School of Finance and Commerce

Course Code : BBAF3020

Course Name: Financial Derivatives

Financial Derivatives

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Lecture -1

Topic covered

- Definition of Derivative
- How to manage risk through derivative
- Derivative product
- Types of derivatives
- Types of participants
- Functions of derivatives
- Criticisms of derivatives

Derivatives

- Risks of price, exchange rate and interest rate can be managed through products that are specially designed for hedging.
- These products are classified as derivatives.
- Derivatives are the products that derive their value from some other asset called underlying asset
- but in other aspects they may remain distinctly different from and independent of the underlying asset.

Managing Risks

- The ways to manage risk include attempt to control potential damage, diffuse it, diversify and/or transfer risk to those willing to accept it.

- One can manage risk by **transferring** it to another party who is willing to assume risk. Risk per se cannot be eliminated but can be transferred from those trying to evade to those willing to assume.

- Management of risk through derivatives is commonly referred as hedging which enable offsetting of risk emanating from a situation from another.

Derivative Products

- Variety of derivatives are available; both standard products that are traded on an exchange as well as tailor-made, to suit various applications.
- Four broad types of derivative instruments are:
- Forwards,
- Futures,
- Options, and
- Swaps.

Types of Derivatives

- **Based on the underlying asset**
  - Commodities
  - Currencies
  - Shares/Indices
  - Interest Rates

- **Based on how traded**
  - Over-the-counter (OTC)
  - Exchange Traded

Types of Participants

Hedgers
those who use derivatives for hedging i.e. reduce or eliminate risk.
Speculators
those who take positions in derivatives to increase returns by assuming increased risk. They provide much needed liquidity to markets.
Arbitrageurs
those who exploit mispricing in different markets; They assume riskless and profitable positions.
All 3 participants are essential for efficient functioning.

Functions of Derivatives

Three functions of derivatives

- Enable price discovery
- Facilitate transfer of Risk
- Provide Leverage

Criticisms of Derivatives

- **Increased volatility:**

Though used for efficient price discovery, derivatives when used as a speculative product can cause increased volatility in spot prices.

- **Increased bankruptcies:**

Derivatives being leveraged products enable taking disproportionate positions and have led to several disasters and bankruptcies.

- **Increased burden of regulations:**

Derivatives transactions hide more than what they reveal, as they escape accounting. For financial discipline and better disclosures new rules have to be

References:

- srivastava, r. (2017). *financial derivative and risk management.* new delhi: oxford university press.
- hull, j. c. (1988). *options, futures and other derivatives.* (9th, Ed.) pearson.

Thanks you