assets may be shares, debentures, tangible commodities, currencies, short term or long-term financial securities, etc. If the underlying asset is a financial asset, the derivative is called financial derivatives. On the other hand, if the underlying asset is a commodity, the derivative is called commodity derivative. By using derivative contracts, investors can transfer any undesired risk, for a price, to other parties who either want to assume that risk or have risks which offset that risk.

1.2 Derivative Markets

Derivative markets are markets for contractual instruments whose performance is determined by the way in which another instrument performs. Derivative contracts are agreement between a buyer and a seller for monetary considerations. Derivative contracts can either be over-the-counter (OTC) contracts or exchange-traded contracts. OTC contracts are between private parties and the terms of the contract are decided between them initially. These contracts are highly unregulated and less transparent. E.g., forwards, swaps, etc. Exchange traded contracts are traded and regulated on derivative exchanges in order to ensure transparency.

1.3 Basic Derivative Instruments

The basic kinds of derivative securities are forwards and futures; swaps; and options.

➤ Forwards

A forward contract is one in which two parties (referred to as the “counterparties” to the transaction) commit to the terms of a specified trade to be carried out on a specified date in the future. Forward contracts are bilateral or “over the counter” (OTC) contracts, i.e., they are negotiated directly between buyer and seller. On the positive side, this means they

are customizable in terms of the maturity date, the specific quality (grade) to be delivered, etc. On the other hand, each party also takes on the risk of the other counterparty's default.

➤ Futures

A futures contract is, in essence, a forward contract that is traded on an organized exchange rather than negotiated bilaterally. Futures contracts grew out of forward contracts in the mid-19th century. Futures contract terms (maturity dates, deliverable grade of the underlying, etc.) are standardized, and the exchange guarantees performance on the contract. Participants in futures markets are required to post "margin," which is essentially collateral against default.

➤ Options

An option is a financial security that gives the holder the right, but not the obligation, to take part in a specified trade. There are two basic kinds of options (and a great many variants on these structures). In a call option, the holder of the option has the right, but not the obligation, to buy the specified underlying asset at a price specified in the contract (called the "strike price"). In a put option, the holder of the option has the right to sell the underlying asset at the specified strike price.

The holder of the option is also variously referred to as the long position in the option or the buyer of the option. The other counterparty in option trade who has an obligation to take part in the trade if the option buyer should decide to exercise his right is called the seller or writer of the option or the short position in the option. In exchange for providing the option holder with optionality concerning the trade, the option writer receives an up-front fee called the option price or the option premium.

Options trade both on organized exchanges and in the over-the-counter (OTC) market. Exchange-traded options exist on equities, equity indices, currencies, and interest rates and bonds, among others. Exchange-traded options are standardized in terms of expiry dates and strike prices. OTC options are customizable and exhibit a great deal more variety

➤ Swaps

Swaps, like forwards, are over-the-counter contracts. In a forward, the two counterparties commit to a single trade or single exchange of cash flows. In a swap, the counterparties commit to multiple exchanges of cash flows over several dates in the future.¹ Swaps are most common in the interest-rate derivatives market, where the typical contract has the parties exchanging one interest index for another computed on a given notional principal amount. (For example, one counterparty in the swap may make floating-rate payments indexed to Libor, while the other makes fixed-rate payments on the same principal amount.) They are also popular in the currency market, where the swap involves an exchange of principal and currency in one exchange for principal and currency in another.

1.4 Participants in Derivatives Market

Following are the major participants in a derivative market.

- **Hedgers:** Hedgers seek to protect themselves against price change in an asset in which they have an interest. They have risk exposure which they offset by a derivative. In hedging, both the parties enjoy a 'win-win' situation.
- **Speculators:** Speculators are major players in derivative market without whom, the market probably would not exist. They are the participants who are ready to take a risk for some return. Price differentials of the assets in the same market constitute the profit or loss for speculators.
- **Arbitrageurs:** Arbitrageurs try to make profit by taking into account the price differences of two markets. When the price of security is low in one market, they purchase securities and sell the same in an occasion of high security price. An arbitrage opportunity exists when one can make non-zero profit with no net investment or risk.

1.5 Role and Functions of Derivatives

Derivatives usually perform the following functions.

- **Price discovery of the underlying asset**

Price discovery is a method of determining the price for a specific commodity or security through basic supply and demand factors related to the market. Price discovery is the

general process used in determining the spot price. These prices are dependent upon market conditions affecting supply and demand. For example, if the demand for a particular commodity is higher than its supply, the price will typically increase and vice versa.

Futures market prices depend on a continuous flow of information from around the world and require a high degree of transparency. A broad range of factors (climatic conditions, political situations, debt default, refugee displacement, land reclamation and environmental health, for example) impact supply and demand of assets (commodities in particular) - and thus the current and future prices of the underlying asset on which the derivative contract is based. This kind of information and the way people absorb it constantly changes the price of a commodity. This process is known as price discovery.

➤ Techniques of risk management

Financial derivatives are useful for dealing with various types of risks, mainly market, credit and operational risks. The importance of derivatives has been increasing since the instrument has been used to hedge against price movements. The financial tool assists with the transfer of risks associated with a specific portfolio without requiring selling the portfolio itself. Essentially, derivatives allow investors to manage their risks and so reach the desired risk profile and allocation more efficiently.

The relationship between derivatives and risk management is relatively simple. Derivatives are seen as the tool that enables banks and other financial institutions to break down risks into smaller elements. From this, the elements can be bought or sold to align with the risk management objectives. So, the original purpose of derivatives was to hedge and spread risks. The main motive of the financial tool has aided with the great development and expansion of derivatives.

➤ Operational advantages

Derivative markets entail lower transaction costs. They have greater liquidity compared to spot markets. Derivative markets allow short selling of underlying securities more easily.

➤ Market efficiency

Spot markets for securities probably would be efficient even if there were no derivative markets. A few profitable arbitrage opportunities exist, however, even in markets that are usually efficient. The presence of these opportunities means that the price of some assets is temporarily out of line. Investors can earn returns that exceed what the market deems fair for the given risk level. There are important linkages between spot and derivative prices. The ease and low cost of transacting in these markets facilitate the arbitrage trading and rapid price adjustments that quickly eradicate these profit opportunities. Society benefits because the prices of underlying goods more accurately reflect the good's true economic values.

1.6 Importance of Derivatives

➤ Risk Sharing

Derivatives are mainly used to hedge risk associated with the underlying asset to the willing parties to take risk. The risk comes from several sources and is unavoidable. Derivatives are mainly intended to reduce the risks through transferring, spreading, etc. to the third parties who are risk seekers. The reducible risks include business risk, market risk, interest rate risk, inflation risk, currency risk/exchange rate risk, political risk, credit risk, weather risk, legal and regulatory risks, operational risks, valuation risks, etc.

These risks can be reduced in different ways such as,

- ❖ By selling the source of it
- ❖ By diversification
- ❖ By buying insurance against losses

➤ Implementation of Asset allocation Decisions

Derivatives are useful in implementing the asset allocation strategies on account of their property of low cost of diversification and leverage.

➤ Information gathering

Derivative markets affect the information structure of the financial system. The economic benefit of the information is that the potential imbalances can be visualized more easily by the higher implied volatilities.

➤ Price discovery and Liquidity

Derivative markets offer liquidity in their transactions. Futures and forwards markets are the important source of price information.

2.0. PERFORMANCE OF DERIVATIVE MARKET IN INDIA

2.1 Derivatives on BSE

Trading in Derivatives is enabled through a separate frontend system called, Derivatives Trading and Settlement System (DTSS) and Trader Work Station (TWS). It is also extendable through Intermediate Messaging Layer (IML) where trading members can access the exchange systems through their own customized software. BSE has not been as attractive as NSE in attracting its participants towards this segment. And the performance of BSE in Derivative segment has been naive which is now reporting a daily turnover of nearly 10,000 million. Presently, the BSE F&O segment covers 88 scrips. It also includes 7 Indices including the flagship product SENSEX. The BSE F&O segment also has unique product - the Weekly Options being available on SENSEX and 4 other scrips (Reliance Industries, Satyam, State Bank of India and Tata Steel). The newly introduced SENSEX Mini Derivatives product is also available in this feed (a data format used for providing users with frequently updated content). The data includes Close Price, OHLC (Open High Low Close), Buy Price, Sell Price, Buy Quantity, Sell Quantity, Total Volume, Trade Count, etc.

2.2 Derivatives on NSE

The National Stock Exchange of India Limited (NSE) commenced trading in Derivatives with the launch of Index Futures on 12th June, 2000. The Futures and Options segment of NSE has made a mark for itself globally. In the Futures and Options segment, trading in S&P CNX Nifty Index, CNX IT index, Bank Nifty Index, Nifty Midcap 50 index and single

stocks are available. Trading in Mini Nifty Futures & Options and long-term Options on S&P CNX Nifty are also available. The average daily turnover in the F&O Segment of the exchange during 2009-10 was at ₹ 72,392 crores (US \$16,097 million). NSE's automated screen-based trading, a modern and fully computerized trading system, is designed to offer investors across the length and breadth of the country a safe and easy way to invest. The NSE trading system called National Exchange for Automated Trading (NEAT) is a fully automated screen-based trading system based on the principle of an order driven market.

2.3 Equity Derivative

Equity Derivative is a class of Derivatives whose value is at least partly derived from one or more underlying equity securities. Options and Futures are by far the most common Equity Derivatives. Two major products under Equity Derivatives are Futures and Options which are available on Indices and Stocks. Futures & Options (F&O) segment of NSE provides for trading in Derivatives Instruments like Index Futures, Index Options, Stock Options, and Stock Futures. National Securities Clearing Corporation Limited (NSCCL) is the clearing and settlement agency for all deals executed on the Derivatives (Futures & Options) segment. It acts as legal counter-party to all deals on NSE's F&O segment and guarantees settlement. A clearing member (CM) of NSCCL has the responsibility of clearing and settlement all deals executed by the trading members (TM) on NSE who clear and settle such deals through them.

2.4 Performance of Single Stock Derivatives and Stock Index Derivatives

Stock Index acts as a bench mark for evaluating the performance of the market. Any investor entering into the market would necessarily make a comprehensive evaluation of the trends in the market indices and uses the result of the evaluation as a proxy to estimate the future potential that the market promises or carries. Volatile nature of market indices is said to have major influence on the performance of the investment held by the investors in the market. Volatile nature of market (due to a vulnerable nature of factors influencing) forced the market regulator viz., SEBI to look for an innovative tool to hedge the risk. In this background, SEBI introduced Index Derivatives (Futures) in June 2000 and later introduced Index Derivatives (Options) and Equity Futures and Options (F&O) in the year 2001. Capital Markets have been observing a significant growth and succeeded in attracting

a number of investment participants towards Derivative trading either for the purpose of hedging their performance risk or using them as investment tool to accomplish their speculative objective by taking contrarian/opposite position in the market against the market movements.

2.5 Performance of Indian F&O Vs Global Exchanges

Indian Capital Markets against the global markets are still in naive/nascent stage as their presence in the Indian markets is just over a decade from now. The experience of Indian Capital Markets reveals that the Derivatives have greatly been successful in supplementing the cash market by creating better liquidity platform and leveraging opportunities for the instruments traded. The cash markets have observed a high degree of positive correlation with the performance of the Derivatives. Derivative since its introduction in Indian Capital Markets has brought about a paradigm shift in the capital market operations in India. Table - 3.12 presented below provides the performance of Indian Capital Markets in Derivative trading among the top ten performers globally.

3.0 RECENT TRENDS IN FINANCIAL DERIVATIVE MARKETS

Derivative is a financial instrument whose value is based on or value is derived from one or more underlying assets. The underlying 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 of two categories: 1) Exchange traded 2) Over the counter

3.1. Derivative market in India

Derivatives 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 futures trading way back in 1875. Derivatives trading commenced in India in June 2000 after SEBI granted the final approval to this effect in May 2001 on the recommendation of L. C Gupta

committee. SEBI approved trading in index futures contracts based on various stock market indices such as, S&P CNX, Nifty and Sensex. Subsequently, index-based trading was permitted in options as well as individual securities. The trading in BSE Sensex options commenced on June 4, 2001 and the trading in options on individual securities commenced in July 2001. Futures contracts on individual stocks were launched in November 2001. The derivatives trading on NSE commenced with S&P CNX Nifty Index futures on June 12, 2000. The trading in index options commenced on June 4, 2001 and trading in options on individual securities commenced on July 2, 2001. Single stock futures were launched on November 9, 2001. The index futures and options contract on NSE are based on S&P CNX. In June 2003, NSE introduced Interest Rate Futures which were subsequently banned due to pricing issue.

3.2 SEBI Rules

- Participation of Eligible Foreign Investors (EFIs) in Commodity Derivatives in IFSC- SEBI made the amendment in rule o participation of foreign investors in derivative market as per the guidelines.
- Physical settlement of stock derivatives- it has been decided that physical settlement shall be made mandatory for all stock derivatives. Stocks which are being cash settled shall be ranked in descending order based on daily market capitalization averaged for the month of December 2018 SEBI has said that the bottom 50 stocks in the derivatives segment will move to delivery settlement every quarter in 2019. This means, within nine months the entire equity market will shift to delivery trading. In January 2018, SEBI first announced bringing 42 stocks in the derivatives segment under compulsory delivery settlement. SEBI has now said that entire derivative trading should move to delivery settlement from the current cash system in a phased manner in 2019. The new system is aimed at discouraging excessive speculation and abrupt market volatility.

Trading hours for commodity derivatives segment- trading hours for commodity derivatives segment which are presently fixed between 10:00 am and 11:55 pm starting October.

1. Trading in metal

MCX will start with delivery trading in zinc and nickel. The exchange has been paying hefty fee to the London Metal Exchange and the Chicago Mercantile Exchange for price discovery even as domestic companies that require hedging mostly stay away due to non-availability of local price and speculators dominate, experts say. Commodity derivatives was launched by MCX in 2013 and the exchange never made any attempt to shift to delivery trades until new entrants in the segment, the NSE and the BSE, were not asked to do so. Domestic price discovery is possible if delivery of goods is involved as it could promote local price pooling. Tata Steel, Vedanta and Hindalco are among top global companies exporting base metals.

2. Trading in crude oil and natural gas

With natural gas demand growing faster than for any other fossil fuel, LNG futures may be finally taking off. Derivatives represented about 2 percent of global LNG production at the beginning of 2017 as an array of contracts around the world struggled to gain traction. But by the end of last year, volumes had grown to almost 23 percent, led by a burgeoning Intercontinental Exchange Inc. contract based on S&P Global Platts' Japan-Korea Marker spot price assessments. While volumes are a long way off established global energy benchmarks such as Brent crude -- where trade dwarfs worldwide oil production many times over -- the accelerating growth in LNG derivatives illustrates how the market is maturing. An explosion in supply, from the U.S. to Australia, is bringing more market participants and a shift away from traditional pricing.

3. Artificial intelligence in trading

Derivative market is an indispensable part of financial services, it is a large global hut and have enormous space to accommodate the latest of technology. Blockchain, AI and robotics are already targeting it. We know that almost any asset can be traded as futures and options in derivative market. However the complexity of these instrument creates challenges for investors. Due to constantly changing marketplace dynamics and regulatory guidelines, robust pricing solutions are critical. A proper pricing tool is a requirement from buy-side and sell-side trading desks to compliance, for pricing and accounting teams etc. The most popular options available in market have certain limitations which cannot be ignored. For example the solutions are so complicated that to use them one needs to be

trained first. These solutions are so heavily priced that not everyone can afford to be benefited, also due to their large size they are restricted to terminals and can be used with limited devices. Let us consider some scenarios to elaborate further.

4.0 DEVELOPMENT OF FINANCIAL DERIVATIVES MARKETS IN INDIA

During the 1980s and 1990s, a major growth sector in financial markets was the trade in so called [derivatives](#).

In the financial markets, stock prices, share prices, bond prices, currency rates, interest rates and dividends go up and down, creating [risk](#). Derivative products are financial products which are used to control risk or paradoxically exploit risk. It is also called financial economics.

Derivative products or instruments help the issuers to gain an unusual profit from issuing the instruments. For using the help of these products a contract has to be made. Derivative contracts are mainly 4 types

1. Future
2. Forward
3. Option
4. Swap

Seemingly, the most obvious buyers and sellers of currency are importers and exporters of goods. While this may have been true in the distant past when international trade created the demand for currency markets, importers and exporters now represent only 1/32 of foreign exchange dealing, according to the Bank for International Settlements.

The picture of foreign currency transactions today shows:

- Banks/Institutions
- Speculators
- Government spending (for example, military bases abroad)
- Importers/Exporters

- Tourists

The Indian derivatives market is in existence for very long. In the derivatives market, we deal with derivative securities. In the Indian derivatives market, trade takes place with the help of derivative securities. Such derivative securities or instruments are forward, futures options and swaps. Participants in derivatives securities not only trade in these simple derivative securities but also trade hybrid derivative instrument.

4.1 ORIGIN OF THE DERIVATIVES MARKET IN INDIA

Derivatives market in India has a history dating back in 1875. The Bombay Cotton Trading Association started future trading in this year. History suggests that by 1900 India became one of the world's largest futures trading industry.

However after independence, in 1952, the government of India officially put a ban on cash settlement and options trading. This ban on commodities future trading was uplift in the year 2000. The creation of National Electronics Commodity Exchange made it possible.

In 1993, the National stocks Exchange, an electronics based trading exchange came into existence. The Bombay stock exchange was already fully functional for over 100 years then.

Over the BSE, forward trading was there in the form of Badla trading, but formally derivatives trading kicked started in its present form after 2001 only. The NSE started trading in CNX Nifty index futures on June 12, 2000, based on CNX Nifty 50 index

5.0 IMPACT OF DERIVATIVES ON EFFICIENCY OF STOCK MARKET

5.1 Introduction:

Derivatives, such as futures or options, are financial contracts which derive their value from a spot price, which is called the "underlying". Derivative products like index futures, stock futures, index options and stock options have become important instruments of price discovery, portfolio diversification and risk hedging in stock markets all over the world in recent times. In the last decade, many emerging and transition economies have started introducing derivative contracts. Ever since index futures were introduced by the National Stock Exchange (NSE) in June 2000, there has been a lot of controversy regarding their

usage. Derivatives are known to be a double edged sword, you can use it to kill enemies, kill yourself or for self-defense.

The introduction of derivative products may increase volatility in component stocks. This is because the spot and future markets are linked through risk transfer (hedging) and price discovery, two major contributions of the futures markets to economic activity. Theoretically, the impact of stock index futures and options on the stock market volatility is still not clear. The linkage between these derivatives markets and the stock market is generally established through arbitraging activities.

The study of impact of derivative trading is important as increased spot market volatility resulting from futures trading may suggest a need for more regulations. The findings of the study will be useful for investors to make investment decision.

Introduction of derivative products, however, has not always been perceived in a positive light all over the world. It is, in fact, perceived as a market for speculators and concerns that it may have adverse impact on the volatility of the spot market. Government had earlier banned futures trading in commodities on the belief that they were over speculated and caused an inflationary situation. Now trading has been resumed on four banned commodities, after the inflation rate has moderated. There is also a hope that government may soon lift the trading ban on food grains. This offers great relief for importers and exporters to hedge their positions. Earlier, an expert committee headed by Abhijit Sen was constituted to study the impact of futures trading on agricultural commodity prices. Wheat, urad, tur and rice were among the products that were considered in the report.

This paper tries to study whether the Indian stock markets show some significant change in the volatility after the introduction of derivatives trading. This paper also tries to examine whether decline or rise in volatility can be attributed to introduction of derivatives alone or due to some other macroeconomic reasons.

There is a common belief that stock index futures are more volatile than underlying spot market because of their operational and institutional properties. The close relationship between the two markets makes the transfer of volatility possible from futures market to the underlying spot market. It is therefore, not surprising that the inception of futures

contract relating to stock market has attracted the attention of researchers all over the world, and also led some observers to attribute stock market volatility to futures trading. Various studies have been conducted to assess the impact of derivatives trading on the underlying market mostly related to US and other developed countries markets. Very few studies attempted to know the impact of introduction of derivatives trading in emerging market economies like India.

Both theoretical and empirical studies were carried out to assess the impact of listing of futures and options on the cash market. Two main bodies of theory about the impact of derivatives trading on the spot market are prevailing in the literature and both are contradicting each other. One school of thought argues that the introduction of futures trading increases the spot market volatility and thereby, destabilizes the market. They are the proponents of 'Destabilizing forces' hypothesis. (Lockwood and Linn, 1990)) They explain that derivatives market provides an additional channel by which information can be transmitted to the cash markets. Frequent arrival and rapid processing of information might lead to increased volatility in the underlying spot market. They also attribute increased volatility to highly speculative and levered participants.

Others argue that the introduction of futures actually reduces the spot market volatility and thereby, stabilizes the market. They are the proponents of 'Market completion' hypothesis. There is an argument that derivatives trading helps in price discovery, improve the overall market depth, enhance market efficiency, augment market liquidity, reduce asymmetric information and thereby reduce volatility of the cash market. The impact that the derivatives market has on the underlying spot market remains an issue debated again and again with arguments both in favors and against them.

This study seeks to examine the volatility of the spot market due to the derivatives market. Whether the volatility of the spot market has increased, decreased or remained the same. If increased then, what extent it is due to futures market. We use Autoregressive framework to model returns volatility. To measure volatility in the markets, the VIX (Volatility Index) computed by the National Stock Exchange is used. To eliminate the effect of factors other than stock index futures (i.e., the macroeconomic factors) determining the changes in

volatility in the post derivative period, the model is used for estimation after adjusting the stock return equation for market factors.

The studies in the Indian context have evaluated the trends in NSE and not on the Stock Exchange, Mumbai (BSE) for the reason that the turnover in NSE captures an overwhelmingly large part of the derivatives market.

We use Nifty Junior as surrogate indices to capture and study the market wide factors contributing to the changes in spot market volatility. This gives a better idea as to whether the introduction of index futures in itself caused a decline in the volatility of spot market or the overall market wide volatility has decreased, and thus, causing a decrease in volatility of indices on which derivative products have been introduced. The volumes on NIFTY also has a large impact on the volatility, thus in the model to measure volatility volumes are also considered as a factor. We seek to compare this volatility with the volatility prevailing in the market before the index futures (i.e. Nifty futures) and check if it is statistically significant.

The issue of the impact of derivative trading on stock market volatility has received considerable attention during past few years. Although many factors contribute to stock market volatility, there is concern about the impact of derivative trading on stock market volatility. A large number of theoretical and empirical studies have examined the effect of stock index futures and options on the volatility of the underlying spot market. Some researchers have argued that introduction of derivatives affect the volatility of stock market while others disagree with the statement.

The derivatives were launched mainly with the twin objective of risk transfer and to increase liquidity thereby ensuring better market efficiency. In India, derivatives trading started in June 2000 with introduction of Index future followed by index options in June 2001, and options and futures on individual securities in July 2001 and November 2001, respectively. Since inception, National Stock Exchange of India (NSE) established itself as the sole market leader in this segment in the country and during 2008-09, it accounted for 99 % of the market share (NSE, 2009). The total turnover on the F&O Segment was Rs. 11,010,482 crore (US \$ 2,161,037 million) during 2008-09. The average daily turnover during 2008-09 was Rs.45, 311 crore (US \$ 8,893 million).

Conclusion: Risk is a situation where actual outcome may deviate from expected outcome. Risk is categorized into two forms such as internal risk and external risk. Risk management refers to the process of understanding, mitigation and sharing of risk. This is not about to see what will happen in future, instead it deals to work out in advance what might happen. Therefore, it is called as proactive management rather than reactive. Risk management plays a key role in the financial industry and an integral part of it. Markets and risk management practices grow with the progress of business. The growth of the business and market expansion pose challenges for managing the risk. As a result, financial instruments evolved to manage the risks which are known as financial derivatives. There are different forms of contract but most common forms include futures, forwards, options and swaps. Financial derivative is a tool used by the companies to manage the risk. In simple word, it is used to hedge the risk which is being faced by the company. There are two important functions which are played by the financial derivatives namely hedging and speculation. Hedge instruments are used with an attempt to reduce the risk level attached with the underlying transactions. Hedgers protect their assets or liabilities from the adverse change by entering into derivative contract. Speculation presumes the financial risk with the prediction of gain from market fluctuations. Therefore, financial derivative play key role for managing risk. The efficient use of financial derivatives reduces risk level and increases rate of return. Thus, it is improving the financial health of business and climate.
