Journal of Advances and Scholarly Researches in Allied Education
Vol. XIV, Issue No. 2, January-2018, ISSN 2230-7540

A Review of Challenges issue and Economic Contribution of derivative market

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Abstract - The derivatives market plays a crucial role in the Indian economy. Financial instrument, indicator, or commodity-specific instruction for the purpose of risk management in the financial markets. The Indian derivatives industry is worth several trillion dollars and is quickly developing. Examples of Derivative Instruments include those based on commodities, precious metals, foreign exchange rates, bonds, shares and share warrants, short-term securities, and money market products. Both the National Stock Exchange (NSE) and the Bombay Stock Exchange are major participants in India's derivatives market (BSE). Potential topics include the popularity of derivatives in the Indian economy. In this paper discuss the difficulties encountered by the derivatives industry, the market's worth, and the significance of its future prospects in the current investigation.

Keywords - Economic Contribution, Derivative ,market, issue

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INTRODUCTION

Derivative markets have been operational in India for years. The Bombay Cotton Trade Association was the first to establish futures trading in 1875. This is the first centralized exchange for trading futures contracts. The Bombay Cotton Exchange Ltd. followed in 1893, the Gujarat Vyapari Mandall in 1900, and the Calcutta Hesstan Exchange Ltd. in 1919. As the nation gained its independence, the derivative market went full circle, going from outlawing all derivative trading to reintroducing them just recently. After the government of India outlawed cash settlement and options trading in 1952, derivatives trading moved to the more nebulous forwards markets. The government's stance has changed in recent years to promote a greater role for market-based pricing and less suspect derivatives trading. The securities laws (Amendment) order 1995 promulgated the first step toward the implementation of financial derivatives trading in India. It allowed for cancellation in the event of a ban on security choices. Since the turn of the millennium in 2000, numerous commodities have had their futures trading bans lifted.[1]

The growth of a country's economy is largely dependent on the success of its derivatives market. The fluctuating interest rates, stock prices, and currency rates across global financial markets have added uncertainty to the global business community's bottom line. The very existence of the corporate world has been put in jeopardy as a result of negative shifts in macroeconomic factors. Derivatives, a class of new financial products, are needed in the Indian financial markets to mitigate this kind of risk. The primary goal of these products is to mitigate financial risks by providing guarantees to pricing at future periods. The history and present status of India's derivative market are documented here. Our goal with this research was to examine the derivatives market in India. This study aims to illustrate the development and expansion of NSE's financial derivative in India from the 2010–2011 to the 2016–2017 fiscal years. From Rs.17663664.57 Cr. in 2009-2010, the market's annual revenue has increased to Rs.1163539816.124 Cr. in 2016-17.

Bombay Stock Exchange

The Bombay Stock Exchange, or BSE as it is often called, opened for business in 1875. The first and oldest stock market in Asia, both were founded in India. On June 9, 2000, a sub-instrument of derivative trading known as a "futures contract" went live for the first time. Another 'index choice' sub-tool will be released on June 1, 2001. The debut of "weekly options" on September 13, 2004 was a watershed moment for the derivatives market and a major accomplishment for the BSE. As of October 1, 2008, BSE began trading currency futures.[2]

National Stock Exchange

The NSE, or National Stock Exchange, was founded in 1992. The stock market there is the third biggest in the world. Its first derivative product, 'Index future,' went on the market on June 12, 2000. However, "index option" didn't appear until June 4, 2001. Securities and Exchange Board of India mandated

233 futures contracts. NSE made history when it introduced "Mini Index Future & Options" need Rs. 1 million (about $15,000) in order to get started with a contract. The National Stock Exchange of India (NSE) was the first in the Indian Derivative market to sell currency future contracts on the US dollar and the Indian rupee on August 29, 2008.

CHALLENGES OF DERIVATIVE MARKET

Although the derivatives market has demonstrated impressive growth in recent years, serious problems have not been addressed. The derivatives market is growing in terms of the types of instruments exchanged and the amount of trading, but that is not the primary goal. That is, many exchanges have not yet been established. However, the unanswered questions and the way they are portrayed as major obstacles make the future of derivative markets seem bleak.[3]

- **Cash vs Physical Settlement**: As a result of the Forward Contract Act of 1952, the proportion of commodities derivatives that need physical settlement is very small. Contracts that have not yet matured cannot be settled for cash in accordance with this Act. What this means is that at the time of maturity, all outstanding contracts must be paid by actual delivery. Participants work out their positions before reaching adulthood in order to break out of this cluster. The derivatives market is faced with a significant issue in the form of the necessity to amend this Act.
- **Issue for market Stability and Development**: Due to its explosive expansion, the over-the-counter derivatives market is receiving close attention from regulatory and supervisory organizations. In this period of global turmoil, some people turn to OTC (Over-the-Counter) derivatives as a means of relieving their stress. The detractors' claims that this market is less transparent, has lower capital requirements, and has more systemic risk are the biggest obstacles to overcome.[4]
- **The Warehousing and Standardization:** For the country's commodity derivative market to function normally, an efficient and effective storage infrastructure is required. There is a serious problem facing the derivative market: a lack of well-standardized laboratories and quality testing facilities for the final customer who gets physical delivery.
- **Lack of Economics of Scale:** The derivatives market has not yet reached a critical mass to benefit from economies of scale. Although 80 commodities are traded on a variety of commodity exchanges, in practice only a select handful are widely traded. The Indian government is looking at merging two different markets into one. It also implies that regulatory bodies like the Reserve Bank of India, the Forward Market Commission, the Securities and Exchange Board of India, and the Department of Companies Affairs would be able to work together more efficiently and accomplish their missions more effectively.
- **The Regulatory:** Similar to how the independent Security Exchange Board of India oversees the security market, a similar regulatory mechanism is needed for the derivatives market. On the flip side, the Forward Market Commission (FMC) regulates derivatives and is funded by the Department of Consumer Affairs; hence, a centralized authority is necessary for the growth of this market. The regulatory agencies, SEBI and FMC, must coordinate their efforts for optimal outcomes.
- **Competition of OTC derivatives with the Exchange traded derivatives:** It is recommended that OTC derivatives be converted to Exchange trading derivatives after a financial crisis. According to experts, this will improve the clearing and settlement process while also increasing transparency and liquidity. The preceding recommendations assume that trade in OTC items is currently conducted only by telephone and that no clearing mechanism exists.
- **Strengthening the Centralized Clearing Parties:** Established in 2002, CCIL provides India with its only centralized clearing party for outstanding processing and settlement services. Currently, it settles all Indian Revenue Service transactions, guarantees the settlement of trades in government securities, clears Collateralized Borrowing and Lending Obligation (CBLO), and settles trades in foreign currencies (IRS). Certified Financial Services Auditor's (CFSA) report opinion that concentration of such a wide spectrum of activities leads to concentration of risk in one entity, despite the fact that the CCIL's concentration of business relating to money, securities, and forex market helps in pooling risk and reducing the overall transactions cost for the system. Therefore, it is essential to fortify an increasing number of cleaning parties.[5]
- **New derivative products for Credit Risk Transfer (CRT):** All forms of credit risk transfer (guarantees, loan syndication, and securitization) have been around for quite some time. Despite this, there has been a steady and fast expansion of novel CR T forms linked to credit derivatives. Credit Default Swaps (CDS) on single corporate ent ity and collaterized debt obligation are the most widely used credit derivatives. After 2005, CRT activity increased significantly for two more underlying asset types, asset-backed securities and leveraged loans. Institutions of higher financial standing abroad have long had access to futures that may hedge against the risk of credit default, but in India, this option was off-limits until very recently. In its second-quarter monetary policy for 2009–10, the RBI said that it plans

to continue with prudence in this area. As of the 1st of December 2011, the RBI has mandated protections for a fundamental over-the-counter single-name credit default swap (CDS) for corporate bonds for resident firms.

ECONOMIC CONTRIBUTION OF DERIVATIVE MARKET IN INDIA

Since the derivatives market in India is expanding, it has been shown that it serves a number of important economic roles, including those listed below.[6]

- Derivative market represents the pricing assessment of the market players regarding the future This may lead to the discovery of present and future pricing in the properly structured market.
- The derivatives market is a well-functioning exchange where investors' exposure to risk is evenly dispersed.
- More and more market participants are engaging in high-volume trading of derivatives since they are generated from the fundamental value of assets.
- Historically, the educated have been swayed by Derivative because of the clarity and breadth of its vision. In the long run, this will assist the economy expand, which in turn will generate more jobs and commerce.

FINANCIAL DERIVATIVES

A derivative is a financial instrument whose worth is "derived" from that of another security or economic factor. Because the derivative's value is tied to the performance of other markets or factors, it may be used as a tool for risk management and transfer.

Financial derivatives are described by John C. Hull as "instruments whose value is derived from the values of other, more fundamental underlying variables."

Robert L. McDonald uses a similar definition. Simply put, "a derivative is just a financial instrument (or perhaps just an agreement between two persons) whose value is based on the price of something else."[7]

Factors Affecting Growth of Derivatives

The rates of expansion of derivatives are sensitive to a wide range of variables. The following are a few of the most crucial considerations:

1. The increased volatility of asset values in the financial markets.
2. There has been a general trend toward more international financial market integration.
3. Significant enhancements to communication infrastructure and a precipitous decrease in their prices.

Underlying Asset in a Derivatives Contract

Value of a derivative instrument, as stated above, is tied to the value of the underlying asset. There are a wide variety of possible formats for the underlying asset:[8]

- Currency or exchange rates abroad
- Bonds are a sort of financial security issued by a government, company, or other entity in exchange for interest payments over a certain period of time.
- Granola, java beans, and orange juice are just few examples of commodities.
- Gold and silver are examples of precious metals.
- Currency or exchange rates abroad
- Government and corporate bonds, corporate bonds, agency bonds, municipal bonds, and other forms of bonds.
- Companies whose stock and warrants trade on a recognized exchange or in the Stock Index
- Short term securities such as T-bills
- Over- the Counter (OTC)2 money market products such as loans or deposits.

STOCK MARKET DERIVATIVES

In 1850, five Gujarati and one Parsi stockbroker convened beneath a banyan tree in front of Bombay Town Hall to introduce the notion of a stock market to India. As the number of members grew, the group moved to larger quarters on Dalal Street in 1874 and formally incorporated as "The Native Share & Stock Brokers Association" the following year. The Indian government officially recognized the BSE as a stock exchange under the Securities Contract Regulation Act for the first time in 1956. The concept of a Derivatives Market predates the year 2000, although it wasn't fully formed until that year. The results were dramatic for the Indian economy and economy. Over the course of the previous decade, derivatives have become a standard part of the global financial system. The finest part about this instrument is that it reduces the danger of further losses and helps investors prepare for future difficulties.[9] Derivatives have quickly become more popular and trusted by institutional investors than any other kind of stock market instrument, primary or secondary, in this little period of time. Hedgers were aided by this because they were able to balance off the value of their commodity (asset) in the futures market against the value in the cash market. Equity futures trading on the spot market in India has historically occurred on a weekly or biweekly basis. The benefits of separating the spot market from the futures market, such as easier price discovery and more hedging options, are absent from these markets. Two kinds of derivatives are commonplace in India's main

market.

- Convertible bonds
- Warrants

Due to the listing and trading of these warrants, one might argue that a rudimentary options market already exists in our economy. In addition, the underground economy is home to a plethora of vibrant derivatives markets. In these exchanges, people buy and sell contracts like bhav-bhav and teji-mandi. These unregulated marketplaces exist apart from India's official financial institutions and attract just a small percentage of the population.[10]

When the securities laws (Amendment) Ordinance, 1995 was passed, it removed the ban on options in securities, which was the first step toward introducing derivatives trading in India in its present guise. Nonetheless, it was the SEBI that provided the actual impetus for the derivatives market in India. An "adequate regulatory framework for derivativestradingin India" was developed by a group chaired by Dr. L C Gupta and established by the securities market regulator in November 1996.

Index futures contracts based on the S&P CNX Nifty and the BSE 30 (sensex) index were first traded on the NSE and BSE in 2000 after being approved by SEBI. Trading in options based on these two indices, as well as trading in options on individual stocks, were thereafter given the green light. The first Individual Stock Futures Contracts were traded on November 9, 2001. Both trading and settlement take place in accordance with the guidelines established by the relevant exchanges. Even yet, early trading activity was quite low.

As can be seen from recent trading activity in the derivatives markets, single stock futures continue to play a large role. According to a recent news article, the amount of futures trading on Indian exchanges has become worldwide. That futures closely resemble the old badla system is a theory put up to explain traders' irrational conduct. However, the market does not benefit from these kinds of distortions.

Options and futures trading on certain equities has been authorized by SEBI, but not on all of the listed stocks. Options trading is restricted to a small subset of equities, excluding those with a reputation for extreme volatility and low market value. Among market participants, this move by SEBI is quite unpopular. They claim that investors who want to hedge against market risk should not bother with stock options. If a stock's volatility is high, then listing options on it is a must. Instead of simply banning trading in options on low market capital stocks, the yare strongly advocating that SEBI design an effective monitoring, surveillance, and risk management system at the level of the exchanges and clearing house to prevent and manage the default risks that are likely to arise due to such high volatility. SEBI should take a look at these criticisms. To prevent such manipulations, it may need to take a position and penalize those corporations that engage in such practices severely.

Equity futures products may now be used for "hedging and port foliore balancing" by mutual funds. Fund managers are not fond of this use since they know the line between hedging and speculating is thin and they might be subject to regulatory scrutiny at any time.

UNRESOLVED ISSUES AND FUTURE PROSPECTS OF DERIVATIVES MARKET

As much progress as the derivatives market has made in recent years, the system's long-term challenges remain unsolved. While the variety of goods available for derivative trading has grown and the value of transactions has skyrocketed, achieving the goals of establishing several derivative exchanges and maintaining the current pace of development remain serious challenges that need to be addressed without delay. Here are a few examples of the most pressing open questions.[11]

1) **Issues for Market Stability and Development:** Authorities are paying close attention to the Over-the-Counter (OTC) derivatives market because of its massive size and rapid expansion. Many people believe that some over-the-counter derivatives have contributed to the current worldwide financial crisis by increasing the tensions involved. OTC markets are sometimes criticized for being less transparent, heavily leveraged, having laxer capital rules, and hiding components of systemic risk.
2) **The Warehousing and Standardization:** To function properly, a country's commodities derivatives market requires an advanced, cost-effective, dependable, and easy storage infrastructure. "A sophisticated warehousing business has yet to come forth," the Habibullah (2003) task team conceded. Further, there should be quality testing facilities or independent laboratories in each area to guarantee the quality, grade, and quantity of commodities so that they are uniformly standard and the final customer who gets physical delivery is not surprised.
3) **Cash vs. Physical Settlement:** Of the overall commodities derivatives trading in the nation, only roughly 1–5% gets paid in physical delivery. Current inefficiencies in the warehousing system are likely to blame. Since a reliable delivery system is essential to the success of any commodity exchange, it is clear that the storage issue must be treated as an emergency. Presently, under the Forward Contracts (Regulation) Act 1952, cash settlement of outstanding contracts is not permitted, which creates a significant obstacle in the cash settlement of commodities derivative contracts at maturity. What this means is that at the time of maturity, all outstanding contracts must be paid by actual delivery. This problem is avoided if participants establish their roles

before reaching adulthood. Most contracts are thus paid in cash prior to maturity. The legislation should be changed so that it more closely resembles common practice, which will save participants from having to go through needless hoops.

4) **Increased Off-Balance Sheet Exposure of Indian Banks:** The Reserve Bank of India (RBI) is worried about the growing trend of Indian banks using derivatives as an off-balance sheet (OBS) item. In the last few years, the risk associated with OBS use has increased dramatically. The total notional principal amount of O BS exposure increased from Rs.8,42,000 crore at the end of March 2002 to Rs.149,69,000 crore at the end of March 2008.
5) **The Regulator:** As trading activity and volume expand, the market will need a strong and impartial regulator, such as India's Securities and Exchange Board of India (SEBI). In contrast to the independence enjoyed by SEBI, the Forwards Markets Commission (FMC) gets funds from the Ministry of Consumer Affairs, Food, and Public Distribution. The government must provide the FMC more powers if the commodities markets are to develop in a controlled manner. The SEBI and FMC need to work closely together due to the interconnected nature of the stock and currency markets.
6) **Lack of Economies of Scale:** There are far too many commodities exchanges (3 at the national level and 21 at the regional level). Derivatives may be traded on more than 80 different underlying assets, although in reality, this is true for just a small subset of commodities. Once again, there are just a few number of exchanges that see the bulk of the trading volume. All of this disperses volumes and makes certain trades unfeasible. Potential solutions include merging some trades together. Convergence between securities and commodities derivatives markets is another topic of heated dispute. The Indian government has stated its desire to merge the two markets. The expansion of the commodities derivatives market is predicted to benefit from the merging of these markets due to the economies of scale and scope that would result from their integration.
7) **Tax and Legal bottlenecks:** At the current time, some items cannot be transported freely across states in India due to tax regulations. In order for a national market for commodities and derivatives to grow, they must be eliminated.[12]
8) **New Derivatives Products for Credit Risk Transfer (CRT):** Guarantees, loan syndication, and securitization are all examples of credit risk transfer (CRT), which has been around for quite some time. However, the development of novel CRT related with credit derivatives has been steady and fast. Credit derivatives provide a global framework for banks and financial institutions to hedge against credit default risk. Up until recently, however, credit derivatives were illegal in India. The Reserve Bank of India (RBI) said in their Q2 2009–10 Monetary Policy Statement that they would be taking precautions in this area. As of the 1st of December 2011, the RBI has instituted safeguarded standards for a fundamental single-name CDS for corporate bonds traded over-the-counter by resident businesses.

CONCLUSION

There is a rising awareness that the financial derivative market plays a crucial part in both risk mitigation and economic expansion. In part because of this revolutionary change, financial derivatives have risen to prominence among all other financial instruments. With a lengthy history of trading in a wide variety of derivatives products, the Indian derivative market has seen impressive expansion throughout the years. The price of der ivatives has risen and fallen. Derivative products have evolved and expanded to accommodate a wide range of investors' needs. Innovation and a sea change in the financial environment have given financial derivatives a position of honor among all financial instruments. In recent years, derivatives' growth has outpaced that of their worldwide equivalent. Derivatives have a significant impact on the Indian market and will continue to play an important role in its development.

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