Chapter–5: Derivatives

Types of Derivatives

Forwards: A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's pre-agreed price.

Futures: A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts, such as futures of the Nifty index.

Options: An Option is a contract which gives the right, but not an obligation, to buy or sell the underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him. Options are of two types - Calls and Puts options:

'Calls' give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future date.

'Puts' give the buyer the right, but not the obligation to sell a given quantity of underlying asset at a given price on or before a given future date.

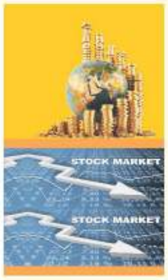
Presently, at NSE futures and options are traded on the Nifty, CNX IT, BANK Nifty and 116 single stocks.

Warrants: Options generally have lives of up to one year. The majority of options traded on exchanges have maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-the-counter.

Option Premium

At the time of buying an option contract, the buyer has to pay premium. The premium is the price for acquiring the right to buy or sell. It is price paid by the option buyer to the option seller for acquiring the right to buy or sell. Option premiums are always paid upfront.

Commodity Exchange



A Commodity Exchange is an association, or a company of any other body corporate organizing futures trading in commodities. In a wider sense, it is taken to include any organized market place where trade is routed through one mechanism, allowing effective competition among buyers and among sellers - this would include auction-type exchanges, but not wholesale markets, where trade is localized, but effectively takes place through many non-related individual transactions between different permutations of buyers and sellers.

Meaning of Commodity

FCRA Forward Contracts (Regulation) Act, 1952 defines "goods" as "every kind of movable property other than actionable claims, money and securities". Futures' trading is organized in such goods or commodities as are permitted by the Central Government. At present, all goods and products of agricultural (including plantation), mineral and fossil origin are allowed for futures trading under the auspices of the commodity exchanges recognized under the FCRA.

Commodity derivatives market

Commodity derivatives market trade contracts for which the underlying asset is commodity. It can be an agricultural commodity like wheat, soybeans, rapeseed, cotton, etc or precious metals like gold, silver, etc.

Difference between Commodity and Financial derivatives

The basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. However there are some features which are very peculiar to commodity derivative markets. In the case of financial derivatives, most of these contracts are cash settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing. Similarly, the concept of varying quality of asset does not really exist as far as financial underlyings are concerned. However in the case of commodities, the quality of the asset underlying a contract can vary at times.