Emerging Trends In the Indian Derivatives Market, Challenges And Future Prospects.

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Abstract: Derivatives market is a important factor of Indian market .It is a financial instruction that are linked to a specific financial instrument or indicator or commodity and though which specific risks can be treated in financial markets in their own right. The scenario of derivative market in India has reached to multi-trillion dollar level and with the passage of time it is increasing like anything. The derivative instruments generally includes Commodities, Precious metals, Foreign Exchange rates, Bonds, Shares and share warrants, Short term securities and Money market products In India, there are two major markets namely National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) along with other Exchanges of India are the market for derivatives. Here we may discuss the performance of derivatives products in Indian market. In the present set of Investigation the author is going to report challenges faced by derivative market and value of derivatives market and importance of future prospects.

Key words: Derivatives, market, financial, commodity, exchange rates, bonds, share.

Introduction

The derivative markets have become an integral part of modern financial system in less than three decades of their emergence. But still the Indian derivatives market is not so well developed as compared to the other country's derivatives market. So there is a need to understand the present level of growth and development of financial derivatives markets in India.

In financial terms, a derivative is a financial instrument - or more simply, an agreement between two people or two parties - that has a value determined by the price of something else (called the underlying). Some of the widely known underlying assets are: , Indexes (consumer price index (CPI), stock market index, weather conditions or inflation) , Bonds , Currencies , Interest rates ,Exchange rates , Commodities ,Stocks (equities)

Review of Literature

Chatrath, Ramchander and Song, 1995

The critics of the derivative market called it as a market for speculators. Little cash is involved in this market which is the main reason of its risky nature. Thus, it is argued that the contributors of speculative traders in systems, which allow high degrees of leverage, lower the quality of information in the market. These uninformed traders could play a destabilizing role in cash markets.

Ayuso and Nuñez (1995) argue that the transference of the risk to the derivative markets could improve, to a substantial extent, the transactions of the spot market. This is because it is not necessary to include a risk premium in the spot market to compensate the fluctuations of theprices.

Hentchell & Smith 1997 Discuss that Derivative product can reduce need on the part of firm and banks to hold idle precautionary balance to tide over unexpected adversities, thereby reducing the fraction of funds with these organization that remain unproductive.

Sahoo (1997) opines "Derivatives products initially emerged, as hedging devices against fluctuation in commodity prices and the commodity-linked derivatives remained the sole form of such products for many years. Marlowe (2000) argues that the emergence of the derivative market products most notably forwards, futures and options can be traced back to the willingness of risk-averse economic agents to guard themselves against uncertainties arising out of fluctuations in asset prices. It is generally stated that regulation has an important and critical role to ensure the efficient and smooth functioning of the markets. According to Sahoo (1997) the legal framework for derivatives trading is a critical part of overall regulatory framework of derivative markets. The purpose of regulation is to encourage the efficiency and competition rather than impeding it.

Hathaway (1998) stated that, while there is a perceived similarity of regulatory objective, there is no single preferred model for regulation of derivative markets.

Avadhani (2000) stated that a derivative, an innovative financial instrument, emerged to protect against the risks generated in the past, as the history of financial markets is repleted with crises). Events like the collapse of the fixed exchange rate system in 1971, the Black Monday of October 1987, the steep fall in the Nikkei in 1989, the US bond debacle of 1994, occurred because of very high degree of volatility of financial markets and their unpredictability. Such disasters have become more frequent with increased global integration of markets.

Mr.Jitendra Pande, 2002 define that derivative trading in option reduce risk, as investors are aware of the maximum loss.

Deana Mehta, 2005 Proved that Share futures are most successful in India that anywhere else in the world because they are seen as a substitute for badla. The new system has to better than the old one and not to add risk in the market.

Jiménez (2008) used a large dataset from the credit register in Spain to show that bank borrowers are more likely to default if the loans are made when central bank interest rates are relatively low. They also showed that

(i) the price of risk tends to be low when short- term interest rates are low and

(ii) (ii) if the interest rate is low for a long time, the economy's "portfolio" of loans tends to be

Srivastava, Yadav, Jain (2008) conducted a survey on Derivative trading in Indian Stock Market. The survey revealed that derivative securities have definitely penetrated into the Indian stock market and investors are using these securities for different purposes, namely risk management, profit enhancement, speculation and arbitrage. Financial derivatives have changed the world of finance through the creation of innovative ways to comprehend, measure, and manage risks.

Vashishtha and et. al, (2010), in their study investigated the historical roots of derivative trading, regulation and policy developments, trend and growth, future prospects and challenges of derivative market in India. They had also given attention to the status of global derivatives markets in relation to Indian derivatives market.

Shree Bhagawat and et. al, (2012), in their study tries to describe the concept of financial derivatives as the derivatives revolution in the world of finance due to its full fledged growth with so incomparable swiftness all over the globe.

P.Hemavati (2013) in her study made an endeavour to look over the beginning of derivatives trading in India and its regulation for prolonging the sustainability of derivative trading in relation to Indian capital market.

RESEARCH METHODOLOGY

Research Methodology suggests the ways and methods for conducting research is an exploratoryresearch. This present study has been designed to Emerging In Indian Derivatives Market, Challenges And Future Similarly , it include the precise study of different conditions, which every stock exchange of India has to follow for working on the derivative market and it also clarify that how the derivative market is differs from the cash market. Data and information for the research study were collected and analyzed from secondary published sources such as: Websites of BSE, NSE and SEBI, Internet,reference books, referred journals, and professional magazines. A conceptual analysis is used to explain the various relevant points as required to fulfill the objectives of the study.

Objectives-

1. To understand the concept and to study the current scenario of derivatives market in India and its economics measures.

2. To know about Stock Market Derivatives

3. To know about future of derivative marketing in India

4. To find the growth of derivatives in India

Indian Derivatives Market

Derivative 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 future trading way back in 1875. This was the first organized futures market. Then Bombay Cotton Exchange Ltd. in 1893, Gujarat Vyapari Mandall in 1900, Calcutta Hesstan Exchange Ltd. in 1919 had started future market. After the country attained independence, derivative market came through a full circle from prohibition of all sorts of derivative trades to their recent reintroduction. In 1952, the government of India banned cash settlement and options trading, derivatives trading shifted to informal forwards markets. In recent years government policy has shifted in favor of an increased role at market based pricing and less suspicious derivatives trading. The first step towards introduction of financial derivatives trading in India was the promulgation at the securities laws (Amendment) ordinance 1995. It provided for withdrawal at prohibition on options in securities. The last decade, beginning the year 2000, saw lifting of ban of futures trading in many commodities.

Derivative market has an important role to play in economic development of a country. Change in exchange rates, interest rates and stock prices of different financial markets have increased the financial risk to the corporate world. Adverse changes in the macroeconomic factors have even threatened the very survival of business world. It is therefore necessary to develop a set of new financial instruments known as derivatives in the Indian financial markets, to manage such risk. The objectives of these instruments is to provide commitments to prices for future dates for giving protection against adverse movements in future prices, in order to reduce the extent of financial risks. This paper traces the growth and current position of India derivative market. The present study is an effort to analyze derivative trading in India. It is an effort to demonstrate the growth and expansion of financial derivative of NSE in India the time period i.e. 2010-2011 to 2017-18.The market turnover has grown from Rs.17663664.57 Cr. in 2009-2010 to 1163539816.124 Cr. in 2017-18.

Bombay Stock Exchange

Bombay Stock Exchange also known as BSE was established in 1875. First stock exchange in India and oldest in Asia. Derivative trading was started on June 9, 2000 when it initially started trading as sub tool of derivative called ‘futures contract’ for the first time. It is followed by another sub tool ‘index option’ on June 1, 2001. On September 13, 2004 BSE achieved a new milestone by launching worldwide ‘weekly options’, unparalleled product in the derivative market. In October 1, 2008 currency futures were introduced by BSE.

National Stock Exchange

National Stock Exchange popularly known as NSE was established in 1992.It is the third largest stock exchange in the world. On June 12, 2000 it started trading in ‘Index future’ as its first derivative product. On the other hand ‘index option’ was introduced on June 4, 2001. SEBI stipulated 233 future contracts securities. A landmark was achieved by NSE through introducing ‘Mini Index Future & Options’ with the one lakh as minimum contract size. On August 29, 2008 NSE Introduced in Indian Derivative market ‘currency future contract’ on US Dollar –Rupee.

CHALLENGES OF DERIVATIVE MARKET

Derivative market has shown a great potential in the last few years, but the real issues are yet not been resolved. Instruments traded under derivative market and its volume of trade is also increasing day by day, but the main objective .i.e. Setting up of different exchanges yet not achieved .On the other hand future prospects of derivative markets are not sound because of the unresolved issues and they are framed as big challenges in the way.

- **Cash vs Physical Settlement**: The percentage of physical settlement under commodity derivatives is very less because of the Forward Contract Act, 1952. In this Act, cash settlement of outstanding contracts at maturity is disallowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To overcome this huddle participants settle their positions before maturity. This Act, needs to be adjusted which is a big challenge in front of derivative market.

- **Issue for market Stability and Development**: Regulators and Supervisory bodies are having an eye on the counter derivative market due to its rapid growth. Some OTC (Over the Counter) derivatives are taken as stress relievers in the tough time of global crisis. But the big challenge is to overcome the assumption of the critics that this market is less transparent, weaker capital requirement and systematic risk.

- **The Warehousing and Standardization:** Effective and Efficient warehousing system is necessary for smooth working of Commodity derivative market in the country. A well standardized labs and quality testing centers for the ultimate buyer who takes the physical delivery are in deficiency which is a big challenge in front of the derivative market.

- **Lack of Economics of Scale:** Derivative market is still to achieve the stage of Economic of Scale. No matter there is number of commodity exchanges under which 80 commodities are traded, but in reality only few commodities are popular. Indian Government having the intention to integrate two markets .Which will reduce the effort and increase the competitive spirit and also increase the coordination among various regulating authorities such as Reserve Bank of India, Forward Market Commission, Securities and Exchange Board of India and the Department of Companies affairs of etc.

- **The Regulatory:** Derivative market requires a setting up of a regulatory system like security market which is regulated by Security Exchange Board of India which is an independent body. On other side derivative is controlled by FMC (Forward Market Commission) which depends upon the funds of Department of Consumer Affairs for the development of this market a sole powered body is required. Both the regulatory authorities' i.e.SEBI and FMC are also required to work closely for better results

- **Competition of OTC derivatives with the Exchange traded derivatives:** After financial crisis it is advisable to transform OTC derivatives into Exchange trade derivative. Advisors are having the view that this will increase the transparency, liquidity and on the other side clearing and settlement procedure is better. All the above advices are based on the assumption that the existing method of trading in OTC products is all based on telephone trading and there is no clearing system in place.

- **Strengthening the Centralized Clearing Parties:** CCIL, which started functioning in 2002, is the only centralized clearing party for great processing and settlement services in India. It currently provides a guaranteed settlement facility for Government Security trading, Clearing of Collateralized Borrowing and Lending Obligation (CBLO), guaranteed settlement of foreign exchange trading and settlement of all Indian Revenue Service (IRS). Though the concentration of business relating to money, securities and forex market with the CCIL helps in pooling risk and reducing the overall transactions cost for the system, the Certified Financial Services Auditor's (CFSA) report opinion that the concentration of such a wide spectrum of activities leads to concentration of risk in one entity. Therefore, there is a need to strengthen more and more clearing parties.

- **New derivative products for Credit Risk Transfer (CRT):** Credit risk transfer in broad since (including guarantees, loans syndication and securitization) has a long history. However there has been a sustained and rapid growth of new and innovative forms of CRT associated with credit derivatives. The most common credit derivatives are Credit Default Swaps (CDS) on single corporate entity and collaterized debt obligation. Once 2005, CRT activity became significant for two additional underlying asset classes-asset backed securities and leveraged loans. Internationally, banks and financial institutions are able to protect themselves from credit derivatives were not allowed in India until recently. The RBI has made an announcement in its second-quarter monetary policy2009-10 that it has considered it appropriate to proceed with caution on this issue. To start with 1st December, 2011, RBI has introduced guidelines for a basic, over-the-counter, single name CDS for corporate bonds for residents entities, subjects to safeguards.

ECONOMIC CONTRIBUTION OF DERIVATIVE MARKET IN INDIA

As emerging growth of derivative market in India, it has been proved that the derivative market is also performing the various economic functions that are:

- Derivative market reflects the price perception of the market participants about the future This may lead to the discovery of current and future prices in the well organized market.
- Derivative market is a well organized market where the risk is well distributed among the investors that can easily appetite by them.
- Derivatives are derived from the underlying value of assets due to that quality more and more players are trading in high volume.
- Derivative has a tradition of influencing educated class with its clear and broad prospective. This all will help the economy to develop and create new employment opportunities, new business.

FINANCIAL DERIVATIVES

A derivative is an instrument whose value is 'derived' from another security or economic variable. The dependence of the derivative's value on other prices or variables makes it an excellent vehicle for transferring and managing risk.

According to **John C. Hull,** "A derivative can be defined as a financial instrument whose value depends on (or derives from) the values of other, more basic underlying variables."

Also defined by **Robert L. McDonald** "A derivative is simply a financial instrument (or even more simply an agreement between two people) which has a value determined by the price of something else."

Factors Affecting Growth of Derivatives:

Growths of derivatives are affected by a number of factors. Some of the important factors are stated below. 1. Increased volatility in asset prices in financial markets. 2. Increased integration of national financial markets with the international markets. 3. Marked improvement in communication facilities and sharp decline in their costs.

Underlying Asset in a Derivatives Contract

As defined above, the value of a derivative instrument depends upon the underlying asset. The underlying asset may assume many forms:

- Foreign exchange rates or currencies;
- Bonds of different types, including medium to long term negotiable debt securities issued by
- governments, companies, etc.
- Commodities including grain, coffee beans, orange juice;
- Precious metals like gold and silver;
- Foreign exchange rates or currencies;
- Bonds of different types, including medium to long term negotiable debt securities issued by
- governments, companies, etc.
- Shares and share warrants of companies traded on recognized stock exchanges and Stock Index
- Short term securities such as T-bills; and
- Over- the Counter (OTC)2 money market products such as loans or deposits.

STOCK MARKET DERIVATIVES

The concept of stock exchange was introduced in India in 1850 when four Gujarati and one Parsi stockbroker came together under banyan tree in front of Bombay Town Hall. As the member's increased the location was shifted to Dalal Street in the year 1874 and made an official organization known as 'The Native Share & Stock Brokers Association' in 1875. In 1956, the BSE became the first stock exchange to be recognized by the Indian Government under the Securities Contract Regulation Act. The concept of Derivative market was also very old but it was officially introduced in 2000. This instrument brought a drastic impression on Indian market. In a time span of 10 years (app.) the derivative instruments are having its known place in trading market. The best quality of this instrument is its risk averter nature which helps the investors to settle down their losses and plan for their future hurdles. In this limited time period derivative market gained name, fame & reliability from the investors and other investment institutes in comparison to other instruments in stock market ,whether lies under primary or secondary market. In the case of hedgers it helped them to offset the value of their asset (commodity) in future market with concern to cash market. Today trading on the spot market for equity in India has always been a futures market with weekly/fortnightly settlements. These markets features the risks and difficulties of futures market, But without the gains in price discovery and hedging services that come with separation the spot market from the futures market. India's primary market is acquainted with two types of derivatives

- Convertible bonds
- Warrants

As these warrants are listed and traded, it could be said that options market of a limited sort already exist in our market. Besides, a wide range of interesting derivatives markets exists in the in-formal sector. Contracts such as bhav-bhav" teji-**mandi**" etc. are traded in these markets. These informal markets enjoy a very limited participation and have their presence out side the conventional institutions of India 's financial system.

The first step towards introduction of derivatives trading in India in its current format was the promulgation of the securities laws (Amendment) Ordinance, 1995 that withdrew the prohibition on options in securities. The real push to derivatives market in India was however given by the SEBI. The security market watchdog, in November 1996by setting up a committee under the chairmanship of Dr L C Gupta to devel op "appropriate regulatory framework for derivatives trading in India. "

In 2000, SEBI permitted NSE and BSE to commence trading in index futures contracts based on S&P CNX Nifty and BSE 30(sensex) index. This was followed by approval for trading in options based on these two indexes and options on individual securities. Futures contracts on Individual stocks were launched on November 9,2001.Trading and settlement is done in accordance with the rules of the respective exchanges. But the trading volumes were initially quite modest.

This could be due to

- Initially, few members have been permitted by SEBI to trade on derivatives.
- FII'S, MFS have been allowed to have a very limited participation;
- Mandatory requirements for brokerage firms to have" SEBI approved-certification-test-passed" brokers for undertaking derivatives trading' and
- Lack of clarity on taxation and accounting aspects under derivatives trading.

The current trading behavior in the derivatives segments reveals that single stock futures continues to account for sizeable proportion. A recent press report indicates that futures in Indian exchanges have reached global volumes. One possible reason for such skewed behavior of the traders could be that futures closely resemble the erstwhile badla system. Such distortions are not however in the interest of the market.

SEBI has permitted trading in options and futures on individual stocks, but not on all the listed stocks. It was very selective, stocks that are said to be highly volatile with allow market capitalization are not allowed for option trading. This act of SEBI is strongly resented by a section of the market. Their argument is that equity options are in dispensable to investors who need to protect their investment from volatility. The higher the volatility of a stock the more necessary it is to list options on that stock. The yare highly vocal in arguing that SEBI should design an effective monitoring, surveillance and risk management system at the level of the exchanges and clearing house to avert and manage the default risks that are likely to arise owing to high volatility in low market capital stocks instead of simply banning trading in options on them. SEBI needs to examine these arguments. It may have to take a stand to nip in the bud all kinds of manipulations by handling out severe punishments to all such erring companies.

Today, mutual funds are permitted to use equity derivatives products for "hedging and portfolio rebalancing". However, such usage is not favored by fund managers as they strongly apprehend that the dividing line between hedging and speculation being thin, they may always get exposed to the questioning by the regulatory authorities.

Unresolved Issues and Future Prospects of Derivatives Market

Even though the derivatives market has shown good progress in the last few years, the real issues facing the future of the market have not yet been resolved. The number of products allowed for derivative trading have increased and the volume and the value of business has zoomed, but the objectives of setting up different derivative exchanges may not be achieved and the growth rates witnessed may not be sustainable unless these real issues are sorted out as soon as possible. Some of the main unresolved issues are as under.

1) **Issues for Market Stability and Development:** The enormous size and fast growth of the Over the Counter (OTC) derivatives market has attracted the attention of regulators and supervisory bodies. Some OTC derivatives have been viewed as amplifiers of the stress in the present global financial crisis. The more common criticisms relate to the fact that the OTC markets are less transparent and highly leveraged, have weaker capital requirements and contain elements of hidden systemic risk.

2) **The Warehousing and Standardization:** For commodity derivatives market to work smoothly, it is necessary to have a sophisticated, cost-effective, reliable and convenient warehousing system in the country. The Habibullah (2003) task force admitted, "A sophisticated warehousing industry has yet to come about". Further, independent labs or quality testing centers should be set up in each region to certify the quality, grade and quantity of commodities so that they are appropriately standardized and there are no shocks waiting for the ultimate buyer who takes the physical delivery.

3) **Cash vs. Physical Settlement:** Only about 1% to 5% of the total commodity derivatives trade in the country is settled in physical delivery. It is probably due to the inefficiencies in the present warehousing system. Therefore the warehousing problem obviously has to be handled on a war footing, as a good delivery system is the backbone of any commodity trade. A major problem in cash settlement of commodity derivative contracts is that at present, under the Forward Contracts (Regulation) Act 1952, cash settlement of outstanding contracts at maturity is disallowed. In other words, all outstanding contracts at maturity should be settled in physical delivery. To avoid this, participants settle their positions before maturity. So, in practice, most contracts are settled in cash but before maturity. There is a need to modify the law to bring it closer to the widespread practice and save the participants from unnecessary hassles.

4) **Increased Off-Balance Sheet Exposure of Indian Banks:** The growth of derivatives as off-balance sheet (OBS) items of Indian Banks has been an area of concern for the RBI. The OBS exposure/risk has increased significantly in recent years. The notional principal amount of OBS exposure increased from Rs.8,42,000 crore at the end of March 2002 (approximately $181 billion at the exchange rate of Rs.46.6 to a US $) to Rs.149,69,000 crore (approximately $321 billion) at the end of March 2008. (RBI, 2009).

5) **The Regulator:** As the market activity pick-up and the volumes rise, the market will definitely need a strong and independent regulator; similar to the Securities and Exchange Board of India (SEBI) that regulates the securities markets. Unlike SEBI which is an independent body, the Forwards Markets Commission (FMC) is under the Department of Consumer Affairs (Ministry of Consumer Affairs, Food and Public Distribution) and depends on it for funds. It is imperative that the Government should grant more powers to the FMC to ensure an orderly development of the commodity markets. The SEBI and FMC also need to work closely with each other due to the inter-relationship between the two markets.

6) Lack of Economies of Scale: There are too many (3 national level and 21 regional) commodity exchanges. Though over 80 commodities are allowed for derivatives trading, in practice derivatives are popular for only a few commodities. Again, most of the trade takes place only on a few exchanges. All this splits volumes and makes some exchanges unviable. This problem can possibly be addressed by consolidating some exchanges. Also, the question of convergence of securities and commodities derivatives markets has been debated for a long time now. The Government of India has announced its intention to integrate the two markets. It is felt that convergence of these

derivative markets would bring in economies of scale and scope without having to duplicate the efforts, thereby giving a boost to the growth of commodity derivatives market.

7) **Tax and Legal bottlenecks:** In India, at present there are tax restrictions on the movement of certain goods from one state to another. These need to be removed so that a truly national market could develop for commodities and derivatives.

8) **New Derivatives Products for Credit Risk Transfer (CRT):** Credit risk transfer (CRT), in a broad sense (including guarantees, loan syndication, and securitization), has a long history. However, there has been a sustained and rapid growth of new and innovative forms of CRT associated with credit derivatives. Internationally, banks and financial institutions are able to protect themselves from credit default risk through the mechanism of credit derivatives. However, credit derivatives were not allowed in India until recently. The RBI has made an announcement in its second-quarter monetary policy 2009-10 that it has considered it appropriate to proceed with caution on this issue. To start with Ist December 2011, RBI has introduced guidelines for a basic, over-the-counter, single name CDS for corporate bonds for resident entities, subject to safeguards.

CONCLUSION:

There is an increasing sense that financial derivative market has a vital role in risk management and economic growth .Financial derivatives have earned a significant place in all the financial instruments (products), due to innovation and revolutionized the landscape. The Indian derivative market has achieved tremendous growth over the years, and also has a long history of trading in various derivatives products. The derivatives market has seen ups and downs. The new and innovative derivative products have emerged over the time to meet the various needs of the different types of investors. Financial derivatives have earned a well deserved extremely significant place among all the financial instruments (products), due to innovation and revolutionized the landscape. The growth of derivatives in the recent years has surpassed the growth of its counterpart globally. Finally we can say there is big significance and contribution of derivatives to Indian market and good importance in future prospects .

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