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AN ELEMENTARY STUDY OF DERIVATIVES WITH RESPECT TO BANK NIFTY

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Abstract

Stock market is a platform for buying and selling of shares. These shares can be traded as equity shares as well as derivatives. Investments in the equity shares can be for short term as well as long term. Option chains of stock as well as option chains of the indices has a monthly and weekly expiry, respectively. All the activities of share market are regulated by Securities and Exchange Board of India (SEBI). The purpose of research is to study about one of the option Indices i.e., Bank Nifty. Bank Nifty Consist of twelve bank stocks, of which highest share is of HDFC Bank which is 29.01%. And lowest share is of Bandhan Bank which is 1.25%. Price movement in Bank Nifty depends upon various factors.

Keywords

Bank Nifty, Derivatives, Futures and Options, Banking, Finance, Stock Market, Trading

Introduction

Bank Nifty was founded on 15th September, 2003 by National Stock Exchange (NSE). It considers its base year as 1st January, 2000 and base value is considered as 1000. All the 12 banks involved in Bank Nifty Index are liquid. It is the popular index for investor who want to gain exposure to Indian banking sector.

The two most common types of derivatives on Bank Nifty are futures and options. A futures contract is an agreement to buy or sell a specified quantity of Bank Nifty at a predetermined price on a future date. An options contract gives the holder the right, but not the obligation, to buy or sell a specified quantity of Bank Nifty at a predetermined price on or before a future date.

In finance, a derivative is a financial contract that derives its value from the performance of an underlying asset, index, or interest rate. This underlying asset can be anything from a stock or bond to a commodity or currency. Derivatives are used for a variety of purposes, including hedging, speculation, and arbitrage.

Some of the most common derivatives are Futures Contract, Forward Contract, options and swaps. A futures contract is an agreement to buy or sell an asset at a predetermined price on a specific future date.

A forward contract is similar to a futures contract, but it is traded over-the-counter (OTC) between two private parties. Forwards are not standardized, so the terms of the contract can be negotiated between the buyer and seller. Options contracts provide the right, but not the obligation, to buy/sell an asset at a specific price on or before a specific date. A swap is a contract between two parties to exchange cash flows based on different underlying assets or indexes. Swaps are often used to hedge against interest rate risk or currency risk.

Derivatives can be a complex financial instrument, and it is important to understand the risks involved before using them. Some of the risks associated with derivatives includes Leverage, Liquidity, Counterparty risk etc. It is advised to consult a financial advisor before trading in derivatives for the proper guidance (Investopedia, 2024).

The Bank Nifty, also known as NIFTY Bank, is a stock market index in India that tracks the performance of the banking sector. It consists of the 12 most liquid and large-capitalized banking stocks listed on the National Stock Exchange (NSE).

The index includes both public and private sector banks, with some of the major constituents being HDFC Bank, ICICI Bank, Axis Bank, Kotak Mahindra Bank, and State Bank of India.
The Bank Nifty is an index of the 12 most liquid and highly capitalized stocks from the banking sector in India. It is a benchmark for the Indian banking industry and is widely used by investors to track the performance of the sector. It was launched in 2000 and is maintained by the National Stock Exchange of India (NSE). The index is calculated using the free-float market capitalization method, which means that the weightage of each stock in the index is based on its market capitalization.

The top five constituents of the Bank Nifty as of January 23, 2024 are HDFC Bank, ICICI Bank, Axis Bank, Kotak Mahindra Bank, and State Bank of India. These five banks account for over 60% of the weightage of the index.

The Bank Nifty is a volatile index, which means that it can experience large swings in price. This is because the banking sector is sensitive to a number of factors, such as interest rates, economic growth, and government policy. It is a popular choice for investors who want to gain exposure to the Indian banking sector. However, it is important to remember that the Bank Nifty is a volatile index and is not suitable for all investors. (Indian Economy & Market, 2024)

Resulting Discussion

Derivatives can be used for various purposes such as hedging risk, speculating future price movement and generating income. Hedging risk: Banks and other financial institutions use derivatives to hedge their risk exposure to changes in the value of Bank Nifty. For example, a bank may buy Bank Nifty futures contracts to protect itself against a decline in the value of its banking portfolio.

Speculating on future price movements: Investors can use derivatives to speculate on future price movements of Bank Nifty. For example, an investor who believes that Bank Nifty will rise in the future may buy Bank Nifty futures contracts. Investors can use derivatives to generate income by selling options contracts. For example, an investor may sell Bank Nifty call options to earn a premium. (Finsec, n.d.)

Trades in the Bank Nifty can be executed at any time in between the market hours on any of the five working days. These Trades can be executed by the use of any broking application. These broking applications charges a brokerage on per order basis as per the guidelines of SEBI and NSE. Before Starting a derivative trading such as trading in Bank Nifty broking application displays various Guidelines and Regulations as well as the risk involved in Derivative trading.

Trading in the bank nifty can be done on Intraday basis as well as the weekly or the monthly contract basis. Under Intraday Trading the buy and sell order of the trades are executed on the same day in between 9:15 am to 3:15 pm. If the sell order is not placed by the trader before 3:15 pm then it will get automatically executed at 3:15 pm. In weekly trading the trader while executing a buy order should execute it on delivery basis so that the sell order can be placed on or before the weekly expiry. Weekly expiry of Bank Nifty is on every Wednesday. Monthly trading can be done based on monthly or quarterly expiry. Here the buy order can be placed on delivery for the monthly option chain. This option chain can be for one month two month or three months. Trader can trade in any of the option chains up to their respective expiry. Monthly expiry is on last Thursday of every month. And quarterly expiry is on last Thursdays of every third month.

From 1st March 2024 these expiries will be on last Wednesdays. Quarterly expiry is in March, June, September and December. Options can be bought on various strike prices. These strike prices can be above or below the current market value. It means options can be bought on At the Money, In the Money or Out of the Money.

Although trading in the options such as Bank Nifty is risky, trader can set the stoploss in order to minimize the losses. Stoploss can be defined as the price at which the sell order gets automatically placed in order to minimize the loss. Stoploss can vary from trader to trader depending upon their risk bearing capacity. On reaching the stop loss the sell order gets automatically placed and this can prevent the further losses of the trader in case the price of the option falls below it. In the same way trader can set the target price. It is the price at which a sell order can be placed by the trader after earning required profit.

(https://in.investing.com/analysis/what-bank-nifty-chart-is-trying-to-say-200451198, 2024)

To summarise, bank nifty is an index which consists of twelve most liquid banks. The price movement in bank nifty depends on various factors. The traders who wish to get an exposure of banking sector can trade in Bank Nifty. Stoploss and Targets can be used as per the trader's risk capacity. As trading in derivatives such as Bank Nifty is risky, it is advised to consult financial adviser for proper guidance.

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