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An Overview of Derivatives Instruments

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ABSTRACT

Derivative as a financial contract or security deriving its value based on its relationship to, financial instrument (primitive security) or economic good (commodity).Derivatives generally fall into three broad categories options, futures and forwards, swaps Derivatives are generally used as an instrument to hedge risk, but can also be used for speculative purposes. To hedge this risk, the investor could purchase currency futures to lock in a specified exchange rate for the future stock sale and currency conversion. Derivatives are essential tools to determine both current and future prices.

KEYWORDS : DERIVATIVE OPTIONS, FUTURES, FORWARDS, SWAPS, MARKET

INTRODUCTION: -

Derivatives can be traced back to Aristotle (Cecchetti 2006), a precise an economic perspective, any security deriving its value from one or more primitive securities could be referred to as a derivative.The derivatives financial term of finance and financial instrument of derivative used in hedging the risk.

A derivative is a financial instrument whose value is based on one or more underlying assets. In practice, it is a contract between two parties that specifies conditions (especially the dates, resulting values of the underlying variables, and notional amounts) under which payments are to be made between the parties.

One of the oldest derivatives is rice futures, which have been traded on the Dojima Rice Exchange since the eighteenth century. Derivatives are broadly categorized by the relationship between the underlying asset and the derivative (such as forward, option, swap); the type of underlying asset (such as equity derivatives, foreign exchange derivatives, interest rate derivatives, commodity derivatives, or credit derivatives); the market in which they trade (such as exchange-traded or over-the-counter); and their pay-off profile.

Derivatives can be used for speculation ("bets") or to hedge ("insurance"). For example, a speculator may sell deep in-the-money naked calls on a stock, expecting the stock price to plummet, but exposing himself to potentially unlimited losses. Very commonly, companies buy currency forwards in order to limit losses due to fluctuations in the exchange rate of two currencies.

Third parties can use publicly available derivative prices as educated predictions of uncertain future outcomes, for example, the likelihood that a corporation will default on its debts.

Definition of Derivatives

"Derivatives are financial contracts on a pre-determined payoff structure, whose value Derives from underlying reference assets, such as securities, commodities, market Indices, interest rates, or foreign exchange rates etc",

A financial derivative is a contract between two (or more) parties where payment is based on (i.e., "derived" from) some agreed-upon benchmark

WHY DERIVATIVES USE:

Derivatives are risk-shifting devices. Initially, they were used to reduce exposure to changes in such factors as weather, foreign exchange rates, interest rates, or stock indexes.

For example, if an American company expects payment for a shipment of goods in British Pound Sterling, it may enter into a derivative contract with another party to reduce the risk that the exchange rate with the U.S. Dollar will be more unfavorable at the time the bill is due and paid. Under the derivative instrument, the other party is obligated to pay the company the amount due at the exchange rate in effect when the derivative contract was executed. By using a derivative product, the company has shifted the risk of exchange rate movement to another party.

More recently, derivatives have been used to segregate categories of investment risk that may appeal to different investment strategies used by mutual fund managers, corporate treasurers or pension fund administrators. These investment managers may decide that it is more beneficial to assume a specific "risk" characteristic of a security.

DERIVATIVE INSTRUMENTS

A **derivative instrument** is a financial instrument which derives its value from the value of some other financial instrument or variable. Derivative instruments, Risk management techniques are primarily structured to reduce risk on which many derivative instruments are traded help to spread risk.

Derivatives and related items affect financial position, performance, and cash flow. In doing so, firms must indicate which instruments are used to manage risk, provide information about the volume of derivatives activity, and create tabular disclosures detailing the fair value of derivatives and where they are reported on the balance sheet, as well as the amount of derivative gains and losses and where they are reported on the income statement.

The most common types of derivatives are: (1) options, (2) futures and forwards contracts,And (3) swaps

OPTIONS

The purchaser of an Option has rights (but not obligations) to buy or sell the asset during a given time for a specified price (the "Strike" price). An Option to buy is known as a "Call," and an Option to sell is called a "Put."

The seller of a Call Option is obligated to sell the asset to the party that purchased the Option. The seller of a Put Option is obligated to buy the asset.

In a "Covered" Option, the seller of the Option already owns the asset. In a "Naked" Option, the seller does *not* own the asset

Options are traded on organized exchanges and OTC.

FUTURE CONTRACT

A Future is a contract to buy or sell a standard quantity and quality of an asset or security at a specified date and price.

Futures are similar to Forward Contracts, but are standardized and traded on an exchange, and are valued daily. The daily value provides both parties with an accounting of their financial obligations under the terms of the Future.

Unlike Forward Contracts, the counterparty to the buyer or seller in a Futures contract is the clearing corporation on the appropriate exchange.

Futures often are settled in cash or cash equivalents, rather than requiring physical delivery of the underlying asset.

FORWARD CONTRACT
In a Forward Contract, both the seller and the purchaser are obligated to trade a security or other asset at a specified date in the future. The price paid for the security or asset may be agreed upon at the time the contract is entered into or may be determined at delivery.

Forward Contracts generally are traded OTC.

SWAP
A Swap is a simultaneous buying and selling of the same security or obligation. Perhaps the best-known Swap occurs when two parties exchange interest payments based on an identical principal amount, called the "notional principal amount."

Think of an interest rate Swap as follows: Party a holds a 10-year $10,000 home equity loan that has a fixed interest rate of 7 percent, and Party B holds a 10-year $10,000 home equity loan that has an adjustable interest rate that will change over the "life" of the mortgage. If Party A and Party B were to exchange interest rate payments on their otherwise identical mortgages, they would have engaged in an interest rate Swap.

The most common underlying assets include: commodities, stocks, bonds, interest rates and currencies.

Derivatives are generally used as an instrument to hedge risk, but can also be used for speculative purposes. For example, a European investor purchasing shares of an American company off of an American exchange (using U.S. dollars to do so) would be exposed to exchange-rate risk while holding that stock. To hedge this risk, the investor could purchase currency futures to lock in a specified exchange rate for the future stock sale and currency conversion back into Euros.

REPAYMENT OF FINANCIAL DERIVATIVES
- In creating a financial derivative, the means for, basis of, and rate of payment are specified.
- Payment may be in currency, securities, a physical entity such as gold or silver, an agricultural product such as wheat or pork, a transitory commodity such as communication bandwidth or energy.
- The amount of payment may be tied to movement of interest rates, stock indexes, or foreign currency.
- Financial derivatives also may involve leveraging, with significant percentages of the money involved being borrowed. Leveraging thus acts to multiply (favorably or unfavorably) impacts on total payment obligations of the parties to the derivative instrument.

RIGHTS OF USE
A type of swap is represented by swapping capacity on networks using instruments called "indefeasible rights of use", or IRUs. Companies buying an IRU might book the price as a capital expense, which could be spread over a number of years. But the income from IRUs could be booked as immediate revenue, which would bring an immediate boost to the bottom line.

Technically, the practice is within the arcane rules that govern financial derivative accounting methods, but only if the swap transactions are real and entered into for a genuine business purpose.

COMBINED DERIVATIVE PRODUCTS
The range of derivative products is limited only by the human imagination. Therefore, it is not unusual for financial derivatives to be merged in various combinations to form new derivative products.

For instance, a company may find it advantageous to finance operations by issuing debt, the interest rate of which is determined by some unrelated index. The company may have exchanged the liability for interest payments with another party. This product combines a Structured Note with an interest rate Swap.

HEDGE FUNDS
A "hedge fund" is a private partnership aimed at very wealthy investors. It can use strategies to reduce risk. But it may also use leverage, which increases the level of risk and the potential rewards.

Hedge funds can invest in virtually anything anywhere. They can hold stocks, bonds, and government securities in all global markets. They may purchase currencies, derivatives, commodities, and tangible assets. They may leverage their portfolios by borrowing money against their assets, or by borrowing stocks from investment brokers and selling them (shorting). They may also invest in closely held companies.

Hedge funds are not registered as publicly traded securities. For this reason, they are available only to those fitting the Securities and Exchange Commission definition of "accredited investors"—individuals with a net worth exceeding $1 million or with income greater than $200,000 ($300,000 for couples) in each of the two years prior to the investment and with a reasonable expectation of sustainability.

Institutional investors, such as pension plans and limited partnerships, have higher minimum requirements. The SEC reasons that these investors have financial advisers or are savvy enough to evaluate sophisticated investments for them.

Some investors use hedge funds to reduce risk in their portfolio by diversifying into uncommon or alternative investments like commodities or foreign currencies. Others use hedge funds as the primary means of implementing their long-term investment strategy.

Conclusion
Derivative is a financial instrument, in the forward and future swap under the market using instrument. Derivatives instruments available for trading are also expanding. Its reduce the portfolio risk in the commodities and forward currencies, its impact of the share market and commodities, future market price of investment, main role of the derivatives on import rates and currency, with derivatives to deal through credit risk.

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