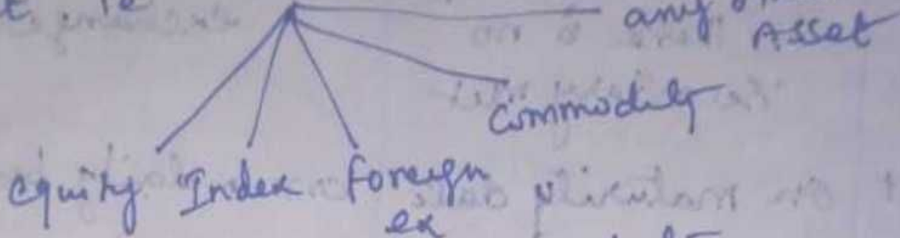
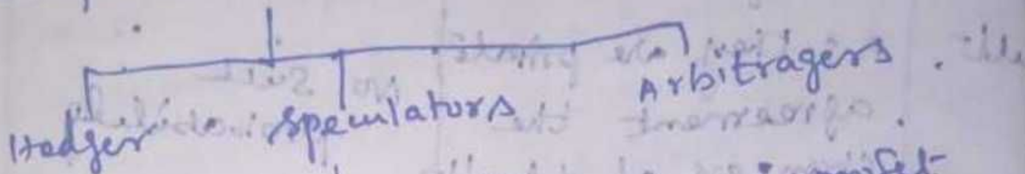
Derivatives UNIT V

A derivatives is a financial security whose value is derived from an underlying Asset ie



participants in derivative Market



Hedger

1. They face risk associated with price.
2. They use future and option mkt to ↓ or eliminate the risk

Speculators

↓ future movements the price of asset

Arbitragers

make profit by taking advantage of differences prices between of the same product across diff mkt.

Types

1) forward Contract
2) future
3) option
4) Swap.

	Forward Contract	Future Contract.
1) Meaning	It is an agreement between parties to buy and sell the underlying asset at a specified date and agreed rate in future	parties ⇒ exchange an asset for cash at a future price and future specified date

2) Type of Contract	Customised Contract	Standardised Contract
3) Traded on	Over the Counter ie there is no secondary mkt	on stock exchange
4) settlement	on maturity date	on a daily basis
5) Risk	High	low
6) Default	As they are private agreement the chances of default are relatively high	No such probability
7) Size of Contract	Depend on the contract terms	fixed.
8) Collateral	not required	Initial margin required
9) Maturity	As per the terms of contract	predetermined date
10) Regulation	self regulated	By stock exchange
11) Liquidity	low	high

3) Options → right to buy / sell the underlying asset.

Types of option.

Call option

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

Put option

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

European option - Can be exercised only on the date of option expiry

American option - Can be exercised anytime before the option expiry

4) Swap - These are private agreements between two parties to exchange cash flows in the future according to a formula.

Types of Swap

Interest rate Swaps

These entail swapping only the interest-related cash flows between the parties in the same currency

Currency Swaps

These entail swapping both principal and interest between the parties, with the cash flows in one direction being in a different currency than those in the opposite direction.